Review of Australia's Future Tax System

Joint submission by the Corporate Tax Association and Ernst & Young to the Review

17 October 2008

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To the Review Panel

Review of Australia's future tax system

The Corporate Tax Association and Ernst & Young provide this joint submission to this Review of Australia's Future Tax System ('this Review') to address the key strategic issues for Australia's tax and transfer system, its problems and the actions which should be investigated to deal with those problems.

We welcome this Review and its willingness to seek input in setting its workplan. To assist this Review we set out in a summary form not only the relevant principles (aligned to the approach of the Business Coalition for Tax Reform) but also various detailed actions for consideration.

Australia's tax and transfer system, with its many federal-state interactions, needs to support Australia's growth and productivity. This requires reform to the system which is overly complex, overly costly to administer for both governments and the community, and creates tax deadweights to Australia's growth, as confirmed in the Treasury Architecture paper ("TAP") of August 2008. Businesses are facing significant capital expenditure and restructure decisions, due to the combination of globalisation of business, global climate change policies which will impact capital and location decisions, global competition on tax by developed countries as well as emerging countries, and the current global economic turmoil. For Australia's tax system not to be internationally competitive creates strategic risks.

The tax system, at federal and state level, should be designed for stable operation through the business cycle, which suggests a move away from the dominance of income tax to other revenue sources.

Australia's tax system needs to be internationally competitive in its encouragement of capital investment in Australian business, plant and equipment, infrastructure and business intangible assets in Australia, to supplement our skilled people and natural resources so as to enhance productivity.

Australia's corporate tax rate is currently too high. As well, the dividend imputation system needs to be modernised in several respects to remedy those aspects that disadvantage Australian businesses with international activities and international shareholders. These dynamic businesses, which Australia should retain and attract, should not have tax hurdles which encourage them to move offshore.

Australia's capital allowances are not internationally competitive and do not encourage investment in modern capital equipment, a key driver of growth, productivity and prosperity. The capital allowance rules should be aligned with our competitors, in relation to plant and equipment and also in relation to business intangible assets such as know-how, to encourage innovation and the development of businesses with significant expertise and intellectual property, in Australia.

Tax competitiveness is relevant to international tax rules also. Australia should consider the abolition of interest withholding tax on foreign borrowings by Australian businesses, and withholding taxes on financings, which affect the cost structure and competitiveness of Australian business. As well, the recommendations of the Board of Taxation review of the international tax anti-deferral rules will need action, rather than being deferred to 2010 pending the work of this Review.

The tax system should harmonise with broader government policy objectives. For example, the challenge of an ageing economy and workforce participation make it more important for capital expenditure to be encouraged to build productivity, for Australia to have modern world class capital equipment such as that

CORPORATE TAX ASSOCIATION of Australia Incorporated attracted by our competitors. Also, looking to climate change policies, the Carbon Pollution Reduction Scheme may not in itself deliver sufficient signals to achieve the government policy objectives, so the tax system may need to provide appropriate incentives for business to invest in capital equipment to achieve reduced emissions and significantly reduce energy consumption. As well, the tax system should harmonise with Australia's policies to attract regional and global headquarters locations in Australia, to attract high value manufacturing in areas of innovation and with high intellectual property value and for Australia to be a services hub generally.

For this reason an enhanced governance process needs to be built into Australia's tax policy, with a strategic and inclusive approach, rather than reviews occurring once a decade.

Inefficient taxes must be eliminated, targeting the most inefficient of the 260 taxes levied by the federal and state governments. These include various heads of stamp duty, and possibly payroll tax.

Inefficient and compliance-intensive features of taxes should be reformed. A national initiative should strive for single or uniform state and territory tax laws, like the Uniform Companies Act, not just harmonised '8 packs' of state and territory tax laws. We support the Council of Australian governments proactively improving the efficiency and administration of state taxes, with a stronger federal-state tax reform agreement than before. State tax reforms may require new sources of tax revenue for the states, but not a multiplicity of new state taxes; perhaps giving the states a share of income tax is appropriate.

Tax law complexity should be reduced. Strategies include the alignment of similar concepts across state and federal taxation to simplify compliance. The excessive complexity of Australia's federal tax system and its over-engineered prescriptive rules can be reduced; priorities include a drastic overhaul of the fringe benefits tax, streamlining the employee share scheme rules and allowing audited financial accounts to be used as shortcuts or proxies for various key tax calculations. Over time the 1936 Income Tax Assessment Act can be merged into the 1997 Act and segments of the 1997 Act can be streamlined.

We identify significant distortions in the operation of the capital-revenue distinction for tax purposes and the treatment of tax losses.

Business supports a tax and transfer system that encourages individuals to participate in the workforce and to remain in the workforce (addressing the demographic challenges). This requires attention to Australia's marginal tax rates and attracting globally mobile people including current expatriates as well as mechanisms to streamline tax compliance by individuals.

We agree with the need for action to encourage savings by Australians by an improved tax treatment of savings, to remedy the over-taxation identified in the TAP.

The administration practices of the ATO and other tax collector agencies create complexity, tax uncertainty and deadweight costs, as the TAP recognises. These magnify and exacerbate the challenges of complexity, misalignment and gaps in tax policies and legislation. Australia could consider a board or an oversight authority to add to the governance of the ATO (such as the US, UK and Canadian tax authorities have). We also recommend improved governance processes around ATO dispute management and support ATO express authorisation to exercise discretions in favour of taxpayers and to use administrative shortcuts.

We would be pleased to meet with this Review and provide further information and priorities for reform. If you would like to discuss this submission please contact in the first instance any of:

- Frank Drenth or Michelle De Niese of the Corporate Tax Association on 03 9600 4411; or
- Alf Capito of Ernst & Young on 02 8295 6473 or Tony Stolarek of Ernst & Young on 03 8650 7654.

Yours sincerely

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Corporate Tax Association and Ernst & Young
Submission to the review of Australia's future tax system

For the convenience of this Review, this submission is abbreviated and does not reanalyse the detail of strategic issues and problems where these have been covered in "The Architecture of Australia's Tax and Transfer System" ("TAP"), issued by the Federal Treasury in August 2008. We can provide significant further materials in relation to the discussion as required.

This submission is organised to align with the principles of the Business Coalition for Tax Reform (BCTR).

1. A stable tax revenue base

A BCTR objective is for Australia to have a stable tax base, less exposed to business cycles. This Review should consider whether a reorientation of the tax base from a heavy income tax orientation towards consumption may smooth out some volatility of tax collections during business cycles.

Australia's tax system is, as is clear in the TAP, overly focused on the taxation of income and capital income, and insufficiently focused on other government revenue such as taxing consumption. This results in income taxes which are internationally uncompetitive, which is of concern when seeking to attract businesses and individuals to remain in and to come to Australia to invest and work. We would have preferred this Review to consider Australia's GST, its rate and base as an element in the strategy. However, as this was not included in the terms of reference, we do not discuss this issue further.

2. An internationally competitive business tax system is needed for Australia's development and future

With the global mobility of people, capital and business investment, Australia's business tax environment must be internationally competitive to encourage businesses to invest in Australia to develop Australia's economy and opportunities for Australians, to remain headquartered in Australia in relation to their global activities and to establish Australia as a internationally attractive headquarters location. The major global disturbances to the financial markets exacerbate this issue, as businesses globally are looking to streamline their processes and functions and exhaustively confirm that every single aspect of their affairs is at maximum competitiveness, including their supply chains, their international locations and their tax efficiency and risk management.

We support Australia's strategy to develop Australia as a financial services hub. This has been accompanied by various measures effective already, and reviews designed to build Australia's financial services capacity.

However, Australia is also not an internationally competitive location, from a tax perspective, for capital investment in establishing new manufacturing or resource industries or expanding existing ones. Nor is it internationally competitive as a location for companies, listed or headquartered in Australia, to conduct global activities, whether in the services or manufacturing industries.

This has occurred because tax competitiveness is a dynamic process and, notwithstanding major and valuable Australian tax reforms in the 1980s, 1990s and more recently, other countries have also reformed their tax systems to attract globally mobile investment and talented people, with a focus on reducing income tax rates. As a recent OECD paper has suggested "Corporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes. Recurrent taxes on immovable property appear to have the least impact. A revenue neutral growth-oriented tax reform would, therefore, be to shift part of the revenue base from income taxes to less distortive taxes such as recurrent taxes on immovable property or consumption."[1]

[1] Taxation and Economic Growth, No 620, OECD Economics Department Working Papers from OECD Economics Department, http://econpapers.repec.org/paper/oececoaaa/620-en.htm

2.1 An internationally competitive, lower, corporate tax

Australia's corporate tax rate is now too high.

Comments

Australia's company tax rate, while competitive in 2000 in light of the Ralph RBT recommendations, has not kept pace with international trends and is now quite high in both effective tax rate terms and nominal tax rate terms. TAP Chart 5.10 shows that Australia's corporate tax rate of 30% is significantly higher than the OECD average of 26.6%. This impairs Australia's competitiveness in attracting and retaining businesses.

Suggested action

Australia's corporate tax rate needs to be reduced. The rate should be competitive with relevant countries including the higher-growth OECD countries and the more developed Asian economies.

As well, the data on comparative company tax rates should be updated to include forward-looking company tax rates announced and planned by other countries.

The UK company tax rate of 28% introduced in the 2008 Budget is an appropriate first step for consideration. The UK lower company tax rate retained attractive broadband depreciation rates, albeit somewhat reduced.

2.2 Aligning dividend imputation to a global capital market and global activity by Australian companies

Aspects of the dividend imputation system disadvantage Australian companies which compete globally. These can be rectified without requiring replacement of the dividend imputation system.

Comments

Where Australian companies, with Australian shareholders, grow internationally and keep their headquarters in Australia, they face excessive tax burdens on the underlying income. TAP chart 8.10 confirms that Australian companies with Australian shareholders have an uncompetitive tax environment when they operate in comparable-tax countries. Such growing, dynamic Australian companies, which Australia should retain, face tax pressures to relocate offshore.

This was recognised as overdue for correction in the Board of Taxation 2003 report into Australia's international tax arrangements[2]. It was a focus of the Ernst & Young 2006 report "Taxation of Investment in Australia"[3].

This inefficient policy has been grafted onto the imputation system by various dividend streaming and other tax rules. The Board of Taxation 2008 report into off-market share buy-backs may add further problems for companies seeking to efficiently use their imputation attributes.

At a time of global capital mobility, the dividend imputation system should not create inefficiency and wastage of imputation credits. It should not disadvantage dynamic smaller and larger companies wanting to remain based in Australia and expanding globally.

New Zealand recognised this in its 2008 tax consultation paper on how to approach streaming measures for its imputation system. That paper recognises the need for international orientation of companies. It proposes for discussion introducing dividend streaming of certain foreign income[4] whereby foreign active income might be streamed to foreign shareholders of NZ companies without consuming NZ imputation credits, which could be retained for NZ investors.

Some studies suggest that franking credits are not valued by Australian shareholders, or the capital markets. However if Australian companies could monetise or stream their franking credits, including

[2] Review of International Taxation Arrangements, 2003, page 12.

[3] Ernst & Young, "Taxation of Investment in Australia", March 2006

[4] "Streaming and refundability of imputation credits: a government tax policy discussion document" published in August 2008 by the Policy Advice Division of Inland Revenue - http://taxpolicy.ird.govt.nz/index.php?view=619. See especially paragraphs 2.43 – 2.53.

the use of off-market share buy-backs with auction pricing, the credits would have a clearer commercial value and would be factored into the price of companies efficiently.

Because many countries have moved away from dividend imputation, some suggest that the dividend imputation system can be eliminated and replaced by another mechanism which might reduce company taxes[5]. However, the dividend imputation system is an integral element of Australia's stock market capitalisation of major Australian listed companies and the taxation of superannuation funds for Australia. Countries which do not have imputation systems use alternative mechanisms to integrate company and shareholder taxation (see the TAP box 8.4) including ideas such as allowing companies deductions for dividends paid, or giving companies no deductions for either interest or dividends paid, with reductions in the corporate tax rate and appropriate concessions to reduce the capital taxation paid by shareholders.

Suggested action

The imputation system needs adjustment to protect Australia's competitiveness.

a) Imputation credits should attach to dividends paid by Australian companies to Australian shareholders from foreign earnings: partial franking, at least, should apply as recommended by the 2003 Board of Taxation report. The previous government implemented many major international tax reforms, however this measure requires action to overcome the disadvantage to Australian companies retaining Australia as their base.

b) Australian companies with global shareholders could be permitted to stream foreign income to the foreign shareholders while retaining franking credits for Australian shareholders, at least to some extent, as NZ is considering. If unlimited streaming is considered inappropriate, then there might be some specific level of streaming which reconciles international competitiveness and revenue maximisation objectives.

c) The current approaches of the ATO in relation to corporate capital management appear inconsistent with the legislative policy. As well, the strategic competitiveness issues should be considered in relation to the Board of Taxation report into Australia's off-market share buy-back tax rules, which we understand has been presented to government. Tax-efficient off-market share buy-backs enhance the capital strength of Australian based companies, to retain the benefit of their franking credits to strengthen the companies. Restrictions on the use of off-market share buy-backs will impair Australian companies' efficient capital management.

d) The imputation system needs some inappropriate policy issues removed. For example why, today, should a company which overfranks its dividend by more than 10% and pays franking deficits tax lose 30% of the offset?

e) There is no need to remove dividend imputation to allow tax reform or internationally competitive tax settings. Major tax architecture improvements can be achieved, including a lower company tax rate and improved treatment of capital expenditure by business, without having to eliminate or drastically alter the dividend imputation system. If it were thought necessary to review or adjust the imputation system, this would require careful analysis and consultation to avoid disturbing Australia's capital markets and Australian companies' financial health and competitiveness. We can discuss our views on these issues with this Review further.

2.3 An internationally competitive tax system for capital investment in Australia

2.3.1 Investment in plant and equipment and infrastructure

Australia's growth requires business capital investment to supplement Australia's workforce and natural resources, to enhance productivity and prosperity. Unfortunately Australia's tax capital

[5] "We note a CEDA 2007 discussion paper and the Review of Australia's National Innovation System. "Tax cuts to compete – the influence of corporate taxation on Australia's economic growth" by Dr Nick Gruen of Lateral Economics, released for the Committee for Economic Development of Australia (CEDA) as a discussion paper in 2007
http://www.lateraleconomics.com.au/outputs/CEDA%20Tax%20cuts%20to%20compete.pdf
As well, the "Venturous Australia" draft report of the Review of the National Innovation System, in which Dr Gruen participated, at http://www.innovation.gov.au/innovationreview/Pages/home.aspx refers in section 8 to 'recent proposals for a revenue neutral reduction in the company tax rate funded by the abolition of dividend imputation"

allowances for plant and equipment do not make Australia an internationally competitive location from a tax perspective in which to make capital investments.

Comments

The tax rules impede capital investment in manufacturing, technology and infrastructure, and are relevant when considering Australian businesses' investment in equipment to deal with Australia's climate change policies.

These issues need urgent attention, as the current global business environment, global climate change policies and financial uncertainty are causing businesses to consider significant re-engineering of their international structures and investments, with a close eye on the tax environments offered by many countries.

Suggested action

Our recommendations for attention, which are discussed at Appendix A in more detail, include:

a) Replacing Australia's uncompetitive and complex effective life regime with an internationally competitive capital allowance scheme with "broadbanding" rules and attractive capital allowances rates.

b) Eliminating the tax disadvantage for improvements and technological updates of Australian capital equipment.

c) Eliminating a feature which causes assets under the diminishing value capital allowance rules to never be fully depreciated.

d) Limiting the excessively long effective lives for long-lived assets and infrastructure.

e) Reviewing the Buildings capital allowances.

f) The 'black holes' capital allowances have retained black holes and should be adjusted.

g) Addressing tax problems for managed funds investing in infrastructure assets.

2.3.2 Business capital investment in intellectual property (intangible assets)

Australia's tax treatment of business intangible assets is outdated and internationally uncompetitive.

Comments

Unlike many other countries, Australia still does not allow tax amortisation of business intangible assets, such as special processes, systems, and techniques not being copyrights or patents. This places Australian businesses at a competitive disadvantage in business acquisitions[6]. An acquirer of a business receives tax amortisation only for tangible assets such as physical plant and equipment and a narrow range of intangible assets but with no recognition for intangible assets such as specialist processes or knowledge which have significant commercial value.

In an environment where intangible assets are as important as tangible assets for many businesses, this tax treatment makes Australian business less competitive than companies from the United States, United Kingdom, Germany, Netherlands, Indonesia and others which do offer such capital allowances, when they are bidding to acquire companies rich in intangible assets. The UK introduced such a tax reform in 2002 to remain competitive internationally. Some would suggest that business intangibles are of permanent value and need no amortisation, but business experience is that acquired business intangibles decline in value over time, and they receive no recognition for Australian tax purposes so long as they are held.

The Ralph Review of Business Taxation favoured such a reform in 1999. Despite being prevented from recommending reform because of its revenue neutrality requirement, that Review strongly supported such reforms and stated that "…the scope for amortisation treatment be re-examined should the current reforms prove to be more revenue positive than the estimates included in this report…. this treatment disadvantages Australian entities in competitive takeover situations where

[6] This issue was analysed in detail in the Ernst & Young 2006 report, "Taxation of Investment in Australia: The need for ongoing reform", in Section 4.1.4. This discussion draws briefly on that analysis.

they are competing with bidders based in jurisdictions that provide taxation depreciation for acquired goodwill….”

Suggested action

Australia needs to explore again an internationally comparable tax amortisation regime for intangible property acquired in the course of an acquisition of a business or company carrying on a business, as recognised in the Ralph review. The amortisation could be over an effective life of 15 years or, at the taxpayer's option, over the life adopted in a taxpayer's audited financial statements. The UK and US provide models for the approach, which should cover business intangible property in the course of an acquisition of a business or company carrying on a business and could include the goodwill of the target business recorded under accounting standards.

2.4 Ensuring competitive tax rules for international transactions

2.4.1 Board of Taxation international tax review

Foreign owned groups which might be encouraged to use Australia as a regional headquarters, and Australian groups which want to grow globally while retaining their Australian headquarters and employment, need efficient international tax rules for their international activities.

Comments

Building on major recent reforms, the Board of Taxation has recently concluded its Review of International Anti Tax Deferral Rules. We expect that it has recommended that the government focus on ensuring that policy settings and outcomes are appropriate and that there be an appropriate balance between revenue concerns and industry competitiveness and tax compliance costs. These issues are more significant than mere harmonisation of the existing regimes and we expect that the direction flagged by the Board involves genuine modernisation of the rules involving substantial improvements both in policy and compliance terms.

Suggested action

On the basis that the recommendations and suggestions made by the Board of Taxation in its Review of International Anti Tax Deferral Rules are consistent with its public discussion papers, targeting international competitiveness, the recommendations should be implemented to ensure that Australia’s rules for controlled foreign companies and foreign investment funds remain internationally competitive.

2.4.2 Reducing withholding taxes on the use of foreign borrowings for use in Australia, given the cost and competitiveness issues

Interest withholding tax (IWT) is an impediment to legitimate foreign borrowing and the investment of capital in Australia. The tax on lease payments to non-residents (imposed under the royalty withholding tax rules) has the same outcome.

Comments

Australia’s IWT means that funds which are sourced globally, to be used in Australia, bear a tax penalty of an additional 10% IWT.

Various mechanisms for exemptions from IWT are no longer effective given the new financial markets and the current financial markets instability. Investments, and loans, are made globally, with an increasing trend for direct lending to occur from major pools of capital including sovereign wealth funds and foreign entities with huge reserves, which no longer need bank intermediaries. This is exacerbated with the failure of bank intermediaries in the US and Europe.

As a result Australian borrowers are facing deadweight costs. For this reason, Canada has in 2008 removed its IWT on arm’s length outbound interest payments to unrelated residents of all countries.

Where Australian firms finance their assets by lease payments to non-residents, the royalty withholding taxes apply, which are inefficient in not being aligned to the treatment of interest.

Looking at Australian IWT concessions, the Section 128F IWT exemption for interest on certain publicly offered company debentures or debt interests is now far less effective than in the past because of market unwillingness to buy publicly offered company debentures or debt interests.

As well, some of Australia's double tax agreements have recently introduced withholding IWT exemptions for certain borrowings by financial institutions. These are now seen to be too narrow.

Suggested action

First, Australia should consider abolition of IWT. This policy needs urgent consideration and should not wait for this Review to report in 2009. whilst we acknowledge the Canadian initiative, we note that an IWT removal for Australia should apply also to interest paid to associates which are merely conduits for foreign-sourced debt.

Second, the tax policies in relation to withholding taxes in respect of lease payments made should be aligned to the tax treatment of IWT generally, and not just in recent renegotiation of US and UK treaties. The current 'drip feed' of concessions through treaty renegotiations is inefficient and requires domestic tax reform.

Third, if IWT is not eliminated entirely, then a broader IWT concession should replace the current section 128F IWT exemption for interest on certain publicly offered company debentures or debt interests. The s.128F exemption should be adjusted to remove the requirement for public offering.

Fourth, Australia should consider broadening its double tax agreement exemptions from IWT.

2.5 Ensuring that Australia's tax loss rules are competitive at a time of heightened uncertainty and capital mobility

Australia's rules in relation to tax losses are too restrictive and not internationally competitive. This is particularly relevant at a time of uncertain economic and financial conditions when businesses may be looking at volatile trading and tax outcomes and potential ownership changes; and are conscious of the international comparatives when assessing where to locate their functions and investments.

Other countries have more generous rules in relation to tax losses than Australia, as noted at page 254 of the TAP. Such rules include the ability to carry losses back as well as forward.

Suggested actions

First, Australia should introduce loss carry back rules.

Second, remaining problems with the company loss recoupment tests must be addressed, including the issues listed in the backlog of unlegislated measures presented in the 2008 Budget.

Third, significant problems with the operation of the same business test (SBT) must also be addressed. The test is designed as a fall back where the COT is failed, to allow the continued use of losses where there is no trafficking in those losses. However the harsh interpretation of the SBT rules by the ATO and a limited interpretation of the rules in recent court decisions means this test needs to be amended. The SBT should have a purpose test, so that it applies only where a company was acquired for a non-incidental purpose of using its losses.

Fourth, the interaction of the loss rules with new tax regimes including tax consolidation should be examined to ensure the policy to allow continued use of losses has not been over diluted. In particular the tax consolidation regime has resulted in further difficulties for groups seeking to apply the SBT. Restrictions on the use of losses of acquired entities under the available fraction rules should also be recognised in this context.

Fifth, Australia quarantines losses incurred on capital assets (capital losses) for offset only against capital gains. The definition of capital gains and capital losses is highly problematical for businesses and needs statutory clarification as discussed at section 7.1.

Sixth, the use of consortium, joint venture and other structures by companies in undertaking infrastructure and other major projects present particular problems in passing the loss tests, which can be a disincentive to investment. Amendments to the application of the SBT to such arrangements and further concessions to the loss rules, including for example flow through of losses in some circumstances, should be examined.

3. Consistency of the tax and transfer system with broader government policy objectives

The tax system should be harmonised with Australia's broader policy objectives at a strategic level. Traditionally governments have provided particular incentives to encourage activity, but without broader consideration of negative features of the tax system.

3.1 Ensuring that Australia's tax policies for capital investment arising from greenhouse gas policies and businesses do not result in business investments bypassing Australia

We are conscious that the existing tax rules for capital expenditure may not be sufficient to generate the capital investment required to underpin Australia's move to a less carbon emission intensive economy.

Comments

The 'diabolical problem'[7] of new climate change policies and higher energy costs will cause many businesses to consider major capital expenditure to replace or augment existing capital equipment to reduce emissions profiles or to reduce energy consumption.

These decisions are sensitive to the tax environments and incentives offered by many countries.

There is a significant risk that some Australian businesses will find the Australian tax environment for new capital expenditure to deal with climate change initiatives to be less attractive than other countries and will make their investments overseas.

Suggested action

The first action, at this strategic time, is to ensure that Australia's tax rules dealing with capital expenditure on capital equipment are internationally competitive as discussed at section 2.3.

As well, this Review needs to consider whether the CPRS and its mechanisms need to be augmented by tax incentives to encourage businesses to make the necessary expenditures on capital equipment and innovation to proactively deal with energy pricing and emissions reduction policy objectives.

In responding to the Green Paper, the CTA and Ernst & Young submitted that business needed to have appropriate tax incentives to facilitate significant capital investment to deal with the CPRS, especially in the initial transitional phase. The March 2008 joint report of Ernst & Young and the Institute of Chartered Accountants "Australia's Proposed Emissions Trading Scheme – The Tax Policy Dimension"[8] highlighted potential incentives. Some might target enhancing Australian climate-related innovation and R&D by adjusting the R&D concession, including R&D in foreign locations to benefit the Australian economy. Additionally they might target the tax outcomes of costly capital expenditures to replace existing equipment or alter equipment - potential incentives include increasing depreciation rates for capital expenditure that can be demonstrated to reduce carbon emissions, introducing an emission reduction investment allowance deduction, specific concessions in the tax loss rules for companies in emissions-intensive industries and considering outright deductibility of certain expenditures.

3.2 Alignments with other key sectoral and economic development policies

The tax system needs to be aligned with other key development strategies for Australia.

Comments

For example, if Australia is to promote itself as a business-friendly destination and location for regional headquarters, then obstacles to such activity need to be removed. In this context, the key

[7] Refer the Garnaut Climate Change Review -http://www.garnautreview.org.au/domino/Web_Notes/Garnaut/garnautweb.nsf-
[8] Ernst & Young and Institute of Chartered Accountants joint paper, authored by Ernst & Young, "Australia's Proposed Emissions Trading Scheme – The Tax Policy Dimensions" issued in March 2008, available from http://www.ey.com/global/Content.nsf/Australia/Climate_Change

issues would relate to Australia's international tax rules, treatment of cross-border transactions, and Australia's reputation for the complexity of its tax laws and the approach of its tax administration.

Other examples include the issues concerning capital allowances for tangible assets in the minerals processing, manufacturing and energy sectors and intangible assets in the services sector including financial services. These sectors have potential for growth and export revenue for Australia and will play a key role in the development of Australia's economy and help Australia provide opportunities and prosperity for its citizens.

Suggested action

government needs to ensure that appropriate formal mechanisms are in place to ensure that tax policy informs the debate on and contributes to the development of industry and economic policy.

This integration with other policies should be part of the improved tax governance process which we discuss at section 6.1.

4. Removing inefficient taxes and reducing inefficiency

The TAP clearly outlines the inefficiency and deadweight costs arising from up to 160 state and local taxes.

If an Australian business operates in every state and territory, it must deal with up to eight different state and territory payroll tax Acts, eight different conveyance duty (stamp duty) Acts, eight different insurance, fire service levies, and other tax Acts, all of which are administered by eight different revenue authorities. This is very inefficient.

We provide input on the suggested action in a general sense and in relation to stamp duties and payroll taxes.

4.1 Eliminating the most inefficient state taxes or streamlining them

State taxes, by their nature and their administration, are inherently inefficient and undesirable in a modern country with no trade barriers and an integrated economy.

Comments

Whenever an Australian business considers a business reorganisation within Australia to improve efficiency, or establishing a service activity in a particular location within Australia, or establishing a segment headquarters in one state or territory, a huge array of complex state and territory tax issues arise. The transactions within the group, state stamp duty exposures in relation to any restructures, and other state taxes payable in relation to transactions with customers.

On 12 June 2008 the Independent Pricing and Regulatory Tribunal released a draft report recommending changes to the NSW tax system, but noting limits to the reforms that a state can achieve on its own. The IPART CEO and Tribunal Member, Jim Cox said[9] "The states have some very sound taxes – such as Payroll Tax – but on balance the Commonwealth taxes are more efficient and equitable. If we can make greater use of these taxes and reduce or eliminate some of the more inefficient state taxes then we can achieve real gains."

Suggested action

The first strategy is to consider elimination of various heads of state taxes. This will require addressing vertical fiscal imbalance, noted at section 5, below.

For the taxes to be retained, each should be implemented in one single uniform statute instead of up to eight legislative instruments across the states and territories.

A less effective alternative is to unify the laws with consistent definitions, rates and thresholds across the entire nation. Earlier this year, on 29 March 2008, the state and territory treasurers announced a national overhaul of payroll tax partially along those lines, discussed at section 4.3 below.

[9] "IPART Recommends Overhaul of State Taxes, 12 June 2008" at http://www.ipart.nsw.gov.au/files/Media%20release%20for%20Draft%20Report%20-%20Review%20of%20State%20Taxation%20-%2012%20June%202008%20-%20PDF%20WEBSITE%20VERSION.PDF

4.2 Stamp duties on business restructures should be reformed

In relation to business transactions, the states' and territories' business restructure rules need to be harmonised and uniform across Australia.

Comments

It is common for a business to restructure itself in order to attract capital or investment, with perhaps a merger of entities, or a demerger, or restructure of activities while maintaining the same ownership. In such cases, various states impose conveyance duties even where there is no change of ownership. Some states administer the business restructure concessions reasonably, while others are very restrictive or unsympathetic in applications for relief under their statutes.

Suggested action

A significant priority should be an aligned, consistent approach to the grant of relief from conveyance duties for business restructures. Ideally, there should be a single agency responsible for the applications.

4.3 The most inefficient stamp duties should be removed or reformed

Stamp duty is an inefficient and inconsistent state tax which should be reformed using the approaches at 4.1.

Suggested action

The prime candidates for elimination are:

Stamp duties and conveyance duties on business restructures;

Stamp duties on insurance, and fire services levies;

Stamp duties on asset transfers;

Stamp duty on leases and non-residential conveyances; and

Stamp duty on security granted over loans.

4.4 Elimination or harmonisation of payroll tax

Payroll tax is an anachronistic and inefficient tax that adversely affects Australia's international business competitiveness.

Comments

Australia is one of the few countries to levy payroll taxes, and the high rates impact international competitiveness. Payroll tax causes significant compliance costs especially for large and small business. The different rates involve state competition but add to compliance costs.

The tax free thresholds for employers add compliance complexity in terms of managing the exemptions. More significantly, they affect business structures inappropriately. For example, businesses which operate through franchise structures find that individual franchisees benefit from payroll tax exemptions and do not pay payroll tax, however businesses operating through single corporate groups miss out on the exemptions and have additional costs. This distorts pricing, competitiveness and efficiency of Australia's service and even manufacturing sector, particularly given the high rates of payroll tax. We support encouragement of small business and financial support to it, but the payroll tax exemption is a compliance-intensive, complex and distortive mechanism to achieve this.

Suggested action

This Review should consider abolishing payroll tax. This would require compensating the states appropriately.

If payroll tax cannot be eliminated then, the strategy should be as follows.

First, the tax free thresholds for employers could be eliminated, to simplify and broaden payroll tax, and lead to lower rates. This action will also reduce structural distortions which adversely affect business pricing, competitiveness and efficiency. We support providing financial assistance to small business[10], however the support could be provided through grants, thereby removing the complex payroll tax threshold rules.

Australia could eventually replace the various statutes with one single uniform statute.

A less effective alternative is to unify the laws with consistent definitions, rates and thresholds across the entire nation. Earlier this year, on 29 March 2008, the state and territory treasurers announced a national overhaul of payroll tax arrangements in which the states and territories agreed to adopt common provisions and definitions for 8 key payroll tax areas but to retain control over individual rates and thresholds. This is not enough, as there will continue to be differences in thresholds, rates and administration. This issue is discussed in relation to other state taxes at section 4.1.

Additional reforms, to reduce business compliance costs, could include single payments, lodgement of one return with Australia wide employees of a group, only one registration, a central Commonwealth body responsible for administration and collection to reduce compliance costs, and for the Commonwealth to pass payroll tax on the states based on break up of state by state payrolls provided with the one tax return.

5. Addressing state and federal vertical fiscal imbalance

We agree with the need for the federal government and states to address vertical fiscal imbalance, to enable the states to replace their taxes, which are inefficient and less equitable than the taxes which the Commonwealth government can impose.

We support consideration of more effective tax bases for the states. This could include the states having a direct share of federal income tax, which would not impose additional compliance and efficiency issues for Australian business and households.

It might also involve Commonwealth adoption of direct funding and service responsibilities for various public services and goods provided currently by the states. Finally, it might also involve retaining the existing grants processes but ensuring they operate in an effective manner to provide the states with funding more efficiently.

6. Reducing tax and transfer complexity, to enhance growth

6.1 Improving tax policy processes and governance

Improved strategic management is needed of Australia’s tax policy, rather than a reactive approach.

Comments

We recognise the initiative of the government, in particular the Assistant Treasurer and Minister for Competition & Consumer Affairs, Mr Chris Bowen, to appoint a Tax Design Review Panel which reported in 2008, and an implementation plan for the recommendations being developed.

In our view, in addition to the issues around legislation development, there is a governance gap in relation to tax policy development in Australia.

There appears to be an unclear or undeveloped responsibility for tax policy to keep Australia competitive as distinct from bringing in the revenue. There appears to be a lack of clear accountability for tax competitiveness policy by Treasury, no clear role for the ATO which appears to focus more on tax collection or ‘integrity’ measures, and an unclear process for prioritising the measures and presenting these to government.

This Review with its strategic approach is a welcome initiative. This Review should build a competitiveness strategy into Australia’s tax policy system to replace periodic, generational or once-a-decade 'catch up' processes.

[10] For example, $37,380 is the value of the current tax free threshold for payroll tax in NSW, based on the NSW 6% payroll tax rate, calculated on the maximum exemption threshold of $623,000.

Suggested action

Australia needs stronger governance over tax policy development in Australia to ensure that our system remains competitive. A Tax Policy Oversight board might be modelled on the approach of the Reserve Bank of Australia board. This board might provide counsel or input to the government and to Federal Treasury in relation to strategic issues around business tax competitiveness in Australia, the sequencing priority and direction to be adopted for the Australian tax systems, and consider periodic competitiveness reviews.

The existing Board of Taxation is used occasionally to assist in specific policy design but has no formal strategic or statutory role. The Board of Taxation might be developed strategically in this direction.

6.2 Priorities for reducing complexity in tax legislation

We strongly support a reduction of complexity to enhance efficiency. As the TAP notes at page 5 "every hour spent by households and business grappling with the myriad of tax rules and obligations … is an hour not used use to produce goods and services … that are of a higher value to Australians".

6.2.1 Reducing complexity in the fringe benefits tax

The complexity and compliance costs of the fringe benefits tax (FBT) are not justified by the revenue it raises.

Comments

The FBT rules need major strategic review. They are hugely complex and inefficient in compliance terms, with inconsistent policies and exemptions (eg treatment of remote area housing). For many businesses, FBT requires more compliance processes, form-filling and documentation than does income tax. FBT illustrates a policy mindset of "plug every gap and collect every dollar, irrespective of compliance costs and complexity". For example car parking fringe benefits require physical distance measurements of which carparks are nearby, then calculating and tracking those carparks' fees continuously. In-house benefits have the same excessive administrative approaches. Such concepts are completely inappropriate for a tax which does not even figure in the list of top 10 taxes by revenue earned.

Suggested action

First, the application of FBT must be narrowed. FBT should only apply to benefits included in employment contracts as salary package components which have been converted into benefits. This could be supported by an integrity measure using the 'reasonable to conclude' basis as introduced in one recent FBT amendment[11]. We suggest this would deal appropriately with cars, loans and housing, the major benefits. The minor benefits such as entertainment, minor benefits and other in-house benefits such as in-house travel, which are hugely compliance intensive, should either not be taxed at all or have some standard, flat, FBT values with minimal compliance.

Second, the FBT rate should be addressed. FBT is currently imposed at, essentially, the top marginal tax rate even where employees are at middle or lower rates. We suggest exploration of a mechanism to use lower rates for employees on rates below the top marginal tax rate.

Additionally, FBT grouping would also assist some businesses.

6.2.2 Streamlining the employee share scheme rules

The employee share scheme tax rules are hugely complex and costly to comply with. The rules should be redesigned to streamline compliance, with improved exemptions.

Comments

[11] Tax Laws Amendment (2008 Measures No. 5) Bill 2008, Schedule 4, items 8,22,31 and 40. See also - Explanatory Memorandum Para 4.10.

The employee share scheme rules need major strategic review. They are hugely complex and inefficient in compliance terms for employees and for employers, with many taxing points, tax collection issues and uncertainties. They have exemptions for under $1,000 benefits (an extremely low amount in today's terms) and the numerous taxing points for employees, employers and associated entities result in much tax support required by employers. The rules were reviewed in 2000 by a parliamentary committee[12] with no action taken other than rectifying various integrity gaps.

Suggested action

The employee share scheme rules are a fertile area for review in the medium term, to ensure that the rules encourage employee share participation for the Australian workforce with streamlined compliance and design of the rules.

6.2.3 Reducing tax complexity by increased use of audited financial statements

Tax compliance could be streamlined by the increased use of audited financial statements.

Comments

The use of financial statements as a basis for tax returns is appropriate for some businesses, but should not be mandatory for all taxpayers' tax treatment of income and expenditure recognition (including capital allowances).

Financial statements show various unrealised gains and losses in the values of certain assets and liabilities. Their use as a tax base may be acceptable for companies, such as banks and financial institutions, which trade in or deal in the bulk of their assets, and their use has been accepted in four elective methods proposed under the Taxation of Financial Arrangements (TOFA) draft legislation.

However, where most of a company's assets are of a long-term nature, such as resources assets, land and buildings and plant and equipment which are not on the market, it is not appropriate to use values from financial statements in relation to such assets.

Even where financial statements are used, they need monitoring of changes to accounting standards. For example, with the use of financial statements for thin capitalisation rules, amendments were needed to deal with the introduction of Australian equivalents to international reporting standards (IFRS).

Suggested action

First, the tax law could allow taxpayers at their option to use financial statements as a basis for their income tax returns, for at least some taxpayers.

Second, the tax laws could provide for express use of financial statements as shortcuts or mechanisms to drive tax compliance in particular areas, such as the existing use of financial statements for thin capitalisation purposes, tax consolidation purposes and for four optional methods under TOFA stages 3 and 4 (TOFA 3&4).

Such financial statements shortcuts might include allowing the tax treatment of cost or market valuation of trading stock to follow the financial statements. There is currently a long-running discussion with the ATO in relation to the differences in cost of trading stock for accounting purposes and cost for tax purposes. It would be far less complex and more productive for taxpayers to use the costs of trading stock in audited accounts for tax purposes.

As well, in relation to TOFA 3&4, financial statements shortcuts could be used in relation to the accruals method, in addition to the specific areas where they are currently proposed to be used.

Third, the tax law should state a general policy willingness to accept the values in audited financial statements for purposes of compliance shortcuts and authorise the ATO to permit the development of compliance shortcuts using financial statements, without requiring further legislative changes. This would send a signal to the ATO to consider proactively adopting such shortcuts where appropriate, to significantly reduce compliance costs and complexity.

[12] Standing Committee on Employment, Education and Workplace Relations, Inquiry into employee share ownership in Australian enterprises
Shared Endeavours http://www.aph.gov.au/House/committee/ewr/eso/Report/Index.htm

6.2.4 Reducing complexity by harmonisation of various state and Federal taxes imposed on similar tax bases

It would be efficient for similar taxes in different jurisdictions to be imposed on the same tax base.

Comments

We note, for example, that payroll as a tax base is addressed in various tax statutes, but in subtly different ways, which create ambiguity, confusion and administration and compliance costs. Payroll is addressed in the income tax Pay As You Earn rules (tax withholdings from income), FBT, state payroll taxes and workers' compensation insurance. They all consider concepts of what is an employee, what are earnings, what is an employer, etc.

The concepts are all subject to different statutory interpretations, adding to compliance costs and uncertainty.

Suggested action

Australia should consider harmonised definitions across multiple taxes, starting with payroll tax.

Other core concepts to be harmonised could be developed along similar lines, perhaps including definitions of income or other elements of business indirect and direct taxation.

6.2.5 Reducing complexity by ATO use of discretions in favour of taxpayers

Given the challenging tax legislative environment, Australia should consider express statutory authorisation of and indeed instructions to the ATO to use its powers to provide extra statutory concessions in favour of taxpayers. This proposal, which was submitted to and taken up as recommendation 24 of the Tax Design Review Panel report of April 2008[13], has the potential to significantly reduce uncertainty and frustration. Models include those in the UK and, in Australia, APRA and ASIC discretionary exemptions. We recognise that the favourable exercise of discretions in favour of taxpayers, to rectify defects in the legislation, is but an interim step to rectifying those legislative gaps. These issues can be worked through in developing this policy.

6.3 Reducing complexity in tax administration

6.3.1 Addressing governance and controversy management in the ATO

Improved processes and rules are needed for the interaction between the ATO, taxpayers and their advisers. We agree with the comment in the TAP at page 315 that "the implementation of policy has a direct bearing on the level of certainty, transparency and compliance costs … the approach taken by administrators can have a significant bearing on the complexity experienced by taxpayers and recipients".

Comments

Australia's tax administration, and the experience which business taxpayers have with the administrators, have become an international competitiveness issue, as well as adding risks and inefficiencies for purely domestic business. Some global companies now consider Australia to have a 'tax uncertainty premium', increased by tax administrators' propensity to change their approaches relating to what was thought to be settled law and practice.

The complexity, gaps and uncertainty in many aspects of our tax legislation add to the challenges for the tax collectors of the ATO and State Revenue Offices in dealing with Australian households and businesses, and vice versa.

The ATO has various initiatives which are designed to improve its relationship with business taxpayers, particularly larger business taxpayers. These have followed major irritations such as those documented in the review by Kevin Burges of the experience of business with the ATO[14]. The ATO is, for example, trialling various initiatives around better relationships with the Top 50 companies in particular.

[13] http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1342
[14] Available from http://www.ato.gov.au/large/content.asp?doc=/content/64790.htm&mnu=39884&mfp=001/009

However there are more fundamental issues than relationship management. Relationship management with large companies will not resolve issues like the ATO revisiting arguments which have been settled for many years, either in statute or in practice, and raising new positions which are claimed to operate retrospectively across the entire community, creating penalty and risk issues. We refer for example to the claimed override of Australia's thin capitalisation rules by the transfer pricing rules, the deductibility of interest expenses for Australian listed companies, the revenue-capital characterisation of income and expenses and some core concepts in the debt-equity rules.

There appears to be a strategic problem in the ATO management of efficient tax compliance and achievement of commercial tax outcomes, which many in the ATO see as conflicting with its responsibility to follow tax legislation. The ATO has various administrative powers but many in the ATO appear to consider the ATO to be constrained under the Financial Management Act.

More significantly, any substantial ATO decision appears to involve the interaction of up to four different groups within the ATO. An officer in the segment has responsibility for the relationship with a taxpayer. If there is a relevant ATO industry segment or functional group (through its centres of expertise) it is responsible for consistency at that level. Where a particular matter involves a precedential view which might be relevant for other taxpayers or across the entire economy, the Tax Counsel Network is responsible for the precedential view. Additionally, if the company is under a tax audit, the tax audit team, often led by very senior officers, appears to influence the outcomes.

As a result, there will often be situations where a particular interpretation might be appropriate for a taxpayer, but ATO sensitivity to the implications for the general segment, or for the ATO precedential view in other contexts, of ATO sensitivities to positions it is taking in tax audits on that or other taxpayers, prevent a favourable view being achieved. These tensions apply to ATO public rulings and these can be compromised.

This structure of split responsibilities is very sensitive to the culture of the revenue collecting agencies (federal and state) and of individuals within those revenue collecting agencies, with often insufficient regard paid by individuals to Australia's attractiveness as a location to do business, business efficiency, Australia-wide implications and compliance costs.

This problem is magnified by the requirement for businesses to disclose in their financial statements the assessments received from revenue agencies. Once an assessment is issued by the ATO (or State Revenue Offices) there is a sharply increased disclosure requirement, an increased threat to an organisation's reputation, and an increased uncertainty, in its financial statements, arising from that assessment. In this environment, there is a competitive advantage provided to the Australian revenue, as compared with business, except in the rare instances where an issue is so significant that a business is prepared to challenge the issue. Even in those cases the process of judicial review can take many years. The ATO sometimes uses alternative dispute resolution (ADR) however it seems not to be offered consistently.

Suggested actions

a) Consider adjusted governance of the ATO activities, using Reserve Bank, US, UK and Canadian models

In the same way as business has governance arrangements over its executives by virtue of its board of directors, consideration could be given to the ATO having a governance mechanism involving a Board, which can provide significant counsel and oversight to the ATO in its activities. Other countries use this approach; the US[15], Canada[16] and the UK[17] all have boards appointed by

[15] The IRS Oversight Board is a 9 member independent body charged to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so that it may move forward in a cogent, focused direction. 7 members, confirmed by the Senate, have professional experience or expertise in key business and tax administration areas. The Secretary of Treasury and the Commissioner of Internal Revenue are also members of the Board. See http://www.treas.gov/irsob/

[16] Canada's Board of Management consists of 15 members, 11 nominated by the provinces and territories. It oversees the organization and management of the CRA, including the development of the Corporate Business Plan, and the management of policies related to resources, services, property and personnel. It does not have administer and enforce legislation or access confidential client information. .See http://www.cra-arc.gc.ca/gncy/brd/bm-bkgrd-eng.html

[17] The Board of HM Revenue & Customs has a non-HMRC chair, 3 non-executive directors and 4 non-HMRC advisers. See http://www.hmrc.gov.uk/board/index.htm

government which perform an oversight function of the relevant Revenue authority, with governance over budgeting and strategic planning, with the boards comprised of internal and external representatives from a range of different backgrounds. Some Australian government agencies have boards which make significant input into the activities or strategy, for example that of the Reserve Bank and the ASIC Advisory Board.

A board for the ATO might benefit both the ATO and the community by strategic input and governance over ATO relationships and strategies for improving the effectiveness and efficiency of its activities, including international competitiveness issues.

b) Separating ATO mechanisms to manage uncertainty and disputes from the audit function

To resolve the strategic blockage in the resolution of uncertain issues as between the ATO and business, Australia should introduce a capacity for an independent review of a dispute, before the ATO issues an assessment which must be disclosed in the financial statements of a business.

There are many precedents for independent review or advice, available to this review in other government contexts. Even the ATO uses a general anti-avoidance rules panel ("GAAR panel") in relation to matters involving the tax avoidance rules of Part IVA and similar rules, which includes various external business people and professionals. However the GAAR panel is solely advisory and the decisions are made by the ATO.

In the near term a mechanism could be developed for an independent review of an ATO dispute with a taxpayer by an independent review panel, potentially involving external representatives but quite separate from the ATO auditors. The internal review panel could operate in a quasi-judicial manner, with appearances by taxpayers and ATO officers, and could review the issue, its alignment with policy, and whether the matters should be settled by the ATO before an assessment is raised.

A longer-term issue is whether the GAAR panel should be statutorily permitted to make decisions in relation to GAAR matters rather than merely providing advisory input to the ATO.

6.3.2 Reducing administrative complexity by a single revenue collection agency to administer state and territory taxes

It would be very efficient to have one agency responsible for the collection of the state taxes of all states, to reduce the inconsistent approaches used across the eight states and territories.

Comments

This is a challenging issue politically, from the perspective of state governments and state sovereignty. However, the cost of state and territory tax collection agencies which is borne by the states and territories and ultimately all Australians; as well multiple compliance costs borne by the business sector, are too high and must be addressed.

Suggested action

A national agency taking over all state taxes for all states should be explored as a strategy. The implementation might be gradual, on a tax by tax basis; for example the national agency might commence with payroll tax.

This single agency might be the ATO or, to create some competitive efficiency tension, a new agency assembled from elements of the existing state Revenue Offices, or another agency.

7. Minimising distortions

7.1 Reducing distortions from the revenue-capital distinction

Australia's capital gains tax rules are overly prescriptive, excessively complex and cause much confusion and inefficiency.

A major problem has arisen with the distinctions between capital gains and ordinary income characterisation and the overlap with income tax rules. These issues raise challenges for managed funds, for companies as well as Australian businesses, in distinguishing between which gains are capital and which are revenue, and which losses are capital and which are revenue. This strategic gap is currently causing significant uncertainty and tension involving the ATO at the corporate, managed funds and smaller business levels.

Suggested action

A high priority tax reform is to clarify the distinction between capital and income in the tax law, with specific holding period rules (as are used in other countries) to replace the present uncertain position. Such rules would significantly reduce inefficiencies and enhance compliance.

In the medium to long term, the CGT law could be streamlined to reduce its bulk.

7.2 Enhancing superannuation and retirement savings

a) **Resist the temptation to make superannuation savings less attractive**

Australians should provide for their future retirement (rather than immediate consumption). We are concerned that suggestions to increase the tax burden on superannuation could reduce the attractiveness of superannuation contributions which are an important element of national savings.

In particular, some stakeholders might suggest that tax deductibility of superannuation contributions is inappropriate relative to other forms of savings. However, superannuation funds are taxable with significant taxes being paid by the sector (Australia is almost unique in the world in this respect).

b) **Reduce distortions impeding to merger of superannuation funds**

Australia has taken action to encourage desirable consolidation and mergers of businesses through various tax rollovers and other merger mechanisms[18]. Unfortunately superannuation funds which seek to consolidate have no tax merger or rollover mechanisms, so a merger results in tax disadvantages including realisation of gains and losses which impede or prevent efficient transactions. Tax policy should facilitate mergers of superannuation funds, to enhance efficiency of Australia's retirement savings.

7.3 Reduce distortions and tax aspects impeding workforce participation

Australia needs more competitive personal tax rules to encourage labour force participation. This includes addressing welfare to work traps and the need for lower effective marginal tax rates and lower personal tax rates to cater for increasing labour mobility.

This action is strategically important, recognising the achievements of low net taxes for lower income Australians. Lower to middle income Australian households pay little net tax after transfer payments – see for example charts 7.4, 7.5 and 3.9 onwards of the TAP.

Australia's personal taxes need further attention by this Review, building on planned reductions in personal tax rates from initiatives of this and the previous government. Chart 5.8 of the TAP suggests that the UK top rate is both reached at a lower multiple of average weekly earnings but is significantly lower than the Australian top marginal tax rate on earned income; the US top rate is fractionally lower than Australia's top marginal tax rate but is reached at a level of over 8 times average weekly earnings as compared with Australia's 2.6 times; even Germany's top marginal tax rate, comparable with Australia's, is reached at 6 times weekly average earnings.

Suggested action

First, more analysis is needed to establish whether Australia's personal tax rates are internationally competitive, identifying impacts for individuals on twice average weekly earnings (AWE), three times AWE and higher. These individuals, with marketable and valuable skills in the workforce, need to be retained in the workforce in Australia and they should not have to pay a higher, top rate, tax than their peers in other countries.

Second, Australia's personal tax strategy will need to attract expatriates back to Australia, given the demographic challenges and the greater number of young Australians leaving Australia for some

[18] The Financial Sector (Business Transfer and Group Restructure) Act 1999 removed numerous regulatory impediments and allowed restructures which could be treated as mergers for tax purposes, with no disposals or loss of attributes arising for tax purposes.

years and enjoying working in other countries with very competitive tax environments. Further incentives to repatriate Australians who are overseas should be explored, such as concessions similar to those given to temporary residents for a limited time after their return (the relief could be tapered to ease them back into what will still likely be a higher taxing regime in Australia).

7.4 Encouraging Australian savings by an improved treatment of capital income

Australia's taxation of capital gains earned by individuals is broadly comparable with the top 10 OECD countries: the TAP confirms at Chart 5.9 that Australia's CGT impost is not lower than in comparable countries.

However, Australia's taxation of interest income, and savings leading to interest income, is high when compared with other savings mechanisms including the purchase of rental property, listed company shares etc and when compared with other countries, refer charts 5.9 and 8.3 of the TAP. As the TAP points out, the inflation component generally represents the major proportion of the return on low yielding assets such as bank deposits, so Australia has a very high effective tax rate on savings.

This does not imply a need to increase the taxation on capital income other than interest income. Rather, it is a signal that Australia could do more to encourage savings by its households. Indeed the International Monetary Fund has been noting since 2006 Australian banks' dependence on wholesale funding, often from overseas, rather than domestic savings[19]

Suggested action

Australia should consider reducing the tax which is imposed on interest income, in order to encourage savings by Australians. A preferred strategy is using a lower, schedular, tax rate on interest income. A schedular concession exists in many OECD countries, as noted in the TAP. A further alternative is a final withholding tax regime, used in some other countries.

Such concessions on interest income will need to be appropriately targeted to encourage savings for Australian households, for example by limiting the concession to interest on savings of say $200,000 (indexed annually) deposited in designated accounts, or to an amount of say $20,000 (indexed annually). The levels should be set to encourage savings by Australian salary and wage earners. [20]

7.5 Streamlining households' compliance costs for income tax and transfers

In the medium term, options to reduce compliance costs and complexity for personal tax could be explored. These might include an optional income tax based on family income including that of the spouse, aligning the approaches to the family income calculations used for tax transfer payments. This could reduce income-splitting behaviours, reduce costs of compliance and provide an efficiency dividend.

As well, Australians with low or middle incomes might be offered an option to eliminate personal income tax returns, involving final tax withholdings on capital income, as adopted in the UK and some other countries. This would require the introduction of tax withholding mechanisms in relation to interest, dividends and perhaps property income, and might involve 'cashing in' typical entitlements to work related expenses. It would operate at the option of taxpayers.

[19] A 2006 IMF report, "Australia: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Insurance Regulation, Securities Regulation, and Payment Systems" is at http://www.imf.org/external/pubs/cat/longres.cfm?sk=20026.0 This issue was raised again the August 2008 IMF country report on Australia, at http://www.imf.org/external/pubs/ft/scr/2008/cr08311.pdf

[20] Canada introduced in 2008 a new Tax-Free Savings Account, a flexible savings vehicle that allows Canadians to contribute up to $5,000 a year to the account with all investment income, including capital gains, and withdrawals being tax-free. This amount is too low, in our view.. See http://www.budget.gc.ca/2008/plan/chap3b-eng.asp

Appendix A

Rectifying Australia's taxation of business capital investment in plant and equipment and infrastructure to encourage business investment, productivity gains and resulting employment – supporting section 2.3.1

a) The effective life misnomer

The core principle for capital allowances, 'effective life', is an uncompetitive principle which is stated in a misleading fashion in the tax law. It emerged from the Ralph Review process which achieved a lower company tax rate but, because of the revenue neutrality constraint imposed by the federal government, the lower corporate tax rate was to be funded by reducing capital allowances on plant and equipment.

The reductions to the capital allowances for plant and equipment were based around the concept of 'effective life'. But 'effective life' was defined inappropriately, causing a fundamental tax policy problem and making Australia's capital allowances internationally uncompetitive.

The definition of effective life[1] focuses not on the **commercial effective life for the acquirer** but, essentially, on the **physical life of an asset for any business**. Assume that an asset (say, modern transport equipment) is acquired by a business for a 6 year period to extract maximum value, and is then sold for a low price to some other buyer who might retain it for 15 more years. The effective life under the statute is 21 years, irrespective of the fact that the commercial life, the period of greatest value of the asset, is 6 years for the initial acquirer. So the statutory designation of 'effective life' does not look to the period of time during which a business can commercially extract the maximum value from the asset (i.e. its effective life from the viewpoint of capital expenditure budgeting).

This has impaired Australia's international competitiveness. Some competitor countries, even those which engaged in base broadening activities in relation to business capital expenditure, did not reduce capital allowances severely. Other countries retained higher nominal company tax rates with concessional capital write-off rates in relation to plant and equipment. This includes not only the US but also the UK[2].

This inappropriate policy required government interventions to rectify the capital allowance write-offs[3] for pipelines for energy and utilities, motor transport equipment (e.g. trucks) and aircraft. However every such modification required a lengthy approach to government and public relations activities to highlight the threat of capital expenditure droughts or businesses leaving Australia.

Australia's capital allowance rules for investment in plant and equipment remain uncompetitive, even after the introduction of double declining value depreciation in the 2006 budget.

Suggested action

The effective life regime should be replaced by an internationally competitive capital allowance scheme. This should include "broadbanding" rules, involving several bands with attractive rates of write-off. This is currently the approach of the UK, a country led by a Labour government which is conscious of its international competitiveness for investment.

The broadband rates should be set at internationally competitive levels, which might involve reducing some of the statutory capped lives in s. 40-102.

[1] In section 40-105 of the ITAA 1997
[2] In the UK most plant and machinery is depreciable at a diminishing balance rate of 20% per year. A special class of long-life assets (defined as those with a useful life of more than 25 years) is depreciable at a diminishing balance rate of 10%.
An annual investment allowance of GBP50,000 is available to all businesses. The rate is 100%, effectively meaning that the first GBP50,000 incurred on plant and equipment each year may be written off immediately.
A 100% depreciation allowance is available to businesses for expenditure on low-emission cars, gas-refueling infrastructure, water technologies and energy-saving technologies. Losses derived from this allowance may be surrendered in exchange for a cash payment.
[3] These improvements involved statutory caps, in section 40-102 of ITAA 1997

b) The tax penalty for improvements and technological updates of capital equipment

Where capital improvements are made to an asset with a cost of more than 10% of the asset's cost , its effective life is required to be reviewed using the inappropriate 'physical life' model discussed above[4], and may be extended, even though its period of greatest value may not lengthen.

Suggested action

This tax penalty for improvements and technological updates of capital equipment (s.40-110(1)(b)) should be removed.

c) The 'diminishing value tail' should be eliminated

For assets under the diminishing value capital allowance rules, the cost of the asset is never written off, because the annual claim is a percentage of the opening value. By contrast the straight line method sees the asset fully depreciated after the effective life is reached.

Suggested action

The diminishing value tail should be removed, by a statutory write-off of the 'end of the tail'. Where an asset under the diminishing value method reaches the end of the statutory life period, the remainder of the written down value of the asset in that year should be written off.

d) Excessively long effective lives for long-lived assets and infrastructure should be limited

The current effective lives are problematical for long-lived assets as well as shorter-lived assets. Many infrastructure assets have tax effective lives of 40 years or more, far longer than the commercial time horizon for capital budgeting. Thus the annual capital allowances (say 2.5 per cent per annum) are less than the inflation rate. In a real, inflation-adjusted sense, there is no capital allowance at all. This is why businesses have difficulty in justifying investment in long-lived or infrastructure assets.

Suggested action

Australia's capital allowances should have a maximum effective life cap of 20 years.

e) Buildings capital allowances need to be reviewed

The effective lives for buildings have received no policy attention despite being planned for examination after the Ralph Review. Australia's capital allowance rules applicable to buildings need review.

f) Black holes rules retain black holes and should be adjusted

The black hole rules were intended to provide write-offs in relation to business capital expenditure which was otherwise ineligible for capital allowance write-offs. However the rules are highly complex and cause many business expenditures to be capitalised into the cost of assets with no tax capital allowances and no tax recognition during the holding period of the assets. Despite being amended in 2005, these rules are still somewhat ambiguous in their scope and application.

Suggested action

The black holes rules need adjustment. For example all lease-related costs should be eligible for the 5-year write-off. An effective black hole regime should ensure that all costs (apart from purchased goodwill) in relation to the acquisition of a business should ultimately be deductible (through amortisation, where not available for immediate write-off or deductible under other provisions).

g) Problems for managed funds investing in infrastructure assets should be resolved

Broadly, an Australian widely held trust, or trust with a superannuation fund investment in excess of 20%, is taxed as a company[5] if it engages in activities other than purely passive investment in rental producing

[4] Under s.40-110(1)(b) of the 1997 Income Tax Assessment Act

property. Investment in an infrastructure project such as a toll road, a port or a transport system does not equate to passive generation of rental activity from a property.

Therefore, a pure infrastructure investment in a managed fund prima facie would cause the fund to be exposed to company taxation. The government has introduced, in the 2008 Federal Budget, interim changes to Division 6C, pending a review of taxation of managed investment trusts by the Board of Taxation, which did not address this issue.

Suggested action

Division 6C needs adjustment or removal to facilitate investment in infrastructure assets by managed funds, whether under the Board of Taxation review or this Review.

[5] Under Div 6C of the 1936 Income Tax Assessment Act