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TAXATION INSTITUTE of AUSTRALIA
IT'S ESSENTIAL

5 May 2009

AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Email: AFTSubmissions@treasury.gov.au

Dear Sir

Australia's Future Tax System (AFTS)

The Taxation Institute of Australia ('Taxation Institute') is pleased to provide the attached submission in response to the Australia's Future Tax System Review Panel's ('AFTS Review Panel') Consultation Paper (*Australia's Future Tax System - Consultation Paper*) released on 10 December 2008 for public submissions.

The Taxation Institute strongly supports the AFTS Review in which it has been an active participant having made written submissions in response to the first consultation paper in December 2008 and on the retirement income system earlier this year. We have also welcomed the opportunities provided to meet with the Review Panel members.

In preparing this submission the Taxation Institute has not repeated all matters covered in its previous submissions and has concentrated on responding to those questions in the Consultation Paper, which are within the areas where it can contribute specialist tax commentary without expressing views on particular social policy issues. Nevertheless the Taxation Institute considers social considerations an important aspect of such a review and commends the Government for soliciting broad community feedback as part of the Review.

However, there are two significant areas which limit the scope of the comprehensive Review. The first is the limitations contained within the Review's Terms of Reference, being the exclusion of GST from the Review and the second is that the focus of most of the position questions in the Consultation Paper is on the operation of the domestic tax transfer system and do not directly address the international tax policy objectives. These issues are addressed in our submission but we note that in relation to the second of these that, we recommend that the Panel seek targeted consultation on the international dimensions that inform or drive the future design of the Australian tax-transfer system. We would welcome an opportunity for our representatives to discuss this with the Panel.

The Taxation Institute is also able to make representatives available for further discussions on tax policy review priorities during the course of this Review and welcomes the opportunity to do so. If you require any further information or assistance in respect of our submission, please 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

Joan Roberts
President

Australia's Future Tax System

Submission by the Taxation Institute of Australia

May 2009

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INTRODUCTION

About the Taxation Institute of Australia

The Taxation Institute of Australia ('Taxation Institute') is a national body of over 11,000 members, with a focus solely on taxation. Our members include tax agents, accountants, lawyers and members of the judiciary with an interest in taxation, in all its various forms, as well as officers of the Australian Taxation Office ('ATO'), Treasury and State Revenue Offices.

From its inception in 1943, the Taxation Institute has been a leading advocate and consultative body on the development and implementation of taxation policy and the administration of the tax laws. In particular, our Constitution provides that one of the Institute's roles is to contribute to the debate on tax-related issues in the community by advancing public knowledge and understanding of tax, the practices of public authorities administering tax laws and the attitude of Governments to tax. As part of this role, the Institute has made numerous major submissions on tax reform, particularly over the last decade.

In its advocacy and consultation, the Institute has worked closely in consultation with the Parliament of Australia (through Ministers and Parliamentary Committees), the Treasury and the ATO (as well their international counterparts), regulatory review agencies (including the Board of Taxation, Inspector General of Taxation, the Australian National Audit Office and the Tax Agents' Boards) and State and Territory Revenue authorities. We also have strong and constructive relationships with other tax professional, industry representative, and academic and research bodies, both in Australia and overseas.

Our submission draws on this considerable experience.

Structure and scope of our submission

Our submission responds to most of the key questions raised in AFTS Review Panel's Consultation Paper (*Australia's Future Tax System - Consultation Paper*) released on 10 December 2008 for public submissions. . Where the Taxation Institute is not addressing a particular consultation question that question is excluded from the following.

Broad community feedback

Consistent with the AFTS Panel's current focus on gathering broad community feedback, to ensure the broadest possible base for Member feedback in preparing this submission we:

- surveyed our members across Australia (via an online questionnaire to gather Member views on the key reform issues and potential options for addressing them); and
- received input through a working group drawn from all states.

This feedback has been considered in the preparation of our submission.

EXECUTIVE SUMMARY

The Taxation Institute supports the Australia's Future Tax System Review (the Review) which encompasses Australian Government and State taxes, except the GST, and interactions with the transfer system as an important and timely opportunity to review and improve Australia's existing tax systems.

Whilst our submission covers a range of issues we stress that there are two significant areas which limit the comprehensive scope of the Review:

- the limitations contained within the Review's Terms of Reference, being the exclusion of GST from the Review; and

- the focus of most of the position questions in the Consultation Paper which is on the operation of the domestic tax transfer system and do not directly address the international tax policy objectives. Issues associated with tax treaties, source, residency and foreign source income rules are clearly not an area of focus. The Taxation Institute submits that the absence of an international focus has the potential to undermine the development of a sustainable tax system that deals with the Australia's changing role in the international environment. Therefore, we recommend that the Panel seek targeted consultation on the international dimensions that inform or drive the future design of the Australian tax-transfer system;

Key points raised by the Taxation Institute in response to the questions posed by the AFTS Review include:

- One of the challenges for the Australia's tax-transfer system is that there are people currently in the tax system who, from an administrative point of view, should not be there. This is particularly so in the case individual taxpayers. Under a new tax transfer system there is a need to find ways to reduce compliance costs that also allow for the equitable taxing of these taxpayers. However, any removal from the tax system would only operate whilst the person was within the transfer system. Where their circumstances change, resulting in movement from the transfer system to employment/business, then the engagement with the tax system will recommence. This is crucial from a tax compliance view point to ensure that persons do not fall from one system into the shadow economy.

- Given that non-cash remuneration in association with employment provides economic benefit, in principle it should be taxed provided the mechanism for taxation satisfies the criteria of efficiency, equity and simplicity. The current taxation of non-cash benefits at the employer level via the *Fringe Benefits Tax Assessment Act 1986* is complex, uncertain, distortionary, and imposes high compliance costs. Although it is politically easier to tax the employer/provider, rather than the employee, one reform option is to consider standardising the taxation on non-cash benefits by the taxing them in the hands of the persons providing the service that gave rise to the non-cash benefit, or consider simplifying the taxation of non-cash benefits by just targeting the major benefits widely offered as packaged benefits.

- Encouraging voluntary savings is essential for ensuring retirement income security both now and in the future, along with a government provided Age Pension and compulsory savings enforced through Superannuation Guarantee (SG).

CHAPTER 1 CHALLENGES AND OPPORTUNITIES FOR REFORM

1.1 In considering the community's aspirations for the type of society that Australia should become over the next two decades and beyond, which key features should inform or drive the future design of the Australian tax-transfer system?

The Taxation Institute believes that the key features of tax policy that should drive the future design of the Australian tax-transfer system needed to deliver that vision therefore are:

- equity (both horizontal and vertical equity);[1]
- efficiency;[2] and
- simplicity (including certainty, which in turn embodies concepts such as clarity, consistency and stability).[3]

As well these key criteria and others such as sustainability underpinning tax policy, there is a need to also address the international dimensions of Australia's tax policy. For example the adoption of OECD endorsed positions as part of Australia's model tax treaty without consideration of domestic reform in the area of the foreign source income rules could give rise to unfortunate tax policy outcomes.

Therefore, it is concerning that the focus of most of the position questions in the Consultation Paper is on the operation of the domestic tax transfer system and do not directly address the international tax policy objectives. Issues associated with tax treaties, source, residency and foreign source income rules are clearly not an area of focus. This is illustrated as follows.

First, when addressing equity the focus is upon the domestic tax policy objective of "individual" or "inter-individual" equity as opposed to the international tax policy objective of "inter-nation equity". Inter-nation equity focuses on ensuring that each country linked in a cross border transaction receives an equitable share of tax revenue arising from that transaction (ie an equitable distribution of the competence to tax). Equity in the context of inter-nation equity depends upon tax rates in the source country and the allocation of the tax base between the source and residency country.

Secondly, when looking at efficiency the questions focus on domestic efficiency (tax neutrality) rather than international neutrality objectives of capital export neutrality (CEN),[4] capital import

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1 By equity we mean. Horizontal equity requires that "[i]ndividuals in similar circumstances should be taxed similarly while vertical equity requires that the ". . . tax burdens should depend upon ability to pay . . ., the greater burden falling on those more able to pay", This definition has wide spread acceptance eg Commonwealth, The Board of Taxation, Commonwealth, *International Taxation: A Report to the Treasurer* (2003), 32; the Commonwealth, Reform of the Australia Tax System: *Draft White Paper* (1985), 14; and the New Zealand *Report of the Task Force on Tax Reform* (1982) (the Mc Caw Report), 68. In Review of Business Taxation, Commonwealth, *A Strong Foundation* (1999), 63 and 75 it is suggested that horizontal equity can be achieved through ensuring all forms of income (wages, rent, capital gains, etc) are taxed equally

2 The efficiency of the tax system domestically can be determined by a number of aspects, being the level of taxation and the method of collection or the form that the system takes. Crucial in any evaluation is the degree to which the income tax base is comprehensive, as substantial domestic neutrality in relation to business financial and investment decisions can only be achieved through a comprehensive income tax see generally the 1985 Draft White paper, above n 1, 15.

3 Simplicity is evidenced by seven concepts: predictability (ease of understanding) of a rule's intended (and actual) scope; proportionality (complexity proportional to the policy); consistency (avoids arbitrary distinctions); low compliance burdens; easy administration; co-ordination with other tax rules; or clear expression - Graeme S Cooper, 'Themes and issues in tax simplification' (1993) 10 *Australian Tax Forum* 417, 424.

4 Capital export neutrality (CEN) aims for neutrality in international investment decisions by ensuring that regardless where income is earned (domestically or overseas), residents are taxed on that income at the same effective tax rate ensuring equal pre-tax rates of return on investments between countries. CEN is achieved solely by taxation

neutrality (CIN) [5] and national neutrality.[6] All three neutrality objectives exist in the international tax rules of most jurisdictions.[7] Although domestic neutrality is a vital tax policy objective, problems arise due to:

> . . . interactions between the tax systems of the domestic country, the country of the source of the income or residence of the investor, and third countries (in relation to conduit cases).[8]

Efficiency will also be compromised even where the same level of income tax is imposed in Australia and in another jurisdiction, if profitability differential arises from an international tax difference, such as an excise. Thus, in order to evaluate the efficiency of the system, it must be measured as a whole, including the impact of foreign taxes on the system.[9]

Further, care must be taken to ensure that in devising outcomes for a 21st century tax system that any recommended change to the domestic law, that is based upon theoretical substance without any regard to form, is not compromised by tax treaties that fail to recognise the domestic tax treatment and do not provide double tax relief.

The Taxation Institute submits that the absence of an international focus has the potential to undermine the development of a sustainable tax system that deals with the Australia's changing role in the international environment. Therefore, we recommend that the Panel seek targeted consultation on the international dimensions that inform or drive the future design of the Australian tax-transfer system.

1.2 Assuming that the absolute size of government will not fall, should (and can) Australia nonetheless aim to reduce the burden of taxation over time by promoting faster economic growth than public spending growth? Can it be demonstrated that alternative tax policies could help deliver that outcome?

In looking at tax policies to help deliver a reduction of the burden of taxation by promoting faster economic growth than public spending growth, it is prudent to focus on tax policies that encompass both direct and indirect methods of taxation. Whilst the Taxation Institute strongly supports the

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based upon country of residence. Tax measures aimed at achieving CEN seek to offset the effects of source country taxation through tax credits for foreign tax paid by residents through domestic foreign tax credit regimes and/or under tax treaty obligations to provide credits for foreign tax. The broad focus of the CFC and FIF measures is aimed at ensuring CEN – see Paul J Keating, Commonwealth, *Taxation of Foreign Source Income: A Consultative Document* (1988), 5. CEN is often proposed as the dominant theory as it maximises global welfare and is consistent with the "horizontal and vertical equity benchmarks for individual taxpayers under a progressive tax system."

5 Capital import neutrality (CIN) aims for neutrality in international savings decisions by ensuring that regardless of where capital is invested (domestically or overseas) the income derived, is taxed at the same rate, so that the effective after-tax rate of return on an investment in any particular country is the same for all investors regardless of investors' place of residence. CIN is achieved by giving primacy to tax to the source country. CIN is seen as more practical being based upon considerations of international competitiveness rather than economic theory (Dale Pinto, *E-Commerce and Source-Based Income Taxation* (2003), 26). Further, it has been argued that deviation from CIN may in fact favour high marginal cost producers ahead of low cost producers (Michael J Graetz 'Taxing international income: Inadequate principles, outdated concepts, and unsatisfactory policies' (2001) 26 *Brooklyn Journal of International Law* 1357, 1366-7).

6 National neutrality aims for neutrality in investment decisions of residents by ensuring equality between the pre-tax (gross) return on domestic investments and the post-foreign tax return on foreign investments. This occurs where foreign investment income of a resident investor is taxed (without deferral) at the same domestic tax rate as domestic income and with foreign tax treated as a deductible expense. Richard L Doernberg, *International Taxation in a Nutshell* (5th ed, 2001).

7 The Treasury, Commonwealth, *Review of International Taxation Arrangements: Consultation Paper* (2002), 93.

8 Ibid, 92.

9 Taxation Review Committee, Commonwealth, *Full Report* (1975) (Asprey Report), 258 and JE Meade et al, *The Structure and Reform of Direct Taxation* (1978), 7-23.

AFTS Review, we remain disappointed that GST and other potential methods of indirect taxation are not included within the Review. As the Taxation Institute identified some 80 pages of issues with the GST as part of the Board of Taxation's *Review of the Legal Framework for the Administration of GST*, the Taxation Institute continues to call on the Government to introduce a comprehensive review of the GST. It is essential that the Government opens up the GST system to a full review to ensure its complexity is streamlined and the costs of GST compliance reduced within the context of the broader AFTS Review.

As well as the direct tax burden there needs to be a conscious effort to reduce the consequential tax burden being the high level of compliance costs. A key element to this process is simplicity. The absence of simplicity results in tax laws that are complex (uncertain) and poorly designed which in turn:

- imposes high compliance costs on the community;
- imposes high administrative costs on the tax authorities;
- results in socially unproductive and costly tax litigation;
- is counterproductive to the economic development of the country, in particular by jeopardizing economic neutrality;
- acts against public involvement in policy development; and
- generates disrespect for the rule of law.

The broad causes of complexity in tax law are tax policy trade-offs, tax system interactions, poor policy development and poor drafting.[10]

Complexity also arises from poor execution of operative and administrative rules which underlie the day to day operation of the income tax law. [11]

Therefore, as there is no one particular policy cause for complexity there is no easy policy fix for complexity. The solution is incremental change. As stated in the Taxation Institute's 20 October 2008 submission in response to the AFTS Review Panel's invitation on 19 August 2008 for public submissions, a approach for tackling complexity could include the following tax-transfer design features:

- *Taxation is an integral part of any policy design:* Taxation must be an integral part of any policy design, not an after thought. The current Carbon Pollution Reduction Scheme process is an example where a design based around a carbon measurement system coupled with a policy of the creation of deep markets for permits has resulted in intractable tax complexity from the

10 Adam Broke, 'Simplification of tax or I wouldn't start from here' [2000] *British Tax Review* 18 sees four causes of complexity: diversity, volume, drafting and language. See generally the Taskforce on Reducing Regulatory Burdens on Business, *Rethinking Regulation* (2006). The Review of Business Taxation, *A Strong Foundation* (1999), xvii-xviii and 64-65, notes that '[c]omplexity, as the other side of the simplification coin, is not something identifiable that has been grafted onto the business tax system. It derives from multiple sources such as tax legislation that encourages highly technical interpretation by courts; importation of external legal concepts into tax legislation; a wide range of tax preferences; equity concerns; and complex business arrangements, to name but a few.' Cooper (1993) ibid at 420 who asserts that despite the number of articles and claims 'there is little empirical work that can verify the grand, but largely unsupported claims for the benefits of simplification.'

11 Cooper (1993) ibid at 424 and Michael Dirkis, "Complexity arising from the design of the administrative rules underlying the income tax law" in Graeme Cooper (ed), *Executing Australia's Income Tax*, Conference Series No 25, Australian Tax Research Foundation (2008), 287-305.

mismatch between reporting and the taxable entities and increased GST revenue despite the policy desire to not raise additional revenue.

- *Move away from global policy solutions:* There is a need to abandon the preoccupation with the continued adoption of global policy solutions. Examples of such poor policy designs leading to large compliance costs are Fringe Benefits Tax and the Foreign Investment Fund provisions where everything is a fringe benefit or a FIF unless there is an exemption.
- *Avoid over prescriptive tax laws:* There is a need to abandon the preoccupation with the "chase every cent" policy. The over- prescriptive nature of the laws and the "chase every cent" policy has in some cases resulted in a concession being so complex that few take it up, eg the former Simplified Tax System (STS) for small business. A comparison is the New Zealand approach to taxing fringe benefits which does not chase the last cent by focusing on the major benefits resulting in a less complex system.
- *Accurately identify and monitor compliance costs:* In order for the tax policy to be properly developed, it needs to be made with full knowledge about the costs of compliance of a measure. The Treasury, in consultation with the Australian Taxation Office should develop an enhanced ability to monitor and model taxpayers' compliance costs in the tax system. This should be supported by technological infrastructure that allows for a timely and robust monitoring capacity. Where the public good is deemed to be more important than the additional compliance costs imposed, Government needs to investigate the feasibility of compensation via a direct concession, via rebate (tax offset), a cash grant (based upon a percentage of turnover or the actual level of cost to the business) or a lower tax rate for business income of small businesses.
- *Compatibility of tax regime with international norms:* Australia has to deal in a global environment. Using terminology and tax concepts unique to Australia (eg in debit equity, in the GST terminology and in treaties) creates both treaty and other interface problems for both in bound and out bound investment.
- *Certainty in tax administration:* Ensuring that administrative systems that are introduced in order to implement tax change are consistent with the overall policy and are designed to minimise compliance and administrative costs. This also involves ensuring that legal clarification being undertaken in a manner that accords with the policy intentions of the legislation and delivers pragmatic and practical outcomes consistent with modern commercial and business practices.

CHAPTER 2 PRINCIPLES AND FEATURES OF A NEW SYSTEM

Many of the key principles and features of a new tax transfer system are discussed in response to specific questions in other sections of the submission. However there are some key concerns that merit exploration in this context.

First, as stated in the Taxation Institute's 20 October 2008 submission, there is a need to reduce complexity and introduce better levels of equity into Australia's personal taxation system by eliminating the current tax/welfare churn, which causes significant confusion about how tax should be collected at this level. For instance, current research indicates that: [12]

- the number of families receiving more tax offsets and transfer system benefits than they pay in income tax has increased by over 276,000 over the past four years to a record 4.113 million (42.2% of 9.754 million families); and

- whilst 996,000 people have moved down a tax bracket from 30% to 15%, there is a new and significant problem for 134,000 taxpayers being pushed up a bracket from 30% to 40%.

One of the challenges for the Australia's tax-transfer system is that there are people currently in the tax system who, from an administrative point of view, should not be there. Under a new tax transfer system there is a need to find ways to reduce compliance costs that also allow for the equitable taxing of these taxpayers. However, any removal from the tax system would only operate whilst the person was within the transfer system. Where their circumstances change, resulting in movement from the transfer system to employment/business, then the engagement with the tax system will recommence. This is crucial from a tax compliance view point to ensure that persons do not fall from one system into the shadow economy.

Second, the nature of the tax transfer system, which involves multiple interactions with government, has become extremely complex with many potential distortions. The ability for the ordinary citizen to understand their rights and obligations has been significantly impeded to the point that the integrity of the system has become compromised. A new tax-transfer system needs to acknowledge and cater for the likelihood of changing work patterns and provide support (or at least eliminate disincentives) for people to vary work patterns over time.

Third, one of the major challenges for the AFTS Review is to ensure that there are sufficient and appropriate incentives to enhance Australia's productivity and international competitiveness. Central to ensuring these incentives are in place is a review of the current role and structure of company taxation in Australia. There are clearly concerns at present about the international competitiveness of our current rate of corporate tax and tensions around how we tax business entities (for instance whether to apply substance over form under regimes such the Taxation of Financial Arrangements (TOFA) and the debt/equity rules). However, the Taxation Institute is not advocating that this review should necessarily be about pursuing the lowest rate of company tax or adopting all the most attractive features of other countries' tax systems as a way to make Australia internationally competitive. It is about having an equitable comparative international tax system that people can understand and comply with cost efficiently.

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12 According to research carried out by *The Weekend Australia* (also involving the Melbourne Institute of Applied Economic and Social Research) and reported in the article "Four in 10 families pay no tax" in *The Weekend Australian,* September 20-21, 2008, p1

CHAPTER 3 THE REVENUE MIX

3.1 What problems, if any, are generated by the overall mix of taxes in Australia on business and labour income, consumption, transactions and assets, and what changes, if any, should be made?

Generally Australia continues to have an over reliance on direct taxation through the income tax system. This overreliance is reflected in high effective marginal tax rates, which creates the barriers for women to return to work and for persons in receipt of welfare benefits returning to employment. Therefore, there is a need to consider expanding the consumption tax base and lowering reliance on direct taxation.

However, any increase in indirect tax through the increase in tax rates is regressive for low income earners as the majority of their income earned or benefits received are spent on goods and services. Therefore, as part of any alteration of the tax mix, there is a need to devise proper and adequate compensation packages or through adjusting the application of income tax.

3.2 Does Australia's tax system penalise (or favour) the returns to savings relative to other activities and should this lead to changes in the structure of taxes and means tests?

The taxation of savings under Australia's current tax regime is distorted because of different tax treatments for different forms of saving. The rate of tax applicable to savings is inconsistent due to:

- the failure to take into account the impact of inflation and GDP growth means that certain forms of savings are taxed at a higher rate than others; and

- the capital gains tax discount, whilst ameliorating the impact of inflation and GDP growth, goes further and directly encourages investment in assets with an expected capital appreciation. To the extent that this provides capital to business at a lower cost, where that capital is productively employed this can be beneficial for the economy. However, it is not clear that the capital is always productively employed.

The structure of the taxation of capital gains and its separation from other forms of taxed income and gains also gives rise to inefficiencies. Full integration of the capital and income tax systems would demand that gains be added to other forms of incomes and losses be offset. While there have been arguments that the quarantining of capital losses is necessary to protect against selective realisation of losses to reduce tax, there is an adequate anti-avoidance rule that already prevents the realisation of losses for this purpose. The continued quarantining creates distortions that impact not only on tax rates but also on the benefits otherwise available to taxpayers/beneficiaries.

3.3 Does Australia's tax-transfer system appropriately deal with property and wealth, or should new approaches be introduced? What, if any, implications would any changes have for the taxation (or means testing) of capital income flowing from property and wealth?

Australia's current tax system does not seem to appropriately deal with property and wealth, especially from a State perspective. In addition to the discussion of CGT noted in 3.2 above, state land and stamp taxes are also a form of wealth tax that impacts on the overall return from selected forms of property. The impact of these can result in effective tax rates much greater than is reasonable for the fostering of suitable residential property or normal business transactions (including insurances).

3.4 Assuming no increase in the rate or base of the GST, what principles should guide the future development of other consumption taxes in Australia, and is there a need to change the role and structure of such taxes?

The Taxation Institute believes it is premature to discuss potential principles to guide the future development of other consumptions taxes in Australia without expressing our concern that we do not accept that it is necessary to introduce other consumption taxes simply because of an assumption of no increase in the rate or base GST. There are already a range of consumption like taxes in Australia, many being the so called user charges that fall heavily on those on lower incomes. Any additional consumption taxes will only increase complexity without necessarily benefitting the revenue. The focus should be on rationalisation no increasing the scope.

If the Review is not looking at the rate of GST, it is certainly necessary to look at its scope/base.

Reference should also be made to our comments on state and local taxes and transfer below in the section entitled *State and Local Taxes and Transfer in the Australian Federation.*

3.5 Could greater application of user charges, rather than general taxes, in the funding of government services or infrastructure bring social, environmental or economic benefits?

Please refer to comments made below at 9.2.

CHAPTER 4 PERSONAL TAX AND TRANSFERS

4.1 How might the personal tax system be changed to better achieve the goals of greater simplicity, transparency, equity and efficiency?

Given the interaction with the transfers system, rationalisation of these systems is highly desirable. Such rationalisation should reduce some of the inequities that arise under current rules and reduce compliance and administration costs.

As stated in the Taxation Institute's 20 October 2008 submission, there are numerous distortions in the current taxation treatment of individuals. In particular, there are people currently in the tax system who, from an administrative point of view, should not be there (42.2% of families) and there is a need to find ways to reduce compliance costs that also allow for the equitable taxing of individuals. Personal taxation distortions arise principally in respect of how income is recognized and in respect of allowable deductions.

The Australian tax system has been based on the individual as the taxing unit rather than the family and the taxation of the individual depends upon the categorization of income into "income from personal service" and "income from business". This historic classification process is arbitrary and complex leading to distortions such as personal tax minimisation arrangements including:

- the proliferation of "independent contractors" which continue to work at the principal contractor's previous employer, with the perceived potential to split income with spouses;

- the continued use of "husband-and-wife partnerships" by tradesman and farmers, where almost all (if not all) of the income is earned through the efforts of only one of the partners;

- the use of family trusts and service entities, with the potential to distribute business and investment income to lower-taxed beneficiaries and companies; and

- the use of family companies solely to earn investment and business income which is taxed only at 30%, rather than at the shareholders' high marginal tax rates.

In order to counter these specific legislation in respect of personal service business have been introduced (via Part 2-42 of the *Income Tax Assessment Act 1997 (Cth)* (ITAA 1997)) which has created both complexity and additional compliance costs.

However, in respect of many tax offsets and social security (transfer system) purposes family income is used. As a result families paying different amounts of tax where there is one principal earner versus dual income earners may in fact receive similar tax transfer benefits.

These distortions are continued in the context of deductions, in particular with the operation of ss 8-1 and 8-2 ITAA 1997 being a major source of dispute between the ATO and taxpayers. For instance, an "employee" taxpayer will be denied expenses associated in gaining piece meal work as they are capital (eg management fees paid by footballers, computer consultants, nurses, etc). Similar expenses associated with employment are denied either because they are deemed to occur prior to the income earning process (travel to work and child care expenses) or as they are private expenses (home office). This is also arbitrary as "business" taxpayers will often be able to claim many of these expenses.

There are at least four broad options for addressing personal taxation challenges:

- recognise a "family" taxable entity basis (for instance all individual taxpayers should be able to lodge joint income tax returns overcoming the current mis-match between the measurement of family income for taxable and social security (transfer system) purposes);

- review the place of the individual within the tax-transfer system and remove complexity through a combination of transferring responsibility for tax collection to others (thereby effectively removing people/returns from the system as in New Zealand, the UK, Spain and Japan), simplifying the law and administration (for instance, through reviewing the deductibility of work related expenses, reviewing personal tax rates and looking at withholding tax at source on interest and dividends) and masking complexity through technology (for instance, through pre-filling of returns);

- replace the current capital/revenue distinction (e.g., as retained in s 8-2 of ITAA 1997 Act) with a system which effectively allows, as a general deduction, losses or outgoings incurred for the purpose of producing assessable income or, in carrying on a business for that purpose, but which provides for a number of specific exclusions unencumbered by phrases such as 'capital' or 'of a capital nature'; and

- provide incentives for taxpayers to save (for instance through targeted exemptions from tax and/or reduced tax on classes of income, such as capital gains and savings)

4.2 What is the appropriate distribution of income tax across income levels and how should it differ from the current distribution? Should governments seek to maintain a similar distribution over time, or should they fix the value of current tax thresholds through indexation?

While there is much to be said for the simplicity of fewer tax scales, equity would suggest a highly graduated tax scale apply to income levels. This may allow greater flexibility to governments to better target levels of income and benefits and allow consistency between taxes and benefits.

4.3 Is the personal income tax base appropriately defined? Should reforms such as changes to the scope of deductions or other measures be considered?

Refer to comments at 4.1 above.

4.4 Should the tax treatment of transfer payments be reconsidered? Should transfer payments be taxed at the same rate or a lower rate than earned income?

The Taxation Institute believes that is premature to reconsider the tax treatment of transfer payments and the rate at which they are taxed without first reconsidering the way in which eligibility to benefits under the tax-transfer system is currently measured.

The current measurement of eligibility for benefits under the tax-transfer system is driven by the concept of taxable income. This measurement results in an inequitable distortion in the access to benefits between those on lower taxable incomes supplemented by other benefits not accounted for in their taxable income and those on higher taxable incomes with no access to these other benefits.

If Australia continues with an integrated tax-transfer system, it is crucial that all income, including benefits not currently accounted for in taxable income, are taken into account and uplifted for tax effect purposes. This will ensure the correct level of income is arrived at in determining access to transfer payments and will impact on the calculation of Average Weekly Earnings and the correct amount of tax to be paid.

4.5 Should people in different circumstances be taxed differently (for example, by age, occupation, location), and what might be the implications of such arrangements? Are tax offsets the best way to achieve differential taxation?

The Taxation Institute believes that the transparency of tax rates is essential in achieving equitable differential taxation. Currently, although set rates of tax are applicable, due to a wide range of benefits available to supplement income, those rates are largely illusory as the correct taxation position varies by age, occupation and/or location.

4.6 How can fringe benefits tax be simplified while maintaining tax integrity? Would it be better to adopt the general OECD practice of taxing fringe benefits in the hands of employees, rather than employers?

Given that remuneration in a non-cash form provides economic benefit, in principle it should be taxed provided the mechanism for taxation satisfies the criteria of efficiency, equity and simplicity.

Currently, non-cash benefits supplied in association with employment are taxed at the employer level (via the *Fringe Benefits Tax Assessment Act 1986 (Cth)*) (FBT system) while third party non-cash benefits and non-cash benefits provided under independent service arrangements are taxable to the recipient under section 6-10 either by the use of sections 21, 21A and 26(e) of the *Income Tax Assessment Act 1936 (Cth).*

The fringe benefit rules are complex, uncertain, distortionary, and impose high compliance costs. As stated in the Taxation Institute's 20 October 2008 submission, some of the difficulties are as follows:

- the taxation of non-cash ". . . benefits through the employer (rather than the employee) at the top marginal rate is seen as complex, administratively burdensome" (*A Platform for Consultation* (1998) Chapter 38). Much of the complexity arises from the FBT rules being drafted to capture "every cent" of non-cash benefit no matter how minor and the existence of two types of benefits (reportable and non-reportable);

- the FBT system "discriminating against employees on less than the top marginal rate" (*A Platform for Consultation* (1998) Chapter 38);

- the current system is inefficient creating the reduction of income tax through concessionary valuation rules;

- entrenches a wage subsidy from the Commonwealth to charitable and not-for profit employees (by the use of the net reportable fringe benefit in income definitions for Family Assistance);

- entrenches a revenue transfer to the States and Territories allowing them to reduce wages costs through splitting salary sacrifice benefits with employees (including the use of expense payment benefits for non-deductible entertainment); and

- there appears to be little compliance with the taxation of non-employee non-cash benefits.

Thus, the regime for taxing non-cash benefits is inequitable, is unduly complex and administratively costly to comply with.

There are two broad options available to address these system challenges:

- although it is politically easier to tax the employer/provider, rather than the employee,[13] one reform option is to consider standardising the taxation on non-cash benefits by the taxing them in the hands of the persons providing the service that gave rise to the non-cash benefit. This will reduce some of the compliance costs for employers; and
- consider simplifying the taxation of non-cash benefits by just targeting the major benefits widely offered as packaged benefits.

4.7 Are the current categorical distinctions for income support, including rates of payment and income tests, still relevant? If not, would other categories be better? What goals or principles should guide categorical distinctions and associated payment rates?

Refer to comments at point 4.4 above.

4.12 In a targeted system there is a trade-off between the level of income support and workforce incentives. Given this, what priority should be given to reducing the disincentives to work?

Determining a trade-off between the level of income support and workforce incentives could be well served by an appropriate use of income tax credits.

4.14 Does the tax-transfer system create disincentives for individuals seeking to acquire new skills or upgrade existing skills? If so, what sort of tax or transfer changes would provide better incentives?

There is often no support for the independent undertaking of upgrading of skills to meet new and emerging needs in the workplace. This can apply not only to the cost of higher education, which represents a barrier to educational improvement, but also to the time out necessary to undertake such further study. Employers often have no incentive to provide the time out if there is no foreseeable and direct benefit to the business. Employees can often ill afford the time necessary to undertake the further study given often competing demands for their time (child rearing and other community responsibilities). Skills training should also be fully tax deductible. Equity in this regard is essential to encourage effective workforce participation.

[13] Historically, every time Governments have attempted to strengthen the taxation of non cash benefits they have had to back down, e.g. (I) the former s 26AB introduced by Whitlam Government in the early 1970's to assess motor vehicle benefits was withdrawn as it effected many workers and union officials; and (II) the Fraser Government's s 26AAAA, which assessed taxpayers in respect of housing benefits, lead to mining strikes in late 1970's and another Government back down.

CHAPTER 5 THE RETIREMENT INCOME SYSTEM

5.1 In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?

Following the lodgment of the Taxation Institute's submission in February 2009 in response to the Australia's Future Tax System Review retirement income consultation paper, representatives from the Taxation Institute met with members of the Review Panel in Melbourne on 6 March 2009 to discuss our submission. Our comments set out below reflect and are consistent with our February 2009 submission in response to the above retirement income paper, particularly in respect of compulsory savings and support for the retirement income system through taxation and other concessions.

In terms of the objectives that are relevant in setting retirement income policy, Australia has consciously embarked on a retirement incomes system fundamentally based in self funding. A system based on self funding hands responsibility for retirement incomes to individuals and removes an entitlement mentality that a government pension based approach otherwise engenders.

In this context, the Taxation Institute believes that voluntary savings, along with a government provided Age Pension and compulsory savings enforced through Superannuation Guarantee (SG), provide an appropriate three pillar structure for ensuring retirement income security for Australians both now and in the future.

It is necessary that the three pillar system ensures there is an adequate level of income in retirement – something more than simple subsistence. Based on various actuarial studies done, this is likely to involve:

- a greater level of through working life contributions to superannuation; and
- an acknowledgement that there will be periods of non-work for many contributors due to a range of factors including child rearing.

Desirable system features to achieve this include:

- adequate contributions to superannuation, encouraging voluntary savings in addition to compulsory contributions through SG;
- education of the benefits of superannuation; and
- a greater focus on an incomes based retirement approach.

Whilst the SG is an integral part of the three pillar retirement income system, the Taxation Institute is concerned to ensure the level of compulsory saving does not have an unnecessary adverse impact on pre-retirement standards of living. In particular, the adequacy projections suggest a person working 35 years will have a reasonable saving but the difficulties arise for those with shorter or broken working lives. Simply raising the SG rate overall does not fix these problems, which should perhaps be dealt with through other methods including the social security system and further encouragement of voluntary savings. It will be important to have a safety net in the event that some still "fall through the cracks", as well as for the period until those who have significant periods of inadequate superannuation cover have been attended to. The Taxation Institute considers it important to maintain the equilibrium of the three pillars.

The taxation of superannuation funds will impact on the ability to provide the support required.

5.2 As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?

As noted in our February 2009 submission, retirement income system strategies to accommodate individuals in the groups indicated above, who are partially or fully excluded from the mature SG system, include:

- the use of co-contributions;
- increased scope for the deductibility of superannuation contributions; and
- allowing limited access to non-concessional contributions.

Co-contributions

The Taxation Institute supports the retention of the current co-contribution scheme and recommends that consideration should be given to allowing individuals to make "catch-up co-contributions" to encourage those who have been out of the workforce or otherwise on low or nil incomes for extended periods (for example due to parental leave) to access the co-contribution, so as to provide an incentive for those individuals to increase the level of their superannuation savings.

It may be necessary to impose limits on the period of time for which individuals would be entitled to make "catch up co-contributions". For example, it may be appropriate to limit the period to the time the individual was out of the workforce, or on low income. The "catch up co-contributions" should be made available beyond the current cap for co-contributions of $60,342 (for assessable income and reportable fringe benefits). It may be that an averaging of the individual's income be considered, say, over the preceding 5 years.

Deductibility of superannuation contributions

The Taxation Institute recommends a review of the deductibility rules for personal superannuation contributions, notably the requirement at section 290-160 ITAA 1997 that earnings as an employee must be less than 10% of the total assessable income plus reportable fringe benefits (the "10% rule").

This rule originated when the constraints on annual deductions did not involve a single personal cap. In particular, the 10% rule was intended to inhibit the use by each single individual of two deduction limits. With the introduction of universal annual limits that apply on a person by person basis, we maintain that the 10% rule is no longer necessary and adds a needless complication to the deduction rules.

If the 10% rule were abolished, individuals would be able to deduct personal contributions, subject to the remaining conditions set out at sections 290-155 to 290-170 ITAA 1997, and subject to the individual concessional contribution cap. As currently, notice of intention to claim a contribution would be provided to the complying fund's trustee and the amount under the notice would be aggregated by the ATO with other concessional contributions. No double dipping would result.

Additional benefits would arise.

For instance, equity concerns have been expressed that salary sacrifice arrangements are not universally accessible. Salary sacrifice arrangement rules are also subject to complex rules about "prospective" sacrifice and concerns about when an amount of earnings has already been derived. If individual deductions were not subject to the 10% rule, the individuals concerned would no longer need to enter into complex contractual arrangements with their employers to ensure deductibility of amounts in excess of SG minimum or other mandated amounts. They could seek a deduction for the additional amount through their personal income tax returns, and this would remove significant administrative complexity.

Further, this arrangement would remove much of the complexity of the new arrangements for reporting employer superannuation support in excess of the SG minimum, originally proposed in the Treasury Consultation Paper *Reforms to Income Tests*, and issued for public comment in November 2008. On the basis of removing complexity alone abolition of the 10% rule is imperative.

Access to non-concessional contributions

There is a significant disincentive or an inadequate incentive for taxpayers, particularly small business owners, to make non-concessional contributions to superannuation where it is then subject to preservation and cannot be generally accessed until preservation age.

Given the financial risks that taxpayers face over their lifetime there is a natural reluctance to put savings into a preserved and non-accessible environment notwithstanding that such savings may attract a lower rate of taxation.

We suggest that consideration be given to allowing access to non-concessional contributions by removing the release conditions that apply to those amounts. The earnings on those amounts should be required to be retained in the superannuation system and be subject to preservation; so these earnings are locked in to the superannuation system. We expect there may be significant growth in investments made into the superannuation system if such contributions were made accessible. The contribution limits provide a natural guard against taxpayers seeking to abuse such a facility.

5.3 Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some another alternative?

Refer to comments in 6.1 above.

5.4 What should the role of the government be in assisting individuals to meet their retirement income expectations in relation to the support provided by the Age Pension, the level of compulsory savings and incentives to make additional savings? Should the role of government change as an individual's income increases over their working life?

As minimum levels of superannuation savings need to be maintained over an individual's working life, the Taxation Institute believes there should be no change to the role of government in assisting individuals to meet their retirement income expectations, regardless of any increase in an individual's income earning capacity.

5.5 Do the settings of the retirement income system, such as the level of SG and access to concessions, adequately consider the needs and preferences of individuals both before and after retirement?

Whilst the SG is an integral part of the three pillar retirement income system, the Taxation Institute is concerned to ensure the level of compulsory saving does not have an unnecessary adverse impact on pre-retirement standards of living. Whilst we are aware of concerns that the current 9% SG is not set an appropriate level to provide sustainable retirement income into the future, as indicated in 6.1 above, we believe that simply raising the SG rate overall does not fix this problem, which should perhaps be dealt with through other methods including the social security system and further encouragement of voluntary savings.

With reference to access to concessions, refer to comments in 6.2 and 6.6.

5.6 Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are the current concessions properly targeted and, if not, how should they be reformed?

Current level of superannuation income tax concessions

As noted in our February 2009 submission, at times there has been criticism from certain sections of the community in respect of the assistance given to the superannuation system through the tax concessions provided. This criticism has been fuelled by the regular release by Treasury of estimates of the annual cost of providing these tax concessions. Many, however, believe that the estimates calculated by Treasury are overstated.

There is widespread support for a superannuation system under which the Federal Government offers assistance to individuals who wish to provide for their retirement through superannuation. Many in the community see the assistance offered as a prerequisite to saving through the superannuation system, due the inaccessibility of the savings for long periods of time through the preservation rules.

Prior to the current economic climate, the tax concessions afforded to the superannuation system had not unduly impacted the budgetary position of the Federal Government. Whilst there may be arguments for and against specific aspects of the tax concessions provided to the superannuation system, we believe that the current level of concessions is not unreasonable and needs to be maintained into the future. This is a case of short term pain for long term gain because it will ensure more people make provision for their retirement rather than relying completely on future government funded retirement.

Properly targeted concessions – greater incentive for lower income earners to save in superannuation

As noted in our February 2009 submission, whilst clearly a significant generalisation, there are broadly three groups of retirees:

- a group that will never have earned enough during their working lives to have made any significant retirement savings;
- a group that is already motivated by existing concessions to save; and
- a group that is not currently motivated by existing concessions to save but may be encouraged to do so if additional or alternative concession options are available.

Whilst the Taxation Institute believes that policy development needs to encourage all three groups to save through superannuation, we recommend at this stage that the review focus in particular on the third group listed above ('Target Group'), without removing the incentive for the second group to continue their valuable saving activity. This policy development could focus on three main areas:

- means testing;
- tax incentives; and
- non-tax incentives.

Means testing

Any form of means test in relation to an age pension presents a problem for those individuals who have the potential to exceed the income and asset levels over which the government funded pension is reduced.

Every additional dollar they save has the potential to reduce their government funded benefits without necessarily making the individual any better off in retirement. This issue is most relevant for the Target Group.

Given the fact that government funded benefits will be lost as a result of additional savings by the Target Group, the financial and other incentives required in order to lift their savings rate must be very significant.

The fact that the Target Group are relatively poor savers is a possible indication that the current incentives are insufficient to redress this problem.

Commentary on superannuation policy too often focuses on the cost to revenue of providing superannuation tax concessions, but there are clearly even more significant longer term and enduring revenue benefits to be had from encouraging more Australians to fund their own retirement and relying less on government provided benefits. These revenue benefits must also be included in any analysis of this issue.

Tax incentives

Currently a contribution tax is levied on concessional contributions at 15%. The Taxation Institute is concerned that this rate of tax is too high in relation to the Target Group, particularly if most individuals within this Group pay a 30% rate or less on their personal incomes. The 15% (or less) tax differential between personal income and a concessional superannuation contribution is an insufficient incentive to make up for the fact that the additional saving will reduce the Target Group's government provided benefits and be locked away in superannuation until preservation age.

We believe that policy measures are required in order to increase the tax incentive for the Target Group. We suggest that consideration be given to:

- providing a form of taxation rebate that might be offered to employees where their total taxable income for a financial year attracts a personal marginal rate of taxation of less than 15%. Currently that would apply to any person earning less than $34,000 per annum. This type of rebate would remove the disincentive currently faced by these employees to receive remuneration by way of additional employer contributions. It may be particularly important if consideration is being given to the introduction of soft compulsion or increasing the superannuation guarantee rate; and

- increasing the current level of co-contributions.

Other incentives to encourage voluntary superannuation contributions

Tax concessions are not the only way to encourage the Target Group to make additional savings. In order to encourage personal retirement saving, we believe the preservation age for voluntary superannuation contributions (ie, non-concessional contributions and contributions in excess of SG) must be set at an age significantly less than the age pension age.

In our view, any move to align preservation age for voluntary superannuation contributions with the age pension age will have a negative impact on all voluntary superannuation savings. We also suggest that:

- in order to prevent abuse of this differential that any benefits taken before age pension age must be taken in the form of a non-commutable income stream (eg, a term allocated pension), noting that any disincentive to this as a result of the application of bankruptcy laws will need also to be addressed; and

- the link between retirement from the work force and the ability to access superannuation at preservation age be removed entirely in relation to any non-commutable income stream. This principle has already been established in relation to transition to retirement pensions but does not apply to term allocated pensions.

The above measures will:

- encourage additional savings (because they will be accessible before retirement age);

- not result in any "double dipping" because the additional income stream is non-commutable; and

- not result in any additional losses to the workforce, as there is no link between retirement and the ability to access non-commutable income streams once preservation age has been reached

5.7 At what age should an individual be able to access their superannuation and at what age should they become eligible for the Age Pension?

As noted in our February 2009 submission, the recent Simplified Super changes removed the taxes on most superannuation benefits received by individuals on and after their 60^{th} birthday. The Taxation Institute supports the general thrust of most superannuation benefits being tax free after a certain age. The change has had a positive impact on the community's perception of the superannuation system and, over time, will result in significant simplification of the system and cost savings to participants.

Over the years, there has been much debate about the trend of retirement ages. For many years, the belief was that the trend was very much towards retirement at younger ages. However, over recent years and in the current economic climate, many believe that sentiment has changed and the trend is now for longer participation in the workforce.

The age at which most superannuation benefits become tax free, whilst consistent with the long term preservation age, is inconsistent with the retirement age for age pensions:

- the age pension age is currently 65 for males and 63.5 for females. The latter is scheduled to increase to age 65 by 1 January 2014; and

- the current preservation age in the superannuation system is 55 for all members and this is scheduled to increase to age 60 by 1 July 2024.

Subject to our comments in relation to non-concessional contributions and contributions in excess of SG in 6.6 above, we believe that consistency across the various ages may be an appropriate long term goal for all compulsory SG contributions, any lump sum payment and the government provided age pension. This would result, over time, in increases in the preservation age and the age at which most superannuation benefits become tax free.

5.8 What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings?

While the imperfections of financial markets have been shown up in recent times, there is no real viable alternative for the investment of retirement funds. The inadequacies of the financial markets needs to be addressed through appropriate supervision and regulation rather than changing the basis of investment for retirement. The government's role should be focused on regulating, controlling and supporting the financial system.

5.9 In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?

The Taxation Institute acknowledges changes to the tax treatment of retirement superannuation have greatly reduced complexity for retirees.

However, as indicated in 6.6, the Taxation Institute is concerned about the need to alleviate current levels of complexity around contributions for lower income earners to encourage voluntary savings in this group. As low income individuals pay a 30% rate or less on their personal incomes, the 15% (or less) tax differential between personal income and a concessional superannuation contribution is an insufficient incentive to make up for the fact that the additional saving will reduce government provided benefits and be locked away in superannuation until preservation age.

As noted above, we recommend a form of taxation rebate that might be offered to employees where their total taxable income for a financial year attracts a personal marginal rate of taxation of less than 15%. Currently that would apply to any person earning less than $34,000 per annum.

This type of rebate would remove the disincentive currently faced by these employees to receive remuneration by way of additional employer contributions.

5.10 The Age Pension serves two roles, as a safety-net for individuals who are unable to sufficiently save for their retirement and as an income supplement for many individuals who do save. What should be the role for the Age Pension and means testing in a future retirement income system and what impact does this have on its sustainability into the future?

The Taxation Institute believes that voluntary savings, along with a government provided Age Pension and compulsory savings enforced through Superannuation Guarantee (SG), provide an appropriate three pillar structure for ensuring retirement income security for Australians both now and in the future. In this context, the Age Pension should continue to serve both as a safety-net and income supplement for appropriate individual both now and into the future.

5.12 What impact could financial intermediation have on the effectiveness of retirement income policy?

Given the complexity of the superannuation environment, the Taxation Institute supports the need for individuals to seek financial intermediation from appropriately qualified advisers, subject to the qualification that this intermediation should not extend to tax advice and services regulated by the *Tax Agent Services Act 2009*, unless the financial intermediary is also appropriately registered to provide these tax services.

CHAPTER 6 TAXING BUSINESS AND INVESTMENT

6.1 Can the tax system be structured to better attract investment to Australia in a way that increases national income, and if so how? For any given revenue outcome, what are the relative merits of broader base/lower rate (comprehensive income tax) or narrower base/higher rate (a narrow income tax or an expenditure tax) approaches?

From the point of structuring the tax system to attract investment to Australia, the Taxation Institute is concerned that any increase in the overall corporate sector tax burden makes Australia less competitive on a comparative basis with other industrialised economies, particularly where Australia's corporate tax base is broader than many of those countries.

The Taxation Institute believes that there is scope for considering a reduction of Australia's current corporate rate in the context of a comparison with other industrialised economies in particular. Structuring the tax system to increase national income at the same time as attracting investment to Australia is a matter of balancing the benefits of a reduced corporate tax rate applied to an appropriately broad base with the anticipated inflow of additional income.

6.2 What changes, if any, to the tax system would improve the ability of Australian companies to operate internationally orientated businesses? How should the tax treatment of companies and shareholders be integrated in an open economy?

As noted in the Taxation Institute's 20 October 2008 submission in response to the AFTS Review Panel's invitation on 19 August 2008 for public submissions, Australia currently has a relatively high dependence on company income tax as part of its revenue base. However, the current complexity of the corporate tax regime has generated large levels of uncertainty in business transactions, with detrimental effects on both the ability of Australian companies to operate efficiently, profitably and cost effectively and on foreign investors seeking to invest in Australia. Given the complexity, lack of certainty and the perceived arbitrariness of the outcomes of the corporate tax laws, it is not uncommon to find potential foreign investors seeking to invest in other jurisdictions where tax laws are less arbitrary and carry less compliance costs.

There are three broad options for addressing these corporate taxation challenges:

- simplify the taxation of companies by exploring the possibility of a flow through taxing system for companies that is broadly consistent with the taxation of partnerships and trusts, with tax levied at the appropriate level of earning (e.g., at shareholder level) either directly or via withholding taxes. However, in exploring a flow through taxing model for companies, the Taxation Institute recognises that one major impediment is the current treatment of foreign residents where the focus has been on reducing withholding taxes through both domestic law and double tax treaty changes. Therefore, the adoption of this change would require the reintroduction of various withholding taxes;

- if companies remain as taxable entities, consider whether or not to maintain the current imputation system. Whilst we recognise that international developments show a move away from such systems, the Taxation Institute believes there needs to be good cause to make any changes to the dividend imputation system – it is supported strongly by Australian investors, aids in reducing corporate tax minimisation, achieves equity by eliminating double taxation and is an essential component of the design of our current system for taxing superannuation funds;

- if dividend imputation is maintained, there are a number of other key options that need to be explored:

- o review the current headline rate of Australian company tax in an international context to maintain our international competitiveness as a destination for foreign investment; and
- o review the current appropriateness of the corporate tax base to ensure that there are not inherent inefficiencies and distortions that drive inappropriate corporate practices (e.g., ensure current capital allowances reflect the value experienced in the market place, review the treatment of goodwill, assess the appropriateness of current capital management rules, review black hole expenditure, and consider providing for loss carry-backs, currently a major point of departure with a number of Australia's key trading partners).

6.6 Should the tax system be structured to cater for the specific circumstances of small business, and if so, how?

The Australian taxation landscape has never really come to terms with the concept of what it means to be a small business compared with small to medium sized businesses and larger businesses. There is a range of different definitions depending upon the policy objective. Whilst various attempts have been made by successive governments to demonstrate that they have an understanding of what a small business is, tax initiatives in the SME sector have been ad-hoc and reactive in nature. This has contributed to policy makers inadequately identifying and targeting relevant tax concessions in this sector. Previous legislation to standardize the eligibility criteria for small business tax concessions was a step in the right direction. However, what is clear is that a change in approach is well overdue.

It is recommended that in the medium to longer term, it would be beneficial to have agreed definitions not only around the term SME, but also its various sub-sets (eg micro-business, entrepreneur etc) and tax policy set accordingly.

The importance of the SME sector to the Australian economy means that economic policy must take into account the impact on SMEs and that SME specific policies must be developed in a co-ordinated and logical manner, with the emphasis being on moving towards the development of appropriate medium to longer term SME tax policy.

As a guide, when setting tax policy for Australian SMEs, it is recommended that further research and analysis be undertaken in relation to the following matters, amongst others:

- Lowering the overall tax burden. Many OECD countries have lower corporate tax rates for small firms. As a general proposition, a company that pays a regular dividend to its shareholders owners/investors, irrespective of the stock price, will always be viewed favourably by prospective investors. This is equally true of both large and small companies. Shareholders reap the benefits of receiving cash dividends on a regular basis, and the presence of dividends will help support the market value of the company that is being built.

- Tax policy should assist SMEs maintain profitability whilst also easing cash flow burdens. In this regard, any proposed changes to the Dividend Imputation regime should take into account any adverse commercial and tax implications for SMEs. This could be also achieved by encouraging the retention of taxable profits. In this way, profits may be reinvested into the business by SME owners helping to establish a capital base, instead of using the monies personally. The implications for SME owner remuneration will need to be considered as part of this process.

- More focused approach on developing appropriate SME tax strategies rather than tax compliance. The tax system should be able to provide a framework to both encourage people to take the risk and start up a business, as well as providing further incentives along the way to those who succeed in their ventures. This involves having a more detailed understanding in relation to the composition of the SME sector, as well as the potential impact that changes in tax policy may have.

- Increase investment tax incentives and initiatives for SMEs. These types of initiatives more strongly influence SME investment decisions vis-à-vis larger businesses.

- Increase management and employee tax participation incentives. In particular, increasing the tax free movement of capital when introducing new people into the business via share plans. Currently, this is stifled by Australia's CGT General Value Shifting provisions.

6.7 Should the tax system be restructured to deliver a more neutral tax treatment for the different forms of return on household savings and investments, and if so, how?

As noted in the Taxation Institute's 20 October 2008 submission in response to the AFTS Review Panel's invitation on 19 August 2008 for public submissions, the taxation of savings under Australia's current tax regime is distorted because of different tax treatments for different forms of saving. For instance, currently the tax regime effectively encourages the acquisition of capital assets (shares/land) and investment in superannuation over saving through interest bearing accounts.

Whilst the Taxation Institute is not advocating that the tax treatment of forms of saving other than interest bearing savings accounts should be changed, we believe there is a need to broaden the tax effective options for saving by improving the taxation of interest bearing savings accounts. This issue has now assumed more significance in the current troubled financial environment.

CHAPTER 7 NOT-FOR-PROFIT ORGANISATIONS

7.1 What is the appropriate tax treatment for NFP organisations, including compliance obligations?

In addressing the broader tax reform agenda, it is important that any proposals for reform do not result in a paradigm shift that undermines or dilutes the non-profit *raison d'étre* and community oriented service ethos of genuine NFP organisations to the detriment of community at large.

In considering the appropriate tax treatment of NFP organisations in this context, there is a fundamental issue currently about whether and to what extent such an organisation can carry on a business.

From a policy perspective, if you are going to pursue a market oriented solution to the appropriate tax treatment of a NFP organisation, it is about balancing the realisation of competitive neutrality and tax equivalence amongst NFP organisations and other organisations and the broader business community. In a perfect world, the relationship between these bodies should be on equal terms, particularly where the core business and the purpose of the organisations coincide. However, the Taxation Institute is concerned that this type of approach needs to be applied with caution across the NFP sector.

Any appropriate tax treatment needs to reflect that there is a genuine distinction between the activities of an NFP organisation, which conducts its activities and services as a direct consequence of its non-profit community orientation rather than a profit making motive, and other entities running businesses where services are provided that are driven primarily by a profit motive that is the basis of all business decisions made by that entity.

On this basis, the Taxation Institute believes that NFPs should be allowed to carry on a business and that the tax system needs to support genuine NFP organisations and philanthropic activity.

7.2 Given the impact of the tax concessions for NFP organisations on competition, compliance costs and equity, would alternative arrangements (such as the provision of direct funding) be a more efficient way of assisting these organisations to further their philanthropic and community-based activities?

Subject to our comments in 7.1 above, the Taxation Institute acknowledges the argument that there is scope for limiting access to the concessional tax treatment of the business activities of an NFP organisation that are not a core activity of the reason for being an NFP organisation. For example a religious organisation that carries on a breakfast cereal and food product business. However, this suggestion would be difficult to achieve in practice across the NFP sector. This difficulty is illustrated by a University, which also conducts non-core activities such as bars, accommodation and conference facilities, sporting clubs, investments in land, and research companies.

If the NFP has gift-deductible status, in general terms, there is little difference between the NFP carrying on the business directly and the NFP owning a company which carries on the business but which makes annual tax deductible gifts to the NFP. The only likely difference is getting the amount of the gift correct (assuming that gifts in excess of taxable income will not give rise to a carry forward loss). But on the basis that the NFP can re-contribute the excess to the company or the company has sufficient reserves to enable it to make the gift, there is very little difference between the two. There is a permanent difference if the NFP does not have gift deductible status.

CHAPTER 8 COMPLEXITY — COST, RISK AND TRANSPARENCY

8.1 Which taxes or transfers are the most complex and impose the greatest costs? How should these costs be reduced (by abolishing the taxes or transfers or by making the rules applying to them simpler)?

Refer to comments at 1.1 and 1.2 above.

8.2 In what ways might the administration of Australia's tax-transfer system be changed to better meet the needs of individuals and businesses? How might the process of personal income tax returns be simplified, including by removing the requirement for some taxpayers to lodge returns? Should the administration of the system be more integrated (across taxes and transfers and between jurisdictions)? How might advances in technology assist?

Refer to comments at 4.1 – 4.16 and 6.1 – 6.7 above.

In relation to the simplification of the process of preparing individual tax returns through the use of technology, the Taxation Institute has worked in consultation with the ATO in the recent past on the use of pre-filling of tax returns. Whilst Australia's capacity for effective pre-filling of tax returns is constantly expanding, in terms of its administration, unlike a number of other countries where pre-filling (pre-population) has evolved in a structural way over 20 years with legislative amendments to support its adoption, pre-filling in Australia has been grafted on to the current tax system with a number of administrative difficulties. There is a need to review the administration current use of tax return pre-filling with a view to identifying and implementing international best practices in this area that minimise any potential reverse work loads on taxpayers and their tax agents.

8.3 To what extent might policy objectives be traded off to achieve a simpler system? In what areas should efficiency, equity or choice be traded off for simplicity?

Simplicity may not always prevail but must be seriously considered and where appropriate have a greater weight.

8.4 How could the governance of the tax-transfer system be reformed to reduce complexity, uncertainty and cost, and to improve transparency, understanding and support for the system?

Refer to comments at 1.1 and 1.2 above.

CHAPTER 9 STATE AND LOCAL TAXES AND TRANSFERS IN THE AUSTRALIAN FEDERATION

9.1 Noting the overall structure of Australia's federal financial arrangements, what changes, if any, should be made to the assignment of revenue raising powers and intergovernmental transfers in Australia?

As stated in the Taxation Institute's 20 October 2008 submission in response to the AFTS Review Panel's invitation on 19 August 2008 for public submissions, the Taxation Institute is concerned that the current Federal-State tax divide unnecessarily impacts adversely on many taxpayers, particularly those in businesses operating across State borders that are affected by too many taxes imposed at various levels of government. Key concerns here are complexity and the cost of complying with various levels of taxes.

Whilst there is a need to continue the harmonisation of States taxes (such as stamp duty and payroll tax) and to remove inefficient and "nuisance" State taxes, one of the key causes of complexity and upward pressure on costs of compliance is how State taxes are administered and collected.

Furthermore, it is desirable for tax and spending obligations to be transparent and fairly balanced. Each level of government should raise or receive revenue on an agreed basis and should be accountable to its citizens in spending the money or share of taxes received to provide the services for which it is responsible or has a mandate.

9.2 Given the widely held view in submissions that the current state tax arrangements need to be reformed, what changes should be made to state and local government own source revenue instruments? What scope is there for greater use of user charging to bring social, environmental or economic benefits?

User charging models recover costs for services provided. They are not a tax and should not be used as a mechanism for mere revenue raising.

Whilst there is scope for States to generate own source revenue through user charging, this needs to be carefully balanced with the role of governments to pursue social policy goals, which may necessitate effectively under-pricing the goods and/or services provided under the user charging model. A State or Local government's ability to pursue social policy goals should not be compromised by the user charging model unless other reliable mechanisms are in place to pursue these goals.

9.3 What is the appropriate allocation of the roles of the Australian and state governments in income redistribution?

Refer to comments in 9.1.

9.4 What opportunities could be pursued to deliver more seamless administrative arrangements of the tax-transfer system across the federation?

Options to address the current model for the Federal – State tax divide include:

- a standard administrative and legal structure for State taxes administrated by the Commonwealth (for instance, the Commonwealth having administrative responsibility for the common taxes levied by all States and Territories such as payroll tax);

- replace State and Territory taxes with a uniform income tax surcharge; or
- if State and Territory taxes remain, grant States and Territories access to additional Federal funding through further tax sharing (for instance, through allocating part of company tax); and link this funding to enforceable commitments to eliminate inefficient State taxes and improving service delivery.

If any proposed tax reform entails conferring a new revenue-raising power on the Commonwealth, or on the States (or the Territories), the constitutionality of such a measure ought to be considered by the Review Panel. Before the Review Panel recommends a particular tax reform which would involve an extension to the tax base of the Commonwealth, or of the States, the Panel should consider whether there may be any constitutional impediments to such a measure. The recent High Court challenge to the constitutionality of the "Tax Bonus" payments (the stimulus package) after the payments had been announced is an example of the difficulties which can be created if changes to fundamental taxation arrangements are not subjected to a constitutional "stress test" before they are adopted by the relevant government[14].

If any shift in taxing powers is to be considered by the Panel, the Panel must consider how, or whether, any such changes could be "entrenched" and how the Commonwealth can prevent any State from imposing its own separate tax, or surcharge. This could involve a referral by the States of their law-making functions or by an "intergovernmental agreement" to be entered into by the Commonwealth and the States.

14 *Pape v Commissioner of Taxation of the Commonwealth of Australia*. Transcript of argument at [2009] HCATrans 59, 30 and 31 March 2009.

CHAPTER 13 TAX-TRANSFER IMPACTS ON THE ENVIRONMENT

13.1 Bearing in mind that tax is one of several possible instruments that can address environmental externalities, what opportunities exist to use specific environmental taxes to address Australia's environmental challenges?

In Europe a range of eco-taxes have been introduced on coal, natural gas, electricity, gasoline, diesel fuel, car taxes (including registration tax, vehicle excise duty, ownership fees, countervailing charges, insurance liability duties, road taxes, vehicle excise duty, green owner tax (based on fuel consumption), and "distance-and-weight-based tax on heavy vehicles") and in respect of land fill and plastic bags. However, given the everyday dependence on energy products (oil derivatives and electricity), demand for them is non-elastic[15] and the taxes regressively affect the household income, regardless of the method of imposing such taxes.[16]

In general the revenue raised from these taxes has been applied to industry, in the form of investment aid for energy preservation or through the reduction of employers' social security contribution. This tax shift moderates, but it does not eliminate the regressive effect of ecotaxes.[17]

The Australian experience is similar with the revenue generated from petroleum excises being applied to consolidated revenue save some support to industry through fuel offset schemes (eg the Fuel Tax Credit Scheme). Other environmental taxes such as landfill fees etc are used for general local government purposes.

Given the non-elasticity demand, the effectiveness of such taxes in meeting their environmental objects is not clear. This is partially due to industry exemptions, offsets and community compensation methods. Therefore it is difficult to mount an argument for an expansion of such taxes (blunt instruments) beyond the proposed Carbon Pollution Reduction Scheme.

13.2 Noting that many submissions raise concerns over unintended environmental consequences of taxes and transfers, such as the fringe benefits tax concession for cars, are there features of the tax-transfer system which encourage poor environmental outcomes and how might such outcomes be addressed?

The ABS 2007 Motor Vehicle Census (MVC) indicates that the total number of registered motor vehicles on Australian roads as at 31 March 2007 was 14,774,921.[18] However the number of cars that are salary packaged show that a mere 35,980 cars used the statutory formula method, (and just 16,590 cars used the alternative method – the operating cost method).[19] Therefore, the removal of the FBT concession for cars or the modification of the statutory formula would do little to reduce Australia's overall GHG emissions profile. [20] Although green house gas reduction is incremental given:

- the relative low levels of emissions arising from FBT vehicles;
- that FBT concession gives rise to a fleet of new well maintained vehicles which produce less pollution; and

15 OECD, *The Political Economy of Environmentally Related Taxes* (2006), 50-51.
16 Monika Milošević and Miloš Milošević, "Taxes as the environmental gate-keepers: Towards a polluter pays tax system" presented to the 21st Australasian Tax Teachers Conference, Christchurch, 20 January 2009.
17 Milošević ibid.
18 Australian Bureau of Statistics, *2007 Motor Vehicle Census,* 9309.0, (31 March 2007).
19 Australian Taxation Office, *Taxation Statistics 2005-06*, Table 6: Fringe benefits tax - Selected benefit items, 2003-04 to 2006-07 FBT years
20 Hope Ashiabor, "Dismantling the Fringe Benefits Tax Concession for motor vehicles as a response to managing Australia's Greenhouse Gas Emissions Reduction Strategy: An effective solution or a mere pipe dream" presented to the 21st Australasian Tax Teachers Conference, Christchurch, 21 January 2009.

- the increase in compliance costs from both the removal of FBT or the statutory method;[21]

changes in this area will be at best symbolic.

There exists a range of other more costly concessions which create greater levels of carbon pollution. Examples include the $2.39 billion New South Wales' Cash Back Scheme (where the State Government reimburses commuters for tolls paid on the M4 and M5),[22] and the reduced import tariffs for the importation of less fuel efficient 4WD vehicles.[23] It is these concessions that deserve closer scrutiny.

13.3 Given the environmental challenges confronting Australian society, are there opportunities to shape tax-transfer policies which do not currently affect the environment in ways which could deliver better environmental outcomes?

In order to achieve greenhouse gas emissions reduction policy objective, there is a need to do more than introduce the CPRS to encourage behavioural change and investment. This is particularly so if the tax outcomes result in expenditure on permits rather than reduction of emissions, which is what is needed.

> For example, if a business has $100 to spend and may either use it to acquire permits or make improvements to its plant so as to reduce emissions of greenhouse gasses, the business will question how it should spend its money. If hypothetically, that expenditure would either fund the cost of a permit or reduce emissions by the quantity covered by the permit, then the question is what expenditure delivers the best financial outcome. If a full deduction on acquisition of a permit is allowed but the expenditure on improvement of the plant does not give rise to an immediate deduction, but is recognised over a period of time, then the business may question why it should spend its money reducing carbon emissions when it can acquire a permit and get an immediate deduction.

Unless the entire tax treatment has been thought through, the very policy objects of the scheme may be compromised. This process is incremental involving both clarification of the current law and policy objectives in a future system. Therefore, tax policy should encourage and facilitate early abatement activities, rather than inhibit. This involves ensuring that:

- there are no black holes in respect related to abatement activities;

- indirect taxes (such as GST, and excise and State/Territory taxes) do not contain disincentives to early abatement;

- there is a concessional treatment of equipment and investment in alternative energy production (such as geothermal), other clean technologies and the developing carbon sinks such as biosequestration (carbon sink forests) or geosequestration (carbon capture and storage); and

- voluntary climate change response activities are supported.

Similar approaches are also needed in respect of water conservation and land degradation.

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21 Ashiabor, ibid.
22 Linton Besser, "Billions blown in tolls fiasco", Sydney Morning Herald 31 December 2008, cited in Ashiabor ibid.
23 Under the *Customs Tariff Act 1995* (Cth) Customs Act, the applicable rate of import duty for "off-road and 4WD" vehicles and their component parts is 5 per cent, whilst the standard rate for other passenger vehicles is 10 per cent, cited in Ashiabor ibid.