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Budget Policy Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Email: prebudgetsubs@treasury.gov.au

Dear Sir

2009-10 Pre-budget Submission

The Taxation Institute of Australia ('Taxation Institute') is pleased to provide its response to the Treasurer's Media Release dated 24 November 2008 calling for submissions regarding priorities for the 2009-10 Budget. We note that a key focus of the 2009-10 Budget process is the challenges of the unprecedented set of economic conditions in the current global financial crisis.

In deciding on the taxation issues to bring to the Government's attention at this time, the Taxation Institute is mindful that the Government has commenced its Australia's Future Tax System Review ('AFTS Review'). The Taxation Institute has already made a preliminary submission to the AFTS Review Panel identifying a number of taxation reform options to address the challenges to our tax-transfer system in areas such as company taxation, personal taxation, the taxation of non-cash benefits and State and Territory taxation. We believe that these recommended reform options are more appropriately pursued by the Taxation Institute with the Government in our further submissions to the AFTS Review rather than in our 2009-10 Budget submission.

Therefore, our 2009-10 Budget submission focuses on a range of tax issues outside the immediate scope of our initial submission the AFTS Review that can be addressed in the 2009-10 Budget, particularly in light of the global financial crisis. The following key recommendations, as discussed in the attached appendix, are directed towards tax aspects in this context:

1. Ensuring business viability

- Increase capital allowances
- Increase scope of the investment allowance incentive
- Provide greater general flexibility for PAYG instalment variations
- Provide more flexibility for business and investment income instalment calculations
- Clarify the Commissioner's powers to apply refunds against debt due but not payable
- Align lodgment dates
- Allow imputation credits to flow through family trusts that are in loss positions

2. Ensuring equity in calculating superannuation income stream payments

- provide some form of adjustment to the calculation of income stream payments to take account of the impact of the global financial crisis

3. Reducing compliance costs

- Remove unnecessary tax provisions
- Clarify the operation of the imputation rules

4. Promoting fairness

- Review the tax rates for non-residents
- Remove the bias against foreign income
- Permit deferral of employee share plan taxation between unforeseen cessation of employment (eg, retrenchment) and exercise of share options

5. Climate change

- Ensure current taxation laws facilitate early abatement activities
- Ensure current taxation laws do not impede the development of alternative energy sources

Finally, the Taxation Institute would welcome an invitation to participate in any Budget lock-up on 12 May 2009, prior to the Treasurer's Budget speech to the Parliament and the public release of the Budget papers. We did participate in the 2005 to 2008 lock-ups. Given that our 11,000 tax practitioner members throughout Australia (ranging from small rural and suburban accountants to senior members of the bar specialising in tax) rely upon our report of key budget measures affecting their clients, it is crucial that we are able to report this in a time efficient manner.

Should you have any queries with respect to any of the matters raised above please do not hesitate to contact Joan Roberts on 03 9611 0178 or the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis on 02 8223 0011.

Yours faithfully

Joan Roberts
President

APPENDIX

Taxation Institute of Australia
Pre-Budget Submission 2009-10

1. Ensuring business viability

The Taxation Institute recommends the following initiatives aimed at ensuring ongoing business viability in both the domestic and international contexts in light of the global financial crisis.

1.1 Increase capital allowances (depreciation) on plant

There is a need to look closely at Australia's current capital allowances on plant to ensure Australia remains globally competitive. When the corporate tax rate was reduced to 30%, it was also anticipated that tax depreciation rates would generally be reduced by using actual effective lives instead of the then current accelerated depreciation rates. However, as a result of the ATO's on-going capital allowances effective life reviews, there has been a significant across the board extension of the effective lives of many business assets. A company or industry that maintains their plant responsibly and well is effectively now disadvantaged under the capital allowances system for doing so.

The Taxation Institute recommends that consideration be give to introducing a statutory life cap of 15 years, as well as the ability to change over from a diminished value to prime cost calculation methodology at any time.

1.2 Increase scope of the investment allowance incentive

The Taxation Institute welcomes the Government's announcement on 12 December 2008 of a temporary 10% investment allowance by way of additional tax deduction applicable to most new tangible depreciating assets over $10,000 that are acquired or ordered by the end of the 2009 financial year.

As indicated by the Treasurer (Press Release No 141, 12 December 2008) "[i]n practical terms, this is an added incentive for businesses to proceed with their investment plans in this difficult environment."

However, we note that the Treasurer has also indicated that assets to which Division 40 ITAA 1997 does not apply will not qualify for the investment allowance. This means capital works for which you can deduct amounts under Division 43 of the ITAA 1997 will not qualify for the investment allowance. In the interests of encouraging businesses to proceed with their investment plans as a boost to business investment and the Australian economy generally, we recommend that this incentive is extended to expenditure that is deductible under Division 43.

1.3 Provide greater general flexibility for PAYG instalment variations

Whilst the Taxation Institute welcomes the Government's recent assistance to business by allowing a reduction in quarterly pay-as-you-go (PAYG) instalments payable on 21 January 2009 or 28 February 2009 by 20 per cent, we recommend that there is a need to review the current PAYG regime to provide more flexibility for businesses to meet their PAYG obligations, particularly in difficult economic times. For instance, quarterly payers of PAYG currently have a 15% margin of error in varying their PAYG instalment rate before any penalties may be payable.

Given the difficult economic climate in which businesses are currently operating, the Taxation Institute recommends that consideration be given to allowing more flexibility in the margin of error when self assessing a variation in PAYG instalment rates (e.g., increase the permissible margin of error beyond 15%).

1.4 Provide greater flexibility for business and investment income instalment calculations

The meaning of "instalment income" for the purposes of calculating PAYG instalments on business and investment income under the *Taxation Administration Act 1953* is not in all cases a fair representation of the taxable income of a business or investment entity. In practical terms, this may discourage these entities from confidently making a variation of their PAYG instalment income based on an estimate of taxable income, given the potential exposure to penalties if the variation is not acceptable under the PAYG laws.

We recommend that the definition of "instalment income" is amended to include a discretion for the Commissioner to accept other factors or means of determining taxable income that more appropriately represent the taxable income of a particular entity for these purposes.

1.5 Clarify the Commissioner's powers to apply refunds against debts due but not payable

Currently the Commissioner is empowered to apply refunds against tax debts due but not payable. Where this occurs large compliance costs may be incurred where the taxpayer needs to seek a refund of the resultant over payment where the payment, which has not been processed at the time the offset occurs, has already been made in respect of the debt.

Such an offset power should not exist as a matter of course and should only be available where there is a poor payment history and the refund is at risk. As well as imposing high compliance costs, the current process creates cash flow difficulties for businesses and creates a disincentive against lodging any form early that gives rise to a tax liability. This disincentive goes against the spirit of regular progressive lodgement of forms.

1.6 Align lodgement dates

Given that multi-handling of files gives rise to additional compliance costs it is crucial to minimise the number of times practitioners need to work on a client's file. This can be achieved by aligning lodgement dates such that two tasks can be done at once.

One example arises in the context of payroll activities. Many small businesses rely on their tax agents to carry out a range of tasks including payroll activities, which includes calculating the superannuation guarantee contribution (SGC) and PAYGW amounts. Currently, SGC payment dates are monthly while the PAYGW obligations for most small businesses are quarterly. Although it is recognised that this mismatch is due to competing policies, it results in additional compliance costs and negates the BAS December lodgement concession. This concession recognises that much of Australia is on holiday in January. Under the concession the December BAS, including PAYGW amounts, is to be lodged by 28 February. However, as the same information is needed to complete the SGC due in late January, the concession is illusory for those taxpayers and creates additional compliance costs through the double handling of files.

Therefore, the Taxation Institute recommends that there should be, as part of compliance cost reduction, a review of all lodgement dates to ensure mismatches are minimised. One clear area of saving is to align SGC dates with BAS lodgement dates. An alternative to set dates would be to provide the Commissioner with the ability to extend dates in a manner similar to that that exists under the tax agent lodgement program.

1.7 Allow imputation credits to flow through family trusts that are in loss positions

Although trusts are in effect a flow through entity, there is no mechanism currently that allows franking credits to flow through the trust to the beneficiaries when the trust is in a loss position.

This is inconsistent with provisions, applicable from 1 July 2000, that allow resident individuals and certain other entities to a refund of imputation credits where a taxpayer's total imputation credits

attached to franked dividends exceed the taxpayer's income tax liability for the particular income year in question. Currently, under these provisions, a resident trustee is only eligible for a refund of excess imputation credits where the trustee is liable to be assessed under section 99 of the ITAA 1936.

This is a significant problem presently for rural Australia, where the increasing trend of the formation of incorporated rural co-operatives and the holding of the primary producer's shares in trust have resulted in the loss of excess imputation credits at a time when primary producers could well do with the extra income.

2. Ensuring equity in calculating superannuation income stream payments

The global financial crisis has had a downward impact on the value of most superannuation funds' assets and their return on investments, particularly in the past twelve months. In turn, this has impacted on each fund members' account balances and retirement entitlements in various ways, particularly those wanting to draw on their benefits through income stream payments such as pensions.

For those who have reached their preservation age, there are minimum withdrawal limits based on a percentage of a fund member's account balance at the start of the financial year in which the income stream payment is made. These minimum withdrawal limits vary from 4% to 14% depending on the fund member's age. Whilst there are generally no limits on the maximum amount that can be withdrawn as an annual income stream, there is a maximum withdrawal limit under the transition to retirement rules, which currently set at no more than 10% of the pension account balance at the start of the financial year.

The global financial crisis has impacted directly on members seeking to draw on their benefits under the above entitlements. For instance, the income stream payment for fund members drawing on their benefits during the current financial year is calculated on their account balance as at 1 July 2008. However, given the drop in asset values and return on investments in the second half of 2008, for most of these fund members their actual account balance currently could be significantly less the account balance struck at 1 July 2008. Therefore, their income stream payment is effectively inflated and does not reflect an amount calculated in respect of the current real value of the balance of their account.

The Taxation Institute recommends that the Government provide some form of adjustment to the calculation of income stream payments in the above circumstances to take account of the impact of the global financial crisis on superannuation funds and members' entitlements to draw on their benefits. From a policy perspective, this will ensure members are not forced to take an income stream that is not sustainable by their actual account balance, resulting in a reduction in the maximum amount fund members could receive, which would retain more money in the superannuation system with a corresponding reduction in disposal income.

3. Reducing compliance costs

The Taxation Institute recommends the following initiatives to assist in alleviating the impact of the global financial crisis on businesses and individuals through reducing tax compliance costs.

3.1 Remove unnecessary tax provisions

In light of the AFTS review, the Taxation Institute also recommends that the Government initiate a comprehensive methodical review of our tax laws to remove all unnecessary provisions.

The Taxation Institute acknowledges that the *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* removed a lot of the deadwood from our tax legislation with the removal of a tranche of inoperative provisions. However, we nevertheless believe that this is only the first step. There is now an opportunity in the 2009-10 Budget to go beyond the boundaries of this initial clean

up and provide appropriate funding for a methodical review of all our tax laws to remove unnecessary and redundant provisions.

To progress this type of review, the Taxation Institute produced the report in 2006, *Beyond 4100 - A report on measures to combat rising compliance costs through reducing tax law complexity*. The report focuses on identifying generic causes of complexity in the Australian income tax system and provides specific examples of complexities that may be regarded as being attributable to each generic cause. The report successfully builds on the work already undertaken in removing inoperative provisions.

The Taxation Institute developed a series of detailed case studies illustrating the effects of the combination of multiple causes of complexity in the operation of the current income tax rules which appear in the report. Our report's recommendations focused on the following four areas:

(i) repeal provisions rendered unnecessary by subsequent developments in the law;
(ii) repeal or redraft provisions whose literal meaning is rarely or never enforced;
(iii) rationalisation of rules through the adoption of common or more general rules; and
(iv) proposals relating to de minimis rules.

The recommendations are designed to impact favourably on compliance cost reduction at no or negligible cost to the Revenue.

Given the Government's prior support (whilst in opposition) of a number of the key recommendations of our report, as demonstrated through moving amendments to the *Tax Law Amendment (Repeal to Inoperative Provision) Act 2006 (the Inoperative Provisions Act)*, we call upon the Government to instigate a comprehensive and methodical review of our tax laws with a view to reassessing the effectiveness and relevance of all tax provisions. This review could be carried out through a task force established specifically for this purpose or under the direction of the Board of the Taxation.

3.2 Clarify the operation of the imputation rules

With the introduction of the Simplified Imputation System into the ITAA 1997 in 2002 (via by the *New Business Tax System (Imputation) Act 2002)*, the former imputation rules in Part IIIAA of the ITAA 1936 ceased to have application from 1 July 2002 (refer former section 160AOAA of the ITAA 1936). However, not all the imputation rules were incorporated into the ITAA 1997, in particular the so-called 45 day rule. Despite this occurring the ATO has maintained that the rules continue to have operation (see Taxation Determination TD 2007/11). The situation is further confused with the passage of the *Inoperative Provisions Act,* which deems Part IIIA to be inoperative from 14 September 2006. This is leading to unnecessary compliance costs and community uncertainty.

The Taxation Institute urges the Government as a matter of priority to complete the rewrite of imputation rules in the ITAA 1997. If a shareholding rule still exists then the period should be replaced by a 15 day rule as recommended by the Review of Business Taxation (Recommendation 6.7, *A Tax System Redesigned* (1999)).

4. Promoting fairness

The Taxation Institute recommends the following initiatives to improve the equity of our current tax regime.

4.1 Review the tax rates for non-residents

For the 2008-09 year, the tax rate for non-residents with taxable incomes of $0-34,000 is 29%. Other than slight increases in the threshold at which the next highest rate of 30% begins (e.g., an increase of the threshold for the 2008-09 year to $34,000 from the previous threshold $30,000), the 29% rate itself has been in place since prior to 1990. In 1990, Australian residents were also taxed

at 29% at reasonably low income levels ($12,600 - $19,500). Since 1990 the low income rate for resident individuals has been reduced several times, with the rate for the 2008-09 year being 15% for income from $6,000 - $34,000.

It would appear that we are taxing non-residents at almost double the rate of residents at low income levels where the comparative rate of taxation in the non-resident's country of residence is not uncommonly far less than 29%. With the Government's aspirational plan of reducing residents' personal income tax rates this inequity will become greater.

In the United Kingdom the starting rate band is 10% to 22%, in the United States it is 10% to 15%, and in New Zealand it is 12.5% to 21%. No different rates are applied to non-residents in these countries.

There would be some cost to the Revenue in adjusting the non-resident tax rate in line with resident tax rates. On an individual basis, it would seem these groups are paying a disproportionate level of tax in Australia on their Australian income. The Taxation Institute requests Government consider aligning low income non-resident tax rates with those of residents

4.2 Remove the bias against foreign income

The Board of Taxation in its 2003 *International Taxation: A report to the Treasurer* recognised that Australian resident shareholders do not receive credits for foreign company tax (usually the main tax on a company's offshore investments) paid by a branch or offshore subsidiary of an Australian company. As a result, there is a tax bias in favour of domestic investment that can affect the cost of capital for Australian multinationals undertaking direct investments offshore. To overcome this bias the Board of Taxation recommended that:

- domestic shareholder tax relief should be provided for unfranked dividends paid out of FSI derived after the commencement date; and
- relief should be provided by way of a non-refundable tax credit of 20% and without any requirement to trace foreign tax paid or incurred.

The Board also recommended dividend streaming of foreign source income. Although the then Government rejected these recommendations, it did indicate that the matter needed further consideration. The Taxation Institute recommends that the Government review this crucial issue.

4.3 Permit deferral of employee share plan taxation between unforeseen cessation of employment (eg, retrenchment) and exercise of share options

The employee share plan rules facilitate tax on certain employee share options (that meet specified criteria) being levied upon exercise of the options, rather than when the options are granted. That rule is understood to reflect good policy that the tax liability should not be levied until the options can be exercised (and the shares disposed of) so as to fund the underlying tax liability.

However, even where the options meet the relevant criteria, and postponement of the tax liability is available, the tax liability may be triggered by certain earlier events including cessation of the relevant employment. That could be harsh, for example, an employee who is retrenched may suffer a tax liability on such options because of the cessation of employment, at exactly the time when it is most inconvenient. This is likely to become an increasingly important issue during the current global financial crisis..

In practice, most employee share option plans are currently devised to alleviate this, in that the options will be dealt with one way or another upon cessation of employment. However, on equity grounds it would be preferable for the tax liability to arise only when the options are realised (or at least are capable of realisation). A similar problem, though not identical, arises in relation to employee shares and the triggering of a tax liability on cessation of employment, and likewise the Taxation Institute believes that cessation of employment should not be an automatic tax trigger point for employee shares in those circumstances.

5. Climate Change

Whilst the Taxation Institute acknowledges the Government's current climate change review program is currently underway, in particular the December 2008 release of its white paper *Carbon Pollution Reduction Scheme – Australia's Low Pollution Future*, we suggest that there are some climate change related tax issues that benefit from immediate consideration in the context of the 2009-10 Budget.

5.1 Ensure that the current taxation laws facilitate early abatement activities

In response to environmental concerns, many businesses are adopting carbon abatement strategies ahead of any form of Government regulation. However, it is still not clear under the current taxation laws how such activities are treated. Therefore, prior to finalising the carbon pollution reduction regime, measures need to be introduced to ensure that the current taxation laws facilitate early abatement activities, rather than inhibit them.

Therefore there is a need to:

- ensure that the black hole provisions in section 40-880 of the ITAA 1997 operate appropriately, for example, ensure these provisions capture costs related to abatement activities which are not otherwise relieved under the ITAA 1997;
- ensure indirect taxes (such as GST, and excise and State/Territory taxes) do not contain disincentives to early abatement;
- ensure that there is a concessional exemption under the *Customs Act 1901* for equipment imported for geothermal drilling as well as hydrocarbon drilling;
- consider clarifying tax policy as to whether and to what extent deductions should be available under section 40-755 of the ITAA 1997 for activities directed at preventing and remedying general pollution from carbon emissions; and
- clarify the tax treatment of voluntary climate change response activities and related government incentives, in particular, consideration needs to be given to determine the extent to which, if any, such costs meet the deductibility criteria in section 8-1 of the ITAA 1997.

Other direct incentives could also be provided to support early abatement activities. They include:

- accelerate deductions for tax depreciation on specified abatement technologies by introducing accelerated effective lives (including statutory caps) for such depreciating assets;
- consider concessions for early abatement related activities in respect of indirect taxes (such as GST, and excise and State/Territory taxes);
- consider expanding the current R&D tax incentive by allowing certain emissions abatement related capital expenditure to be deemed to be eligible R&D expenditure and creating a premium R&D category for R&D that results in emissions abatement. This could be done as part of the current review of R & D ; and
- consider immediate deductions, possibly for an initial concessionary period, for specified abatement expenditures and activities.

5.2 Ensure that current tax laws do not impede development of alternative energy sources

As renewable and alternative energy sources are crucial to any carbon reduction strategy it is important to ensure that the development of alternative energy sources is not impeded by the current tax laws. For example, it will be necessary to consider the capital allowances treatment of investments in low-emissions technologies and other expenditure aimed at emissions reductions.

The environmental protection activity immediate deduction in section 40-755 currently has no application where expenditure is incurred on activities to prevent, fight or remedy general greenhouse gas pollution (see Register of Private Binding Rulings Authorisation Number 72229). Many activities that will be undertaken in response to climate change are likely to fall into this category and are therefore unlikely to be deductible under section 40-755.

Similarly, as the tax law stands at the moment there is divergent tax treatment for geothermal when compared to hydrocarbon exploration tenements and assets. The operative provisions of Division 40 (40-30, 40-80, 40-730 etc) of the ITAA 1997 does not include expenditure referable to geothermal exploration as activities that qualify for deduction within the Division.

This area of activity was not contemplated at the time of enactment of the provisions and is only in recent years coming to prominence as new energy sources are being sought. It is now time for the provisions to be amended to treat expenditure referable to geothermal exploration tenements and assets in line with hydrocarbon tenements and assets to ensure that those investing in this activity are not at a disadvantage.

Other direct incentives could also be provided to support the development of renewable energies. This could involve providing accelerated deductions for tax depreciation in relation to capital investment in specific renewable energies. This approach is adopted in a number of other countries. For example, France allows tax depreciation over 12 months for equipment utilised in certain wind power projects.