Henry Tax Review Consultation Paper

Executive Summary

CPA Australia represents the diverse interests of more than 122,000 finance, accounting and business advisers worldwide. We are committed to working with governments and their agencies to ensure economic and social policies foster an environment that facilitates sustainable economic growth. We have been a contributor to public policy on a range of fronts including tax for decades. Recent submissions by our organisation on issues relevant to the Henry Review include those relating to the 2020 Summit, the Review of the National Innovation System, our initial submission to the Henry Review, the CPRS and our recent 2009-2010 pre-budget submission. Other submissions include those on the Tax Agent Services Bill as well as those to relevant government agencies such as the Board of Taxation, Inspector-General of Taxation and, of course, the Australian Taxation Office. We are also active in making submissions to various state governments and their agencies including pre-budget submissions and submissions on state tax reform as well as others dealing with state revenue legislation and administration matters.

In this regard, we welcome the opportunity to contribute to the Henry Review's thinking on tax reform. This submission has been developed on behalf of the organisation with member input particularly though our member committees, including our Taxation Centre of Excellence and the National Tax Practice Committee. The submission provides comments and recommendations where possible on the majority of the questions raised in the consultation paper.

Some key messages are follows:

- CPA Australia believes that, as an aspirational goal, Australia's tax to GDP ratio should be reduced below 30% (inclusive of the Superannuation Guarantee Charge) as compared to its level at end 2007/08 of 30.8% (on an SGC exclusive basis)
- personal tax reform must continue including further reductions in income tax rates in line with the government's previous commitments together with a focus on reducing effective marginal tax rates (EMTRs)
- we continue to support taxing fringe benefits in the hands of employers but the existing legislation needs to be significantly simplified to reduce compliance costs for employers, particularly SMEs
- we support the current approach of providing health and aged care to older Australians through the health sector but these costs should be taken into account when determining the appropriate retirement savings targets and at what level the safety net of the first pillar should be set
- the company tax rate needs to be reduced and we suggest initially to 25% but a longer aspirational term target of 20% to ensure that Australia remains an attractive location for foreign investment
- taxes on capital income – interest, dividends, rents and capital gains – should be reduced in line with the company tax rate to encourage increased savings and investment, subject to a cap to ensure equity for lower income earners
- the CGT small business concessions should be retained to provide incentives to individuals to start their own businesses and help fund their future retirement with consequent reduced pressure on the public purse
- while we do not see a compelling case for a move away from the existing dividend imputation system at this stage, we support further work on the existing system in

conjunction with other potential company tax models in the context of the current review to ensure that the Australian economy remains internationally competitive

- we support moves to achieve a more neutral treatment of the different forms of return on personal savings/investments to the extent that this is feasible such as via our proposal for a flat/capped tax rate on capital income
- there does not appear to be any single answer to reducing excessive complexity in the existing business tax regime, but a statutory regime for the taxation of certain trusts and an increase in the existing de minimis threshold for SMEs under the new TOFA legislation would be a useful start
- there is little scope for reducing the number of individual income tax returns due to the increasing complexity in this area particularly in respect to work-related expense (WRE) deductions, the growing range of investments held by individual taxpayers and the growth in the proportion of the total workforce who are self-employed
- we broadly support the current tax treatment of not-for-profit organisations although we note that that current FBT exemptions for relevant charities appear to be overly complex and this should be addressed via a major rewrite of the current FBT legislation
- state tax reform is necessary to enhance economic growth and increase the sustainability of state governments while also recognising the need to address the current vertical fiscal imbalance (VFI) problem to the extent practicable
- housing policy in Australia seems to be broadly successful but existing assistance to low income earners should be closely monitored to ensure that it is adequate and effective, particularly in the retirement income context
- the existing taxation of alcohol and tobacco seems broadly appropriate because they appear to be generally efficient, but we do not support taxes on luxury goods as they give rise to additional complexity and are inconsistent with the role of the main broad based taxes of GST and income tax
- we support the retention of fuel excise as an efficient means of raising revenue, but its future role should be considered in the context of the taxation of the transport sector generally including the impact of the proposed CPRS and other related imposts such as road user and congestion/time of day charges
- given the target set by the government to reduce Australia's greenhouse gas emissions and the coverage of the proposed CPRS, complementary policy measures including tax measures accessible by all businesses are required as part of a wider approach to emissions reductions, and
- it may be appropriate for Australia's current resource taxation arrangements to be reviewed to more closely align them with trends in other jurisdictions, such as greater use of profit based royalties imposed at lower/more flexible rates where appropriate.

CPA Australia Responses to Henry Tax Review Consultation Questions

1. Challenges and opportunities for reform

Question 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?***

As per our earlier submission to the 'Review', CPA Australia considers that the key features for the design of a modern tax-transfer system for Australia should be as follows:

- the design of the tax system should be consistent with the traditional principles of equity, simplicity (or eliminating unnecessary complexity) and efficiency (or neutrality), and also result in a robust and stable revenue base
- the tax system should support Australia's international competitiveness and support a growing and vibrant business sector, and minimise the tax administration burden on all businesses
- the tax-transfer system should, to the maximum extent possible, be consistent with broader government policy objectives in areas such as climate change, the proposed Carbon Pollution Reduction Scheme (CPRS), population policy, globalisation and technological change
- the design of the tax-transfer system should endeavour to minimise distortionary effects on behaviour, including workforce participation, rates of saving, and engagement in entrepreneurial and commercial activities.
- where the design of the tax-transfer system involves making trade-offs between competing policy objectives, this should be done in an open and transparent way
- the design of the tax-transfer system should satisfy the certainty criterion but also be flexible so that it can adapt to changing domestic and international circumstances
- to the maximum extent possible, the most inefficient of taxes levied by the commonwealth, state, territory and local governments should be removed
- the current imbalances between the spending responsibilities and revenue raising powers of the Commonwealth and the states (VFI) should be addressed in a way that is simple, transparent and provides sufficient certainty for both levels of government, and
- appropriate incentives should be given to the states to improve efficiencies in service delivery, ease compliance burdens and duplication of effort for taxpayers and to remove inefficient taxes.

Question 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?***

We believe that Australia's tax to GDP ratio should be maintained below 30% (inclusive of the Superannuation Guarantee Charge or SGC) as compared to its level at end 2007/08 of 30.8% (up from 30.5% in 2006/07) on an SGC exclusive basis. While the SGC is not officially classified as a tax it should arguably be included in inter-country tax burden comparisons since it is a compulsory impost on employers (equivalent to around 4% of GDP) and its exclusion may distort comparisons with other countries which fund retirement pensions, etc. from hypothecated taxes. Accordingly, we would support appropriate measures to achieve the above objective as an aspirational one over time, in conjunction with the current aim of a balanced budget over the forward estimates period, including by promoting faster economic growth than public spending growth.

Such measures could include the following:

- continuation of the current/proposed personal tax reform program including addressing the effective marginal tax rate (EMTR) problem
- a reduction in the existing company tax rate to 25%, with further reductions over the medium term to 20%, and
- taxing income from capital (interest, rent, capital gains and dividends, etc) at a flat (capped) rate of 25% (and subsequently at 20%) consistent with the company tax rate in the hands of individual taxpayers (unless a lower marginal or concessional rate is otherwise applicable).

However, taxing dividends under such a flat and capped rate arrangement could entail some additional complexity under the current dividend imputation system.

An alternative option to reducing the company tax rate could involve a narrowing of the company tax base to achieve a similar reduction in the company tax burden along the following lines:

- providing a deduction for purchased goodwill
- introducing tax rules allowing a limited carry-back of tax losses
- providing Australian investors a 20% tax credit on any unfranked dividends sourced from taxable offshore profits or alternatively removing the current restrictions on dividend streaming arrangements, and
- a range of measures to encourage appropriate behavioural change in respect to reducing carbon emissions and achieving environmental sustainability.

Our preference though is for the first approach above given that it facilitates a reduction in the tax on capital income and thus encourages increased savings and investment, and brings us more into line with other OECD countries in this area.

2. The structure of the tax-transfer system

NB. No consultation questions in this chapter.

3. **The revenue mix**

Question 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?

CPA Australia considers that the major problems arising from the current mix of taxes in Australia on business and labour income, consumption, transactions and assets are as follows:

- the excessive taxation of capital income vis-à-vis other OECD countries, including particularly the over-reliance on revenue from company taxation
- Australia's lower share of tax revenue from labour income and our lesser reliance on consumption taxes (particularly broad-based consumption taxes) than other OECD countries
- complexity of the Australian tax system as reflected both in the policy and legislation areas and exacerbated by the excessive number of inefficient taxes levied across the various (Commonwealth/state/local government) taxing jurisdictions
- lack of neutrality in the tax treatment of capital income as reflected in the differences in the treatment of superannuation, owner occupied homes, rental properties, listed shares, interest bearing securities and bank deposits
- these differences are further accentuated when the tax regimes for different holding entities (companies, partnerships, trusts, etc) and different financing decisions are taken into account
- large number of inefficient taxes (particularly duties on property conveyances/transfers and insurance contracts) at the state level including variations between the states in respect to such taxes and their administration
- complexity of Australia's current arrangements for the taxation of international transactions involving both residents and non-residents
- the complexity of Australia's transfer system due to the wide range of benefits available and the nature of their interaction with the tax system including the provision of 'welfare' type benefits through the tax system and the high effective marginal tax rates (EMTRs) applicable to many transfer recipients, and
- the use of the tax system for purposes other than raising revenue (as reflected in the current level of tax expenditures) such as to pursue social policy, industry assistance and/or environmental objectives.

Proposed changes/reforms required to address the abovementioned issues are also discussed in our earlier submission to the Henry Review[1]

Question 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 Australian tax system does not tax the returns to savings (investment income) on a neutral basis, for example:

- realised capital gains arising from the sale of shares, property, etc. are generally taxed in the hands of individuals under the existing discount arrangements except where derived through a company where they are either taxed at 30%, or at relevant personal marginal rates in the hands of individual shareholders where the gains are distributed to shareholders as dividend income

[1] CPA Australia, Submission on Australia's Future Tax System Review, October 2008 https://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FECB-CAC118B2/cpa/hs.xsl/14131_30770_ENA_HTML.htm

- dividend income is taxed to individual shareholders on a receipts basis at their personal marginal rates under the current dividend imputation system

- interest income is taxed in the hands of individuals when received at their personal marginal tax rates (although the new TOFA regime will tax interest on an accruals basis in the hands of certain taxpayers), and

- rental income from property is taxed on a receipts basis as per interest income

The returns to savings/investments can also be impacted by other taxes including state asset and transaction based taxes such as stamp duties on real property transfers and land tax.

Question 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?

CPA Australia believes that the inefficient state/territory duties on business real property transfers should be removed as part of a wider reform of existing state/territory tax taxation arrangements, as discussed in more detail (see our response to Question 9.2) in this submission. The existing generous treatment of owner-occupied residential property under existing Commonwealth pension, etc. means testing arrangements would also appear to warrant review at an appropriate stage. For example, such property is currently disregarded in determining eligibility for income support purposes so that a person with a multi-million dollar house could still qualify for the age pension or related benefits.

Question 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?

As Australia already relies more heavily on taxes on specific goods and services (including alcohol, tobacco, luxury cars, fuel, motor vehicles and gambling) than most other countries, it is difficult to see that much additional revenue could be obtained from this area in future. We note though that the bulk of this revenue comes from the taxes on alcohol, tobacco and fuel where demand is most inelastic and thus such taxes are relatively efficient.

While pay-roll tax could be regarded as a tax on consumption to the extent that it is passed forward to consumers, the scope for obtaining increased revenues from this source could also be limited given opposition to pay-roll tax from the SME sector. While most other OECD countries utilise social security contributions from employers to fund age pension and other related benefits, other pay-roll taxes are either zero or relatively minor in such countries.

Question 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?

There would appear to be some scope for increased reliance on user charges in respect to some services currently provided by state/territory governments, particularly in the transport infrastructure/services area. However, any review of user charges should ensure that such charges are not simply disguised taxes but be designed to cover the cost of the relevant services being provided.

We would also note that the provision of services to the general public at below cost is not an efficient way to assist lower income earners. Such assistance can be more effectively provided on a more targeted basis by the Commonwealth via the transfer system.

4. Personal tax and transfers

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

CPA Australia strongly supports the changes to the personal tax system in recent years. These include the continuation of these reforms via the further personal tax cuts scheduled for 1 July 2009 and 1 July 2010, as well as the proposed introduction of the aspirational personal income tax scale (which would incorporate a four tier rate scale of 15%, 30%, 35% and 40% coupled with an effective tax-free threshold of at least $20,000) from 1 July 2013 subject to developments in respect to the GFC and prevailing economic conditions.

These proposed changes should operate to further ameliorate the impact of high effective marginal tax rates (EMTRs) – arising from the interaction of the progressive income tax system with social security means testing arrangements – on lower income earners and thus encourage increased worker participation rates which are important given the ageing population problem.

Question 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?

We believe that the foreshadowed aspirational scale referred to above reflects an appropriate distribution of income across income levels at this stage. It is not possible to forecast or otherwise indicate at present the timeframe over which such a rate scale might be maintained as that would depend on a range of factors (including the extent to which other broad based taxes can be accessed by the Commonwealth and/or the states) that cannot be reliably estimated at this point. Nevertheless, our broad preference would be for such a rate scale to be replaced within, say three years, by a scale which incorporated a flatter (less progressive) rate structure (particularly through a further reduction in the top marginal tax rate) to be introduced at a later date (say-2017/18). Further moves to such a flatter rate structure would, in our view, increase incentives to work, save and invest as well as assist in reducing effective marginal tax rates (EMTRs) for lower income earners. On the assumption that the Reserve Bank can continue to restrain inflation in the years ahead, we would prefer regular reviews of the personal rate scale in the Budget context in lieu of indexation of thresholds, etc.

Question 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?

In our view the current personal income tax base which comprises assessable income (generally salary/wage income, investment income, etc) less allowable deductions (primarily work-related expenses or WREs) is broadly appropriate.

There is a strong argument on equity grounds for retaining WREs in their present form since there are many employees (particularly those employed by SMEs) who are not currently reimbursed by their employers for such expenses and who may thus be disadvantaged by any replacement of WREs by a standard deduction or rebate approach for all employees. While it may be argued that those employers who do not meet such expenses might do so if WREs were largely or wholly removed, this would simply impose additional costs on SMEs with adverse implications for jobs. This seems particularly inappropriate in current circumstances due to the impact of the global economic/financial crisis.

Question 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?

We note that most social security payments are treated as assessable income but with a portion of the payment being exempt (generally a supplementary amount associated with the main payment where certain other eligibility requirements are met). While welfare beneficiaries are also eligible for special tax offsets and rebates (SATO, LITR, etc) to also minimise any tax liability that might otherwise arise, they are currently still subject to the same personal rate scale as other taxpayers.

The current tax exemption for family payments such as (FTB A & B) may now warrant review particularly since the latter have now been effectively recognised as transfer payments by being paid via Centrelink. The availability of the LITR for minors could also be reviewed to determine whether the current approach is consistent with equity considerations.

In our view, the need for a lower tax rate to apply to transfer payments is somewhat problematic since the existing tax offsets/rebates effectively already reduce the tax rate applicable to such payments, and this approach would also appear to give greater flexibility in varying the rate of tax applicable to such payments as well as minimising the complexity of the rate scale. As against this, it could be argued that the use of a lower rate could reduce complexity and increase transparency in this area. However, we also note that a lower rate would be more costly than the currently more targeted approach since it would be available to all taxpayers. On balance, we see no need to change the present position in this area.

Question 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?

We note that the current personal rate scale applies equally to all taxpayers regardless of their different circumstances in respect to age, occupation, location, etc.

As noted above, age already plays some role (albeit relatively minor) in the tax treatment of supplementary amounts paid under the existing transfer system.

The recognition of the different circumstances of certain individual taxpayers on the abovementioned basis arises largely as a result of specific tax offsets/rebates in the tax law including particularly the following:

- senior Australians tax offset (SATO)
- entrepreneurs tax offset (ETO)
- low income tax rebate (LITR)
- mature age worker tax offset (MAWTO), and
- zone rebates.

The main problem with these measures is that they increase the complexity of the personal tax system and thus are no doubt of some significance in encouraging taxpayers who benefit from them to seek the services of tax agents for the purpose of preparing and lodging their annual income tax returns.

While the zone rebates have been part of the personal income tax system for many years, the other measures have only been introduced more recently.

The effect of the various rebates is effectively to provide an increased tax-free threshold to the relevant taxpayers. In certain respects, this approach is more effective in targeting assistance at particular categories of taxpayers than an equivalent increase in the tax-free threshold since the latter would benefit all taxpayers including higher income earners and would thus be more costly.

The rationale for the special assistance provided to the various classes of taxpayers is reasonably self-evident although there are somewhat different reasons applicable in each case which are not entirely clear, for example:

- the LITR is designed to reduce the tax burden on low income earners
- SATO is designed to provide additional assistance to certain low income aged persons such as age pensioners and self-funded retirees
- the ETO is designed to encourage and assist taxpayers who decide to be self-employed
- the MAWTO is designed to reward people who remain longer in the work-force, and
- the zone rebates appear to be designed to provide some compensation for the higher costs involved in living in certain remote areas of Australia.

The main questions arising here appear to be whether the above assistance is necessary and/or effective and, if so, whether it might be more appropriately provided via the transfer system which could have the additional advantage of greater transparency, as well as reducing the complexity of the personal tax system.

Regarding the zone rebate, it would appear to warrant some review as to its effectiveness given that it has been in place for many years. For example, higher wage rates would appear to be the major inducement to encourage people to move to remote areas. People in these areas would also be eligible for assistance via the other offsets/rebates subject to meeting the required eligibility requirements. Conversely, the rebate has not been increased/kept pace with the cost of living for many years.

Question 4.6 How can fringe benefits tax (FBT) 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?

We continue to support taxing of fringe benefits in the hands of employers. However, it is imperative that there be a major rewrite of the current FBT legislation with a view to achieving considerable abbreviation and simplification of the existing law as broadly outlined in our previous submission. This could also provide an opportunity to achieve some reforms in this area particularly in respect to the current rules applicable to motor vehicle fringe benefits.

Question 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?

We believe that the current categorical distinctions in the transfer system as between pensions, allowances, supplements and concession cards are still relevant to some extent, but that they need to be modified to take account of the need to encourage increased workforce participation as a response to the challenges posed by population ageing.

For this reason, we would suggest that age pensions could retain some of their more generous attributes (subject to appropriate age adjustments) on the basis that these beneficiaries would generally comprise people who are not expected to be in the workforce. However, payments to other classes of beneficiaries presently entitled to pension payments (e.g. widows, sole parents, and the disabled) could generally be in the form of allowances as this would be consistent with recent changes to the transfer system (including particularly via the welfare to work reforms) to encourage increased workforce participation by people in these categories where appropriate.

Under this approach, allowances could continue to be paid to people with work and study obligations (including the unemployed) on the basis that they are not expected to need support for an extended period. Supplements and concession cards could also be continued as at present as an appropriate form of more limited assistance for certain low income earners experiencing problems with renting and some self-funded retirees.

We believe that this relatively straightforward approach would be preferable at this stage to a major revamp of the existing tax-transfer system via the introduction of a negative income tax.

Question 4.8 What priority should be given to the different objectives associated with family assistance, such as poverty alleviation, recognising the social value of child rearing, facilitating workforce participation of parents, and early childhood education? Would it be better to provide less family assistance to higher income earners?

We note that the key ongoing forms of family assistance include family tax benefit (FBT A & B), child care assistance (CCB & CCTR) and possibly paid parental leave subject to the government's consideration of the Productivity Commission's February 2009 report on this topic.

We have had some concerns with FTB A & B payments for several reasons, including that they are paid through the tax system, their rationale is unclear and they are overly complex. There would appear to be a case for these payments to be more tightly targeted and directed more to reducing child poverty. We also note the recent transfer of responsibility for FTB payments from the ATO to Centrelink.

Question 4.9 What are the key factors that should affect rates of transfer payments? What should be the relative importance of duration on income support, costs of work and job search, costs of children, value of home production and the level of the federal minimum wage?

The key factor affecting benefit rates should continue to be the expected duration of income support which we note is the rationale for the historical difference between pension rates for aged persons and allowances for the unemployed. Other factors mentioned in the consultation paper may be relevant for other transfer payments such as costs of job search for the unemployed and the costs associated with child rearing in respect to family benefits.

Question 4.10 Should transfer payments have a common benchmark? If so, should it be a proportion of a wage measure, and if so, which one? Or is there a better benchmark? Should there be a common indexation arrangement?

We broadly support the current position on payment rates including where single rate pensions paid to those recipients who are generally not expected to work (e.g. age pension, DSP, adult/child carer payments) are paid at a higher rate – currently 25% of Male Total Average Weekly Earnings (MTAWE) - while allowances paid to unemployed people, etc. are paid at a lower rate. It is noted also that recipients of these allowances are now generally subject to a work test under the 2006 welfare to work reforms. Given the link between allowances and the federal minimum wage (FMW) over the past 20 years, it may be appropriate for allowances to be set at around 40% of the FMW going forward. Given these links, there would not appear to be a need for specific indexation arrangements.

Question 4.11 Should payments to retired people remain linked to payments for people of working age?

See comments on 4.10 above.

Question 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?

CPA Australia has long held the view that high effective marginal tax rates (EMTRs) for welfare recipients should be reduced where possible to encourage greater workforce participation in light of the challenges facing Australia from population ageing in particular. Consistent with this, we believe that high priority should be accorded to reducing work disincentives.

Question 4.13 What structure of income tests and taxes would best support the increasing diversity of work and the need to increase workforce participation, and where should improved incentives be targeted?

Broadly and amongst other things, a tax/transfer system structure that minimises EMTRs seems necessary to increase worker participation. A flatter income tax scale is critical here, and thus it is extremely important for the government to proceed with its ongoing personal tax reforms in its next two Budgets and to implement the further aspirational reforms in 2013/14 in line with its earlier commitments in this regard.

Question 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?

A reduction in EMTRs and taxes on capital income to encourage saving would provide greater incentives for individuals to invest in human capital via education and skill enhancements since the overall returns from such investments would effectively be taxed at lower rates..

Question 4.15 Given the competing demands of targeting assistance to people when they need it and minimising unnecessary transactions, what changes could be made to existing tax and transfer policies?

We favour a greater separation of the tax and transfer systems as reflected in our earlier comments about the need to remove 'welfare' from the tax system. Increased integration of the two systems would appear to us to entail increased complexity and difficulties associated with the appropriate unit of assessment since a family basis is likely to reduce work incentives for a low income partner.

Question 4.16 Should the different bases of assessment for tax and transfers be reconsidered (including the unit of assessment, income definitions, period of assessment and assets treatment)?

See comments on 4.15 above.

5. The retirement income system

Question 5.1 to 5.12 inclusive

Responses to Questions 5.1 to 5.12 are contained in CPA Australia's submission to the AFTS Secretariat of 27 February 2009 on the Retirement Income Consultation Paper[2]

Question 5.13 The cost of providing health and aged care to older Australians is currently met by government through the health sector. Should retirement income policy take into account projected increases in health costs for older Australians? If so, what would be the most effective mechanism and how might the transition to such a system be achieved?

We support the current system of health and aged care to older Australians being provided by the government through the health sector. However, it must be recognised that many health and aged care costs are still met by the individual or their families as they age, and this is particularly so for self funded retirees. As such, these costs need to be taken into account when determining what are appropriate retirement savings targets and what level the safety net of the first pillar should be set.

[2] CPA Australia, Submission on Australia's Future Tax System Retirement Income Consultation Paper, February 2009
http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FECB-95B15C4E/cpa/hs.xsl/14131_31713_ENA_HTML.htm

6. Taxing business and investment

Question 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 a broader base/lower rate (comprehensive income tax) or narrower base/higher rate (a narrow income tax or an expenditure tax) approaches?***

As indicated in our earlier submission to the Henry Review, CPA Australia favours a reduction in the company tax rate and lower taxation of capital income generally in order to encourage increased foreign investment in Australia and to bring the tax treatment of capital income more into line with the position in other comparable OECD countries. We also argued for more favourable write-off arrangements for certain goodwill expenditure and a limited carry-back of tax losses, although there may be a trade-off here with an appropriate lower company tax rate.

We have been very supportive of the current dividend imputation system since its inception in 1987. However, we note that it is now facing a number of challenges in respect to the treatment of foreign investors and offshore investments by Australian based companies. While measures to deal with these problems will give rise to some additional complexity in this area, in our view this does not provide a compelling case for a move away from dividend imputation at this stage. We would particularly note in this regard the significant importance of the existing imputation regime for the retirement income strategies of older Australians including self-funded retirees.

Nevertheless, we accept further work on the current imputation system in conjunction with other potential company tax models (including those mentioned in the consultation paper) is warranted in the context of the current review. However, a key feature of any new regime would need to be some alternative form of taxation relief in respect of dividends as we would not support a return to the former classical system of company taxation which involved the double taxation of corporate earnings.

In this regard, we note that the following alternative corporate tax models have been put forward for comment by the Review Panel:

- the introduction of a lower company tax rate (say 25% or less) combined with a broader corporate tax base and a lower flat tax on dividend income of, say, 10% or complete exemption of dividend income in the hands of shareholders

- further widening of the company tax base - including by limiting interest deductions as proposed under the 'comprehensive business income tax' (CBIT) previously proposed by the US Treasury (1992) – or in part as done recently in Germany, combined with a commensurately lower company tax rate, or

- a narrowing of the company tax base in preference to reducing the existing company tax rate such as via more concessional write-off arrangements or, more radically, by moving to a business level expenditure tax (BLET) such as a cash-flow tax or an ACE (allowance for corporate equity) regime.

We note that the UK Mirrlees Review is currently considering possible reform options in respect to the UK's company tax arrangements in response to the impact of globalisation and the growth of the financial sector. However, there does not yet appear to be a complete consensus on the part of UK tax experts on the way forward in this complex area. It is also of interest to note the comment in this context that the higher tax rate required under an ACE regime could provide increased incentives to multinational companies to shift profits to jurisdictions with lower statutory tax rates.

In this light, we are unable to reach any final conclusions on the above options at this stage and reserve our position pending more detailed study of the different approaches canvassed above. In particular, we look forward to seeing the results of the Review Panel's further work in this area (including commissioned research into the various alternative existing business tax models) in due course.

Question 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?

We proposed in our first submission to the Henry Review the introduction of a 20% tax credit for Australian investors on any unfranked dividends sourced from taxable offshore profits, as previously recommended by the Board of Taxation. An alternative option that could also be considered is the introduction of appropriate dividend streaming arrangements subject to any necessary anti-avoidance arrangements. While these changes are designed to address the current bias against offshore investment by Australian based companies inherent in our dividend imputation system, the wider changes that may be required to appropriately address the tax treatment of companies and their shareholders in an open economy will clearly depend on the nature of our corporate tax system going forward.

While we also support moves to further Australia's development as a financial services centre, we note the arguments in the consultation paper that:

- shareholder-level taxation is not relevant to companies' investment decisions as non-resident investors are the marginal source of financing, and
- dividend streaming would not be an appropriate policy response to this perceived problem as it raises other issues and is arguably already achieved in other ways (such as via dual listed company structures or share buy-backs).

We also note that other issues relating to improved tax settings to assist in furthering Australia's development as a regional financial services centre are canvassed elsewhere in the consultation paper including alternative approaches to the application of GST to financial services.

Again however, the precise options in this area will depend on the decisions taken in respect to the future shape of Australia's company tax structure.

Question 6.3 Can the tax system be restructured to improve resource allocation within the economy and minimise operating costs, and if so, how? What changes would reduce distortions to risk taking and encourage entrepreneurial activity?

We note the argument in the consultation paper that most of the biases and complexities inherent in the current business/investment tax system could potentially be addressed under an expenditure tax system although the treatment of net losses would still be an issue.

We agree that comprehensive adjustments to the tax system to deal with inflation are now less necessary given the general focus on price stability and the undue complexity that would be associated with any such changes.

The comments in the consultation paper regarding the existing tax treatment of acquired goodwill are also noted including that such investment already has access to deductions equivalent to allowing write-off based on economic depreciation.

Regarding capital gains tax we note the following possible alternatives (not necessarily improvements) to the current CGT rules:

- introduction of stepped CGT rates with the rate of tax declining the longer an asset is held

- provide an uplift to realised gains with symmetrical treatment for realised losses equivalent to accruals based taxation, or
- provide CGT exemptions for assets held beyond five or 10 years in order to simplify record-keeping requirements.

There are clearly problems (including potentially increased complexity) associated with all of these options and it is difficult to support them in their present form.

We would support moves towards a more uniform/symmetrical treatment of gains/losses under the existing income tax/CGT system.

Regarding the income tax loss rules, the following problems are also noted:

- requirement for losses to be carried forward to be offset against future income in some circumstances
- restrictions on access to current and carried forward losses in some cases, and
- disproportionate treatment of losses under a progressive personal income tax system.

The following possible improvements (subject to integrity issues and tax collection impacts) are noted:

- allowance of loss carry-back against (time-limited) past tax payments
- index carried-forward losses by a risk-free rate of return (uplifted to compensate investors for the risk that the loss will never be utilised)
- providing refunds proportionate to the losses
- allowing losses to be offset against a firm's other tax payments
- allowing losses to be traded, and/or
- allowing losses to pass from an entity to the underlying owners.

We agree that the merits of such proposals may depend in part on the following:

- how they interact with other parts of the tax system, such as dividend imputation and CGT
- long-standing integrity concerns around artificially generated losses
- net impact on operating (compliance/administrative) costs
- concerns regarding timing misalignments (e.g. negatively-geared rental properties), and
- treatment of existing accumulated losses.

As indicated in many earlier submissions, CPA Australia believes that companies should be allowed to carry back losses for a limited period of between one and three years to offset against taxable income consistent with the loss recoupment policies of other major OECD countries.

We also note that we have sought improvements to existing R&D tax concessions in the context of the recent Cutler review. As noted in the consultation paper, such concessions can generally be justified on the basis that reliance on the market alone would not be sufficient to ensure that an appropriate amount of R&D is undertaken. However, there is always the question whether the use of direct grants is a more efficient and transparent way to provide such assistance. In the case of R&D, it appears that the use of the tax system may be the best approach, notwithstanding the additional complexity that results, given that this is the option generally adopted in other OECD countries.

On the other hand, the case for including film investment incentives in the tax law seems less clear-cut and thus the use of direct grants, etc. for this purpose may be more appropriate. The provision of assistance to some sectors via more favourable capital write-off arrangements may also warrant review on transparency grounds alone.

Broader measures to enhance the competitiveness of the Australian economy should also remove the need for more specific measures and thus contribute to reducing the complexity of the overall business tax system.

Question 6.4 What principal goals should inform the taxation of capital gains in Australia, and what, if any, changes should be made to capital gains tax (CGT) as a result?

The main goals in respect to the taxation of capital gains should be the standard tax criteria of efficiency (neutrality), simplicity and equity, but should also have regard to Australia's greater reliance on the taxation of capital income than many other countries. In particular, it is noted that Australia has one of the higher maximum personal tax rates on capital gains vis-à-vis major OECD countries even despite our current discount approach to the taxing of such gains.

Possible improvements to the existing CGT provisions should therefore be considered in the context of potential changes to capital income taxation generally which is discussed further below.

The small business CGT concessions operate as a separate regime to reflect the fact that many small business owners effectively see their business as their superannuation. The need for such provisions, which are quite complex, can also be considered further in the context of potential reforms to capital income taxation as well as proposals to increase the access by self-employed persons to the superannuation guarantee (SGC) regime.

With over 1.89 million businesses in Australia (out of a total of 2 million businesses) having an annual turnover of less than $2million[3], 28 per cent of Australia's business operators (526,000) are aged 55 or over[4] and an increasing number of individuals (26,548) and companies (3,772) using these concessions (to the value of $3.4 billion in 2006/07)[5], there is a strong argument for retaining the existing concessions. These concessions may also provide a much needed incentive for individuals to pursue self-employment and establish strong and successful small businesses which are arguably the 'engine-room' of the economy.

We would also support a rewrite of the CGT provisions to further reduce complexity in this area.

Question 6.5 Should the tax system provide a more neutral treatment of different financing arrangements (debt, equity and retained earnings), and if so, how. What principles should inform approaches to entity taxation?

CPA Australia strongly supports a neutral treatment of different financing arrangements and sees this as a significant principle in informing approaches to company/entity taxation.

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[3] Pg 7 *Counts of Australian Businesses, including entries and exits: June 2003 to June 2007* Australian Bureau of Statistics December 2007

[4] Pg 6 *Counts of Australian Business Operators 2006-07* Australian Bureau of Statistics October 2008

[5] Pg 85 *Taxation Statistics 2006-07* Australian Taxation Office 2009

We note, of course, that this was one of the main reasons behind the introduction of the existing dividend imputation regime as well as also addressing the double taxation of dividends under the previous classical regime. The introduction of the CGT provisions also reduced (but did not eliminate) the bias towards financing investments by retained earnings.

We note that other options for achieving a more neutral treatment in this area could include the following:

- a business level expenditure tax regime such as ACE (allowance for corporate equity) or a business cash-flow tax, or

- a comprehensive business income tax (CBIT) regime.

The CBIT approach would not appear to be appropriate in the Australian context as it could increase the cost of debt financed from foreign investors.

As noted above, there are, of course, other considerations relevant to adopting these business tax models (particularly for SMEs) including the different circumstances of firms and owners.

A more appropriate approach to dealing with these issues for SMEs could be to resolve the 'integration' issue by allowing a 'flow-through' tax treatment for SMEs probably on an optional or elective basis. This matter is discussed further below in our response to Question 6.6.

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

The main rationale for having some specific and/or concessional rules for small business is to counter some of the disadvantages associated with being small including higher tax compliance costs and potentially less ability to obtain timely loss offsets. Whether existing concessions are adequate remains a moot point.

We note that optional entity flow-through arrangements have recently been put forward in some submissions and that the Panel is seeking further views on this approach. In essence, such arrangements would effectively provide partnership-like tax treatment to a small business (including the ability to pass losses through to the owners/shareholders) while still enabling the business owners to retain the advantages of limited liability.

While this approach would remove the need for a small business to comply with various company–specific tax rules (particularly on losses), it could also give rise to some additional complexity in other areas. There is also the question as to whether a new regime is required given that many small business owners already use trusts structures (mainly discretionary trusts) to achieve a flow-through approach although many of the tax rules applicable to these trusts are currently complex and uncertain and may also be subject to further review shortly in light of the conclusions emerging from the BoT's current review of managed investment trusts.

The definition of a small business may also need to be clarified as the current tax law often provides different treatment for a broad range of SMEs including those with an annual turnover of less than $100m (this is also subject to certain asset-related tests) in the case of TOFA. There is also the outstanding issue of whether this latter limit should be increased to $250m consistent with the ATO's recent (August 2008) change to its SME threshold as reflected in its latest (2009/10) compliance program.

Also, as noted above, we favour the retention of the current small business CGT concessions which is one example of structuring the tax system to cater for the needs of the small business sector.

Question 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?

CPA Australia supports moves to achieve a more neutral treatment of the different forms of return on personal savings/investments where this is feasible.

This view was the basis of the proposal in our initial submission to the Review for the introduction of a flat/capped rate on capital income including interest, dividends, rental income and realised capital gains. Options to achieve this result in other OECD countries include scheduler or dual rate structures involving the application of a low flat tax rate to capital income.

The globalisation of capital investment flows and the increased competition for mobile capital also raises the question as to whether Australia should be differentiating between the taxation of capital income and labour income. For example, a low flat and uniform tax rate on capital income (including realised capital gains) would enhance Australia's ability to both attract foreign investment and increase domestic savings.

As such a rate should desirably be aligned with the company tax rate, it may be desirable in the short-term to maintain a broader company tax base so that such a flat tax on capital income could be set at the relevant company rate of 25% or 20% as discussed above.

To ensure that dividend income was taxed at the relevant flat rate rate, it would only be necessary for the flat rate to be applied under the current dividend imputation system in lieu of the taxpayer's personal marginal rate as occurs at present, except where the taxpayer's marginal rate was less than the capped/flat rate in which case the relevant lower marginal rate would apply.

An alternative approach could be to return to a modified version of the previous 'classical system' of company taxation but to exempt dividends in the hands of shareholders. While this system would be simpler than dividend imputation, it could raise issues in respect to the ongoing availability of deductions for any interest costs incurred in deriving such income with potential implications also for negative gearing arrangements in respect to property investments. However, these potential difficulties could probably be avoided by simply treating such income as non-assessable.

7. Not-for-profit organisations

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

We broadly support the current income tax exemptions available for charities, PBIs and other relevant NFP organisations (public hospitals, etc) and the GST concessions but note that there appears to be scope for some reforms in this area such as in the FBT area and in respect to the treatment of donations.

The current FBT exemptions appear to be overly complex and generate high compliance costs which may be passed on to the intended beneficiaries in some cases. It may be more efficient, therefore, to replace the current exemptions with direct financial assistance to the relevant bodies. Alternatively, if fringe benefits were to be taxed in the hands of recipients then this issue may need to be reviewed further.

It is not entirely clear that tax system complexity would be further reduced by replacing deductible donations with matched government funding arrangements for existing DGAs as there may also be some additional complexity for these bodies associated with the alternative option.

Question 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?***

See comments on 7.1 above.

8. Complexity – cost, risk and transparency

Question 8.1 ***The business income tax system (including company tax) is broadly the major source of complexity in the overall tax system including particularly the specific tax provisions referred to in this chapter such as those relating to the taxation of trusts, consolidated company groups, taxation of financial arrangements (TOFA), some of the small business tax concessions, company loss and FBT rules and the CGT provisions.***

Broadly, excessive complexity in these areas should be addressed as follows:

- Division 6 (ITA 1936) should be replaced by a more appropriate/simpler statutory regime based on recommendations arising out of the BoT's current review of Managed Investment Trusts to the extent that such recommendations are considered to be relevant to other trusts

- the consolidated company group provisions should be simplified to the extent possible including in respect to their interaction with other business tax provisions

- TOFA provisions could be simplified for SMEs by increasing the relevant de minimis annual turnover threshold to $250 million (in line with the comparable SME threshold adopted by the ATO for its 2009/10 Compliance Program) and removing the existing asset based thresholds

- the CGT provisions (including those relating to the CGT small business concessions) should be simplified to the extent possible. Such simplification could be assisted by the introduction of a flat rate of tax on capital income (including capital gains) as this could remove the need for the use of a separate discount factor, and

- the remaining small business entity concessions should also be simplified to the extent possible.

In relation to the transfer system, the most significant complexity appears to come from the interaction of that system with the tax system which gives rise to high EMTRs and thus can discourage work-force participation. However, bearing in mind that the transfer system should be designed to assist particularly those most in need such as low income earners then it is imperative that it be kept as simple as possible with any residual complexity being addressed by way of customer assistance from Centrelink or private sector welfare bodies to some extent where appropriate.

Question 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?***

As noted in the AFTS' architecture and consultation papers, the great bulk of transfers are administered/paid by the Commonwealth with state and local governments generally only providing a small number of additional concessions (such as in respect to reduced public transport and utility charges and local rates) to holders of certain Commonwealth concession cards. At the Commonwealth level, transfer payments are usually administered by the Commonwealth while the ATO is responsible for the administration of tax-based concessions such as tax credits, offsets, etc. We note that family tax benefits (FTBs) will only be claimable through Centrelink as from 1 July 2009 and we support this in line with our general policy as mentioned in our October submission that welfare type benefits should only be paid by Centrelink.

We would welcome further improvements in this area particularly via Commonwealth/State co-operation through COAG including:

- centralisation of tax administration functions for all Australian jurisdictions in a central agency such as the ATO

- similar centralisation of the administration of all transfer payments and related concessions with Centrelink (which may involve some small increases in some transfers to compensate those welfare beneficiaries who currently benefit from state and/or local government discounts for holders of certain Commonwealth concession cards).

We note in this regard that while the recent extensive harmonisation of state pay-roll tax regimes has been welcomed by ourselves and the affected taxpayers, some problems are now still arising due to differences in interpretation of common provisions by SROs in different jurisdictions.

While we broadly support further simplification of the tax system including for individual taxpayers, we doubt whether it is possible or feasible to relieve many such taxpayers of the obligation to lodge an annual tax return. Some relevant factors in this regard are:

- many individual taxpayers currently claim work-related expense (WRE) deductions as well as a range of tax offsets/rebates via their annual tax return

- the affairs of many individual taxpayers are now more complex than in earlier years due to them holding a wider range of investments (e.g., securities, shares, deposits, rental properties, etc) and holding them either directly or through different vehicles such as managed funds, listed and unlisted unit trusts, listed investment companies, etc.

- many individual taxpayers are also involved in small businesses as owners or associates and thus derive income via a company and/or trust structure and in such circumstances it is generally more practicable for the relevant individual returns to be completed together with other more complex entity returns by a registered tax agent

- increased complexity of the tax law in respect to individuals particularly in respect to the taxation of capital gains and the associated record-keeping requirements

- while ATO pre-filling can assist taxpayers in this regard, there is still a need for a large number of taxpayers to obtain assistance from tax agents to properly complete their returns

- tax agents also have a significant role in tax administration in ensuring that a higher proportion of taxpayers lodge more accurate returns on time than would otherwise be the case, and

- as recently reflected in the payment arrangements for the tax bonus component of the recent fiscal stimulus measures, tax agents can also assist governments in the effective implementation of such measures.

Further, some of the measures that would appear necessary to significantly reduce the number of taxpayers lodging annual returns include:

- rationalisation and/or removal of most WREs (even if this is replaced by a standard deduction or rebate, many taxpayers may still be worse off)

- introduction of more extensive withholding arrangements on payments of interest, dividends, etc.

which may not be welcomed by affected taxpayers in light of earlier surveys indicating that they place a high value on their annual tax refunds.

Such a change could also impact the viability of many small tax agent practices and we note in this regard the recent JCPAA Report that recommended the need to pay appropriate adjustment assistance to agents in this event.

We note that improvements in technology can also assist both taxpayers and tax agents to lodge regularly and in a timely manner.

Finally, we note that there are a range of options available for some individual taxpayers with simple returns (eg. minimal or no WREs nor investment income other than from bank, etc deposits) to lodge as self-preparers and currently around 25% of taxpayer do so. The options available to self-preparers has been expanded in recent years and now include an ATO phone facility, and an electronic option (eTax) as well as the more traditional standard hard-copy paper return format.

Question 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?

As indicated above, we believe that there is a case to apply an appropriate reduced rate of tax to capital income to be aligned with a proposed new company tax rate (25%) which should be reduced to 20% at a later date. This approach would achieve a more neutral and simpler treatment of capital income than applies under the current regime.

Equity should also be enhanced by creating a more level playing field than currently exists, particularly via the use of a capped rate which still enables lower income earners to take advantage of lower marginal tax rates.

Question 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?

CPA Australia welcomes changes in recent years to deal with excessive complexity and enhance transparency including the establishment of the Board of Taxation (BoT) and the Inspector-General General of Taxation (IGT). We note also that the continuing work of the Australian National Audit Office (ANAO) in respect to its performance reviews of the ATO and the role of the Tax Ombudsman in dealing with taxpayers' complaints is also important in this regard.

In particular, we welcome the current review of the rulings system by the IGT given the current uncertainties and difficulties in this area given the different roles and status of private rulings, ATO Interpretive Decisions (ATOIDs) and public binding rulings.

The recent move to further enhance consultation arrangements on policy development and new legislation are also welcomed.

We also believe that there would be merit in enhancing governance arrangements for the ATO by establishing a Board which could assist the Commissioner in dealing with strategic and other important issues arising in his administration of the ATO. While it is recognised that the responsibility for appointing the Commissioner would (and should) remain with the Treasurer as the responsible Minister and that the Commissioner would continue to report to the Parliament via the Treasurer, there would still, in our view, be an important role for the Board in assisting the Commissioner in the discharge of his important responsibilities to taxpayers. We note in this regards that the tax administrations in both the USA and the UK both operate under a formal Board arrangement.

9. State and local taxes and transfers

Question 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 you will be aware, CPA Australia has been seeking further reform of inefficient state/territory taxes via a new Intergovernmental Agreement (IGA) for a number of years including via submissions to Federal and state governments. In this regard, we also refer you to our earlier comments to the Review Panel on this topic in our 17 October 2008 submission in response to the Review's Architecture Paper. We have also been pursuing this matter via the Business Coalition for Tax Reform (BCTR).

In essence, we (and presumably other relevant industry/professional bodies) place a higher priority on state tax reform as a result of the perceived benefits of this approach in the form of increased economic growth vis-à-vis wider changes to Commonwealth/State relations such as addressing the vertical fiscal imbalance problem.

Under current constitutional arrangements, the distribution of expenditure and taxation responsibilities between the Commonwealth and the states is characterised by vertical fiscal imbalance (VFI) in that the states do not have sufficient revenue raising powers to adequately meet their spending responsibilities whereas the Commonwealth is in the opposite position as its revenue raising powers exceed their expenditure responsibilities. This position has arisen to some extent as a result of the High Court's restrictive interpretation of state taxing powers particularly in respect to indirect taxes.

The existing imbalance is overcome in practice primarily by the Commonwealth providing financial assistance to the states via general purpose assistance grants (currently via the states receiving the GST moneys collected by the Commonwealth on the basis of distributions as recommended by the Commonwealth Grants Commission) as well as specific purpose financial assistance for education, housing, etc which is generally subject to conditions, although these have recently been broad-banded to give greater flexibility to the states in how the funds should be used to meet specific objectives. While these measures ensure that the states have sufficient resources to meet their wide ranging responsibilities, particularly in areas such as health education, transport, etc and the associated infrastructure requirements, it is argued that this tends to blur accountability between the two levels of government.

Dealing with the VFI issue can be complicated in the context of implementing appropriate state tax reform since the latter involves removal of some inefficient state taxes and their replacement with more efficient Commonwealth/State taxes. The financing of the removal of such inefficient taxes by increased Commonwealth transfers to the states would arguably worsen the current VFI problem.

One possible option for the Commonwealth to ameliorate or reduce the current level of VFI while also addressing state tax reform would be to introduce an element of tax base sharing as occurs in other federal systems such as Canada. In particular, the states could be given access to the Commonwealth's income tax base via the imposition of state income tax surcharges on the existing personal income tax rate scale. We note though that the states have previously been given the option of doing this but they did not take it up perhaps because they felt that Commonwealth income tax was already too high and thus it did not give them sufficient scope to raise significant additional revenue in this way.

While it might be argued that there is greater scope for the states to now be given access to the income tax base as a result of the reductions in personal income tax in recent years, such a move may appear to run counter to the Commonwealth's commitment to further personal tax cuts from 30 June 2009 and 30 June 2010 as well as to the aspirational personal rate scale from 30 June 2013.

Another option could be for the Commonwealth to increase the current GST rate and/or broaden the base of the tax but this option is outside the scope of the current review. That option would not completely address the VFI problem but may ameliorate it given the role of the states in the administration of the GST. The increased revenues available from the auctioning of permits under the proposed carbon pollution reduction scheme (CPRS) could also assist in this area.

Any changes to the current assignment of revenue raising powers would appear to require constitutional change which, of course, could be difficult to obtain in a timely manner if at all. Any increase in intergovernmental transfers from the Commonwealth may not address the VFI problem (see further comments on this option below).

Question 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?

Proposed reform of state/territory taxes under a new IGA could be broadly along the following lines:

- removal of duties on business real property transfers and insurance premiums
- replacement of existing motor vehicle transfer duties with taxes which are more closely linked to motor vehicle usage such as congestion/road user charges
- review of existing state environmental taxes to ensure consistency with the Commonwealth's proposed CPRS, and
- harmonisation of the tax base rules for the remaining state taxes including in respect to the interpretation and general administration of these taxes.

The above reforms could be funded wholly or in part by the extension of relevant federal and/or state broad based taxes as well as additional revenues expected to arise from stronger economic growth due to the replacement of inefficient narrow-based transaction taxes with more efficient broad-based taxes.

In relation to the issue of user charges for the provision of services, this appears to be more relevant to the states than the Commonwealth since the states are the major provider of services in the federation. We believe that this matter probably warrants a separate review, but our preliminary views on the matter are broadly as follows:

- we note that some state roads are already subject to tolls where they have been constructed under public/private partnership arrangements
- such charging though is not necessarily efficient because it may limit the use of such roads as some motorists may be deterred by the costs involved
- some form of time-of-day or congestion pricing would appear to encourage more efficient use of the road network and these should be introduced where practicable
- there seems to be some evidence that time-of-day tolling may not be practicable on PPP roads perhaps due to prior contractual arrangements – if so, such arrangements may need to be reviewed in future
- user charging for state provided transport/utility, etc services should generally be on a fully commercial basis

- assistance to lower income earners is generally more efficiently and effectively provided via the tax/transfer systems rather than by way of concessional charges/prices on government provided services, and

- we note that the privatisation of some public sector entities (particularly in Victoria) has reduced the extent of the above practice in recent years.

A move to a more commercial approach in setting user charges could assist the states in implementing state tax reform and/or addressing the current VFI problem.

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

We believe that the Commonwealth should continue to be primarily responsible for income redistribution via its comprehensive tax and transfer systems subject to appropriate changes to these systems to enhance their efficiency. The main rationale for this rests on the fact that it is the Commonwealth that has both the necessary tax and spending powers to achieve this objective.

The states' role in income distribution is relatively minor since it is largely confined to the provision of transport/utility concessions to lower income earners. As noted above, our view is that this approach should be discontinued.

Many local government authorities (councils/shires) also commonly provide concessions to certain lower income earners in the form of reduced rates. Again, we believe that such assistance, if necessary, should be provided via the existing transfer system rather than via concessions on local government rates.

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

As mentioned previously, CPA Australia believes that the administration of state taxes (particularly where such taxes have been harmonised across different state/territory jurisdictions) should be transferred from the various state revenue offices (SROs) to the Australian Taxation Office (ATO) to ensure uniformity in the administration of such taxes throughout the federation.

We note in this regard that notwithstanding the harmonisation of some states' payroll tax legislation, problems can still arise from different interpretations of the same or similar provisions by the various SROs.

10. Tax and transfer impacts on housing

Question 10.1 What should be the objective of the tax-transfer system in respect of housing? Should there be assistance for housing over other assets or services? Should assistance be based on housing tenures? Should assistance be focused on people on low incomes? Should assistance differ between public and private tenants?

We note that assistance to owner occupied housing is currently provided through the tax system as such housing is not subject to income tax. However, owner occupied housing is subject to stamp duty and local government rates and GST applies to new dwellings and renovations of existing dwellings.

As noted in the consultation paper, both the Commonwealth and State Governments provide direct assistance to first home owners via FHSA, FHOG and the recently introduced Commonwealth tax-favoured savings arrangements. Assistance is also provided to lower income earners via a range of schemes including public housing, rental assistance, home purchase assistance (states only) and the national rental affordability scheme. In addition, owner occupied housing is treated on a concessional basis for social security purposes.

Unlike owner-occupied housing, investment in residential property is treated similarly to other assets. While the interaction of negative gearing and existing capital gains tax (CGT) arrangements are generally favourable for such investments, residential rental properties are also subject to state land tax. Some of the benefits arising here may flow through to renters including long-term lower income renters.

While some equity concerns in respect to housing access are addressed by the tax-transfer system through the types of programs mentioned above, it seems that more should be done to assist non-home owners. This could be done to some extent via changes to the superannuation system as we noted in our earlier submission to the Review on retirement income issues.

It could be argued that housing policy in Australia is broadly successful given the relatively long-standing 70/30 ratio of homeowners to renters which is high by international standards. Nevertheless, existing assistance to low income earners should be closely monitored to ensure that it is adequate and effective as it appears that more emphasis going forward should be on ensuring that appropriate housing options and other income support is available to non-home owners.

Question 10.2 What role, if any, should the tax-transfer system play in respect of housing affordability? Should the tax-transfer system be used to influence housing supply and/or demand to improve housing affordability? What changes, if any, should be made to housing-related transfers that assist disadvantaged households to find housing?

As indicated above, we believe that housing policy should be directed to ensuring that an adequate supply of affordable housing is available for non-home owners given the likelihood that a significant proportion (ie. around 30%) of the population will continue to remain in this category. Given the likely difficulties involved in removing the existing tax preferences for housing (which appear to be generally replicated in most other OECD countries), it is important that appropriate assistance continues to be provided to non-home owners via the transfer system.

Supply side issues should preferably be addressed more directly (such as via changes to planning regulations, etc) rather than via the tax/transfer system.

Question 10.3 Recognising the influence that some taxes and transfers have on the use of housing and residential land, what changes, if any, should be made to ensure the housing stock and residential land are used efficiently?

As indicated previously and reiterated above, CPA Australia believes that the removal of stamp duties on residential property transfers and their replacement by a modified land tax on a broadly revenue neutral basis would increase the overall efficiency of the existing residential housing taxation regime.

We also believe that there is a case for reviewing the current exemption of owner-occupied housing from the assets test for Commonwealth income support on both equity and efficiency grounds.

We have proposed above the modernisation of state land taxes by replacing progressive rate schedules with a single rate structure as already applies in NSW. This would enhance efficiency by being more neutral as between different classes of investors and, as noted in the consultation paper, could lead to increased investment in the rental housing market.

11. Taxes on specific goods and services

Question 11.1 Is it appropriate to use taxes on specific goods or services to influence individual consumption choices, and if so, what principles can be applied in designing the structure and rates of such taxes?

We believe that from an efficiency and equity (distributional) standpoint that the same rate of tax should be applied to different types of alcoholic beverages.

The principles governing these excise taxes should include the following:

- correcting negative externalities
- revenue raising efficiency, and
- distributional incidence (equity).

The more egregious effects of alcoholic drinks should be addressed by appropriate regulatory measures.

Question 11.2 Can the competing potential objectives of alcohol taxation, including revenue raising, health policy and industry assistance, be resolved? What does this mean for the decision to tax alcohol more than other commodities?

Our understanding is that it is often difficult to meet all of the above objectives so the usual compromise in Australia is to focus more on the latter two criteria above (see answer to previous question) supplemented by appropriate regulatory measures. This approach also tends to minimise complexity.

Question 11.3 What is the appropriate specific goal of taxing tobacco? Is it necessary to change the structure or rate of tobacco taxes?

In theory, the appropriate goal here might be to reduce tobacco use and its associated health impacts by increasing taxes on tobacco. However, this approach might provide increased incentives for illicit trade in tobacco and thus could be counter-productive. Accordingly, we broadly support the current tax regime for this product coupled with an appropriate regulatory regime to protect both smokers and non-smokers.

Question 11.4 If health and other social costs represent the principal rationale for specific taxes on alcohol and tobacco, is any purpose served in retaining duty free concessions for passenger importation of these items?

It is difficult to see any purpose for retention of the existing concessions for inbound passenger importation of these items given that the main beneficiaries of the concessions would appear to be Australian tourists returning from abroad and, to a lesser extent, the operators of duty free shops at Australian airports and elsewhere. The existing concessions in this area are also arguably inconsistent with the policy behind the current excise regimes and also detrimental to some extent to most Australian based retailers of such products. They could also be regarded as inequitable given that most Australians travelling overseas are probably higher income earners.

As against this, it could be argued that the current excises are primarily imposed for revenue purposes particularly given that we rely less on a broad-based consumption tax (GST) than most other OECD countries, and that the other effects of the existing concessions are not significant.

On balance, it may be desirable for the existing concessions to be removed unless the impact on duty free shops is significant given that they also serve inbound tourists.

Question 11.5 Are taxes on specific 'luxury' goods an effective way of making the tax system more progressive? If so, what principles should apply to the design and coverage of these taxes?

CPA Australia is opposed to the introduction of taxes on so-called 'luxury' goods as this approach would introduce additional complexity into the tax system and seems inconsistent with the moves in Australia and other jurisdictions in recent years towards the use of more efficient broad-based consumption or GST/VAT type taxes. We note that Australia's former wholesale sales tax was effectively a multi-rate tax with higher taxes on luxury goods (but not services) which was abolished from 1 July 2000 as a result of the introduction of the GST.

Consistent with the above comments, we believe that the existing LCT is an anomaly and should be abolished at an appropriate stage, particularly given the likelihood of many such vehicles being taxed further under the CPRS and/or other more specific environmental taxes.

Question 11.6 Should the tax system have a role in influencing the relative prices of different types of cars, including luxury cars and higher polluting cars, and if so on what basis? What does this mean for taxes on the purchase price of motor vehicles?

We would broadly support the further consideration of appropriate environmental taxes on motor vehicles as a complementary measure to the CPRS such as a tax related to a vehicle's fuel efficiency, particularly given current concerns regarding the potential scope and effectiveness of the CPRS in relation to the transport sector. Such a measure may also need to be harmonised with other potential motor vehicle taxes such as congestion and/or road user charges.

12. Fuel, roads and transport

Question 12.1 How can motor vehicle related taxes and road funding arrangements be designed to improve the efficiency of transport of people and goods in Australia?

We note in this context that while fuel excise may have originally been designed as a means to fund road construction, the reality is that fuel excise revenues are not hypothecated for this purpose.

The primary rationale for fuel excise today is that it is an efficient means of raising revenue since demand for fuel is relatively inelastic (unresponsive to price movements) and its administration is relatively straightforward given the small number of collection points.

Going forward however, the structure of fuel taxation and the taxation of transportation generally could be broadly along the following lines:

- fuel excise could remain with its level being determined by general revenue requirements, the impact of the CPRS and other taxes on the transportation sector, and
- as noted above, such other taxes could include road user charges and/or congestion (time-of-day) taxes
- road user charges currently apply to heavy trucks with the tax depending on such factors as the weight and wheel base of the vehicle, and these would presumably remain
- road transport is also likely to face increased costs relating to emissions as a result of the CPRS
- congestion/time-of-day charges could also apply to motor vehicles and heavy trucks in highly congested urban areas
- existing state taxes (such as transfer duties and registration fees) are relatively inefficient and should be removed
- the operation of fuel tax rebates would also need to be reviewed, and
- the impact of existing tolls on PPP roads should also be taken into account in this context as they may be difficult to remove/vary due to prior contractual arrangements.

Question 12.2 What should be the role, if any, of fuel taxes? What does this mean for how fuels and their uses are taxed and the rates of tax applied?

As noted above, fuel tax could retain its existing role as a general excise tax imposed primarily for general revenue raising purposes if appropriate. This matter would need to be considered in light of the ongoing evolution of Australia's tax structure and the overall burden and purpose of taxes on the transport sector.

Question 12.3 Do the existing tax arrangements lead people to make economically inefficient transport choices, and if so, how might they be improved?

The existing tax arrangements for the transport sector are not as efficient as they should be as they have generally been imposed at different times and for varying reasons largely related to the revenue raising requirements of Commonwealth and State Governments.

Improvements to the current regimes could be undertaken along the lines suggested above (see particularly answers to above questions in this segment).

13. Tax-transfer impacts on the environment

In general, CPA Australia believes that judiciously targeted and carefully designed taxation policies have a pivotal role to play as part of Government's broader policy response to Australia's various environmental challenges. Where such taxation and transfer policies are targeted at reducing greenhouse gas emissions, such policies should complement the impact of the Carbon Pollution Reduction Scheme (CPRS).

In particular, a properly designed emissions trading scheme that incorporates well calibrated caps and emissions trajectories is central to addressing the failure to price greenhouse gas emissions. Such an approach though is clearly only one part (but a major part) of a comprehensive package of policies required to reduce greenhouse gas emissions.

Given the target set by the government to reduce Australia's greenhouse gas emissions and the coverage of the proposed CPRS, complementary policy measures, including tax measures accessible by all businesses are required as part of a package response to climate change.

Any reduction in greenhouse gas emissions that such measures can achieve should result in lower emission unit prices in the long term. Without incentives for uncovered emissions to be reduced, liable entities under the CPRS will have to bear an increasing burden to achieve the 60 percent reduction target for Australia set by the government.

In addition, such complementary measures will add to the price signal that the CPRS creates for the estimated 1,000 liable entities and the two million non-liable entities, further encouraging behavioural change, which will in turn lead to a reduction in greenhouse gas emissions.

In addition, the measures CPA Australia propose are not dependant on passage of the CPRS Bill or on it starting on 1 July 2010. There is sufficient justification to commence complementary measures as soon as possible, not only to improve environmental outcomes from an early date but well-designed measures will also have a stimulatory economic effect.

Any new or improved tax measures should be designed to redirect behaviour towards more environmentally sustainable activities.

We believe that environmental taxes, tax incentives and transfer payments should be designed to address or encourage specific environmental behaviour, wherever practicable. For example, a miner could received an immediate write off for all expenditure incurred in rehabilitating a mine site or a steel producer could be given tax incentives to encourage them to recycle gases generated from production back into the production process.

We also contend that climate change can also be effectively combated if individuals are also encouraged to change their patterns of consumption. In this context, we would support consideration being given to rebates (transfer payments) being paid to individuals who undertake certain specified activity that is considered beneficial to the environment.

Question 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?

As stated in the above introductory comments to this chapter, CPA Australia supports a properly designed emissions trading scheme. We also support the use of specific environmental taxes, where they are designed to encourage or change a specific behaviour, or reduce the incidence of that behaviour occurring.

For example, we suggest that the Review consider the recommendation contained in the OECD's *Environmental Performance Review - Australia 2007* that suggested Australia should 'redouble efforts to cut emissions from the transport sector' by improving the balance of transport modes through the use of congestion and road pricing, fuel and vehicle taxation and parking charges.[6]

Question 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 poor outcomes be addressed?

In addition to considering new tax measures or extending existing measures, we support the Review's consideration of the impact that current taxation laws have on behaviour. In particular, we support the review of the concessional treatment of car fringe benefits under the statutory formula method in the fringe benefits tax (FBT) legislation where FBT liability falls as total kilometres travelled.

We acknowledges that there are a number of competing policy priorities that need to be considered concerning the future viability of the concessional tax treatment of car fringe benefits calculated under the statutory formula method.

It is recognised that this tax concession provides certain employees with a tax incentive to acquire or lease motor vehicles which are often locally manufactured although the utility of this measure has diminished in recent years given decreasing rates of marginal tax and a reduction in the number of new vehicles acquired which are locally made.

At the same time we recognise that the application of the concession is dysfunctional from an environmental perspective as the FBT liability falls as the annual kilometres travelled in a vehicle increases.

In our view it may be prudent in the medium and long term to consider the efficacy of the concession and whether some of the Government funding currently subsidising the concession could instead be directed by way of government grants to the local car manufacturing industry (including its supplier network) so that the dual goals of lower pollution and support for the local car industry are both realised.

Alternatively, the concession could be recalibrated at a later date so that the amount of FBT paid was directly linked to the emissions generated by a vehicle so that the amount of FBT paid was progressively reduced as the emissions emitted commensurately reduced. Such a proposal may be viable in the medium to long term when the local manufacture of environmentally friendly cars is expected to be more prevalent.

Question 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 environment outcomes?

We believe that the most significant existing feature of the Australian income tax legislation which could be amended to specifically deliver better environmental outcome over the medium to long-term would be for the existing Research and Development (R&D) tax concession to be amended so that a 200 percent concessional tax deduction was provided for both research and development into new or improved low emissions and carbon capture and storage technology. Alternatively, an equivalent fully refundable tax credit should be provided if the tax credit regime recommended in the 'ventuousAustralia' report is ultimately adopted by Government.

[6] Pg 14 *Environmental Performance Reviews: Australia 2007* Organisation for Economic Co-operation and Development.

In our view, the R & D concession needs to be significantly increased if companies are to include such tax concessions in their business strategies as the current 125% concession is of only marginal value to companies in determining whether particular projects proceed.

To encourage the early adoption of existing low emissions technology, the Review should consider introducing a 20 percent investment allowance along the lines of the temporary investment break as proposed in the *Tax Laws Amendment (Small Business and General Business Tax Break) Bill 2009*, albeit limited to only capital expenditure on low emissions depreciating assets. Regard may also be had to providing accelerated tax depreciation on replacing or upgrading existing depreciating assets which utilise low emissions technology.

14. Natural resource charging

Question 14.1 When considering the appropriate return to the Australian community for the use of its non-renewable resources, what relative weight should be given to the determinants of that return?

We broadly agree with the analysis of this issue in the consultation paper which, as we understand it, argues for the overall return to the community to be based on the appropriate government charging of private firms for the use of Australia's natural resources (which are owned by the community) and/or appropriate taxation of the returns to private producers arising from their development of the resource.

The determination of the relevant charge should reflect a balance between the returns required by private firms to develop the resource with the community's valuation of the resource. The latter may be difficult to determine but will generally be based on the market value of the resource having regard to the costs and risks associated with developing the resource. An example is for the relevant government to charge for the right to explore or use an asset, or in some cases to control such use by regulation.

Taxation measures used include company tax as well as specific resource taxes such as resource rent taxes (such as PRRT), royalties (generally levied on an *ad valorem* basis) and excise arrangements in the mining, oil and gas sectors.

We note also that state governments may prefer royalty arrangements (due to their revenue stability) rather than resource rents which tend to be more variable than the value/volume of the resource sold since they are designed to capture a portion of the above-normal profits accruing to mining and petroleum companies. However, the Commonwealth may see the latter as being more consistent with its macroeconomic stabilisation objectives.

Question 14.2 What is the most appropriate method of charging for Australia's non-renewable resources, given they are immobile but that Australia needs to compete globally for mining investment?

In light of the information contained in the consultation paper, it may be appropriate for Australia's mineral taxation arrangements to be reviewed to more closely align them with regimes in other countries as follows:

- greater use of profit based royalties imposed at a lower and/or more flexible rates, particularly by the states (implementation of our proposals on state tax reform may assist with this transition), and

- increased emphasis on transparency of mineral taxation systems.

Question 14.3 What is the role of the tax system in ensuring that renewable resources are used both sustainably and efficiently?

We broadly agree with the approach outlined in the consultation paper that governments may intervene to ensure that renewable resources are used sustainably through the imposition of a royalty-type tax which seeks to align extraction levels with sustainable supply and takes into account the ecological value of resources subject to any practical difficulties in implementing this approach such as may arise in the forestry sector.

It is noted that some problems in this area arise from certain external costs associated with timber extracted from a native forest (e.g. loss of habitat for wildlife) and the institutional arrangements in the forestry area such as the public ownership of native forests and their management by state forest agencies that are near monopoly suppliers of native forest timber. As pricing practices in this area appear to be deficient, the consequent underpricing of timber may increase the depletion rate of native forests.

We support this problem being addressed by governments imposing a sustainable extraction limit on the available resource with the consequent rents being captured by governments via appropriate auction/tender arrangements.