

**Business
Coalition for
Tax
Reform**

Level 11, 455 Bourke Street
Melbourne Vic 3000
Telephone (03) 9600 4411
Facsimile: (03) 9600 4055

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AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: AFTSubmissions@treasury.gov.au

Dear Sir / Madam

SUBMISSION – HENRY REVIEW ARCHITECTURE PAPER

The Business Coalition for Tax Reform (BCTR) is a forum that brings together the views of the business community on tax reform issues. BCTR members share a desire to develop a unified business approach to building a better taxation system that enhances both international and domestic business competitiveness and fairness, and which assists in creating a business climate that is conducive to investment, growth, job creation and private saving.

A list of BCTR member organisations is contained in Appendix B.

The BCTR is pleased to provide its comments on the “Architecture of Australia’s tax and transfer system” (the paper), released by the Australian Treasury as input to the “Australia’s future tax system” (AFTS) review that was announced by the Treasurer in May.

The various tables included at the end of Chapter 2 of the paper provide a most comprehensive source of information about various aspects of Australia’s tax and transfer system, and its authors are to be congratulated for their thoroughness. Together with the analysis in the later parts of the paper, stakeholders should be able to develop a common understanding of the current state of the system being reviewed.

As indicated in the foreword to the paper, it is for the Review Panel to make actual recommendations about possible future change and we understand from the Media Release dated 19 August 2008 that it is proposed to release a consultation paper later this year.

In responding to the paper, and as a way of assisting the Review Panel in settling its consultation paper, the BCTR has developed a number of tax and transfer system design principles it considers might usefully guide the review. Rather than set out these principles in isolation, we have endeavoured to enliven them by providing a number of specific policy issues that the Review Panel might wish to consider in framing its consultation paper. Accordingly, we have not precisely followed the format suggested in the Media Release.

For example, we take up the issue of dividend imputation under international competitiveness. Imputation has been an important feature of Australia’s business and personal tax system for more than 20 years. Other countries have been modifying their tax systems in this regard and, while at this stage the BCTR’s view is that the system should be maintained in its present form, we believe the Review Panel should seek feedback from stakeholders and consider making recommendations about its retention or otherwise.

Likewise, under the principle of avoiding unnecessary complexity, we have suggested (among other things) that the fringe benefits tax system might benefit from an overhaul, and that reporting entities might be given the option of using audited accounts for tax (subject to making a limited number of policy based adjustments). We wish to emphasise that the specific issues put forward are not intended to be exhaustive. Nor, at this early stage, is the BCTR strongly attached to any particular policy outcomes. The issues are included simply as a way of illustrating the suggested principles and as a guide for the Review Panel in going forward.

Just prior to the announcement of the current review, the BCTR has commissioned some research into the reform of State taxation, which is being carried out by the Centre for International Economics. We expect the report to be finalised in the coming weeks, and would be pleased to provide it to the Review as further input from the BCTR.

In the event you have any questions regarding the matters canvassed in the submission (Appendix A) please do not hesitate to contact me on 03 9634 9901, or Frank Drenth on 03 9600 4411. In the meantime, I look forward to meeting with the Review in Melbourne on Thursday next week.

Yours faithfully

A handwritten signature in black ink, appearing to read 'John Stanhope', written in a cursive style.

John Stanhope
Chairman

Appendix A

SUBMISSION – AUSTRALIA’S FUTURE TAX SYSTEM ARCHITECTURE PAPER BUSINESS COALITION FOR TAX REFORM

The suggested tax and transfer system design principles are as follows:

1. *The design of the tax system should result in a robust and stable revenue base.*

This goes to the question of the tax mix, and the paper noted in Chapter 6 that Australia collects a high share of tax revenue from labour income and capital income when compared to other OECD countries. On the other hand, our tax burden on consumption is currently among the lowest in the OECD.

The BCTR notes Australia’s relatively high dependence on company income tax – both in absolute terms and as a percentage of GDP. While the paper attributes this mainly to profit growth, we would observe that of all the main revenue sources, company income tax is probably most subject to fluctuations. Stamp duty on real property conveyancing also tends to fluctuate with economic cycles. An undue reliance on unstable revenue sources is not ideal.

As a general rule, a well designed tax is one that has a broad base and a low rate. Australia has a number of taxes that fail to meet this test - in particular the GST with its narrow base, as well as payroll tax and some land taxes which have a range of exemptions. There may be sound policy reasons for this but, to the extent permitted by its terms of reference, the Review Panel might usefully examine that aspect of the tax system.

2. *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.*

On competitiveness

For all Australia’s positive attributes, such as political stability, a sound system of regulation and a well educated workforce, our location represents an inherent disadvantage in attracting and retaining investment.

This is not to suggest that our tax system should always offer the lowest rates and the most generous incentives. For example, we may not want to offer a 10 per cent company income tax rate as Ireland does, or to allow individuals to offset housing loan interest against other income as the US does. Nor should our tax system be designed by cherry-picking what some stakeholders might regard as the most favourable features of other countries’ tax systems.

However, businesses can often choose where to invest, and we do need to look carefully at every aspect of our tax system to ensure we are as competitive as we can be, having regard to our revenue needs and other policy considerations.

The following list covers a number of issues where the BCTR believes Australia may be less competitive than other countries:

- *Company income tax rate*

Other countries have moved on rates since the *Warburton/Hendy* report of just two years ago, and Australia's company income tax rate is now well above those of most competitor countries. Given the responsiveness of foreign direct investment to tax, a reduction in both the nominal and effective corporate income tax burden is likely to improve economic growth.

- *Dividend imputation*

This is not strictly a competitive issue so much as an important point of difference. Australia is now one of just two countries having a full imputation system, with many other countries recently moving away from such systems. Notwithstanding these international developments, the imputation system is well understood and supported by Australian investors and is also an integral part of our unique system of taxing the in-fund earnings of superannuation funds. Without wanting to prejudge the issue, the BCTR would not be inclined to support any major changes to dividend imputation. However, we would expect the Review Panel to include it as an important policy setting that warrants its attention.

- *Capital allowances*

While we note the uplift in diminishing value capital allowance rates implemented about two years ago, there are residual business concerns that in many cases an asset's effective life as defined under the current tax law (which includes business use in the secondary market) does not reflect the reduction in value actually experienced in the marketplace. As a related matter, the BCTR is concerned that the much faster tax amortisation rates offered by competitor countries across a range of capital assets can make a difference at the margin for some large capital intensive projects.

Australia's tax treatment of acquired intangibles is much less favourable than a number of other countries, and the 'blackhole' rules still do not catch all business expenditure. These last two issues go to the question of having the appropriate tax base.

- *Treatment of losses*

Australia's failure to provide for loss carry-backs represents another major point of difference when compared with a number of other countries. This can result in stranded losses in some cyclical industries, as well as for terminating projects with significant closing down costs. The absence of loss carry backs can also unfairly impact on businesses and individual taxpayers where capital losses follow capital gains realised in earlier income years.

In addition, there are aspects of the continuity of ownership test and the same business test we believe also do not work as well as they could.

- *International tax rules*

The BCTR acknowledges the positive changes that have been made to Australia's international tax rules since the Review of Australia's International Tax Arrangements by the Board of Taxation in 2003. However, further improvements are needed to attract and retain globally focused companies, in particular in relation to the very high tax burden facing resident shareholders on the distribution of taxed foreign earnings. We believe the Review Panel should reconsider two recommendations made by the Board of Taxation in this regard – the streaming of foreign income to foreign shareholders (an issue New Zealand has raised recently in a bilateral context), and a partial imputation credit for dividends paid by Australian companies out of underlying foreign earnings.

On the tax administrative burden

This issue is linked to competitiveness because of the perception held by business that the Australian Taxation Office at times contributes to compliance costs, risk and uncertainty through its aggressive and unanticipated interpretation of the income tax laws (sometimes with retrospective effect).

While we recognise the ATO is bound by the law, the BCTR believes that the ATO at times fails to adopt a sufficiently commercial approach in its interpretation and administration of the tax laws. Nor, in our view, does the ATO always pay sufficient regard to the policy context of the law it is interpreting.

We note the recent recommendation by the Tax Design Review Panel for the Commissioner to be given discretionary powers to interpret the tax law in a manner that gives effect to the intention of the Parliament where he would otherwise consider himself as being bound by what he regards as the clear words of the legislation (which is not something that business always sees eye to eye on with the ATO). Provided the use of such powers was confined to situations where taxpayers are relieved of what would otherwise have been an unintended tax liability, the BCTR would be supportive of introducing such a discretion.

Although it is beginning to take steps to assist large businesses in achieving certainty regarding their tax obligations, the ATO does not always welcome criticism, particularly in relation to its approach to statutory interpretation.

The BCTR believes some sort of external oversight may assist the ATO in adopting a more commercial approach across a range of its activities. We note in this regard that the IRS in the US and Revenue Canada operate under the auspices of external boards.

The administrative burden imposed by the tax laws should be more carefully considered at the policy development/law design stage. While this has been much talked about, the reality is that business hasn't seen this applied in practice. Road testing aspects of proposed legislation would assist in avoiding both unintended technical consequences and undue compliance requirements.

3. *The tax-transfer system should, to the maximum extent possible, be consistent with broader government policy objectives in areas such as climate change, the emissions trading system, population policy, globalisation and technological change.*

When developing tax policies, it is important to ensure they are not inconsistent with other broad areas of government policy. Likewise, when other policies are being developed, it is sometimes necessary to ensure their interaction with the tax laws will not result in unintended outcomes. The recent Green Paper on emissions trading represents an example where the associated income tax issues were considered in an integrated way and a number of specific tax rules are expected to be included in legislation to be introduced later this year.

4. *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. It should also be consistent with the traditional principles of equity, simplicity (or eliminating unnecessary complexity) and efficiency.*

On distortions and the taxation of savings

One issue that assumes greater than normal significance in today's fragile financial environment is the relative disadvantage of ordinary interest bearing savings instruments. They are taxed on the inflation inclusive part of the nominal interest rate, which is not attractive when compared to other forms of savings that enjoy different tax treatment – e.g. superannuation savings, direct investment in shares (franking and CGT discount), and negatively geared investments generally.

Without suggesting these other forms of saving should have their tax treatment changed, there is probably an argument for improved taxation of interest bearing deposits and other savings instruments which produce an interest like return. To avoid distortions, any such changes should apply to collective investment vehicles on a flow through basis.

On efficiency and labour participation

Being a tax oriented group, the BCTR has not previously devoted a great deal of resources to the shape of the transfer system. Nevertheless, we recognise the two systems are intricately linked, and there are efficiency aspects of the transfer system that business takes a strong interest in – especially labour participation rates.

In a broad sense, we would like the welfare to work interface to operate as smoothly as possible, and for EMTRs to be as low as they can be. Having said that, the fact remains that high EMTRs are the inevitable consequence of our targeted welfare system. There are two obvious ways around high EMTRs – one is having universal benefits and the other is to have no benefits at all. In our view, neither of these two alternatives represent good policy.

EMTRs have over recent years been reduced by pushing the taper further up the income chain, which creates further inefficiencies as middle to high income households have some of their tax dollars returned as welfare benefits and results in criticism of 'churning'.

On complexity

We agree that while the actual cost of compliance may be difficult to measure reliably, it is probably higher than it needs to be.

The BCTR believes this is partly attributable to an anti-avoidance mindset that stems from the early tax avoidance schemes of the 1970s and 80s. For a time, the tax laws were drafted in excruciating detail, with complex anti-avoidance rules propping up specific integrity measures. Often, those highly detailed rules in themselves created planning opportunities which would then be shut down with yet further amendments. This is slowly changing, but the legacy of complexity is immense.

In its approach to reviewing the anti-tax-deferral rules that is currently under way, the Board of Taxation clearly recognises that in striking a balance between preventing the deferral of tax by accumulating income offshore and imposing undue compliance costs on business, it would be unproductive to seek to tax every dollar of what might be regarded as incidental tax deferral as part of normal business operations.

Accordingly, the Board's Issues Paper released earlier this year proposed a number of sensible exemptions which ensure that legitimate businesses are not burdened with high compliance costs in an area that presents little real risk. If adopted by the government, these recommendations would slash hundreds of pages from the income tax law, as well as relieving business of unnecessary compliance costs.

Likewise, the Commissioner of Taxation has, in some of his recent speeches, referred to optimising the level of voluntary compliance by adopting a risk based approach to the compliance activities conducted by the ATO.

In the meantime, there are aspects of the current tax system that we believe could be modified to significantly reduce complexity and hence compliance costs without adversely impacting on the integrity of the tax base. We put forward the following non-exhaustive list for the Review Panel's consideration:

- *Fringe Benefits Tax*

For a tax that falls mainly on company cars, the compliance costs associated with FBT seem extraordinarily high. Most taxpayers who are burdened with these compliance costs have long realised that the work involved in capturing the various 'rats and mice' benefits is quite disproportionate to the tax raised. Most of these things are not easily identified in mainstream business systems, and large businesses apply significant resources in tracking down minor benefits and reporting them on earnings summaries. A number of reviews over the years have failed to address these problems in a meaningful way.

The BCTR believes that if the FBT system were designed today, and its designers applied the mindset adopted by the Board of Taxation in its review of the anti-tax-deferral rules (in other words, a risk based approach that avoids imposing unnecessary compliance costs by seeking to tax every last dollar), it would be a much easier tax to comply with.

A streamlined FBT might, for example, only tax cars (but not 'pool cars'), loans, residential housing, expense reimbursements and any other benefits that could reasonably be regarded as being part of an employee's remuneration package (this last catch all category has been used already in relation to employee meal cards). Such a system would do away with the need to record who went to sporting or cultural events (and with whom), the occasional personal use of pool cars and a myriad of other obscure 'benefits'.

- *The use of audited accounts by reporting entities*

One way of cutting through the inordinate level of complexity might be to allow reporting entities to elect to account for tax on the basis of their audited accounts. There would need to be a number of policy based adjustments made to the audited accounts, for example write downs and provisions would generally be taxed on a realisation basis. There would need to be other adjustments, but hopefully they could be kept to a minimum. Such a proposal is not as radical as it may sound - the TOFA 3 & 4 measures that are expected to be legislated later this year go some way to allowing some entities to rely on audited accounts in relation to financial assets and liabilities.

Some businesses might be concerned about the risk of paying tax on unrealised gains. As in a number of the proposed TOFA 3 & 4 elections, the BCTR would see such a scheme as operating on an opt in basis.

There may also be concerns about the way in which the accounting standards are subject to change – sometimes from stakeholders in other jurisdictions. That may be true up to a point, but the standards have to be formally adopted by the Australian accounting regulator before coming into effect here. More broadly, we believe there would be a useful tension between the managers of reporting entities wishing to disclose strong earnings and their preference not to pay more tax than necessary.

- *Individual income tax returns*

It should be possible, through a system of withholding for certain investment income, to do away with the need for most individuals to lodge income tax returns. Other countries have managed to achieve this, and Australia should be able to as well.

One of the issues often raised as an obstacle to such an outcome is that Australians love claiming work related expenses – an item that has been growing rapidly over recent years. The BCTR believes this concern can be overcome by 'buying out' WREs through further modifications to rates and/or thresholds. We understand that most WREs are claimed by the top quintile of taxpayers by taxable income. As a *quid pro quo* for this group receiving the aspirational tax cuts the government took to the last election, WREs should either be eliminated entirely or at least capped at, say, \$1,000.

5. *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.*

Trade-offs between equity on the one hand and simplicity or efficiency on the other hand have always been a feature of the tax system. Sometimes this will involve making difficult economic and political judgments. To the greatest extent possible, stakeholders should be engaged so that there is a broad understanding about how competing policy objectives have been resolved.

One example of such a trade-off is covered in Box 3.6 on page 170 of the paper in the discussion on taxing the individual versus the family unit. While equity considerations around the ability to pay might tend to support a family basis of taxation, efficiency issues (specifically, participation rates for secondary earners) favour an individual basis.

6. *The design of the tax-transfer system should be flexible so that it can adapt to changing domestic and international circumstances.*

The current international financial crisis underscores the need to design a tax system that can be adapted to suit changing economic and political circumstances.

Having said that, the BCTR does not suggest the current review should specifically tailor Australia's tax system to address concerns raised by the current crisis. Issues such as the treatment of losses and perhaps the taxation of savings might come under closer scrutiny in such times. Generally speaking, however, our tax system should be designed for the long term, and it should function equally well in times of prosperity and adversity.

7. *To the maximum extent possible, the most inefficient of taxes levied by the commonwealth, state, territory and local governments should be removed.*

As highlighted last year in the joint Business Council of Australia/Corporate Tax Association *Tax Nation* report, and as confirmed in the paper, Australia has too many business taxes imposed by various levels of government. Some of those taxes raise very little revenue, but they all involve compliance and administration costs. While there has been encouraging recent progress on payroll tax harmonisation, inconsistencies in similar taxes between States remain a problem for business.

A project should be undertaken to look at harmonising commonly used terms (such as 'employee', 'income', 'salary and wages') that are used in various State and Federal taxing statutes, but which are often slightly different from each other, usually for no discernable sound reason.

The BCTR regards the intergovernmental agreement on the introduction of the GST as unfinished business. We believe there was an understanding that the States would go beyond merely considering the abolition of certain taxes and charges once GST revenue reached a certain level, and the clear expectation was that some of the more inefficient taxes would have been eliminated by now. The review represents a timely opportunity to revisit this important issue.

8. *The imbalances between the spending responsibilities and revenue raising powers of the different levels of government should be addressed in a way that is simple, transparent and provides sufficient certainty for each level of government.*

This is a difficult issue that poses significant constitutional and political challenges. Nevertheless, it seems clear that the imbalance between taxing capacity and spending obligations needs to be reduced. The current arrangements make for poor accountability on the part of the States and the absence of politically attractive new sources of tax has tended to push the States into raising a number of inefficient taxes.

9. *States should be financially motivated to improve efficiencies in service delivery, to ease administrative burdens and duplication of effort for taxpayers and to remove inefficient taxes.*

With the benefit of hindsight and without minimising the political difficulties involved, it now seems the States were given unfettered access to the GST in 2000 without being asked for much in return.

If the Federal government were to address the fiscal imbalance by granting the States access to untied funding, for example by transferring part of company income tax, then certain enforceable undertakings should be sought from the States in terms of achieving greater efficiencies in service delivery (for example in health and education). As a *quid pro quo*, the States should at the same time be required to remove a number of their more inefficient taxes.

To improve administrative arrangements and reduce compliance costs for businesses operating in a number of States, the BCTR believes the administration of payroll tax (in the event it is retained) should be centralised with the ATO. Consideration should also be given to transferring the administration of most other State taxes to the ATO under a service agreement.

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Appendix B

Business Coalition for Tax Reform members

Australian Financial Markets Association

Australian Industry Group

Australian Institute of Company Directors

Business Council of Australia

Corporate Tax Association of Australia

Council of Small Business Organisations of Australia

CPA Australia

Group of 100

Institute of Chartered Accountants in Australia

Insurance Council of Australia

Investment and Financial Services Association Ltd

Minerals Council of Australia

National Institute of Accountants

Property Council of Australia

Real Estate Institute of Australia