The Institute of
Chartered Accountants
in Australia

1 May 2009

AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

By email: AFTSubmissions@treasury.gov.au

Dear Dr Henry

Australia's Future Tax System Review – Second submission

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to make its second submission to the Future Tax System Review. This second submission has been prepared in response to the Consultation Paper released in December 2008.

As you will no doubt be aware, the Institute lodged its first submission to the Review jointly with KPMG last year. This second submission prepared by the Institute reinforces our position on a number of the key issues that were explored in detail in the first joint submission. In this submission the Institute has specifically focussed on initiatives which are directed at reducing complexity and supporting business activity for the future prosperity of the entire economy.

The Institute has not sought to respond to every question presented in the Consultation Paper, in particular we have not provided responses to questions relating primarily to the transfer system.

It is worth pointing out that the Institute has also submitted a response to the AFTS Review's consultation process relating to the retirement income system in February 2009.

Lastly, the Institute would very much welcome any opportunity to discuss our views with the AFTS Review Panel directly, or through further analysis of specific issues emerging from the targeted discussion papers which we understand are being commissioned by the Review.

If you would like to discuss any aspect of our submission please contact the Institute's Tax Counsel, Yasser El-Ansary on 02 9290 5623.

Yours faithfully

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The Institute of Chartered Accountants in Australia

Australia's Future Tax System Review Second Submission

The Institute of Chartered Accountants in Australia

The Institute of Chartered Accountants in Australia (the Institute) is the professional body representing Chartered Accountants in Australia. Our reach extends to more than 62,000 of today's and tomorrow's business leaders, representing over 50,000 Chartered Accountants and 12,000 of Australia's best accounting graduates who are currently enrolled in our world class Chartered Accountants postgraduate program.

Our members work in diverse roles across commerce and industry, academia, government, and public practice throughout Australia and in 140 countries around the world.

We aim to lead the profession by delivering visionary leadership projects, setting the benchmark for the highest ethical, professional and educational standards, and enhancing and promoting the Chartered Accountant brand. We also represent the interests of members to government, industry, academia and the general public by actively engaging our membership and local and international bodies on public policy, government legislation and regulatory issues.

The Institute can leverage advantages for its members as a founding member of the Global Accounting Alliance (GAA), an international accounting coalition formed by the world's premier accounting bodies. With a membership of approximately 775,000, the GAA promotes quality professional services, shares information, and collaborates on international accounting issues.

Established in 1928, the Institute is constituted by Royal Charter. For further information about the Institute, visit **charteredaccountants.com.au**

The Institute of Chartered Accountants in Australia

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Executive summary: 'fortune favours the brave'

The opportunity is now

Over many decades, the Australian economy has developed into a recognised open world economy. Barriers to trade and investment have gradually eased, and Australia is now in fierce competition for global capital. In many ways, the domestic economy has flourished despite the fact that Australia's taxation system has not kept pace.

The future direction of Australia's tax-transfer system should recognise the vital role played by all sectors of the community, as well as all elements of the business sector. In particular, the future direction of tax policy should, amongst other things, seek to deliver increased incentives to enter and carry on business activities, whilst at the same time ensuring that the administrative complexity of the system is kept to the absolute minimum. Valuable time devoted by individuals and businesses to administrative arrangements around taxation compliance is generally regarded as unproductive time because it takes them away from the more direct aspects of running their business, and ultimately, deriving profits.

The Australia's Future Tax System Review (the AFTS Review) has the scope to recommend to Government a variety of changes to our existing tax and transfer systems which will place Australia at the ready for the challenges of the future. To achieve significant and long-lasting structural reform of Australia's tax and transfer systems, important decisions will need to be made about either retaining key features of our current systems, or exploring the options available for moving away from certain aspects. In many ways, 'fortune will favour the brave' because a clear direction for the long-term future will, of itself, deliver benefits to taxpayers who are seeking certainty around the policy settings that the Government is focussed on.

This second submission

The Institute has previously put forward a first round submission to the AFTS Review during late 2008. The first submission was prepared jointly with KPMG (the joint submission). In this second submission, the Institute has reinforced a number of the key issues previously set out in the more detailed first joint submission.

In particular, this second submission highlights the importance of a number of key focus areas which the Institute believes the AFTS Review should explore, and in some cases, carry-out further investigation and economic analysis where appropriate.

Going forward, Australia must determine whether it will follow the global trend towards a **greater degree of reliance on consumption taxes** as a significant source of government revenues. Irrespective of the source of the revenue, our future tax system must in the future be structured so as to **not create unintended distortions** in taxpayer behaviour.

Full consideration will need to be given to reform of the existing fringe benefits tax regime and whether it is appropriate and desirable to move towards a system where **benefits are taxed in the hands of employees** rather than employers. At a broader level, the AFTS Review has the scope to examine all options available to **reduce the incidence of tax-transfer system 'churn'** and to **simplify the burgeoning level of complexity** inherent in the operation of Australia's tax regimes at both Federal and State level.

The role of businesses, both large and small, in our economy is significant. For this reason the Institute has identified a range of issues in this second submission which warrant consideration by the AFTS Review. In particular, the **competitiveness of Australia's corporate tax system**, and the design **principles of how taxation laws apply to small businesses** stand-out as clear priorities for the AFTS Review.

Further views to be considered

It is anticipated by the Institute that during June 2009, it will be able to provide the AFTS Review with the published consolidation of the broad economic and tax policy views which emerged during the Institute-sponsored *Business Tax Reform in Retrospect and Prospect* tax conference run by the Universities of New South Wales and Monash held in Sydney during February 2009. A number of AFTS Review Secretariat members attended this tax conference.

The next steps

The Institute welcomes the opportunity to provide the AFTS Review with its views as set out in this second submission. Whilst the challenge ahead for the AFTS Review is a significant one – it is an important first step on the path towards improved tax and transfer systems which will help secure Australia's economic prosperity in the future.

The type of society we all want to live in

Consultation Paper questions answered in whole or in part in this section:

Q1.1 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?

After a long period of economic prosperity, Australia now finds itself facing a significant number of challenges. Some of those challenges have their origins in past decisions which were taken for short-term expediency, at the cost of longer-term structural reform. Australia's current taxation system fits neatly into this synopsis: our taxation system has traceable links back to the early 20th century. Without question, the world is a very different place now, and the way in which individuals and businesses conduct themselves has evolved considerably.

The AFTS Review has the opportunity to examine closely the underlying structure of our current tax and transfer systems, and identify minor or major areas for improvement for the future.

As our country continues on its trajectory towards a greater role on the world-stage, and as each and every citizen expects more from their contribution to society, the demands placed on the government of the day rise at an exponential pace. The underpinnings of our tax and transfer systems will need to be such that it becomes the 'bedrock', or the foundation, upon which the greater demands of our society will be met in the future.

Current and future issues such as changing demographics, climate change, workforce participation, savings patterns, retirement incomes and investment decisions will all impact, and be impacted by, the taxation and transfer systems.

Because of this, the AFTS Review will need to ensure that Australia's tax system and revenue collection is:

- stable and less susceptible to externalities or 'shocks';
- competitive by world standards;
- transparent and unambiguous; and
- simple.

These considerations will also underpin the policy objectives of equity, neutrality and efficiency.

Exclusion of GST from the AFTS Review

The global push towards a greater degree of reliance on consumption taxes, rather than taxes on business and capital income, should be echoed here in Australia rather than resisted. Progression down this path necessarily means that some State taxes may have a greater role to play in our revenue base in the future, as would the goods and services tax (GST). It is worth acknowledging again that it is disappointing the Federal Government excluded GST from being considered as part of the AFTS Review; the Institute believes that a full and comprehensive review into our future tax system is somewhat compromised as a result of this decision.

The overall revenue mix: a clear bias needs to be addressed

Consultation Paper questions answered in whole or in part in this section:

Q3.1 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?

Q3.2 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?

It is widely accepted that despite the overall desirability of a move towards a greater degree of reliance on consumption taxes as opposed to business and capital income taxes, such a move can result in certain undesirable social and economic policy outcomes.

Nonetheless, the efficiency, equity and simplicity benefits to taxpayers of a move towards more reliance on consumption taxes could be significant. Where undesirable social and economic policy outcomes arise as a result, it is likely they could be appropriately addressed through targeted policies such as personal tax cuts, or other measures that sit outside the tax system. In other words, any broader problems arising from a shift towards consumption taxes can be managed.

As noted in the earlier section, the exclusion of GST from the scope of the AFTS Review is considered by the Institute to be a constraining factor in a full and comprehensive debate in this area. Where possible, we believe the AFTS Review should recommend to Government in its report that at some point in the medium-term a full examination of Australia's GST system (including its base and rate) will be necessary as part of the reform of our future tax system.

International comparisons suggest that our system does not favour returns to saving; this is of concern because Australians have typically found it difficult to save and therefore more perhaps should be done via the tax system to encourage that outcome. Australia's current and future demographic challenges in relation to the ageing of its population will, in the view of the Institute, hasten the need for this tax policy setting. This is discussed further in the Personal Tax section below.

The guiding principle that ought to be adopted in relation to the future development of consumption tax policies in Australia relates to efficiency and simplicity. The role of State taxes is discussed in the sections below, however it is worth pointing out here that any moves towards greater reliance on Federal and State consumption taxes will require a corresponding improvement in the way in which those taxes are currently administered. In our view the policy objective will not have been met if taxpayers are burdened with increased complexity and compliance costs as a result of such a move.

Australia's personal income tax regime: reducing distortions should be a priority

Consultation Paper questions answered in whole or in part in this section:

Q4.1 How might the personal tax system be changed to better achieve the goals of greater simplicity, transparency, equity and efficiency?

Q4.2 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?

Q4.3 Is the personal income tax base appropriately defined? Should reforms such as changes to the scope of deductions or other measures be considered?

The distribution of personal income tax

The appropriate distribution of income tax across income levels is interwoven with other areas of the AFTS Review, some of which are addressed in the sections below.

As the AFTS Review's Consultation Paper identifies, a number of submissions in the first round argue that high personal tax rates reduce incentives to acquire new skills. Some submissions also suggest that high rates serve as a key risk factor in Australia's ability to retain highly skilled workers in Australia (commonly referred to as the 'brain drain' effect).

Some stakeholders suggest that the highest personal income tax rate should more closely, or immediately, align with the corporate tax rate; this argument presupposes that doing so will yield the dual-benefit of attracting and retaining high skilled labour, whilst at the same time reducing incentives for tax minimisation.

The Institute is of the view that the distribution of income tax across income levels should seek to ensure, amongst other things, that Australia's personal income tax regime is competitive with overseas countries given the emergence in recent times of an increasingly mobile labour force. In addition, the advantages of an approach such as this would also extend to providing increased incentives to participate in the workforce. These outcomes directly address the competitiveness and workforce participation challenges we mentioned in the sections above.

For a number of years, the Institute has also been in favour of a model in which the highest personal income tax rate is aligned with the corporate rate – in order to limit opportunities and incentives to warehouse income. Apart from a relatively short period of time following the introduction of our current dividend imputation system, the highest personal income tax rate and the corporate tax rates have not been aligned in Australia. Traditionally, successive Australian governments have sought to overcome this divergence by legislating measures to limit the warehousing opportunities that can exist. Proposals to introduce some sort of 'look through' system for small businesses would, if adopted, perhaps go some way to eliminating such warehousing opportunities in that particular sector of the economy.

The Government's previously announced 'aspirational' personal tax rate goals would have imposed a 30 percent marginal tax rate on personal taxable income between the range of $37,001 and $180,000, and 40 percent for incomes above $180,000 per annum by fiscal year 2013-2014. However, the Government has determined that those goals – which in any event do not achieve an alignment of the highest personal tax rate with the prevailing 30 percent corporate tax rate – have been deferred until Australia's overall economic conditions improve.

Alignment of the company and highest personal income tax rates therefore appears unlikely, at least in the near term. Current economic conditions aside, the recommended reductions in the corporate tax burden, as advocated in the Institute's previous joint submission to the AFTS Review as well as this one, may necessitate a review of the 'aspirational' personal income tax rates once again in the future.

The Institute supports the view that personal income tax thresholds should be indexed to movements in the Consumer Price Index. Doing so would help to safeguard against the risk that the real value of an individual's after-tax income is not eroded by 'bracket creep'. The Institute acknowledges the fact that, as highlighted in the AFTS Review's Architecture Paper, frequent adjustments to the personal income tax thresholds over the past ten years have more than compensated for the effect of inflation over the past two decades.

It is also appropriate for the AFTS Review to consider whether personal income tax thresholds should be indexed to wages growth indicators as an alternative to CPI.

Defining the personal income tax base

The Institute believes that it is entirely appropriate for the AFTS Review to consider reforms to the personal income tax base.

The current tax system distorts savings decisions as it generally favours investment in appreciating assets, for example shares, real property and superannuation, whilst appearing to discourage savings decisions involving the retention of cash reserves and generation of interest yield returns which are taxed at an individual's marginal tax rate. In our view, all savings decisions should be encouraged, regardless of the asset class or vehicle through which an individual's savings decision is given effect.

Fringe benefits tax regime: back to basics

Consultation Paper questions answered in whole or in part in this section:

Q4.6 How can fringe benefits tax be simplified while maintaining tax integrity? Would it be better to adopt the general OECD practice of taxing fringe benefits in the hands of employees, rather than employers?

Returning the focus back to the key policy objective

Australia's fringe benefits tax (FBT) regime was introduced to ensure that the integrity of the tax system was maintained in situations where individuals elected to take a portion of their remuneration package in the form of benefits instead of cash salary and wages. Over the years, the FBT regime has morphed into a complex web of rules and subjective definitional boundaries that has arguably gone beyond the fundamental policy objective of maintaining integrity (in many respects, we now have an 'integrity at any cost approach').

There have been a number of suggestions over recent years for reforms to the operation of Australia's FBT regime. Such suggestions have included recommendations as part of the Review of Business Taxation in 1999 that, amongst other things, fringe benefits should be viewed as employee income and therefore taxed in the hands of those employees. Since that time, no significant moves in this direction have taken place notwithstanding the merits of that particular argument.

In 2006 the Institute commissioned a study by the highly regarded Atax School of the Faculty of Law at the University of New South Wales. The decision by the Institute to conduct this study was primarily borne out of our member's concerns about the spiralling day-to-day FBT compliance cost burden which exists for Australian businesses, particularly SMEs.

A copy of that report, titled *Fringe benefits tax design: decision time* is available on the Institute's website.

In the report by Associate Professor Neil Warren, Atax concludes that there are 'substantial economic efficiency, equity and simplicity gains' that could be derived from implementing the recommendations listed below.

> **Recommendation 1:** Fringe benefits should be taxed in the hands of employees and therefore subject to their personal income marginal tax rate, in which case reportable fringe benefits could be eliminated.
>
> **Recommendation 2:** Statutory formula fractions for motor vehicles should be adjusted to have the same impact as the application of the operating costs method.
>
> **Recommendation 3:** The subsidy to the domestic motor vehicle industry arising from the fractions applied under the statutory formula should be replaced with a direct grant by government to this sector.
>
> **Recommendation 4:** The exempt minor fringe benefits threshold should be increased in-line with CPI increases since the introduction of FBT in 1986. This threshold should also be indexed and adjusted annually.
>
> **Recommendation 5:** Fringe benefits with high compliance costs should be made non-deductible rather than taxable and therefore excluded from being classified as 'reportable fringe benefits'.

Recommendation 6: When taxing fringe benefits in the hands of employees, 'excluded benefits' that cannot be allocated to individual employees should become non-deductible to employers.

Recommendation 7: When taxing fringe benefits in the hands of employees, the reportable fringe benefits threshold should be abolished.

Recommendation 8: Fringe benefit compliance costs and the extent to which high compliance costs result in non-compliance should be reviewed.

Recommendation 9: When taxing fringe benefits in the hands of employees, the Irish model for administering the taxation of fringe benefits should be adopted.[1]

Recommendation 10: Taxing fringe benefits in the hands of employees would automatically align the fringe benefits and personal income reporting periods. The case for alignment without taxing fringe benefits in employee hands should be made clearer.

Recommendation 11: Revenue-neutral reforms to the taxation of fringe benefits should be introduced in two stages to ease complexities which may arise during the transition.

Although the study conducted by Atax was undertaken at a time when the Federal Budget was characterised by significant fiscal surpluses, it was thought that the removal of concessionally-taxed benefits would assist in funding the reforms suggested. Ignoring the immediate Federal Budget considerations at this point in time, the longer-term objective of the potential FBT reforms outlined above could still be delivered.

There are arguments which support the view that, consistent with general OECD practice, fringe benefits should form part of the tax base within the personal income tax system. It is suggested that this sort of approach would improve the equity of the FBT regime, whilst at the same time allowing the FBT base to be simplified and thereby minimising the current administrative compliance burden.

An additional 'payoff' from a move to taxing the value of fringe benefits in the hands of employees would be that it would also allow for improvements in the interaction of the tax system with the various means testing processes that currently exist within the transfer system.

We note that the Government has asked the AFTS Review to specifically examine the complexity of the existing fringe benefit arrangements for the not-for-profit (NFP) sector and make recommendations to improve equity and simplicity in the longer term. The Institute supports such an analysis which we also expect would identify whether or not direct grants of financial assistance would be a more efficient mechanism to deliver FBT concessions to the NFP sector.

[1] The Report is premised on the basis that fringe benefits should be grossed up which is also the case in New Zealand and Ireland. The preference for the Irish model over the New Zealand model is in part influenced by the fact that the approach adopted in New Zealand is driven by a desire to have as many taxpayers as possible removed from having to lodge income tax returns.

Interactions between the tax and transfer systems: clear boundaries required

Consultation Paper questions answered in whole or in part in this section:

Q4.15 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?

Q4.16 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)?

The tax-transfer 'churn'

The AFTS Review's Consultation Paper observes that the tax-transfer 'churn' could be reduced through greater integration of the tax and transfer systems. The Paper suggests that a greater alignment of the two systems across key structural elements such as the unit and period of assessment, along with a uniform approach to the treatment of income and assets, could deliver such greater integration.

Consistent with the previous position articulated by the Institute in its previous joint submission to the AFTS Review, there would certainly appear to be opportunities to harmonise some of the different characteristics that exist as between the current tax and transfer systems. Some of the specific areas which should be reviewed include the various income and asset tests, assessment processes and consideration of whether assessments should be extended so as to regard the family unit as a single taxpayer.

At the other extreme, the Consultation Paper suggests that an alternative approach could be to reduce 'churn' by enforcing a greater degree of separation, rather than alignment, between the two systems than is presently the case.

The Institute welcomes the fact that the relative merits of these vastly different strategies are being considered by the AFTS Review.

On balance, the Institute has argued in support of greater separation, rather than alignment, of the tax and transfer systems. The Institute's view has been informed not only by the perceived inefficiencies and lack of transparency issues highlighted in the Consultation Paper, but also at a very real and practical level by:

- difficulties faced by our members who are required to deal with non-tax law obligations in which they may not have the requisite experience or expertise;

- additional compliance costs relating to transfer system education and administration absorbed by our members, where such costs are traditionally difficult to recover from their clients (compliance costs in this context escape both the tax and transfer administration arms of government, as well as taxpayers, and therefore in the short-term fall on the intermediary who is typically a tax agent);

- inefficiencies and asymmetry which have arisen in the past between the tax and transfer legislation, for example non-aligned lodgment dates and definitional differences.

Any recommendations to make significant policy changes in any of these areas would, of course, require careful consideration of not only the immediate tax and transfer policy outcomes, but in all likelihood, also the broader social policy outcomes which may arise.

The taxation of business and investment activities: the heart of the economy, rewarding entrepreneurship

Consultation Paper questions answered in whole or in part in this section:

Q6.1 Can the tax system be structured to better attract investment to Australia in a way that increases national income, and if so how? For any given revenue outcome, what are the relative merits of broader base/lower rate (comprehensive income tax) or narrower base/higher rate (a narrow income tax or an expenditure tax) approaches?

Q6.2 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?

Q6.3 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?

Q6.4 What principal goals should inform the taxation of capital gains in Australia, and what, if any, changes should be made to capital gains tax as a result?

Q6.6 Should the tax system be structured to cater for the specific circumstances of small business, and if so, how?

Q6.7 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?

The Institute is mindful of the importance of attracting foreign investment to Australia in a way that increases national income. In responding to certain questions posed by the AFTS Review, we have focussed in particular on the corporate tax rate, the tax base and beneficial changes made to Australia's international tax arrangements over the past few years that in our view should be retained.

Falling behind – Competitiveness of Australia's corporate tax system

In Chapter 4 of its prior joint submission, the Institute compared the taxation of capital income, trends in corporate tax rates and corporate tax burdens. The following conclusions were reached:

1. Based on those comparisons, it would seem difficult to classify Australia as a 'low tax country'.

2. The AFTS Review's Architecture Paper states that Australia's relative tax burden, represented by total tax revenue as a percentage of GDP, places Australia in 23rd place amongst the OECD top 30. However, further analysis suggests that Australia's corporate tax burden, measured in terms of corporate tax as a percentage of GDP, has been amongst the highest in the OECD for some years now.

3. Given the increasing global mobility of capital, Australia's current corporate tax burden does not appear to be internationally competitive and is potentially placing Australia at a disadvantage when trying to attract offshore investment funds.

4. Australia is competing for the same offshore investment capital in a number of corporate sectors that are established, or are being established, by countries within the Asia Pacific region. In certain corporate sectors therefore, Australia is faced with strong regional competition from countries such as Singapore and Hong Kong, which have corporate tax rates of 18 percent and 16.5 percent respectively.

5. Australia's taxation of capital income regime, and in particular, the corporate tax burden, should be reviewed as a priority in order to address the competitiveness challenges described above.

The Institute reiterates its support for the recommendation reached in Chapter 4 of its prior joint submission that the AFTS Review should analyse Australia's approach to the taxation of capital income and assess whether Australia has the right incentives for individuals to provide for their future and to provide capital to businesses. In particular, the AFTS Review should examine the current corporate tax burden as a review priority.

The Institute's prior joint submission also explores the link (in Chapter 5) between corporate tax and productivity. In particular, the focus is on the link between how corporate tax impacts both economic growth (and vice-versa) and foreign direct investment. The recommendation arising from that analysis was that in analysing the corporate tax burden and considering the affordability of a corporate tax rate reduction, the modelling by the AFTS Review should weigh-up the longer term productivity and investment benefits against any short-term adverse impacts on government revenue.

It is worth noting that recent speeches delivered by both the Chair of the AFTS Review, as well as the Federal Treasurer, lend support to the economic argument concerning the economic growth and real labour income benefits which can accrue from a reduction to the corporate tax rate.

The Institute's prior joint submission also stated that a number of studies already indicate that capital is more responsive than labour supply to tax cuts with greater potential for GDP growth. The AFTS Review should take into account the findings of these studies in modelling the cost-benefit analysis of corporate tax reform as compared to other reforms to the taxation of capital income.

The AFTS Review's decision to commission further work on examining the efficiency and distributional consequences of corporate income tax and other investment taxes is supported by the Institute. In our view, the results of these studies should be made available for further public consultation when they are completed; doing so would allow numerous stakeholders – who may not have the capacity to undertake such studies of their own accord – to have the opportunity to consider the underlying economic arguments put forward.

In terms of the corporate tax rate, the Institute's previous joint submission recommended that the AFTS Review explore the merits of Australia adopting an 'aspirational' goal of reducing the corporate tax rate from 30 percent to 20 percent, with an interim step-down in the rate to 25 percent. This position remains the Institute's preferred recommendation in this area.

Definition of the 'base' needs work

The Institute welcomes the AFTS Review's approach to examining the current base of the corporate income tax system. Over recent years, changes to the Australian taxation system, whilst generally motivated by relevant objectives, have had the effect of increasing complexity. In some instances the recent changes have also had the effect of narrowing the 'base' of corporate taxation. A reconsideration of the base, and thereby, seeking to achieve the aspirational goals as set out above (being an ultimate 20 percent corporate tax rate) would be supported by the Institute.

Some examples of areas within the existing system which could be reviewed from a 'tax base' perspective include, but are not limited to, the following:

- amortisation of acquired goodwill and other intangibles not covered under the uniform capital allowance provisions;

- accelerated depreciation (which was largely abolished following the Ralph Business Tax Review but some statutory life caps have since been introduced);

- company loss and bad debt utilisation rules, specifically:

  - Enhancing the same business test to make it more 'workable'
  - Allowing losses on start-up expenses for large scale infrastructure projects to be refundable
  - Allowing consortium companies to flow-through losses to their shareholders, similar to the United Kingdom, and
  - Introducing loss carry-back rules;

- availability of concessions, such as research & development.

Attracting important 'inbound' investment

Attracting foreign investment into Australia also hinges on the tax treatment of non-residents (or inbound investors).

The Review of International Tax Arrangements, conducted by the Board of Taxation (BOT) in 2002, examined a range of tax issues affecting such things as the international competitiveness of Australia, both in attracting foreign investment (both portfolio and non-portfolio investors), as well as for Australian-based companies investing overseas.

Some of the BOT's recommendations resulted in important changes that improved Australia's attractiveness to offshore investors. These changes, which the Institute supports, included:

- winding back taxation of the capital gains of non-residents by limiting this to 'taxable Australian property';
- introducing conduit income rules so that foreign residents could receive foreign source income via an Australian intermediate (conduit) company without imposition of further tax by Australia;
- a broad exemption for non-portfolio dividends and branch profits; and
- improvements to the rules governing managed funds (note this work continues in regard to the changes made last year to the withholding arrangements and the Board's current review of the taxation of managed investment trusts).

Managed investment trusts

Another part of the equation for attracting offshore investment into Australia concerns the tax environment for managed investment trusts. This area is currently under review by the BOT, together with the interim changes made to Divisions 6B and 6C of the *Income Tax Assessment Act 1936.*

From the AFTS Review's Consultation Paper the Institute also notes that this BOT review will play a role in investigating the tax policy settings that would assist in positioning Australia as a financial services hub for the Asia-Pacific region.

As with the BOT's review of the anti-tax-deferral regimes discussed below, the Institute anticipates that recommendations from this review will be considered either in advance, or as part, of the AFTS Review.

Australia's dividend imputation system

The Institute's previous joint submission discussed Australia's current dividend imputation system and concluded that the AFTS Review should address whether the system should be retained or improved.

The dividend imputation system has been an important part of Australia's corporate tax system since its introduction. Over recent times there have emerged competing views as to its future. These views range from extending imputation by allowing franking credits in respect of foreign taxes paid, through to abolishing imputation and in its place funding a reduction to the corporate tax rate.

Importantly, the Institute's previous joint submission emphasised that a compelling case for abolition of the existing dividend imputation system has not yet been made.

In the Institute's previous joint submission, we stated that the dividend imputation system has suited Australia's circumstances relatively well so far. Like almost any tax system it has its shortcomings, some of those being relatively minor. Whilst there is the suggestion that the abolition of dividend imputation could fund sizable reductions in the corporate tax burden, this is likely to come at a cost to other parts of the economy.

That said, the Institute recognises that there are crucial features of the current dividend imputation system that require close consideration in any review, these include:

- the imputation system removes the double taxation that arises under a 'classical' system of taxation (i.e. where profits are taxed at the company level and then again at the shareholder level, as was previously the case in Australia);
- imputation serves to provide more neutral treatment of equity and debt and enhances the integrity of the tax system;
- Australia has a unique approach to the taxation of superannuation funds, and its significance in the structure, design and operation of our superannuation fund industry cannot be underestimated;
- the core features of the imputation system have been one of the factors which have encouraged Australian investors to participate in equity markets; and
- the imputation system has generated pricing signals and measurements which have made it attractive for Australian investors to acquire shares in Australian-based and Australian-focused companies.

On the basis that the current dividend imputation model is retained in Australia, the Institute believes that there are a range of specific issues which ought to be considered further by the AFTS Review. In particular, there should be a focus on changes to the imputation rules in relation to the taxation of international business and international transactions where foreign-sourced income is derived.

As stated in the Institute's previous joint submission (Chapter 6):

> "It should also be noted that an imputation reform proposal for foreign taxes paid was tabled in 2002 when the Government engaged the BOT to consult on whether a change was necessary to Australia's dividend imputation system. The BOT recommended that domestic shareholders' tax relief should be provided for unfranked dividends paid out of foreign source income derived after the commencement date and that the relief should be by way of a non-refundable tax credit for 20 percent and without any requirement to trace foreign tax paid or incurred.[2]

[2] The BOT, *International Taxation, A Report to the Treasurer, Volume 1*, *The BOT's Recommendations*, Chapter 2 (28 February 2003)

> The BOT also recommended, as an alternative, the streaming of foreign income to foreign shareholders (and, as a consequence, streaming of imputation credits to Australian shareholders). The idea of this proposal was to enable a swapping of credits between foreign and Australian shareholders, which is intended to indirectly achieve a result similar to giving Australian shareholders a credit for foreign taxes.[3] However, the Government at the time decided not to proceed with the implementation of the proposals, but did not rule out future consideration of the issues examined by the BOT.[4]
>
> The bias against Australian multinational companies earning offshore income is arguably a more significant challenge to Australia's dividend imputation system in an increasingly globalised world. However, it is important to note that options have already been identified to reduce this bias (albeit there will be revenue effects) without abandoning the dividend imputation system altogether."

The Institute recognises that an approach such as that identified above would need to be costed in order to better inform the economic decision about the merits of the approach. However, we believe that the following behavioural and economic issues would flow from this suggested approach:

(a) The provision of a credit to Australian shareholders in relation to unfranked dividends from foreign income would amount to a form of tax incentive.

(b) The net effect of the tax incentive would be to retain an attractive environment for emerging Australian companies, growing on the global markets, to raise their capital in Australia.

(c) For Australian global companies to retain an Australian base, and raise capital in Australian markets, this is an important element in protecting the relationship of those companies with their Australian investors, and their ongoing activity in Australia.

The Institute has not commissioned economic research on this issue such as the effect on the cost of capital. However, anecdotally it appears that without change in this area, Australian companies that 'go global' and lose their relationship with Australian investors and Australian capital raising will be more likely to migrate. Alternatively, they may be more likely to have relatively lower share prices resulting in takeovers by non-Australian companies.

Giving businesses room to grow – Improving 'outbound' investment

Another dimension to improving the ability of Australian companies to operate internationally-orientated businesses from a tax perspective is to have appropriate anti-tax-deferral regimes. In Australia at this point in time, these rules consist of the controlled foreign company, foreign investment fund, transferor trust and deemed present entitlement rules.

The BOT was asked to review these arrangements by the previous government on 10 October 2006. The objectives of the review were broadly stated as being focussed on reducing compliance costs for Australian businesses operating overseas, whilst also aiming to remove obstacles to their international competitiveness and continuing to counter tax deferral.

The Institute understands that the BOT delivered its report to the current Government in September 2008 and we await its response to those recommendations. The Institute anticipates that these will be dealt with either in advance of, or as part of, the AFTS Review as those issues form an important factor in the 'going global' equation for many businesses.

[3] The BOT, *International Taxation, A Report to the Treasurer, Volume 1*, *The BOT's Recommendations*, Chapter 2 (28 February 2003)
[4] Australian Government, *Treasurer Media Release No. 032, Review of International Taxation Arrangements* (13 May 2003)

Exploring the options – Alternative models for taxing corporates

In assessing Australia's competitiveness going forward (both for inbound and outbound investors); the Institute's previous joint submission compared some of the advantages and disadvantages of alternative corporate taxation models. The Institute encourages the AFTS Review to conduct further and more detailed evaluation on the relative merits of any significant changes to Australia's current corporate taxation model as part of the AFTS Review.

The various taxation models discussed in the Institute's previous joint submission included:

- allowance for corporate equity;
- shareholder allowance for corporate equity;
- allowance for shareholder equity;
- comprehensive business income tax;
- dual income tax;
- corporate cash flow tax; and
- flat tax.

Whether the impetus be globalisation, specific regional objectives or macro-economic policy, the Institute recommends that the AFTS Review carefully evaluate the merits of the above alternative corporate tax models to determine whether such models offer (either in whole or in part) possible reform options that would be appropriate in an Australian context.

Improving resource allocation and encouraging entrepreneurial activity

The Institute supports the AFTS Review's decision to undertake further analysis in this important area.

Measurement of the decline in asset values for tax purposes was raised in the section above dealing with the tax 'base' where we have stated our view that this issue warrants close focus for the AFTS Review. The arguments in the AFTS Review's Consultation Paper both for, and against, the amortisation of acquired goodwill and intangibles and differing depreciation write-offs for tangible assets should be explored as part of the AFTS Review.

Similarly, the AFTS Review should also seek to determine its view on the appropriate tax treatment of losses. As stated above, the Institute believes that enhancements in all of these areas of the tax system are required. Ensuring that business decisions to enter new markets domestically and internationally is important for Australia's future economic prosperity, therefore improvements to the tax system that deliver such results should be carefully considered.

Taxation of capital

The Institute notes the comments in the AFTS Review's Consultation Paper on biases arising from the CGT treatment of appreciating assets. However, the Institute is conscious of the importance the so-called 'realisation principle' has played in the existing tax policy in this area. In brief, this principle dictates that taxes should be levied at times when taxpayers are likely to have the means to pay – in the case of capital gains, this is typically at that point in time when they are 'realised'.

The Institute is of the view that there are many circumstances where taxation on a basis other than realisation would seem unworkable and inequitable.

For completeness, we also note that recognition of certain expenses associated with acquisition of capital assets are also deferred until realisation.

The Institute shares the concerns of some other stakeholders as to the growing complexity and record-keeping requirements associated with the current CGT regime. In the past, the Institute has raised with government the possibility of adopting some form of a 'stepped CGT rate' depending on the length of time an asset has been held, which is in-line with the approach adopted in a variety of other jurisdictions. Further analysis into the merits of such an approach should be considered by the AFTS Review.

Other arguments in the area of CGT suggest that the tax treatment of capital losses should also be considered, including reconsideration of the rationale for quarantining capital losses from revenue losses (in other words, the existing rules which dictate that capital losses can only be offset only against future capital gains).

Other considerations for the AFTS Review should, in our view, include an analysis of the unintended CGT outcomes that may sometimes arise as a result of differences between timing of cash receipts as compared to contract terms and the realisation principles that are required to be applied in such circumstances.

Small businesses – unique in every aspect

The Institute has been a long-standing advocate for simplification of tax laws and easing of the compliance burden for small business. The Institute therefore supports measures in the tax system to cater for small business. In particular, we support initiatives that seek to free small business from the more onerous, complex and compliance-intensive tax rules that apply to larger businesses.

Although the "simplified" tax system seems not to have delivered on its objectives, small business should be given options to use a cash-based (with amortisation) tax reporting system or a "look-through" taxation arrangement for shareholders and owners.

In regard to the "look-through" approach, in April 2008 the Institute produced jointly with Deloitte a submission titled *Entity Flow-Through Taxation* (EFT). The EFT Submission was referred by the Federal Minister for Small Business to the AFTS Review for consideration and the Institute welcomes debate on the proposals put forward as part of this consultation process.

One of the key principles put forward as part of the EFT regime would be to view SMEs as partnerships; that is, ignore the operating entity and instead tax the profits in the hands of the owners of the business. Under this EFT regime, there would be no need for integrity measures such as: Division 7A of the ITAA 1936; carry-forward company loss provisions; fringe benefits tax provisions; the consolidation regime; family trust elections; trust loss rules, or franking credit rules.

In relation to reducing complexity for small businesses more generally, the Institute acknowledges that there have already been positive moves made to streamline the eligibility criteria for the various existing small business concessions. Specifically, Tax Laws Amendment (Small Business) Act 2007 introduced measures to align the thresholds for the various small business tax concessions. Under these measures, an entity will be a small business entity if it:

- carries on a business; and
- satisfies the $2 million aggregated turnover test.

Entities that satisfy this test can then choose to access the following concessions (subject to any additional criteria relating to each specific concession):

- small business CGT concessions (for example, the 15-year asset exemption, 50 percent active asset reduction, retirement exemption and small business roll-over);
- simplified tax system concessions (for example, the simplified depreciation rules, simplified trading stock rules, immediate deduction for certain prepaid business expenses);

- choice to account for GST on a cash basis, annual apportionment of GST input tax credits and choice to pay GST by instalments;
- FBT car parking exemption; and
- PAYG instalments based on gross domestic product adjusted notional tax.

The Institute believes that there are further opportunities available to reduce complexity for small businesses such as via a redesign of the existing simplified tax system and reassessment of the scope of this system, as also recommended in the Institute's previous joint submission. Developments in other regulatory regimes provide opportunities for harmonisation as well. For example, the recent initiatives to reduce the financial reporting burden for private entities means there should be opportunities for coordination of tax responses in a manner that complements other regulatory regimes.

Encouraging savings

As stated by the Institute in its previous joint submission, the historically negative levels of household savings make the case for mandatory savings in the form of superannuation highly desirable. This approach has the dual benefit of also supporting Australian capital markets with funds currently under management of about A$1 trillion.

The Institute considers that other forms of savings, not just superannuation, should be encouraged through the tax system. As noted in the previous submission, Australia's tax rates on various forms of capital income are very high in comparison with other OECD countries. This makes Australia potentially vulnerable given the increasingly mobile capital flows in the global economy.

Tax policy settings that encourage other forms of savings will no doubt be an important consideration for the AFTS Review.

Managed investment schemes

The Institute acknowledges that tax-driven managed investment scheme (MIS) have had some favourable impacts with respect to investment and job creation in certain regional areas across Australia. However, in some instances MISs have lead to distortions in rural land prices as MIS promoters and investors compete for land with other rural producers.

The tax incentives associated with MIS create some distortions in the playing field in terms of the acquisition of productive rural land by providing the MIS promoters and investors with an incentive which is not available to other rural producers. The AFTS Review should consider this as part of the broader analysis into desirable and undesirable policy outcomes in the future tax system.

Rural and regional businesses – supporting local communities

Any review of Australia's tax system needs to recognise the economic contribution of rural producers, especially with respect to export earnings. Although the current tax system incorporates a variety of initiatives which recognise the cyclical nature of rural activity, the system doesn't appear to appropriately cater for the consequences faced by producers arising from the challenges of climate change. Some of those challenges involve the requirement to reduce carbon emissions in the future and increasing community expectations around environmental stewardship principles.

The Institute recommends that the AFTS Review also examine the existing regional business incentives, such as the zone rebate scheme, impacting not only rural producers but the broader business community across regional Australia

Complexity and compliance costs: back to the future

Consultation Paper questions answered in whole or in part in this section:

Q8.1 Which taxes or transfers are the most complex and impose the greatest costs? How should these costs be reduced (by abolishing the taxes or transfers or by making the rules applying to them simpler)?

Q8.2 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?

Q8.3 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?

Q8.4 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?

Simplify, simplify, simplify

As noted in the AFTS Review's own Consultation Paper, there are at least 125 different Australian taxes, many of which are levied on essentially similar transactions by different Australian governments with relatively little harmonisation across jurisdictions. Of these, in fiscal year 2006-07, ten taxes accounted for 90 percent of total tax revenue collected by Australian governments, with the remaining 115 taxes accounting for the other 10 percent. There are also around 40 cash transfer payments made by the Australian governments, and around 300 tax concessions (or "tax expenditures").

Chapter 11 of the Institute's previous joint submission draws attention to the draft report of the Independent Pricing and Regulatory Tribunal of New South Wales (IPART NSW) which assessed a number of NSW and Commonwealth taxes based on criteria of efficiency, equity, transparency, simplicity and robustness. We are not aware of the extent to which similar work may or may not have been done in respect of other Australian jurisdictions.

Based on comments in the AFTS Review's Architecture Paper, and the IPART NSW draft report, the Institute has previously recommended that a strategy be developed to:

- eliminate inefficient taxes and that, as a starting point, the AFTS Review produce a discussion paper for consultation on this topic in conjunction with Coalition of Australian Governments (COAG); and
- harmonise and/or consolidate into one national regime, generally with one tax administrator, a number of State tax regimes. Again, a possible way to progress this issue would be to produce, in conjunction with COAG, a discussion paper for consultation.

The Institute is pleased to note that the AFTS Review either has, or is considering, commissioning research which will aim to assess the efficiency costs of the major taxes currently being levied in Australia at all levels of government, alongside the benefits which may accrue from any potential changes to the existing systems.

We note that the Business Coalition on Tax Reform (BCTR) has recently completed a report in conjunction with the Centre for International Economics in relation to state business tax reform, for submission to the AFTS Review. This report provides a comparative analysis of the relative merits of the key state taxes, highlighting the most efficient and inefficient taxes. As it is backed by economic modelling, it is insightful as it illustrates, by way of three alternative 'change portfolios', that potential economy-wide benefits could be delivered by reforming state taxes and eliminating the poorest performing taxes.

At a basic level, as noted in the Institute's previous joint submission, legislation governing the largest revenue tax system in Australia, income tax, currently spans two acts. For the reasons set out in that submission, we recommend that an integrated tax code be developed with a consistent structure, language and standardised definitions in a process which allows the tax policy settings underpinning the existing tax laws to be challenged to keep pace with economic changes.

The Institute also recommended tax system changes that align or better interact with financial reports prepared by businesses in accordance with accounting standards. The Institute is pleased that the AFTS Review's Consultation Paper acknowledges that there may be scope for improving certainty and reducing compliance costs through the greater use of accounting concepts for those businesses that produce financial reports in accordance with those standards.

Clearly, tax administrators have a role to play in mitigating the level of complexity within the tax system. Whilst the current division of responsibility between tax administration and tax policy appears logical, greater transparency of the tax administrator's views on tax law policy and complexity would in our view be beneficial, particularly as part of an annual care and maintenance process. Consistent with the Institute's previous joint submission, tax administrators should form an integral part of the development of tax policy and their involvement in the process should be more transparent.

Skyrocketing compliance costs

The AFTS Review's Consultation Paper notes that it has, or is considering, commissioning research into tax and transfer compliance costs which aims to draw together and build on results from existing research to identify a framework for calculating estimates of compliance costs in the future. The Institute welcomes this initiative.

As noted above, the administration of the tax system would be significantly simplified by eliminating inefficient taxes and either harmonising or centralising similar taxes. This would reduce the significant compliance burden absorbed by taxpayers because of differing rules to collect similar taxes across different Australian jurisdictions.

A simplified approach would reduce the significant compliance cost to taxpayers which, as identified in the BCTR's state taxes report, also presents potential economy-wide growth opportunities that could be unlocked. Further potential can be derived from eliminating inefficient taxes and by centralising the administration of the more efficient state taxes.

The Institute's previous joint submission to the AFTS Review also suggested that, as headline tax rates converge, the 'friendliness' of a tax system may emerge as an important differentiator of any given country's tax system appeal to business. As suggested by the Institute previously, we believe merit exists in:

- a greater focus on post-implementation review of new legislation and the implementation of an annual 'care and maintenance' program to ensure the tax system is operating as intended and is efficient from the end user's perspective;
- tax system changes that align or better interact with financial reports generated in accordance with recognised accounting standards; and
- enhancing the tax policy and design processes in-line with the recommendations of the Tax Design Review Panel.

For small business, the AFTS Review's Consultation Paper acknowledges calls for a separate and less complex tax system for small business or a review of existing arrangements for small business to ensure they are appropriately targeted. In the sections above the Institute makes reference to the work we have previously undertaken in this area.

The Institute supports the AFTS Review's endeavours to investigate further the feasibility of excluding certain taxpayers from the requirement to lodge personal income tax returns. That said, we believe it would only be appropriate for such an approach to be adopted if the decision is based on the premise that it would be an 'optional' decision for taxpayers. This is considered important so that taxpayers are not prohibited from being able to claim legitimate work-related expense deductions against their assessable income based on appropriate substantiation.

A move towards the exclusion from preparation of personal tax return approach may require extending withholding of taxes at source to include, at a minimum, interest on bank deposits. It may also necessitate severing the links between the tax and transfer systems as we have discussed above.

The Institute supports the ongoing efforts of the Australian Tax Office to pre-populate income tax returns in order to minimise compliance costs for individual taxpayers, which has the dual benefit of also improving the overall compliance and reporting rate.

It is worth noting that the Institute is also in support of the joint efforts of the Commonwealth and State Governments to reduce the current reporting requirements imposed on business through the Standard Business Reporting Program.

'Over-engineering' tax laws

As a general observation which applies to most Australian taxation laws, we believe that there is a tendency for legislation to be drafted and administered in a manner designed to protect the revenue at all costs. This in itself means that there is scope to significantly simplify legislation at the cost of equity and/or efficiency to a greater extent than is presently the case.

Regardless of different perspectives on this issue, the development of a framework for calculating estimates of compliance costs in the future may go some way to ensuring that for new legislation there is, or perceived to be, a better calibration of the intended policy objectives along with the difficult exercise of keeping new taxation laws as simple as possible.

Tax policy design – good work done, but more to do

The Institute welcomes the adoption by the Government of the recommendations of the Tax Design Review Panel. However, the Institute identified in its previous joint submission some barriers to open and ongoing tax policy design consultation including:

- the significant backlog of tax measures announced but not yet enacted; and
- the perception, in part caused by the backlog of tax measures, that a number of government stakeholders in the responsible agencies do not have sufficient "headcount" to handle the significant workload generated by the complexity of the existing system.

The Institute would therefore support any recommendations by the AFTS Review to increase resourcing in the appropriate government agencies to allow for the full implementation of the remaining recommendations from the Tax Design Review Panel. The Government is to be commended for implementing a number of key recommendations in this area expeditiously.

State and local tax regimes: it doesn't have to be this complex

Consultation Paper questions answered in whole or in part in this section:

Q9.1 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?

Q9.2 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?

Q9.4 What opportunities could be pursued to deliver more seamless administrative arrangements of the tax-transfer system across the federation?

It's not a competition – it's about raising taxes efficiently

In line with the Institute's view that state taxes should be reformed so as to move towards greater reliance on more efficient taxes and a more streamlined, central administration structure, consideration should be given to assigning appropriate revenue raising powers to achieve this objective. This may necessarily involve increasing the Vertical Fiscal Imbalance (VFI) which may involve a 'trade-off' between efficiency and accountability; however additional measures could be considered if necessary to address any accountability concerns.

For example, as mentioned in the AFTS Review's Consultation Paper, a re-distribution of expenditure functions and responsibilities from State to Federal level (particularly those of national significance such as water, natural resource management, health and infrastructure) could be a viable solution for aligning accountability and revenue raising powers.

Greater accountability – harmonisation is the way to go

Given the complexity of the differing payroll tax regimes across the States, the Institute endorses the recent steps nationally to harmonise payroll tax arrangements to deliver compliance cost savings. In addition, to improve the efficiency of payroll tax administration, the Institute urges the return to a single payroll tax regime administered nationally, on a similar basis to the existing GST system.

Similar to payroll tax, land tax regimes in the various States suffer from complexity and inconsistency as between jurisdictions. Complexities include the fact that each State has different rates, different thresholds and different exemptions. Inconsistencies include different grouping rules and calculation methods where a taxpayer owns more than one property in more than one jurisdiction.

To improve the efficiency of land tax administration, the Institute believes that the AFTS Review should recommend harmonisation of land tax across all jurisdictions. Once again, ideally one single land tax regime administered nationally would also be highly desirable, consistent with the approach recommended above in relation to payroll tax.

Regarding stamp duties, the Institute encourages the State governments to abolish stamp duties in accordance with the timetable (that is by 1 July 2013) established in the most recent Intergovernmental Agreement on Federal Financial Relations (IGA), which took effect on 1 January 2009. Furthermore, in the spirit of the IGA, we would encourage the AFTS Review to examine the merits and appropriateness of the remaining stamp duties such as duties on real non-residential and real residential property and insurance duty.

The Institute believes that such a review may ultimately recommend that these duties be added to the "specified inefficient taxes which impede economic activity", as stated in Schedule B to the IGA on 'Taxation Reform'. In this context, the Institute notes that the analysis undertaken in the BCTR report (referred to above) on state business tax reform identifies duties on real property as amongst the 'worst' performing state taxes in terms of efficiency, equity, cost effectiveness and neutrality.

Additionally, each of the proposed 'change portfolios' referred to in the BCTR report used to model projected Australia-wide economic impacts indicate that significant GDP growth could be generated by the removal of such inefficient taxes in favour of more efficient, broader-based taxes.

Interaction between tax and environmental policies: our future looks green

Consultation Paper questions answered in whole or in part in this section:

Q13.1 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?

Encouraging 'green' behaviour through tax policy

The Institute supports initiatives delivered via the tax system which have the effect of encouraging green behaviour by both individual and business taxpayers. In addressing environmental issues generally, the importance of Australia having a favourable regime that fosters and promotes innovation cannot be overstated.

As the AFTS Review will be aware, improvements to the existing R&D tax concessions have recently been considered as part of the Government-commissioned Review into Innovation. The Institute looks forward to the release of the final report from the expert review panel and the Government's response to these recommendations. However, we have included some of the key points here in this AFTS Review submission in the event that some of these initiatives are delayed.

Some of the initiatives identified by the Innovation Review included:

- replacing the existing R&D tax concession (and its various permutations) with a two layered tax credit. A 40 percent non-refundable tax credit would be available to large firms, with a refundable tax credit of 50 percent available to smaller firms with turnover of less than $50 million; and
- extending eligibility for the 40 percent tax credit to all R&D expenditure undertaken in Australia.

In its October 2008 submission on the review panel's report *'Venturous Australia – building strength in innovation'*, the Institute argued the case for simplification of the R&D tax concession and the removal of existing complexities and inefficiencies. The Institute's key recommendations addressed a number of broad issues including the proposed refundable R&D tax credit and its application to SMEs, the "on own behalf" test and the breadth of eligible R&D activities.

The proposed emissions trading scheme

Given the significant role that can be played by delivering incentives through the tax system and influencing taxpayer behaviour, the Institute is of the view that certain measures need to be introduced in the immediate-term to support the substantial private investment in green technologies that will be required in conjunction with the proposed CPRS regime.

Such tax incentives should ideally have formed part of the CPRS implementation program already announced by the Government, as affected businesses will need to begin (if they have not already) investing in appropriate new technologies in order to appropriately manage their carbon emission obligations.

The Institute has publicly stated this view in recent hearings held by the Senate Standing Committee on Economics during its inquiry into the proposed CPRS.

The Institute has put forward in its submissions to Government the initiatives that we believe should be introduced in through the R&D system in order to support the large scale private investment required to achieve carbon pollution reduction targets. Some of the measures put forward include increasing the deduction on eligible "green" technology R&D expenditure to 200 percent and the introduction of a refundable tax offset for certain eligible businesses and activities.

Other incentives suggested in the Institute’s previous joint submission to Government included:

- changes to existing capital allowance provisions;
- introduction of specific provisions such as increased depreciation rates (either through asset-class specific rates or via a flat loading rate) applicable to emissions-reducing capital expenditure. Such measures would need to specifically include expenditure relating to "add-on" or refitting of existing plant and equipment;
- introduction of a targeted investment allowance; and
- amending the concept of ‘taxable purpose’ in the context of various provisions in the income tax legislation to expressly encompass activities that have the purpose of emissions abatement by a business.