THE TAX INSTITUTE

AUSTRALIAN TAX
RESEARCH FOUNDATION

THE CASE FOR CHANGE

A paper to prompt discussion for the future of Australia's tax system

JULY 2021

Tax. It’s at the heart of the economy. And it’s always changing.

THE TAX INSTITUTE

AUSTRALIAN TAX RESEARCH FOUNDATION

THE CASE FOR CHANGE

A paper to prompt discussion for the future of Australia's tax system

JULY 2021

The Pillars of Reform

Business Taxation

Personal Tax and Transfer

Superannuation and Retirement

Indirect Tax

L37, 100 Miller Street,
North Sydney NSW 2060, Australia

www.taxinstitute.com.au

Contents

It’s time to draw a new blueprint for the future of our tax system.

THE CASE FOR CHANGE

Peter Godber, CTA
President

Welcome to the *Case for Change*. This document represents the culmination of over a year's work involving hundreds of people, each of whom has been passionate about fixing all or some part of the tax system.

What I am sure each contributor has also had in common is a belief that a good tax system is fundamental to the success of our economy and our future. As Oliver Wendell Holmes, former Justice of the United States Supreme Court, said, "Taxes are what we pay for a civilized society". To be a great society, we must have a number of fundamental building blocks, providing the environment where businesses and employment can flourish and not be weighed down by an inefficient and moribund tax system.

What has also been common among participants and contributors to this *Case for Change* is the view that our current tax system is so much less than it could be and that there is much scope for improvement. The opportunity to have a facilitative, simple and equitable tax system is within reach should our politicians be prepared to grasp the opportunity.

When The Tax Institute embarked on this process, it was not apparent how broad and wide our engagement would become. We started by engaging with our volunteers on our various state and national technical committees, identifying within their areas of expertise what the pressing issues were, and what opportunities for improvement could be seized. That feedback was then put to various commentators and discussants for consideration and building upon, through a series of over 30 events over the course of 2020 as part of The Tax Summit: Project Reform. Through that series, The Tax Institute hosted focus sessions, seminars, keynotes, roundtable discussions and the Virtual Summit.

We were pleased that so many participants outside our membership base were also willing to contribute. From a former federal treasurer to a current state treasurer, from opposition spokespersons to policy advisers and administrators, from representatives of large business, small business, civil society, think tanks, academia and other professional bodies. A broad cross-section of society was invited and most were willing to participate. In the end, hundreds of people were involved.

It is perhaps that broad level of interest that gives us the greatest hope that policymakers and politicians of all colours will note the groundswell of support for fundamental tax reform. The *Case for Change* does not represent a blueprint for tax reform. It is, and intends to be, a discussion starter, identifying some of the more important areas of reform of the tax system that should be debated. Not every suggestion that has come forward through the course of the project has been included. Rather, there has been a process of debating internally and distilling those ideas to present them as options that can be weighed, recognising that not all agree on the best option and that, sometimes, reasonable minds can differ. In the end, it is the work of The Tax Institute and does not seek to represent the views of any participant. I would like to thank the many volunteers and other individuals who gave freely of their time and energy to contribute their ideas and views. Without them, this would not have been possible.

We look forward to the next stage of the ongoing debate that we hope will ultimately lead to significant tax reform to power our economy on to support a greater society.

Disclaimer

The Tax Institute and ATRF gratefully acknowledge the contributions of the individuals (and organisations) named in this paper.

The Tax Institute is a membership-based organisation which operates for, and on behalf of, its members. To prepare this paper, The Tax Institute and ATRF have undertaken significant groundwork and consulted widely. Over the course of 2020 as part of The Tax Summit: Project Reform, The Tax Institute hosted over 30 events including focus sessions, seminars, keynotes, roundtable discussions and the Virtual Summit.

Many of the issues identified, and potential options for reform, contained in this paper have been put forward by the broad range of contributors throughout The Tax Summit: Project Reform. The individuals acknowledged in this paper have contributed to it in a variety of ways. Some have been involved as speakers at events hosted by The Tax Institute, others have prepared papers identifying issues and potential options for reform, and some have been involved in reviewing parts of this paper from a technical perspective.

Some aspects of the system affect certain groups more acutely than others, and it is inevitable that there will be competing priorities in achieving tax reform and views on the best way to do so. We acknowledge that reasonable minds can differ and that, in many cases, there can be more than one solution to any given problem. In certain cases, views put forward by members have differed and The Tax Institute and ATRF have had to make a decision on what to prioritise and put forward in this paper.

The issues, ideas and options for reform that are presented in this paper have been distilled by The Tax Institute's Tax Policy and Advocacy team, and are presented as the views of The Tax Institute and ATRF. They do not represent the views of any particular contributor named in this paper.

The purpose of this paper is to spark debate and initiate a course of action. This paper is not a blueprint for the design of a new tax system. It is evidence that we are in dire need of one. It is the culmination of a self-initiated project with the overall objective of achieving a better Australian tax system for all Australians.

Importantly, this paper is not an exhaustive review of the entire Australian tax system. It does not contemplate every single aspect of the Australian tax system, nor does it delve into the details of each regime considered, except where it has been relevant or necessary to do so to draw out the issues. We have mostly focused on the macro-level design issues, as we consider there are fundamental issues with the structure of our tax system which must be addressed.

Australian society and our economic landscape are ever-changing. For the most part, issues discussed in this paper have persisted for many years. However, given that we are living through unprecedented times where the situation is rapidly changing, we bring to your attention that matters discussed in this paper are current as of June 2021.

This paper is for discussion purposes only and should not be used or treated as professional advice of any kind. Readers should rely on their own enquires and should seek professional advice before making any decisions concerning their own interests.

Acronyms | Abbreviations

Term	Explanation
AAT	Administrative Appeals Tribunal
ABN	Australian business number
ABR	Australian Business Register
ABS	Australian Bureau of Statistics
ACE	Allowance for corporate equity
ACN	Australian company number
ACNC	Australian Charities and Not-for-profits Commission
ACT	Australian Capital Territory
AEST	Australian Eastern Standard Time
ALP	Australian Labor Party
AMIT	Attribution managed investment trust
ANU	Australian National University
ASBFEO	Australian Small Business and Family Enterprise Ombudsman
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
AWOTE	Average weekly ordinary time earnings
BAS	Business activity statement
BEPS	Base erosion and profit shifting
Board	Board of Taxation
BREPI	Base rate entity passive income
CDF	Commercial debt forgiveness
CFC	Controlled foreign company
CGT	Capital gains tax
CLP	Corporate limited partnership
COT	Continuity of ownership test
CPI	Consumer price index
CTE	Corporate tax entity
DGR	Deductible gift recipient
DISER	Department of Industry, Science, Energy and Resources
DPT	Diverted profits tax
EOI	Exchange of information

Term	Explanation
ESIC	Early-stage innovation company
ESS	Employee share scheme
ESVCLP	Early stage venture capital limited partnership
ETP	Eligible termination payment
FBT	Fringe benefits tax
FBTAA 1986	*Fringe Benefits Tax Assessment Act 1986* (Cth)
FEDA	Full expensing of depreciating assets
FITO	Foreign income tax offset
Forex	Foreign exchange
GDP	Gross domestic product
GFC	Global financial crisis
GTL	Gas-to-liquids
GST	Goods and services tax
GST Act	*A New Tax System (Goods and Services Tax) Act 1999* (Cth)
IAWO	Instant asset write-off
IGTO	Inspector-General of Taxation and Taxation Ombudsman
IP	Intellectual property
ITAA 1936	*Income Tax Assessment Act 1936* (Cth)
ITAA 1997	*Income Tax Assessment Act 1997* (Cth)
IT(TP)A	*Income Tax (Transitional Provisions) Act 1997* (Cth)
LCT	Luxury car tax
LNG	Liquefied natural gas
MAAL	Multinational anti-avoidance law
MEC	Multiple entry consolidated
MIT	Managed investment trust
MLI	*Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*
MNAV	Maximum net asset value
MRE	Main residence exemption
MRRT	Mineral resource rent tax
NANE	Non-assessable non-exempt
NFP	Not-for-profit
NGO	Non-government organisation
OECD	Organisation for Economic Co-operation and Development
OTE	Ordinary time earnings

Term	Explanation
PAYG	Pay as you go
PBO	Parliamentary Budget Office
PE	Permanent establishment
PPP	Public-private partnership
PRRT	Petroleum resource rent tax
PRRT Regulations	*Petroleum Resource Rent Tax Assessment Regulation 2015* (Cth)
PRRTAA	*Petroleum Resource Rent Tax Assessment Act 1987* (Cth)
PSB	Personal services business
PSI	Personal services income
R&D	Research and development
R&DTI	Research and development tax incentive
RBL	Reasonable benefit limits
RPM	Residual pricing method
RSPT	Resource super profits tax
SBE	Small business entity
SBITO	Small business income tax offset
SBRR	Small business restructure roll-over
SBSCH	Small Business Superannuation Clearing House
SBT	Same business test
SFT	Supplementary financial tax
SG	Superannuation guarantee
SGAA	*Superannuation Guarantee (Administration) Act 1992* (Cth)
SGC	Superannuation guarantee charge
SIB	Social impact bond
SISA	*Superannuation Industry (Supervision) Act 1993* (Cth)
SISR	*Superannuation Industry (Supervision) Regulations 1994* (Cth)
SME	Small to medium-sized enterprise
SMSF	Self-managed superannuation fund
STP	Single Touch Payroll
TAA 1953	*Taxation Administration Act 1953* (Cth)
TAP	Taxable Australian property
TARP	Taxable Australian real property
TBA	Transfer balance account
TBC	Transfer balance cap

Term	Explanation
TFN	Tax file number
TOFA	Taxation of financial arrangements
TSB	Total superannuation balance
TPB	Tax Practitioners Board
UK	United Kingdom
UPE	Unpaid present entitlement
US	United States of America
VAT	Value-added tax
VCLP	Venture capital limited partnership
VFI	Vertical fiscal imbalance
WET	Wine equalisation tax
WHT	Withholding tax
WST	Wholesale sales tax

In this discussion paper, references to legislative provisions are generally to the ITAA 1936 or the ITAA 1997, as appropriate, unless stated otherwise. References to States also include the Australian Capital Territory and Northern Territory.

Reports | Reviews

2019 Review	Board of Taxation, *Review of small business tax concessions – a report to the Treasurer*, Australian Government, Canberra, March 2019.
Asprey report	Commonwealth Taxation Review Committee and Justice K Asprey (Chairman), *Full report, 31 January 1975*, Australian Government Publishing Service, Canberra, 1975.
Callaghan review	M Callaghan, *Petroleum resource rent tax review – final report*, Australian Government, 13 April 2017.
Campbell Inquiry	Committee of Inquiry into the Australian Financial System, *Australian financial system: final report of the Committee of Inquiry*, Australian Government Publishing Service, 1981.
Henry review	Australia's Future Tax System Review Panel (Dr Ken Henry, Chair), *Australia's future tax system: report to the Treasurer*, 23 December 2009.
Ligertwood Committee review	Commonwealth Committee on Taxation (Australia), *Report of the Commonwealth Committee on Taxation*, Canberra, 1961.
Ralph review	Review of Business Taxation (John Ralph, Chair), *A tax system redesigned: more certain, equitable and durable*, final report of the Review of Business Taxation, July 1999.
RATS paper	*Reform of the Australian tax system*, draft white paper, Australian Government Publishing Service, Canberra, 1985.
Thodey report	Federal Financial Relations Review (David Thodey, AO, Chair), *NSW review of federal financial relations – supporting the road to recovery*, final report, NSW Treasury, August 2020.

Cases

British Mexican Petroleum Co Ltd v Jackson (1932) 16 TC 570
Burton v FCT [2019] FCAFC 141
Bywater Investments Ltd v FCT [2016] HCA 45
Commissioner of State Revenue (Vic) v The Optical Superstore Pty Ltd as trustee for OS Management S Trust [2019] VSCA 197
Dempsey and FCT [2014] AATA 335
Drake Personnel Ltd v Commissioner of State Revenue [2000] VSCA 122
Eichmann v FCT [2020] FCAFC 155
FCT v Bamford; Bamford v FCT [2010] HCA 10
FCT v Qantas Airways Ltd [2014] FCAFC 168
FCT v Unilever Australia Securities Ltd (1995) 127 ALR 437
Harding v FCT [2019] FCAFC 29
Hunter Douglas Ltd v FCT (1982) 82 ATC 4550
International Nickel Australia Ltd v FCT [1977] HCA 49
John Holland Group Pty Ltd v FCT [2015] FCAFC 82
Moreton Resources Ltd v Innovation and Science Australia [2019] FCAFC 120
Peter Greensill Family Co Pty Ltd (trustee) v FCT [2020] FCA 559
Stockton v FCT [2019] FCA 1679
Virgin Australia Airlines Pty Ltd v FCT [2021] FCA 523

The Case for Reform

1. The case for reform

Recovering from the events of 2020

Between 2019 and 2021, Australia experienced unprecedented events that shook the economy and adversely impacted the lives of many Australians and businesses. The widespread bushfires, floods and the COVID-19 pandemic have had a shattering effect, not to mention other global issues which have also, directly or indirectly, affected the Australian economy and our relations with other nations. In addition, while the worst of some of these events is over, others persist, and the impact of all is long-lasting. The economic and social fallout from these events, including the devastating loss of lives, destruction of property and infrastructure, closure of businesses and job cuts following strict lockdowns, and shrinking household spending, plunged the Australian economy into a recession for the first time in 30 years.

The government was swift in its responses to provide support to individuals and businesses affected by these crises. The temporary stimulus measures ranging from the cash flow boost to JobKeeper and JobMaker, among others, have been critical in ensuring that many businesses stay afloat through these trying times.

Now, to propel Australia forward from this recession, the government must look beyond temporary measures, and invest in long-term solutions to address the current economic crisis and the aftermath of 2019–21. Australia needs solutions that will:

- generate revenue to support ongoing government expenditure;
- support economic growth and create jobs; and
- improve equity for the generations to come who will continue to bear the brunt of the economic fallout of 2019–21.

Tax reform – a key part of the solution

Holistic reform of the Australian tax system is fundamental to achieving any of these objectives:[1]

> The tax system serves an important role in funding the quality public services that benefit individual members of the community as well as the economy more broadly. Through its design it can have an important impact on the growth rate and allocation of resources in the economy.

Over the past few decades, the taxation and superannuation systems have played an important role in supporting and strengthening the resilience of the Australian economy and fiscal position. This is particularly evident when compared to other countries during other periods of severe economic downturn, such as, for example, the GFC of 2008–09 (the only major economic shock Australia has experienced since the introduction of the GST, other than the COVID-19 pandemic).

However, our ability to weather the storm in the past may provide a false sense of security and it would be remiss of the government to rest on its laurels now. Today, Australia is facing different economic challenges than in the past. The emerging economic and social implications of the

1 Henry review, Part one – Overview, p. viii.

bushfires, floods and the COVID-19 pandemic have placed greater pressure on budgets at all levels of government. These events have tested the capability and durability of the tax system to support the recovery, and further growth, of Australia's economy.

We now have unimaginable levels of debt at the state and federal level. Even taking into account the current record low interest rates, at a very minimum, the principal on these debts eventually must be repaid.

For the tax system to support Australia in bringing its debt back under control over the long term, revenue must be raised from efficient and sustainable tax bases. As demonstrated throughout this paper, the vast majority of revenue collected currently comes from unsustainable sources. Sweeping reform of the entire tax system is vital and must begin now so that we can implement the right structures to drive Australia out of this recession and towards economic prosperity.

Moreover, when assessing the long-term impacts of the pandemic, an important variable is the impact of halted migration (and tourism), although this is expected to be somewhat mitigated by a corresponding reduction in GDP. Lower net immigration in 2019–20 and 2020–21 due to restrictions on international travel is likely to permanently reduce Australia's population compared to pre-COVID-19 assumptions. This is expected to cause a flow-on decline in household consumption and therefore GST revenue over the longer term.[2] Similarly, a lower number of temporary visitors affects not only the tourism and related sectors, but also translates to lower education exports, healthcare as well as flow on effects to retail, trade and other sectors.

Rebalancing the tax mix

Australia's low tax revenue

Australia has relatively low tax revenue as a percentage of GDP compared to other OECD countries. In 2018, Australia had a tax revenue as a percentage of GDP of 26.7%, while the OECD average was 33.9% and common comparative countries such as New Zealand and the UK were both 32.9%, and Canada was 33.2%.[3]

Over-reliance on income tax

Despite the aforementioned *comparatively* lower rates of tax, the mix of income taxes in Australia has largely been unchanged for approximately 60 years, with a significant reliance on taxes, including company tax.[4] In 2017–18, 51.3% of tax collected was from personal income tax.[5] More than two-thirds of Australia's tax receipts come through personal and corporate income taxes — which is approximately twice the OECD average. Most other advanced economies have placed a considerably higher reliance on the taxation of consumption (or value-added) taxes.[6]

2 PBO, *Structural trends in GST*, report no. 02/2020, Commonwealth of Australia, 2020, p. 4.

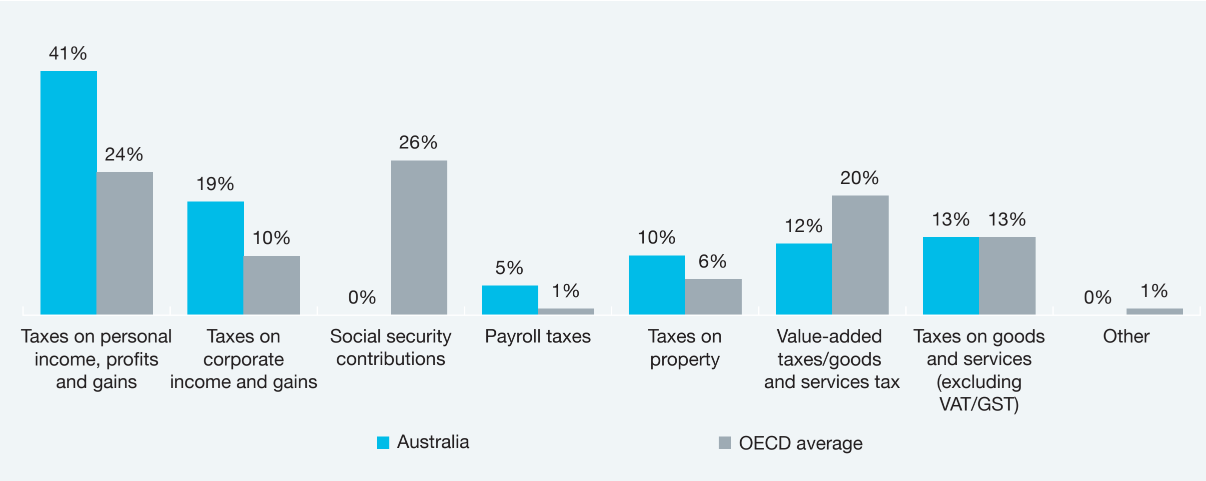
3 OECD, *Revenue statistics 2020*, OECD Publishing, 2020, p. 23. Available at https://doi.org/10.1787/8625f8e5-en.

4 M Stewart, A Moore, P Whiteford and RQ Grafton, *A stocktake of the tax system and directions for reform: five years after the Henry review*, Tax and Transfer Policy Institute, 2015, p. 30.

5 ATO, *Taxation statistics 2017-18 snapshot*, chart 3, 2020. Available at www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2017-18/?anchor=alltaxreturns#alltaxreturns.

6 OECD, *Revenue statistics 2020 – Australia*, OECD Publishing, 2020, p. 1. Available at www.oecd.org/tax/revenue-statistics-australia.pdf.

Figure 1. Tax structure of Australia compared with OECD average (2018)



Source: OECD, *Revenue statistics 2020 – Australia,* OECD Publishing.[7]

The introduction of the GST was a critical addition to the Australian tax mix. Specifically, the GST introduced to the existing tax mix a broader tax base than the previous narrow sales tax base. However, Australia's tax mix is still highly skewed toward direct taxes on individuals and corporations. According to the ABS, in 2018–19, taxes on income, profits and capital gains accounted for 60.5% of total taxation revenue, while the GST accounted for a mere 11.6%.[8]

While income tax revenue is significantly higher than the OECD average, GST revenue is relatively low compared to other OECD countries, in which VAT comprises, on average, 20% of total tax revenue. Further, concessions and exemptions that are available within the Australian GST regime are broader, relative to other OECD countries.[9] In 2018–19, the GST collected was $65.1b and GST concessions cost $26.4b. According to the ATO, the GST tax gap for that year amounted to $5.8b.[10] Together, these figures indicate that almost half the potential revenue from the GST, as it currently applies, is not being collected. The GST tax gap is largely attributable to overclaimed deductions and the cash economy. However, it can be seen that an incredibly large amount of revenue has been forgone by virtue of concessions and other forms of reliefs from GST.

The Henry and Thodey reviews agreed with the OECD assessment that consumption is 'one of the most efficient and sustainable tax bases available to governments' and that 'empirical evidence indicates that a broad based tax on consumption is one of the least damaging taxes to economic growth'.[11] This is because taxing consumption does not distort economic growth, but rather encourages investment and saving since it does not tax the normal return to capital.

---

7 OECD, *Revenue statistics 2020 – Australia*, OECD Publishing, 2020, p. 2. Available at www.oecd.org/tax/revenue-statistics-australia.pdf.

8 ABS, *Taxation revenue, Australia*. Statistics about taxation revenue collected by the various levels of government in Australia, catalogue no. 5506.0. Available at www.abs.gov.au/statistics/economy/government/taxation-revenue-australia/latest-release#key-statistics.

9 OECD, *Choosing a broad base – low rate approach to taxation*, OECD Tax Policy Studies, No. 19, OECD Publishing, Paris, 2010. Available at www.oecd-ilibrary.org/docserver/9789264091320-en.pdf?expires=1622624951&id=id&accname=ocid41018480&checksum=C37D3AFFEF42FFD4364A4EE7213CCCFC.

10 ATO, *Goods and services tax gap*. Available at www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Goods-and-services-tax-gap/.

11 Henry review, Part one – Overview, p. 51.

Increasing reliance on the GST as a source of revenue is an important strategy to rectify some of the fundamental issues associated with Australia's current tax mix. If increased productivity and workforce participation remain at the forefront of the agenda (as they should), it is unsustainable and counterintuitive to rely on personal income taxes, particularly as Australia's ageing population moves into retirement. Further, heavy reliance on corporate taxes is less conducive to economic growth.

On the other hand, with some necessary reforms, the GST has the potential to be a comparatively stable and reliable revenue stream. The current relative volatility of the GST can be attributed, in part, to the broad range of exemptions to the regime.

In addition to encouraging productivity and workforce participation by shifting reliance from income taxes, improvements to the GST can alleviate reliance on even more volatile, distortionary and inefficient revenue streams that are imposed at the state level, such as stamp duties and insurance levies.

Another benefit to greater reliance on the GST is the reduced scope for significant tax planning and potential tax avoidance. The availability of unilateral choices within the income tax system lends itself to tax planning in a manner which does not readily translate in a consumption tax system, particularly where both sides to a transaction are required to report consistent information to the ATO.

Overall, there are a range of reasons demonstrating the importance of not only undertaking a comprehensive review of the existing GST regime, but also taking action to rebalance the tax mix with a shift away from income taxes towards a greater reliance on consumption tax.

A tax system must support, not impede, the economy

A tax system is designed to raise the money that governments need to provide the services demanded by society. This means that imposts by governments can take many forms, be it user charges or traditional revenue raising.

A *good* tax system not only raises the right amount of revenue, but is also conscious of the impact that taxes have on economic activity. A tax system that causes the least possible impediment to economic growth and productivity[12] is to be preferred to one that has no regard for the impact on economic activity. Tax systems are traditionally gauged on the basis of three accepted fundamental principles: efficiency, equity and simplicity.

Efficiency

The OECD[13] seeks to rank various taxes according to the relative harm they might inflict on economic growth. The conclusion, in terms of efficiency and efficacy, is that the most harmful type of taxes for economic growth are corporate taxes, followed by personal income taxes, and then consumption taxes, with recurrent taxes on immovable residential property being the least harmful. Accordingly, taxes on immovable residential land impose the lowest cost on economic growth. This conclusion is similar to that recently described in the report commissioned by the

12 R Deutsch, "Tax reform in the roaring 20s: some ideas from The Tax Institute", (2020) 55(2) *Taxation in Australia* 69.

13 OECD, *Tax policy reform and economic growth,* OECD Publishing, 2010. Available at read.oecd-ilibrary.org/taxation/tax-policy-reform-and-economic-growth_9789264091085-en#page4.

New South Wales Government into federal financial relations (the Thodey report).[14] That report notes that land tax is efficient and one that could be more broadly based is to be preferred as a substitute for the highly inefficient stamp duty.

Further, while the Thodey report notes the relative efficiency of the GST (in particular, when compared to income and corporate taxes), it also notes that there are major risks to its resilience[15] and that it has failed to be the growth tax it was designed to be because of the relatively narrow base. That is, the proportion of household expenditure that is subject to GST is shrinking[16] and this trend is likely to continue with demographic changes as well as technological change.

It is also well documented that Australia has a comparatively high reliance on corporate taxes compared to other jurisdictions. In the OECD's *Revenue statistics 2020*,[17] Australia ranks fourth highest when it comes to the proportion of tax raised from companies (the first three countries are Chile, Colombia and Mexico). Australia ranks equal second highest on the proportion of revenue from personal income tax and third lowest on consumption taxes. One must ask, are we so significantly out of step for any good reason? Do we know something that other countries don't, or have we been left behind? Noting that our national productivity growth has been extraordinarily low over the last 20 years, we should ask, to what extent is this attributable to the current mix of taxes? How much is the current tax system impeding productivity and economic growth? Why must we continue to restrict our growth and opportunities with a system that fails to tax the right activities in a balanced and sensible way?

To many, the solution is obvious.

The right mix of taxes would reduce reliance on the known inefficient taxes and increase the proportion of revenue raised by efficient taxes. This is true economic reform — reform which enhances productivity and creates employment.

Equity

While a shift away from taxing income to relying more on consumption taxes and a land-based tax may be desirable from an efficiency point of view, it is important to factor in fairness.

Equity and fairness lead to a more cohesive society. A system that is fair, and can be explained and perceived as fair, improves confidence that tax is being paid appropriately by the right contributors. The focus in recent years about multinational corporates not paying 'the right amount of tax' illustrates this. The ATO reports that, in fact, one-third of companies listed on the ASX actually make real economic loss in any one year or that significant accumulated losses are legitimately applied against otherwise taxable incomes. Media reports often overlook this fact, creating the misleading impression that one-third of corporates do not pay any tax.[18] The truth

14 Thodey report, p. 33 (quoting J Nassios, J Madden, J Giesecke, J Dixon, N Tran, P Dixon, M Rimmer, P Adams and J Freebairn, *The economic impact and efficiency of state and federal taxes in Australia, CoPS/IMPACT working paper G-289*, April 2019. Available at www.copsmodels.com/ftp/workpapr/g-289.pdf).

15 Thodey report, p. 32.

16 PBO, *Structural trends in GST*, report no. 02/2020, Commonwealth of Australia, 2020.

17 OECD, *Revenue statistics 2020*, OECD Publishing, Paris, 2020. Available at www.oecd-ilibrary.org/taxation/revenue-statistics-2020_8625f8e5-en.

18 N Khadem, "ATO data reveals one third of large companies pay no tax", *ABC News*, updated 2 January 2020. Available at www.abc.net.au/news/2019-12-12/ato-corporate-tax-transparency-data-companies-no-tax-paid/11789048?nw=0.

is that the corporates were fully compliant with the law and paid what was due in most cases.[19] However, what the law requires to be paid and how that amount should be determined have not kept pace with community expectations. Politicians (some of whom were apparently 'outraged' by certain behaviours) were those responsible for ensuring that the legislation kept pace with those changing expectations.

Accordingly, it is important that tax laws are consistent with community expectations of fairness. That it has apparently ceased to be so is a failure of successive governments to invest in ongoing maintenance of the system. While apparently somewhat mundane, it is clear what happens when that maintenance is neglected. In fact, the only 'maintenance' seems to be to introduce highly technical and complicated laws that are narrowly based and merely add to the community's lack of understanding and, ultimately, lack of trust in the tax system.

Australia prides itself on being a society of equals where everyone gets a 'fair go'. It is unsurprising, therefore, that a system that maintains an appropriate level of progressiveness on income (and wealth distribution) will gain acceptance and support from the community. The importance of ensuring that the social security (i.e. transfer) system is playing its part in maintaining that fairness is critical and should not be overlooked in any debate regarding the fairness of the system.

However, when considering the appropriate fairness settings in a tax and transfer system, not all taxes are as equitable as they may superficially seem. The International Monetary Fund, in its work "Tax policy for developing countries", said:[20]

> Another concern in the choice between taxing income and taxing consumption involves their relative impact on equity. Taxing consumption has traditionally been thought to be inherently more regressive (that is, harder on the poor than the rich) than taxing income. Doubt has been cast on this belief as well. Theoretical and practical considerations suggest that the equity concerns about the traditional form of taxing consumption are probably overstated and that, for developing countries, attempts to address these concerns by such initiatives as graduated consumption taxes would be ineffective and administratively impractical.

As noted in a *Taxation in Australia* journal article from 2020,[21] what superficially can seem regressive might actually be progressive. Thus, the differential treatment of food, depending on whether or not it is classified as a pre-prepared meal, may actually mean that lower socio-economic sections of society are spending a higher proportion of their income on GST than was previously understood, and that some higher socio-economic sections of society may not be paying GST on what may be considered 'luxury' items.

A tax reform process must include better education of the real impact of taxes on different sections of society and expose for debate what is truly progressive and what is not. For example, recent work by Treasury suggests that there seems to be no convincing correlation between payroll tax and the employment decision, though we acknowledge that there are competing views.[22]

---

19 The "Tax gap" reports from the ATO bear this out.

20 International Monetary Fund, "Tax policy for developing countries", *Economic issues no. 27*, March 2001. Available at www.imf.org/external/pubs/ft/issues/issues27.

21 A Mills, "Tax reform: selected issues", (2020) 55(2) *Taxation in Australia* 71.

22 B Ralston, *Does payroll tax affect firm behaviour?*, Treasury working paper, April 2018. Available at treasury.gov.au/sites/default/files/2019-03/p2018-t280988-1.pdf.

Such education and debate must also address the real incidence of taxes: the way in which certain taxes impact not only the 'payers' of the tax, but also the consumers, employers, employees and other businesses that interact with the payers.

Perhaps one of the starkest discussions that ran as a theme across a number of The Tax Summit: Project Reform sessions was the impact of the interaction of the tax and transfer system on working parents and the high effective marginal tax rates that they — usually working mothers — face. This is one of the most unfair features of our current system and could fall under the heading of 'gender equity' in our tax system. Primary carers can face a net *cost* of working an additional day once effective marginal tax rates are added to the cost of childcare itself. This should be regarded as one of the most fundamental failures of our system. This is further expanded on in Chapter 8. The fact that it seems to be acknowledged but little is done about it is a further indictment on the way in which society and our politicians respond to such failures. It is the role of bodies like The Tax Institute to prosecute the changes necessary to rectify this shameful situation.

Also raised during The Tax Summit: Project Reform discourse was intergenerational equity. This is an important issue, not only because inequities exist between different age groups at different times — and there may be good reason for that — but also because little work seems to have been done and minimal debate has occurred about what taxes are borne and what benefits are received over the course of a lifetime. Further, this issue is exacerbated by the fact that there is a risk of that equation changing through policy decisions that may not have regard to the longitudinal impact. Thorough research is necessary to have an informed debate about the right tax settings across a lifetime and to ensure that certainty is built into those settings.

Finally, equity must also consider the treatment of different types of income earned — known as 'horizontal equity'. Often what is called out in this part of the debate is the differing treatment of the taxation of savings and the taxation of labour income. While valid, the debate on horizontal equity should be widened to include the taxation of the same income in the hands of different entities and whether that is an appropriate setting. Currently, small business income is taxed in a variety of ways depending on whether the chosen business vehicle is a sole trader, partnership, limited partnership, trust or company. Such differences create complexity and leave open significant planning opportunities which undermines confidence in the equity of the tax system.

Simplicity

The third main feature of a good tax system is simplicity.

Simplicity generally promotes cost efficiency, which provides an environment for greater investment and builds trust in the system.

The complexity of the current system is reflected in the multiple laws and the detailed rules which are often overlaid on already complex rules. While the Board recommended, and the government implemented, a significant reduction in the size of the tax laws in the mid-2000s, the laws have since grown again and now exceed 10,000 pages.

Complexity reduces the ease of doing business and deters both domestic and foreign direct investment.

The most telling statistic of the complexity in the Australian tax system is the estimated cost of meeting obligations to register, calculate and pay tax liabilities. The estimated compliance costs of some $40b per annum[23] is a dead weight cost on business and Australians. It represents more than 10 times the cost of running the ATO. It represents significant red tape and is a drag on economic activity. That means reduced economic welfare for Australians through lower investment, resulting in fewer employment opportunities.

Additionally, a complex system reduces the level of trust in the system and is connected to perceptions of unfairness in the system. Because the system is complex and seems impenetrable — other than to the *cognoscenti* — it has the appearance of being capable of manipulation by those fortunate enough to be advised by that *cognoscenti*, irrespective of the truth of that.

A feature of simplicity (and one that is often called out separately) is the sustainability and stability of a system. A system designed with these features is flexible and minimises the need for constant tinkering. Fewer changes foster certainty, confidence and trust. We have seen what happens when a system is not designed for the long term or is designed in a way that is inflexible to changing economic or societal circumstances and imperatives — it has resulted in our current inefficient, inequitable and complex tax system.

Another perspective of certainty is that a system should be clearly understood by society, which requires a level of transparency. However, other aspects are equally important — the need for our system to be integrated into other systems, given the openness of our economy and the considerable trade and flow of capital, as well as being positioned to create the best kind of jobs. Or, to express it as the Prime Minister did in 2020 — it's about creating investment and jobs.

How does the current system measure up?

Efficiency

Various reports have pointed out that Australia relies on a number of high economic cost taxes. At a state level, examples include the various duties, whether on real property or other transfer (e.g. cars) duties, and insurance duties. At a federal level, there is a high reliance on income taxes. All of these taxes have an 'excess marginal burden' or the value destroyed for the dollar of revenue raised. The Thodey report sets this out most recently but it has been a theme of previous tax reviews, including the Henry review[24] in 2009.

Equity

The incidence of high effective marginal tax rates on some sections of society has been referred to above and discussed during the course of The Tax Summit: Project Reform event series in 2020, backed up by the work done by Associate Professor Ann Kayis-Kumar (UNSW), Professor Miranda Stewart (University of Melbourne) and others, and reflected in publications by the Grattan Institute, among others.

Importantly, this work shows how the tax system does not sit alone but interacts with other systems (transfer/social security). People often forget that these systems were once highly integrated, with many transfer benefits being delivered through the tax system. This is less so today and may well be part of the reason for what is now a very disjointed and incoherent system.

---

23 *Re:think – Tax discussion paper*, Commonwealth of Australia, March 2015, p. 171.

24 Henry review. Available at treasury.gov.au/review/the-australias-future-tax-system-review/final-report.

Similarly, the retirement system must not only integrate with other parts of the tax and transfer system, but it must also satisfy community expectations of fairness and equity. There was considerable (and perhaps surprising) agreement among experts in this area during the course of The Tax Summit: Project Reform event series that the current design of the taxation of superannuation is far too generous. The fact that the taxation is levied at concessional rates on contributions and income of the funds during the accumulation phase for members, yet fund income and benefits during the retirement phase are exempt, means that concessions are significant and their affordability in the context of the whole system is questionable.

The government's recent *Retirement income review* noted:[25]

> Contributions and earnings tax concessions together were estimated to cost a total of $41.55 billion in revenue forgone terms in 2018-19 (Chart 4A-6). Of this, $18.3 billion was employer contributions tax concessions (both compulsory and salary sacrifice) and $22.1 billion was earnings tax concessions. Only $1.1 billion was personal contributions tax concessions, reflecting that less than 10 per cent of personal contributions are concessional.

To some extent, the tax concessions drive the complexity in the design of the tax rules as integrity measures are built in.

Simplicity

The sheer size of the Australian tax law (exceeding 10,000 pages) is often highly intricate, and much of it applies only to a small proportion of the taxpayer population. This has been referred to above as have the other features, which give rise to a poor score for the tax system on these criteria.

The ATO has attempted to 'paper over the complexity' in the system. While there is much to be admired in an administrator proposing to use technology to mitigate the adverse effects of the complexity in the system, it means that the general population will not be aware of the unnecessary complexity that exists in the tax system. Additionally, the way in which ATO guidance is structured and the design of the ATO website mean that, often, further issues of accessibility and complexity are created.

Rather than paper over complexity, it might be better to address the fundamental complexity so that it is not necessary to use some of the revenue collected in simplifying the user experience. If the system is simplified, less will then need to be spent trying to create the appearance of simplicity.

Trust and transparency

The lack of trust manifests itself in many ways. The lack of trust in the efficacy of the system exists because of the complexity. This emanates from a suspicion of large/multinational corporates and high net worth individuals and the perception that, if you can afford to pay for 'smart tax lawyers and accountants', you can avoid paying your fair share of tax — irrespective of the truth.[26]

---

25 Treasury, *Retirement income review, final report*, July 2020, p. 381. Available at treasury.gov.au/publication/p2020-100554.

26 ATO, *Australian tax gaps – overview*. Available at www.ato.gov.au/about-ato/research-and-statistics/in-detail/tax-gap/australian-tax-gaps-overview/?anchor=Whywemeasurethetaxgap#Whywemeasurethetaxgap.

A lack of trust between the administrator and the taxpayer adds to the compliance costs imposed on taxpayers. Despite that apparent lack of trust between the administrator and taxpayers in relation to particular dealings, there is a valuable commodity in our system: the relatively high(er) trust in the ATO as administrator, which helps foster the relatively high levels of voluntary compliance that Australia enjoys. This issue is explored further in Chapter 13.

Levels of reform

The system as a whole

Considering the whole system, reform is about the choice of taxes, taking into account the principles above. It is also about the mix of taxes.

Putting aside single tax solutions for the reasons outlined above, we are left with choosing which taxes to put into the mix and what weighting should be given to each of those taxes. Obviously, land tax and consumption taxes should be given greater weight than is currently the case as they are the more efficient taxes. However, we are unlikely to move away from some form of tax on income and profits/gains, so it is important that they too be in the mix.

The balance could be shifted away from taxes on income and profits/gains which are less economically efficient in favour of GST and land tax. Other taxes can be designed so they are more economically efficient. Payroll tax is a clear example that falls into this category. Similarly, income tax could be made more efficient through changes to thresholds and rates.

Some of the smaller, nuisance taxes could easily be repealed. Some of the insurance duties which impact adversely on behaviour could similarly be abolished. Similarly, the excise regime on alcohol could either be scrapped or rationalised and a step in this direction was seen in the 2021-22 Federal Budget.

The superannuation tax rules could be rewritten in a way that is able to be applied by the average practitioner and comprehensible to the majority of superannuation fund members. It is unlikely that most politicians would be able to describe the intricate and complex superannuation rules that they have created in any level of detail.

These and other examples are explored in further detail throughout this paper.

Whatever choices are made, a clear eye will need to be kept on the impact on various sections of the community to ensure that any impacts are considered and dealt with appropriately. This is addressed below.

The design of the system

As we drill down to the next level, the question is how to design each of the taxes so that they have the greatest effect with the least economic impost.

This is more challenging, and vested interests will inevitably attempt to ensure that the system continues to work for them. This is evident from the anomalies in the way the current system works that provide perceived benefits for some.

The work that The Tax Institute's volunteers have done and much of the discussion throughout The Tax Summit: Project Reform event series in 2020 was focused on this. The range of matters that this *Case for Change* covers is a testament to the extensive contribution from so many.

While the contributors are recognised in this document, the views that are finally expressed are those of The Tax Institute. Reasonable minds can differ on what is the best solution to a problem.

Much of what needs to be considered at this level is set out in the sections that follow. The range of matters covered in this document, while extraordinarily extensive, are not comprehensive. Nonetheless, the discussion and options for reform set out herein contain the basis for improvements to the current tax system that will assist in taking the Australian economy forward — in creating the right environment for the encouragement of investment and the creation of jobs, and building a fairer, smarter and simpler system with less red tape.

Disclaimer

The views, opinions, ideas and potential options for reform do not represent the views of any individual member of The Tax Institute or ATRF. This paper should be read and considered in its entirety. To consider any single measure or option for reform in isolation is contrary to the spirit and fundamental objective of this discussion paper.

Business Taxation

2. Large business and international

Overview

This chapter will identify the obstacles and opportunities to encourage both an outward-looking Australian corporate sector and an attractive environment for foreign capital. It considers how current settings could be recalibrated to be consistent with leading international trends for corporate taxation and moving beyond the traditional parameters of corporate taxation.

Over-reliance on corporate tax as a source of revenue, disproportionately targeted integrity measures and high compliance costs

When reviewing the state of the Australian economy and the ability of the tax system to support it in present circumstances and into the future, an initial consideration is complexity. While some argue that a complex economy requires a complex system, there is no evidence to support this claim. In fact, other countries with equally complex economies have much simpler systems. Accordingly, it is difficult to say that Australia has achieved the right balance or is even headed in the right direction with a tax system able to support its economy in the future.

In the context of the current economic climate, taking into account factors such as the challenges of a global economy, increased digitalisation, declining growth and productivity, and the impact of the COVID-19 pandemic, corporate tax as a major source of revenue is unsustainable.

The current economy, often dubbed the 'fourth industrial revolution', and the fate of the future economy need to be considered alongside the issues associated with this, including inefficiency in the tax system, the rise of artificial intelligence, climate change, Australia's ageing demographic and intergenerational concerns.

As highlighted throughout this paper, around 90% of Australian tax revenue is raised through only 10 out of some 125 different taxes that are currently levied on businesses and individuals.[27] As also discussed throughout this paper, the tax mix must be reviewed and reset, with a shift away from an over-reliance on income and corporate taxes towards greater balance across key revenue heads, including consumption taxes.

It would be invaluable to launch an educational program for taxpayers to better understand the scope and purpose of consumption tax. This would assist taxpayers to understand the rationale and merits of such a shift, the true impact on their day-to-day activities, and would ultimately support voluntary compliance.

In the corporate sector, significant compliance costs consume a disproportionate amount of tax function time and resources despite ATO data indicating a high level of voluntary tax compliance

27 Henry review, p. 11.

by large corporates.[28] This is exacerbated by unilateral departures from international practices and OECD/G20 guidelines. Examples in recent history have included the approach to the DPT[29] and the hybrid mismatch integrity rule.

In relation to the DPT, not only did Australia progress with its implementation ahead of the agreed OECD timetable, the end result was also a significant departure from what was envisaged as part of the OECD's BEPS Project.[30] The draconian operation of the DPT, its interaction with the existing general anti-avoidance regime contained in Pt IVA, and its exclusion from the scope of our tax treaty network have been the subject of criticism, domestically and internationally.

Likewise, the hybrid mismatch rules did not entirely follow the OECD recommendations, with one of the most notable departures being the introduction of a targeted integrity rule. At a very high level, the rule is designed to prevent multinational groups from establishing structures to circumvent the hybrid mismatch rules and effectively requires lending into Australia to be taxed at a rate in excess of 10% in a foreign jurisdiction. It is a departure from the general deduction/non-inclusion rule, which does not require foreign tax to be payable in a particular jurisdiction.

The Tax Institute supports the significant progress achieved to address BEPS at the international level collectively by the OECD/G20, and the implementation of domestic measures that complement this work. It is noted that the OECD has on more than one occasion cautioned against unilateral moves by individual countries.[31] These departures undermine Australia's commitment to the OECD and multilaterally coordinated responses to international issues. Not only do such actions put Australia at risk of adverse responses from other jurisdictions, they also give rise to additional costs for multinational corporations in complying with different rules in the various jurisdictions in which they operate.

There are significant discrepancies in the proportion of tax collected compared to the number of different taxes. This is exacerbated by the disproportionate collection of tax in terms of the taxpayers affected. The Australian economy is dominated by the mining, retail and financial services sectors. Large corporates operating in Australia are responsible for approximately 62% of all corporate tax paid and collecting 65% of net GST. This gives rise to a degree of reliance on the same taxpayers in these industries and an overall concentration risk.

Over several decades, there has been strong international competition for inward investment and this has had a significant role in influencing other countries' decisions to lower their corporate tax rates.[32] It is also important to recognise that a headline corporate tax rate is not the starting and finishing point of a sophisticated corporate tax regime. Other factors which go to the tax base, such as incentives, allowances, concessions and, of course, integrity measures, are critical factors which affect a country's attractiveness for corporate investment and activity. Those factors impact

28 www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Large-corporate-groups-income-tax-gap/. ATO data on the large corporate groups income tax gap indicates that in 2017–18, there was a net gap of 3.7%, meaning that large corporate groups paid over 96% of the theoretical total amount of income tax payable by them that year. This is one of the lowest income tax gaps reported (refer www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Australian-tax-gaps-overview/?anchor=Whywemeasurethetaxgap#Whywemeasurethetaxgap).

29 And, indeed, the MAAL.

30 It is also noted that the administrative process of challenging a DPT assessment was a significant departure from existing procedures under Pt IVC of the TAA 1953.

31 Senate Economics References Committee Inquiry into Corporate Tax Avoidance, evidence of Mr Pascal Saint-Amans, Director of Centre for Tax Policy and Administration, OECD, Hansard, 9 April 2015, pp. 60-61.

32 M Devereux, "Be cautious about raising the corporation tax rate", Oxford University Centre for Business Taxation, 25 February 2021.

the effective tax rate, the importance of which should not be ignored in assessing Australia's overall competitiveness. It is also important to keep in mind that a corporate tax does not simply fall to companies. Like other taxes, corporate tax is ultimately borne by individuals, directly, in terms of shareholders, but also indirectly, in terms of workers, consumers and others.[33] This is an important consideration in assessing how progressive or regressive corporate tax may in fact be, and may provide some support for a shift towards source-based taxing of economic activity (considered below in the international context).

Research undertaken by Treasury has demonstrated that an improvement in Australia's living standards must be driven by a higher level of labour productivity and that this can be achieved through a reduction in the company tax rate, among other things. The reduced capital investment in the last twenty years in Australia has been a significant cause of lower levels of productivity. The Productivity Commission noted that weakness in labour productivity "can be partly attributed to a marked slowdown in investment in capital – so much so that the ratio of capital to labour has fallen – 'capital shallowing'".[34] Ironically, this has occurred at a time when, due to global monetary loosening, there is an increasing pool of investment capital available to be deployed.

Addressing the corporate tax rate to reduce the drag on the economy of an inefficient tax should thereby encourage investment. This is the case even after allowing for a shift in the tax mix to greater reliance on other taxes, or a reduction in government spending to recover lost revenue, because it lowers the before-tax cost of capital. The result is that investment is encouraged which increases capital stock and labour productivity.[35] Ultimately, increased productivity results in increases in living standards.

The government and the Australian people need to consider what Australia's future looks like, and whether the path we are headed down aligns with what we want it to look like. For example, will our economy be a net capital importer or net capital exporter in future? While the argument is not beyond controversy, government policy on matters such as the corporate tax rate and foreign investment rules, among other things, has a significant impact on foreign investment. The tax system as a whole is in dire need of a comprehensive review followed by genuine reform.

Tax policy and system maintenance

The structures of the Australian economy, the tax system and our political model are impediments to broad tax reform. There are missed opportunities for the government due to delays in producing policy. However, the commercial world does not stop spinning and businesses and investors move on without waiting for government policy to do what is prudent, commercial, and appropriate from a risk management perspective. Where such business decisions lead to investment in jurisdictions other than Australia, including by Australian investors, it can be significantly detrimental to Australia's economy and future.

Although Australia is reliant on foreign capital, there are few incentives for foreign investors to enter the Australian market. On the other hand, there is little broad appreciation that the taxation of foreign equity and debt is deliberately differentiated. Debt taxation is substantially driven by international norms and negotiated outcomes, recognising that the cost of tax on debt is

---

33 M Devereux, "Be cautious about raising the corporation tax rate", Oxford University Centre for Business Taxation, 25 February 2021.

34 Productivity Commission, PC Productivity Bulletin, May 2019.

35 Treasury, *Analysis of the long term effects of a company tax cut*, Treasury working paper, 2016.

often borne by the Australian borrower. Similarly, together with the Thin Capitalisation rules, the Australian settings mean the effective overall rate of tax for foreign corporate investors can be lower than the headline rate of corporate tax. This is a deliberate policy setting to encourage foreign investment.

Likewise, although encouraging Australian business growth and expansion appears to be a priority, there is a lack of genuine support for the overseas expansion of Australian businesses. Innovation is perceived as a cost rather than as an investment.[36] This is compounded by significant concerns from foreign investors and multinational enterprises about the Australian tax policy settings and the impact of the political environment, particularly during continued periods of political volatility and instability. The Australian political landscape has become accustomed to a level of political discourse which is short-sighted and antagonistic, at times, even within the same political party. A tendency to espouse what sounds immediately attractive on the surface, and what is therefore expected to win votes, rather than having the courage to lead the debate on what is actually needed, particularly where the two do not align, has had a damaging effect on Australia's ability to develop sound tax policy and law. This detracts from sensible discussion of holistic tax reform and is ultimately to the detriment of the Australian people.

The tax policy framework must therefore be reset. Tax reform must be driven by a forward-looking focus and must keep in mind how foreign capital can be attracted and can create a stronger economy through new industries and jobs. Tax reform and incentives underpinned by sound tax policy will encourage business investment and job creation in Australia. Options for better tax policy formulation are contained in Chapter 13.

2.1 Fundamentals of the Australian corporate tax system

Corporate residency and liability to tax

Companies that are resident in Australia for income tax purposes (see below) are subject to Australian corporate tax on worldwide taxable profits, including capital gains. Non-resident companies are subject to Australian corporate tax on their Australian-sourced profits only. Where a company is resident in a country with which Australia, has concluded a tax treaty, Australia's right to tax business profits is generally limited to profits attributable to a PE in Australia, as defined in each particular tax treaty and subject to any modification by the operation of the MLI.

A company is a resident of Australia for income tax purposes if it is incorporated in Australia or, if not incorporated in Australia, it carries on business in Australia and either: (i) its central management and control are in Australia; or (ii) its voting power is controlled by shareholders who are residents of Australia.

Current guidance from the ATO has indicated that if a foreign incorporated company carries on a business and has its central management and control in Australia, it will carry on business in Australia with the meaning of the 'central management and control' test of residency, even though no part of the actual trading or investment operations of the business take places in

36 Refer Chapter 8.

Australia.[37] However, in the 2020–21 federal Budget, the federal government announced proposed amendments to the existing legislation to clarify the position.[38] The proposed amendments are intended to ensure that a foreign incorporated company will only be treated as an Australian tax resident if it has a 'significant economic connection to Australia'. This test will be satisfied where both the company's core commercial activities are undertaken in Australia and its central management and control is in Australia.

The announced measure is consistent with the recommendation made by the Board in its 2020 report titled *Review of corporate tax residency*[39] and is designed to reflect the position prior to the decision in *Bywater Investments Ltd v FCT*[40] *(Bywater)*. This was a welcome announcement which substantially reinstates the position in the withdrawn TR 2004/15.[41] Enactment of the amendments will provide long-awaited certainty for corporate taxpayers. This is a positive step in the right direction to encourage greater foreign investment in Australia. However, this must be coupled with further action, including, first and foremost, a reduction in the corporate tax rate (see below).

The corporate tax rate(s)

There are two fundamental issues with the Australian corporate tax rate(s). The first is that the system is complicated by dual rates, and the second is that the headline rate is too high.

Dual rate system

Currently, Australia operates a dual corporate tax rate system. A headline rate of 30% applies to most companies. However, from the 2017–18 income year, a lower rate applies to 'base rate entities' with a lower aggregated turnover and income that is not predominantly passive. From the 2017–18 to 2019–20 income years, companies that are base rate entities were taxed at a lower company tax rate of 27.5%. That rate reduced to 26% for the 2020–21 income year and to 25% in the 2021–22 income year. A base rate entity is a company that has an aggregated turnover less than the aggregated turnover threshold of $50m from the 2018–19 income year (formerly $25m). In addition, 80% or less of its assessable income may be BREPI. This is in place of the requirement to be carrying on a business.

The Tax Institute is of the view that a single corporate tax rate across all companies should apply in Australia. The dual system has added a range of complexities to an already complex system. It produces anomalous outcomes, particularly because a company can oscillate between the two rates from one year to the next. A significant area in which this issue manifests is in determining a company's franking rate. The imputation rules can cause a company's tax rate to differ from its franking rate, and the franking rate can also change from one year to the next. The current system

37 ATO, TR 2018/5 – Income tax: central management and control test of residency.

38 Australian Government, Budget 2020-21, "Clarifying the corporate residency test", *Budget paper no. 2, receipt measures*, p.13. Available at budget.gov.au/2020-21/content/bp2/download/bp2_01_receipt.pdf.

39 Board of Taxation, *Review of corporate tax residency – a report to the Treasurer*, Australian Government, Canberra, 2020.

40 [2016] HCA 45.

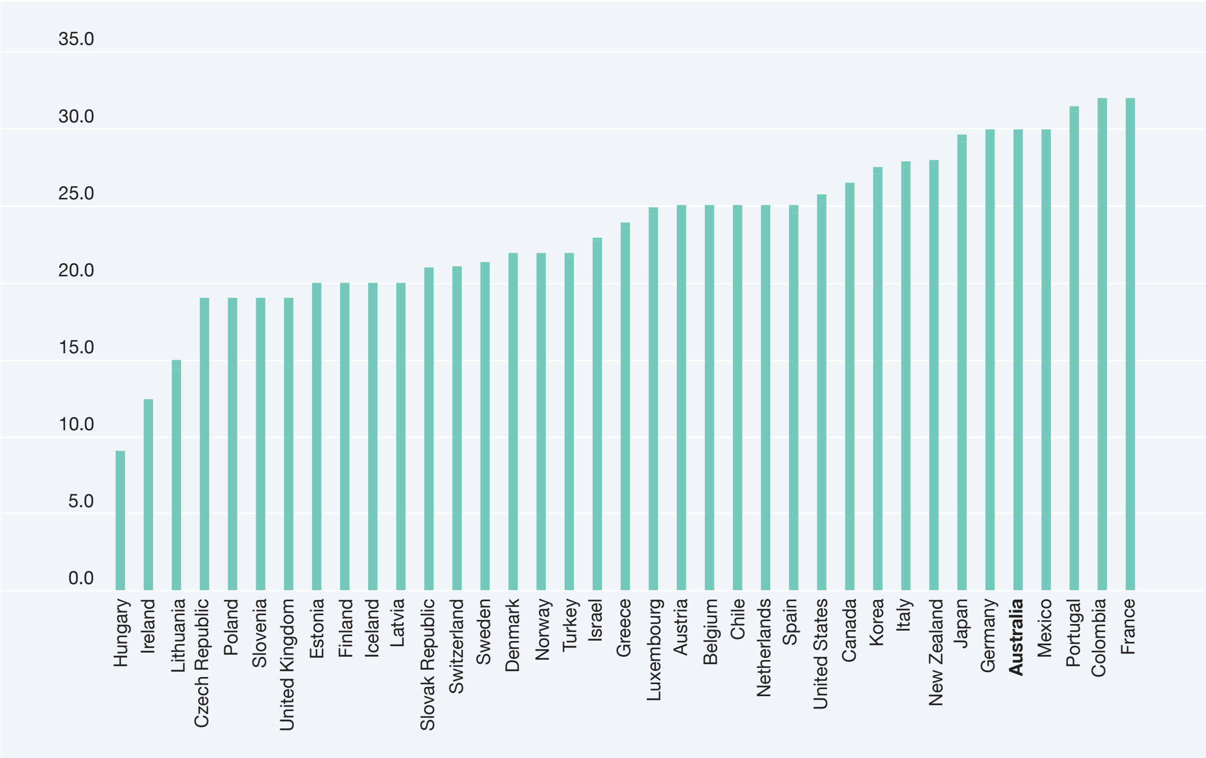
41 The measure will have effect from the first income year after the enabling legislation is enacted. However, taxpayers will have the option of applying the new law retrospectively from 15 March 2017, being the date on which the ATO withdrew TR 2004/15: Income tax: residence of companies not incorporated in Australia – carrying on a business in Australia and central management and control (TR 2004/15), in light of the decision in *Bywater*. It will be important that the start date election is carefully drafted in the legislation and clarity is provided as to whether it will only be able to be retrospectively applied from 15 March 2017 or if it may be applied from any date thereafter (for example, by companies incorporated after 15 March 2017).

of companies franking dividends at different tax rates depending on their turnover and income year is complicated. It can encourage or discourage the payment of dividends based on the tax outcome of the dividend rather than underlying economic or commercial reasons. The identification of different franking rates also leads to a greater risk of errors in the preparation of tax returns and year-end affairs, thereby increasing the compliance burden and potential for disputes. Anomalous outcomes also arise in relation to the operation of the rules as they apply to non-portfolio dividends and shares held by trusts interposed between trading companies and corporate beneficiaries. Some of these outcomes are considered in further detail in Chapter 3.

The headline corporate tax rate

Australia's headline corporate tax rate is one of the highest in the OECD (see Figure 2).[42] The corporate tax rate in any jurisdiction is an important consideration for potential investors. Australia's current rate is uncompetitive when benchmarked against other OECD countries, and indeed when compared to other countries in the Asia-Pacific region and its major trading partners.

Figure 2. Corporate tax rates across OECD countries



Source: OECD, *Corporate tax statistics database*.

This is a disincentive to foreign investment, on which Australia is heavily reliant. Further, in combination with factors such as the current lack of legislated incentives to innovate and develop IP onshore, and Australia's CFC rules, it unfairly disadvantages Australian businesses and hinders their ability to expand both nationally and across borders.

42 It should be noted that some of the tax rates included in the graph have been adjusted to take into account surtaxes and other related imposts such as sub-central government taxes.

The Tax Institute has persistently advocated that a single, lower rate, no higher than 25%, should apply to all companies, irrespective of their aggregated turnover or proportion of passive income. Even with a flat corporate tax rate of 25%, Australia would remain in the top one-third of OECD countries' highest corporate income tax rates, acknowledging the recent 2021 Budget announcement by the UK Chancellor of an increase to the UK corporate tax rate from 19% to 25%,[43] and the expected increase by the Biden Administration of the US corporate tax rate from 21% to 28%.[44] While acknowledging reductions in corporate tax rates are difficult politically, having regard to the foregoing, the known economic cost of corporate taxes[45] and the unwieldy dual rate should, at a minimum, suggest the rates be aligned at the lower 25% rate.

In the Asia-Pacific region, a rate of 25% would remain substantially higher than the headline corporate tax rate of neighbouring countries. While this would still leave Australia in a relatively uncompetitive position in the Asia-Pacific region, given the contentious debate surrounding the reduction of the rate, it is viewed as a step in the right direction. Looking ahead, we also recommend a reassessment of the impact of the rate and consideration of a further slight reduction in the future. We acknowledge that the G7 have recently agreed to a proposal by the US in connection with the work of the OECD that a minimum corporate tax rate of 15% be adopted.

We acknowledge that an alternative source of revenue to compensate for the perceived loss of revenue that may result from a rate cut may be required. In this regard, a shift in the tax mix away from relying on corporate tax towards relying on more broad-based consumption taxes should assist to compensate for the reduction in corporate tax revenue collections if the corporate tax rate were to be reduced. Appropriate modifications to the dividend imputation system could provide another way to fund the reduction in the corporate tax rate. Some such modifications are considered below.

Entity taxation and imputation

Income tax was introduced in Australia in 1915. Under that system, companies were taxed only on their retained profits via a deduction for dividends paid. Shareholders were taxed on the dividends received. In 1922, the system was reformed to treat all company profits as taxable. The non-refundable rebate continued with the effect that those individual shareholders on higher marginal rates received a full rebate for corporate tax paid, whereas individuals on lower marginal rates did not. In 1940, the rebate for dividends was removed due to an increased need for revenue to fund Australia's Second World War efforts. While it had been intended only as a temporary measure, the absence of the rebate lasted well beyond the end of the war.[46]

In a classical company taxation system, a company is taxed on its income as an entity distinct from its shareholders, each of whom are taxed individually on their dividend income at their personal marginal tax rates. Without modification, this system gives rise to double taxation,

43 HMRC, *Budget 2021: overview of tax legislation and rates (OOTLAR)*, March 2021. Available at www.gov.uk/government/publications/budget-2021-overview-of-tax-legislation-and-rates-ootlar/budget-2021-overview-of-tax-legislation-and-rates-ootlar.

44 G Watson, H Li and T LaJoie, *Details and analysis of President Joe Biden's campaign tax plan*, Tax Foundation, October 2020. Available at taxfoundation.org/joe-biden-tax-plan-2020/.

45 There are many studies that have pointed out that corporate taxes have the highest or among the highest excess marginal burden; see, for example, C Murphy, *Efficiency of the tax system: a marginal excess burden analysis*, TTPI Working Paper 4/2016, Tax and Transfer Policy Institute, Australian National University, June 2016.

46 Treasury, *A brief history of Australia's tax system*, September 2006. Available at treasury.gov.au/publication/economic-roundup-winter-2006/a-brief-history-of-australias-tax-system.

whereby tax is payable on the same income by two different entities (being, first by the company, and second, by the shareholder on receipt of a dividend in that shareholder's proportionate holding). This was the case in Australia between 1940 and 1986.[47]

Such double taxation is remedied in different ways around the world. In some cases, the company is treated as a 'look-through' (similar to our trust taxation system), while in other countries, Australia included, a credit is effectively allowed to the shareholder for some or all of the tax already paid by the company. That is, the tax paid by the company is *imputed* to the shareholder.

The imputation system was introduced in Australia in 1987 and is now over 30 years old. It is a full imputation system whereby a company which pays corporate tax on its income may attach a franking (imputation) credit to distributions made to its shareholders up to an amount equal to the tax paid by the company (that is, a franked divided). The franking credit may then be used by the shareholder to offset their personal tax liability.

As noted in the *Financial system inquiry final report* in November 2014:[48]

> The implications of dividend imputation are less clear. The introduction of imputation reduced firms' cost of equity; however, the effectiveness of imputation in lowering the cost of capital arguably has declined as the economy has become more open. The tax benefits of imputation may encourage domestic investors to invest in domestic firms with domestically-focused investments, which would limit opportunities and increase risk from less diversified portfolios.
>
> To the extent that imputation distorts the allocation of funding, a lower company tax rate would be likely to reduce those distortions. A lower company tax rate would also enhance Australia's attractiveness as a place to invest, which would increase Australia's productivity and living standards.

Refund of franking credits

The Australian system goes a step further than standard full imputation and allows for a refund of franking credits where the tax rate payable by the shareholder is lower than the company tax rate. This aspect of the imputation system was introduced in 2000 by the Howard Government to provide relief to low-income shareholders. This change also benefited superannuation funds. The combination of this refund system coupled with a low rate of tax (or nil in the case of income from assets set aside to pay superannuation income streams) has made investment in Australian shares very attractive to Australian superannuation funds.

Interaction with tax concessions and other forms of income

Full imputation can undo some of the work done by concessions that operate to effectively reduce the corporate tax payable, such as the R&D tax incentive and, more recently, the tax-free cash flow boost stimulus measure in response to the COVID-19 pandemic. Such concessions are intended to be tax-free for the recipient company, however once that income is distributed in the

47 Treasury, *A brief history of Australia's tax system*, September 2006. Available at treasury.gov.au/publication/economic-roundup-winter-2006/a-brief-history-of-australias-tax-system.

48 D Murray, *Financial system inquiry final report*, November 2014, p. 17. Available at treasury.gov.au/sites/default/files/2019-03/p2014-FSI-01Final-Report.pdf.

form of a divided to shareholders, tax is effectively required to be paid on the distribution at the tax rate of the shareholders without a tax offset thus undoing the tax free concession granted to the company. Anomalies also arise where resident companies expand offshore and repatriate profits as NANE income under Subdiv 768-A of the ITAA 1997. Investors seeking franking credits are less likely to invest in such companies and the current system does not lend itself to a simple solution in such cases.

Franking credits are valued by Australian resident shareholders as a tax offset though offer little value to non-resident shareholders, other than eliminating the need for dividend WHT to the extent that the dividend is franked. This potentially influences (and distorts) corporate behaviour and incentives in respect of the location of investment, financing and distribution policies.

Integrity measures

Over the years, a number of integrity measures have been introduced to target the manipulation of the imputation system. Among others, these measures include:

- anti-streaming rules: to ensure that franking benefits are not streamed mainly to members that would receive a greater benefit;
- anti-avoidance rules: to address franking credit schemes;
- holding period and related payment rules: to prevent trading schemes where a taxpayer might, for example, acquire shares cum dividend, receive the dividend and franking credits, and dispose at a loss;
- rules to counteract dividend streaming, stripping and washing;
- share capital tainting rules: to prevent companies disguising a dividend as a tax-preferred capital distribution from the share capital account; and
- debt/equity rules to prevent payments in the nature of interest being treated as dividends and vice versa.

Such measures have been enacted at various stages to target particular instances of contrivance relevant to financial markets at the time. While for the most part they have been effective, in certain cases, they have become outdated, and many have actually been repealed but are retained by reference or inference. Unsurprisingly, the variety of different measures introduces an additional layer of complexity and brings with it an additional administrative burden.

Options for reform

There are three primary options to address issues in the imputation system: full imputation, partial imputation and no imputation. Full imputation could be retained, largely without modification but critically with the removal of the two-tiered system. Alternatively, Australia could move to a partial imputation system. This would involve a degree of imputation that balances the impact on superannuation funds and individual investors with the removal of some of the biases that currently exist. Such a partial imputation system could be achieved in numerous ways. For example, imputation could be permitted up to a dollar limit or a percentage, with the excess either exempt or taxed at a flat rate, potentially lower than the corporate tax rate. Rather than a global change, partial imputation could apply to particular classes of shareholders or to certain types of companies, though it is acknowledged that this would introduce a greater degree of complexity into the system.

Alternatively, imputation could be replaced with a lower corporate tax rate combined with certain exemptions and allowances. A number of jurisdictions fully exempt company-to-company dividends. For example, in the UK, provided that certain broad conditions are met, foreign and UK dividends received by UK companies are exempt. Individuals in the UK do not pay tax on dividend income that falls within their personal allowance (being akin to the tax-free threshold) or the amount which comprises their dividend allowance (GBP2,000 of an individual's dividend income for the 2020–21 year). To the extent that dividend income exceeds those allowances (noting that dividends are taxed at the individual's highest marginal tax rate), the rate of tax paid on such income depends on the individual's income tax band. Importantly, the dividend allowance operates as a 0% tax rate. It does not reduce total income for UK tax purposes with the effect that dividend income that is untaxed as a result of the allowance is still included in an individual's basic rate and higher rate limits.[49] Adopting this approach *without* reducing corporate tax rates at the same time would represent an effective increase in taxation of company profits which is not advocated given the inefficiency of corporate taxes as referred to above.

Another option is to introduce a WHT system, much like current arrangements in respect of cross-border distributions. A further alternative may be a return to a full classical system (no imputation), with a suitably reduced company tax rate. Such a proposal would recognise the advantages of investment through a company vehicle, and otherwise leave shareholders in positions which differ according to their individual circumstances. It is acknowledged that this option would be out of step internationally and highly unpalatable politically.

A further approach might be to consider a dividend deduction regime. This would result in no taxation on distributed profits at the company level but taxation at the shareholder level. Whether concessional rates of tax should apply to shareholders, as in the UK, would need to be considered. Retained profits would be subject to corporate tax. The outcome would be very close to the current imputation regime, although the mechanism would differ.

There are features of an ACE in a deduction system, albeit such regimes generally involve high taxes on the remaining profits, often described as economic rents. Under an ACE, the overall corporate tax is reduced but with a narrow base and higher headline rate. Concessional taxation at the shareholder level may also apply (or there could be retention of imputation but with an expected lower rate of imputation/franking being passed to shareholders by virtue of less tax being paid by the company). Thus, an ACE represents a viable alternative and is often cited as such.[50]

The European Commission has recently suggested that to address the debt-equity bias in corporate taxation, an allowance for corporate taxation should be created.[51] This would be a form of ACE. It is considered in the paper that such an allowance would result in higher levels of equity financing thereby making companies less vulnerable to economic shocks.

49 Sometimes referred to as 'exemption with progression'.

50 See, for example, D Ingles and M Stewart, "Australia's company tax: options for fiscally sustainable reform, updated post Trump", TTPI Working Paper 3/2018, Tax and Transfer Policy Institute, Australian National University; and studies references therein.

51 European Commission, *Business taxation for the 21st century*, Brussels, 18 May 2021.

Utilisation of tax losses

Provided that certain tests are satisfied, company tax losses may be carried forward indefinitely and applied against taxable income in later years. Losses were briefly permitted to be carried back in the 2012–13 income year to the 2011–12 income year, though this reform was short-lived and subsequently repealed. As part of the 2020–21 federal Budget, the government announced a temporary loss carry-back measure, permitting eligible corporate entities with less than $5b turnover in a relevant loss year to carry back certain tax losses. Originally expiring in the 2021-22 year it was extended in the 2021-22 federal Budget to apply to losses up to the 2022-23 income year. In such cases, companies can claim a refundable tax offset up to the amount of their previous income tax liabilities and their franking account balance at the end of the year in which the tax return in which the tax offset is claimed is filed.

It would be an understatement to say that the company loss rules are complex. We highlight below certain significant challenges:

- challenges in applying the COT, including practical and administrative difficulties of tracing through entities;
- uncertain application of the SBT and similar business test, heavily left to the discretion of the Commissioner; and
- ambiguity in the interpretation and application of the loss integrity provisions, such as in relation to the unrealised net loss provisions contained in Subdiv 165-CC and the inter-entity loss duplication rules contained in Subdiv 165-CD.[52]

The interaction between the loss rules and particular regimes within the tax system, such as the tax consolidation rules,[53] gives rise to additional layers of complexity. We also note that there are the different regimes for company losses and trust losses, and of course the separate but related issue of the different treatment of revenue and capital losses and specifically the artificial quarantining of capital losses. Quarantining of capital losses is a completely artificial concept. To quarantine all losses and require them to be carried forward is problematic in itself, and largely without justification other than the protection of the revenue base. However, the quarantining of capital losses as a further subset gives rise to another layer of complexity including timing issues, among other things. While this has the potential to affect a broad range of taxpayers, it can often be problematic for large businesses, and unnecessarily so, given that there is no differential in the tax rate.

This complexity stifles genuine business restructuring and has the potential to discourage innovation and risk-taking. The Tax Institute considers that it is time to reassess why losses are treated so differently to other tax assets.

Trading in loss-making companies has gained a negative connotation, though this was not always the case. In fact, until the beginning of the 1960s, it was not considered problematic.[54] The underlying premise as to why tax losses are treated differently to other assets with certain tax attributes is essentially to protect the revenue base, given that part of the underlying principle is to slow the rate at which losses are utilised. However, this is mostly a timing issue and only

52 ITAA 1997.

53 Div 707 of the ITAA 1997.

54 Ligertwood Committee review.

occasionally a permanent (and unjustified) gain to the Revenue. In a 'pure' system, the artificiality of the 'income year' for an ongoing business would be recognised and a tax refund given for loss recorded in a given tax period, in the same way tax is collected when a profit arises in a tax period.

When parties trade in assets carrying particular tax attributes, the threshold issue is largely around market value pricing. Otherwise, it can be noted that in particular regimes, such as in the context of building allowances, deductions transfer from one party to another based on the expenditure by the original owner of the relevant asset.[55] There is no reason in principle why a similar approach could not be applied to tax losses, other than the protection of the revenue. It should not matter that a third party is willing to pay for a bundle of losses upfront, rather than the original owner waiting to generate enough future income to have the funds returned by the government by virtue of the offset.

If some form of limitation on the utilisation is required due to concerns on the impact on the revenue, an alternative option would be to allow simplified access to losses, potentially on a straight-line basis for a finite period, for example, 10% each year for 10 years. If such a model were given effect, it would do away with the need for most of the loss rules, including the COT and SBT, and the various associated administrative and compliance costs.

Further, noting the artificial construct of a 'tax year', given that businesses generally operate both before and after a tax year, there should be no reason why losses may not be carried back, subject of course to reasonable integrity measures.

There is no denying that integrity measures must underpin the tax system to ensure that contrivance is deterred and counteracted. In the case of dealings in losses, this may be to prevent duplication or artificial manufacture of losses. However, such measures must be balanced to ensure that the tax system not only permits, but also supports legitimate business restructures and transactions.

Capital gains tax

CGT events underpin the CGT system, but this was not always the case and was not originally intended. When CGT was introduced in 1985, it was a simpler system, essentially based around assets which were disposed of, having been previously acquired. Today, we have more than 50 different CGT events and, suffice to say, the system has got out of hand. It is important to stop and reassess how and why we arrived at this position and, more importantly, to course correct.

Around a decade before the CGT was introduced, the Asprey report recommended the introduction of a tax on realised capital gains.[56] Although it did not prescribe all aspects of the calculation of the capital gain, the Asprey report recommended:

> 23.39. It is recommended that to determine the amount of the gain there should be deducted from the proceeds of *sale of the asset*:
>
> (a) The cost of the asset, including all costs directly incurred in the purchase such as stamp duty, legal costs and agent's commission. This will apply in the case of assets

55 Div 42 of the ITAA 1997.

56 Asprey report.

> purchased after the date of introduction of the tax, while to those already owned by the taxpayer at that date the provisions outlined in paragraphs 23.31–23.34 will apply.
>
> (b) Expenditure incurred in enhancing the value of the asset or preserving the taxpayer's title to it. This would usually include the cost of improvements and additions but not expenditure that has been previously allowed as a deduction for income tax purposes. In particular, expenditure related to the use or enjoyment of the asset would not form part of the cost base nor would outgoings such as repairs or interest which have been allowed as a deduction for income tax purposes.
>
> (c) Costs directly incurred in the sale of the asset, such as stamp duty, legal costs and agent's commission. (emphasis added)

The Asprey report's recommendations did not go so far as to presuppose the means of realisation of a capital gain, nor to prescribe the calculation of costs to be taken into account.

About a decade later, the 1985 draft white paper *Reform of the Australian tax system* (colloquially known as the RATS paper) considered certain issues associated with the taxation of gains on capital.[57] It addressed some of the different models and experience of other jurisdictions including, but not limited to, the issues of 'lock-in', 'bunching' and timing. The RATS paper contemplated the principle of symmetrical treatment between capital gains and losses, the effect of which would treat losses as deductible on realisation in the same way that gains would be assessable on realisation. Similar to the Asprey report, it did not prescribe the manner in which gains or losses should be determined. Rather, it provided something closer to a broad overarching policy statement of CGT.[58]

Despite the broad principles contemplated ahead of its enactment, the CGT rules took a somewhat different path. While the detail of the government announcement introducing the new rules was largely consistent with the RATS paper, the first notable difference related to timing — the rules only applied to assets acquired after 19 September 1985.[59] It would be an understatement to describe the legislation that followed as overly prescriptive, though as we can see from the current rules, that was just the beginning. Concepts like 'asset', 'disposal' and 'acquisition' were thought necessary to be defined.[60] New principles, such as in relation to timing, which did not always follow ordinary concepts, were also introduced, as well as prescriptive rules for the calculation of a capital gain or loss, the determination of parts of consideration and cost base.[61] The overly prescriptive approach taken in the ITAA 1936 necessitated adjustments for exceptions and modifications.[62]

---

57 RATS paper, ch 7.

58 A Mills, "CGT events: the case for: the current list of 36 CGT events should be removed and replaced with a more coherent conceptually based system", presented at the Australian Taxation System: The 2017 Great Debate, The Tax Institute, August 2017.

59 Being the date of the announcement by the then Treasurer. See Commonwealth, Parliamentary debates, House of Representatives, 19 September 1985, no. 144.

60 Ss 160A and 160M of the ITAA 1936.

61 Ss 160U, 160Z, 160ZD and 160ZH of the ITAA 1936.

62 See, for example, former ss 160ZK, 160ZL and 160ZM, and Divs 5–8 and 10–13 of the ITAA 1936.

Suffice to say, the 1997 rewrite introducing the concept of CGT events was no improvement in terms of the sheer volume of the legislation, nor the gaps that nevertheless arose.[63] In many aspects of the Australian tax system, we have gone so far down the path of equity that we have lost all sight of simplicity, and sometimes even equity itself. The CGT provisions are no exception. A law that at its core is simple to express and can, in fact, be done in a few paragraphs need not be over-engineered into volumes of legislation, the only solution to which is even more legislation. This is a fundamental design flaw and must be corrected before it is worsened.

Section 104-5 of the ITAA 1997 contains a summary of the current CGT events, extracted at a high level in Table 1.

Table 1. Summary of CGT events

A1 – disposal of a CGT asset.	H2 – receipt for event relating to a CGT asset.
B1 – use and enjoyment before title passes.	I1 – individual or company stops being an Australian resident.
C1 – loss or destruction of a CGT asset.	I2 – trust stops being a resident trust.
C2 – cancellation, surrender and similar endings.	J1 – company stops being a member of wholly-owned group after roll-over.
C3 – end of option to acquire shares, etc.	J2 – change in relation to replacement asset or improved asset after a roll-over under Subdivision 152-E.
D1 – creating contractual or other rights.	J4 – trust fails to cease to exist after a roll-over under Subdivision 124-N.
D2 – granting an option.	J5 – failure to acquire replacement asset and to incur fourth element expenditure after a roll-over under Subdivision 152-E.
D3 – granting a right to income from mining.	J6 – cost of acquisition of replacement asset or amount of fourth element expenditure, or both, not sufficient to cover disregarded capital gain.
D4 – entering into a conservation covenant.	K1 – as the result of an incoming international transfer of a Kyoto unit or an Australian carbon credit unit from your foreign account or your nominee’s foreign account, you start to hold the unit as a registered emissions unit.
E1 – creating a trust over a CGT asset.	K2 – bankrupt pays amount in relation to debt.
E2 – transferring a CGT asset to a trust.	K3 – asset passing to tax-advantaged entity.
E3 – converting a trust to a unit trust.	K4 – CGT asset starts being trading stock.
E4 – capital payment for trust interest.	K5 – special capital loss from collectable that has fallen in market value.
E5 – beneficiary becoming entitled to a trust asset.	K6 – pre-CGT shares or trust interest.
E6 – disposal to beneficiary to end income right.	K7 – balancing adjustment occurs for a depreciating asset that you used for purposes other than taxable purposes.

63 A Mills, “CGT events: the case for: the current list of 36 CGT events should be removed and replaced with a more coherent conceptually based system”, presented at The Australian Taxation System: The 2017 Great Debate, The Tax Institute, August 2017.

E7 – disposal to beneficiary to end capital interest.	K8 – direct value shifts affecting your equity or loan interests in a company or trust.
E8 – disposal by beneficiary of capital interest.	K9 – entitlement to receive payment of a carried interest.
E9 – creating a trust over future property.	K10 – you make a forex realisation gain covered by item 1 of the table in subsection 775-70(1).
E10 – annual cost base reduction exceeds cost base of interest in AMIT.	K11 – you make a forex realisation loss covered by item1 of the table in subsection 775-75(1).
F1 – granting a lease.	K12 – foreign hybrid loss exposure adjustment.
F2 – granting a long term lease.	L1 – reduction under section 705-57 in tax cost setting amount of assets of entity becoming subsidiary member of consolidated group or MEC group.
F3 – lessor pays lessee to get lease changed.	L2 – amount remaining after step 3A etc. of joining allocable cost amount is negative.
F4 – lessee receives payment for changing lease.	L3 – tax cost setting amounts for retained cost base assets exceed joining allocable cost amount.
F5 – lessor receives payment for changing lease.	L4 – no reset cost base assets against which to apply excess of net allocable cost amount on joining.
G1 – capital payment for shares.	L5 – amount remaining after step 4 of leaving allocable cost amount is negative.
G3 – liquidator or administrator declares shares or financial instruments worthless.	L6 – error in calculation of tax cost setting amount for joining entity's assets: CGT event L6.
H1 – forfeiture of a deposit.	L8 – reduction in tax cost setting amount for reset cost base assets on joining cannot be allocated.

While the current rules could be described as comprehensive, at least in the sense that they attempt to cover all bases, they are still deficient and there remains numerous gaps in the system. Notable inadequacies relate to the treatment of earnouts, liabilities, foreign exchange gains and losses on liabilities originally addressed by Div 3B of the ITAA 1936 and the subsequent band-aid solution of Div 775 of the ITAA 1997, the CDF rules, defeasance gains, limited recourse debt rules, gains on financial arrangement liabilities and, of course, in relation to aspects of consolidation.[64] Some of these regimes are considered further throughout this chapter.

It is possible to do away with the 54 CGT events and introduce a simplified, principled provision using ss 6-5 and 8-1 as a model. Such a provision would broadly require the inclusion in assessable income of any net capital gain made, being capital gains less capital losses.[65] Following this path, at most, we may simply retain a slightly modified version of s 100-45, which sets out how to calculate the capital gain or loss for most CGT events.[66] The effect still would be to include net capital gains in taxable income. Ultimately, the same outcome, but without the unnecessary complexity of determining the relevant CGT event and navigating its nuances. Such a simpler rule would also be broader in its scope — it could cover gains and losses on liabilities,

64 A Mills, "CGT events: the case for: the current list of 36 CGT events should be removed and replaced with a more coherent conceptually based system", presented at The Australian Taxation System: The 2017 Great Debate, The Tax Institute, August 2017.

65 Ibid.

66 Modified to delete the reference to 'most CGT events'.

for example. That would obviate the need for the many special rules that presently exist to overcome the currently narrow base of the CGT regime.

Not only would this save significant administrative and compliance costs, it would also increase flexibility and ensure our CGT rules are future-proofed without the need for ad hoc solutions in response to changes in our economic landscape and emerging practices. Together, these factors would, of course, positively impact productivity.

CGT roll-overs

The broader CGT regime encompasses various forms of concessions, exemptions and other reliefs, ranging from discounted rates for certain taxpayers, to roll-overs which allow certain capital gain to be deferred or, in some cases, disregarded. Existing roll-overs (and any proposed reforms) must be considered in the context of the existing system of CGT regime, centred around CGT events (and any broader reforms that are required). There are a number of different CGT roll-overs which may be broadly categorised into groups. These include same asset or replacement asset roll-overs, scrip-for-scrip roll-over, demergers, small business restructures, and those related to relationship breakdowns.

The Board is currently in the process of a review of CGT roll-over relief which was announced in December 2019.[67] As part of this process, the Board has identified elements of the policy underpinning the availability of CGT roll-overs.[68] Roll-overs are essentially intended to overcome distortions in investment decisions arising from the particular expression in our laws of a realisation method of CGT. Among other things, one of the fundamental principles underpinning roll-over relief is that there should not be a taxing event where there is continuity in the economic ownership of a CGT asset. This, and the broader policy of roll-over reliefs, should underpin any proposed reforms in this area.

Moreover, roll-overs are fundamentally not anti-avoidance provisions. Of course, integrity measures are required to ensure that roll-overs are not manipulated. However, such measures are inherent in some of the conditions for existing roll-overs, and are, of course, found in the general anti-avoidance regime contained in Pt IVA.[69] However, to ensure a balanced outcome, and particularly since the problems identified in relation to the existing roll-overs generally do not relate to integrity concerns, the starting point should not be to approach a change from an anti-avoidance perspective.

The Tax Institute has made submissions to the Board in respect of the ongoing review.[70] We are of the view that, in the existing system, the preferred option is to resolve particular issues arising in the context of certain roll-overs. This is not to say that broader reforms are not possible, or indeed desirable. However, such reforms must be part of a more expansive, holistic package which takes into account the CGT provisions dictating the triggering of a liability (to which roll-over relief may apply). The proposed general business restructure roll-over, particularly in the form contained in the Board's second consultation paper, is not the solution. The proposal, while intending to introduce

---

67 The Hon. Michael Sukkar, MP, "Board of Taxation to review CGT rollover provisions", media release, 12 December 2019. Available at ministers.treasury.gov.au/ministers/michael-sukkar-2019/media-releases/board-taxation-review-cgt-rollover-provisions.

68 Board of Taxation, *Review of CGT rollovers*, consultation guide, February 2020.

69 ITAA 1936.

70 The Tax Institute, *Review of CGT rollovers – comments on second consultation paper*, February 2021; and *Review of CGT rollovers*, July 2020.

simplicity into a complex system, instead introduces ambiguity which has the potential to increase administrative and compliance costs and exacerbate the challenges it seeks to resolve.

While a general roll-over is unlikely to be workable in the current CGT landscape, it may be more feasible if the CGT regime is simplified as suggested above. Importantly, given that CGT can be triggered in a private or domestic context, and the policy underlying the availability of roll-over relief is not limited to business restructures, a general roll-over would need to be broad enough to cover such circumstances. It would be inconsistent with the policy of CGT roll-overs to introduce a general roll-over which is designed to replace some existing roll-overs but simply eliminates certain others in the process.

2.2 Grouping and consolidation

Tax consolidation

The tax consolidation rules were initially introduced as an integrity measure to overcome loss duplication arrangements that had been implemented under the former loss grouping rules, and as an administrative measure to simplify the management of the tax affairs of groups of companies. However, in light of the volumes of legislation governing the various aspects of the tax consolidation regime, coupled with hundreds of pages of explanatory materials, not to mention the plethora of ATO products on the subject, it is difficult to say that this has been achieved.

The regime attempts to treat the acquisition or disposal of shares in a company as if it were an acquisition or disposal of the underlying assets and liabilities by requiring tax cost setting calculations on entry into, and exit from, a group by members. However, despite the over-engineered rules, there remain opportunities for double taxation and non-taxation. Additionally, the economic purity approach that is embedded in the regime gives rise to odd outcomes such as deemed capital gains arising on the *acquisition* of another entity. This is difficult to explain to the average Australian businessperson let alone one from overseas. Moreover, it creates planning opportunities such as through the manipulation of stepped-up or stepped-down cost bases, depending on the desired outcome.

Given the Australia-centric approach, anomalies and inefficiencies arise on the inclusion of offshore operations. Issues arise in the context of franking where distributions are made to shareholders of consolidated groups which have foreign operations and income. In an increasingly global market, the rules must be flexible enough to support Australian businesses doing business abroad without imposing a disproportionately high cost of compliance.

The tax consolidation regime has the potential to be much simpler than it is. The short answer is simply to conceptually follow accounting consolidation principles (but with a 100% ownership requirement)[71]. Fundamental concepts underlying the existing system could be retained. For example, intragroup transactions would continue to be disregarded and a single return could be lodged for administrative ease. It is acknowledged that without a single entity rule, there may need to be provisions dealing with the payment of tax and joint and several liability. The concepts of a tax sharing agreement and tax funding agreement could be leveraged and the underlying

71 This should not be taken to suggest that International Financial Reporting Standards accounting standards should be adopted as this brings different complexities. Rather, that the concept or approach that each entity continues to stand as an independent tax entity with elimination of intercompany transactions would remove many of the anomalies that exist in the current system.

premises of those arrangements would continue to be applicable. This would safeguard the revenue and would also continue to provide protection to individual companies within a group.

We would argue against reducing ownership thresholds to a proportion less than 100%, as is the case in other jurisdictions such as the UK (which provides for group relief rather than consolidation), and indeed other Australian regimes such as the GST grouping provisions, given that it would introduce the need for additional calculations and unnecessary complexity.

The tax consolidation regime has been considered as a stand-alone regime by the Board and has also been reviewed as part of broader reports on aspects of the tax system.[72] The Tax Institute considers that it would be worthwhile to revisit the Board's recommendations, particularly to revisit the entire consolidation model. The research and analysis have already been undertaken and simpler options have been canvassed. While arrangements would be required to address intermediate issues from the existing regime, these can be managed through adequate transitional periods and measures. In the absence of fundamental change, some examples of specific areas which, at a minimum, require clarification and simplification are the MEC rules and the churning rules.

2.3 Other special regimes within the corporate tax system

There are a number of special regimes within the corporate tax system which have been developed to address particular kinds of transactions or the characterisation of certain instruments. Examples include, the TOFA regime (contained in Div 230), arrangements treated as a sale and loan (contained in Div 240), limited recourse debt (contained in Div 243), the CDF rules (contained in Div 245), foreign currency exchange gains and losses (contained in Div 775), and the debt/equity rules (contained in Div 974). Other regimes deal with the use and treatment of certain classes of assets. Examples include capital allowances and capital works (contained in Divs 40 and 43, respectively), and assets put to tax preferred use (contained in Div 250). For the most part, these regimes have been over-engineered and yet add little value to the system, particularly if a reassessment of the design of the system is considered.

The taxation of financial arrangements regime

Taking the TOFA regime as an example, it is plain to see that it is rife with complexity. The rules are overcomplicated and yet still give rise to anomalous outcomes. Potential misalignment with accounting standards can occur, depending on the method applied (that is, the realisation method and four elective tax-timing methods). Supposed hedging rules simply do not work for many financial and investment bodies. Further, there is inconsistent application between financial and non-financial institutions though the underlying rationale is questionable. The overall regime and its complexities impede, rather than encourage, economic growth.

The preferable solution is simply to abolish Div 230 and to instead allow the usual assessable income rules (that include some level of alignment of the tax treatment to accepted accounting and commercial principles) to operate. The need for a provision dealing with deferred interest

72 Board of Taxation, *Post-implementation review into certain aspects of the consolidation regime*, Australian Government, Canberra, 2012; and Board of Taxation, *Post-implementation review of certain aspects of the consolidation tax cost setting process*, Australian Government, Canberra, 2013.

arrangements could be addressed in a number of ways, the simplest of which may be a revision to Div 16E or a similar rule.[73]

If it is to be retained, at a minimum its application should be confined to financial institutions only. This will relieve average corporates, whose dealings may otherwise fall within the scope of the regime, from the task of navigating the technical complexities, as well as the inevitable administrative burden and increased compliance costs. Alternatively, the tax treatment could be made consistent across all entities and thresholds determining the mandatory application of the TOFA regime increased to effectively exclude average corporates. Importantly, regardless of the option chosen, the onerous administrative and compliance burden associated with documentation and record-keeping requirements and the unintended consequences must be alleviated.

Foreign exchange rules

The issues

The forex gains and loss rules contained in Div 775 of the ITAA 1997 have been criticised for being ineffective. Of course, it is not possible to consider those rules without also considering the way foreign exchange gains and losses can also be assessed under Div 230 (the TOFA rules).

The rules in Div 775 contain ostensibly five forex events that need to be potentially considered. Interestingly, when Div 775 was introduced, it was said to override any other provision of the tax law. However, when the TOFA rules in Div 230 were introduced, they also contained a provision that overrode every other provision of the tax law. It remains unclear whether Div 230 overrides Div 775, despite each claiming supremacy. That is, perhaps, indicative of the problems that stem from these detailed and complex provisions.

A casual observer might consider that, if there were ordinary income rules dealing with gains and losses and capital gains and losses rules, that there might be no need for such provisions dealing with such specific types of events. Unfortunately, the path to this overly complex place where we now sit is founded in decisions made some 35 years ago.

Prior to the introduction of CGT rules in 1985, it was clear that foreign exchange gains and losses on revenue account were assessable under the ordinary income and deduction provisions of the tax law in the same way that revenue asset profits had been treated for decades. The apparent gap at that time was gains and losses on capital account which, like capital gains and losses generally, were not within the tax net prior to 1985.

As has been noted in this paper, the path of drafting the law based around concepts of CGT events in relation to assets not only limits the different ways in which a capital gain or loss may arise, but also addresses only half of the balance sheet. That there could be gains and losses arising on the discharge or compromise of liabilities had long been recognised.[74] Whether such a gain or loss should be brought to account was, prior to the introduction of CGT

73 Division 16E was originally enacted in response to an increase in certain kinds of structured financial transactions and investments which deferred the payment of income to the investor (deferred interest arrangements). Such arrangements gave rise to tax deferral advantages which were sought to be counteracted by Div 16E.

74 See, for example, *British Mexican Petroleum Co Ltd v Jackson (1932)* 16 TC 570, where the House of Lords found the amount of the profit on discharge of a liability was not included in income, and compare to *International Nickel Australia Ltd* [1977] HCA 49 and similar cases where the gain was held to be on revenue account usually on the basis that the underlying application of borrowings, etc, had a revenue flavour.

in Australia, determined on whether the underlying liability was on revenue or capital account.[75] What became quickly apparent was that the structure of the CGT provisions meant that it was possible (even likely) to have scenarios where there could be no relevant disposal of an asset on which a gain or loss could be said to arise.[76]

As a result, the tax laws were substantially deficient when dealing with gains and losses on liabilities on capital account.

Division 3B/Division 775

Division 3B was introduced into the ITAA 1936 in 1987. In the second reading speech introducing the Bill,[77] it was said that the purpose was to allow deductions and treat as assessable income losses and gains on foreign exchange. At a time of high interest rates and Swiss Franc loans, it was relatively easy to make a case that there was a similarity between foreign exchange gains and losses and interest on loans (superficially attractive despite being internally inconsistent), and therefore should be taxed on the same basis as interest.

Perhaps most importantly, despite there having been the announcement of the introduction of a CGT on 19 September 1985, the then Treasurer announced on 18 February 1986 (before the introduction of the Income Tax Assessment Amendment (Capital Gains) Bill 1986) that there would be specific rules to deal with exchange gains and losses on ‘borrowings and loans’. What one can immediately glean is that there is something more at play here — an acknowledgment that the CGT rules as announced were not going to cover gains (and losses) on liabilities. This may have been a lost opportunity to rethink the design of the CGT rules before their introduction to parliament.

The so-called solution or ‘patch’

To overcome the ‘gap’ in the law regarding gains and losses (although the latter were not usually the focus of amendments) of a capital nature on liabilities, various specific solutions were implemented in addition to Div 3B (and subsequently Div 775). However, these have created their own gaps and mismatches. Simple concepts such as hedging do not work properly. All gains are treated as being on revenue account, even if the true nature of the gain or loss is on capital account. The current solution is also excessively and unnecessarily complicated and falls into the same kinds of drafting traps as the CGT.

Option

Specific rules on forex are unnecessary and can be abolished if the correct underlying framework is in place. This means a comprehensive CGT regime that incorporates gains and losses on liabilities (and which is simply expressed), which then allows the common income/loss and capital gain/capital loss rules to operate in relation to forex gains and losses of all kinds and gives them appropriate treatment.

75 Cf *Hunter Douglas Ltd v FCT* (1982) 82 ATC 4550.

76 See *FCT v Unilever Australia Securities Ltd* (1995) 127 ALR 437; 95 ATC 4117 per Beaumont J at ATC 4135-4136.

77 Taxation Law Amendment Bill (No. 5) 1986.

Business capital expenditure

Section 40-880 of the ITAA 1997 provides a deduction for certain business capital expenditure (also referred to as blackhole expenditure) on a straight-line basis over a five-year period. It applies as a last resort provision to capital costs incurred in relation to a past, current, or proposed business that is not otherwise dealt with under the income tax law.

However, while broad on its face, s 40-880 contains a number of exclusions. Among other reasons, capital expenditure is generally not deductible under s 40-880 to the extent that it is:

- private or domestic in nature;
- deductible under another provision of the income tax law;
- in relation to a lease or other legal or equitable right;
- non-deductible under the income tax laws;
- forms part of the cost of land or of depreciating assets; or
- taken into account in calculating a capital gain or loss.

The appropriateness of some of the exclusions to s 40-880 may be questioned. A fundamental principle of deductibility is that expenditure is either already immediately deductible, or goes to the cost base of an asset, or will in future form part of the calculation of the cost base of an asset. Where expenditure falls outside these circumstances, it should be caught under s 40-880, which itself could be expressed more simply in light of the above principle.

Insurance tax

The tax regimes applying to general and life insurance (Divs 320 and 321 of the ITAA 1997 and Division 15 of the ITAA 1936) have particular complications and peculiarities that are in need of reform.

In the case of Div 321, applying to general insurance activities, the Division represents a codification of the general principles that existed previously. Those principles followed accounting and business principles that underlay the operation of the industry and borrowed from long-standing principles of returning income and claiming expenses. By writing those principles into Div 321, little has been added other than the constrictions of legislated rules that become unwieldy as soon as the accounting principles or general business approaches change. This then requires the industry or the tax administration to try to reconcile those differences which would not have arisen had the regime been left to the broad accounting and business principles that existed previously.

In the case of Div 320, applying to life insurance companies, the rewrite from the ITAA 1936 of special rules was firstly built on suspicion of earlier practices, despite it resulting in a regime that still sought to create multiple taxation regimes in the one taxpayer. This gave rise to theoretical legislated divisions which had then to be replicated by business to accord with the tax regime. This is known as the tax tail wagging the business dog.

Again, such an approach has given rise to anomalies and, when then added to other theoretical regimes (like consolidation) gives rise to even more anomalies, all of which demand further amendments. This ongoing tinkering with the regime means it also becomes unwieldy and is proof of the adage that the more words that are written, the more problems that arise.

Division 15 is a specific regime designed to deal with non-resident insurers. It is a relic of a time when large (usually UK) foreign insurers would compete but, not having a presence in Australia would not be subject to tax in Australia, (one might call it a pre-BEPS, BEPS issue). Australia's right to tax has been preserved in DTAs. It would appear to be contrary to our free trade principles and should be reconsidered in the light of subsequent developments.

2.4 Transfer pricing

While it is fair to say that Australia's international transfer pricing rules are adequate and broadly consistent with international best practice, there is a dire need to cut red tape and alleviate the associated administrative burden imposed on businesses. There are two elements to this: legislative reform and administrative action.

In terms of legislative reform, other jurisdictions, such as the UK, have exempted small businesses from their transfer pricing rules and significantly reduced the circumstances in which medium-sized businesses might be subject to such rules. The approach taken in the UK seems sensible when the compliance cost burden is weighed-up against the relatively small risk to the revenue.

Further, the transfer pricing record-keeping rules in Subdiv 284-E of Sch 1 to the TAA 1953 adopt a one-size fits all approach that applies equally to small businesses and to large businesses, regardless of the size and extent of an entity's cross-border related party dealings. However, the cost associated with complying with these rules (e.g. adviser fees and internal staff costs) is disproportionately higher for small businesses relative to the generally smaller size of their cross-border transactions and to the potential revenue at risk.

A review of the various record keeping requirements, particularly those in Subdiv 284-E of the TAA 1953, is warranted with a view to introducing appropriate *de minimis* and safe harbour provisions to reduce administrative and compliance costs for small businesses, SMEs and for large businesses that have cross-border dealings that represent a low risk to the revenue.

In relation to administrative action, not only is it possible to simplify disclosures required in terms of the international dealings schedule, it is also possible, and indeed desirable, to improve *de minimis* requirements for SMEs and to make the simplified transfer pricing record-keeping options introduced by the ATO as an administrative concession accessible to more taxpayers.

Options for reform

- Exempt small businesses that are not 'significant global entities' from the transfer pricing rules to reduce the compliance cost burden for all such entities relative to the small risk to the revenue.
- Review the record keeping requirements in Subdiv 284-E of the TAA 1953 with a view to introducing appropriate *de minimis* and safe harbour provisions to reduce administrative and compliance costs for small businesses, SMEs and for large businesses that have cross-border related party dealings that represent a low risk to the revenue.
- Review the simplified transfer pricing record-keeping options introduced by the ATO as an administrative concession to make them accessible to more taxpayers.

Domestic rules

The domestic situation is quite different. Our international transfer pricing regime, while administratively onerous, is at least comprehensive. The same cannot be said of our domestic rules. Australia has taken a piecemeal approach to addressing domestic transactions between related parties. Unlike other countries, like the UK, which operate established domestic transfer pricing regimes, Australia has select market value substitution rules and arm's length conditions embedded in particular regimes in relation to asset transfers such as in the context of CGT, value shifting and for stamp duty purposes. These appear to have been inserted into provisions as knee-jerk integrity rules that can give rise to different outcomes depending on how they have been crafted for a particular regime within the law. Indeed, in the absence of a comprehensive domestic arm's length or market value substitution rule, specific and complicated integrity rules have been put in place to prevent the behaviour that could otherwise have been more easily addressed through a comprehensive approach.

Rather than this inconsistent and confusing approach, it would be preferable to have a single overarching principle that transactions be conducted on market value terms.

There is no reason, in principle, why a clear broad-based and consistent domestic market value substitution rules could not apply to all transactions. We recommend that any such framework should be principles based, not follow international transfer pricing approaches (for compliance cost reasons), and incorporate *de minimis* provisions and safe harbours for SMEs. Clear and enhanced ATO guidance is necessary to support taxpayers to understand their obligations and to facilitate its administration without undue complexity and compliance costs.

2.5 International

Part of Australia's challenge in moving past the economic recession, and other challenges brought about by the COVID-19 pandemic, will be attracting foreign capital. This will be the case for all countries emerging from the pandemic so the need for a competitive edge to attract foreign capital is heightened. As alluded to throughout this chapter, despite our dependence on it, Australia's current domestic and international tax settings hardly incentivise or even facilitate foreign investment.

There are a number of fundamental issues with the design of our international tax system which call into question its effectiveness and viability in current times, let alone the future. The Australian tax system is, in many ways, complex and over-complicated. Our international tax rules are no exception. This is not least because our international tax system incorporates many domestic principles and laws such as residency, source, foreign tax credits, and general anti-avoidance rules.

In addition, it encompasses a range of independently complex regimes including transfer pricing, CFC rules, specific anti-avoidance provisions such as the MAAL and the DPT, a number of tax treaties and tax EOI agreements, and, of course, the MLI. Each of these regimes is supplemented by a plethora of ATO products including determinations, tax rulings, practical compliance guidelines, and taxpayer alerts. The same can be expected in the advent of a future digital services tax. This is an overwhelming amount of information to be digested by parties looking to engage in cross-border transactions, or practitioners engaged to advise on them.

It is of little reassurance or justification that many other countries have taken similar, if not more complex, approaches to international tax. This is particularly so since it is not the case for all countries and there are some standout regimes such as that of Singapore and Hong Kong, which facilitate foreign investment in a far simpler manner (suggested below).

To add to these issues, there have been a number of relatively recent decisions, namely, *Peter Greensill Family Co Pty Ltd (trustee) v FCT*[78] and *Burton v FCT*,[79] that have called into question the policy settings in our international tax system. While the decisions in these cases are not questioned based on the operation of the law, they appear to be inconsistent with the policy intent. These decisions are considered below.

Perhaps even more importantly – and which, in some cases, flies in the face of proposals that might otherwise be considered – is the work over the last decade internationally to address BEPS. This has manifested in some of the previously mentioned rules that have been put in place such as DPT, the MLI and Anti-Hybrid rules. It is also the basis for the emerging consensus among members of the OECD/G20 Inclusive Framework around Pillar One (on re-allocation of taxing rights) and Pillar Two (the global anti-base erosion mechanism) and, in particular, the concept of a minimum level of tax.

The solutions to overarching design issues and specific gripes within the international tax system, some of which are considered below, will be found in strategic and carefully planned policy and law.

Residence versus source-based taxation

A core concept in the tax system of all countries are the concepts of residence and source. In Australia, we have used both of these markers to determine the type or level of tax to be borne. Other countries have tipped the balance away from residence and been more reliant on source. Occasionally, a country (e.g. the US) will adopt an indicium of citizenship rather than residency for individuals. Different rules may exist for corporates versus individuals.

One potentially simple, but significant, move towards a simpler, more effective international tax system would be to tip the balance further in favour of source-based taxation,[80] much like the systems implemented in Singapore and Hong Kong, referred to above. However, immediate acknowledgement needs to be given to international trends and the need to remain within a consistent framework with those trends. Thus, it would be unrealistic to expect that our CFC rules could be abandoned given the strong support internationally for such rules and the role they play in maintaining tax system integrity and prevent base erosion and profit shifting.

Nonetheless, consistent with other domestic considerations, Australia could consider taxing economic activity, regardless of the person or entity which undertakes the activity. While this might suggest less differentiation of tax having regard to residency, there can be an opportunity to improve and simplify the treatment of foreign sourced income of residents and clarify the treatment of non-residents. In each case such changes could enhance Australia as a base for knowledge and services workers.

78 (2020) FCA 559.

79 (2019) FCAFC 141.

80 Asprey report.

As noted previously, the federal government announced in the 2020-21 Budget that recommendations proposed by the Board to clarify the residency of companies would be adopted.

Australia's tax treaty network

For a developed country, Australia has a very small treaty network of around 45 tax treaties.[81] While most of our treaties reflect our trading and investment relationships, occasionally treaties have been entered into for political, rather than economic, reasons and ultimately add little value to Australia's trading position. The UK has more than 130 tax treaties with its trading partners, making it one of the largest tax treaty networks.[82] Canada has around 100 tax treaties and the US follows closely behind with almost 70 tax treaties.[83]

While this is not to suggest that Australia should be aiming for the same, it does warrant a review of our existing treaty network and whether there should be new treaties negotiated to facilitate international trade. In any such review, it would be important to consider the merits of following the UN model convention or the OECD model convention, depending on the circumstances, and particularly, the extent to which Australia should concede to emerging countries.

It should be noted that the federal government has provided funding to Treasury to expand its Treaties negotiation project which is intended to cover updating certain existing treaties and addressing requests for new treaties from some 20 countries.[84] An expansion of the treaty network would seem desirable.

Tax treaties are often viewed politically as a forfeiture or concession of revenue. While this is prima facie true, it is a narrow-minded and short-sighted view of the purpose of a tax treaty. Rather, it is important to return to the inherently reciprocal nature of a treaty, and acknowledge that while Australia may, under a tax treaty, provide concessional treatment to foreign businesses operating here, the reciprocal treatment will be afforded to Australian businesses operating in the counterparty jurisdiction. This is just one means by which the government can support Australian businesses to expand offshore.

Permanent establishments

The concept of a PE is established in both domestic law and various tax treaties that have been concluded between Australia and other jurisdictions. Where a company is resident in a country with which Australia has concluded a tax treaty, it is important to have regard to the definition of PE contained therein as this will generally apply in priority to the domestic law.

Broadly, under Australia's domestic law, a PE is a place at or through which a person carries on any business, and includes:

---

81 Treasury, *Income tax treaties*. Available at treasury.gov.au/tax-treaties/income-tax-treaties.

82 HMRC, *Tax treaties*. Available at www.gov.uk/government/collections/tax-treaties.

83 Government of Canada, Department of Finance, *Tax treaties*. Available at www.canada.ca/en/department-finance/programs/tax-policy/tax-treaties.html; and IRS, *United States income tax treaties – A to Z*. Available at www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z.

84 Treasury Response to Question on notice no. 70 by Senator E Abetz on 27 October 2020, Portfolio question number: BET070, Budget estimates, Economics Committee, Treasury Portfolio.

- a place where the person is carrying on business through an agent (except where the agent does not have, or does not habitually exercise, a general authority to negotiate and conclude contracts on behalf of the person);
- a place where the person has, is using, or is installing substantial equipment or substantial machinery;
- a place where the person is engaged in a construction contract; and
- a place where another person manufactures, assembles, processes, packs or distributes goods on behalf of the person.[85]

Most tax treaties contain a definition of PE that is similar to the definition under domestic law, though generally more comprehensive.[86] It is also necessary to be mindful of the impact of the MLI, which sits above and modifies many of Australia's existing tax treaties on a treaty-by-treaty basis.

In order to ensure the dexterity of Australia's domestic and international law, we must acknowledge our ever-changing economic landscape, and our legal and administrative framework must be able to withstand and facilitate change. In the context of PEs, we must acknowledge that new ways of doing business in a modern economy increasingly do not fall squarely within traditional concepts. One important step to achieving this will be to continue to monitor the work being done by the OECD on tax challenges arising from digitalisation through Pillar One and Pillar Two.[87] Australia's engagement in this work is critical, though it is recommended that this is done in a multilateral way, in communication and agreement with our counterparties, rather than independently in a way that deviates from the principles and foundations underpinning Pillar One and Pillar Two.

Foreign income tax offsets

Formerly, foreign tax credits and, more broadly, foreign losses were quarantined. The foreign tax credit and foreign loss quarantining rules formed part of the tax reforms introduced in 1986 and were justified on the basis of protecting Australia's tax base.[88] As foreign source income became generally assessable, the foreign tax credit system was intended to provide relief from double taxation. This was given effect through a credit which was allowed for foreign income tax paid on an amount of foreign income included in assessable income. The former credit was capped at the lesser of the Australian tax that would be payable on the foreign income or the actual foreign tax paid. For a number of reasons, the former rules were abolished and replaced with a new set of provisions, rewritten into the ITAA 1997.

Division 770 of the ITAA 1997 contains provisions in relation to the availability and calculation of FITOs. Claiming a FITO of up to $1,000 is relatively straightforward. However, a FITO in excess of this amount requires detailed calculations. First, a taxpayer must work out their FITO limit. This is essentially based on the difference between the taxpayers actual tax liability and the tax liability

85 S 6 of the ITAA 1936.

86 See, for example, the *Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains*, art 5 (the Australia–United Kingdom tax treaty).

87 www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint.pdf; and www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint.pdf.

88 Para 1.5 of the explanatory memorandum to the Tax Laws Amendment (2007 Measures No. 4) Bill 2007.

they would have incurred were certain foreign taxed and foreign source income and deductions disregarded. This can have the effect of reducing the FITO able to be utilised and the foreign income tax paid in excess of the limit can neither be carried forward nor refunded.

One of the main issues with Australia's FITO system is its interaction with other regimes, such as the CGT. This issue has manifested in recent case law. In *Burton*, due to the fact that only half the capital gain on an asset was included in the assessable income of an Australian taxpayer, only half the tax could be used as a FITO.[89] Had Australia chosen instead to include the whole capital gain but tax it at half the otherwise applicable rate (which mathematically would have given rise to the same amount of tax), a full FITO would have arisen and it would have been consistent with the treatment in the US in that case.

A starting point may be to revisit the recommendations contained in the *Review of international tax arrangements*.[90] A simple comparison of net foreign income and foreign tax paid may be a simple solution and draws on the former system. Revisiting the former system, and reassessing the ways in which issues in that system could be resolved, would also have the benefit of bringing Australia more closely in line with international practices. This should help reduce anomalous circumstances arising from a clash of systems, such as where Australia discounts capital gains but other jurisdictions instead use discounted rates.

Trusts and foreign income

Over the years, there have been a number of cases in respect of trusts and foreign income that have given rise to anomalous outcomes. Some such cases have been the subject of ATO rulings, though the guidance has done little to resolve systemic issues.

These outcomes have sometimes arisen due to the operation of s 99B of the ITAA 1936. Section 99B addresses the receipt of trust income not previously subject to tax and broadly provides for the reduction of the amount that would be included in a trust beneficiary's assessable income for a number of reasons.[91] Such amounts are treated as NANE income.[92]

There have been incidences of perceived overreach by the ATO in respect of the application of s 99B. For example, ATO ID 2011/93 provides that an amount paid to an Australian resident beneficiary of a non-resident trust which is entirely attributable to foreign source income derived by the trustee when the beneficiary was, at the time, a non-resident, is to be included in that beneficiary's assessable income.[93] The trust had derived foreign source income, accumulated it as trust capital and paid the (*corpus*) amount, which comprised previous income, to the beneficiary.

Along the same lines, TD 2017/23 and TD 2017/24, which relate to the treatment of capital gains that flow through foreign trusts, confirmed the ATO's view that, as distinct from Australian trusts,

---

89 *Burton v FCT* (2019) FCAFC 141.

90 Board of Taxation, *Review of international taxation arrangements*, Australian Government, Canberra, 2003. Available at taxboard.gov.au/consultation/international-taxation-arrangements.

91 S 99B(2) of the ITAA 1936.

92 S 99B(2A) of the ITAA 1936.

93 ATO, ID 2011/93 – Income tax: application of section 99B of the Income Tax Assessment Act 1936 when accumulated foreign source income is paid to an Australian resident beneficiary who was a non-resident when the trustee derived the income.

capital gains do *not* retain their character as they flow through a foreign trust.[94] The flow-on effect is that Australian resident beneficiaries are therefore taxed on distributed capital gains as ordinary income. This of course means that they cannot access concessional treatment through the CGT discount, where it would otherwise have been available. Suffice to say that the finalisation of the ATO's view in this form was unexpected by many given that it was contrary to the established market view. The effect of TD 2017/23 and TD 2017/24 was to narrow the residency assumption in s 95 of the ITAA 1936 by taking the view that it is overridden by Div 855 of the ITAA 1997, and expanding the scope of s 99B.

The issue continues in the context of capital gains and non-resident beneficiaries with TD 2019/D6 and TD 2019/D7, both of which remain in draft form.[95] Compounding the effect of TD 2017/23 and TD 2017/24, in TD 2019/D6, the Commissioner takes the view that a foreign beneficiary presently or specifically entitled to a capital gain made by an Australian discretionary trust on a non-TAP asset is assessable on the capital gain even though that would not occur if the foreign resident made the gain directly or through a fixed trust, rather than through a discretionary trust. In TD 2019/D7, the Commissioner takes the view that a foreign beneficiary of a discretionary trust is assessable on non-TAP capital gains irrespective of whether the gain is Australian sourced.

Most recently, in *Greensill*, a foreign resident beneficiary of an Australian discretionary trust received a distribution out of capital gains derived from the sale of non-TAP assets.[96] Essentially, looking through the trust, the transaction involved the disposal of non-TAP assets by a non-resident. While, prima facie, this could be expected to fall outside the scope of Australian CGT, anomalies arising from the Australian rules governing the taxation of trusts meant that Australian tax was held to apply. It should be noted that, if the holding of the non-TAP assets were direct or through a fixed trust, this outcome would not have arisen.

The broader integrity concern in this context seems to be that discretionary trusts have been subject to manipulation for a number of reasons, including their closely held nature, the bespoke character of the governing document (being, the trust deed), as well as the lack of transparency and codified regulation (as distinct from companies). Therefore, actual or perceived avoidance or contrivance is the underlying issue. In contrast, the same integrity concerns do not seem to apply to other types of income flowing through discretionary trusts. This is clearly an anomaly and reveals an inconsistency in the underlying policy. Moreover, the ATO interpretation shows an inconsistency with the broad principles of territoriality of taxation; that is, that countries do not usually seek to impose tax on the foreign income of non-residents other than in exceptional circumstances. The Tax Institute recommends that the way in which avoidance and contrivance are addressed should be reconsidered. Doing so will address the underlying issues that give rise

94 ATO, TD 2017/23 – Income tax: does the residency assumption in subsection 95(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) apply for the purpose of section 855-10 of the *Income Tax Assessment Act 1997* (ITAA 1997), which disregards certain capital gains of a trust which is a foreign trust for CGT purposes?; and ATO, TD 2017/24 – Income tax: where an amount included in a beneficiary's assessable income under subsection 99B(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) had its origins in a capital gain from non-taxable Australian property of a foreign trust, can the beneficiary offset capital losses or a carry-forward net capital loss ('capital loss offset') or access the CGT discount in relation to the amount?

95 ATO, TD 2019/D6 – Income tax: does Subdivision 855-A (or subsection 768-915(1)) of the *Income Tax Assessment Act 1997* disregard a capital gain that a foreign resident (or temporary resident) beneficiary of a resident non-fixed trust makes because of subsection 115-215(3)?; and ATO, TD 2019/D7 – Income tax: is the source concept in Division 6 of Part III of the *Income Tax Assessment Act 1936* relevant in determining whether a non-resident beneficiary of a resident trust (or trustee for them) is assessed on an amount of trust capital gain arising under Subdivision 115-C of the *Income Tax Assessment Act 1997*?

96 *Peter Greensill Family Co Pty Ltd (trustee) v FCT* [2020] FCA 559.

to such anomalous outcomes. Furthermore, it is recommended that the treatment of income flowing through trusts to non-residents be reviewed to ensure consistency across income and consistency with general principles of territoriality of taxation.

Options for reform

- Rebalance the tax mix to shift away from a heavy reliance on corporate and income taxes towards a greater reliance on consumption taxes.
- Incentivise foreign investment into Australia and the expansion of Australian businesses offshore through tax reform and incentives underpinned by sound tax policy.
- Reset the tax policy framework and reconsider who is best placed to undertake tax policy development and tax reform initiatives, keeping in mind a long-term vision for the tax system and the ever-changing economic landscape.
- Lower the corporate tax rate to no higher than 25% and eliminate the dual rate system.
- Revisit the imputation system and consider alternatives in line with international practices.
- Simplify the carry-forward and allow the carry-back of losses.
- Treat losses like other tax assets and change the negative connotations associated with the acquisition of loss-making companies.
- Simplify the CGT regime using a principles-based approach. Introduce correspondingly simplified roll-over relief that supports the fundamental policy.
- Simplify the tax consolidation rules to follow accounting principles in terms of grouping.
- Clarify and simplify the operation of certain aspects of the existing tax consolidation system if they are proposed to be retained.
- Abolish TOFA, the CDF rules and other regimes (in tandem with a simplified but broader CGT regime), the transactions relating to which can be addressed in a simpler manner.
- Revisit and simplify the provisions dealing with the treatment of particular kinds of assets including Divs 40, 43 and 250 of the ITAA 1997.
- Enact a uniform domestic market value rule with appropriate *de minimis* and safe harbour provisions, as well as simplified record-keeping requirements to reduce administrative and compliance costs.
- Move from a residence-based to a source-based system of international taxation.
- Revisit Australia's tax treaty network and consider gaps where agreements may be negotiated with existing or potential trading partners.
- Revisit the *Review of international tax arrangements* recommendations to resolve issues in the FITO regime.[97] Resolve issues of interactions and clashes between different systems such as in the context of CGT.

97 Board of Taxation, *Review of international taxation arrangements*, Australian Government, Canberra, 2003. Available at taxboard.gov.au/consultation/international-taxation-arrangements.

Disclaimer

The views, opinions, ideas and potential options for reform do not represent the views of any individual member of The Tax Institute or ATRF. This paper should be read and considered in its entirety. To consider any single measure or option for reform in isolation is contrary to the spirit and fundamental objective of this discussion paper.

3. Taxation of SMEs

Overview

Role of SMEs in the Australian economy

According to a report by the ASBFEO *Small business counts – December 2020*,[98] small businesses:

- account for between 97.4% and 98.4% of all businesses, depending on whether 'small business' is defined based on the number of employees or turnover;
- contributed almost $418b to GDP in 2018–19, equivalent to over 32% of Australia's total economy;
- employ over 4.7 million people and 41% of the business workforce;
- employed, as at December 2019, 165,197 apprentices and trainees, which represents 61% of Australia's apprentices and trainees; and
- accounted for 22% of total tax revenue from companies in 2017–18, according to ATO data.

Around two-thirds of The Tax Institute members represent or act for SMEs.

In acknowledging the importance of small businesses to the Australian economy and society, for many decades, governments have enacted various tax policies which have sought to balance revenue with the particular needs of small businesses.

Summary of key issues — taxation of SMEs

This part of the *Case for Change* considers how the taxation of SMEs could be redesigned to:

- liberate the flow of capital;
- reduce compliance costs; and
- reduce complexity while maintaining integrity in the system.

The taxation of SMEs is unnecessarily complex, and the design of the law produces anomalous outcomes depending on the choice of business structure.

The key issues examined in this part of the paper are:

- taxation of entities — should business income be taxed the same, irrespective of the legal structure?
- taxation on a flow-through basis — should income be taxed at the shareholder or beneficiary level (akin to partnerships)?
- corporate tax rate and imputation regime — appropriateness of current settings;
- trusts — overdue reform of Div 6 of Pt III of the ITAA 1936 and associated provisions; and
- reform of Div 7A of Pt III of the ITAA 1936 and its interaction with Div 6.

98 Australian Small Business and Family Enterprise Ombudsman, *Small business counts – December 2020*, 2020.

Issues

Base rate entity rules

While many SMEs currently benefit from a lower tax rate under the base rate entity rules, various challenges and anomalous outcomes arise due to the design of those rules. Anomalies arise such as where, assuming the aggregated turnover is less than $50m and there is no significant passive income for example:

- business income derived by a company that is distributed to another company via a trust is taxed at the higher rate (assuming there is no other income), but income distributed directly to another company is taxed at the lower rate;
- a company carrying on a business of plant or equipment hire is taxed at the higher rate, yet a dormant company must frank its distributions at the lower rate; and
- a company that derives both business income and rent suffers a massive decline in its business revenue due to the COVID-19 pandemic may extraordinarily find itself being taxed at the higher rate as a result.

Unnecessary complexity exists due to the potential misalignment of a company's tax rate and its maximum franking rate, resulting in top-up tax or trapped franking credits where dividends flow between companies that are base rate entities and those that are not. The misalignment is compounded by companies being required to use current year figures to determine their tax rate but prior year figures to determine their franking rate. Further complexities arise where distributions flow through trusts. These issues are discussed further below.

Potential variation in franking rate from year to year

Just as a CTE's tax rate can vary from year to year depending on the amount of the entity's aggregated turnover and proportion of BREPI to the entity's assessable income, its franking rate is also dependent on aggregated turnover and BREPI but in respect of the previous income year.

While the rules determining an entity's maximum franking rate were purposely designed to overcome the difficulty that an entity does not determine its aggregated turnover and BREPI for an income year until after the end of that income year, the practical effect of the franking rules is that:

- the two-tier system is complex;
- the complex base rate entity rules mean an entity's maximum franking rate can vary from its corporate tax rate and from year to year; and
- SME corporate taxpayers suffer increased compliance costs, are subject to anomalies and there is an increased risk of errors in calculating the entity's corporate tax rate and maximum franking rate.

Imputation system

Further issues with the imputation system exist beyond those associated with the base rate entities rules discussed above, including as follows.

Integrity and administrative measures

There is a range of complex integrity measures, including:

- anti-streaming rules;
- anti-avoidance rules: franking credit schemes;
- benchmark franking rules, franking account return, franking deficit tax;
- debt/equity rules;
- 'exempting entity' and 'former exempting entity' rules;
- holding period and related payment rules; and
- share capital tainting rules.

The complexity of these rules results in increased compliance costs, anomalies and errors. This is exacerbated by the fact the many of these integrity rules have been repealed and are only included by inference in the current law. Further, those rules were drafted in the mid-1990s and reflect the thinking of the financial markets at the time. Much has changed in the financial markets since then and, in addition to being complex, these provisions have been shown to be dated.

Loss of concessionary treatment of tax-advantaged income

The nature of the imputation system is such that there is a loss of concessionary treatment on distribution of tax-advantaged income by a CTE to shareholders. This includes the R&D tax incentive, offshore income, NANE income, capital gains sheltered by the 50% small business reduction in Subdiv 152-C of the ITAA 1997 and the recent cash flow boost.

Such amounts are assessable to shareholders as dividends, which negates the concessionary treatment afforded to the company, turning what should have been a benefit into a timing difference.

Interaction with settings in the superannuation system

During the 2019 federal election campaign, a policy proposal was aired to deny refundable excess franking credits, other than for those who would fall within a narrow set of exclusions (e.g. pensioner guarantee).

There was little evidence that the concerns emanated from the availability of refundable excess franking credits for low income earners. Rather, the concerns related to high-balance SMSFs in pension phase that benefit from large refunds of excess franking credits due to the tax-free income derived from assets set aside to pay a superannuation income stream and the generally lower tax rate that applies to superannuation funds.

The interaction of the proposal with the policy of tax-free earnings while a fund is in pension phase and the operation of the TBC is highly complex. Ironically, the operation of the proposed measure would have disproportionately affected smaller SMSFs more so than SMSFs (and other funds) with substantially larger member balances in excess of the TBC. This was because the tax liabilities arising from having to hold significant assets in accumulation phase (subject to tax) meant larger balance funds would be able to avail themselves of a greater proportion of the refundable franking credits than smaller balance funds who stood to lose access to up to 100% of their refundable franking credits.[99] It is perhaps an example of policy design needing to be fully aired and discussed to ensure it has the desired impact rather than having the opposite effect to that intended.

Before a conclusion is drawn that the deficiency lies in the design of the imputation rules, consideration could be given to the appropriateness of the superannuation settings and their interaction with the imputation system.

The introduction of the $1.6m general TBC from 1 July 2017 partially mitigated the availability of full refunds of excess franking credits, as income from fund balances above $1.6m are now subject to a form of taxation, albeit at a rate lower than the corporate tax rate.[100]

Entity taxation

Currently, the manner in which an entity's business income is taxed depends on:

- the legal form of the entity through which the income is derived;
- whether the income is business or 'active income' versus passive income; and
- whether the income has a revenue or capital character.

Net business income that is derived by a:

- CTE[101] is taxed at the entity's corporate tax rate (currently either 30% or 25% (from 1 July 2021));
- trust is taxed to the beneficiary — to the extent that the beneficiary is presently entitled to a share of the income of the trust estate, and based on the 'proportionate approach'.[102] Otherwise the taxable income is assessable to the trustee, at the top marginal tax rate plus Medicare levy;
- partnership is included in the assessable of each of the partners and taxed at the rate applicable to the partner; or
- sole trader is assessable to the individual and subject to marginal tax rates.

This creates uneven tax outcomes depending on the type of entity and provides an incentive for businesses to be carried on by companies to benefit from the lower tax rate.[103] This results in increased exposure to Div 7A and the PSI rules.

Attempts have been made over the years, including the entity taxation model released on 12 October 2000 which proposed to tax non-fixed trusts as companies from 1 July 2001,[104] but none have successfully removed the inconsistency in the tax treatment of business income across entity types.

---

99 Based on modelling undertaken by The Tax Institute, a fund with a balance of $800,000, and assuming a 5% return on investment (wholly invested in equities) would have foregone 100% of its franking credits, whereas a fund with a balance of $100m would have foregone only 50.5% of its franking credits. That modelling also shows that funds with investments spread across equities, property and fixed interest would similarly result in 100% loss of franking credits in a fund of $800,000 but *no* loss of franking credits for a fund size of around $10m.

100 The general TBC has been indexed to $1.7m from 1 July 2021.

101 This includes 'deemed' companies such as public trading trusts covered by Div 6C of Pt III of the ITAA 1936 and limited partnerships covered by Div 5A of Pt III of the ITAA 1936.

102 Confirmed by *FCT v Bamford; Bamford v FCT* [2010] HCA 10.

103 As compared with marginal tax rates.

104 Released by the Howard Government as an exposure draft of the New Business Tax System (Entity Taxation) Bill 2000.

Many problems are caused by the divergence of the top marginal tax rate plus Medicare levy which applies under s 99A of the ITAA 1936, where income is retained by a trustee of a trust or is distributed to beneficiaries whose taxable incomes exceed $180,000. This has led to the incorporation of thousands of corporate beneficiaries to ensure trust income is taxed at no more than the corporate rate.

Taxation of trusts

The wide use of trusts for investment and business purposes is an Australian anomaly. The use of discretionary trusts and unit trusts is particularly prevalent in the SME sector. The laws affecting trusts are confusing and lack clarity, particularly given the unavoidable interaction of trust law with tax law. Each trust is governed by its own particular trust deed and the relevant State Trustee Act.

This distinguishes Australia from other jurisdictions. Business is looking for a simple and flexible structure with limited liability. Partnerships were used extensively for decades before the uptake of trusts from the 1960s–1970s; however, partnerships were unable to provide limited liability. Limited partnerships have been used extensively as look-through investment vehicles in other jurisdictions, and look-through or disregarded companies (S-corps in the US) have been adopted elsewhere. We had the window but missed the opportunity to offer a simple protected structure to taxpayers. We could repeal Div 5A of Pt III of the ITAA 1936 and allow limited partnerships to be taxed like ordinary partnerships. This would be attractive to many SMEs.

Copious articles have been written over the decades by the best minds in the judiciary and legal/accounting profession who have identified, dissected and debated the problems inherent in Div 6.[105] Attempts to reform Div 6 have been largely unsuccessful, notably in 2010 following the High Court's decision in *FCT v Bamford*[106] which finally provided some certainty in relation to some long-debated but relatively narrow issues regarding the taxation of trusts.[107]

There was a flurry of activity following the *Bamford* decision, including a consultation paper[108] in 2011 and a policy options paper in 2012 which set out proposed reforms to the taxation of trust income.[109] However, only some limited trust streaming provisions relating to capital gains and franked distributions emerged from the extensive and earnest efforts to reform Div 6.

Section 100A of the ITAA 1936, which deals with reimbursement agreements, has been in the law since 1981 and treats a beneficiary as not being presently entitled where the present entitlement arose out of a reimbursement agreement. The exclusion in s 100A(13) for 'an agreement, arrangement or understanding entered into in the course of ordinary family or commercial dealing' has been calling out for judicial clarification for decades.

In the meantime, the profession sought interpretive guidance from the ATO, which was first provided in the form of a non-binding document titled *Trust taxation – reimbursement agreement*

105 And this is without addressing the many other provisions and special rules that affect the taxation of trusts.

106 *FCT v Bamford; Bamford v FCT* [2010] HCA 10.

107 *Bamford* definitional problem of the meaning of 'income of the trust estate' as used in s 97 of the ITAA 1936 and confirmed the so-called 'proportionate approach' in applying the term 'share of the income of the trust estate'.

108 Treasury, *Modernising the taxation of trust income — options for reform*, November 2011. Available at treasury.gov.au/sites/default/files/2019-03/Consultation_Paper_Modernising_Taxation.pdf.

109 Treasury, *Taxing trust income — options for reform*, October 2012. Available at treasury.gov.au/sites/default/files/2019-03/Options_paper.pdf.

on 2 July 2014. Since then, the profession has continued to seek binding guidance from the ATO. The ATO's Advice under development program advises that a draft ruling will set out the Commissioner's preliminary views on the exclusions from a 'reimbursement agreement' for agreements:

- not entered into with a purpose of eliminating or reducing someone's income tax; and
- entered into in the course of ordinary family or commercial dealings.

The expected completion is yet to be advised but targeted consultation on this issue has commenced.

A number of issues regarding the taxation of trusts remain, including the following.

- Two significant draft ATO rulings relevant to the taxation of trusts remain unfinalised after many years — TR 2004/D25[110] and TR 2012/D1.[111]
- The rule against perpetuities in all States/Territories other than South Australia, which commonly limits the effective life of a trust under trust law to 80 years.[112] Large numbers of trusts are expected to vest over the next few decades which will result in significant tax liabilities, including CGT liabilities, assessable balancing adjustments under Div 40 of the ITAA 1997 and stamp duty liabilities.
- Recent court decisions have highlighted issues with the interaction of the CGT discount and international matters, including the treatment of foreign beneficiaries of Australian non-fixed trusts with non-TARP CGT assets[113] and FITOs.[114] This is also addressed further in Chapter 2 – Large business and international.
- There are multiple reporting and loss recoupment regimes which were each designed to target a perceived mischief, but which are complex in their operation and interaction and are in many cases poorly understood and applied. These are set out below.
- Broader, non-tax specific problems, include:
  - a lack of codification of trust law and a wide range of trust deeds; and
  - a lack of transparency due to the absence of an external regulator and a central register (there is no equivalent to ASIC for trusts).

More than 30 separate set of rules affect trusts (many of which themselves contain dozens more rules). Any examination of that extensive list shows that the interplay and application of the legislative provisions affecting trusts is unworkable, and almost impossible to fully comply with.

110 ATO, TR 2004/D25 – Income tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*.

111 ATO, TR 2012/D1 – Income tax: meaning of 'income of the trust estate' in Division 6 of Part III of the *Income Tax Assessment Act 1936* and related provisions.

112 A trust's perpetuity period may be shorter than 80 years pursuant to the trust deed.

113 *Peter Greensill Family Co Pty Ltd (trustee) v FCT* [2020] FCA 559.

114 *Burton v FCT* [2019] FCAFC 141.

An obvious area of reform is the sets of provisions applying to closely held trusts. There is both an overlap of and mutual exclusivity between:

- the trustee beneficiary reporting rules in Div 6D of Pt III of the ITAA 1936;
- the TFN reporting rules for closely held trusts in ss 12-175 and 12-180 of Sch 1 to the TAA 1953; and
- the trust loss provisions in Sch 2F to the ITAA 1936, which includes the rules governing family trust elections, interposed entity elections and family trust distribution tax.

Options

Corporate tax rate and imputation system

Throughout The Tax Institute's The Tax Summit: Project Reform event series, there was widespread:

- criticism of the current two-tiered corporate tax rate system which leads to complexity and anomalous outcomes; and
- support for reducing the corporate tax rate to 25% and aligning the corporate tax rate and the franking rate for all CTEs, regardless of size, activity or income type (see further discussion below).

Alternative arrangements could include:

- the abolition of imputation (completely or partially), associated with:
  - lowering the corporate tax rate for all CTEs to 15%; and
  - introducing a partial exemption from income tax for dividend income;
- denying refundable excess franking credits only for superannuation funds where the members' TBCs exceed $1.6m;[115]
- adopting international arrangements such as those existing in the US and UK tax systems which generally exempt company-to-company dividends (as did Australia prior to 1987); or
- adopting a potential flow-through design, whereby tax is imposed at the shareholder level not on the CTE. A single-rate WHT system could be introduced which would result in fewer distortions with respect to offshore income.

It was uniformly agreed that the collection and administration of tax should be reformed by simplifying the franking administrative rules.

Entity taxation

Throughout The Tax Institute's The Tax Summit: Project Reform event series, there was also widespread support for a significant reform which would tax business income at a lower rate than non-business or passive income.

115 The general TBC has been indexed to $1.7m from 1 July 2021.

The entity taxation model released on 12 October 2000 which proposed to tax non-fixed trusts as companies from 1 July 2001 faced opposition and had a number of drawbacks including that, if implemented, the imputation system and Div 7A would apply to trusts.[116]

In addressing the perennial discussion of whether trusts should be taxed like companies, and the inconsistency in the tax treatment of business income across entity types, the reforms discussed below could be considered.

Single business tax rate

Business or 'active' income could be taxed at a single business tax rate, such as 25%. The key features of this reform are as follows.

- Passive or non-business income could be subject to different tax rate.
- The lower business rate would apply to capital gains from active assets and other statutory income from business, as well as ordinary income derived in the ordinary course of carrying on a business.
- Applying a lower rate for business/active income would, in many cases, eliminate a primary reason for establishing corporate beneficiaries.
- No CGT discount would be available on the business profits or gains as access to the lower tax rate would counter the loss of the 50% CGT discount for trusts and partnerships.
- The business tax rate would be 'agnostic' across entity types, that is, there would be no differentiation in the tax treatment of business/active income derived by a company, a trustee of a trust, a partnership or a sole trader.

Alternative arrangements could include the following.

- Taxing companies, trusts and partnerships on a flow-through basis, akin to the treatment of CLPs in the US, rather than taxing the income at the entity level.
- Basing joint tax returns on the family unit — this, combined with the business tax rate for all business operators regardless of entity type (including sole traders), would overcome PSI issues, income splitting arrangements via trusts and artificial arrangements in partnerships. This would be limited to business income, so limits should still apply to splitting personal exertion income.
- Subjecting the business income of sole traders (e.g. gig economy) to tax at no more than 25%, in cases where their marginal tax rate is higher. This would ensure that the business income of sole traders is taxed at the same business tax rate that would apply to other types of entities, such as companies and trusts. While this would allow sole traders to have their business income taxed at a rate that is less than salary or wage income earned by employees, the lower rate would:
    - acknowledge that they carry more risk than employees;
    - reward entrepreneurial activity; and
    - remove income-splitting incentives to divert sole trader income to other entities.

116 Released by the Howard Government as an exposure draft of the New Business Tax System (Entity Taxation) Bill 2000.

The lower business tax rate could apply to funds left in a business bank account and not withdrawn or applied for private use. This would address concerns about ensuring that the lower tax rate would not be applied to all of the individual's taxable income (e.g. passive or employment income). It is also acknowledged there are difficulties when dealing with fungible assets such as bank accounts, as well as practical implementation issues.

Derivation of passive income by business entities

To ensure that the lower business tax rate applies only to business or active income and not passive income, a BREPI-style test could apply so that the entity is taxed at a higher rate if more than 80% of its assessable income is passive in nature. Alternatively, the higher tax rate could apply only to the passive income, with the lower business tax rate applying to the business income, but this approach comes with the drawback that more than one tax rate could apply to a single entity, which increases the complexity.

In determining what constitutes business or active income versus passive income, sensible and workable definitions of passive income — particularly around the meaning of non-portfolio dividends and royalties — should apply. This would have the benefit of addressing the existing anomalous outcomes under the BREPI rules. Alternatively, the meaning of 'active income' in the CFC rules could be adopted more widely, though most SME practitioners are not familiar with the operation of the CFC rules so this approach could be more complex for taxpayers.

Treatment of funds

Cash retained by the business entity is typically used to fund the working capital and acquisition of income-producing assets. This includes funds retained by the trustee of a trust, which is currently subject to the highest marginal tax rate plus the Medicare levy, or funds which are retained or lent back to the trustee of a trust by a company, notwithstanding the distribution of the underlying profits to a corporate beneficiary.[117]

All funds retained and applied for a taxable purpose by a business entity should be taxed at the lower business tax rate. This includes funds retained by the trustee of a trust. This could be achieved by either amending the applicable rate under s 99A to tax retained business income at the lower business tax rate, or taxing these amounts under another new/amended provision.[118] This would ensure that business income taxed at the trustee rate is equivalent to the reduced 'entity' business tax rate.

Funds applied for a taxable purpose by a company (e.g. funds lent to a related entity for working capital) should not be subject to Div 7A if the loan is managed on complying loan terms, and should not constitute an assessable distribution (see discussion on Div 7A below).

Funds applied for a non-taxable purpose (e.g. private consumption) should be treated as a liberation of funds and an assessable distribution. Exceptions should apply to repayments of credit loans, returns of capital, repayments of UPEs and similar amounts on which tax has already been paid under any former regime. Regard would need to be had to practical implementation.

117 S 99A of the ITAA 1936.

118 It is likely that a s 99A rate would not be relevant in many cases as the new business tax rate would be levied at the entity level, not under Div 6.

Introducing a lower business tax rate across all entities would have the following additional benefits:

- income distributed to trust beneficiaries would be taxed at their marginal rates on receipt of cash funds rather than on a present entitlement to a share of the income of the trust estate;
- issues associated with Div 7A and s 100A would be greatly reduced, if not eliminated; and
- there would be no streaming issues[119] as all income is 'entity' income, and taxed at a flat rate, with a credit for the tax paid attached to distributions to stakeholders.

Cash flow taxation model

Reform of the taxation of SMEs could take the form of a cash flow taxation model, which is based on the premise that SMEs below a prescribed aggregated turnover threshold could choose to account for their:

- income and capital gains on a cash receipts basis; and
- deductions on a cash payments basis.

This simpler system would overcome the perennial revenue–capital dichotomy of having to characterise receipts and outgoings on revenue or capital account, and would remove the accruals basis of reporting income for tax purposes for these entities. It means, in practice, that these businesses could effectively determine their taxable income based on their bank statements, rather than having to apply complex tax law to ascertain their assessable income and allowable deductions, which are often affected by timing differences that have no permanent impact on the revenue collection of the government. It would also aid in the removal of most, if not all, 'tax reconciliation items' whereby businesses reconcile their financial statements/accounts with their income tax return.

In particular, adopting a cash flow taxation model would support businesses operationally by permanently allowing full expensing of:

- depreciating assets in the income year in which they are paid for — this would eliminate the complex pooling rules in Subdiv 328-D of the ITAA 1997;[120] and
- prepayments in the income year in which they are made — this would eliminate the prepayment rules for eligible entities.

Consideration would need to be given to a suitable aggregated turnover threshold below which an entity would be eligible for cash flow taxation. The Tax Institute suggests that the threshold should be no less than $20m, but a $50m threshold would be more appropriate, so that a greater of number of SMEs could choose to adopt cash flow taxation and the threshold would align with other existing SME concession thresholds.

---

119 Subdivs 115-C and 207-B of the ITAA 1997.

120 The pooling rules in Subdiv 328-D of the ITAA 1997 may have been intended to provide simpler depreciation rules for smaller businesses, but the interaction of the pooling rules with the IAWO, the new FEDA measure, the backing business investment incentive, and the various exclusions (including those assets that are subject to Subdiv 40-E and those that are let predominantly on a depreciating asset lease) has made this area of the law unintentionally very complicated. Further, special rules that adjust the pool balance where there is a change in the taxable purpose proportion of an asset allocated to the pool deal with disposals of assets and prescribe when the pool balance is required to be fully deducted are often poorly understood.

Under a cash flow taxation model, a business would, amongst other things:

- claim a deduction for:
  - all trading stock purchases without having to account for opening and closing stock each year;
  - all depreciating assets (including intangible assets such as patents, registered designs, copyright and software) that have a taxable purpose (or to the extent of their taxable purpose), regardless of their effective life; and
  - all prepayments, regardless of their eligible service period;
- not have to deal with tax reconciliation items such as capital works claims under Div 43 of the ITAA 1997 because the building would be fully deductible at the time of purchase;
- be assessed on all receipts, whether of a revenue or capital nature,[121] including the proceeds from capital gains and unearned income received in advance; and
- account for capital gains when the capital proceeds are received, not some other timing (such as the date the contract is entered into under CGT event A1).

An exception would need to be made for certain CGT asset acquisitions such as business real property.[122]

Taxation of trusts

Possible reforms of the taxation of trusts include the following.

- **Section 99A** — if the rate payable on retained business/active income under s 99A is capped at the lower business tax rate, there would likely be less impetus to establish corporate beneficiaries. Further, the rate could be imposed on all business/active income outside Div 6 so the s 99A rate could be confined to retained passive income.
- **Repeal antiquated trustee beneficiary reporting rules** — the duplicate layers of trustee reporting (i.e. trustee beneficiary reporting rules, TFN reporting, trust loss rules and family trust elections) should be removed and the reporting streamlined. The trustee beneficiary reporting rules in Div 6D were introduced before the introduction of the TFN reporting rules[123] for closely held trusts. The trustee beneficiary reporting rules are not well understood or applied by taxpayers and practitioners — label **P** in the distribution statement in the trust tax return ('tax-preferred amounts'[124]) is invariably incorrectly completed, and label **Q** in the distribution statement ('untaxed part of a share of the net income'[125] of a closely held trust) reports information in the tax return that is already reported elsewhere in the return. The trustee beneficiary reporting rules should be repealed and greater reliance placed on the more effective and efficient TFN reporting rules.

---

121 There would also be no need to distinguish between ordinary and statutory income, although a rethink of the calculation to determine aggregated turnover in s 328-120 of the ITAA 1997 would be required as it includes only ordinary income derived in the ordinary course of carrying on a business.

122 This would also extend to goodwill and intangible assets that generally do not have an effective life, such as trademarks.

123 Ss 12-175 and 12-180 in Sch 1 to the TAA 1953.

124 S 102UI of the ITAA 1936.

125 S 102UE of the ITAA 1936.

- **Establish a central regulator** — consideration should be given to how the tax system could deal with non-tax issues, given the absence of an external regulator akin to ASIC and a central registry of trusts (including bare trusts). The ATO or the Registrar of the ABR could be responsible for the governance of such a system, and consideration given to whether any or all of the registry should be publicly visible. The introduction of a registration system for trusts could possibly be extended to include partnerships, in association with stronger regulatory requirements.

Better design of loss provisions

As noted in Chapter 2, the current structure of the company and trust loss rules is unnecessarily complicated and often hard to apply — even if there is a clear intention that the losses should be available. Those rules impact disproportionately in terms of their complexity and compliance cost on small businesses. The suggestions contained in that chapter would provide proportionately greater benefit to such small businesses.

No doubt, other options could also be explored.

Options for reform

- Reduce the corporate tax rate to 25% and align the corporate tax rate and the franking rate for all CTEs, regardless of size, activity or income type.
- Completely or partially abolish imputation associated with lowering the corporate tax rate for all CTEs to 15% and introducing a partial exemption from income tax for dividend income.
- Adopting a potential flow-through design, whereby tax is imposed at the shareholder level not on the CTE, accompanied by the introduction of a single-rate WHT system.
- Align the taxation of trusts and companies — this would include extending Div 7A to trusts.
- Provide an ability for trusts to accumulate business income without penalty tax rates applying. This would be associated with:
    - aligning the s 99A rate with the corporate tax rate, which would resolve most Div 7A issues; and
    - allowing tax paid by the trust to be passed to beneficiaries in the form of a franking credit.
- Allow for the accumulation of income based on the trustee's choice, e.g. at the corporate tax rate or, alternatively, tax beneficiaries based on present entitlement attribution, or another alternative.
- All business or 'active' income could be taxed at a single business tax rate, such as 25%, irrespective of the type of legal entity through which it is derived.
- Taxing companies, trusts and partnerships on a flow-through basis, akin to the treatment of CLPs in the US, rather than taxing the income at the entity level.
- To ensure that the lower business tax rate applies only to business or active income and not passive income, a BREPI-style test could apply so that the entity is taxed at a higher rate if more than 80% of its assessable income is passive in nature.

- Alternatively, the higher tax rate could apply only to the passive income, with the lower business tax rate applying to the business income.
- Reform of the taxation of SMEs could take the form of a cash flow taxation model.
- Extension of the attribution approach to trusts — extend Div 276 of the ITAA 1997 (AMIT rules) to other trusts with appropriate modifications.
- Repeal trustee beneficiary reporting rules and rely more heavily on TFN reporting rules.
- Establish a central registry of trusts (including bare trusts).
- Consider a roll-over for CGT assets and depreciating assets that are active business assets to address the federal tax implications of hundreds of thousands of trusts reaching the end of their perpetuity period.
- Allow losses to be recouped over a set number of years or on a straight-line basis, without the need for the complex COT and similar business tests.

4. Small and family business concessions

Overview

Several policy goals have influenced tax legislation in the small business sector. One goal has been to incentivise greater small business capital re-investment. Another has been to provide small business owners with access to funds for their retirement,[126] as 62% of Australian businesses are sole traders with no employees.[127] Both of these policies have guided the creation of the small business concessions rules.

However, as a result of continuous and piecemeal legislative amendments, the tax rules affecting small business taxpayers have grown both in length and complexity. Each new amendment has imposed additional compliance costs on small business taxpayers who often do not have access to the advisory resources that larger businesses enjoy.

In light of this, The Tax Institute considers that the tax law relating to small business concessions is due for significant reform.

Board of Taxation review of the small business tax concessions

The Tax Institute's *Case for Change* is not the first time the need for such reform has been highlighted. The Board specifically identified the small business tax concessions as needing major reform in its 2019 Review. The Board made several recommendations to overhaul the current system including:

- applying a $10m threshold across all concessions while maintaining the current SBE definition;
- repealing the $6m MNAV test;
- replacing or reforming the SBITO with an alternative measure for non-corporate businesses;
- repealing the SBE rules relating to trading stock; and
- simplifying the SBE rules relating to the pooling rules by having a single depreciation rate of 30%.[128]

The Tax Institute endorses the intent behind the Board's recommendations, but also seeks to build on them so that the small business tax concessions rules are easily understood and applied, equitable, efficient, and meet the overarching policy purpose for which they were introduced.

126 Peter Costello, "The new business tax system", media release no. 058, 21 September 1999.

127 Australian Small Business and Family Enterprise Ombudsman, *Small business counts*, Australian Government, Canberra, 2019, p. 7.

128 2019 Review.

Meaning of ‘small business’ based on aggregated turnover test and other thresholds

Following the enactment of the *New Business Tax System (Simplified Tax System) Act 2000* in response to the recommendations of the Ralph review,[129] the aggregated turnover test formed a fundamental part of the former simplified tax system (redesigned in 2007 as the SBE regime).

An individual, partnership, company or trust is an SBE if it carries on a business in an income year and has an aggregated turnover of less than $2m in the previous income year or is likely to have an aggregated turnover of less than $2m in the current income year.[130]

Eligibility for the small business CGT concessions in Div 152 of the ITAA 1997 was broadened in 2007 to include the $2m aggregated turnover test.[131] The $2m threshold was then increased with effect from 1 July 2016 to $10m as an economic policy measure. However, as the Board’s 2019 Review notes,[132] the increased threshold was not ‘applied across the board, effectively fracturing the small business definition’.[133] This theme runs through this chapter of the *Case for Change*.

The $10m threshold was further increased to $50m for 10 small business concessions (see Table 2) following an announcement in the federal Budget 2020–21.[134]

Summary of aggregated turnover tests applied throughout the tax law

Table 2 sets out the measures throughout the tax law which rely on the aggregated turnover test, most of which apply differing thresholds. There are at least 25 different small business concessions, most of which rely on the entity satisfying the aggregated turnover test.

Table 2. Summary of aggregated turnover tests applied through the tax law

Threshold	Application	Legislative reference
$2m	Used to determine if a taxpayer is a CGT SBE being an alternative pathway to the $6m MNAV test to access the small business CGT concessions	s 152-10(1)(c)(i) and s 15210(1AA) of the ITAA 1997
$5m	Used to determine if a taxpayer is eligible for the SBITO	s 328-357 of the ITAA 1997
$10m	Used to determine if a taxpayer is eligible for a range of small business concessions:	
	• simplified depreciation rules	s 328-175 of the ITAA 1997
	• small business restructure roll-over	s 328-430 of the ITAA 1997
	• accounting on a cash basis (GST attribution)	s 29-40(1)(a) of the GST Act
	• apportioning input tax credits on an annual basis	s 131-5(1)(a)(i) of the GST Act
	• pay GST by quarterly instalments	s 162-5(1)(a)(i) of the GST Act
	• not subject to indirect value shifting rules	s 727-15(8) of the ITAA 1997

129 Ralph review.

130 S 328-110 of the ITAA 1997.

131 In addition to the $6m MNAV test.

132 2019 Review, p. 17 at para 3.17.

133 Ibid at para 3.18.

134 This measure is contained in Sch 3 to the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020* which was enacted on 14 October 2020 as Act No. 92 of 2020.

Threshold	Application	Legislative reference
$20m	Used to determine if a taxpayer is eligible for a refundable R&D tax offset	s 355-100 of the ITAA 1997
$50m	Used to determine if a taxpayer is eligible for a range of small-to-medium business concessions:	
	• $150,000 IAWO (medium-sized business)	s 40-82(4) of the ITAA 1997
	• simplified trading stock rules[135]	s 328-285(2) of the ITAA 1997
	• base rate entity rules (corporate tax rate)	s 23AA of the *Income Tax Rates Act 1986* (Cth)
	• immediate deduction for certain start-up expenses[136]	s 40-880(2A) of the ITAA 1997
	• immediate deduction for certain prepaid expenditure[137]	s 82KZMA(2)(a) and s 82KZMD of the ITAA 1936
	• FBT exemption for car parking benefits[138]	s 58GA(1A) of the FBTA
	• FBT exemption for multiple work-related portable electronic devices[133]	s 58X(5) of the FBTA
	• remit PAYG instalments based on GDPadjusted notional tax[139]	s 45-130(1A) of Sch 1 to the TAA 1953
	• settle excise duty monthly on eligible goods[140]	s 61C(1AA) of the *Excise Act 1901*
	• settle excise-equivalent customs duty monthly on eligible goods[141]	s 69(1AA) of the *Customs Act 1901*
	• two-year amendment period[142]	items 1, 2 and 3 of the table in s 170(1), and s 170(14) of the ITAA 1936
	• simplified accounting method determination for GST purposes[143]	s 123-7(1A) of the GST Act
$100m	Used to determine if an entity is required to apply the TOFA provisions	s 230-455(4)(a) of the ITAA 1997
$500m	Used to determine if a taxpayer is eligible for:	
	• the $150,000 IAWO (large business)	s 40-82(4A) of the ITAA 1997
	• accelerated decline in value under the backing business investment measure	s 40-120(2)(b) (in Subdiv 40BA) of the IT(TP)A
$5b[144]	Used to determine if:	
	• an entity is eligible for FEDA	s 40-155 (in Subdiv 40BB) of the IT(TP)A
	• a CTE is eligible for temporary loss carry back	s 160-20 of the ITAA 1997

135 Turnover threshold increased from $10m to $50m with effect from 1 July 2021.

136 Turnover threshold increased from $10m to $50m with effect from 1 July 2020.

137 Ibid.

138 Turnover threshold increased from $10m to $50m with effect from 1 April 2021.

139 Turnover threshold increased from $10m to $50m with effect from 1 July 2021.

140 Ibid.

141 Ibid.

142 Ibid.

143 Ibid.

144 These two measures are not strictly SBE measures, but they rely on the same meaning of aggregated turnover that applies to SBEs.

Summary of other small business eligibility thresholds

Table 3 sets out the small business measures throughout the tax law which are based on other eligibility conditions.

Table 3. Summary of other small business eligibility thresholds applied through the tax law

Threshold	Application	Legislative reference
$6m MNAV	Used to determine if a taxpayer satisfies the MNAV test being an alternative pathway to access the small business CGT concessions	s 152-10(1)(c)(ii) and s 15215 of the ITAA 1997
	Used to determine if a taxpayer satisfies the MNAV test being an alternative exemption from the indirect value shifting rules	s 727-15(8) of the ITAA 1997
$2m debt deductions	Used to determine if a taxpayer is required to apply the thin capitalisation rules	s 820-35 of the ITAA 1997
'Family group'	Used to determine whether a trust that has made a family trust election or an entity that has made an interposed entity election has made a distribution outside the 'family group' of the test individual	s 272-90 in Sch 2F to the ITAA 1936
4 or fewer employees	Used by the ATO to determine if an employer is eligible to apply for the STP micro employer quarterly reporting concession	

There are also parameters which define a small business within the *Corporations Act 2001* and the financial services sector.

The *Corporations Act 2001* defines[145] a small proprietary company to be one which satisfies at least two of the following paragraphs:

(a) the consolidated revenue for the financial year of the company and the entities it controls (if any) is *less than $25m*;

(b) the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is *less than $12.5m*;

(c) the company and the entities it controls (if any) have fewer than 50 employees at the end of the financial year.

The *Financial Sector (Collection of Data) Act 2001* imposes reporting obligations on registered financial corporations where the assets are $50m or more.

4.1 Small business CGT concessions

Historical note — small business CGT relief

It has been government policy for more than 35 years to provide some form of relief from CGT for small business taxpayers. The concessions were introduced to further encourage investment in small business and assist small business taxpayers to provide for their retirement. More

145 S 45A(2) of the *Corporations Act 2001*.

particularly, the concessions were designed to provide a retirement funding equivalent for SME owners who reinvest in their business rather than contribute to superannuation.

Overview of the small business CGT concessions

The small business CGT concessions are some of the most, if not the most, important bundle of tax concessions available to small businesses. The concessions, in Div 152 of the ITAA 1997, enable small business taxpayers to significantly reduce or disregard captain gains that have occurred after 11:45pm on 21 September 1999.

Division 152 enables small businesses to access four significant concessions:

- a 15-year exemption on the disposal of business assets (Subdiv 152-B);
- a 50% reduction on the disposal of business assets (Subdiv 152-C);
- a retirement exemption on the disposal of business assets (Subdiv 152-D); and
- a roll-over into replacement business assets (Subdiv 152-E).

The policy rationale for the concessions is to enable small business owners to adequately fund their retirement from the disposal of their business or business assets as it was acknowledged that, due to constraints on cash flow, they may not be able to avail themselves throughout their working lives of the concessionary superannuation normally available to employees.[146]

To be eligible to access these concessions in relation to a capital gain happening from a CGT event, a taxpayer must satisfy the 'basic conditions' set out in s 152-10 of the ITAA 1997, including that the taxpayer has to satisfy at least one of the following conditions:

- the taxpayer is a CGT SBE (satisfies the $2m aggregated turnover test) for the income year;
- the MNAV test — that is, the net value of the taxpayer's CGT assets, and those of the affiliates of the taxpayer and any entities connected with the taxpayer, does not exceed $6m just before the CGT event;[147] or
- the taxpayer is a partner in a partnership that is a CGT SBE and the CGT asset is an interest in the asset of the partnership.[148]

The CGT asset must also satisfy the active asset test. An active asset is a CGT asset used in the carrying on of a business by the taxpayer, an affiliate of the taxpayer or an entity connected with the taxpayer.[149]

Overview of the aggregation rules

The aggregation rules are a major source of the complexity when determining whether a taxpayer is eligible for a small business tax concession. The aggregation rules are applied to determine whether an entity is an 'affiliate'[150] of another entity or is 'connected with'[151] that entity (i.e. whether

146 Peter Costello, "The new business tax system", media release no. 058, 21 September 1999.

147 S 152-15 of the ITAA 1997.

148 An additional alternative condition is available in s 152-10(1A) and (1B) which deal with passively held assets.

149 S 152-40 of the ITAA 1997.

150 S 328-130 of the ITAA 1997.

151 S 328-125 of the ITAA 1997.

one entity controls or is controlled by another entity, or is commonly controlled by the same third entity, based on a 40% control test[152]).

The 40% control test in s 328-125(2) applies for the purpose of determining whether a partnership, a company or a non-discretionary trust is connected with an entity. An alternative 40% voting test also applies in the case of companies,[153] and a modified 40% test for trustees and beneficiaries of discretionary trusts is set out in s 328-125(4).

These grouping rules are similar to those which apply for the purposes of the CFC rules in Pt X of the ITAA 1936. While the specific wording varies, the broad design of the SBE aggregation rules is akin to the tests that apply when determining whether a taxpayer controls a foreign company, tests which tend to be within the province of larger, more complex taxpayers.

The aggregation rules are relevant to the following tests in Table 4 (the first two tests are threshold tests which include the annual turnovers or net asset values of affiliates of the taxpayer and entities connected with the taxpayer).

Table 4. Relevant tests applying aggregation rule

Test	Application	Legislative reference
SBE aggregated turnover test	Used to determine if the taxpayer satisfies the $2m aggregated turnover test to access the small business CGT concessions	s 152-10(1AA) of the ITAA 1997
	It is also used to determine eligibility for a range of other small business tax concessions	s 328-110 of the ITAA 1997
MNAV test	Used to determine whether the taxpayer satisfies the $6m MNAV test	s 152-15 of the ITAA 1997
Active asset test	Used to determine whether an asset owned by the taxpayer satisfies the active asset test[154]	s 152-40 of the ITAA 1997

Overview of the active asset test

A CGT asset is an active asset used, or held ready for use, in the course of carrying on of a business by an entity, its affiliate or an entity connected with it.[155]

The active asset test stipulates that, for a CGT asset to qualify as an active asset, the asset must:[156]

- if owned for 15 years or less — be active for a total of at least half of that period; or
- if owned for more than 15 years — be active for a total of at least 7½ years during the period.

The period starts from the time the asset is acquired and ends at the CGT event. However, if the business ceased to be carried on in the 12 months before the CGT event (or any longer period

152 S 328-125(1) of the ITAA 1997.

153 S 328-125(2)(b) of the ITAA 1997.

154 The active asset test does not include the annual turnovers or net asset values of affiliates of the taxpayer and entities connected with the taxpayer. Instead this test permits an asset owned by a taxpayer to be active where it is used in a business carried on by an affiliate of the taxpayer or an entity connected with the taxpayer.

155 S 152-40 of the ITAA 1997.

156 S 152-35 of the ITAA 1997.

that the Commissioner allows), the period starts from the time the asset is acquired and ends at the cessation of the business.

4.2 Employee share scheme 'concessions'

The provision of remuneration and incentives to employees in the form of shares or options have been around for many years. The tax laws have endeavoured to assess such benefits as remuneration, and therefore ordinary income through the evolution of the provisions from s 26AAC to Div 13A of Pt III of the ITAA 1936 through to what is now Div 83A of the ITAA 1997.

Each evolution of the tax provisions sought the same policy outcome — to include in the assessable income of an individual the discount received on shares or rights/options. However, incentivised by the differential taxation of income and capital, taxpayers and their advisers continue to seek opportunities to have the gains arising from the respective instruments assessed on capital account.

Due to the significant variation in the different classes and terms of shares and options which can be issued, the provisions have been excessively complex. These complexities are most pronounced in relation to the valuation rules for unlisted shares and options. The complexities also arise due to the continued amendment to address the underlying behaviours of having the shares or options assessed on capital account rather than revenue account, and to address international tax issues associated with an ever-increasing globally mobile workforce.

The replacement of Div 13A with Div 83A, however, introduced additional complexity and administration for little gain in addressing the inherent issues in the system. These current provisions were introduced in an environment clouded by concerns over the effectiveness of the former elections to be taxed upfront under Div 13A, where the government held an opinion that such elections were 'held in the top draw' to hedge market movement. As such, Div 83A was developed as a self-operative provision.

Today's employee share and option schemes developed predominantly for private entities have somewhat rendered these provisions ineffective yet again. For start-up entities and large businesses, they remain overly cumbersome and burdensome.

Issues

Meaning of 'small business'

One of the primary tax issues facing the small business sector is the uncertainty surrounding the meaning of what a 'small business' is.

As can be seen from Table 4, although the primary meaning of SBE is set out in s 328-110 of the ITAA 1997 based on the aggregated turnover test in s 328-115, the turnover threshold is modified eight times for the purposes of a range of small business tax concessions. Further, there are alternative meanings of 'small business' beyond the aggregated turnover test (see Table 2) for the purposes of other small business concessions.

Entities must remain below the specified thresholds for the aggregated turnover test applicable to the particular measure, or satisfy other eligibility tests, to access one or more of the small business tax concessions. Knowing which threshold or test to apply and when has unnecessarily increased the complexity and compliance costs for SMEs.

Entities must consider the following when determining whether they are eligible for one or more small business concessions:

- the applicable threshold for the aggregated turnover test, or other eligibility test;
- the period in which the measure applies (particularly important where the measure is temporary or the relevant turnover threshold has increased with effect from a certain date); and
- other eligibility conditions, including changes to those conditions.[157]

Determining whether the eligibility conditions for some of these concessions have been satisfied has become incredibly complex. This has resulted in some advisers outsourcing this work to experts due to concerns about advising beyond their experience and abilities. Constant legislative change in pursuit of distinct policy intents has caused an interplay of provisions which many SMEs and their advisers find highly confusing and complex. Of greater concern is the increased likelihood that errors are being made in applying the law, which can result in messy reviews later, should the ATO determine that a taxpayer is not entitled to a concession the taxpayer had understood was available to them.

Much of the complexity in determining an entity's aggregated turnover arises from applying the grouping rules (i.e. the 'connected with' and 'affiliate' provisions) discussed below.

This outcome seems to be counterintuitive to the policy intent of supporting small businesses and ensuring they do not incur substantial compliance costs in complying with the law.

Complex eligibility criteria significantly increases compliance costs for small business taxpayers

A taxpayer can access the small business CGT concessions only if they, and the CGT asset, satisfy a range of eligibility conditions. The costs incurred by small business taxpayers in determining eligibility to access the concessions are often disproportionate to the benefit received and contrary to the overarching policy of the concessions, which is to maximise the cash in small business taxpayers' pockets upon retirement.

Several commentators over the years have noted that the eligibility rules around Div 152 have failed to meet the 'simplicity' principle needed in an efficient and equitable tax regime.[158] In a 2015 survey (the 2015 survey), 20 tax practitioners from 10 chartered accountancy firms were asked about the practical complexity of the SBE CGT regime.[159] The survey made several important findings:

- 85% of the tax practitioners believed that their small business taxpayer clients had a 'very poor' or 'poor' knowledge of the CGT provisions;[160]

157 For example, the changes made to the eligibility conditions in s 152-10 of the ITAA 1997 where a CGT event happens to a share in a company or an interest in a trust on or after 8 February 2018.

158 See P Kenny, "The 1999 review of business taxation: should we fast track small business tax reform?", (2008) 18(1) *Revenue Law Journal*; C Coleman and C Evans, "Tax compliance issues for small business in Australia", in N Warren (ed), *Taxing small business: developing good tax policies for SMEs*, Australian Tax Research Foundation, 2003, pp. 147-181; C Evans, "Studying the studies: an overview of recent research into taxation operating costs" (2003) 1(1) *eJournal of Tax Research* 64-92.

159 K Sadiq and S Marsden, "The small business CGT concessions: evidence from the perspective of the tax practitioner", (2015) 24(1) *Revenue Law Journal* 11.

160 Ibid, p. 13.

- small business taxpayers were 'almost entirely reliant' on their tax advisers to explain the small business CGT concessions to them;[161] and
- 75% of the tax practitioners believed that the interpretation and the application of the basic conditions in Div 152 was the most complex aspect of the process.[162]

The corollary of this complexity is that small business taxpayers are paying high fees to their advisers to determine whether they are eligible for small business CGT relief. As the Board's 2019 Review notes:[163]

> The generosity of the concessions is matched by equally complex legislation that leads to increased compliance costs and distortions in business decision-making.

Good tax law should not require advisers to hold the hand of their business clients at every step. The complexity of the small business tax concessions, magnified by the added layers of legislation every few years, has caused small business taxpayers to rely too heavily on their tax advisers at significant cost.

For this reason, reform that simplifies the legislation is much needed.

Practical problems with the 'affiliate' and 'connected with' tests

The aggregation rules were introduced in 2001 to prevent a larger group from breaking itself into smaller entities to exploit access to the then simplified tax system. Today, the aggregation rules continue to operate as integrity rules and apply to a wide range of measures across the tax law.

Rules originally designed for micro businesses not fit-for-purpose for large businesses

The operation of the aggregation rules is problematic, as they satisfy policy outcomes in some contexts but fail in others. The scaling of the same aggregation rules originally designed for micro businesses (i.e. those with an aggregated turnover of less than $2m) for much larger businesses has caused practical difficulties for businesses and their advisers.

The aggregation rules are not fit-for-purpose for larger businesses, as evidenced by the recent amendments to the expansion of the temporary FEDA measure beyond businesses with an aggregated turnover of less than $500m to those with an aggregated turnover of less than $5b. Following the original enactment of the measures in Subdiv 40BB of the IT(TP)A,[164] the measures were modified on 17 December 2020[165] to provide an alternative mechanism to the existing test for working out if the $5b threshold applies to qualify for the temporary full expensing concession. This was to overcome large companies operating in Australia with substantial foreign ownership (i.e. at least 40%) by multinationals failing the $5b aggregated turnover test due to the domestic turnovers of the Australian-based businesses being grouped with their shareholders' global turnovers.

---

161 Ibid.

162 Ibid, p. 14.

163 2019 Review, p. VII.

164 Contained in Sch 7 to the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020* which was enacted on 14 October 2020 as Act No. 92 of 2020.

165 Amended by Sch 1 to the *Treasury Laws Amendment (2020 Measures No. 6) Act 2020* which was enacted on 17 December 2020 as Act No. 141 of 2020.

Complexity in identifying affiliates and entities 'connected with' the taxpayer

The Board's 2019 Review noted several issues with the affiliate test. While the affiliate test is not often applied in practice, stakeholders reported to the Board that when the test is used, it is unclear. The uncertainty exists because the test involves concepts such as 'reasonably be expected to act' and 'in concert with', which, according to the Review, 'are difficult to apply in practice and lead to 'grey' positions being taken'.[166]

There have been few cases in which the courts have had cause to consider the operation of the affiliate rule. This has contributed to the lack of understanding as to how it should be applied.

As the 2015 survey highlighted earlier notes:[167]

> [One] of the main complexities in analysing the basic conditions arises from having to trace through a clients' structure to identify connected entities and associates.

Although the control test in s 328-125 is more easily calculable than the affiliate test in s 328-130, the control test is no less complex in its application. The following aspects of the control test present continual challenges for practitioners and their clients.

- The confusion which arises from the inconsistency between the significant individual test in s 152-70,[168] which, broadly, is based on holding or receiving at least 20% of income *or* capital entitlements in an entity, and the control test, which is based on holding or receiving at least 40% of income *and* capital entitlements.
- The complex operation of the four-year rule for beneficiaries of discretionary trusts in s 328-125(4), including:
  - the determination of the four-year period as it applies for different purposes (MNAV test and the aggregated turnover test versus the active asset test);
  - the dependency on the terms of trust deeds to characterise trust income and capital;
  - the inability, in many cases, to correctly identity beneficiaries who are connected with the trust due to inaccessible information (for example, a beneficiary who received at least 40% of the trust income or capital three years ago who is no longer in contact with the family but who remains connected with the trust for four years after the year in which that distribution was received); and
  - the difficulty in applying the four-year rule to groups comprising many layers of trusts and corporate beneficiaries.
- The inordinate time needing to be spent to determine whether an entity or individual is connected with an entity can be disproportionate to the benefit available under the concession.
- There is a high risk of erring when applying the control test, which can lead to taxpayers unwittingly thinking they are entitled to a concession when they are not.

---

166 2019 Review, p. 65 at para 5.86.

167 K Sadiq and S Marsden, "The small business CGT concessions: evidence from the perspective of the tax practitioner", (2015) 24(1) *Revenue Law Journal* 15. Note that the reference to 'connected entities and associates' here means entities connected with the taxpayer and affiliates of the taxpayer.

168 This provision explains how to calculate the direct *small business participation percentage* which primarily determines whether the significant individual test is satisfied.

Integrity measures are constricting the practical operation of, and access to, the concessions

The 40% control test and the affiliate rule are integrity measures which serve to ensure that larger groups do not inappropriately access the concessions.

The February 2018 amendments affecting CGT events that happen to shares in companies and interests in trusts were similarly designed to close a loophole that allowed high wealth individuals to inappropriately access the concessions. However, they were overengineered and greatly increased the complexity of the eligibility rules, making this a specialist area for advisers. The fact that the commencement of the amendments was delayed by nearly eight months reflected the chasm that existed between what was foreshadowed in the federal Budget 2017–18 announcement and the eventual form of the rules when the exposure draft legislation was released on 8 February 2018. They were poles apart and the Senate's insistence on a delay to the start date was appropriate.

Acknowledging that there is a role for integrity provisions in the law to ensure small business concessions are appropriately targeted and accessed, there are concerns across the profession that the complexity of the integrity rules are constricting the practical operation of, and access to, the concessions. The additional law created by the 2018 amendments is highly technical, and many SME practitioners have indicated that they will outsource work associated with applying the new integrity rules due to their complexity and the increased risk and exposure for their practices of inadvertent negligence. There is also a concern of potential consequential litigation from getting it wrong.

A balance must be struck between ensuring the law contains adequate integrity provisions and ensuring the law is workable, able to be understood and achieves the policy intent in the most efficient way. There is enormous scope for the small business CGT concessions to be simplified, streamlined and better targeted.

Difficulties associated with the active asset test

The difficulties taxpayers face in applying the concessions is exemplified in the recent Full Federal Court decision in *Eichmann.*[169] This case dealt with interpretational differences in what should have been a relatively straightforward set of circumstances.

Applying the active asset test to shares in companies and interests in trusts

The active asset test is particularly difficult to apply to shares in companies and interests in trusts. Section 152-40(3) sets out a modified test for these types of CGT assets. However, this test requires the taxpayer to determine whether, broadly, at least 80% of the assets in the company or trust are active for at least half the time the shares in the company or interests in the trust have been held. The test is complex to apply, prone to error and needs simplifying.

169 *Eichmann v FCT* [2020] FCAFC 155.

Design of law changes is causing anomalous outcomes

Much of the complexity of tax law affecting small businesses is derived from the way the law has been drafted. As new policies are legislated, layers upon layers of rules compound, which increases the complexity for taxpayers. Provisions that interrelate on a particular issue are commonly found in entirely different areas of legislation.

New full expensing of depreciating assets measures an example of clunky complex legal design

The temporary FEDA measure is a prime example of clunky legislative design. The original IAWO for SBEs was designed to help small businesses to write off assets and to encourage them to invest in capital assets. It was originally set at $1,000 for businesses with an aggregated turnover of less than $2m. The ability to fully expense a depreciating asset (albeit temporarily) now applies for businesses with an aggregated turnover of less than $5b with no cap on the cost of the asset, a far cry from the original legislative design.

The increases in the thresholds over the years are set out in Table 5.

Table 5. Instant asset write-off and full expensing of depreciating assets thresholds

Aggregated turnover threshold	Cap on cost of asset	Period of concession[170]
Less than $2m	Less than $1,000	1 July 2001 to before 7:30pm on 12 May 2015
Less than $2m/less than $10m[171]	Less than $20,000	From 7:30pm on 12 May 2015 to before 29 January 2019
Less than $10m	Less than $25,000	From 29 January 2019 to before 7:30pm on 2 April 2019
Less than $50m	Less than $30,000	From 7:30pm on 2 April 2019 to before 12 March 2020
Less than $500m	Less than $150,000	From 12 March 2020 to 31 December 2020[172]
Less than $5b	No cap	From 7:30pm on 6 October 2020 to 30 June 2022

The above measures are contained in, or interact with, the following legislative provisions:

- generally, Div 40 of the ITAA 1997;
- generally, Subdiv 328-D of the ITAA 1997;
- s 328-180 of the ITAA 1997 — IAWO for SBEs;
- s 328-180 of the IT(TP)A — temporary IAWO rules for SBEs;
- s 328-181 of the IT(TP)A — temporary full expensing of general small business pool rules for SBEs;

170 Detailed eligibility rules in respect of the date the asset was first acquired or held ready for use, and the date the asset was first used or installed ready for use, apply. These detailed rules are not reproduced here. The dates indicated in the table are broadly the dates of application of the measure.

171 The SBE aggregated turnover threshold increased from $2m to $10m on 1 July 2016.

172 The $150,000 was originally intended to end on 30 June 2020, but it was extended to 31 December 2020.

- s 328-210 of the ITAA 1997 — full expensing of general small business pool;
- s 40-82 of the ITAA 1997 — IAWO for medium-sized and large businesses, i.e. aggregated turnover of at least $10m to less than $500m;
- Subdiv 40-BA of the IT(TP)A — backing business investment measure (50% accelerated depreciation in the first year); and
- Subdiv 40-BB of the IT(TP)A — FEDA for businesses with an aggregated turnover of less than $5b.

With even a cursory glance at the above table and extensive list of interrelated legislative provisions — noting the spread of rules across multiple pieces of legislation and divisions of the law, together with different thresholds for different taxpayers at different times — it becomes evident that law design is a major contributing force to complexity.

The way in which the new temporary FEDA measure has been implemented, while a worthwhile and effective measure, has increased complexity for taxpayers. New Subdiv 40-BB of the IT(TP)A contains integrity rules, various exclusions and a clause that gives this new subdivision priority over all other legislative provisions with some exceptions.

Rather than implementing the FEDA measure in a different subdivision, drafters could have instead amended existing provisions, namely ss 328-180 and 40-82, to give effect to the new policy. Now, small business taxpayers and their tax advisers must consider how the existing rules interrelate with the new rules. All of this just to write off an asset, which is a timing difference only and has no permanent impact on the revenue.

To avoid these sorts of anomalous outcomes, legal drafters should consult with expert stakeholders (including the professional bodies) so that the law is drafted in a way that is easily understood and readily explainable to small business taxpayers and practitioners.

Concessions need to be tailored to the small business life cycle

The small business life cycle

In maximising the benefits obtainable by small businesses from tax concessions, the government should recognise that small businesses, rather than being monoliths, are incredibly varied and diverse, and primarily operate in 'life cycles'. This is a key recommendation in the Board's 2019 Review.[173]

Small businesses typically go through five stages of evolution: inception, survival, growth, expansion and maturity. The support a small business needs in the form of concessions will depend on its stage of evolution. As the Board's 2019 Review notes, small businesses in the inception stage seek cash and capital markets, while small businesses in the maturity stage are looking for succession.[174] Without a proper understanding of how small businesses evolve, concession measures cannot effectively meet their policy goals.

173 2019 Review, p. 36 at para 4.45.

174 Ibid.

Concessions should provide the benefit at the time it is needed

The Board's 2019 Review found that almost all of the concessions available to small businesses targeted those at the maturity stage of their evolution.[175] This makes sense in light of a goal of enabling small business taxpayers to retire with more money in their pocket.

However, in the age of start-ups and innovation, the government must focus not only on the retirement of small business taxpayers, but also on supporting newly formed businesses so that they can survive and flourish. This requires rethinking the approach to small business concessions to create a landscape that better accommodates inception-stage small businesses and supports them through the operational phase to retirement or exit.

Tax concessions should provide small businesses with the targeted benefit at the time that they need it the most. Accordingly:

- concessional measures should encourage entrepreneurial activity and support start-ups;
- cash flow assistance should be targeted during the phase of business operations — for example, retaining permanently temporary measures such as the IAWO/FEDA and loss carry-back (or adopting cash flow taxation as suggested above); and
- measures should support retirement and exit strategies — including the role of the existing superannuation lifetime CGT cap.

Some small business measures not widely adopted

Some small business tax concessions have not been widely adopted as they are perceived, or have proven, to be impractical or the eligibility requirements were too hard to satisfy.

These include the following measures.

- **Simplified trading stock rule** — most businesses undertake stocktakes for commercial reasons regardless of the rule in s 328-285 of the ITAA 1997 which allows SBEs to choose not to account for changes in their trading stock if the difference between their opening and closing stock is no more than $5,000. Of course, in order to qualify for this concession, the taxpayer is required to determine whether the movement in their trading stock is no more than $5,000, which is difficult to determine in the absence of conducting a physical stocktake or maintaining sophisticated stock records. This concession does not have the effect of reducing the compliance burden, which was the very thing the rules were designed to alleviate.
- **FBT record-keeping exemption**[176] — employers are allowed to not maintain FBT records if their aggregate fringe benefits amount does not exceed the exemption threshold. This has broadly been regarded as a useless concession as how does a business know whether they have exceeded the exemption threshold if they are not required to keep records? And small businesses must keep records to show that they fall below the threshold; in each case defeating the exemption completely.

175 Ibid, p. 37 at para 4.47.
176 S 135C of the FBTAA 1986.

- **Small business restructure roll-over**[177] — this beneficial measure allows an SBE to transfer active assets from one entity to another entity without triggering adverse tax outcomes in relation to CGT assets, depreciating assets and trading stock. However, the fundamental drawback with the SBRR, as highlighted by the Board's 2019 Review, is that the requirements for eligibility are 'too complex' for small businesses to use to with 'confidence'.[178] The issue primarily relates to the requirement that there be a genuine restructure (notwithstanding the existence of the safe harbour rule[179]) and no material change in the ultimate economic ownership.

Small business roll-over

The small business roll-over in Subdiv 152-E of the ITAA 1997 is problematic for a number of reasons.

- Its design adds considerable complexity, requiring the taxpayer to monitor the passage of time from the CGT event (i.e. two years) to determine whether CGT event J5 or J6 happens. Many taxpayers and their advisers regard this concession as simply a two-year deferral of the taxing point of the capital gain, as there is no requirement to establish intent to acquire a replacement active asset at the time of the original CGT event or when choosing to apply the roll-over.
- If a replacement active asset is acquired, there is no tracing or notification to the ATO of this fact, making it incredibly difficult to determine years later when the asset is sold or otherwise ceases to be an active asset to which CGT event J2 has happened. Unlike carried-forward tax losses and capital losses which are reported each year in the income tax return, there is no process other than relying on workpapers to flag that a replacement asset carries with it a deferred J2 capital gain.
- Where an individual who chooses to apply the small business roll-over, thereby deferring the taxable capital gain until at least two years after the CGT event, dies before the end of the replacement asset period, the deferred capital gain is disregarded. CGT event J5 or J6 cannot happen before the end of the replacement asset period so the deferred capital gain cannot be assessed to the deceased taxpayer, and there is no mechanism in the law to 'transfer' the deferred capital gain to the legal personal representative or a beneficiary of the taxpayer's deceased estate. The same outcome arises where the taxpayer dies after a replacement asset is acquired but before CGT event J2 happens.
- The rules relating to the acquisition of a replacement active asset:
    - that is a share in a company or an interest in a trust; or
    - by a company or the trustee of a trust,

  are complex, and not well understood by small business taxpayers and their advisers.
- The small business roll-over does not interact well with other CGT roll-overs, and is reportedly less relevant now that the SBRR may be available.

177 Subdiv 328-G of the ITAA 1997.

178 2019 Review, p. VIII.

179 S 328-435 of the ITAA 1997.

Employee share schemes[180]

Division 83A only addresses those shares or options issued to employees at a discount.[181] Accordingly, if, at the time of acquisition, the share or right was acquired at or even slightly above market value, the provisions do not apply. This is the case even in circumstances where employment conditions apply to the relevant instrument and they are later sold for a gain. By example, a $1 share issued to an employee for $0.99, with employment and sale restrictions, that is sold five years later for $3 is likely to be taxed on revenue account. Whereas that same share issued for $1 or $1.01, with those same employment and sale restrictions, that is sold at the same time is likely to be assessed on capital account and eligible for the CGT discount.

Division 83A's default position is that any discount on shares or options is assessable upfront as ordinary income, unless fact patterns otherwise result in the assessment being made at the deferred taxing point. The provisions achieve this through defining such terminologies as follows.

- **Shares or rights:** to be taxed on a deferred basis, the shares must be ordinary shares or rights to acquire ordinary shares. It is noted in the private client market that there is a greater flexibility over the type of share or right able to be issued and, therefore, a greater choice as to whether the employee will be assessed upfront or on a deferred basis. This can result in future gains being taxed on capital account and eligible for the CGT discount rather than on revenue account, even though the underlying share is at risk of forfeiture.
- **Discount provided:** the provisions apply only to shares or rights issued at a discount to market value. Accordingly, where the market value can be ascertained, there is no real risk of forfeiture, and a loan is issued for the acquisition of the shares or rights, the provisions have no practical implications. This remains the case where underlying put/call options set pre-determined sale prices should the employee leave within a prescribed period.
- **Real risk of forfeiture:** not only must there be a risk of forfeiture, but such a risk must be 'real'. The use of the term 'real' in these provisions creates unnecessary ambiguity, particularly where the concerns this seeks to address are somewhat limited.

Other issues also exist with regard to start-up entities. Employee share and option schemes are a valuable tool for cash-strapped and start-up entities to facilitate the attraction and retention of high-quality staff with the skills and knowledge to help grow those businesses. The current concession for start-up entities — whereby the discount included in the employee's hands is reduced to nil, however, any gains arising on ultimate disposal will be assessed on capital account — provides eligibility criteria which are very limited and too prescriptive.

---

180 In the 2021–22 federal Budget, the government announced that it is proposing to remove the cessation of employment taxing point for tax deferred ESSs which will result in tax being deferred until the earliest of the remaining taxing points: in the case of shares, when there is no risk of forfeiture and no restrictions on disposal; in the case of options, when the employee exercises the option and there is no risk of forfeiting the resulting share and no restrictions on disposal; the maximum period of deferral of 15 years. The change to the cessation of employment taxing point will apply to ESS interests issued on or after 1 July following royal assent. These proposed changes do not address most of the issues raised in this section.

181 S 83A-20 of the ITAA 1997.

To be eligible for the start-up concession, the following conditions must be met (among others):

- the company is a start-up company[182] (i.e. it cannot be listed or a subsidiary of a listed entity, it must be incorporated for less than 10 years, and its aggregated turnover must not exceed $50m);
- if the interest is a share, any discount must be no more than 15% of the market value of the instrument when provided; and
- if the interest is a right, any amount that must be paid to exercise the right must be greater than or equal to the market value of an ordinary share in the company at the time of provision of the right.

These provisions are unnecessarily restrictive and overly burdensome from an evidentiary perspective to facilitate start-up entities attracting and retaining appropriate talent and skills.

Options

Streamline eligibility thresholds across measures

Affirming the Board's recommendations made in the 2019 Review, The Tax Institute is of the view that the eligibility thresholds should be streamlined across various concessions to address the complexity and simplify the small business tax system.

This is one of the most significant tax challenges facing the small business sector, and large-scale reform involving consultations with a broad group of stakeholders could potentially transform the system. Streamlining the eligibility thresholds across most, if not all, of the concessions would have a positive impact by:

- reducing compliance costs for small business taxpayers;
- increasing cash in the pockets of small business taxpayers for capital reinvestment and retirement;
- lessening the burden on tax advisers navigating very complex and tangled rules;
- quickening the pace at which small business tax concessions could be accessed thereby increasing economic activity; and
- creating a business-friendly environment which encourages entrepreneurial and start-up activity.

Alignment of turnover thresholds

Subject to the discussion on repealing the SBITO below, the current aggregated turnover threshold of $5m is unnecessary given the $1,000 cap on the amount of the offset. The aggregated turnover threshold for the SBITO should be aligned with the other concessions, that is, increased to $10m.

Alternatively, the aggregated turnover threshold which applies solely for the purpose of the small business CGT concessions in Div 152 of the ITAA 1997 should be increased to $5m to align with

182 S 83A-33 of the ITAA 1997.

the SBITO turnover threshold. These are just two examples of the unnecessary inconsistency across the small business thresholds.

There may be some efficiency in moving to a universal $10m aggregated turnover threshold for small business, but it could also be more effective to align the threshold more broadly with the $50m turnover threshold under the *Corporations Act 2001* (Cth). This reform is supported by the $50m aggregated turnover threshold which applies for the purpose of the corporate tax rate (base rate entity rules) and the recent amendments which increased the threshold from $10m to $50m for ten small business concessions.[183]

Alternative small business tests

Instead of relying solely on a turnover test for tax purposes (with the exception of the $6m MNAV test), the meaning of 'small business' could be universally determined by reference to satisfying one of three tests:

- aggregated turnover for the income year;
- net assets at a testing point; or
- the number of employees at a testing point.

Alternatively, eligibility could be based primarily on aggregated turnover, with a secondary test using net assets for those who do not satisfy the turnover test.

Applying a turnover test is problematic for high-turnover low-margin businesses that struggle to meet the turnover test. Section 328-120(3) of the ITAA 1997 acknowledges this, but only for businesses that derive their ordinary income from sales of retail fuel. There are many other types of high-turnover and low-margin businesses that are otherwise owned and operated as a small business but which fail the relevant turnover test. This approach needs a rethink. For example, an adjusted turnover based on set commercial margins for industry sectors could be more appropriate.

Consideration should also be given to the imposition of a lifetime cap on certain small business concessions (see "Rationalise small business CGT concessions" below), in which case, an asset threshold may be an unnecessary integrity measure for asset-rich low-turnover activities such as farming.

Reduce complexity of grouping rules

Most of the complexity in determining an entity's aggregated turnover arises from the grouping rules in s 328-125 (about entities connected with the entity) and s 328-130 (about affiliates of the entity). Unless the grouping issues identified above are addressed, there will be no substantial improvement in this area of the law for SBEs.

A sensible reform could involve identifying a family or business group on a basis more akin to the 'family group' as defined in the trust loss provisions in Sch 2F to the ITAA 1936, or a consolidatable group with some special rules for non-fixed trusts. A grouping equivalent to a family

183 The amendments were made by the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020*, which received royal assent on 14 October 2020 as Act No. 92 of 2020.

group or a consolidatable group instead of using the 'connected with' and 'affiliate' rules would provide greater consistency across the tax law and facilitate the transfer:

- and/or utilisation of intragroup losses;
- of intragroup profits by way of income distributions; and
- of CGT assets, depreciating assets and trading stock as part of a business restructure.

Consistent indexation of all thresholds

The small business tax system could be further streamlined if consistent indexation of threshold were applied for all purposes. Thresholds such as the car limit, various superannuation caps, the MRE improvement threshold and the rates for the car expenses cents per kilometre method are indexed annually. However, the indexation method applied to these limits is not consistent across the measures, and most of the small business thresholds are not indexed at all. The CGT retirement exemption limit of $500,000 has not increased since its introduction on 21 September 1999, even though it forms part of the lifetime CGT cap amount which is indexed annually.

'Soften' the hard thresholds

As the law currently stands, all of the aggregated turnover threshold tests to access any of the small business concessions are 'hard' thresholds. This means that if the taxpayer is even $1 over the threshold, they are not eligible for the small business concession.

In The Tax Institute's view, this is an unfair consequence of setting hard lines. While it may be simpler for the ATO to enforce 'hard' thresholds, the system would be more equitable if the thresholds were 'softened' into a tiered system (no more than two or three tiers) whereby a taxpayer who is slightly above the threshold could still access a small concession but at a decreased rate.

Softening the thresholds through tiering would also dissuade taxpayers and their advisers from creating complicated business structures to maximise potential access to the concessions, or engaging in behaviour that is primarily designed to gain access to the concessions. This would resulted in reduced compliance costs and increased satisfaction with a more equitable tax system.

Remove the small business income tax offset

Following the discussion in Chapter 3 on the taxation of SMEs, if the tax treatment of business income were impartial to the entity type, then the SBITO could be repealed as there would be no need to separately target through a tax offset the two-thirds of small businesses that operate outside a corporate structure.

Allow a tax-free period for start-ups

The Board's 2019 Review highlighted that in their inception stage, small businesses do not have access to sufficient concessions that adequately support them through this crucial phase of development. A significant reform would be the introduction of tax-free period for start-up businesses.

Allowing a tax-free period for start-ups for the first two to three years would get these taxpayers into the tax system. It would apply for income tax purposes only, not GST nor PAYG withholding, and would overcome the perennial problem of PAYG instalments compounding[184] in the second year of operation. A threshold could be set, above which the tax-free concession is not available (for example, based on turnover, profit or assets).

Not only would a tax-free period for start-ups provide small businesses in their earliest stages with much needed financial relief, but it would also signal to the global community that Australia is a place that takes start-up innovations and businesses seriously. By aligning the tax law and reducing red tape with the growing culture of risk-taking entrepreneurship, Australia has the potential to create a highly dynamic and thriving start-up environment.

Allow permanent full expensing of depreciating assets and prepayments

It has been a feature since the introduction of the former simplified tax system in 2001 for small businesses to be able to fully expense depreciating assets they acquire. Table 5 sets out the thresholds that have increased since 2015. The FEDA measure applies until 30 June 2022 for business with an aggregated turnover of less than $5b.

The changing rules create complexity and require small businesses to incur unnecessary compliance costs to determine whether a depreciating asset can be fully written off in the year in which it is acquired. It is unnecessary because the impact on government revenue is a timing difference due to the ability to depreciate the asset over its effective life or via a general small business pool.

Similarly, there are complexities associated with the treatment of prepayments. While SBEs can fully expense a prepayment[185] in certain cases, businesses with an aggregated turnover of $10m or more are required to allocate the deduction for the prepayment over its eligible service period.

Permanently allowing full expensing of depreciating assets and prepayments for businesses with an aggregated turnover of less than $50m would align the tax treatment with the outlay of funds, reduce complexity and remove the need for SBEs to maintain a general small business pool under Subdiv 328-D of the ITAA 1997. A suitable cap should apply to depreciating assets that are fully expensed.

Rationalise CGT roll-overs for small business

The law relating to CGT roll-overs for small business should be streamlined to reduce the complexity in meeting the conditions and make them easier to apply.

184 This arises because the payment of PAYG instalments is not triggered until an income tax return is lodged. The income tax payable on the income from the first year of operation is payable on lodgment of the income tax return in addition to PAYG instalments which also become payable for the first time. Essentially, two years' worth of taxes are payable within a 12-month period.

185 Ss 82KZMA(2) and 82KZMD of the ITAA 1936.

Currently, small businesses have a range of CGT roll-overs when restructuring or acquiring a replacement asset:

- roll-over for disposal of assets to a wholly owned company;[186]
- small business roll-over;[187]
- small business restructure roll-over;[188] and
- roll-overs for business restructures.[189]

The objective of a business roll-over is to remove restructuring impediments and reduce complexity. The existing roll-overs listed above, to the extent that they relate to small businesses, should be rationalised into a new single small business CGT roll-over which would allow an entity with an aggregated turnover of less than $50m to roll a taxable capital gain, balancing adjustment amount or other assessable amount from the disposal of active CGT assets, depreciating assets and trading stock into a replacement business/active asset.

The new single CGT roll-over for small businesses would operate as an alternative to the *lifetime business retirement cap* discussed below.

Repeal impractical small business measures

The following small business tax concessions which have not been widely adopted as they are perceived, or have proven, to be impractical should be repealed:

- **the simplified trading stock rule** — most businesses undertake stocktakes for commercial reasons regardless of the rule in s 328-285 of the ITAA 1997, and anecdotally, there is little evidence of its widespread use; and
- **the FBT record-keeping exemption**[190] — similarly, there is little evidence that employers value this concession or find it useful.

The SBRR[191] should be incorporated into a single small business roll-over (discussed below) that simplifies the eligibility requirements.

Rationalise small business CGT concessions

As discussed above, the small business CGT concessions[192] are among the most complicated and least understood provisions affecting small businesses. The constant changes over the years and the intricacy of the integrity measures are an impediment to effortlessly exiting a business by way of sale or retirement. This complexity is inconsistent with the policy intent that concessions be available to small businesses in recognition of their investment in their businesses over the years rather than in the superannuation system.

186 Div 122 of the ITAA 1997, and noting that this roll-over is not limited to small business.

187 Subdiv 152-E of the ITAA 1997.

188 Subdiv 328-G of the ITAA 1997.

189 Div 615 of the ITAA 1997.

190 S 135C of the FBTAA 1986.

191 Subdiv 328-G of the ITAA 1997.

192 Div 152 of the ITAA 1997.

The design of the concessions needs a rethink when it comes to retirement and stakeholders exiting the business, bearing in mind that the purpose of operating a business for most is to build up wealth for retirement.

Goodwill is often the most valuable CGT asset held by a small business. Even prior to the 1999 CGT reforms, goodwill was recognised in the tax law as a valuable asset by exempting all or part of the capital gain from the disposal of goodwill.[193] When the CGT regime was reformed in 1997 and again in 1999, goodwill was subsumed into the definition of a 'CGT asset' to which the concessions apply more broadly.[194]

The four existing small business CGT concessions[195] could be consolidated into a single concession, allowing eligible businesses to disregard the capital gain, balancing adjustment or profit on the disposal of business/active assets up to a prescribed cap. The new concession would be agnostic across business assets, that is, it could apply to goodwill, business real property, plant and equipment, IP and trading stock.

The amount disregarded would be subject to a lifetime cap, reported and tracked through income tax returns in a manner similar to carry-forward losses and identified on the ATO's online services so that taxpayers would be able to determine how much of their lifetime cap has been utilised.

A new '*lifetime business retirement cap'* of, say, $1.7m[196] per stakeholder could apply, unless the government determines that a higher lifetime cap should apply. The current small business CGT concessions theoretically permit up to $6m to be realised tax-free (originally $5m until 1 July 2007), in the circumstance that this wholly comprises internally generated goodwill that has no cost base. The introduction of the $2m aggregated turnover test as an alternative test from 1 July 2007 has permitted greater amounts to be realised tax-free for asset-rich low-turnover businesses. Effectively, the amendments in 2007 uncapped the $6m tax-free limit. Hence, consideration should be given to the setting of an appropriate tax-free limit.

This cap should be indexed annually and would not be subject to the non-concessional contributions cap. The process for contributing the amount to superannuation should be simplified.[197] The funds should be transferred into a regulated superannuation environment except where the stakeholder is older than the age pension age (rather than the current age of 55 which applies for the purpose of the retirement exemption[198] and is inconsistent with other age limits).

Consideration should be given to how the funds are treated in or upon withdrawal from the superannuation environment, but this is a separate matter relating to a sustainable design of the superannuation system.

Introducing a single lifetime business retirement cap to replace the current $500,000 CGT retirement exemption limit and the CGT cap amount would eliminate many of the special rules.

193 Former s 160ZZR of the ITAA 1936 (no longer in force).

194 S 108-5(2)(b) of the ITAA 1997.

195 Div 152 of the ITAA 1997.

196 Consistent with the recently indexed TBC.

197 The current interaction between the small business CGT concessions and s 292-100 of the ITAA 1997 is awkward and needs a rethink.

198 Subdiv 152-D of the ITAA 1997.

Simplify the process for making choices and elections

Taxpayers must evidence the choices they make when applying the tax law. In most cases, a choice made by a taxpayer must be made by the day on which they lodge their income tax return for the year in which the transaction or event occurred, or within a further time allowed by the Commissioner.[199] The way in which the tax return is prepared is usually sufficient evidence of the making of the choice.

However, in some cases, the taxpayer is required to make a written choice, which may or may not be required to be provided to the ATO (depending on the measure). Examples include choosing to apply the retirement exemption and the small business restructure roll-over, and making a family trust election or interposed entity election.

The process for small businesses making choices and elections should prioritise equity, efficiency and common sense over strict legal form. This issue was highlighted in *Davies and FCT*[200] where the AAT decided that:

> … signed elections to apply the small business retirement exemption provisions of [S]ubdivision 152-D of the *Income Tax Assessment Act 1997* (the Act) to the capital gains from the sale of the land … was done in their personal capacities as there is no indication that the elections were signed in any other capacity.

The requirements in the tax law can be very complex and confound even the most seasoned of tax practitioners. The government should strive to simplify the manner in which choices and elections are made, but the law should also allow the intent of the taxpayers to be taken into account when determining eligibility for concessions in cases where the manner in which the choice or election is made may not otherwise fully accord with the strict legal form of the provisions.

Assisting SMEs to build their digital/technological capability

In a modern, digital economy, technological and digital capabilities are essential for the survival and growth of small businesses. Research has demonstrated that digital tools have saved small businesses an average of 10 hours a week of work and boosted revenue by 27%, equating to an additional $385b per year in revenue.[201]

The federal government announced a Small Business Digital Taskforce in 2017 and has accepted the Taskforce's recommendations entirely or in principle.[202] The Empowering Business to Go Digital program has emerged from the Taskforce to specifically deal with the digital needs of small businesses. The objective of the program is to establish an NGO, or leverage an existing NGO, to increase small business awareness and adoption of digital technology, in line with the recommendations of the Small Business Digital Taskforce report.

The next step is to increase funding or to create new programs to assist small businesses in increasing or establishing digital capability so that they are adequately equipped to deal with the

199 S 103-25 of the ITAA 1997.

200 [2009] AATA 297.

201 *Small Business Digital Taskforce – report to the government*, Department of Industry, Innovation and Science, Australian Government, Canberra, 2018.

202 See *Government response to the Small Business Digital Taskforce*, Australian Government, Canberra, 2018.

ever-increasing digitalisation of the Australian economy. Enabling small businesses to digitalise will allow them to recover and reinvent themselves following the COVID-19 pandemic. Ultimately, a strong small business digital infrastructure will create a business environment that is dynamic, competitive and growth-oriented, all of which are good for small businesses and for the Australian economy as a whole.

Redesign the employee share scheme provisions

In reviewing and considering the options available to reform the employee share scheme provisions, simplicity is paramount.

Firstly, the underlying policy intent is that the receipt of shares or options in relation to employment is ordinary income, and any well-designed tax system should align as best as possible the receipt of cash to the assessment of the income, most particularly for individuals not in business. Accordingly, consideration should be given to ensuring that all shares or rights be taxed as ordinary income at the deferred taxing point.

If this is accepted as the most appropriate policy, there will be a natural management of share plans in listed companies as shareholders will be less inclined to support boards granting excessive share remuneration. Further, private groups would not be incentivised to excessively utilise employee share schemes as the ability to utilise the capital treatment under such schemes will be significantly reduced.

In considering such a change, there should be a more considered design of the employment nexus. The risk of forfeiture may be one factor relevant to determining this; however, an employment nexus is a broader concept than this and should be appropriately addressed. Where this is appropriately defined, the concept of deferred taxation could then apply for all shares and rights, whether they are ordinary shares or rights to acquire such shares, and whether or not they have been acquired at a discount. This would significantly simplify the provisions, reduce the ease by which they can be manipulated and likely reduce the incidence of burdensome valuation requirements.

Entry into ‘upfront’ taxation could be designed to cover those instances where there are policy reasons for allowing concessions for future gains to be treated on capital account, for example, start-up entities.

A review of the concessions for start-up entities should also be undertaken to ensure that this is more readily accessible by these entities needing to attract and retain talent without being overly restrictive in what can otherwise be provided to attract such talent.

Options for reform

- Streamline the aggregated turnover thresholds by initially (i.e. in the short term) increasing the SBITO turnover threshold from $5m to $10m, and aligning the aggregated turnover thresholds.
- Consider alternative small business tests.
- Reduce complexity of grouping rules by identifying a family or business group on the basis of the 'family group' (per Sch 2F to the ITAA 1936), or a consolidatable group with some special rules for non-fixed trusts.
- Apply consistent indexation of all small business eligibility thresholds.
- Introduce tapering of eligibility thresholds (for example, above the $6m MNAV test threshold) instead of a hard threshold — this could step down in two to three tiers.
- Remove the SBITO (subject to reforms of the taxation of SMEs).
- Allow a two- to three-year tax-free period for start-ups.
- Allow permanent full expensing of depreciating assets and prepayments.
- Repeal the simplified trading stock rules and the FBT record-keeping exemption as practically, they are of little use to small businesses.
- Rationalise CGT roll-overs into a single small business roll-over.
- Consolidate the four existing small business CGT concessions into a single concession, with an indexed lifetime business retirement cap.
- Simplify the process for making choices and elections.
- Redesign the ESS provisions.

5. Charities and not-for-profits

Overview

The charities and NFP sector in Australia is large, diverse and provides many services to the community. There is a broad range of federal and state tax concessions currently afforded to various types of NFPs. The principle of concessional tax treatment for NFP entities is widely supported by the general public, policymakers and commentators. Concessions for NFPs underpin good tax policy. Income tax exemption specifically was supported in both the Henry review[203] and the Productivity Commission Report.[204] It is clear that 'charitable giving is the lifeblood of civil society'[205] and that such organisations 'make a highly valued contribution to community wellbeing'.[206] Supporting NFPs through tax concessions helps to sustain the sector, and facilitates the NFP entities in successfully undertaking their philanthropic activities, which ultimately should benefit the broader community.[207]

But this is not the only justification for tax concessions for charities and NFPs. Entities pursuing charitable purposes have been exempt from taxation since the first income tax legislation was introduced in England. One reason for this, that must not be overlooked in formulating tax policy, is that charities have only purposes, and are legally prohibited from distributing surpluses for private gain – any surplus must be applied to furthering the charity's purpose. The Australian income tax law rests on a basis that the primary aim is to tax profits and gains made by individuals. If individuals are the appropriate unit upon which to impose income taxes, then there is simply no appropriate individual, in a charity, who has income to tax.

Similarly, where income and profits generated are simply applied to further an entity's a charitable purpose, it can be difficult to identify any amount that should be properly subject to tax. Where a charity performs work which would otherwise need to be performed by or funded by government, adding a tax or compliance burden can also result in increased costs to government.

There have been a number of inquiries and reviews into the NFP sector, which have considered the size, scale and breadth of the sector's contribution to different aspects of society, including, importantly, its significant presence as an employer in Australia.[208] This chapter considers challenges faced by NFP entities in tax treatment and administration at the state and federal levels.

The complexity of the regulatory environment in which NFPs operate is disproportionately high when factored against the risk and need for regulation. Further, there is a willingness and desire to comply within the sector that is difficult to achieve given the complex over-regulation. The NFP sector relies heavily on goodwill, volunteers and the pro-bono contributions of professional

203 Henry review, p. 88.

204 Productivity Commission, *Contribution of the Not-for-Profit Sector: Research Report* (2010).

205 J Malone and R Young, "The responsibility of charity: what constitutes a charity for income tax purposes?", The Tax Institute 6 (Malone, Charities), 26 February 2015, p. 1.

206 Henry review, Part two, p. 205.

207 Henry review, p. 206. See also Malone, Charities, p. 4.

208 See, for example, *Contribution of the not-for-profit sector*, Productivity Commission research report, January 2010; ACNC, *Australian charities report*, September 2014; and, more recently, *Strengthening for purpose: Australian charities and not-for-profits commission – legislation review 2018*, report and recommendations, May 2018.

services. The overarching objective of the reforms recommended in the context of the NFP sector is a reduction in the administrative burden. Simplification of the taxation environment for NFPs is critical to support such organisations to fulfil their objectives without undue administrative complexity.

Harmonisation of cross-jurisdictional administration of charities and not-for-profits

One significant factor which exacerbates compliance costs in the NFP sector is the multiplicity of regulation at the different levels of government. Charities and other NFPs are subject to a large number of different reporting thresholds with multiple regulatory bodies, dependent on their precise legal structure and geographical areas of operation.[209] For a charity that is incorporated and operating in all States and Territories, depending on its particular activities (for example, fundraising), the organisation could be required to deal with over 20 different government departments and agencies. This does not take into account additional agencies involved in respect of local government concessions.

The lack of consistency leads to unnecessary complexity and a heightened risk of organisations inadvertently failing to meet their reporting obligations. It also results in an increased compliance burden which diverts funds from the community focus of the organisations in question. This complexity is exacerbated by a lack of clarity amongst NFPs as to a precise definition of revenue or turnover in an NFP context with receipts from donors and government grants being treated differently depending on the reporting purposes.

These issue have been recognised in several reviews of the NFP regulatory framework, which has been characterised as unnecessarily complex, inconsistent and opaque.[210] Great strides were made with the introduction of the ACNC and the codification of the definition of 'charity' through the *Charities Act 2013* (Cth), though a lack of harmonisation of definitions and regulations across the state and federal levels continues (see discussion below).

To reduce this administrative burden that NFP entities (particularly charities) face in this regard, The Tax Institute recommends the standardisation and harmonisation of the state and federal administration of NFPs. This should involve harmonisation of the definition of 'charity', and consistency in the eligibility criteria for endorsement, registration and exemptions.

A common definition of 'charity'

The most pressing issue for the NFP sector is the burden caused by the lack of harmonisation between state and federal requirements for tax concessions. An entity registered as a charity by the ACNC, endorsed as income tax exempt and entitled to GST concessions and an FBT rebate, may nevertheless fail to meet the definition of 'charity' as applied by the various state revenue offices. For example, Western Australia's charitable exemption from duties ostensibly restricts the eligibility of certain fourth limb charities to 'industrial associations' and 'professional associations'.[211] Particularly since the *Charities Act 2013* was not intended to depart from the common law definition of 'charity', this inconsistency is unnecessary and unworkable.

209 Treasury, *Increasing financial reporting thresholds for ACNC-registered charities*, consultation paper, February 2021. Available at treasury.gov.au/sites/default/files/2021-02/c2021-141336.pdf.

210 Henry review, pp. 207-208.

211 Ss 95 and 96A-C of the *Duties Act 2008* (WA).

Charities which are registered with the ACNC should be deemed to be eligible for the state concessions in all jurisdictions. Serious consideration should be given to addressing this inconsistency and creating uniformity. Harmonisation in this regard would alleviate the need for NFPs to obtain advice pertaining to their eligibility on a state-by-state basis. This has the additional benefit of freeing up professional service providers to instead provide pro bono services on meaningful work undertaken by the NFPs and to better support those organisations in other ways. It would eliminate the administrative burden of applications to, and verifications by, state revenue offices. The flow-on effect is that NFPs would be able to operate more freely across Australia. This is ultimately beneficial to the wider community and the particular sectors in need to which NFPs provide support and charitable services.

Reforming the deductible gift recipient regime based on a clear policy intent

DGRs are organisations which can receive donations that are tax deductible to the donor. DGR endorsement is determined by the ATO. A charity may be wholly or partly DGR endorsed depending broadly on the extent to which it falls within a DGR category. With recent legislative changes, specifically listed entities are able to qualify as DGRs even if they are not registered charities.

Australia's DGR framework remains antiquated, unnecessarily complex and unwieldy. Reforms to the DGR framework were announced in 2017, but as yet, the only legislated reform has been the requirement for all DGRs (other than specifically listed entities) to be registered as charities with the ACNC. This reform suggests that the policy behind DGR endorsement, rather than being to facilitate the movement of private funds to the charitable sector, is instead the same as the policy behind charity endorsement, being broadly to provide concessions where there is public benefit and social contribution.

If this is the case, it follows that the DGR framework should be reformed in light of that policy. The bold but logical conclusion would be that all charities should automatically be eligible for DGR endorsement. Noting the existing condition for an organisation to be registered as a charity (as distinct from an NFP organisation which may not necessarily be a charity), if the issue is that charities with particular purposes or objectives should not be able to obtain DGR status, then it is submitted that this is actually a question of the meaning of a charity.

Short of such a solution, the proposed reforms of removing the registers and public fund requirements should be progressed with priority. In addition, in an era of informed donors seeking specific impact for their donation, consideration should be given to modernising and clarifying the gift rules. This would have the added benefit of generally streamlining the cumbersome DGR framework.

Facilitating the growth and development of social projects and programs

Social impact bonds

Across the NFP sector, there is the continual challenge of fund raising for projects and philanthropic initiatives. Increased access to funding that is linked to accountability for the outcomes delivered would stimulate projects that deliver efficient and effective community benefits. These kinds of opportunities exist and are leveraged in other jurisdictions. For example, SIBs are used in foreign jurisdictions, such as the UK, and smaller scale examples do exist at the state level in Australia, though are, as yet, far less common.[212] Federal support allowing for tax

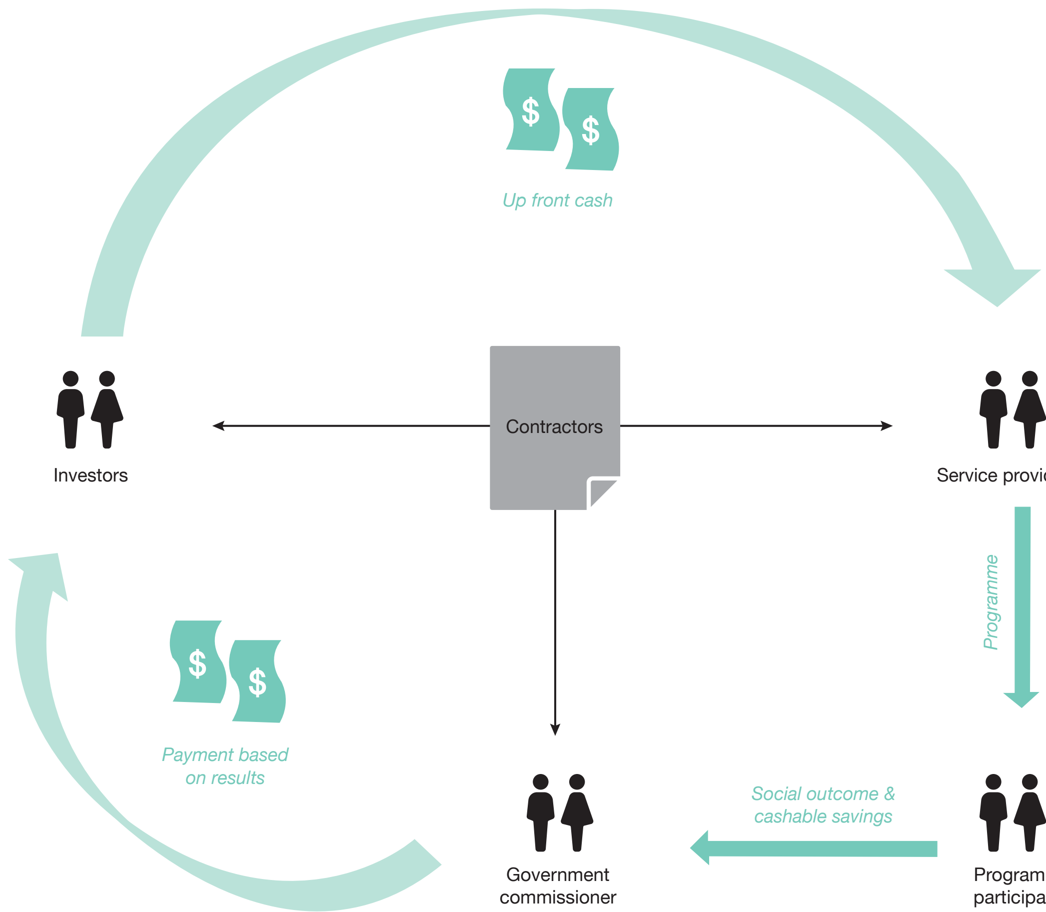
212 See UK: www.gov.uk/guidance/social-impact-bonds, and Australia: www.socialventures.com.au.

concessions for investors has the potential to deliver profound, efficient and effective community benefits. Consideration should be given to the policy design of a federal social impact regime to encourage access to funding and the delivery of outcomes in this sector.

The reference to bonds is a misnomer as SIBs are distinct from bonds in the ordinary sense. SIBs bring together the public, private and voluntary sectors to address social inequities such as homelessness, youth unemployment, matters of public health and education. An SIB is essentially a mechanism which assists an organisation to deliver particular outcomes and makes funding conditional on the achievement of particular results or targets.

While there are a number of ways in which an SIB may operate, a basic example is set out in Figure 3. Social investors seeking both social and financial returns provide upfront capital to charities or other social enterprises to fund the projects undertaken through an SIB. The charity or social enterprise will be tasked with delivering a particular service or objective which improves the social outcomes for a particular sector of society (for example, the alleviation of homelessness). The SIB agreement will outline measurable outcomes (for example, establishment of a particular number of shelters, or registration of a certain number of homeless or at-risk persons in the program). Such outcomes are usually established by the commissioner of the SIB, which is generally a local government authority. Where the outcomes are achieved, the social investors receive a return on their investment.

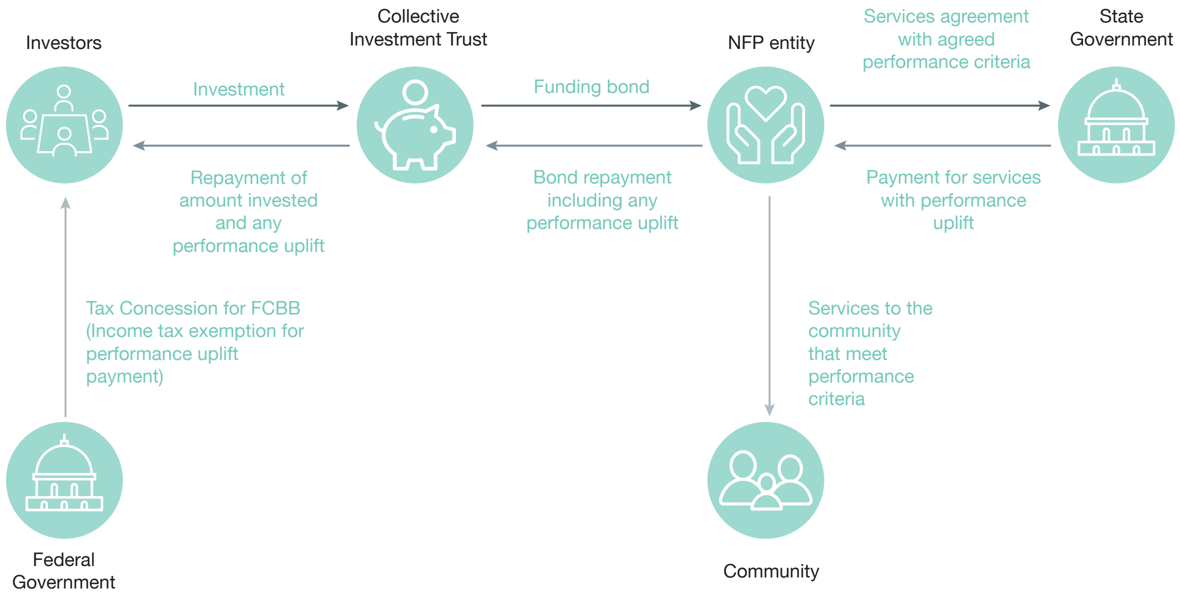
Figure 3. A social impact bond



Source: HMRC, *A guide to social impact bonds.* Available at www.gov.uk/guidance/social-impact-bonds.

Under one model for tax concessions for SIB's, investors might be entitled to an upfront deduction for the amount invested in an SIB and taxed at standard rates on any returns that are ultimately derived. An alternative model could be to allow investors to forego an upfront deduction in favour of future tax concessions on income only once the pre-determined and measurable benefits to the community have been achieved (a federal community benefit bond).[213] There are two key ways in which a tax concession could be applied to support such a scheme. An exemption could apply to treat any income returned from a taxpayer's investment in a federal community benefit bond as tax exempt. Alternatively, a tax offset could apply with a similar operation to the former infrastructure bonds tax offset and carry a flat tax credit/offset.

Figure 4. Illustration of a federal community benefit bond scheme



Source: PwC submission in response to the *Re:think tax discussion paper*, 1 June 2015.

Options for reform

- Harmonise definitions and regulations used across the States and Territories with those used at the federal level to reduce administrative complexity and compliance costs.
- Provide all registered charities and NFPs with DGR endorsement.
- Introduce concessional treatment for social ventures to provide greater support to NFPs to achieve social outcomes.

Disclaimer

The views, opinions, ideas and potential options for reform do not represent the views of any individual member of The Tax Institute or ATRF. This paper should be read and considered in its entirety. To consider any single measure or option for reform in isolation is contrary to the spirit and fundamental objective of this discussion paper

213 PwC submission in response to the *Re:think tax discussion paper*, 1 June 2015.

6. Employment taxes

Overview

Potential for a better workforce and stronger economy

The COVID-19 pandemic has put accelerated pressure on the evolution of the standard work environment and created immense economic pressure. There is no copybook for what future work will be like and previous upheavals from last century won't necessarily provide any indication. Accordingly, we must think and act flexibly.

This section of the *Case for Change* discusses aspects of the Australian tax system that are in urgent need of tax reform to support a more optimal workforce for the current and future economy, and more broadly, for the benefit of society.

Throughout our various discussions and engagement with hundreds of tax experts and other stakeholders, the following priority issues of the workforce and labour market have come to the fore:

- concerns about inefficiency, lack of fairness and inequality in the present system due to the multiple taxing regimes imposed on all those who deal with the labour market, including PAYG withholding, SG, FBT and payroll tax;
- the rapidly changing nature of employment and the labour market and the emergence of new work relationships from the sharing or 'gig' economy (herein, the gig economy) and concerns of the appropriate tax treatment;
- the decline in the rate of economic growth due to demographic changes in our society including an ageing population, the impact of COVID-19 etc; and
- Australia's lagging performance as indicated by average tax wedge statistics (i.e. a measure of the difference between labour costs to the employer versus take home income of the employee) and lack of labour market dynamism (for example, differences in the tax treatment of non-standard workers relative to standard employees) in comparison with other OECD countries.[214]

We address these issues in detail below and explore potential options for consideration.

6.1 Fringe benefits tax

FBT is payable by employers on the 'taxable value' of fringe benefits provided to employees and their associates (for example, family members). The tax is payable on the 'grossed-up' value of the benefit. The 'grossed-up' value is tax-inclusive as it takes account of the FBT rate and also of the employer's ability to claim GST credits on its acquisitions. The FBT rate is imposed at the highest marginal tax rate plus Medicare levy (currently 47% for the year ending 31 March 2021).

---

214 OECD, *Taxing wages 2020,* OECD Publishing, 2020, p. 16. Available at www.oecd-ilibrary.org/taxation/taxing-wages/volume-/issue-_047072cd-en. See also OECD, *Taxing wages 2021*, OECD Publishing, April 2021. Available at www.oecd.org/tax/taxing-wages-20725124.htm.

Fringe benefits tax as a revenue source

The FBT legislation was enacted in 1986 as an integrity measure to ensure that all forms of remuneration paid to employees were subject to appropriate taxation[215] and to overcome the perceived deficiencies of both the scope and administration of s 26(e) of the ITAA 1936. The underlying policy intent being to protect the income tax revenue base and to assess and collect tax from recipients of fringe benefits more efficiently.[216] This section sought to tax, in the hands of the employee, the value to the employee of non-cash benefits received as a result of their employment. The fundamental differences between s 26(e) and the FBT legislation is that (i) employers are taxed (ii) in respect of an objective, grossed-up value of the benefits provided to employees (iii) at the highest marginal tax rate. However, perhaps the most complicating part of the FBT is that the net is cast so widely, many things that are not considered 'benefits' in normal business or commercial terms are prima facie caught by the FBT legislation.

FBT creates a disproportionate compliance burden in comparison to the tax revenue generated. Based on our members' experience, a significant amount of work is required to administer a wide range of benefits where a majority of revenue comes from only a few benefits (e.g. car fringe benefits).

Statistics show the following:

- in 2017–18, FBT made up 0.9% of tax while individual income tax and company tax made up 51.3% and 20.9%, respectively;[217]
- in 2018–19, the net FBT was approximately $3.82b.[218] ATO statistics further show that FBT forms take over 11 hours on average to complete, compared to less than half an hour on average for a BAS or one-and-a-half hours on average for a superannuation return;[219] and
- FBT has lower levels of compliance compared to other taxes with ATO statistics showing that FBT has the highest tax gap in comparison to other taxes ($1.06b and 21.2% net gap for the 2017–18 financial year).[220]

Furthermore, there is the additional complexity arising from the application of FBT to the growing unassigned category of workers outside of traditional employee–employer relationships, arising from the gig economy.

Fringe benefits tax and the not-for-profit sector

NFP entities can apply for endorsement for tax concessions including an FBT exemption or rebate.

---

215 Treasury, *Re:think – tax discussion paper*, 2015, Australian Government.

216 The Hon. Paul Keating, Treasurer, second reading speech for the Fringe Benefits Tax Assessment Bill 1986 and explanatory memorandum.

217 ATO, *Taxation statistics 2017-18*, snapshot, chart 3, 2020. Available at www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2017-18/?anchor=alltaxreturns#alltaxreturns.

218 Australian Government, Data, *Taxation statistics 2017-18*, FBT – Table 1, 2020. Available at data.gov.au/dataset/ds-dga-23b8c299-a85b-4fc0-a07d-5ed14e23a103/details?q=taxation%20statistics%20individuals.

219 ATO, *Taxation statistics 2017-18, Cost of tax compliance – chart 19*, 2020. Available at www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2017-18/?anchor=Chart19#Chart19.

220 ATO, *Annual tax gap refresh findings – table 2*, 2020. Available at www.ato.gov.au/about-ato/research-and-statistics/in-detail/tax-gap/australian-tax-gaps-overview/?anchor=Whywemeasurethetaxgap#Whywemeasurethetaxgap. Note: "net gap" refers to the final uncollected amount after impact of ATO engagement.

FBT has been described as being of substantial importance to such entities, which includes NFPs operating hospitals, ambulances and state governments.[221] The NFP sector maintains that it is often unable to accommodate competitive wages for employees and uses concessional FBT treatment to attract and retain staff. NFP entities have often used fringe benefits as a tax effective means of increasing their employees' renumeration. Salary packaging utilised as a fringe benefit effectively operates to supplement wages or to effectively lower the average tax rate for NFP employees.

The FBT concessions have a distortionary effect in the marketplace in that the concessions have become a critical tool available to NFPs to remain competitive with the private sector in being able to attract, retain and reward staff.[222]

6.2 Payroll tax

Current landscape

Payroll tax is discussed in detail in Chapter 11 of the paper, however issues specifically pertaining to labour force are addressed here.

Payroll tax is a tax on wages, in cash or in kind, provided by employers to their employees. Each of the state-based regimes have nuanced features and different criteria for determining an employer's liability for payroll tax, including different tax-exempt wage thresholds, allowable deductions and rates of tax.

The efficient collection of payroll tax can assist with a stronger economic recovery post-COVID-19. For state governments, payroll tax revenue grows with wages. Without increases to the threshold, average payroll tax rates on businesses will increase as the payrolls of businesses grow.

There is understandable reluctance to reduce or remove payroll taxes as it forms the major source of income for state governments. Nonetheless, state governments effectively forgo payroll tax revenue as a result of adjusting the thresholds and rates. This adds to the confusion and the compliance costs (apart from the impact on state governments' budgets).

Issues in the workforce

The long-run economic incidence of a broad-based payroll tax is similar to that of a broad-based tax on consumption, being that it falls on labour income or wages. Similar to FBT, payroll tax is imposed on the employer but the economic incidence of the tax is ultimately borne by employees. There is some argument that payroll tax is passed onto employees in lower wages, thereby reducing their disposable income available for purchases.[223]

Businesses have genuine difficulties in establishing whether or not they have exposure to payroll tax liability partly due to the lack of harmonisation of the definition of 'employee' across various state payroll tax regimes. The uncertainty of employment status is exacerbated by the emerging

---

221 M Stewart, A Moore, P Whiteford and R Grafton, *A stocktake of the tax system and directions for reform: five years after the Henry review*, Tax and Transfer Policy Institute, 2015, p. 48. Available at taxpolicy.crawford.anu.edu.au/files/uploads/taxstudies_crawford_anu_edu_au/2015-03/stocktake_report_final_web_version.pdf.

222 We note the 2015–16 federal Budget announcement to cap salary sacrificed meal entertainment expenditure at $5,000 which will affect NFP employees.

223 J Freebairn, "Policy and tax reform", paper delivered to the 2014 Financial Services Taxation Conference, February 2014, p. 13.

'worker' category from the gig economy. The consequence being that employers are burdened with the 'employee' versus 'contractor' dichotomy in yet another aspect of the tax system. Consequently, employers are exposed to potentially significant payroll tax liability (with penalties and interest). Furthermore, employers operating across several States have different reporting and payment obligations and are then required to deal with different revenue authorities in each jurisdiction.

Payroll tax has the potential ability to distort economic activity and reduce business productivity by influencing behaviours of key participants.[224] As payroll tax is an additional cost, businesses of all sizes (above or below the tax-free threshold) may feel disincentivised to grow and incur a larger payroll tax liability.

Issues

6.3 The definition of 'employee'

Inconsistent interpretation and widespread misunderstanding

The impost of each type of employment tax is dependent on the definition of 'employee', however the meaning of employee is defined differently for each purpose. Further, the existence of multiple different administrators at the federal and state levels results in additional complexity even where the definitions are common. This leads to widespread misunderstandings and errors by employers in relation to the application of each of these imposts, as well as inconsistencies in enforcement by these revenue authorities.

The divergence in the definition of 'employee' for the purpose of the various imposts, as well as inconsistencies in the determination of who is an employee, inevitably leads to errors in compliance with the requirements of the various taxes and charges levied on employers. Based on feedback from our members and the technical committees, most commonly, this manifests itself in the following ways:

- failure to meet payroll tax, PAYG withholding and superannuation obligations in relation to contractors who fall within the extended definitions of 'employee' for those purposes;
- failure to identify that someone describing themselves as a contractor, is, in fact, an employee; and
- failure to keep pace with changes in the labour market to encompass the emerging work relationships resulting from the sharing or gig economy.

Each of the above shortcomings exposes employers to tax compliance costs by way of penalties and interest due to failure to or delay in lodgment or payment.

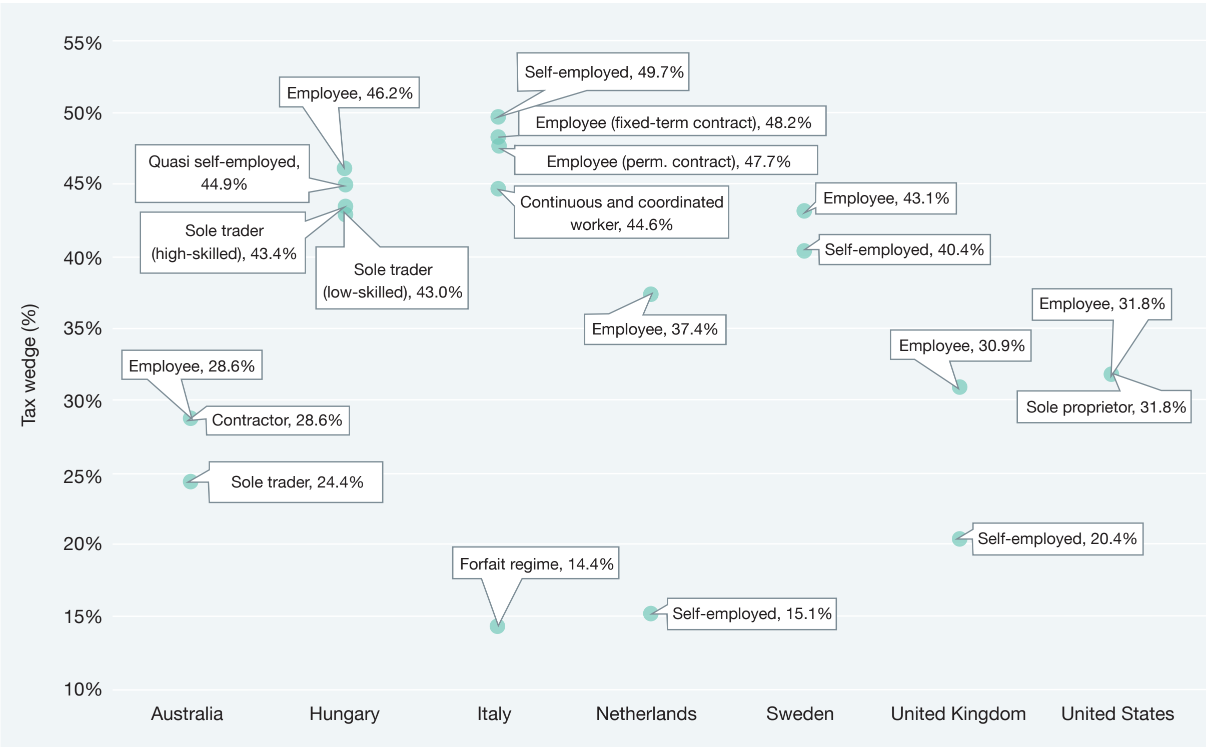
224 R Webb, *Does payroll tax affect firm behaviour?*, Treasury working paper, 2018. Available at treasury.gov.au/publication/p2018-t280988.

Tax systems influence choice of employment form

The OECD recently reported that across OECD countries, there is a growing share of workers earning income outside of the traditional employee–employer relationship.[225] This trend is driven by various factors, including demographic changes, labour market regulation and incentives embedded in the relevant tax system.[226] It was further observed that in certain tax systems, potential tax arbitrage opportunities exist for both employers and individuals due to the differences in the tax treatment of traditional employees versus non-traditional workers (e.g. independent contractors). Figure 5 demonstrates tax wedges for employment forms across OECD countries.[227] For Australia, it is depicted that:

- the tax wedge for employment forms has a moderate degree of dispersion (similar to the UK) demonstrating that there is moderate incentive for businesses to shift between forms; and
- the tax wedge for employees is the highest, which suggests that Australian businesses may lower their tax-related labour costs by choosing an employment form other than standard employment.

Figure 5. Tax wedges for employment forms across countries



Source: OECD, *Taxing wages* 2020, p. 48.

225 OECD, *Taxing wages 2020*, OECD Publishing, 2020, p. 17. Available at https://doi.org/10.1787/8625f8e5-en.

226 Ibid, p. 42.

227 Ibid, p. 48.

Administrative burden

The implementation and administration of employment taxes and the definition of 'employee' needs to be reviewed, simplified and harmonised. There is currently a significant administration and red tape burden on businesses. A few common issues arising for employers are listed below.

- **ATO employee/contractor decision tool** — although designed to assist businesses determine the working arrangement and classification as an employee/contractor, the tool has limited use or binding guidance for taxpayers. Its flaws include:
  - the exclusion of working arrangements that are prevalent and increasing — for example, labour hire firms, individual workers and workers in connection with ride-sourcing arrangements;
  - the capability of being gamed — the tool can easily be manipulated to provide an engineered outcome that is preferred. For example, by purposely overstating or understating one of the ATO's six factors of consideration in determining whether a worker is an employee or contractor;[228] and
  - the lack of consideration of other obligations — for example, payroll tax or WorkCover obligations.
- **Payroll tax groups** — the lodgment of multiple state returns for essentially the same information for different members of the group is highly inefficient (from both a business resource and costs perspective) and administratively cumbersome.
- **Payroll system implementation and configuration** — historically, the payroll systems have required additional set up and continuous monitoring to facilitate the types of employees (full-time, part-time etc.), the types of payment (ordinary, overtime etc.), the different state tax rates and thresholds.

  The ATO's requirement of STP reporting from 1 July 2021 for all employers (except those with closely held payees or an approved deferral/exemption) aims to assist employers streamline their reporting process to the ATO. Rather than reporting PAYG monthly or quarterly, employers are required to report it after each 'payroll event' along with super contributions. However, this does not eliminate the issue arising from the difficulty of classification of the individual as an employee, contractor or other type of worker. The Tax Institute welcomes the expansion of STP (also known as STP Phase 2) as important progress in the data automation of the Australian tax system and for its role in reducing the reporting burden for employers who need to report employee information to multiple government agencies.

6.4 Pay as you go withholding

The legal framework of the PAYG withholding system requires an entity (employer) to withhold an amount from salaries, wages and similar payments paid to an employee.[229] The requirement to withhold is determined by three main questions, being:

---

228 ATO, *Difference between employees and contractors*, 2020 (the ATO outlines six factors being ability to subcontract/delegate, basis of payment, commercial risks, control over the work and independence). Available at www.ato.gov.au/Business/Employee-or-contractor/Difference-between-employees-and-contractors/.

229 S 12-35 of the TAA 1953.

- the definition of an 'employee';
- the type of payments from which an employer must withhold tax (with exemptions including exempt income and fringe benefits); and
- how much tax should be withheld according to the withholding schedules and legislated tax rates.

There is a current design failure with the PAYG withholding system evidenced by the high level of refunds arising from withholding mismatches. The withholding schedules do not take into consideration circumstances, for example, where employees only work part of the year or receive promotions part way through the year. Accordingly, there is a tax process at the end of each financial year to manage deductions and withholding mismatches. However, ATO statistics have reported that tax refunds due to an overcollection of debt is an approach that most taxpayers are reasonably accepting of and happy with.

This raises the question of whether this is a design of the 20th century or whether, with technology, including STP, it could be possible to have a continually adjusting and individualised withholding rate. This would require interaction between the ATO systems and employer systems, but STP has already taken us a long way in that direction by enhancing data collected and ultimately reducing the ATO administrative gap.

Nonetheless, issues with the PAYG withholding system can be reduced where the employee versus contractor distinction is removed. We explore this further below.

6.5 Rapidly changing nature of employment

The COVID-19 pandemic has resulted in a profound shift in society, labour and economic activity, including a trend of employees working from home, rapid digitalisation and the emergence of new work relationships such as the sharing or gig economy. The OECD has reported that industries involving technicians, trade, labour and community services were most affected.[230] Along with COVID-19, our labour supply market is facing the issues of an ageing workforce, the loss of skilled migration, the absence of a temporary workforce of working holidaymakers and reduced economic activity. All of which require the need for individuals to re-skill to meet new opportunities. The evolution of the labour market is, of course, important in a dynamic global economy and as such, there has never been a better time than now for policymakers to consider how the tax and benefit systems may need to be reformed.

The design of the Australian tax system has not kept pace with changes in the labour market. The COVID-19 pandemic has brought into sharp relief the flaws in our system which must be addressed now. As mentioned above, the rapidly changing nature of employment and the labour market has seen the rise of the sharing or gig economy. In the context of tax compliance, non-traditional ways of working have introduced a new level of complexity to be carefully considered alongside the traditional dichotomy between an employee and a contractor.

Without clarity (for example, by way of legislated framework) on the fundamental classification of employment status, the rising gig economy presents further issues across all employment taxes.

---

230 OECD, *OECD economic outlook*, volume 2020, issue 2, OECD Publishing, Paris, 2020. Available at https://doi.org/10.1787/39a88ab1-en.

Clear, harmonious provisions must be introduced across the Australian income tax, employment and superannuation systems in order to address and keep pace with the issues presented by the rapidly changing environment.

6.6 Fringe benefits tax

A highly inefficient, antiquated and burdensome tax

The Tax Institute considers the FBT regime as unnecessarily complex, inefficient and administratively onerous. In the current environment, it is appropriate for the government to take the opportunity to fundamentally reconsider the FBT in light of its disproportionately high compliance costs and onerous regulatory red tape.

The FBT regime has long been criticised for being overengineered and misaligned with policy intent. It is labelled as a tax that fails to strike the right balance between simplicity and fairness and there is much need for improvement or, better yet, complete reform. As raised above, the rules regarding the valuation of particular benefit categories and the application of concessions are overwhelmingly complex for a taxpayer and their professional tax adviser.

The government's announcement in the federal Budget 2020–21 relating to reduced record-keeping requirements for FBT return purposes will assist in reducing the compliance burden and is a step in the right direction. Effective from 1 April 2021, the Commissioner of Taxation has the power to allow employers to rely on existing corporate records (rather than employee declarations and other prescribed records) to finalise their FBT returns. This relieves employers (and in some instances, employees) from the burden of creating additional records to comply with FBT obligations.[231] However, these changes merely seek to redress a fundamental design flaw in legislation that was designed in extraordinary detail and in a pre-digital world. The changes, while welcome, paper over the fact that the FBT law requires a fundamental rethink.

In The Tax Institute's pre-Budget submission 2020-21, we expressed support for the ongoing activity being conducted by the Board regarding the FBT compliance cost review.[232] The findings of the review will be an invaluable resource for the government as it works towards holistic tax reform.

An outdated regime and the definition of 'benefit' is too broad

The Tax Institute also raised concern on behalf of our members that the FBT rules have become antiquated.[233] The FBT rules were designed in a paper-based environment where assessment and verification were not supported by digital processes and automated data exchanges. An important design feature of the FBT was to minimise the number of taxpayers that had to be self-assessed, the forms processed in a partly manual way and audit checks performed. To minimise the impact on the ATO and taxpayers, it was determined to levy the tax on the employer. This resulted in a

231 Australian Government, Budget 2020-21, *Budget paper no. 2*, pp. 15-16. Available at budget.gov.au/2020-21/content/bp2/download/bp2_01_receipt.pdf.

232 Board of Taxation, "Fringe benefits tax compliance cost review", Australian Government, Canberra, 2018 (ongoing review).

233 For example, failing to reflect contemporary work environments such as the home office and commercial car parking arrangements. Another example is the lack of framework for vehicular fringe benefits, particularly in scenarios involving electric vehicles.

design that had the employer — the payer of the benefits — being taxed. It was also designed in a 'catch all' way that meant everything was to be classified as a 'benefit' until specifically excluded.[234] Thus, counterintuitively, salary and wages are caught within the positive definition of 'fringe benefits' only to be excluded by the negative limbs. This approach resulted in many things that are not considered to be real 'benefits' being caught by the rules and having to be specifically excluded, whether eventually or to remain as outliers in an 'unintended consequences' set of provisions. Even exemptions are often directed at half of such unintended consequences. Further, by being levied on the employer at the top marginal rate with confusing 'gross-up' provisions, not only is the wrong taxpayer being taxed, but it is also usually at the wrong rate. This is even more the case when the top marginal rate faced by approximately 94% of taxpayers will be 30% or less in 2024–25, as part of stage 3 of the government's personal income tax plan.[235] Then, further added to this is the 'grossed-up amount' (i.e. often an inflated amount) being used to assess social security entitlements. The above is a demonstration that FBT needs to be abolished and replaced by a system that targets 'real' benefits and levies tax on the correct person at the correct rate.

Excessive red tape

In order to comply with their FBT obligations, employers undertake an unwieldy and unnecessarily complex administrative process:

- firstly, identify the benefits provided to employees, including those as part of their remuneration package and other benefits provided in connection with the business operations of the taxpayer;
- secondly, analyse the benefits to determine whether an exemption applies and whether all relevant criteria is satisfied;
- thirdly, where an exemption does not apply, calculate the taxable value of that fringe benefit, any reduction in taxable value and the resulting FBT liability. This step requires the consideration of different valuation rules that apply to the different categories of fringe benefits. This often involves analysis of a range of conditions which may be found in different parts of the Act, some with multiple valuation options, and some include statutory valuation options. In short, employers are often forced to use a significant amount of internal and/or external resources to obtain sufficient knowledge in order to perform the correct analysis and calculations;
- fourthly, lodge an FBT return and pay FBT; and
- finally, assign benefits to employees under the reportable fringe benefit system and include the amounts on employee payment summaries.

Over time, the government has introduced a raft of exemptions in response to policy objectives, industry, employer and trade union submissions, and case law. While we acknowledge that the design of the FBT regime has required these additional exemptions to appropriately reduce FBT liabilities, it has also made the administration of the FBT law significantly more complicated for

234 At present, there are 100 specific categories of benefits which are exempt from FBT via mechanisms of specific exclusions, exemptions and reduction of taxable value to nil.

235 Announced as part of the 2019-20 Budget measures and as legislated, *Treasury Laws Amendment (Tax Relief So Working Australians Keep More Of Their Money) Act 2019*, enacted on 5 July 2019 as Act No. 52 of 2019.

taxpayers. It would seem that in an attempt to patch over the unintended consequences of the system, it has come with the cost of even greater complexity.

A more recent introduction to the FBT law has been the concept of preventing the application of certain concessions to salary packaged benefits. However, whilst this indicates some recognition of remuneration arrangements, it highlights the mismatch between the marginal income tax rates applied to remuneration income and benefits versus the FBT rate.

The 'otherwise deductible' rule

The current legislative presumption is that an employer is 'taxable unless proven otherwise'. In other words, the employer is alleviated from FBT only on provision of adequate written supporting evidence by the employee which must be in a prescribed format. This is another example of the unnecessary compliance obligations and the excessive red tape which imposes an onerous burden on Australian business taxpayers. A simpler and more streamlined process is required.

The FBT provisions cannot be easily applied to benefits provided to workers that travel internationally, resulting in excessive red tape in order to qualify for exemptions or concessions. There have been numerous cases which have involved extensive litigation, for example, *John Holland Group Pty Ltd v FCT*[236] which looked at fly-in-fly-out employment arrangements. Here, it was held that the air travel provided by the employer was not exempt[237] because the usual place of employment was adjacent to an 'eligible urban area'[238] as defined. As with all cases and as acknowledged by the ATO, the particular facts may result in different conclusions.[239] In some instances, litigation has resulted in FBT applying more broadly than perhaps initially intended, for example, car parking spaces provided by an employer were held to be a 'car parking fringe benefit' in *FCT v Qantas Airways Ltd*[240] (the Qantas case). The Qantas case is a good example of where the original ATO interpretation was consistent with the intent of the law, but was found to be incorrect by the interpretation of the courts. Similar issues and an opposite outcome arose in *Virgin v FCT* [2021] FCA 523 which at the time of writing is on appeal. In spite of this, successive governments have failed to amend the law to reflect the original purpose — another case in point of the lack of maintenance of FBT laws.

The ATO has recently released a stream of further guidance aimed at providing clarity on the interaction between income tax and FBT including, when an employee is able to deduct transport expenses,[241] treatment of car parking fringe benefits[242] and working from home benefits due to COVID-19.[243] Simultaneously, it is understood that the FBT guide will also be updated to provide

236 [2015] FCAFC 82.

237 Under s 47(7) of the FBTAA.

238 S 140 of the FBTAA.

239 ATO, Decision impact statement, *John Holland Group Pty Ltd v FCT*. Available at www.ato.gov.au/law/view/view.htm?docid=%22LIT%2FICD%2FNSD1397%2F2014%2F00001%22.

240 [2014] FCAFC 168.

241 For example, TR 2021/D1 and PCG 2021/D1, both originally published on 17 February 2021. TR 2021/D1 provides 12 examples which attempt to bring to life the ATO's view on when an employee can deduct transport expenses in cars, trains, aeroplanes and other vehicles.

242 ATO, TR 2019/D5 – Fringe benefits tax: car parking benefits which updates TR 96/26 to reflect contemporary commercial car parking arrangements and legal developments such as the Qantas case and *Virgin Blue Airlines Pty Ltd v Commissioner of Taxation* [2010] FCAFC 137.

243 ATO factsheet: "COVID-19 and working from home benefits" (last published 12 March 2021). Available at www.ato.gov.au/law/view/view.htm?docid=%22AFS%2FWFH-FBT-COVID-19%2F00001%22.

further guidance to employers on the potential impact on changed views. The Tax Institute is supportive of the ATO provision of updated guidance to the community but more must be done.

An example – vehicular fringe benefits

Prior to COVID-19, the growth in technology was already creating pressure on the federal government's tax base. This trend is predicted to continue and from a tax perspective, fuel excise is most imminently under threat over the next decade with research showing that the electric vehicle share of new car sales in Australia are expected to reach 8% in 2025 and 27% by 2030.[244] Vehicles are becoming more fuel efficient and the adoption of electric vehicles is increasing. Electric vehicles are expected to match petrol vehicles on both upfront price and range by the mid-2020s.

Despite this, the FBT legislation has changed little since its inception and has not kept pace with the evolution of technology and consumer behaviour. The Tax Institute raises concern on behalf of our members that the provisions relating to car fringe benefits[245] are antiquated and have created disadvantages based on vehicle type (in particular, electric vehicles which are subjected to an inequitable FBT outcome in comparison to fuel-powered vehicles). It is time for a clear, coherent and consistent framework which allows for equitable tax treatment.

Electric cars

Principally, the key concerns raised by our members are as follows.

- Under the statutory method, the taxable value of a fringe benefit associated with an electric vehicle is higher than those related to a fuel-powered vehicle on the basis that electric vehicles have a significantly higher cost price. This is an inequitable tax outcome which creates a disincentive for businesses to extend salary sacrificing arrangements to electric vehicles, which also have the broader benefit of environmental sustainability.
- Where the operating cost method is elected, electric vehicles are again at a disadvantage of potentially having a higher taxable value for FBT purposes as record-keeping of the operating costs for electric vehicles are difficult to maintain on an accurate basis. Electric vehicles are charged via electricity (of various forms, such as solar energy or battery power) and thus, in the absence of a separate meter, there is often no record of the cost incurred by the employee, even though the employee has incurred a relevant cost. This is a relevant outgoing that is not taken into consideration for FBT purposes. Further to this, users of fuel-powered vehicles are able to claim deductions against FBT for fuel costs, however the same does not apply for users of electric vehicles as electricity is not currently defined as a 'fuel' for purposes of FBT.[246]
- Inconsistent FBT outcomes arise in relation to work-related travel due to vehicle type. For example, work-related travel by bus, train or tram produces different FBT outcomes as bus travel can be exempt from FBT (as a motor vehicle) but trains/trams are not. Similarly, bicycles could qualify for an FBT exemption on the basis that they have no motor. Conversely, an e-bike

244 Bureau of Infrastructure, Transport and Regional Economics, *Electric vehicle uptake: modelling a global phenomenon*, research report 151, Canberra, 2019, p. 2. Available at apo.org.au/sites/default/files/resource-files/2019-08/apo-nid253491.pdf.

245 Div 2 of Pt III of the FBTAA.

246 In addition, equipment used for charging their electric vehicles are also not able to be claimed for tax purposes, such as solar panels and home batteries. Commonwealth of Australia, Senate's Select Committee on Electric Vehicles report, 2019, pp. 104-106. Available at www.aph.gov.au/Parliamentary_Business/Committees/Senate/Electric_Vehicles/ElectricVehicles/Report.

(with a motor) could not qualify for an exemption. A further issue is that 'work-related travel' includes travel to and from work for FBT purposes, however is treated as a 'private' expense for the remainder of the tax laws.

6.7 Payroll tax

Lack of harmonisation of the definition of 'employee'

As mentioned above, there is a lack of harmonisation of the definition of 'employee', leaving employers burdened with the employee versus contractor distinction. Employers must either seek tax adviser assistance, which may lack certainty due to the broad interpretation of payroll tax law (recent case law highlights the confusion amongst businesses, practitioners and state revenue authorities),[247] or incur significant payroll tax liability (retrospective assessment plus penalties).

Anomalies over the various states/territories

There is a different application in each State, even with largely harmonised legislation and closer cooperation of the various revenue authorities. This is mainly due to the fact that each jurisdiction has its own legislative regime, rules and interpretations. Accordingly, a particular allowance or benefit could be subject to payroll tax in one state but exempt in another.

There has been discussion of the removal of payroll tax which would result in the loss of a major source of income for state governments. However, note that this has the potential for (greater) VFI if reformed.

Inefficient and cumbersome

There has been strong criticism of payroll tax as an inefficient and cumbersome tax. Some obvious examples of these weaknesses are listed below:

- members of a payroll group must lodge multiple state returns for essentially the same information;
- broad reach of grouping provisions with exclusion left generally to 'the opinion of the Commissioner'; and
- it is potentially distortive and is an existing disincentive and discouragement of wage growth. This is because the liability to payroll tax is based on wages paid and is unconnected to profit, and it excludes the impact of the economy/natural disasters.

Narrow bases are highly inefficient

Broad-based payroll taxes have similar economic consequences to a broad-based consumption tax, making them a relatively efficient way of raising revenue.[248] While similar in many respects, consumption taxes are, in principle, more efficient than payroll taxes as they tax a broader range of activities. Payroll taxes are also a tax on inputs to production, as opposed to a tax

247 *Drake Personnel Ltd v The Commissioner of State Revenue* [2000] VSCA 122; *Commissioner of State Revenue (Vic) v The Optical Superstore Pty Ltd as trustee for OS Management S Trust* [2019] VSCA 197.

248 R Webb, *Does payroll tax affect firm behaviour?*, Treasury working paper, 2018. Available at treasury.gov.au/publication/p2018-t280988.

on consumption. Numerous past reviews have suggested broadening existing payroll taxes by lowering the threshold, removing exemptions and cutting rates as potential options.[249]

The current state payroll taxes are not levied on the optimal broad bases, therefore making payroll tax in Australia less efficient and more complicated than necessary. A significant proportion of the payroll base is not subject to tax due to the tax-free thresholds and other exemptions relating to size of payroll, business type and wage type, which may potentially impact on business decisions to expand.[250] Although this may be "sustainable in the short-term in the face of changes to the way work and businesses are currently arranged",[251] this may not be trend for the long term as the economy and society evolves.

However, these estimates can underestimate revenue foregone because they do not measure the impact of the threshold itself. It was reported by NSW that tax expenditure on payroll tax amounted to $1.67b in 2020–21 or about 19.5% of tax revenue collected.[252] This issue is discussed in further detail in Chapter 11 of this paper.

Options

Fringe benefits tax

Abolish fringe benefits tax; new rules on a principles-based approach

The current FBT regime could be abolished and a principles-based approach to tax law design be applied in the drafting of the new rules (recommendation 112 of the Henry review).[253] A principles-based approach would assist in consistent interpretation of the laws in alignment with their policy objectives and introduce flexibility into the FBT legal and administration system, "rather than simply describing the legal mechanisms and concepts for producing that objective".[254]

The re-design of the law with simpler valuation principles to provide clear definitions or categories to account for non-cash payments could be a significant improvement. The valuation principles could be incorporated into the income tax law for employees and the benefits subjected to PAYG withholding, rather than continuing to impose FBT on employers at what often represents a penal rate of tax. The PAYG withholding system could apply as it exists by requiring employers to remit the relevant amount (which are currently reported as reportable fringe benefit amounts) to the ATO. This has the added benefit of not creating additional administration.

The vast majority of Australian individual taxpayers are taxed at a rate below the top marginal tax rate and, based on government projections, in 2024–25, it is estimated that approximately 94% of taxpayers will face a marginal tax rate of 30% or less.[255] This would deliver a favourable outcome

249 Treasury, *Re:think – tax discussion paper*, 2015, Australian Government; NSW Treasury, *NSW financial audit 2011* (Lambert review), NSW Treasury, Sydney, 2012; and Victorian Competition and Efficiency Commission, *Securing Victoria's future prosperity: a reform agenda*, Victorian Government, Melbourne, 2011.

250 Thodey report, p. 80. See also, Henry review, p. 51 and Campbell Inquiry.

251 Thodey, Discussion paper, October 2019, p. 14.

252 NSW Treasury, Budget Statement 2020-21, *Budget paper no. 1,* Budget statement, Appendices, A2 – Tax expenditure and concessional charges statement, NSW Government, Sydney, 2020, p. 2. Available at www.budget.nsw.gov.au/sites/default/files/2020-11/Appendices%20A2-BP1%20Budget%202020-21.pdf.

253 Henry review, p. 654.

254 Henry review, p. 655.

255 Australian Government, Budget 2020-21, *Budget strategy and outlook. Budget paper no. 1*, pp. 1-17. Available at budget.gov.au/2020-21/content/bp1/download/bp1_w.pdf.

which addresses the inequity in the current system of applying an FBT rate equivalent to the top marginal tax rate.

The income tax mechanism should be used for true remuneration benefits. Benefits that are currently caught in the FBT regime that are not part of a salary package should be challenged as to whether they should be subject to tax as a benefit at all. The taxation of non-remuneration benefits needs to be challenged; if a benefit is not remunerative, should it be subject to tax as a fringe benefit? Any benefit that is non-remunerative in nature could be considered in the context of whether the employer should be entitled to a tax deduction (for example, entertainment expenses) but should *not* be subject to taxation as a form of remuneration. We note that a similar system already exists in New Zealand and we recommend that the New Zealand system be closely examined as a possible framework for Australia.

Further administrative savings – removes the ‘otherwise deductible’ rule

The recommended option has the potential to result in further administrative savings. The ‘otherwise deductible’ rule would no longer be necessary where there is an arrangement that taxed the employee on packaged benefits only and treated it as part of the income tax of the employee. The onus would be on the employee to claim any deductions against the benefits.

Fringe benefits tax and the not-for-profit sector

The Tax Institute supports the Productivity Commission’s recommendation 8.1 of a review, which should draw on the work already undertaken by Treasury’s Not-For-Profit Tax Concession Working Group.[256] The NFP Working Group recommended that the FBT concessions for NFPs be replaced with an alternative support payment to eligible NFPs (limited to salary packaging arrangements). If, after a review is undertaken, the government determines that some/all the FBT concessions should be removed, appropriate transitional rules for phasing out the concessions would need to be made available to the NFP sector, given their ingrained dependence on being able to provide these benefits to employees. This view is consistent with the recommendation in the Henry review[257] that the caps be phased out over a ten-year transition period.

Harmonisation across the Australian tax system

Introduce an all-encompassing concept of a ‘worker’

The Tax Institute is supportive of reform to ensure that tax policy and tax legislation keeps pace with changes in the labour market. The adoption of a broad and inclusive concept of a ‘worker’ to encompass the various classifications, including employees, contractors and non-traditional work relationships resulting from the gig economy could be one such change. The term ‘worker’ could be defined in legislation and apply consistently across the Australian tax system.

Firstly, an all-encompassing concept of a ‘worker’ simplifies the tax system by reducing red tape. The ‘worker’ would efficiently capture all the existing classifications, working arrangements and relationships. Employers would be alleviated from the initial burden of having to classify

256 Treasury, *Final report of the not-for-profit sector tax concession working group*, 2013. Available at treasury.gov.au/sites/default/files/2019-03/NFP-Sector-WG-Final-Report.pdf.

257 Henry review, recommendation 43(a).

the particular individual and ensuring that all employment tax obligations are met based on this classification. Two examples are provided below where the concept of a worker is introduced:

- from a payroll tax perspective, employers must determine the correct rate of deduction (for the non-labour components) applicable to gross payments where the contractor provides equipment and/or material whilst performing a contract. The rate varies with the type of contractor (e.g. architect, carpenter etc.); and
- from a super guarantee contribution perspective, employers undergo a process of consideration as to whether the individual is an employee or contractor and the associated contribution requirements associated with this.

Secondly, an all-encompassing concept of a 'worker' has the potential to make the tax system more efficient as there would be reduced revenue loss for the States as the 'worker' term would capture the previously undefined working relationships arising from the gig economy. In addition, there would be reduced opportunities for arbitrage by businesses in their selection of the type of labour contract offered to an individual, or for individuals in their decision to seek work as an employee or seek to operate as an incorporated or unincorporated contractor.

Harmonisation of the definition of 'employee'

An alternative although less efficacious option for reform is the harmonisation of the definition of 'employee' by adopting a common definition for the purpose of the various taxes and charges that employers are subjected to in respect of wages provided to employees. This would, in turn, simplify the application of employment taxes and ease the administrative and compliance burden.

This could potentially extend to the implementation of a statutory definition, rather than relying on the current approach based on a common law definition. Consultation on design should be sought with the relevant expert practitioners and professional bodies. Furthermore, incorporating the definition of 'employee' into STP reporting and the broad implementation of STP will assist the state governments to collectively reduce the regulatory administrative burden on employers.

Payroll tax

Further harmonisation of payroll tax legislation

Improving the structure of the tax system should begin with recognising that the wellbeing of the Australian people is affected by the taxes of the entire federation. A poorly performing tax affects people no matter which level of government is responsible for it. For example, the States' payroll taxes and the Australian Government's personal income tax both affect the post-tax wages available to workers, which in turn impact on workforce participation decisions.

There is consensus that payroll tax is a relatively efficient, equitable and stable tax but there is scope to broaden the base to improve the revenue of the States and Territories, making the tax system more efficient and resilient.[258] Approximately $26b was raised via payroll and labour force tax nationally in 2018–19.[259]

---

258 M Stewart, A Moore, P Whiteford and R Grafton, *A stocktake of the tax system and directions for reform: five years after the Henry review*, Tax and Transfer Policy Institute, 2015, p. 71.

259 ABS, *Taxation revenue, Australia 2018-19*, ABS, 2020. Available at www.abs.gov.au/statistics/economy/government/taxation-revenue-australia/latest-release.

The Tax Institute supports action to further harmonise the payroll tax base across the States. The coordination of all Australian States to adopt a similar, or the same, policy would ensure consistency and uniform payroll tax legislation across the federation. The alignment of all payroll tax definitions to those used for income tax and employment tax rules would reduce the burdens of regulatory interpretation and compliance on employers. In turn, this would:

- reduce complexities in relation to difference in the details of individual taxes from state to state — relating to what is taxable, who is exempt from paying the tax, the rates and thresholds of the tax, and when the tax must be paid;
- ease administrative and compliance obligations for employers to comply with the rules as a result of a consistent and singular interpretation of the rules; and
- eliminate and ensure the States and Territories can maintain adequate revenue streams.

Options for reform

- Redesign the FBT regime on a principles-based approach and tax benefits in the hands of employees.
- Introduce an all-encompassing concept of a 'worker' which would be a broad and inclusive concept capturing the various classifications (i.e. employee, contractor and non-traditional work relationships resulting from the growing gig economy). The term should be defined in legislation and should apply consistently across all Australian taxes and the superannuation system.
- Alternatively, harmonise the definition of 'employee' in order to simplify the application of employment taxes and ease the administrative and compliance burden.
- Centralise the collection and administration of employment taxes by a single regulator (e.g. the ATO).

7. Incentives for innovation and infrastructure

Overview

What is 'innovation'?

For the purposes of this paper and the debate on what level of support the Australian government should provide for innovation, it is necessary to first understand what is meant by 'innovation'. According to the *Macquarie dictionary,* 'innovation' is 'something new or different introduced; the act of innovating; introducing of new things or methods'.[260] The general definition accepted by the OECD is:[261]

> An **innovation** is a new or improved product or process (or combination thereof) that differs significantly from the unit's previous products or processes and that has been made available to potential users (product) or brought into use by the unit (process).

When considering government support for innovation, such support can be provided for that innovation itself, or the activities, processes and products supporting the development of an innovation, or a combination thereof. In this regard, the OECD provides further definitions around those activities, processes and products related to innovation:[262]

> **Innovation activities** include all developmental, financial and commercial activities undertaken by a firm that are intended to result in an innovation for the firm.
>
> A **business innovation** is a new or improved product or business process (or combination thereof) that differs significantly from the firm's previous products or business processes and that has been introduced on the market or brought into use by the firm.
>
> A **product innovation** is a new or improved good or service that differs significantly from the firm's previous goods or services and that has been introduced on the market.
>
> A **business process innovation** is a new or improved business process for one or more business functions that differs significantly from the firm's previous business processes and that has been brought into use by the firm.

The world will continue to innovate, and those who do not will be left behind. The global economy is evolving and developing at exponential rates with the ongoing search for efficiencies, increased productivity and new ways to increase competition. Not only is there the development of new products and new technologies, but there are also new ways to utilise such technologies to achieve new outcomes. Our future holds a greater use of technology, automation, artificial intelligence and digital disruption.

---

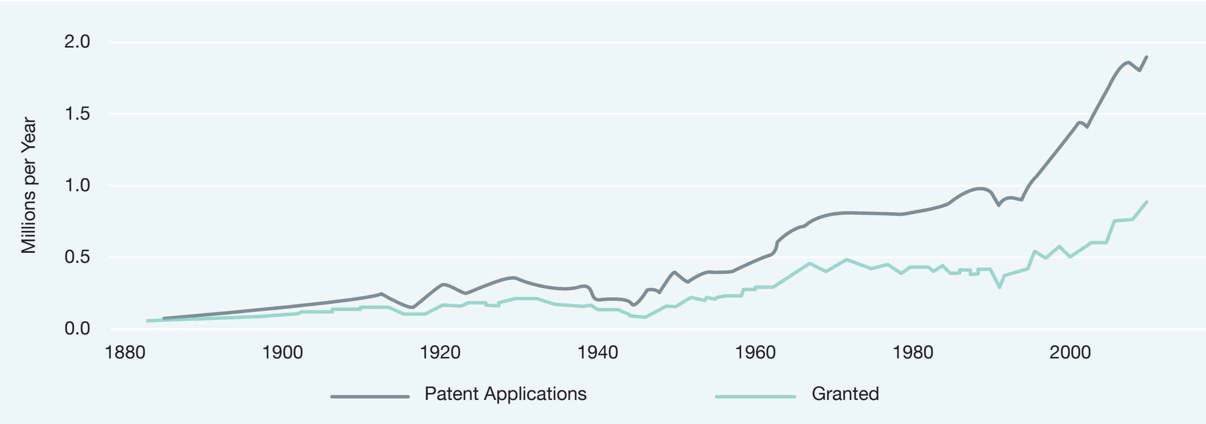
260 *Macquarie concise dictionary*, The Macquarie Library Pty Ltd, 3rd edition, 2003.

261 OECD, *The measurement of scientific, technological and innovation activities; Oslo manual 2018: guidelines for collecting, reporting and using data on innovation*, p. 20.

262 Ibid.

The graph in Figure 6 highlights this exponential growth. As can be seen, the rate of patent applications globally (including those actually granted) have risen at ever-increasing rates, demonstrating the rate at which new innovations are now emerging. This reinforces the importance of governments investing in, supporting and protecting innovation within their jurisdictions so their economies can remain globally competitive for years to come.

Figure 6. Patent applications and patent grants worldwide, 1883–2011



Source[263]

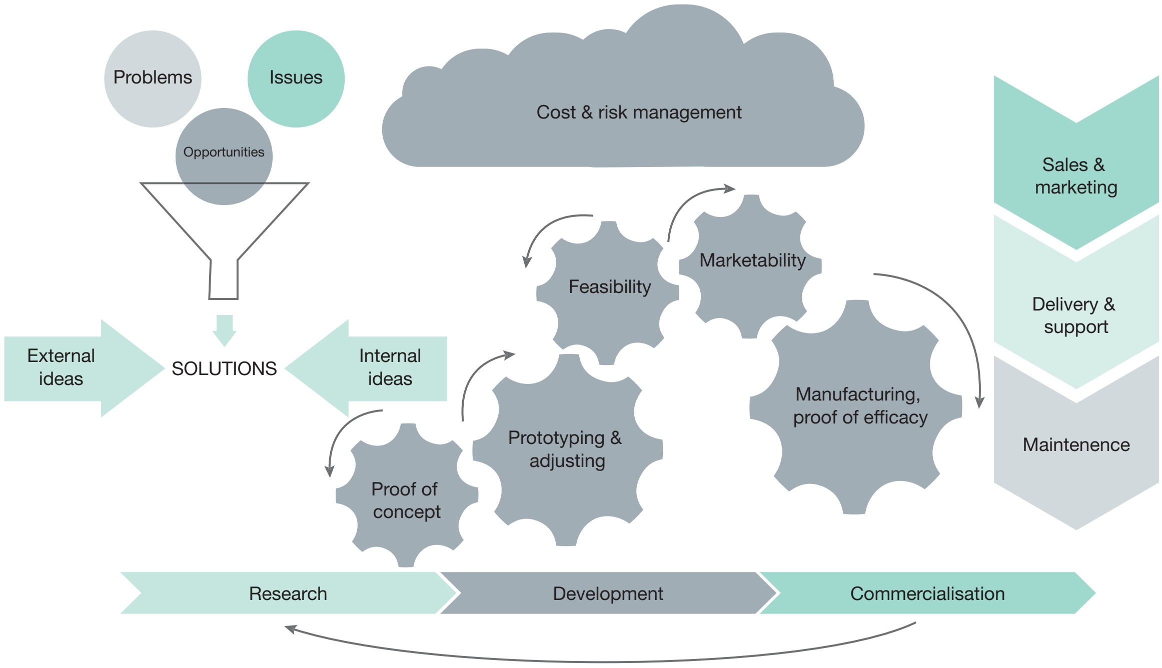
The innovation cycle

There is a need to understand the innovation cycle, as often when we refer to supporting innovation, minds immediately turn to the R&DTI. R&D itself is only one link in the chain. Innovation is a virtuous circle from research to development to commercialisation and back again. Throughout this process, innovators face continual challenges with funding and risk.

The innovation cycle is diagrammatically presented in Figure 7.

263 ResearchGate. Available at www.researchgate.net/figure/2-Patent-Applications-and-Patent-Grants-Worldwide-1883-2011-The-data-above-are-the_fig3_301789991.

Figure 7. Innovation cycle



Funding is required at every stage throughout the life cycle. Innovators often seek external sources of capital to support their activities and this may be from public or private sources. While there may be numerous forms, some of the main identified sources of funding include:[264]

- venture capital: funding provided by venture capital funds backed by high net worth individuals, corporations, large superannuation funds and other entities;
- angel investors: like venture capital, but predominantly high net worth individuals with an expertise or interest in a specific industry or technology;
- debt funding: non-dilutive funding with set repayment terms;
- R&DTI financing: specific financing for R&D with finance amounts and repayment terms linked to claims expected to be made under the R&DTI;
- bootstrapping: funding the activities with your own capital and sustainable revenue sources;
- accelerator funding: accelerators are often market- or industry-focused and offer professional guidance, assistance and networking in addition to startup capital;
- government grants: specific eligibility criteria and application processes apply;
- corporate venture funds: similar to venture capital, but often backed by a corporate with a specific industry focus;
- equity crowdfunding: predominantly a large amount of individuals investing small amounts of money;
- blockchain-based crowdfunding: utilising blockchain/cryptocurrencies to undertake crowdfunding; and
- friends and family funding: utilising personal networks.

264 Fullstack, [Startup funding in Australia: a Fullstack guide].

Risks also exist at every stage throughout the life cycle and innovators are required to manage and mitigate these. According to the AB S, around 50% of all small businesses fail in the first four years of their operation.[265] Acknowledging that there are many reasons why small businesses may fail,[266] due to the increased risks associated with innovation, those small businesses seeking to develop new or improved products or processes would account for the greater proportion of these failures.

As a consequence of these risks, potential investors are more selective with the ways in which their scarce resources are allocated. They are selective toward the industries and activities in which they wish to invest, the stage of the business life cycle at which they wish to invest and the amount they are willing to invest in a particular venture, depending on their motivations and the portfolio's investment mix.

These risks of innovation influence the ease and availability of any of the funding avenues noted above. Furthermore, and most importantly for innovation entities, they influence the cost of the required capital, either through effective costs of borrowing or the dilution of equity ownership.

The role of the tax system in innovation

The revenue collected from the tax system is important to fund expenditure in areas such as health, social welfare and education, and other community projects. Such expenditure may be direct funding of activities, payments via the transfer system or concessions provided through the tax system.

In addition to raising revenues, the tax system may be used to create economic stability or even to facilitate or promote economic growth. It is acknowledged that there are limitations on what tax incentives can achieve, particularly given the need to avoid any tax-induced allocation of resources into unproductive activities;[267] however, the OECD observes that expenditure-based R&D tax incentives have emerged as the primary R&D support tool across many OECD countries, with 30 of the 36 OECD countries offering such incentives in 2019, up from 19 in 2000.[268]

How deep support for innovation should go in so far as targeting specific industries or regions is open for debate, particularly when considered in light of the fundamental principles that a tax system should exhibit equity, efficiency and simplicity.

A dichotomy arises in relation to investment in innovation; one impacting the benefits of investment for both the private entity and the entire Australian economy. The broader economic benefit may often outweigh the perceived personal benefit for private entities to invest in innovation, giving rise to perceived underinvestment in innovation necessary for economic growth. This dichotomy can be difficult for governments to manage in order to generate an acceptable return on investment for innovation incentives. This is highlighted in the Henry review and by the OECD:

265 ABS, *Counts of Australian businesses, including entries and exits*. Available at www.abs.gov.au/statistics/economy/business-indicators/counts-australian-businesses-including-entries-and-exits/latest-release.

266 Openseed, *Understanding failure in the small business realm*. Available at openseed.com.au/blog/analytics/small-business-failure/.

267 *Options for low income countries' effective and efficient use of tax incentives for investment. A report to the G-20 development working group by the IMF, OECD, UN and World Bank*. Available at www.oecd.org/tax/options-for-low-income-countries-effective-and-efficient-use-of-tax-incentives-for-investment.pdf, p. 10.

268 OECD, *The effects of R&D tax incentives and their role in the innovation policy mix: findings from the OECD microBeRD project, 2016-19*, OECD science, technology and industry, policy papers, September 2020 no. 92 (*Findings from the OECD microBeRD project*), p. 11.

As noted in the Henry review:[269]

> Where the research and development of a firm generates spillover benefits for others, the social returns from research and development may be greater than the private returns. A tax-preference or government expenditure that appropriately targets such spillovers may therefore be beneficial and improve overall productivity. But where a subsidy is inappropriately targeted, such incentives can bias the allocation of resources in the economy and actually reduce productivity.

The OECD has further noted:[270]

> Research and development (R&D) is an important driver of innovation and economic growth, but the existence of knowledge spillovers coupled with financing difficulties may make firms invest less in R&D than what would be socially optimal. To encourage demand driven business R&D investment, governments worldwide make use of various policy instruments to incentivise R&D performance. In addition to R&D grants and purchases of R&D services ("direct support"), many governments use the tax system as an additional inducement mechanism. These preferential tax provisions may relate to R&D inputs (expenditures) or outputs (incomes from licensing or asset disposal attributable to R&D or patents).

In managing the dichotomy, governments must consider the return on investment for the broader economy through the government providing support for innovation, and the mechanism through which support is to be provided (i.e. direct funding by way of grant) — indirect funding by way of tax incentive or a mix of both. From a policy perspective, the OECD notes the following:[271]

> Policy mix: The exploratory analysis indicates a similar degree of input additionality for direct R&D government funding measures (IR: 1.4) compared to tax incentives and hints at the potential complementarity of direct and indirect support measures. Direct support measures appear more conducive towards promoting research whereas tax support is principally associated with heightened levels of experimental development. Additionally, a lower level of corporate income taxation is also associated with more R&D investment, although with a lower incrementality ratio than the more targeted R&D support policy measures. One unit of foregone tax revenue corresponds to a 0.24 unit increase in business R&D expenditure.

In a global sense, Australia performs well on the gross incrementality ratio ('bang for the buck') for R&D tax incentives. The results based on OECD R&D survey data indicate a gross incrementality ratio for R&D tax incentives of around 1. This implies that, on average, one extra dollar of R&D tax support translates into one extra dollar of R&D. Noting that not all eligible entities actually benefit from tax incentives, the implied incrementality ratio of tax support may increase by about a third to 1.4. Prior to the recent amendments in October 2020, Australia itself had an implied incrementality ratio of 1.41, demonstrating that there is merit to continued support of R&D activities to create enduring benefits for the Australian economy.[272]

---

269 Henry review, p. 168. Available at treasury.gov.au/sites/default/files/2019-10/afts_final_report_part_2_vol_1_consolidated.pdf.

270 OECD, *Findings from the OECD microBeRD project*, p. 9.

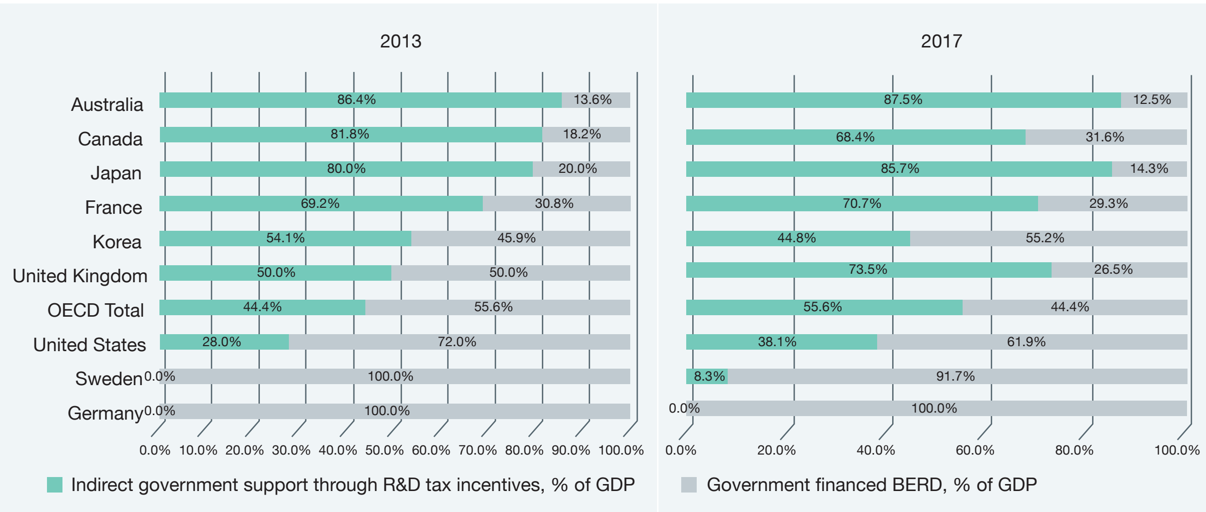
271 Ibid, p. 10.

272 OECD, *Findings from the OECD microBeRD project*, p. 66.

Tax is only one part and cannot be considered in isolation. As noted above, there is a need to consider the mix between direct funding support and tax incentives, the impact of tax policy on access to capital and other funding, and the motivations that influence commercialisation and the desire to retain IP in Australia.

Figure 8 demonstrates government support of R&D activities as a percentage of GDP, comparing the balance of tax incentives for R&D and R&D grants within particular economies. As can be observed, most countries appear to remain relatively stable in their mix; however, of the leading countries, Australia is out of kilter with many of the key economies.

Figure 8. Government support of R&D as a percentage of GDP



Source: OECD[273]

There is a need for governments to support the whole innovation process (the inputs to the outputs), not just one component; balancing the challenges of finance with the encouragement to spend on extra R&D activities. There is also the need to support the appropriate level of risk-taking, not only merely to incentivise capital investment, but to also encourage taking the risk of loss associated with being innovative, this is particularly relevant in the context of the number of failed businesses as highlighted above.

Importance of infrastructure in innovation

It is well known that investing in infrastructure brings with it both social and economic benefits. It not only helps connect towns and cities and supports a growing population, it also assists industrial growth, boosts competitiveness and improves overall societal wellbeing. Investing in the right infrastructure stimulates the productivity of the economy in both the short and long term.[274] Poor infrastructure, or a lack of investment in infrastructure, is therefore an inhibitor to economic growth, productivity and innovation.

---

273 OECD, *Measuring tax support for R&D and innovation: indicators*. Available at www.oecd.org/sti/rd-tax-incentive-indicators.htm (data obtained from the OECD on 4 February 2021).

274 RBA, "Productivity and infrastructure", speech by Philip Lowe to the IARIW-UNSW Conference on Productivity Measurement, Drivers and Trends, Sydney, 26 November 2013. Available at www.rba.gov.au/speeches/2013/sp-dg-261113.html; www.aph.gov.au/Parliamentary_Business/Committees/Senate/Scrutiny_of_Government_Budget_Measures/Budget_Measures/Second%20Interim%20Report/c02.

In Australia, there has been unprecedented levels of expenditure on infrastructure projects.[275] However, in a global context, it is said that 75% of the global infrastructure projected to be in place by 2050 does not yet exist. Astoundingly, considering the levels of finance currently applied to the sector, significant investment gaps arise, which some estimate to be approximately USD15 trillion by 2040.[276]

This places Australia in a precarious position. Many of the infrastructure projects in Australia are targeted through deliberate spending by the government on specific projects. While across infrastructure projects more broadly, the number of PPPs has not seen a continued growth trend.[277] Some analysts are predicting that, even with the record spending on infrastructure, based on Australia's infrastructure needs out to 2035, Australia will have an investment shortfall equal to 1% of GDP. The Australian Government needs to consider the longer-term outlook, particularly in light of whether the government will be able to sustain such high levels of direct infrastructure spending, to ensure that Australia remains competitive in attracting infrastructure investment, given projected global demand for finance, in order to meet our future needs.

The current system in Australia

To provide context, outlined below are some of the programs contained within Australia's tax laws which are targeted toward, or directly influence, investment in innovation.

Infrastructure support

Structures for investment into infrastructure projects can vary significantly for a variety of reasons; from simple trust structures to more complex PPPs comprising a variety of entities to facilitate, amongst other things, investment by domestic, international and NFP entities. The tax treatment will generally follow Australian tax principles relevant to the chosen investment vehicle and the tax profile and tax residency of the ultimate investor.

Managed investment trusts

One vehicle that is often utilised, either alone or in conjunction with other entities, is the MIT.

Specific criteria, as set out in s 275-10 of the ITAA 1997, apply in determining whether a trust is eligible to be an MIT. Certain MITs in which members have clearly defined rights to the income and capital of the trust at all times may make an irrevocable choice to be treated as an AMIT. AMITs provide further concessions for the trust and somewhat ease certain specific administrative burdens.

While there are intricacies and complexities in the specific application of the tax laws to MITs and AMITs, generally speaking, the non-resident WHT rates apply to certain payments made to non-resident investors, with the addition of the following:

- 15% for fund payments made to a resident of a country that has an EOI agreement with Australia;

275 *The rise of megaprojects*, Grattan Institute, November 2020, slide 5.

276 mondovisione.com/media-and-resources/news/closing-the-infrastructure-gap-by-patrick-saner-head-macro-strategy-swiss-re/.

277 Infrastructure Partnerships Australia, *Public private partnerships*. Available at infrastructure.org.au/chart-group/public-private-partnerships/.

- 30% for fund payments made to a resident of a country that does not have an EOI with Australia;
- if the MIT is treated as having non-arm's length income, that income is subject to 30% tax payable by the trustee; and
- trustees of an MIT may make an irrevocable election to apply only the CGT provisions to the sale of eligible assets.

In relation to the 15% WHT for fund payments to residents of countries with which Australia has an EOI arrangement, this rate becomes 30% to the extent that the fund payment is attributable to non-concessional MIT income. An amount will be non-concessional MIT income if it is any of the following:

- MIT cross staple arrangement income;
- MIT trading trust income;
- MIT agricultural income; or
- MIT residential housing income.

The government has released a guidance note to provide an exception to the 30% MIT WHT where a government agency receives approval of an application they make under the economic infrastructure staples tax concession. Where approval is granted, the WHT rate is reduced to 15% to the extent that the income is rent from an investment in land attributed to an approved new economic infrastructure facility or an approved improvement to an economic infrastructure facility. The reduced rate applies only for 15 years.

Incentives for investment in innovation

Early-stage innovation companies

Where taxpayers, including both resident and non-resident taxpayers, invest in newly issued shares in a qualifying ESIC, Div 360 of the ITAA 1997 provides eligible investors with:

- a non-refundable carry-forward tax offset equal to 20% of the amount paid for their eligible investments (capped at an annual affiliate-inclusive amount of $200,000 for sophisticated investors or $10,000 for all other investors); and
- the disregarding of capital gains and losses on qualifying shares that are continuously held for at least 12 months and less than 10 years.

To be classed as an ESIC, a company must not be a foreign company and it must have:

- been incorporated or registered in the Australian Business Register;
- total expenses of $1m or less in the prior income year (including any wholly owned subsidiaries);
- total assessable income of $200,000 or less in the prior income year (including any wholly owned subsidiaries);
- no equity instruments listed for quotation in an official list on any stock exchange (domestic or international); and
- passed the 100-point innovation test or the principles-based innovation test to ensure the company is truly focused on innovation.

The data in Table 6 indicates the extent to which this incentive is utilised.

Table 6. ESIC data based on ESIC forms[278]

Year	No. of ESIC companies	No. of investors	Invested amount ($m)
2017	410	4,300	340
2018	350	3,750	290
2019	230	2,200	180

It should be observed that over the three years of data provided, there has been a significant and continued decrease in the access to this concession. Furthermore, and assuming all relevant investors were sophisticated investors, it should be noted that the maximum total tax benefit under this program in 2019 was $36m (or an average of $54m per year over the three years of data provided).

Venture capital

Limited partnerships are often utilised in commercial situations to provide flexibility around the nature of investments made into such partnerships whilst providing a level of legal protection akin to a company. Australia generally taxes limited partnerships as companies.

However, recognising the commercial benefit of limited partnerships and to encourage investment in innovation, the tax laws contain two core exclusions from the corporate tax treatment of limited partnerships, these include the VCLP and the ESVCLP.

VCLPs and ESVCLPs are jointly administered by the DISER, as well as the ATO.

To be eligible for the underlying tax concessions, an eligible limited partnership must first register with DISER as either a VCLP or ESVCLP. In addition to various conditions which are intended to maintain integrity in the system, the partnership deed must ensure that the partnership is in existence for between five and 15 years and have at least $10m committed capital for VCLPs and between $10m and $200m for ESVCLPs.[279]

Registered VCLPs can make venture capital investments (subject to certain criteria) in companies or unit trusts with total assets of not more than $250m. Registered ESVCLPs can make early-stage venture capital investments (subject to certain criteria) in companies or unit trusts that are at the following stages of development:

- pre-seed;
- seed;
- startup; or
- early expansion.

The investments must be held for a minimum of 12 months.

278 iorder.com.au/publication/Download.aspx?ProdID=1-KQ93ZVD-P1 (information released by the ATO under FOI).

279 Various other eligibility criteria apply. See Pt 2 of the *Venture Capital Act 2002* (Cth).

With regard to the tax benefits, the VCLP and ESVCLP are flow-through vehicles, therefore they themselves are not taxed. Generally, eligible foreign investors in VCLPs are exempt from income tax on their share of profits (capital or revenue); however, Australian resident investors are taxed according to ordinary concepts.

Limited partner investors in an ESVCLP receive a non-refundable carry-forward tax offset of up to 10% of the value of their eligible contributions. In contrast to VCLPs, investors in ESVCLPs are also exempt from tax on their share of:

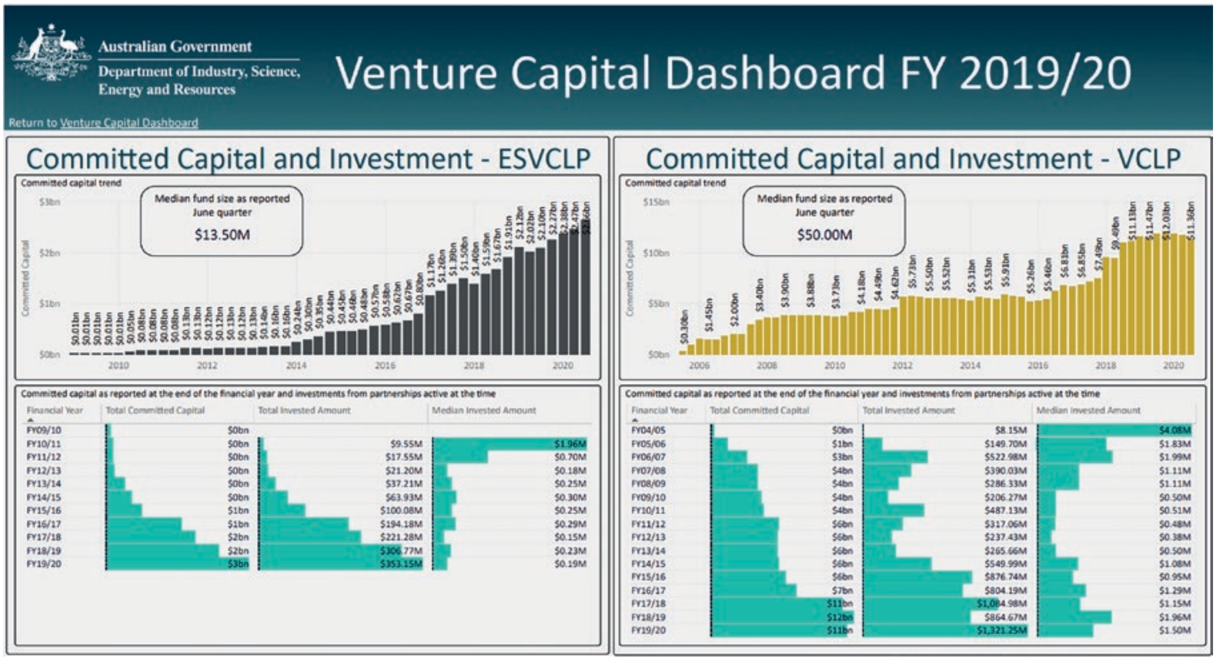
- income and gains from eligible early-stage venture capital investments; and
- income and gains from disposing of eligible venture capital investments (this may be in part where the investee's value exceeds $250m).

General partners of both VCLPs and ESVCLPs can claim their carried interest in the entity on capital account, rather than revenue account.

The dashboard in Figure 9, extracted from DISER's most recent reporting, demonstrates the growth in popularity of both VCLPs and ESVCLPs.[280]

In addition, it is interesting to note the significant variance between the total committed capital and the total amount actually invested between the two different entity types.

Figure 9. Venture capital dashboard FY 2019–20



Employee share schemes

For completeness, we note that the employee share scheme provisions also provide support and assistance to companies, specifically start-up entities, investing in innovation. These concessions facilitate the provision of share capital in lieu of other forms of remuneration to help fund the

280 *Venture capital dashboard FY 2019/20*, Australian Government, Department of Industry, Science, Energy and Resources.

human capital investment rather than drawing on the scarce cash resources often associated with pre-commercialised innovation.

Research and development tax incentive

The R&DTI is contained within Div 355 of the ITAA 1997 with the object set out in s 355-5:

> **Object**
>
> (1) The object of this Division is to encourage industry to conduct research and development activities that might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy.
>
> (2) This object is to be achieved by providing a tax incentive for industry to conduct, in a scientific way, experimental activities for the purpose of generating new knowledge or information in either a general or applied form (including new knowledge in the form of new or improved materials, products, devices, processes or services).

Registered companies with an annual aggregated turnover of less than $20m receive a refundable tax offset; refundable where they are otherwise in a tax loss position. All other registered companies receive a non-refundable tax offset reducing the tax they would otherwise be required to pay.

Following recently enacted amendments, from 1 July 2021, the tax offset rate applicable to registered companies with annual aggregated turnover of less than $20m will be set at 18.5 percentage points above the corporate tax rate (based on present laws, this will result in a 43.5% refundable tax offset). All other registered companies will have a two-tiered R&D intensity system providing a premium intensity benefit of 8.5 percentage points above the corporate tax rate for R&D intensities up to 2%, and 16.5 percentage points above the corporate tax rate for R&D intensities above 2%. The R&D intensity is calculated as R&D spend compared to total business expense.

In Australia the R&DTI is co-administered. AusIndustry is responsible for the registration process, determining whether an activity is eligible R&D and providing advance and overseas finding. The ATO is responsible for the claims process, ensuring that eligible participants claim only those expenses incurred on the registered (core and supporting) R&D activities and that they are appropriately substantiated.[281]

Participants must register their eligible R&D activities with AusIndustry and they have up until the end of the 10th month following year end to do so. However, participants must have registered their activities before they are eligible to make a claim through their income tax return.

The registration and claim processes are fully self-assessed. Participants are required to incur, and fund, the relevant expenditure for an income year, registering and claiming only after the end of a relevant year of income. Both agencies then undertake their reviews post-lodgment, in accordance with the review periods prescribed by the tax laws, to ensure claims are appropriately made and substantiated.

---

281 It is noted that on 11 May 2021, the Board of Taxation announced that it would undertake a review to evaluate the dual-agency administration model for the R&DTI. The terms of reference can be found at taxboard.gov.au/review/dual_agency_administration_model_review.

It should be noted that, based on data released under freedom of information, the ATO advises that in the three years to 2017–18, they only conducted compliance activities on an average of 1.4% of all companies claiming the R&DTI.[282] This same period coincided with a reduction of $1.4b in total offsets claimed to a total of $5.4b and, according to the *Commissioner of Taxation annual report 2019–20*, this has reduced by a further $1b to a total of $4.4b for 2019–20 across an approximate 13% reduction in the number of claims processed across the period 2017–18 to 2019–20.[283]

The above reduction in tax offsets is indicative of a continued reduction in R&D spend within the private sector. When compared to our OECD counterparts, this trend is further exacerbated. From the graph in Figure 10, it can be observed that the domestic spend on R&D as a percentage of GDP in Australia is declining and starting to lose pace with other OCED countries. This trend is in stark contrast to the earlier observation of the OECD's analysis of Australia's incrementality ratio and becomes indicative of the additional deterrent, being the cost of compliance associated with Australia's dual administration and self-assessment regime.

Figure 10. Gross domestic spending on R&D – total, % of GDP, 2000–2018

Source: OECD[284]

Issues in the system

In light of the above context, it is relevant to consider the key issues and obstacles with respect to the support of innovation within the current system in Australia. A number of the most easily

282 iorder.com.au/publication/Download.aspx?ProdID=1-HBXKAZB-P1 (information released by the ATO under FOI).

283 Commissioner of Taxation, Annual report 2019-20, p. 55. Available at www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_Report_2019-20/annual_report_2019-20.pdf.

284 OECD, *Gross domestic spending on R&D* (indicator), 2021, doi: 10.1787/d8b068b4-en (accessed 4 February 2021).

identifiable issues in the current tax system are highlighted below, and it is noted that a more comprehensive and independent review will assist in ensuring that all issues are otherwise identified.

Access to finance

Competitiveness

As noted earlier in this report, Australia faces increasing competitiveness in attracting global finance for infrastructure projects. As the global infrastructure gap and competition increases, available capital will naturally flow to those jurisdictions presenting the greatest opportunity for the highest after-tax commercial return. Australia's tax system limits the attractiveness of Australia's future capital investment. The high corporate tax rate already acts as a disincentive for foreign investors; however, the lack of support for infrastructure investment compounded by the overly complex administrative requirements with varied tax outcomes places Australia further behind.

This same issue also arises for other innovation entities, including, but not limited to, start-up entities. Innovation entities are faced with inherent difficulties in raising funds for their ventures which are exacerbated by the underlying development and commercialisation risks. As noted above, this leads to significant costs of finance and the difficulty in attracting investors. The evidence strongly suggests that the current incentives within the tax system do not go far enough to support the necessary risk-taking by investors to encourage sufficient investment in innovation.

The funding conundrum is further complicated by Australia's mix of direct government support and support provided by way of tax incentive. As noted above, Australia remains significantly out of alignment with the OECD in this regard. As a consequence of this, confusion arises in the R&D market with companies often perceiving the tax offset as a grant;[285] this is exceptionally dangerous in the self-assessment system as the risk of audit and subsequent repayment exists for some years after the refundable tax offset is paid to the innovation entity. Such audits and any consequential audit adjustments may put an innovation entity out of business, particularly those with no, or minimal, income streams.

This shortcoming has also given rise to new funding products, including R&DTI finance. R&DTI finance is a new product which has emerged in the Australian market in recent years. The product provides entities with a loan, in advance of the incurring of any R&D expenditure for a particular year, based upon the expected refund the entity will receive for that year if those R&D expenditures are in fact incurred. When the entity's tax return is lodged with the respective R&DTI claim, the loan is repaid from the resultant refundable tax offset. These products contain significant risk, particularly given the self-assessment nature of the R&DTI.[286] The loans are an attempt to convert what is a tax offset into an upfront advance of funds so as to finance R&D activity to otherwise substitute the shortfall of direct government funding of R&D in Australia.

---

285 S Thomsen, "The startup sector responds to a scathing report into the fraught R&D Tax Incentive", *startupdaily*, 13 December 2019. Available at www.startupdaily.net/2019/12/the-startup-sector-responds-to-a-scathing-report-into-the-fraught-rd-tax-incentive/; C Waters, "Tax office keen to step away from 'problematic area' of R&D claims", *Sydney Morning Herald*, 29 August 2019. Available at www.smh.com.au/business/small-business/tax-office-keen-to-step-away-from-problematic-area-of-r-and-d-claims-20190829-p52m1b.html; M Birney, "Northern reels in $8.6m cash from ATO, pays down $2m debt", *The West Australian*, 14 September 2020. Available at thewest.com.au/business/public-companies/northern-reels-in-86m-cash-from-ato-pays-down-2m-debt-c-1314965.

286 E Koehn, "Startups turn to R&D rebate loans to counter capital crunch", *Sydney Morning Herald*, 29 April 2020. Available at www.smh.com.au/business/small-business/startups-turn-to-r-and-d-rebate-loans-to-counter-capital-crunch-20200429-p54o51.html.

The shortcomings of the tax system resulting in the development of such products is particularly concerning for the integrity of the system. Such products can influence the incidence of fraud within the system due to the requirement to repay the underlying funding. The products also increase the liquidity risk of the innovation entity as any repayment of overclaimed R&DTI will not only have been subject to the cost of finance, but also interest and penalties from the ATO, which could further compromise the survival prospects for the business in certain circumstances. The entity holding all the risk is the innovation entity, this takes the risks of innovation to unacceptable levels for many potential innovators.

Infrastructure

Perceived abuses of the tax system in the infrastructure space led to the ATO releasing Taxpayer Alert TA 2017/1, *Recharacterisation of income from trading businesses*, and a response in which the government introduced legislative measures to address non-concessional MIT income (referred to above). The taxpayer alert focuses on arrangements which recharacterise operating income into more favourably taxed passive income. While not the sole arrangement being addressed, stapled structures are a predominant focus of the alert.

Compounded by these changes, it is perceived that the Australian tax system generally lacks support for infrastructure investment as the access to the limited concessional tax treatments are unnecessarily restrictive. The restrictions inhibit private sector infrastructure projects and therefore further restrict new innovation and Australia's overall progress. The limited concessions which are available contain significant complexities in their administration, and the tax outcomes are mixed and varied. The system's current design therefore further deters potential investors.

Research and development

Low level of collaboration compared to OECD

In Australia, the university sector undertakes a significant amount of research and, for many, these activities further inspire innovation. However, within the present tax laws, there is no inducement for business to collaborate with universities to ensure effective knowledge transfer.

In the *Global Innovation Index 2016*,[287] Australia ranked 20th in the world for university–industry research collaboration. In 2020, Australia had dropped to 39th.[288]

The following comments are observed in the *Performance review of the Australian innovation, science and research system* of 2016:[289]

> R&D tax incentive: the biggest lever the government has does not currently incentivise collaboration with research organisations. This is in contrast to the R&D tax initiatives in some other countries, such as France, which provide a collaboration taxation offset premium as well as a taxation offset premium for employment of researchers. The recent review of the R&D tax incentive recommended the introduction of a collaboration premium under the R&D tax incentive to provide additional support for collaboration activity.

287 S Dutta, B Lanvin and S Wunsch-Vincent, *Global innovation index 2016: winning with global innovation*, p. 179.

288 S Dutta, B Lanvin and S Wunsch-Vincent, *Global innovation index 2020: who will finance innovation?*, p. 219.

289 *Performance review of the Australian innovation, science and research system 2016*, Australian Government, Innovation and Science Australia, p. 28.

It then continued:[290]

> Australian universities are producing some of the best research in the world (see 'Skills'). However, only 4.8 per cent of innovation-active businesses in Australia collaborate with universities or higher education institutions on innovation. Further, between 2003 and 2012, only 9.8 per cent of Australian patents had international co-inventors. In 2010–12, Australia ranked last out of 26 OECD countries on the proportion of both SMEs and large businesses collaborating with universities or other non-commercial research institutions on innovation.

Given the continued lack of incentivisation of collaboration, Australia continues to fall behind in its global positioning and securing its economic future, failing to properly capitalise on its world-leading innovation.

Excessive administration costs

Considering the minimum spend to claim R&DTI is $20,000, from 1 July 2021, an SBE spending that amount and being eligible to a refundable tax offset of 43.5% would receive an amount of $8,700 (assuming it had no other tax payable). This amount can be fairly represented as:

- $5,000 as being a timing benefit (i.e. the conversion of a loss to a cash refund). The loss would have otherwise been a carried-forward tax loss able to offset future assessable income, the value of which being debatable depending on the risks associated with the project; and
- $3,700 as an effective permanent difference.

The costs associated with the significant processes required to keep the necessary records, prepare the relevant plans and engage with the authorities leave many businesses questioning the level R&D spend required to justify the claiming of the incentive.

This issue is further exacerbated by the lack of certainty in the process, given the entire process is self-assessment. That is, whilst an entity may be registered, that registration may be called into question by AusIndustry within the prescribed periods of review. Similarly, within the relevant periods of review, any claims made under that registration may be called into question by the ATO as to whether they fairly qualify as 'R&D expenditure'. This uncertainty can exist for many years after the incurring of the original expenditure.

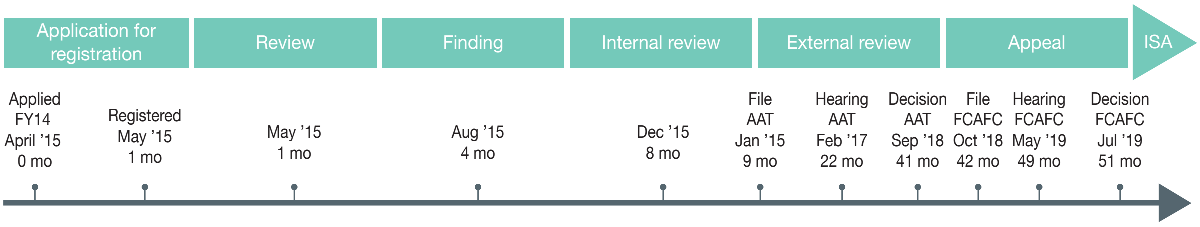
By way of example, in an article authored by Hugh Paynter of Herbert Smith Freehills,[291] a possible dispute resolution timeline (see Figure 11) was set out for the decision in *Moreton Resources*.[292] Interestingly, the Full Federal Court decision was handed down some 51 (four years, three months) months after the last month in which Moreton Resources Limited could have applied for R&D registration for the relevant year; or 73 months (just over six years) after the earliest time the entity may have been eligible to have incurred eligible expenditure.

290 Ibid, p. 83.

291 H Paynter, "Resolving R&D disputes", (2019) 54(3) *Taxation in Australia* 124.

292 *Moreton Resources Ltd v Innovation and Science Australia* [2019] FCAFC 120.

Figure 11. Dispute resolution timeline



Source[293]

These costs and the inherent uncertainty act as a significant deterrent to businesses considering to invest in R&D.[294]

Current administration of definitions does not capture all innovations

Software represents a significant portion of what we do in Australia; however, it has been long reported that software businesses struggle to gain access to the R&DTI.[295] Where industries critical to the enhancement of new technologies and innovation cannot themselves gain access to the R&DTI that is otherwise intended to support innovation, it is not just the industry that suffers; a restriction is placed on the growth potential of the entire Australian economy.

Longer-term economic investment

No support for commercialisation

The support for innovation entities within our tax system effectively ends once a new product or process is developed. Our system does not contain additional incentives to commercialise nor to retain the resultant IP in Australia. This is exacerbated by the lack of competitiveness of Australia's tax system in the international sense.

In 2018, the ABS released data outlining the barriers to innovation for the 2016–17 financial year.[296] For innovation-active businesses, these are summarised in Table 7.

293 H Paynter, "Resolving R&D disputes", (2019) 54(3) *Taxation in Australia* 124 at 128.

294 We anticipate many of the issues and causes will be explored by the Board of Taxation in their review of the R&DTI.

295 S Palmer-Derrien, "R&D tax incentive backtrack welcomed, but software uncertainty remains", *SmartCompany*, 7 October 2020. Available at www.smartcompany.com.au/startupsmart/analysis/rd-tax-incentive-backtrack-software-uncertainty/; J Eyers, "Call for clarity that software qualifies for the R&D tax incentive", *AFR*, 8 September 2020. Available at www.afr.com/technology/call-for-clarity-that-software-qualifies-for-the-rd-tax-incentive-20200907-p55t04.

296 ABS, *Innovation in Australian business, 2016-17*, 81580DO006_201617.

Table 7. Barriers to innovation, 2016–17

Lack of access to additional funds	30.7%
Cost of development or introduction/implementation	20.1%
Lack of skilled persons	24.3%
Lack of access to knowledge or technology to enable development or introduction/ implementation	6.5%
Government regulations and compliance	11.2%
Adherence to standards	3.9%
Uncertain demands for new goods or services	16.6%

It can be observed that access to capital and costs of development or implementation are the main barriers to innovation.

With no further incentives to facilitate capital investment to improve Australian businesses' ability to commercialise in a market already perceived as less attractive, Australian businesses are hamstrung by obstacles on their pathway to take products to market.

Ongoing offshoring of intellectual property

As noted in the preceding sections, innovation businesses within Australia face continued challenges from inception through to commercialisation. Such difficulties include the availability and competitiveness of required capital for the various stages of the business life cycle, the size of the Australian market in comparison to international markets and the general competitiveness of Australia's tax system in extracting the best return in a constrained market for the years of effort preceding commercialisation. These factors either directly or indirectly influence the decisions of innovation companies as they move toward commercialisation.

As a consequence of the above challenges, innovation companies may decide that foreign markets could provide more attractive propositions than retaining any developed IP in Australia. This not only has consequences for the retention of skills, knowledge and assets within Australia upon which Australia could otherwise continue to build, it also inhibits the growth of Australia's potential future tax revenue streams, which would have resulted from the utilisation and exploitation of such assets.

The underlying behaviour reflecting attempts to access international markets, and the attempts by the ATO to utilise administration to deter such behaviour, can be observed from their own publications. Below are extracts from the ATO's *What attracts our attention* publication:

> **Intangible assets**
>
> We review international arrangements that incorrectly characterise either intangible assets, or activities or conditions connected with intangible assets.
>
> … We are also concerned with migration of intangible assets. Migration refers to any transaction(s) that allows an offshore party to access, hold, use, transfer, or obtain benefits in connection with, Australian intangible assets or associated rights.
>
> …

> In particular, we are concerned that: …
>
> - the analysis or methodology used to determine the arm's length conditions or profits connected with these arrangements may result in parties obtaining a transfer pricing benefit for the purposes of Division 815 of the ITAA 1997
> - the Australian entity disposes of their intangible assets to the offshore related party for low consideration on non-arm's length terms, thereby minimising its CGT liability. The Australian entity may have also inappropriately utilised other CGT concessions, such as the rollover in subdivision 126-B ITAA 1997.
> - such arrangements may be entered into or carried out for the dominant or principal purpose of obtaining a tax benefit. This may attract the application of Part IVA of the ITAA 1936 or the diverted profits tax or both
> - intellectual property arrangements involving inadequate reward for:
>   - value contributed by the Australian entity or
>   - non-arm's length migration of rights in property created by the Australian entity.[297]
>
> **Transfer pricing – related party dealings**
>
> Situations that attract our attention include: …
>
> - business restructures that shift Australian assets or operations offshore without arm's length compensation or appropriate recognition for their inherent underlying commercial value.[298]

The ATO is simply administering the current laws and applying them in a manner consistent with protecting Australia's revenue. The drafting of the current laws results in this unnecessary usage of the 'stick' approach, and our country would be better served by laws which promote the retention of IP, thereby reducing the incidence of tax avoidance behaviours and the need to apply scare compliance resources to deter such activities.

Options

Having outlined the current environment and the issues contained within Australia's tax system, we set out below a number of the opportunities available to the government to improve the investment and retention of innovation and IP in Australia.

Infrastructure

The primary focus for the government should be to ensure that Australia's tax system remains competitive to attract and encourage investment in infrastructure as the global infrastructure gap continues to grow. Australia should focus on the competitiveness of the corporate tax rate and

297 www.ato.gov.au/Business/Privately-owned-and-wealthy-groups/What-attracts-our-attention/Business-structure/#Intangibleassets.

298 www.ato.gov.au/Business/Privately-owned-and-wealthy-groups/What-attracts-our-attention/Business-structure/#Transferpricingrelatedpartydealings.

ensure incentives exist within our system to promote private infrastructure development which will ultimately assist the Australian economy.

In doing this, some of the immediate focus areas should include the following:

- reviewing the present thin capitalisation provisions to determine their appropriateness for attracting investment in Australian infrastructure;
- creating a level playing field for our Australian superannuation funds to encourage them to utilise their available capital to invest in infrastructure. This may include providing such entities access to the concessional tax rates available to foreign investors; and
- providing incentives and concessions to drive preferred infrastructure activities, including the investment in 'green' infrastructure, such as solar farms, wind farms etc.

Other areas in which the government should undertake a review include the loss carry-forward rules, public offer debt WHT exemptions, the taxation of public unit trusts that hold infrastructure assets to enable the retention of flow-through treatment and the targeted relaxation of the rules for MITs. Each of these provisions act as a constraint on infrastructure investment and development.

Undertaking the above will assist in making Australia an attractive environment for private investment in infrastructure. This will assist in easing the current and significant public investment in infrastructure and facilitate the growth of PPP activities in Australia.

The government should also consider reforming the taxation system to create further longer-term sustainability of revenue collection. Consideration should be given to whether a shift can be made away from traditional taxes to additional user-pay or congestion taxes for the utilisation and consumption of infrastructure assets and services. New technologies have become available, including GPS technologies, which may be able to assist with the effective imposition of such user charges.

Further consideration should continue to be given to broadening the tax base to ensure that Australia can continue to work toward environmental sustainability targets, rewarding those who exceed targets and taxing those who do not. Such taxes can be accompanied by incentives to drive further innovation to assist Australia to be more sustainable longer term. Due consideration should also be given to the use of direct grants or other non-tax support to keep the tax system free from the complexity arising from differential tax treatment.

Support capital investment

Venture capital

The current underutilisation of ESIC and the excess uninvested committed capital within VCLPs and ESVCLPs indicate that the concessions are poorly targeted and that innovation risks are insufficiently supported.

There is an opportunity to review the scope and benefit otherwise provided under the existing ESIC provisions with the prospect of replacing the incentive with a broader, more beneficial incentive; or complimenting the program with other, more targeted, incentives to attract and support investment in innovation entities. Furthermore, there is an opportunity to remove the discrimination toward Australian resident investors of VCLPs to ensure that they are afforded the same concessions as non-resident investors.

Additionally, the support for risks within innovation entities themselves should be considered to encourage the investment of the committed capital of VCLPs and ESVCLPs into these vehicles. One option may be to consider an alternate test to the similar business test for losses[299] of innovation companies which may have retained the same management team yet raised additional capital (hence failing the COT) to invest into a new innovation activity in a new industry following failure in another.

In addition, this sector would benefit significantly, in terms of improving access to capital and being able to compete at an international level, through the elimination of inefficient taxes and reducing the reliance on corporate and personal tax revenue.

Research and development

The government has a number of opportunities before it which would assist with the appropriate targeting and utilisation of tax concessions to encourage and support R&D activities. The immediate priority of the government should be to resolve the inherent uncertainties within the system predominantly arising from self-assessment.

The government should seek to introduce a grant system under which innovation entities could make applications for funding. Adopting a balance of support between grants and the R&DTI consistent with the OECD average would have a number of benefits:

- greater certainty can be provided upfront to innovation entities without the adverse consequences of subsequent repayment;
- the administration of the R&DTI could be separated such that AusIndustry could administer the grants program and the ATO could administer the R&DTI, independent of each another; and
- innovation entities would obtain a greater level of certainty regarding the level of funding they could utilise for R&D activities without taking on high-risk R&DTI funding.

Following this, the government should revisit the level of support provided through the R&DTI. There are a number of recommendations contained within the *Review of the R&D tax incentive* report (2016)[300] which could be reconsidered and introduced, including the following.

- **Recommendation 2** — collaborative R&D: to introduce a collaboration premium (e.g. up to 20%) for a non-refundable tax offset for collaboration with publicly funded research organisations. Additionally, to encourage strategic R&D partnerships and outsourcing arrangements (sharing risks and benefits and joint ownership of IP rights).
- **Recommendation 3** — introduce a cap (e.g. $2m) on the annual cash refund payable, with remaining offsets to be carried forward. This would have particular relevance where a grant is otherwise introduced.

In reviewing the R&DTI, we support the call by the Australian Small Business and Family Enterprise Ombudsman for greater certainty to be provided to entities conducting innovation on software.[301] The R&DTI should be appropriately updated to make it clear that software development is

299 For alternatives to loss carry forward tests, refer Chapter 1.

300 B Ferris, A Finkel and J Fraser, *Review of the R&D tax incentive,* Australian Government Department of Industry, Innovation and Science, Canberra, 2016. Available at industry.gov.au/innovation/InnovationPolicy/Research-and-development-tax-incentive/Pages/R-and-DTax-Incentive-Review-report-and-submissions.aspx.

301 www.asbfeo.gov.au/news/news-articles/ombudsman-calls-new-software-specific-rd-tax-incentive.

otherwise included within the current R&DTI or, alternatively, a new program otherwise established to appropriately target software innovation.

Further amendments to the R&DTI could include a shift away from the current level of premiums provided over the corporate tax rate, making adjustments to allow for an increase in depreciation deductions for R&D expenditure. These may ultimately include:

- a further accelerated depreciation with an innovation premium for all assets held by an innovation entity;
- implement changes to the corporate tax base (e.g. making the broad IAWO and FEDA measures permanent features of our tax laws).

Irrespective of the ultimate approach chosen by government, it is hoped that the announced review[302] by the Board of the dual administration model of the RDTI will be thorough and will result in improvements the overall administration of the program, cut the excessive red tape and significant costs of compliance, and ensure the greatest level of certainty can be provided to innovation entities upfront, in a sector where it is most needed.

Support of commercialisation and retention of intellectual property

Many countries within the OECD have some form of patent box or preferred income regime targeted to support innovation industries. Many of these have now been reviewed by the OECD and are considered to be non-harmful from a BEPS perspective.[303]

One step in the right direction to address the potential offshoring was the announcement in the federal government's 2021–22 Budget to provide for a 'patent box' regime at a reduced tax rate of 17%. While the details of operation are not clear, presumably to ensure competitiveness of such a regime, the experience of similar schemes in other jurisdictions, for example, the UK and Europe, will be followed to ensure its effectiveness.

Unfortunately, the proposal in the Budget suffers from two limitations. Firstly, it only applies to the medical and biotechnology sectors. While a welcome start, there are many other industries that could be supported through the extension of the regime more broadly.

Secondly, the new regime operates in relation to patents applied for and granted after 11 May 2021 and the benefit will only take effect from 1 July 2022. Reports from industry experts suggest that the real effectiveness of this will not felt until 2026 because of the long lead time between applying for a patent and earning income from commercialisation (often 5–10 years in the medical and biotech sector).[304] Such impediments to the early operation and scope of the regime should be revisited.

302 See budget.gov.au/2021-22/content/jobs.htm - one and taxboard.gov.au/review/dual_agency_administration_model_review.

303 OECD, *Harmful tax practices – peer review results, inclusive framework on BEPS: action 5, update* (as of November 2020), OECD/G20 Base Erosion and Profit Shifting Project, p. 6.

304 V Changarathil, "Patent box: meaningful benefit unlikely before 2026", *The Australian*, 27 May 2021. Available at www.theaustralian.com.au/business/technology/patent-box-meaningful-benefit-unlikely-before-2026/news-story/17ce992eb1ff59295a74c6785008a68d?btr=0bd42d31a1e140781000baacb6e27410. Accessed 28 May 2021.

The legal rights associated with IP are outside of the scope of this paper, however, we recommend that the government consider and implement the Productivity Commission's 2016 recommendations.[305]

Options for reform

- The government should review the tax system's influence on investments into infrastructure and ensure mechanisms are put in place now to secure Australia's competitiveness in attracting funds for infrastructure investment in the future.
- Conduct a review of the support provided to encourage and support investment in innovation entities and implement appropriate incentives which result in the continued and increased investment in innovation entities. This could be as an adjunct to the announced review into VCLP and ESVCLP incentives.[306]
- Consider and implement the Australian Investment Council recommendations summarised in the *Roadmap to recovery* and member survey.[307]
- Consider and implement recommendations from Innovation and Science Australia's *Australia 2030: prosperity through innovation*.
- We recommend that government build upon some of the reviews of the R&DTI conducted in recent years and reconsider and implement the various recommendations appropriate to improving the administration of, and access to, the concession. This should also give consideration to the current scope of definitions within the R&DTI to ensure that either the current program or a complimentary concession captures the software development necessary for Australia's growth and continued competitiveness.
- The government should seriously consider implementing an R&D grant and implement a balanced mix between that grant and the R&DTI. This would provide the opportunity to implement an additional benefit of removing the unnecessary complexities and excessive costs of administration associated with the co-administration of the current incentive.
- We recommend that government implement an OECD BEPS-compliant patent box regime or other regime appropriately focused on the commercialisation and retention of IP in Australia.

305 Productivity Commission, *Intellectual property arrangements: Productivity Commission inquiry report*, 2016. Available at www.pc.gov.au/inquiries/completed/intellectual-property/report/intellectual-property.pdf.

306 digitaleconomy.pmc.gov.au/fact-sheets/investment-incentives.

307 Australian Investment Council, *Roadmap to recovery* (with data from the member survey conducted in May 2020), 2020. Available at www.aic.co/common/Uploaded%20files/Submissions/AIC_Roadmap%20to%20Recovery.pdf.

Personal Tax and Transfer

8. Streamlining the tax system for individuals

Overview

This section considers Australia's individual tax and transfer system and issues arising in the current system that require reform. Individuals income tax is the most important and largest source of government revenue, consistently raising approximately half of total revenue since the 1970s.[308] The following challenges and opportunities for designing a future tax and transfer system for Australia have been identified.

- **Marginal tax rate system lacks transparency** — the interactions between the individual tax system and transfer system such as the various rates, thresholds, offsets and concessions has resulted in non-transparency and clarity as to how the marginal tax rate system applies to individual taxpayers.
- **Workforce participation disincentives for the secondary income earner** — this tax-induced distortion reduces the scale of Australia's labour workforce and has a profound economic and social impact.
- **Unnecessary administrative processes for individual tax compliance, e.g. work-related deductions** — there are difficulties in correctly quantifying work-related costs, in apportioning expenses between income-earning purposes and private (domestic or capital) purposes, and in correctly claiming deductions.
- **Investment assets** — the operation of the negative gearing regime in conjunction with the CGT rules creates the perception of a potential tax advantage and encourages investment behaviour based on CGT discount gains upon sale or disposal. There is a lack of consistent policy across different forms of investment income.
- **Residency** — the current legislation is outdated and not appropriate for today's working environment. The current residency rules are considered most difficult for Australian expatriates and inbound workers.
- **PSI** — the practice of income splitting continues to pose a significant threat to the government's revenue.

The individuals income tax system

'Individuals income tax' is broadly defined as the tax paid on an individual's personal assessable income, less any expenses incurred in generating that income. Personal income typically includes salary and wages, investment income, interest, net capital gains from investments,

308 Treasury, *Re:think – tax discussion paper*, 2015, Australian Government, p. 39. Individuals income tax estimated to accrue approximately $247.6b in revenue or 46.3% of total revenue in 2020–21 per Budget strategy and outlook: *Budget paper no. 1*, 2019–20, pp. 9-24.

and distributions from trusts and partnerships. Individuals also receive fringe benefits, as a form of non-cash remuneration, from employers as part of an employment relationship.[309]

Rates and thresholds

A progressive personal income tax regime has been a well-established feature of Australia's tax-transfer system.[310] The amount that is subject to tax is referred to as 'taxable income' and the applicable tax rate is determined by the schedule of marginal rates and thresholds (refer below) and impacted by levies, concessions or tax offsets where relevant.[311] Above the tax-free threshold, the rates specified at each bracket is the 'marginal' tax rate and is the amount of tax payable on a taxpayer's next dollar of taxable income. This is distinct from the 'average' tax rate on the individual's entire taxable income.[312]

Schedule of resident marginal tax rates – 2020–21

Table 8 sets out the rates applicable to individuals who are Australian residents for tax purposes.

Table 8. Individual income tax rates

Taxable income	Tax on this income
0–$18,200	Nil
$18,201–$45,000	19 cents for each $1 over $18,200
$45,001–$120,000	$5,092 plus 32.5 cents for each $1 over $45,000
$120,001–$180,000	$29,467 plus 37 cents for each $1 over $120,000
$180,001 and over	$51,667 plus 45 cents for each $1 over $180,000

Source: ATO[313]

Concessions and offsets

A broad array of tax concessions can reduce the tax liability of individuals subject to meeting eligibility criteria. The Australian individuals income tax system offers relatively few concessions on labour income (for example, work-related deductions) however, there are various concessions for income from savings (such as superannuation and capital gains) and income from carrying on a business (for example, CGT concessions targeted to SBEs). Further to this, there are certain tax offsets build into the tax system to assist particular groups of taxpayers such as the low-income tax offset and the low and middle income tax offset.

Levies

The main permanent levy in the individuals income tax system is the Medicare levy, which helps fund Australia's public health system. Similar to the social security contributions used in

309 As FBT is levied on and payable by employers, for the purposes of this paper, this is discussed separately in Chapter 6 of this paper.

310 Henry review, p. 80.

311 Treasury, *Re:think – tax discussion paper*, 2015, Australian Government, pp. 35-36.

312 Ibid, p. 36.

313 ATO, *Individual income tax rates*. Available at www.ato.gov.au/rates/individual-income-tax-rates/.

other countries, the Medicare levy is a 2% flat rate applied on an individual's taxable income. Low-income individuals and households may pay a reduced amount of the Medicare levy or are exempt, depending on the circumstances.[314]

Work-related expenses

Work-related expenses incurred by an individual during the production of assessable income are generally deductible. The regime for the availability of deductions is intended to improve the equity of tax treatment between individuals who incur costs in producing assessable income and those who do not. However, the rules can be complex and difficult to comprehend and be applied correctly by individual taxpayers without tax adviser assistance. This issue is explored in further detail below.

CGT discount

Following a recommendation in the Ralph review,[315] the CGT discount was introduced on 21 September 1999 for assets acquired on or after that date, replacing the indexation method.[316] It allows eligible capital gains (discount capital gains) to be reduced by, generally, 50%.[317] To be a discount capital gain, the capital gain must result from a CGT event happening to a CGT asset that has been held for at least 12 months.[318]

The CGT discount was designed to replace the indexation method — a method of applying indexation to the cost base to account for inflationary increases in the value of the asset. Taxpayers who held a CGT asset for at least 12 months could index the cost base of the asset to ensure that inflationary gains would not be assessed.[319]

Since the introduction of the CGT discount in 1999, Australia has been in a low inflation environment. For example, comparing inflation between September 1984 and September 1985 yields a weighted average inflation rate increase of 7.6%, whereas between September 2018 and September 2019, the same inflation rate increased by only 1.7%.[320] Effectively, inflation is not rising with the same velocity as it was when the CGT discount was introduced. In simple mathematical terms that would suggest that the discount should be around 11%. Clearly, such a discount rate would be politically unpalatable but the point of the comparison is that the current rate no longer reflects the policy it was originally designed to replace. Moreover, it is inconsistent with the tax treatment of other unearned income, such as rents and interest.

314 ATO, *Individuals, Medicare levy*. Available at www.ato.gov.au/Individuals/Medicare-levy/#:~:text=The%20Medicare%20levy%20is%202,pay%20on%20your%20taxable%20income.&text=Generally%2C%20the%20pay%20as%20you,lodge%20your%20income%20tax%20return.

315 Ralph review.

316 The indexation method continues to be available for assets acquired at or before 11:45am (AEST) on 21 September 1999.

317 S 115-100 of the ITAA 1997. The discount is 33⅓% /if the gain is made by a complying superannuation.

318 S 115-25 of the ITAA 1997.

319 Div 114 of the ITAA 1997.

320 See Reserve Bank of Australia, *Inflation calculator*. Available at www.rba.gov.au/calculator/quarterDecimal.html.

Main residence exemption

The MRE disregards for CGT purposes any capital gains or losses from a CGT event that happens to a dwelling that is the taxpayer's main residence, provided that certain conditions are met.[321] While there have been various iterations of the MRE since the introduction of CGT in September 1985, the core principle underpinning the MRE has always been to exclude the taxpayer's primary residence from the purview of the CGT regime.[322]

According to the 1985 draft white paper on tax reform, the Prime Minister's decision to spare owner-occupied homes from being subject to CGT was based on ensuring Australia's approach was consistent with overseas practices at the time.[323] Indeed, most countries still provide some form of concessional treatment of gains derived from the sale of a taxpayer's home or main residence.[324]

The MRE is regarded as '<u>sacred</u>' by many. This perception has caused many governments to remain gun shy about making changes that would lessen the generous concession available to homeowners. The MRE is the government's largest tax expenditure item, according to the latest annual *Tax expenditures statement 2017*, which estimates the revenue foregone in 2017–18 due to the MRE at $74b.

In a post-COVID-19 world, the government will need new sources of revenue, which begs the question as to whether the government can afford to continue providing this concession in its current form to homeowners.

Changes to the main residence exemption for foreign residents

A change in the law arising out of the *Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Act 2019*[325] means that foreign residents (i.e. those who are not Australian residents for taxation purposes) are not entitled to the MRE unless:

- the taxpayer is a foreign resident for no more than six continuous years and, during that time, the CGT event which would ordinarily trigger the MRE occurred as a result of a specified 'life event' (whereby the taxpayer, the taxpayer's spouse or the taxpayer's child under 18 years has developed a terminal medical condition or died); or
- the CGT event happened on or before 30 June 2020 and the taxpayer held a continuous ownership interest in the main residence dwelling throughout the period starting just before 7:30pm (AEST) on 9 May 2017 and ending just before the CGT event happens.[326]

---

321 See Subdiv 118-B of the ITAA 1997.

322 Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures No. 2) Bill 2018; and Foreign Acquisitions and Takeovers Fees Imposition Amendment (Near-new Dwelling Interests) Bill 2018, p. 3, citing R Woellner et al, *Australian taxation law 2017,* 27th edition, Oxford University Press, 2017, p. 282.

323 RATS paper. Available at parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id:"library/jrnart/T9MO6".

324 C Cooper et al, *Income taxation commentary and materials,* 9th edition, Thomson Reuters, 2020, p. 117.

325 Enacted on 12 December 2019 as Act No. 129 of 2019.

326 S 118-110 of the IT(TP)A.

Investment income

Different taxation applies to different forms of investment income in the hands of individuals. This was pointed out in the Henry review:[327]

> Comprehensive income taxation, under which all savings income is taxed the same as labour income, is not an appropriate policy goal or benchmark.
>
> The essential reason for treating lifetime, long term savings more favourably is that income taxation creates a bias against savings, particularly long-term savings. Taxes on savings income, including the taxation of inflationary gains, can discriminate against taxpayers who choose to defer consumption and save. The longer the person saves and reinvests, the greater the implicit tax on future consumption (see Chart 4.3). These individuals pay a higher lifetime tax bill than people with similar earnings who choose to save less.
>
> ….
>
> Current arrangements lead to tax outcomes that vary widely depending on the form of saving undertaken (see Chart 4.4). Interest has the least favourable tax treatment. The entire return, including inflationary gains, is included annually in taxable income, generating an effective marginal tax rate on the real return greater than the statutory marginal personal tax rate. In contrast, shares benefit from the CGT discount, while domestic shares also benefit from dividend imputation.
>
> Rental properties benefit from the differential treatment of gains and losses, driven by the capital gains discount and exacerbated by high levels of gearing. Returns from owner-occupied housing are untaxed, giving rise to a zero effective tax rate. For superannuation, the ability to make contributions out of pre-tax income (rather than post-tax income as for other savings, including your own home), can result in a negative effective marginal tax rate on saving through superannuation.
>
> ….
>
> There is considerable evidence that such tax differences can have large effects on the assets in which a household's savings are invested (OECD 2007a). The large variations in tax treatment can therefore alter the allocation, ownership and the management of the nation's savings. This can have adverse impacts on overall economic efficiency, capital market stability and the distribution of risk between individuals. The tax advantages from borrowing to invest in a rental property, also relevant for shares, leads to investors taking on too much debt and distorts the rental property market.

The Henry review recommended a discount to the rate of tax for investment income to remove the inherent taxation bias against savings or income from capital.

However, having regard to the considerable amount of investment capital in the global financial system (sometimes colloquially referred to as 'money looking for a home'), the question of whether the bias needs to be addressed and differential taxation for capital income verses earned income may have changed over the past 12 years and the matter should be re-examined. In this context,

327 Henry review, pp. 32-33.

the question arises whether there should be different approaches to capital income taxation for resident individuals as compared to other types of investors including institutional and foreign investors.

Negative gearing

During 1985, the federal government introduced legislation to abolish 'negative gearing' for real estate investors only, in an attempt to address any tax leakage from revenue sources.[328] The legislation applied to real property bought after 17 July 1985. Due to various pressures, the government repealed the measure, effective from 1 July 1987.[329] Justification for the reversal of the measure was reported on two main grounds. Firstly, the uniformity of tax treatment of interest costs for all types of investment, and secondly, that the perception that tax benefits offered to high income earners by negative gearing were adequately countered by other tax reform measures (for example, with the introduction of the CGT regime).[330]

Current state

Under the current tax system, income from investments, such as rent, dividends or interest, form a part of taxable income. Investment-related expenses, such as interest, council rates and maintenance costs, are generally deductible from taxable income. Where these deductions for property investment exceed the value of investment income from the same asset class, they can be used to offset other income, including other investment income, or income from salary and wages, often referred to as 'negative gearing'. The role of negative gearing in driving investment in rental properties and the broader societal impact on housing affordability and entry to the property market is a contentious issue.

In 2017–18, over 2.2 million individuals owned one or more rental properties with approximately 1.3 million individuals claiming a net rental loss.[331] Deductions relating to rental property (i.e. interest, capital works and other rent-related expenses) exceeded gross rental income by $3.6b.[332]

The tax treatment of investment properties is the same as it is for any investment asset resulting in a mix of current income and capital gain. The rental income is taxed at the individual's marginal tax rate as it is earned and, generally, the capital gain is taxed at 50% upon realisation or disposal of the asset.[333]

---

328 Pt III, Div 3, Subdiv G of the ITAA 1936.

329 J O'Donnell, "Quarantining interest deductions for negatively geared rental property investments", (2005) 3 *eJournal of Tax Research* 65.

330 Commonwealth, Parliamentary debates, House of Representatives, 29 October 1987, p. 1720 (Duffy, Minister for Trade Negotiations).

331 ATO, *Data on returns of individuals*. Available at www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2017-18/?anchor=Individuals#Table6.

332 Total deductions valued at approximately $50b, gross rental income approximately at $46.3b. ATO, *Data on returns of individuals*. Available at www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2017-18/?anchor=Individuals#Table6.

333 Assuming the investment has been owned for more than 12 months.

Individual tax residency and source

Generally, an Australia resident is assessable on their worldwide income derived from all sources, but a non-resident is assessable only on Australian-sourced income.[334] There are also numerous other provisions that are affected by an individual's residency, including provisions relating to:[335]

- marginal tax rates;
- temporary resident rules;
- working holiday maker rules;
- non-resident withholding payments;
- CGT (including the MRE, access to CGT discount, CGT event I1);
- access to franking credits;
- residency of companies and trusts and superannuation funds; and
- application of double tax agreements.

The definition of a 'resident' is set out in s 6(1)(a) of the ITAA 1936. By contrast, a 'non-resident' is defined as being 'a person who is not a resident of Australia'. Accordingly, an individual will be a resident of Australia if they satisfy any one of the four tests — resides test, domicile test, 183-day test or the superannuation test.[336]

On face value, the definition of a 'resident' appears relatively simple. However, in practice, the application of the definition requires detailed factual analysis and reverting to common law principles that have been established through case law. To assist with the interpretation of the current individual tax residency rules for the primary resides test, the Commissioner has listed factors in TR 98/17 that he considers relevant when determining residency, including physical presence, intention and purpose, family, business or employment ties, maintenance and location of assets, and social and living arrangements. [337] However, an approach that involves working through a 'checklist' of factors has attracted widespread criticism from both the courts and from the AAT.[338] Ultimately, where an individual resides is a question of fact and degree and requires consideration of all the relevant circumstances.

In the 2021-22 federal Budget, the government proposed to amend the definition of 'individual resident' to adopt what is touted as a simpler and more certain test. While the proposed primary test of 183 days in Australia is clear and simple to apply, the secondary test presents difficulties in application resulting in curious outcomes. To attract overseas talent and enhance knowledge transfer, one of the fundamental issues is whether a temporary worker should be considered a resident for tax purposes. While rules exist to prevent certain temporary workers from effectively bringing foreign assets into the Australian tax net, the current proposal potentially operates contrary to that principle. Clarity is necessary on this point.

---

334 Ss 6-5 and 6-10 of the ITAA 1997.

335 J Jacques, *Individual tax residency*, The Tax Institute, 2019, p. 6. Available at www.taxinstitute.com.au/tiseminarpaper/individual-tax-residency-paper.

336 If they do not satisfy any of the tests, the individual will be a non-resident.

337 J Jacques, *Individual tax residency*, The Tax Institute, 2019, p. 6. Available at www.taxinstitute.com.au/tiseminarpaper/individual-tax-residency-paper.

338 For example, *Dempsey and FCT* [2014] AATA 335 at [101]. Similar sentiments are also echoed in *Stockton v FCT* [2019] FCA 1679 at [26] and *Harding v FCT* [2019] FCAFC 29 at [7].

Moreover, the proposal on individual residency has been driven, in part, by a significant rise in cases and ruling requests on the resident/non-resident question. That rise only occurred after a change in 2009 restricting the exemption for foreign overseas employment income.[339] Apart from reducing the number of ruling applications and cases going before the AAT and the courts, reinstating the former breadth of that exemption would be both completely consistent with the approach taken for companies in respect of foreign sourced active income[340] as well as encouraging the international movement of people and the associated knowledge transfer benefits that generally arise.

Personal services income

Australian individuals have long used a variety of means to split or alienate income from personal exertion to reduce their overall tax liability. The practice of income splitting poses a significant threat to the government's revenue. Initial attempts by the government to address these practices involved application of the general anti-avoidance provision of Pt IVA of the ITAA 1936 and its predecessor.[341] This had limited success and was at significant administrative cost and effort by the ATO. In response and using the proposal raised in the Ralph review,[342] the specific anti-avoidance provisions for PSI were introduced from 1 July 2000.[343] However, there are shortcomings in practice that still require the Commissioner to resort to Pt IVA in certain circumstances and there are arguments that the existing PSI rules offer limited certainty to taxpayers making a self-assessment.

PSI is income that is for an individual's personal efforts or skills, or would be so if it was the income of the individual who did the work. The PSI rules were designed to improve the integrity of, and equity in, the tax system by ensuring that individuals cannot reduce or defer their income tax by alienating or splitting their PSI through the use of interposed companies, partnerships or trusts, known as the 'personal services entity'.[344]

In order to determine whether the rules apply, a threshold question is whether the individual is an employee or contractor. The rules do not apply if an individual provides their personal services to a service acquirer as an employee, the income derived in this capacity will be the ordinary assessable income of the individual. However, if the individual is not an employee of the service acquirer, the PSI rules may apply.

Typically, the personal services entity receives the PSI of one or more individuals and is interposed between the individual providing the work or services and the service acquirer.[345] The rules do not apply where an individual can establish that they are carrying on a PSB. To be a PSB, one of following tests must be met or where there is a PSB determination in force:

- results test;
- unrelated clients test;
- employment test; or
- business premises test.

339 S 23AG of the ITAA 1936.

340 Div 768 and s 23AH.

341 S 260 of the ITAA 1936.

342 Ralph review.

343 Pt 2-42 of the ITAA 1997.

344 Para 1.5 of the explanatory memorandum to the New Business Tax System (Alienation of Personal Services Income) Bill 2000 (EM).

345 S 86-15(2) of the ITAA 1997.

Issues

The individuals income tax system

Marginal rate taxation

Due to the progressive personal income tax regime and the impact of a variety of levies and tax offsets, the headline marginal rate that may apply can differ greatly to the effective rate of tax ultimately paid by the individual.

For example:

- an individual may start with their applicable marginal rate of tax and have additions of the Medicare levy (2%) and the Medicare levy surcharge (1%, 1.25% or 1.5% depending on their taxable income bracket and for those without adequate private patient hospital insurance); or
- an individual may start with their applicable marginal rate of tax and may be entitled to the low-income tax offset and may also be relieved from the Medicare levy.

These examples illustrate that, due to the various levies, concessions and tax offsets in the system, the applicable tax bracket for an individual may not be easily identified and therefore the tax rate they face lacks transparency and could be improved.

Tax-transfer system interactions

Workforce participation

The current design of Australia's tax and transfer system deters the workforce participation of secondary income earners. This tax-induced distortion reduces the scale of Australia's workforce and has a profound economic and social impact. Secondary income earners in family units are often female with 46% of females employed part time compared to 17% for males.[346] It is reported that the economic productivity foregone annually from disincentives for female participation in the workforce is estimated at $11b.[347]

A recent KPMG report further states:[348]

> ... if the gap between Australia's male and female workforce participation rates could be halved, our annual GDP would be $60 billion greater in 20 years' time, and over the period our cumulative measured living standards would be raised by a massive $140 billion.

Specifically, once the tax and transfer system interactions are accounted for, including higher childcare costs, higher income tax payable and loss of government benefits, the effective marginal

346 M Stewart, *Tax, social policy and gender: rethinking equality and efficiency*, ANU Press, 2017, p. 3. Available at dx.doi.org/10.22459/TSPG.11.2017.01.

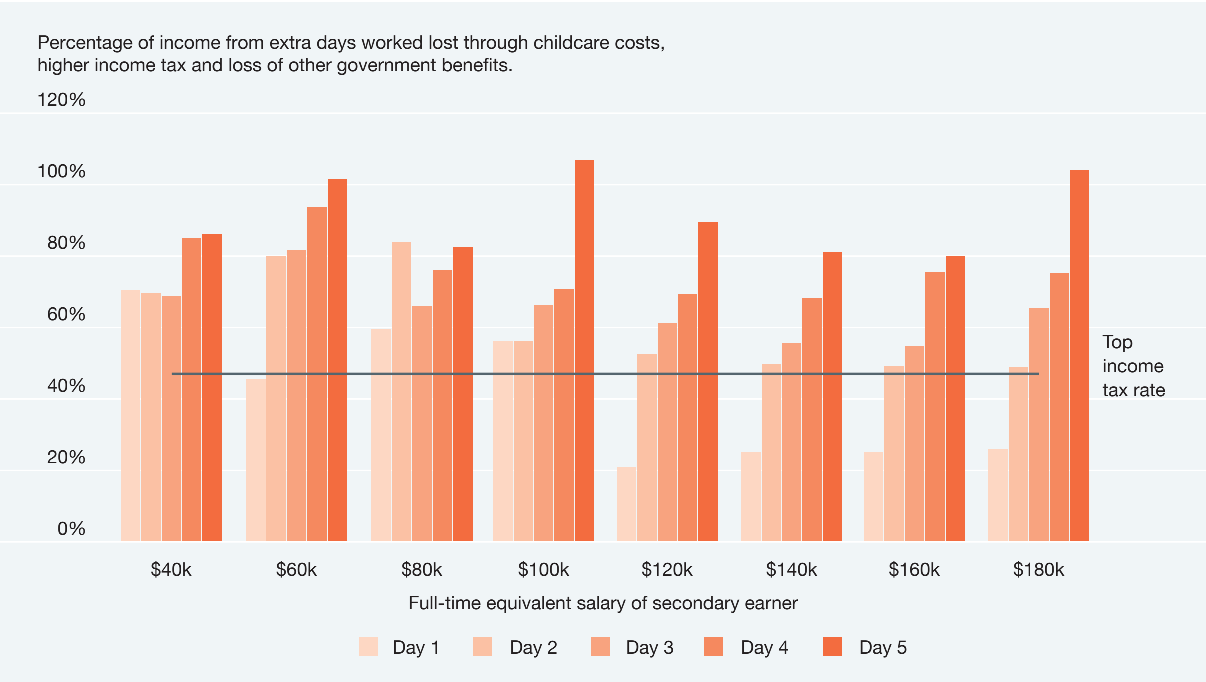
347 D Wood, K Griffiths and O Emslie, *Cheaper childcare: a practical plan to boost female workforce participation*, Grattan Institute, 9 August 2020, p. 13. Available at grattan.edu.au/wp-content/uploads/2020/08/Cheaper-Childcare-Grattan-Institute-Report.pdf.

348 AM Kitchen and G Wardell-Johnson, "Ending workforce discrimination against women", KPMG report, 26 April 2018 Available at home.kpmg/au/en/home/insights/2018/04/ending-workforce-discrimination-against-women.html.

tax rate of secondary earners becomes extremely high — in some cases, over double the top marginal personal income tax rate of 47% (as shown in Figure 12).[349]

The evidence shows that these extremely high effective marginal tax rates deter women, especially those with young children, from working more.[350] For example, a secondary earner on a full-time annual equivalent salary of $60,000 faces an effective marginal tax rate of over 80% when they increase working days from one day/week to two to three days/week (compared to the top marginal personal income tax rate of 47%). Similarly, for secondary earners working on a full-time basis, the effective marginal tax rate is at or above 80% regardless of full-time equivalent salary level. At some income levels, the effective marginal tax rate exceeds 100%.

Figure 12. Workforce disincentives for secondary earners



Source: Grattan Institute, 2020, p. 26.[351]

Furthermore, it is interesting to note that the tax and transfer system uses different bases, for example, joint income base (transfer system) versus individual income base (tax system). The current childcare subsidy is means tested and conducted on joint income, which is consistent with the design of most transfer payments in Australia. Interestingly, research has found that the

---

349 D Wood, K Griffiths and O Emslie, *Cheaper childcare: a practical plan to boost female workforce participation*, Grattan Institute, 9 August 2020. Available at grattan.edu.au/wp-content/uploads/2020/08/Cheaper-Childcare-Grattan-Institute-Report.pdf. See further, M Stewart (ed), *Tax, social policy and gender: rethinking equality and efficiency*, ANU Press, 2017; C Emerson, "Working mothers penalised: childcare subsidies must be reviewed", *AFR*, 1 June 2020.

350 M Stewart, "Mothers have little to show for extra days of work under new tax changes", *The Conversation*, 20 June 2018. Available at theconversation.com/mothers-have-little-to-show-for-extra-days-of-work-under-new-tax-changes-98467.

351 D Wood, K Griffiths and O Emslie, *Cheaper childcare: a practical plan to boost female workforce participation*, Grattan Institute, 9 August 2020, p. 26. Available at grattan.edu.au/wp-content/uploads/2020/08/Cheaper-Childcare-Grattan-Institute-Report.pdf.

majority of Australian families are effectively taxed on a joint income basis and have a marginal tax rate schedule that 'tends towards an inverted U-shaped profile' and is 'no longer progressive'.[352]

Work-related expenses

The regime for the availability of deductions imposes complexity and additional compliance costs on individuals seeking to claim legitimate expenses due to the substantiation rules, particularly where there is a private component to the relevant expense. Determining the extent to which, if at all, certain expenses satisfy the nexus test with income adds to the complication.

Examples of common work-related expenses include home office running expenses, telephone and internet usage expenses, and motor vehicle expenses. These expenses are generally associated with the use of private assets for income-producing purposes.

Based on the latest ATO statistics for 2017–18, the total value of work-related expenses was approximately $21.7b.[353] It is reported that work-related expenses is the main contributor to the individuals net tax gap being approximately $4.4b out of a total individuals tax gap of $8.3b in 2017–18.[354] The ATO has issued a raft of guidance on work-related expense deductions generally and for employees in specific industries to assist them to understand what they may be entitled to claim. This stream of ATO guidance evidences that the rules around deductibility of work-related expenses can be complex and are not easy to navigate by individual taxpayers without assistance.

Therefore, under the current framework, there are difficulties in correctly quantifying work-related costs, in apportioning expenses between income-earning purposes and private (domestic or capital) purposes, and in correctly claiming deductions.

Settings of CGT discount

Rate of CGT discount

The CGT discount was introduced with effect from 21 September 1999 to replace the more complicated indexation method calculation. Division 115 of the ITAA 1997 enables a taxpayer to receive a 50% discount on a capital gain when the CGT asset has been held at least 12 months. The policy rationale for the 50% CGT discount was presented in the Ralph review, which described it as being 'designed to enliven and invigorate the Australian equities markets, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources'.[355]

The primary issue with the current settings of the CGT discount is whether, given today's low inflation climate, the existing general CGT discount rate of 50% is still appropriate. Inflation is not rising at the same rate as the period between the introduction of CGT in September 1985 and the introduction of the CGT discount in September 1999. This suggests that, while a discount rate of 50% may have been considered appropriate in 1999, the rate is now too generous.

352 P Apps, *Family taxation: an unfair and inefficient system*, discussion paper no. 524, Centre for Economic Policy Research, The Australian National University, 2006, p. 3.

353 Australian Government, *ATO, Taxation statistics 2017-18, Individuals – Table 1*. Available at data.gov.au/data/dataset/taxation-statistics-2017-18/resource/de2ebe4a-b17f-491e-931a-a820fa97fee8.

354 ATO, *Trends and latest findings*, 2020. Available at www.ato.gov.au/about-ato/research-and-statistics/in-detail/tax-gap/individuals-not-in-business-income-tax-gap/?anchor=Trendsandlatestfindings#Trendsandlatestfindings.

355 Ralph review.

Further, the flat rate of the current CGT discount raises an equity issue surrounding the tax impact of the disposal of a CGT asset held for 12 months plus one day as compared with long-term asset holdings. It is not fair or equitable that an eligible taxpayer who holds on to an asset for 12 months and one day (assuming the asset is not held as part of a profit-making undertaking[356]) is eligible for the same CGT discount as a taxpayer who holds a CGT asset for 20 years. It cannot be argued that a CGT asset usually experiences inflationary growth of 50% in just 12 months. In a low inflationary period (which has occurred since 1999), the taxpayer who holds the asset for just over 12 months receives a significant benefit for holding on to an asset for a short period of time. The discount should better reflect the impact of inflation, given it was originally designed to be a simpler mechanism to replace the indexation method.

The need for reform of the 50% CGT discount has been recognised at both the political and policy levels:

- in 2009, the Henry review recommended the implementation of a reduced CGT discount rate of 40%;[357] and
- in 2019, the ALP campaigned on a proposed reduction of the rate of the CGT discount from 50% to 25%.[358]

The Tax Institute considers a renewed conversation on the CGT discount is warranted.

Main residence exemption

Design of the main residence exemption

There are manifold issues with the current design of the MRE.

The MRE is a regressive policy. The exemption benefits high-income and high-wealth households more than low-income households, and renters are unable to benefit from the exemption at all. According to the 2016 Census of Population and Housing, around only 67% of Australian have their name on a property title and, of that 67%, around 52% have a mortgage.[359] This means that the lost revenue stemming from the MRE can effectively flow to active property owners and those who are able to accrete land around their main residence block (up to two hectares).

Complexity of the main residence exemption provisions

In their basic form, the MRE rules seem simple enough — a homeowner can disregard the capital gain (or loss) they make on the sale of their home. However, it is apparent from a deeper dive into Subdiv 118-B of the ITAA 1997 that the rules have been designed to cater to almost every personal and familial circumstance. There are provisions which deal with:

- what is an ownership interest in a dwelling that is a main residence;

356 In this case, the gain would be assessable under s 6-5 of the ITAA 1997 rather than the CGT provisions.

357 Henry review, recommendation 14.

358 C Clarke, "Federal election 2019: Labor's capital gains tax plan will have 'bigger impact' on house prices than negative gearing", *ABC News,* 15 May 2019. Available at www.abc.net.au/news/2019-05-15/federal-election-2019-alp-capital-gains-tax-negative-gearing/11108734?nw=0.

359 Australian Institute of Health and Welfare, *Australia's welfare 2019,* "Home ownership and housing tenure", 7 August 2020. Available at www.aihw.gov.au/reports/australias-welfare/home-ownership-and-housing-tenure.

- the treatment of adjacent land (up to two hectares) — the requirements that the adjacent land also be used primarily for private or domestic purposes, and that the same CGT event that happens to the dwelling also happens to the adjacent land confounds many taxpayers;
- delays when moving into a property;
- changing main residence, which provides a six-month overlap rule — this rule is poorly understood, and it is doubtful whether all deferred capital gains arising from exceeding the six-month period attributable to the new main residence are fully accounted for when the latter main residence is sold many years into the future;
- absences from the dwelling, which allows for a (resettable) six-year absence period where the property is used for an income-producing purpose or indefinitely otherwise — the six-year rule is very poorly understood, particularly when it comes to dwellings being made available via sharing economy platforms (such as Airbnb);
- properties that are compulsorily acquired or destroyed;
- the construction, repair or renovation of a dwelling, which allows for a maximum four-year period accompanied by a mandatory three-month rule for the dwelling to be the main residence following the construction, repair or renovation — this rule is also poorly understood;
- the destruction of a dwelling;
- spouses or a dependent child having different main residences;
- marriage or relationship breakdowns;
- partial exemptions where the dwelling was a main residence for only part of the ownership period or was used to produce income;
- dwellings owned by or passing through deceased estates — these are particularly complex rules given their interaction with Div 128 of the ITAA 1997;
- dwellings owned by special disability trusts; and
- dwellings owned by foreign residents.

This approach to cater to almost every personal and familial circumstance is admirable but makes the rules inherently complex. Once multiple properties, holiday homes, divorces, deaths and foreign residency are thrown into the mix, the law becomes incredibly complicated to apply in practice.

2019 changes for foreign residents

The changes made in December 2019 were designed to deny foreign residents access to the MRE from 7:30pm (AEST) on 9 May 2017, subject to a 30 June 2020 transitional rule for existing properties held prior to this date.

The change in the law for foreign residents is not equitable and too complicated. The measures seem to apply prospectively, as they apply to CGT events happening from 7:30pm on 9 May 2017 (or 1 July 2020 under the transitional rule). However, the calculation of the capital gain is based on the original cost base.

The practical effect of these measures is the retrospective denial of the MRE as far back as 20 September 1985, being the commencement of the CGT regime and the MRE. Under the amendments, the availability of the MRE to a taxpayer is based on their tax residency status *at the time of the CGT event, irrespective of the use of the dwelling or the taxpayer's residency status throughout the ownership period*. This has a significant impact on Australian expatriates who sell their former Australian homes while they are a non-resident.

There are some exclusions, but these are, in many cases, not practical or complex to apply. The exclusions ensure that a taxpayer is not subject to the new rules if they:

- return to Australia and establish their tax residency before the CGT event;
- satisfy the 'life events test' which requires that during their first six years of foreign residency, one of the following specified circumstances occurred or the CGT event occurred in relation to a family law matter:
  - terminal medical condition of the taxpayer, their spouse or child under 18 years of age;
  - their spouse or child under 18 years of age died; or
  - divorce or separation.

The following problems arise under these measures:

- the calculation of the capital gain based on the original cost base is inherently unfair, and takes no account of the taxpayer's residency status or the way the property was used throughout the holding period of the property;
- the effective application of the rules as far back as 20 September 1985 means that foreign resident taxpayers are required to establish the cost base of the property, in most cases, without adequate records (see below); and
- the above point is compounded in the case of deceased estates which not only have the same record-keeping issue, but are also subject to additional complex rules — the tax outcome depends not only on the residency status of the foreign resident property owner at the time they died, but also how the beneficiary of the estate uses the property on inheriting it, and the beneficiary's residency status at the time they sell the property.

Complexity and retrospective record-keeping requirements

The compliance burden on foreign residents is unreasonably high. A foreign resident who is subject to CGT as a result of the disposal of a property that was previously their main residence is required to establish the original cost base of the property. However, they were not to know until 2017 at the earliest (many did not realise until some time later) that they had to keep records, which makes it incredibly difficult to correctly calculate the capital gain.

In addition to determining the purchase price and incidental costs of acquiring the property to establish the property's cost base (which will include stamp duty, legal costs, etc.), the taxpayer is also required to retain the necessary records related to any non-deductible holding costs (third element of cost base), such as rates notices, bank statements (for mortgages), receipts for repairs and maintenance, and insurance policy statements. For taxpayers who have held their property for a substantial length of time and who may not have envisaged becoming a non-resident for taxation purposes or the change in the tax law, the burden of being able to accurately substantiate these costs with the relevant records is unnecessarily onerous.

Unclear outcomes in the case of marriage or relationship breakdown

The measures are silent on the interaction between s 118-110(3) and s 118178 where a CGT roll-over is available under Subdiv 126-A. Accordingly, the impact of the measures on a resident individual who sells a dwelling and whose former spouse[360] is a non-resident at the time of the CGT event is unclear. It is possible that the individual selling the property could be adversely affected by the measures notwithstanding that they are a resident at the time of the CGT event.

Assume that:

1. the resident spouse sells a dwelling in Australia which was transferred from their former spouse under a family law settlement;
2. the property is eligible for a CGT roll-over under s 126-5;
3. the resident spouse continues to treat the dwelling as their main residence until they sell it; and
4. the former spouse is a non-resident at the time the CGT event happens to the resident spouse.

There are two possible interpretations:

1. the CGT event doesn't happen to the non-resident former spouse, so there is no impact on their main residence days — accordingly, the resident spouse can take into account the main residence days of their non-resident former spouse and would be eligible for a full MRE on the sale of the property; or
2. notwithstanding that the CGT event doesn't happen to the non-resident former spouse, they are a non-resident at the time the CGT event happens to the resident, so the main residence days of the non-resident former spouse are zeroed out as if they had never lived there — in this case, when the resident spouse sells the property, they will be eligible for only a partial exemption.

This second outcome is an extraordinary one, given that the explanatory memorandum states:[361]

> Individuals who are Australian residents for taxation purposes at the time a CGT event occurs to a dwelling are not affected by this measure.

- the resident may not even know whether their former spouse is a non-resident at the time of the CGT event;[362]
- existing family law settlements would not have taken these measures and this possible outcome into account; and
- it would be very difficult to negotiate a future family law settlement and quantify the tax impact so that an equitable settlement could be reached to take into account the contingency that the former spouse may, one day and following the family law settlement, be a non-resident at the time the resident spouse sells the property.

360 Also includes de facto couples.

361 Para 1.22.

362 Even if the individual was aware that their former spouse was working overseas when they sold their home, they may not be privy to the residency status of their former spouse at that time.

Investment properties

Negative gearing

As a result of costs arising from investment assets being deductible for income tax purposes, taxpayers are effectively able to shelter income from sources other than their investments, such as employment income. This is perceived to give rise to a distortion in the tax system in favour of individuals. This perception is exacerbated by the potential tax advantage that comes on the income side from the taxation of the capital gain earned from the asset. In other words, the ability for eligible individual investors disposing of capital assets to claim deductions and additionally receive a 50% reduction in the taxable capital gain upon disposal contributing to an overall reduction in the tax cost of investing in capital assets.[363] There is also general concern that income from investment properties is not independently verified like other kinds of income. There is also interesting consideration of whether income from investments should be taxed differently to income from personal exertion.[364]

This presents an opportunity for the government to consider improvements in the interactions of the current tax-transfer system and to address the potential tax advantage from investment assets and the economic and social impact by the attractiveness of the CGT discount incentivising investment behaviour.

Depreciation for residential rental properties

Made under the guise of 'housing affordability', the measures were designed to prevent taxpayers from resetting the cost of depreciating assets acquired when purchasing an existing property for use in gaining or producing assessable income from the use of residential premises for the purposes of residential accommodation. In some cases, taxpayers were obtaining quantity surveyor reports that set the cost of some assets above the amount paid by the previous owner of the property. A change in the law was warranted, however, the design of the new rules is not understood by many and there is some anecdotal evidence of unintended non-compliance with the new law.

Where a taxpayer is unable to claim a deduction for the depreciation under s 40-27 of the ITAA 1997, a capital loss under CGT event K7 may arise. The taxpayer must allocate the purchase price as well as the sale price between the amount attributable to the land and buildings and the amount attributable to the depreciable plant and equipment in the property to correctly calculate the capital loss under CGT event K7. In practice, this will generally involve the taxpayer having to obtain a quantity surveyor report on acquisition (which is typical) as well as on disposal (not common). The average tax practitioner does not have the skills or experience to allocate a purchase or sale price between the amount attributable to the land and buildings and the amount attributable to the depreciable plant and equipment.

Further, the limitation in s 40-27 applies only to depreciable assets that have been 'previously used'. This means that if a taxpayer replaces an existing depreciating asset in the property (such as an oven) with a second-hand asset, they will not be able to claim depreciation for that asset and will have to calculate a capital loss under CGT event K7, whereas if they replaced an existing

363 Treasury, *Re:think – tax discussion paper*, 2015, Australian Government, p. 64.

364 One view is that such income should enjoy a lower rate of tax on the basis that it is highly mobile and the alternate view is that such income shouldn't enjoy a tax-free threshold as that exists more for earned income.

depreciating asset with a new asset (such as a new hot water unit), they can claim depreciation on the new asset. This distinction makes it complex for landowners and their advisers to correctly characterise and treat the asset under the tax law, as any prior use of the asset by another person needs to be ascertained.

Deficiencies in vacant land rules

The policy to deny deductions from 1 July 2019 for expenses associated with holding vacant land was announced[365] as part of the 2018–19 federal Budget on 8 May 2018 in the following brief terms:

> This is an integrity measure to address concerns that deductions are being improperly claimed for expenses, such as interest costs, related to holding vacant land, where the land is not genuinely held for the purpose of earning assessable income.

The meaning of 'vacant land' is set out in s 26-102 of the ITAA 1997 and is subject to a range of exclusions and conditions. There is a widespread misconception that the measures only apply to land that is vacant, i.e. it does not have any buildings or other permanent structures. However, for the purposes of s 26-102, it means land that has:[366]

> … no substantial and permanent structure in use or available for use on the land having a purpose that is independent of, and not incidental to, the purpose of any other structure or proposed structure;

This is far broader and includes properties which have a dwelling or some other substantial and permanent structure but they happen not to be in use or available for use.[367]

Some amendments were made to the measures as they were before the Parliament in October 2019 to improve the operation of the rules. However, some of the inserted provisions are deficient and fall short of addressing the concerns raised with the government before the Bill was enacted. The effect of the rules mean that there is overreach, exceptions are poorly constructed and they deny deductions to taxpayers who are unquestionably using the land for a taxable purpose.

Individual tax residency and source

Residency is a "fundamental cornerstone for determining how an individual will be taxed".[368] The current rules for determining individual tax residency were enacted in 1930[369] and have remained predominantly unchanged. Assessing whether an individual is a resident or non-resident is a question of fact and degree. In 2017, the Board commenced a review of the income tax residency rules for individuals which found that the current rules are no longer appropriate and require modernisation and simplification.[370] The Board has since been undertaking further consultation on the design of the new residency rules.

365 The measures are contained in Sch 3 to the *Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Act 2019* which was enacted on 28 October 2019 as Act No. 95 of 2019.

366 S 26-102(1)(b) of the ITAA 1997.

367 The ATO's release of a law companion ruling should increase awareness of the provisions and provide greater clarification and certainty to taxpayers.

368 Board of Taxation, *Review of the income tax residency rules for individuals, report to the Treasurer*, 2017, p. 13. Available at taxboard.gov.au/consultation/self-initiated-review-of-the-income-tax-residency-rules-for-individuals.

369 *Income Tax Assessment Act 1930*. Available at www.legislation.gov.au/Details/C1930A00050.

370 Board of Taxation, *Review of the income tax residency rules for individuals, report to the Treasurer*, 2017, p. 33. Available at taxboard.gov.au/consultation/self-initiated-review-of-the-income-tax-residency-rules-for-individuals.

With increasing global mobility in the workforce, the current legislation is said to be outdated and not suitable for today's working environment.[371] The current residency rules are considered most difficult for Australian expatriates and inbound workers.[372] However, the difficulties with the rules are also a reflection of the attempt to ensure that nuanced situations are addressed as 'not one size fits all'. Thus, while relying on well-established principles over some 80 years, the indicia established by the courts must be applied to individual circumstances. This provides a level of equity for each set of circumstances. Alternatives offered include some level of subjectivity or regard to criteria that can give rise to inappropriate outcomes. Nonetheless, a simple 183 day test as reflected in most treaties is a better starting point for determining residency.

Exemption of certain income earned by Australians working overseas

Most of the recent litigation on residency matters have been in relation to individuals working overseas who sought to have their foreign earnings treated as exempt income following the 2009 changes which greatly restricted the availability of the exemption for foreign employment earnings under s 23AG of the ITAA 1936. This exemption was a relatively simple way of addressing income earned during overseas service. The narrowing seemed to be the catalyst for the change in behaviour that led to several taxpayers attempting to argue that they were non-residents for tax purposes.

The narrowing of the provision also enforced a requirement for a continuous 91-day period offshore which is inflexible and unreasonable for foreign expatriates based in Australia with regional responsibilities (e.g. executives).

Personal services income

As mentioned, the practice of income splitting poses significant threat to the government's revenue. Its popularity amongst Australian taxpayers is the product of having individuals as a 'tax unit' together with progressive tax rates.[373] Major incentives for income splitting (and retention of PSI) include the difference between the company tax rate and the top individual marginal tax rate, and the progressive individual tax brackets which encourage income splitting in order to obtain more than one tax-free threshold and multiple progressive tax rates. Although there has been a recent reduction in tax rates, these incentives still remain for high-income earners.

In releasing the Board's review in 2009,[374] the government announced that the Board had found "evidence of low level of compliance and a degree of uncertainty or 'greyness' around the rules" and furthermore, "the alienation of [PSI] rules in their current form [did] not provide acceptable levels of integrity and equity".[375]

Due to the evolving labour workforce with individuals increasingly becoming 'incorporated contractors' and with the rising modern working arrangements from the gig/service-based economy, the problem has become more widespread. Latest statistics report that the gig

---

371 Board of Taxation, *Review of the income tax residency rules for individuals*, 2017, p. 7. Available at taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2018/07/T307956-income-tax-res-rules.pdf.

372 Board of Taxation, *Reforming individual tax residency rules – a model for modernisation*, 2019, p. 12. Available at taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2019/12/Tax-Residency-Report.pdf.

373 R Vann, "Australia's policy on entity taxation", (2001) 4 *Taxation in Australia* (red series) 3 at 127.

374 Board of Taxation, *Post-implementation review into the alienation of personal services income*, 2009, p. 21, Australian Government, Canberra.

375 The Senator the Hon. Nick Sherry, "Release of report into personal services tax laws", media release, 16 December 2009.

economy grew nine-fold in the four years between 2015–19, reaching $6.3b in total consumer spend and involving as many as 250,000 workers.[376]

Part of the complexity is related to the differing tax treatment and lack of harmonisation of the definition between classifications of employee, contractor and 'worker' from the gig economy. The issue has been identified by various reports and consultations including the OECD,[377] the Black Economy Taskforce, the Board of Taxation[378] and the Henry review. In conjunction, the ATO recently released working guidance in the form of TR 2021/D2 (to combine its former rulings TR 2001/7 and TR 2001/8 and to clarify the view in consideration of relevant judicial decisions).

Personal services business tests

The PSI rules were introduced to overcome problems with using Pt IVA, yet the general anti-avoidance provision must still be resorted to when an entity passes a PSB test but is retaining income, splitting PSI or making excessive payments to associates of the 'test individual'. Further, the Board and the Black Economy Taskforce have raised concerns with the following specific tests.

- **Abuse of the 'results' test** – the 'results test' is at risk of being gamed due to the self-assessment system or misunderstood. Examples of the system being manipulated so as to self-assess as an independent contractor include structuring a contract to seemingly look like a 'results-based' contract when it is not. Examples of payments that do not constitute a result were identified to include 'hourly rate, daily rate, piece rate, percentage of a fee and commission only'.[379]
- **The 'unrelated clients' test is out of step with the modern economy** – the 'unrelated clients' test is not fit-for-purpose in the context of the gig economy. The evolution of online gig platforms has become extraordinarily sophisticated with transaction data reporting three broad categories, private transport, meal delivery and task-based, e.g. respective examples being Uber, Deliveroo and Airtasker.[380] These online platforms have made it "far too easy to conduct minor work for two unrelated clients".[381]
- Based on the Black Economy Taskforce's findings, the assessment and collection of tax for the gig economy is not being accurately assessed.

376 Institute of Actuaries of Australia, *The rise of the gig economy and its impact on the Australian workforce*, 2020, p. 5. Available at actuaries.asn.au/public-policy-and-media/thought-leadership/green-papers/the-rise-of-the-gig-economy-and-its-impact-on-the-australian-workforce.

377 OECD, *Taxing wages 2020*, OECD Publishing, 2020, p. 48. Available at https://doi.org/10.1787/8625f8e5-en.

378 N Sherry (Assistant Treasurer), *Post-implementation review into the alienation of personal services income rules*, 3 June 2009; Henry review, the Black Economy Task Force.

379 Treasury, *Black Economy Task Force – final report*, 2017, p. 248. Available at treasury.gov.au/sites/default/files/2019-03/Black-Economy-Taskforce_Final-Report.pdf.

380 Institute of Actuaries of Australia, *The rise of the gig economy and its impact on the Australian workforce*, 2020, p. 34. Available at actuaries.asn.au/public-policy-and-media/thought-leadership/green-papers/the-rise-of-the-gig-economy-and-its-impact-on-the-australian-workforce.

381 Treasury, *Black Economy Task Force – final report*, 2017, p. 248. Available at treasury.gov.au/sites/default/files/2019-03/Black-Economy-Taskforce_Final-Report.pdf.

Options

The individuals income tax system

Marginal rate taxation

The Tax Institute supports the application of a fully transparent personal marginal tax rate system which simplifies the system and allows individual taxpayers to clearly identify their marginal tax bracket and tax rate. As such, we recommend that the government review the factors that contribute to making the marginal tax rate system non-transparent, and suggest that they could be addressed by changes to the marginal tax rate system. Additional levies and income tax offsets unnecessarily complicate the personal tax rate system and distort the real impost of tax by managing social security matters through the tax system. On this basis, there is merit in conducting a holistic review to determine whether all current levies and tax offsets should be varied, retained or removed.

Furthermore, one of the key issues that has failed to be addressed by successive governments is the high cost to individual taxpayers that arises because the tax, superannuation and social security systems are not properly integrated. To address the inequity arising from the high effective marginal tax rate on secondary income earners in working families, the current design of the tax and transfer system should be reconsidered and reformed.

An adjustment of the tax rate structure could widen the tax base. It has been suggested that the current tax-free threshold is too high and should be reduced. This is, in part, because the tax-free threshold benefits all taxpayers — even those on the top marginal rates. Any reduction in the tax-free threshold would widen the tax base in line with optimal taxation theory. This may require some level of compensation for some 'new' taxpayers and enable tax rates to be lowered for low- and middle-income earners. Any change to the tax-free threshold or any other part of the marginal tax rates should take into consideration the effective marginal tax rate created by the interaction of the tax and transfer system. The individual margin tax rate should be fully transparent so that individual taxpayers can clearly identify which marginal tax bracket they fall into and the rate of tax that will therefore apply.

Tax-transfer system interactions

Workforce participation

The current effective marginal tax rate for secondary income earners penalises the secondary income earner (typically female workers) which disincentivises workforce participation. Removing those disincentives should widen the tax base through increased labour force participation rates, improve productivity and economic efficiency, provide fiscal sustainability, and promote gender equality.

To address the high effective marginal tax rates for secondary income earners (which are a function of individual tax rates, childcare costs and social security benefits), consideration could be given to either expansion of the childcare subsidy or providing universal free childcare.[382]

382 D Wood, K Griffiths and O Emslie, *Cheaper childcare: a practical plan to boost female workforce participation*, Grattan Institute, 9 August 2020. Available at grattan.edu.au/report/cheaper-childcare/.

Work-related expenses

Standard deduction for employees

As an option for the short-term, The Tax Institute supports recommendation 11 of the Henry review — the introduction of a standard work-related deduction for employees.[383] Employees with expenses above the standard deduction threshold should retain the ability to claim actual expenses with full substantiation above a nominated threshold. This would reduce the administrative burden for all stakeholders involved (individuals and the ATO) by simplifying the tax compliance obligations. The standard deduction could be factored into the '[tax tables]' produced by the ATO to assist employers determine the amounts of tax to withhold from salary and wages via the PAYG withholding system. Automatically factoring in the standard deduction to amounts of tax withheld from employees would help to alleviate the compliance burden for individuals.

Other suggestions on standard deduction include:

- no deduction for WRE at all (similar to the NZ model);
- a lower standard amount be set (e.g. $1,000) with a cap at, say, $5,000; or
- a deduction set as a percentage of salary and wage income (the assumption being, although not verified, that higher levels of income may necessitate higher costs).

This is not meant to be a comprehensive list of options nor be taken as an endorsement of these alternatives. Each would need to be accompanied with reductions in personal tax rates.

As technology advances and data automation becomes more sophisticated, with current examples being the use of enhanced data collection and the use of technology such as pre-fill information in myTax including myDeductions, there will be further administrative savings. Tax processes and the tax function has the potential to become so advanced that automated apportionment methodologies may start to be introduced (for example, GPS-related technology in the determination of deductible car expenses).

Comparable international jurisdictions

As an alternative and longer-term option, there are comparable international jurisdictions which operate simpler systems for individuals with more basic tax affairs or allow for deductions for work-related expenses on a more narrow and limited scope. Whilst we acknowledge that no tax system can achieve perfect compliance, Australia could consider drawing on elements of comparable countries' systems to model its own system for individuals. We refer to Table 9 with a summary of this comparison.

383 Henry review, p. 57.

Table 9. Comparable jurisdictions: deductions for work-related expenses

Country	Deductions for work-related expenses?	Scope of deductions and arrangements
Australia	Yes	Incurred in gaining or producing an employee's assessable income.
Canada	Limited	Only deductions specifically legislated, e.g. accounting and legal fees.
Netherlands	Yes – narrow	Most work related are not deductible. Limited exceptions for transport, education and home office expenses. There is an employed person's tax credit.
New Zealand	No	No requirement for individuals whose earnings are limited to salary, wages, dividends and interest income to lodge a tax return. Therefore, no deductions allowable for work-related expenses for employees.
UK	No	No apportionment of expenses, i.e. it is either used wholly and exclusively for work or it is not deductible (also known as the 'wholly and exclusively' test).

Source: Adapted and updated from the Henry review, p. 54; OECD *Taxing wages 2020*.

CGT discount

The tax system should encourage long-term asset ownership rather than rewarding short-term speculative-type behaviour. To encourage this behaviour, there are four potential options for reforming the CGT discount.

Lower discount percentage

The CGT discount rate could be lowered so that it operates as a more accurate proxy for today's low inflation environment. This would require a policy decision as to the appropriate settings for a lower rate, taking into account contemporary rates of inflation in Australia.

Eligibility based on a longer holding period

This option for reforming the CGT discount is aimed at improving the equity issue around aligning the treatment of a taxpayer who holds a CGT asset for 12 months and one day with that of a taxpayer who holds a CGT asset for a much longer period. To ameliorate the disparity, perhaps a longer period of at least two, three or five years before which a taxpayer would be eligible for the CGT discount would be more suitable.

Scaling rate of CGT

An alternative option to basing eligibility for the CGT discount on a longer holding period could involve implementing a scaling rate of CGT. Under this mechanism, a scaling rate would entitle a taxpayer to a higher rate of CGT discount the longer the CGT asset is held. This avenue would provide a greater reward for those taxpayers who hold CGT assets for longer periods.

Revert to indexation method

A more radical option would be to abolish the CGT discount in its entirety and revert solely to the indexation method to more accurately reflect inflationary trends. However, it is noted that the indexation method involves a more complex calculation and commentators have largely agreed that a CGT discount in some form is preferable to reverting to the CGT discount's predecessor.[384]

Reduce the complexity of the main residence exemption rules

The design of the MRE provisions should be simplified to make it easier for taxpayers to determine whether they are entitled to the MRE, and if so, to what extent.

The MRE rules could be reformed in the following respects.

- The operation of the six-month overlap rule in s 118-140 is clumsy to apply in practice as it operates to set the maximum overlap six months back from when the ownership interest in the existing main residence ends. It would be easier to apply in practice if taxpayers were permitted the MRE on two properties at the same time, but only for six months from when the ownership interest in the new main residence starts.
- The operation of the six-year absence rule in s 118-145, its interaction with the cost base resetting rule in s 118-192 and application in the context of the sharing economy is not well understood. Many taxpayers think that temporary absences from the property, rather than the property ceasing to be the main residence of the taxpayer, entitles them to apply the six-year absence rule. The law should be amended to clarify that the six-year absence rule is not available for temporary absences (such as renting the property for a short period through a sharing economy service provider) and there are CGT implications when the property is sold.

Other thoughts on the main residence exemption

Abolish the main residence exemption

A more drastic option for reforming the MRE is to abolish it in its entirety. The primary argument in favour of this approach is that the MRE encourages Australians to invest in 'unproductive' assets (i.e. assets that are not used for an income-producing purpose). If the MRE were to be abolished, that capital or level of investment could be better directed towards income-producing assets or activities. Therefore, from a purely economic perspective, there is an argument not to retain the MRE. It is also worth noting that, if the MRE was to be abolished, the CGT discount would apply to most capital gains made from the disposal of a dwelling that is the taxpayer's main residence. Accordingly, it would be uncommon for the entire capital gain to be taxable.

From a political and policy perspective, however, the argument in favour of retaining the MRE in some form is stronger. The taxation system ought to support Australian home ownership and, as noted above, a system that offers some form of concessional treatment on the sale of the family home is consistent with the worldwide approach.

2019 changes for foreign residents

The changes made in 2019 produce unfair and retrospective tax outcomes for property that was previously the main residence of Australian expatriates who are foreign residents at the time of the CGT event.

384 See, for example: B Freudenberg and J Minas, "Reforming Australia's 50 per cent capital gains tax discount incrementally", (2019) 16(2) *eJournal of Tax Research* 317; and P Kenny, "Australia's capital gains discount: more certain, equitable and durable?", (2005) 1(2) *Journal of the Australasian Tax Teachers Association* 38.

There are two potential options for reforming the application of the MRE to foreign residents and altering the law to make it fairer for Australian expatriates. The MRE could generally be denied to foreign residents, but if the foreign resident had previously been an Australian resident taxpayer, either one of the following two concessions below could apply, both of which are designed to simplify the law and make it more equitable. Either of these modifications would provide a fairer outcome for Australian expatriates without undermining the original policy intent of the measures.

Reset the cost base of the property to its market value

The law should be amended to allow Australian expatriates to reset the cost base of the property to its market value on the day they became a non-resident. This approach is based on the mechanism in s 118-192 of the ITAA 1997, which deals with situations in which a taxpayer initially uses as a property solely as their main residence and subsequently uses the dwelling to produce assessable income. When the taxpayer starts to use the property to produce assessable income, only a partial exemption from CGT is available when the property is sold.

In these situations, s 118-192 provides that, for the purpose of calculating the capital gain, the taxpayer is taken to have acquired the property at the first time the taxpayer uses the dwelling to produce assessable income. The cost base is taken to be the market value of the property at that time. This effectively 'resets' the cost base to the time when the taxpayer's circumstances changed, recognising that a full exemption would have been available had the CGT event happened just before the first use to produce assessable income and the taxpayer has most likely not kept the necessary records to substantiate the cost base for the period it was their main residence. This approach would calculate the capital gain only on the increase in the value of the property since they ceased to be a resident.

Allow Australian expatriates a partial exemption for the number of days they were a resident

This could be achieved by prorating the main residence days for which the individual was an Australian tax resident and lived in the dwelling as their main residence. This approach would be similar to the mechanism in s 115-115 of the ITAA 1997 which allows a prorating of the residency days for CGT discount purposes for certain foreign residents. For assets acquired after 8 May 2012, the CGT discount is unavailable to foreign residents. However, s 115-115 apportions the CGT discount where a CGT event happens after 8 May 2012 and the foreign resident had a period of Australian residency after that date. In a similar vein, the law could be amended to allow the MRE to apply following the disposal of a main residence proportionately based on the number of days the taxpayer was an Australian resident for tax purposes.

Improve operation of vacant land rules

Adult children

The current provisions do not address the common scenario where parents own primary production land and make it available for their adult children to continue to carry on the business.

The wording in s 26-102(2) of the ITAA 1997 should be amended to include adult children, not just those under 18 years of age.

Land is genuinely held for the purpose of earning assessable income

The explanatory memorandum set out the policy intent of the rules which was to ensure that deductions could not be being improperly claimed for expenses related to holding vacant land, where the land is not genuinely held for the purpose of earning assessable income.

However, the effect of the rules is to deny deductions where land is genuinely held for the purpose of earning assessable income. A taxpayer who rents vacant land, even on an arm's length basis, to someone who is not carrying on a business cannot use the exemption in s 26-102(9) because of subsection (b). In this case, there is no need to rely on the taxpayer's assertion that they are using the land for the purpose of earning assessable income as this can be evidenced by corroborating evidence such as rental income receipts.

The wording in s 26-102(9) should be amended to remove para 26102(9)(b) to restore the original policy intent.

Primary production land containing residential premises

The current provisions do not allow landowners to apply the exemptions in s 26-102(8) or (9) where the vacant land contains residential premises. It is common for primary production land to contain residential premises. Allowing taxpayers to use the exemptions in s 26-102(8) or (9) where primary production land contains residential premises is not inconsistent with the policy intent.

The wording in s 26-102(8) and (9) should be amended to remove paragraph (c) in each subsection to restore the original policy intent.

Investment properties

Negative gearing

The current tax system for negative gearing and the CGT discount on investment properties provides an environment to incentivise investment in real property driven by financial gain (i.e. losses in a current year can reduce taxes at an individual's marginal tax rate and any capital gains on property attract the 50% CGT discount). The interaction of the two measures has a much broader economic and social impact on the property market, for example, volatility and reduced home ownership.

Introduce quarantining rules

There is a strong case for principle-based reform such that losses on investments should not be deducted from salary and wage income.[385] The introduction of rules to quarantine losses so they are unable to be written off against salary and wage income would reduce the tax-driven incentive towards such investments.

There are different approaches to quarantining and how the rules should be designed:

- allow losses on investments to apply to all *non-salary and wage income*, including all forms of investment income (such as rental income and interest);

385 J Daley, D Wood and H Parsonage, *Hot property: negative gearing and capital gains tax reform*, Grattan Institute, 2016. Available at grattan.edu.au/report/hot-property/.

- allow losses on investments to apply only to investment income from the *same asset class* — for example, losses on a property investment could be applied to reduce gains on another property but not against dividends from shares. A similar regime exists in the UK and existed for a short while in Australia's history (between 1985 and 1987, refer above to 'Overview'); or
- allow losses on investments to apply only to income (including future capital gains) from the *same asset*.

There are some economic arguments for the last option. It aligns the timing of gains and losses and minimises any tax-driven bias of capital gains over recurrent investment income. However, it may lead to unproductive tax structuring as it may encourage people to hold investments through entity types that have more favourable tax treatment across different types of savings.[386]

Any changes should apply to all types of passive investments so that the tax system does not create bias towards certain classes of assets. Removal of tax incentive for investments should lead investors to shift toward income-producing assets and has the potential to increase income tax collection. There is also the alternate view that less revenue may be collected if some investment properties are replaced by owner-occupier properties.

International comparisons

Australia's tax treatment of property investment losses is more generous than most comparable countries, with most enacting measures to quarantine and limit deductions from investments against salary and wage income.[387] As mentioned above, the negative gearing rules in the UK are limited, losses from investment income are quarantined to the same asset class with excess losses carried forward. The main advantage under this system is that government revenue is not lost, however, there are some disadvantages such as the reduced tax value of losses in the event the marginal tax rates decrease when applied and potentially increased compliance costs.[388]

From a tax policy perspective, the quarantining of losses from the negative gearing of investment assets should be considered in the wider context of the CGT regime. As a model basis, consideration may also be given to the design of the CGT regime which restricts the offset of capital losses only against capital gains.[389] Similar arguments apply to the quarantining of interest deductions on investment assets and the concessional CGT treatment in Australia. Additionally, the transfer system has an existing negative gearing rule requiring investment losses be added back for income testing entitlement to benefits.

Options

A more consistent and principled approach could reasonably be taken across all types of investments to require the apportionment of interest expenditure between income production (deductible to the extent that income is produced) and capital (included in cost base for

386 J Daley, D Wood and H Parsonage, *Hot property: negative gearing and capital gains tax reform*, Grattan Institute, 2016, pp. 56-57. Available at grattan.edu.au/report/hot-property/.

387 J Daley, D Wood and H Parsonage, *Hot property: negative gearing and capital gains tax reform*, Grattan Institute, 2016, pp. 56-57, Appendix D – International comparisons of tax loss deductibility. Available at grattan.edu.au/report/hot-property/.

388 The Tax Institute, "Negative gearing – should we move towards the United Kingdom system?" (technical article). Available at www.taxinstitute.com.au/files/dmfile/Feature_Article_Negative_Gearing_Contax_Sept20121.pdf.

389 S 102-5; J O'Donnell, "Quarantining interest deductions for negatively geared rental property investments", (2005) 3 *eJournal of Tax Research* 65.

CGT purposes). In the short term, the existing regime relating to investment assets can be reformed. Quarantining provisions could be introduced which are similar to the UK model and in consideration of the CGT regime.

Over the longer term, a more fundamental rethink of the taxation of savings income may be appropriate. The Henry review's proposal to align the tax treatment of savings including interest income, net rental income, capital gains and interest expenses would provide a more consistent treatment of household savings and remains a worthy longer-term policy goal subject to being satisfied that the financial environment for such treatment remains valid.[390]

Individual tax residency and source

With regard to the current context of a post-COVID-19 era, a rapidly evolving modern economy and a trend in an increasingly mobile international workforce (disregarding travel restrictions and limitations imposed by COVID-19).[391] The Tax Institute considers it timely to continue the discussion on whether Australia's individual income tax residency rules are appropriate and adequately address the policy objectives of simplicity, equity, efficiency and integrity. It is noted that in the 2021–22 federal budget, the government has endorsed the principles for a revised individual residency test as proposed by the Board in its report of 2019.[392]

Improved certainty, reduced compliance costs and making Australia more attractive as a destination for inbound taxpayers should be a priority in reforming the residency rules. Furthermore, we should not be creating barriers for those Australians seeking to gain valuable experience overseas that the economy should benefit from on their return.

Exemption of certain income earned by Australians working overseas

The Tax Institute is supportive of reform for a more flexible taxing arrangement for those individuals who pay tax in other jurisdictions on income earned offshore. Alternatively, reform by way of a broader application of the qualifying period under s 23AG could be considered. A more lenient and global workforce-friendly approach would be to apply the foreign earnings exemption for temporary residents where the taxpayer has a period of more than 90 days offshore in a tax year without the need for those days to be continuous.

Personal services income

The Tax Institute encourages the government to consider a revised regime in line with the recommendations canvassed and areas of concern identified by the Board of Taxation, the Henry review and the Black Economy Taskforce. Recommendation 10 of the Henry review outlined a revised regime to prevent the alienation of PSI. However, no reforms to the PSI rules emerged and the concerns raised by the Board in 2009 remain valid today. The Board's review suggested non-compliance was an issue with 83.5% of a high-risk sample found to be non-compliant.[393]

---

390 Henry review, pp. 62-75.

391 The increasing mobility of the workforce is causing issues with current residency laws which have recently been described by the Board of Taxation as no longer appropriate for the 21st century: Board of Taxation, *Reforming individual tax residency rules – a model for modernisation*, 2019, p. 5. Available at taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2019/12/Tax-Residency-Report.pdf.

392 Ibid.

393 Board of Taxation, *Post-implementation review into the alienation of personal services income*, 2009, Australian Government, Canberra, p. 21.

It is time to evolve the tax system to be in step with wider economic, technological and social changes.

The following options are put forth for consideration.[394]

- Amend the existing Pt 2-42 so that where PSI rules result in income remaining otherwise unattributed to the test individual, rather than rely on Pt IVA, any PSI left in the interposed entity is attributed to that test individual (or, where income splitting occurs, adjustments are made so that the PSI is attributed to the relevant individual). This would simplify the existing regime and render the existing PSB tests redundant. Alternatively, amendment by the direct attribution of PSI to the relevant individual in all cases would be preferable (or deeming of dividends to the relevant individual). This could be done in conjunction with indexing the marginal tax thresholds to further reduce underlying key incentives for income splitting.
- Alternatively, a system similar to the New Zealand system could be adopted where the PSI regime (or a modified version of it) would only apply where an individual's net PSI is greater than the threshold where the 40% tax rate applies. This would simplify the self-assessment process for many individuals. However, this would not address the underlying incentives driving the splitting of income, such as the lower tax rates and multiple tax-free thresholds.

Meanwhile, ongoing and further consultation by professional bodies with the ATO can support this the process of reform and ensure that changes to the compliance system and the practical implications are appropriately communicated to individual taxpayers. Furthermore, the overlap between the tax system and the social security system must be considered and may create difficulties in the implementation of any options for reform.

Options for reform

- Increase transparency of the marginal tax rate system and how it applies to individual taxpayers.
- In the short term, introduce a standard deduction for work-related expenses with the option to claim actual expenses properly substantiated for employees with expenses above an agreed threshold value.
- Introduce quarantining of losses provisions to the negative gearing regime to streamline the tax treatment of investment properties.
- Improve tax-transfer system interactions, for example, addressing existing workforce participation experience by secondary workers (either by expansion of the subsidy or the introduction of universal free childcare).
- Basing joint tax returns on the family unit.

394 S Pennicott, "Resolving the personal services income dilemma in Australia: an evaluation of alternative anti-avoidance measures", (2007) *JIATax* 2; (2007) 10(1) *Journal of Australian Taxation* 53. Available at classic.austlii.edu.au/au/journals/JIATax/2007/2.html#fn202.

- Modernise the individual tax residency rules and make rules appropriate for today's contemporary working environment. Address existing difficulties in the current residency rules for Australian expatriates and inbound workers.
- Address the ongoing practice of income splitting by revision of the PSI regime in line with the recommendations canvassed and areas of concern identified by the Board of Taxation, the Black Economy Taskforce and the Henry review.

9. Private wealth

Overview

In this chapter, we turn to the taxation of private wealth and the transfer of wealth following death. We consider how a well-designed tax law can improve equity in respect of the tax treatment of private wealth assets and whether more appropriate tax outcomes following the death of a taxpayer can be implemented.

Private wealth clients face many of the same taxation issues as other individuals, and those general issues are covered in the sections of this report related to both individuals and superannuation.

One of the most significant issues in advising private wealth clients is succession planning. Succession planning can be one of the most difficult and challenging areas in which to advise clients as not only is it an emotional issue for all family members involved, but it also traverses a broad range of legal and financial issues of which tax is only one. While this impacts all individuals, the issues arising are more pronounced with private wealth individuals.

The tax issues arising often involve CGT, superannuation, wealth extraction, which itself may include dividends, deemed dividends, loans and trust vesting issues, and tax administration issues on death.

Overarching principles

The overarching principles in tax include that income is taxable when it 'comes home' and capital gains are taxable on realisation of the underlying change in economic ownership. The taxation system needs to appropriately address and facilitate the access to, and taxation of, the profits and wealth accumulated over the years by privately wealthy individuals, with these profits and wealth being situated in personal, corporate, trust or superannuation environments.

In a properly designed system, the profits should be taxable when they are accessed by the respective individuals and wealth should be taxable when realised or transferred subject to specifically targeted roll-overs, deferrals or exemptions aimed at achieving a desired policy intent.

Taxation of trusts

The taxation of trusts has been clearly problematic for some decades. Many of the problems emerge from interactions with other parts of the tax law, in fact, most of the issues surrounding trusts have emerged because of changes to other parts of the tax law. In addition, to address perceived and actual avoidance, the ATO has often adopted positions that go beyond accepted principles of trust law, in the process creating even further issues.

A new approach is needed to address these various issues and reduce the complexity and compliance costs that arise not just from the fundamental problems that have been identified, but also from the additional reporting that has been placed on all trustees in an attempt to deal with some minority cases and issues.

Issues

Access to corporate profits

The inappropriate access of corporate profits has always been a challenge for the tax laws. Predecessors to the current Div 7A were too easily manipulated and required determinations to be made by the Commissioner for the provisions to have effect; being at direct odds with the principles otherwise associated with a self-assessment regime.

From 4 December 1997, Div 7A has had application. The concept behind Div 7A in principle is simple — a self-operating provision ensuring profits extracted directly or indirectly from corporate entities without the intention to repay would be deemed as dividends and assessed in the hands of those who extracted such profit. This could be by way of loan, payment or the provision of, or access to the use of, an asset of the corporate entity. The actual operation and practical implications of Div 7A, on the other hand, are quite complex and onerous. The prescriptive rules have been amended on many occasions in an attempt to patch shortcomings and ease administrative burdens, on both taxpayers and the ATO.

Today, the provisions remain in a state of flux, with the ATO trying to patch technical deficiencies with administrative concessions and interpretative positions by way of rulings or other guidance materials, and the government struggling to achieve comfort in announced reforms which have now been pending for many years. Taxpayers are left to meet the significant compliance requirements imposed by the provisions to retain sufficient evidence to prevent these self-operative provisions applying in a self-assessment regime.

Division 7A therefore places an excessive burden on small businesses and family-owned enterprises for the simple behaviours it is otherwise intended to combat. The prescriptive design of the provisions places unreasonable restrictions on the flow of finance, resulting in the tax system overreaching what a properly designed tax law should otherwise do. Finally, private groups and their advisers are left managing information and records for different loans and UPEs, the implications of which are contingent on the timing of the loan or UPE and the direct/indirect manner in which the loan or UPE arose — all being unnecessary complexity.

Dealing with trust estates

The approach to the taxation of trusts has changed over the last 100 years or so. The first Commonwealth income tax laws approached the taxation of trustees of trust on the basis of the application of general rules of income and deduction but effectively provided a deduction for distributions to beneficiaries.[395] By 1922, one could start to see the emergence of some concepts that are reflected in the current regime.[396] However, there was nothing contained in those provisions about the *nature* of the income of the trust.

The wide use of trusts in Australia is somewhat unique; other jurisdictions limit the use of trusts for the conduct of business either directly or through the tax regime itself. The use of trusts to conduct businesses can be easily observed in the conduct of the business of a deceased taxpayer where the trustee might continue to carry on the business for a considerable period

395 The method involved reducing the tax liability by reference to the distributions (s 27 of the *Income Tax Assessment Act 1915* (Cth)).

396 S 31 of the *Income Tax Assessment Act 1922* (Cth).

for the benefit of income beneficiaries. To distinguish those cases (which, in some instances, continued for many decades) from an inter vivos trust created to carry on a business might be said to be difficult (although not impossible).

Trusts provide the flexibility of look-through taxation (generally), variable interests in the income (although this can also be addressed in the partnership and company context through differential shares or rights) commonly, and limited liability.

The use of trusts as investment vehicles has been common for centuries in the private or family context. Their use continues to be common for these purposes in family situations to protect against marriage breakdowns and ‘spendthrift’ children. The use of trusts as public investment vehicles most obviously emerged in their use by property trusts in the 1970s. This was perhaps because there was no other suitable vehicle that, at that time, did not result in either double taxation (companies) or the loss of tax concessions (such as depreciation and building allowances).

Over time, some of the alienation aspects have been addressed in the penal rates of taxation of minor beneficiaries (Div 6AA).

As alluded to earlier, the plethora of deemed amounts of tax income and amounts that are not represented by cash has been at the base of differences arising between income of the trust and the ‘taxable’ income of the trust. These include franked dividend gross-up amounts, capital gains determined differently (both as to amount and timing) compared to the trust profit, attributable income from various regimes and exemptions provided for (e.g. foreign branch income).

Some of these issues only became apparent by the overlay of the ‘proportional’ approach to the taxation of beneficiaries. This means that a beneficiary is taxed on an amount of the trusts ‘tax’ income by reference to their share of the trust’s income.

Further issues arose from a change of heart by the ATO of the approach to the treatment of different kinds of income in the hands of different beneficiaries. That is, the ‘proportional’ approach meant that there was no distinction between different kinds of tax income. That is, it was irrelevant, according to this view, that a beneficiary was only entitled to, say, rent from Blackacre; if the trust had other kind of income, the beneficiary would be taxed on a portion of all the different kinds of tax income (dividends, interest, rent, foreign income) having regard to their share of the total trust income.

In the period from around 2008–2013, there was a flurry of activity and several projects launched to address some of the issues that had become almost untenable in the uncertainty regarding the way trusts taxation should be approached and the way in which the taxation of trusts was being administered. It might be said that many of those projects were seeking to address symptoms rather than the underlying issues that gave rise to those symptoms.

The only real change from this period was the acknowledgment of streaming of franked dividends and capital gains. The method by which this was achieved was highly complicated and formulaic. That approach has produced its own problems.

Additionally, it is the rates of tax that can apply that encourage certain kinds of behaviour. For example, the high rates of tax applying to undistributed or accumulated income encourages the use of a company beneficiary to limit the tax to the corporate rate. The income is needed for working capital in the business conducted by the trust, which is why it isn’t distributed in the first place. As it is needed for working capital, it is then lent back to the trust, giving rise to the attraction of the anti-avoidance rules in Div 7A.

Additionally, concerns over the potential undermining of the corporate tax base through the use of trusts by large businesses resulted in Div 6C, which is designed to treat such a trust as a corporate entity and subject to corporate tax. The potential reach of those rules has given rise to another phenomenon — the stapled structure. Of course, this has then given rise to an ATO response and further amendments to the law. All this results in highly complicated rules.

Trusts are also subject to a range of highly specific CGT rules that are often complicated but, nonetheless, either give rise to inappropriate taxation or turn out to be not necessarily comprehensive.

Specific regimes have been developed for public investment trusts (MITs and AMITs) that add to the complication (although the underlying concept might reveal an option for reform).

That many of these specific rules exist at all may be the result of consistently narrow thinking that seeks to find solutions only in the trust regime itself. For example, as has been mentioned in Chapter 3, why is there differential taxation of business income based on the vehicle or structure chosen? Why are limited partnerships taxed as companies when they could provide the perfect vehicle for small business to operate giving flow-through treatment, flexibility and limited liability?

Dealing with deceased estates

A capital gain or loss made from a CGT event on death is generally disregarded.[397] Section 128-15 of the ITAA 1997 then sets out various cost base rules in circumstances where CGT assets devolve to a legal personal representative or pass to a beneficiary following the death of a taxpayer and are subsequently disposed of or sold.

The policy intent of this is clear. An estate should not be forced into the sale of an asset to simply fund a tax liability that would otherwise arise on the transfer of assets/wealth to the beneficiaries of a deceased.

However, the drafting of these provisions, while on their face appear simple, give rise to unnecessary complexities when interposed with other provisions within the tax laws.

One example includes the application of the MRE to assets passed to the taxpayer on the death of another.[398] The respective sections provide a full or partial CGT exemption to an individual who has taken ownership of, and subsequently disposes of, property acquired from a deceased estate (either where the ownership interest passes to a beneficiary in a deceased estate or is owned as the trustee of a deceased estate). These rules are overly complex and require the analysis of the deceased's use of the assets and retention of substantiation in relation to the same, which may not always be easily obtained.

Operation of the main residence exemption rules for deceased estates

Pursuant to s 128-15(4) of the ITAA 1997, where a dwelling that was a taxpayer's main residence devolves to a legal personal representative or passes to a beneficiary upon that taxpayer's death,

397 S 128-10 of the ITAA 1997.

398 See ss 118-195 and 118-200 of the ITAA 1997.

the property's cost base is broadly determined according to the market value of the dwelling on the date of the taxpayer's death. This rule eliminates the need to determine and use the original cost base of the asset in CGT calculations and permits the cost base to be reset on the date of death. This rule is designed to reduce complexity and make it easier for those administering an estate or inheriting a property.

There are a number of problems with the operation of the cost base rule in s 128-15(4).

1. These cost base rules are complex and poorly understood. The interaction between the rules set out in s 128-15 compared to the full and partial exemption rules in s 118-195 and s 118-200 are difficult to navigate. This places a heavy burden on those who take possession of property via deceased estates in ensuring they apply the correct tax treatment to that property.

2. The market value deeming rule in s 128-15(4) is limited in its application and inconsistent.

   In practice, this means that the market value rule in s 128-15(4) applies in a narrower set of circumstances than many taxpayers realise.

3. The cost base rules are difficult to apply in practice. This is particularly the case for property that passes through a chain of deceased estates. Where the market value deeming rule in s 128-15(4) does not operate to shift the cost base calculation to the date of death, the compliance burden associated with determining the original cost base of property passing through multigenerational deceased estates is high and complicated. It requires those further down the chain of deceased estates to correctly characterise the use of the property at each stage of ownership through the chain.

Transfer of wealth from the superannuation system

As at 31 December 2020, there was over $3tr[399] in superannuation assets in Australia. While Chapter 10 deals with superannuation more generally, for the purposes of considering superannuation and deceased estates, some issues will be noted here.

The operation of the TBC (see Chapter 10 of this paper) limits the total amount of superannuation that an individual can transfer into retirement phase income streams, including most pensions and annuities. This is complicated when a person receives an income stream from a fund as a consequence of the death of the person whose superannuation benefit is the source of that income stream.

The ATO explains[400] the operation of the TBC on death benefit income streams as follows:

> If you are receiving a death benefit income stream – either by itself or in combination with another super income stream – you need to ensure you don't exceed your personal balance cap.
>
> From 1 July 2017, death benefits can be rolled into another fund. However, the new fund must commence a death benefit income stream or pay the amount out of super as a lump sum (or a combination of these). The death benefit cannot be retained in accumulation phase.

399 Australian Prudential Regulation Authority (APRA), *Quarterly superannuation performance statistics highlights* for the December 2020 quarter (released 2 March 2021).

400 ATO, *Death benefit income streams and your transfer balance cap*, QC 54352 (last modified 4 May 2020).

Where an individual who has already maximised their TBC is the death benefits dependant of an individual who died, they will not be able to receive a death benefit income stream without exceeding their TBC. The death benefit cannot be retained in accumulation phase, so the amount will need to be cashed out or transferred in specie to the death benefits dependant as a death benefit lump sum.

This will result in assets (or cash equivalent where the assets were sold prior to transfer to facilitate the payment of the death benefit lump sum) leaving the concessional superannuation environment. Given the current contribution cap settings,[401] in the decades ahead, the value held in high balance superannuation funds[402] will be transferred out of superannuation and will not be able to be contributed back in. The substantial transfer of billions of dollars out of superannuation assets will pose inevitable questions as to where that wealth will rest.

Options

Division 7A

The government has acknowledged that the rules in Div 7A are in great need of reform. However, the passage of eight years since the post-implementation review of Div 7A by the Board was commissioned in 2012 illustrates the enormous challenge in designing workable reforms.

It will be essential for the profession to constructively engage with the various stakeholders to ensure that the policy objective is reasonable and the enacted provisions are workable, sensible and equitable.

Tax rate differential

The single most significant issue within our tax laws driving the behaviours which Div 7A is designed to combat is the variance in tax outcomes as between companies, trusts and individuals. A properly designed tax system addressing these differences and appropriately balancing the tax mix between income and consumption taxes would alleviate the need for such complex ‘anti-avoidance’-type provisions such as Div 7A. These issues are discussed and addressed throughout this report.

Aligning the section 99A rate with the corporate tax rate would resolve most Division 7A issues

It is common in SME groups for a company to lend funds (whether its own funds or funds borrowed as the financier within a business group) to a related trust. The funds are used by the trust to acquire the business premises or plant and equipment that is leased or made available to the company which carries on the business. This arrangement ensures that the business assets are sufficiently protected. However, the arrangement requires the trust to manage the loan according to Div 7A complying loan terms, or be exposed to being assessed on a deemed

401 $25,000 for concessional contributions and $100,000 for non-concessional contributions ($300,000 under the threeyear bring-forward rule for eligible individuals).

402 A report in April 2015 by R Clare, Director of Research, The Association of Superannuation Funds of Australia Limited, titled *Superannuation and high account balances*, found that more than 210,000 people have more than $1m in superannuation, around 140,000 persons have more than $1.5m, 100,000 in excess of $2m and about 70,000 in excess of $2.5m.

dividend generally equal to the amount of the loan funds. There is no mischief or private use of the funds.

As an alternate to the current approach to the taxation of trusts, if the rate applicable to funds retained by a trustee under s 99A of the ITAA 1936 is aligned with the business tax rate on a universal entity basis, there would be no difference between the corporate tax rate and the rate imposed under s 99A. This would allow an outcome similar to what currently happens when one company lends to another private company (i.e. the loan is excluded under s 109K of the ITAA 1936).

The alignment of the tax rates would also, in many cases, likely eliminate the incentive for taxpayers to establish corporate beneficiaries of trusts.

Allow an 'otherwise deductible rule' for loans made for a taxable purpose

Alternatively, there should be an 'otherwise deductible rule' (akin to the 'other deductible rule' in the FBT laws) which excludes a loan made by a private company to another related entity from being subject to Div 7A where the loan is:

- genuine;
- made in accordance with the powers of the trustee or the company constitution and does not contravene the relevant provisions of the *Corporations Act 2001* (Cth) (such as the provisions relating to directors' duties and trading while insolvent); and
- made for a taxable purpose (for example, to acquire a business, business premises or a rental property or for working capital).

Introduce a self-correction mechanism

While the government announced on 3 May 2016 that a mechanism to allow taxpayers to self-correct breaches of Div 7A would be introduced with effect from 1 July 2016, the start date of the proposed reform has been deferred three times.

Where other reforms are not introduced eliminating the need for Div 7A, The Tax Institute supports the introduction of a self-correction mechanism as soon as possible. It should also be accompanied by a limited-period amnesty (akin to that offered by PS LA 2007/20 in 2007 and 2008) to allow taxpayers to address existing loans that don't comply with Div 7A.

Proposed reforms

Where other reforms are not introduced, due to the passage of time since the original announcement of the reforms to Div 7A on 3 May 2016, the various transitional dates should be modified.

Consideration should also be given to:

- the introduction of equitable transitional rules for existing seven-year loans;
- providing workable safe harbours for the use of company assets;
- introducing more streamlined default loan terms;
- simplifying complying loan arrangements/agreements; and
- a one-off 'tick-the-box' election for exemption from Div 7A for loans to trusts (see below).

The Board's 2014 *Post-implementation review of Division 7A of Part III of the Income Tax Assessment Act 1936*[403] recommended there be a one-off tick-the-box election for exemption from Div 7A whereby trusts could be eligible to make a 'once-and-for-all election' to exclude loans from companies.

The policy rationale behind the 'tick the box' approach was to place company-to-trust loans on the same legal footing as inter-company loans with the understanding that small businesses might operate both companies and trusts to maximise the benefits that each legal structure offered them.

The Tax Institute affirms this recommendation, although notes that if a lower business tax rate was applied to all entities, regardless of legal structure, there would no need for a 'tick-the-box' exemption.

Trusts

The taxation of trusts needs to be looked at holistically and in the context of the system as a whole. Consideration should be given to both previous forms of taxation and whether the proportional approach really serves the system well.

Consideration needs to be given to consistent treatment of the taxation of business income across structures.

The accumulated income of trusts should be taxed at a rate that is more consistent with the reason for the accumulation — that is, the corporate tax rate provides the best surrogate. The number of issues that would be addressed by this simple change are considerable.

There are issues with the interaction of the trust rules with other parts of the legislation (including the international income and credit rules and the CGT rules) and there needs to be a more coherent approach.

The allocation between beneficiaries, generally, could take the model for allocating income that is used for AMITs. The continued attempts to align trust income with tax income of the trust needs a re-think and the question asked, is it really necessary at all?

The taxation of minors needs to be rationalised as it is highly complicated with unintended consequences.

Deceased estates

Addressing the tax exemption on death

The current law reflects a policy intent of ignoring capital gains and losses on death. There is a question as to whether this should be maintained as an appropriate setting in the tax system. The reason for the effective deferral of realisation of a capital gain was to address accusations of the re-introduction of a death tax. Whether that is a valid reason to ignore the capital of a taxpayer on death is questionable given all other tax liabilities are drawn at death. The deferral of gains on realisation of assets is a practical departure to an economist's view of the taxation of gains over the course of a year. The deferral past death is purely political.

403 Board of Taxation, *Post-implementation review of Division 7A of Part III of the Income Tax Assessment Act 1936 – a report to the Assistant Treasurer*, November 2014.

Nonetheless, even if the current setting is maintained, the manner in which this is achieved is open to debate.

A simple outcome with less complexity could be achieved through the provision of a ‘choice’ to taxpayers. One possible option in this regard could be to treat all assets as having been disposed of for their market value in accordance with general CGT principles. Individuals could then choose on an asset-by-asset basis to treat the transfer (for both sale and acquisition purposes) to have been performed at the asset’s cost.

- For a main residence, the treatment would be that which would have applied to the deceased. If a full exemption would have applied to the deceased, no liability arises and the beneficiary acquires the asset at its market value. For a partial exemption, the choice afforded to taxpayers could be a reduction in the new cost base by the amount that would have otherwise been assessable should they not wish for the estate to incur a tax liability. Concessions should be provided to facilitate estates reaching probate.
- For family farms, there may be good reason to defer realisation where the farming business continues to be carried on by a family member; a similar consideration may apply to other types of family businesses. A choice could be provided.
- For trading stock, this would effectively replicate the choices presently available.
- For foreign residents, unless the assets were TAP, no tax liability would arise in any event.
- For pre-CGT assets, no tax liability would arise in any event.
- For all other assets, the choice would afford the estate the ability to choose whether to pay tax or not depending upon the asset composition of the estate.

The drafting of such provisions could result in a simpler and better understood regime.

Other CGT reform options

There are three potential options for reforming the cost base rules for properties passing through deceased estates. The first two avenues propose broadening the application of the market value deeming rule in s 128-15(4) of the ITAA 1997.

Widen the application of the market value deeming rule on the date of death

The scope of the market value deeming rule on the date of death in s 128-15(4) of the ITAA 1997 could be broadened to encompass CGT assets that do not currently qualify for a resetting of the cost base upon death. Although this may result in some currently taxable gains being treated as tax-free, it would improve the operation of the law by minimising the compliance burden of undertaking cumbersome and complicated CGT calculations placed on those whose assets are currently not eligible to reset the cost base of the property to its market value on the date of death.

Other options for deceased estates and wealth taxes

Is there merit in introducing a wealth transfer tax?

It is estimated that over the next two decades, Australians over 60 years of age will transfer $3.5tr in wealth.[404] Notably, around 78% of the estimated wealth transferred will go to roughly 20% of recipients.[405] This indicates that there is significant inequality in Australia with respect to wealth, and this inequality manifests itself in the realm of inheritance.

The topic of wealth or estate taxes, also known as death duties, has been fraught with resistance in Australia since their general removal in the 1970s. The history of estate taxes has been usefully outlined in *A brief history of Australia's tax system*:[406]

> **Estate taxes (death duties)**
>
> Estate taxes were first introduced in the form of probate duties (a tax on property passing by will) charged by courts in the early part of the nineteenth century in New South Wales. By 1901 estate taxes had been adopted by all of the colonies. The rates were progressive and based on the value of the estate, with reasonably high exemption thresholds, thus limiting the impact on small estates. The duties were an important source of state revenue from the end of the nineteenth century through the first part of the twentieth century. In general, estate duties were relatively low cost to administer and, when introduced, were more readily accepted than a wealth tax, levied throughout a taxpayer's life. Gift duties aimed to ensure that estate duties were not circumvented. In 1914, the federal government also introduced a progressive system of estate taxes to help fund wartime expenses.
>
> By the late 1960s and into the early 1970s, state and federal governments were coming under increasing pressure to amend or remove estate duties. Having not been adjusted since the 1940s, individuals with relatively modest levels of wealth were becoming subject to estate duties. At the same time more wealthy individuals were seen to be avoiding the tax through effective estate planning (Groenewegen 1985). With the increasing impost on smaller estates, estate duties became more costly to administer. Rural producers and small business owners also objected to the taxes on the basis that they impeded business succession.
>
> By the 1970s pressure for estate duty concessions had gradually reduced the tax base. In the end, state tax competition led to the abrupt demise of estate duties. After Queensland dispensed with its tax in 1977, there was concern in other states about emigration of residents and capital and the potential impact of the tax on electoral outcomes (Pedrick 1981). The federal government also abolished its estate and gift duties in 1979. By 1984 all estate duties had been removed, both state and federal. This occurred despite various tax review committees recommending refinements to improve the equity, efficiency and simplicity of the tax.

404 J Lin, J Mangan and F Milosavijic, *Back from the dead: Australian inheritance tax*, University of Queensland, August 2018.

405 Ibid.

406 S Reinhardt and L Steel, *A brief history of Australia's tax system*, Tax Analysis Division, Treasury, 4 September 2006.

This history, and the state of the economy post-COVID-19 necessitating new sources of revenue, is the basis for a healthy discussion as to the merit of introducing[407] a wealth transfer tax in Australia.

The argument in favour of introducing a wealth transfer tax, that wealth inequality in Australia is evidenced by the way wealth is transferred upon death, has already been partly outlined above. In furtherance of that argument, the policy intent underpinning the introduction of a wealth transfer tax would be to minimise that wealth inequality and simultaneously boost government revenue.

In many countries, the wealth transfer taxes are set at, in our opinion, prohibitive rates.[408] In Australia, our tax system already collects revenues on the earning of income and profits and on the transfer of wealth, as set out above. If consideration was given to a wealth transfer tax in Australia, it is our opinion that any rate set should be relatively low as compared to other taxes, for example, 5% above a certain threshold of, say, $2.5m or another reasonable amount. This would appropriately account for other taxes already collected during an individual's lifetime. Nonetheless, it must be noted that such taxes usually collect only a small proportion of overall taxes in jurisdictions where they are levied. Whether the cost of compliance and administration outweigh the benefits of imposing such taxes would need to be examined as part of any consideration.

Administration for deceased estates

As a closing remark, it is noted that there are complexities and excessive burdens imposed on administrators of deceased estates, including lodgment requirements and the need for TFNs. The option for reforming the current inefficiencies due to the requirement for deceased estates to have a separate TFN was put forward by the IGTO in her July 2020 report.[409] We recommend a review of the administrative burdens imposed on deceased estates with a view to improving the system for both taxpayer and administrator.

---

407 Many would consider this 'reintroducing'.

408 The UK's rate is 40% above GBP325,000 (with certain exemptions for main residence GBP150,000 and transfers to spouses) plus joint spouse limit can become GBP 650k + 300k; France has a sliding scale for each child beneficiary – over EUR100k: 5% – 45% (nothing for spouse, higher for non-children); the US is complicated but roughly first USD11m exempt then a sliding scale up to 40% between USD11 and USD12m.

409 K Payne, *Death and taxes: an investigation into Australian Taxation Office systems and processes for dealing with deceased estates*, Inspector-General of Taxation, July 2020.

Options for reform

- Improve the cost base rules for properties passing through deceased estates by (subject to possible exceptions):
  - widening the application of the market value deeming rule on the date of death; and
  - introducing a CGT event to happen on the date of death to reset the cost base.
- Options for deceased estates and wealth taxes:
  - consider the merit of introducing a wealth transfer tax; and
  - remove separate TFN requirement for simple deceased estates.
- Revisit the taxation of trusts with a view to addressing anomalies in trust income/tax income interactions.
- Consider providing other flexible options for small businesses to operate through (e.g. limited partnerships as flow-through vehicles — abolish Div 5A).
- Allow streaming of all income through trusts consistent with the economic entitlements of beneficiaries.
- Set the accumulated income tax rate for trusts at the corporate tax rate.

Superannuation and Retirement

10. Design of a sustainable superannuation system

Overview

This chapter considers the fundamental design of the superannuation system, and the best reform options to our tax system to:

1. support a sustainable superannuation and retirement system;
2. reduce unnecessary complexity and ensure greater consistency in the various superannuation caps and thresholds; and
3. encourage improved compliance by employers with the mandatory SG regime.

There are a number of aspects of Australia's superannuation system which are inefficient and complex. Many of these issues are interrelated.

The tax treatment is complex: contributions, earnings and benefits are partially taxed and partially deductible, the result of a pragmatic attempt to reduce tax expenditures, especially those benefiting higher-income individuals, while encouraging compliance.[410]

Successive governments have made significant changes to the taxation of superannuation, and adjusted Australia's superannuation policies in the pursuit of so-called improvements. Changes have also been made to suit the sitting government's political objectives. The superannuation rules have been tinkered with in virtually every parliamentary term since the 1980s. This has resulted in the core objectives of the system being unnecessarily overlaid with complex legislative amendments, policy changes and voluminous quantities of provisions, regulations, rulings and legislative instruments.

Key examples of the complexity include the operation of various thresholds and caps. Other overarching issues include the most appropriate taxation point in the superannuation life cycle and the operation of the SG charge and penalty regime.

There are three primary avenues, or 'pillars', for funding retirement in Australia:

1. superannuation — compulsory SG and voluntary superannuation;
2. private wealth — personal earnings and the accumulation of private wealth in investments held outside the superannuation system; and
3. age pension — government-funded and means-tested.

These pillars were the subject of the government's 2019 *Retirement income review*. The review's final report made the following key observation:

410 *Super taxing – an information paper on the taxation of superannuation and related matters*, Canberra, February 1998.

The retirement income system is complex. There is a need to improve understanding of the system. Complexity, misconceptions and low financial literacy have resulted in people not adequately planning for their retirement or making the most of their assets when in retirement. Adding to complexity is the interaction with other systems, such as the aged care and the tax systems.

Superannuation life cycle: the taxation of contributions, earnings and benefits — historical note

Superannuation may be taxed at three key stages:

1. on contribution — when a pre-tax contribution is made by an employer or a member;
2. during the accumulation phase — tax on the fund earnings; and
3. on withdrawal — when the benefits are paid to the member who has satisfied a condition of release.

Prior to 2007

Until the 1980s, superannuation funds generally paid no tax on contributions and contributions made by both employers and employees were tax deductible (or, in the case of employees, granted a tax offset/rebate from the mid-1970s until the early 1980s). Neither were taxes paid on accumulation, with earnings of superannuation funds being exempt, other than in exceptional circumstances. Taxes on exit were only imposed upon 5% of any lump sum up until 1983 and, if pensions or annuities were taken, tax was paid on those income streams at each recipient's marginal rate (although, a portion of the annuity referable to an employee's own contributions were effectively exempt).

From 1 July 1983, new taxation arrangements for ETP were introduced the . Instead of including only 5% as assessable income, the full amount was included, subject to a maximum marginal rate of 30%. To avoid retrospectivity, the new rules only applied to lump sums attributed to post-30 June 1983 service and the old rate continued to apply to sums attributed to pre-1 July 1983 service.

To further encourage the preservation of benefits for genuine retirement, the 30% on the first $55,000 of the post-30 June 1983 component was reduced to 15% where the recipient had attained the age of 55. No substantive changes were made to the treatment of pensions and annuities.

The 1983 changes substantially increased the assessable amount of lump sum benefits and therefore had the effect of increasing Commonwealth revenues. However, these revenues were not available to the then government, but to future governments when the accumulated benefits were received by retirees.

Effective from 1 July 1988, the taxation of superannuation was fundamentally altered. Until that time, it was reasonable to say that Australia followed many other countries with an exempt[411]-exempt-taxed model for the taxation of superannuation and pensions. That is, the contributions

411 Because contributions are often deductible to the contributor (whether employee or employer), the description of the contributions as being taxed is sometimes considered inaccurate. However, the deductibility is offset by the taxation in the hands of the fund from 1 July 1988 such that the effect is partial taxation.

to the fund were exempt, the earnings in the fund were exempt and the benefits were taxed. The change from 1 July 1988 resulted in what could be best described as a taxed-taxed-taxed model, although the taxation was at reduced rates.

The then government reduced the tax on the post-1983 component of benefits from 30% to 15%, at the same time imposing a 15% tax on all contributions (other than undeducted contributions) and earnings of superannuation funds. This changed the government's collection from a 30% tax rate on benefits payments from the fund to a 15% tax rate on contributions to the fund and a 15% tax rate on benefit payments. Accordingly, the total tax on deductible contributions was reduced to 27.75%. In addition, the bring forward of tax on both contributions and earnings would have an impact on future member benefits and on future government revenue. However, 15% became available to the current government.

The changes on 1 July 1988, provided for the continued exemption of income earned on assets set aside to provide pensions and annuities from tax, despite the new fund earnings tax. Annuities and pensions to members were concessionally taxed via a 15% tax offset (other than unfunded benefits which remained taxed under the 1983 rules).

The 15% superannuation contributions surcharge tax was introduced from 20 August 1996 and applied to certain employer contributions and deductible personal contributions.

Benefits paid as lump sums were taxed at varying rates, depending upon whether the amount of the benefit exceeded the RBL. The use of RBLs was a significant limitation on the tax concessions afforded to superannuation. Amounts in excess of the RBL were taxed at the member's marginal rate plus the Medicare levy, while pensions were included in the recipient's income and taxed at marginal rates.

1 July 2007 changes

In 2007, the Howard Government made substantial changes of far-reaching impact to the taxation of superannuation, namely that:

- RBLs were abolished;
- Australians over the age of 60 could withdraw benefits from their superannuation fund taxfree if from a taxed source; and
- the age-based limits were replaced with concessional and non-concessional contribution caps.

These changes entrenched a permanent and greater concession for superannuation than had previously existed. The transitional period during which large amounts could be contributed to superannuation (in theory designed for those who had failed to made adequate provision to make 'catch up' undeducted contributions before the new limits were imposed). Nonetheless, the exemption for drawdowns from super after age 60 meant a fundamental reduction in overall taxation of superannuation as the superannuation contribution and accumulation tax levels remained unchanged at their concessional levels.

1 July 2017 changes

A raft of measures designed to better target the superannuation concessions were introduced by the Turnbull Government, most of which came into effect on 1 July 2017. Among these measures were the TSB and the TBC. These caps determine eligibility to various superannuation concessions, such as bring-forward nonconcessional contributions and catch-up concessional contributions, spouse offsets and government co-contributions. However, the dollar thresholds for these caps are also set at different values for each of these concessions.

The TBC limits the amount of capital that an individual can set aside to pay a superannuation income stream. The TBC was established at $1.6m (general cap) with the potential for increase via indexation in accordance with movements in CPI. Indexation of $100,000 is applied.[412]

Other changes (with varying effective dates) included:

- a reduction of the cap on concessional contributions to $25,000 per annum (formerly $30,000 for persons aged 50 years or older);
- a reduction of the Division 293 threshold from $300,000 to $250,000. Individuals with income and concessional contributions above this threshold became liable to an additional 15% tax on their concessional contributions;
- a reduction of the non-concessional contribution cap from $180,000 per annum to $100,000 per annum (limited to a threshold equivalent of the TBC);
- a replacement of the low-income superannuation contribution with a 15% low-income superannuation tax offset;
- an increase in the spouse tax offset; and
- the removal of the tax-exempt status of earnings from assets supporting transition to retirement income streams.

The overall effect of these measures was to limit the benefits arising from the 2007 changes, increasing complexity in an already complicated system. Some of these limits have been indexed from 1 July 2021.

Significant restructuring and planning for funds occurred in the lead up to these changes. Of note, some SMSFs are carrying large 'deferred capital gains' that suddenly arose by virtue of the taxation of amounts in excess of TBCs. While many were able to undertake planning to minimise the impact of the changes, the design of both the new rules and the transition was considerably over-engineered and remains an ongoing issue for practitioners and funds.

The upheaval to practitioners and their clients that 'significant' rewrites have cannot be understated. Both the 2007 and 2017 superannuation reforms placed incredible pressure on the system; practitioners have described the period as 'crushing'. Lead times were too short and the complexity was unnecessary.

Superannuation caps and thresholds

The current superannuation system is overly complex given it not only limits the amount that can remain within both accumulation and retirement phase,[413] but also restricts how much a member can contribute in any given income year. It contains a plethora of caps and thresholds, most of which are indexed annually,[414] that require a major overhaul in order to make the system simpler to both understand and administer.

412 The TBC has been indexed from $1.6m to $1.7m from 1 July 2021.

413 Currently $1.6m, but increasing to $1.7m from 1 July 2021.

414 Indexation does not necessarily result in an increase in the particular cap or the threshold.

Table 10 summarises the current caps and thresholds in the superannuation system.

Table 10. Current caps and thresholds in the superannuation system (for 2021–22)

Cap/threshold	Description	Legislative reference
$27,500	Concessional contributions cap	s 291-20(2) of the ITAA 1997
$110,000	Non-concessional contributions cap[415]	s 292-85(2) of the ITAA 1997
$330,000	Non-concessional contributions cap under threeyear bring-forward rule	s 292-85(5)–(7) of the ITAA 1997
$1,615,000	CGT cap amount	s 292-105 of the ITAA 1997
$250,000	Division 293 threshold	s 293-20 of the ITAA 1997
$225,000	Low rate cap amount	s 307-345 of the ITAA 1997
$1,615,000	Untaxed plan cap amount	s 307-550 of the ITAA 1997
See ATO table	Minimum annual payments for superannuation income streams[416]	Sch 7 to the SISR
$225,000	ETP cap for life benefit termination payments	s 82-160 of the ITAA 1997
$225,000	ETP cap for death benefit termination payments	s 82-160 of the ITAA 1997
$58,920[417]	Maximum contribution base for SG purposes	s 15 of the SGAA
 $500 $41,112 $56,112	Co-contribution thresholds: • maximum entitlement • lower-income threshold • higher-income threshold	s 9 and s 10A of the *Superannuation (Government Co-contribution for Low Income Earners) Act 2003*
$500	Low income super tax offset (up to adjusted taxable income of $37,000)	s 12E of the *Superannuation (Government Co-contribution for Low Income Earners) Act 2003*
$1,700,000	General TBC	s 294-35 of the ITAA 1997
$106,250	Defined benefit income cap	s 294-135 of the ITAA 1997
$450	No SG obligation where employee earns less than $450 in a month[418]	s 27(2) of the SGAA

Superannuation concessionary measures

The superannuation system includes a range of targeted concessions that have been designed to provide relief, or assistance to, specific classes of individuals. However, the piecemeal manner in which each measure was designed and added to the existing superannuation rules has resulted in a cluttered, inefficient superannuation regime that most taxpayers and practitioners find difficult to navigate.

Table 11 summarises the current concessionary measures in the superannuation system.

415 The non-concessional contributions cap for a financial year is nil if, immediately before the start of the year, an individual's TSB equals or exceeds the general TBC for the year: s 292-85(2)(b) of the ITAA 1997.

416 These have been temporarily halved due to COVID-19 for the 2019–20 and the 2020–21 financial years.

417 Income per quarter.

418 Subject to abolition as 2021-22 federal Budget proposal.

Table 11. Current concessionary measures in the superannuation system

Measure	Legislative reference
Government co-contributions	*Superannuation (Government Co-contribution for Low Income Earners) Act 2003*
Low income superannuation tax offset	*Superannuation (Government Co-contribution for Low Income Earners) Act 2003*
Spouse contributions tax offset	s 290-230 of the ITAA 1997
Carry-forward concessional contributions	s 291-20(3) of the ITAA 1997
Bring-forward rule for non-concessional contributions	s 292-85(3)–(4) of the ITAA 1997
Employees with multiple employers (SG employer shortfall exemption certificate)	s 19AA, s 19AB and s 19AC of the SGAA
Downsizer contributions	s 292-102 of the ITAA 1997
First home super saver scheme	Div 313 of the ITAA 1997 and Div 138 of the TAA 1953

Superannuation guarantee regime

The key governing legislation for the SG scheme is the SGAA which requires all employers to provide a minimum level of superannuation support.

10.1 Taxation and the superannuation life cycle

Unquestionably the shift in policy from taxing on exit to taxing on entry has brought forward government tax receipts, but is this an appropriate setting for the long-term sustainability of the superannuation system? At which stage in the superannuation life cycle is it most appropriate to impose tax? On the contributions, on the earnings during accumulation phase or on benefit payments (lump sums and income streams) to members, or a combination of two or more of these stages?

Many agree that the current settings on withdrawal are too generous, even those who gladly benefit from the rules introduced with effect from 1 July 2007.

Taxing contribution on entry to superannuation is accompanied by a plethora of complex rules governing how and when contributions can be made. These rules are discussed in more detail under ‘Superannuation caps and thresholds’ below, but they illustrate that the system imposes complex rules to restrict how much is contributed to superannuation rather than impose a higher rate of tax on excessive benefits withdrawn from superannuation.

The former reasonable benefit limits rules (RBLs) were repealed from 1 July 2007 to give way to the generous ‘tax-free after age 60’ regime. However, there was merit in taxing excessive benefits that had accumulated while in a concessionally taxed superannuation environment.

The death benefit system is also in need of a review, including who should receive death benefits and how they should be taxed. The binding death benefit nomination provisions could similarly do with an overhaul. It should be considered how readily death benefits can be, and are, challenged and whether death benefits should be tied to a deceased’s estate.

Other jurisdictions have only one taxing point. Is Australia’s approach to impose tax across the life cycle more equitable or does it just make the system more complicated?

The only thing that is constant in superannuation is change

Superannuation has been viewed as a pliable policy instrument by all governments for the last 50 years. The rules have been altered seemingly every year to achieve the policy objective of the moment, but this approach provides no long-term certainty and it discourages faith in the system that the rules will not change again to meet the short-term policy and fiscal objectives of the day.

One of the reasons for the 'constant tinkering' is because the tax settings of the superannuation system are inequitable and inefficient, and this will therefore always leave it open to future revisions. Compounding this issue is the fact that the superannuation system is such a large 'money pot'.

That said, reform of the superannuation system is needed, to simplify the rules, remove barriers to entry, encourage retirement savings and provide long-term certainty.

The superannuation system is currently riddled with legacy products and procedures. The removal of these relics could help simplify and streamline the system. One example that proponents have long advocated for is the ability to convert defined benefit pensions and market-linked pensions into account-based pensions.

10.2 Superannuation caps and thresholds

As mentioned above, the rules governing how and when contributions can be made are designed to restrict the amount of contributions that are made to a concessionally taxed environment. However, their operation has become unwieldy and inefficient.

The current superannuation system is overly complex given it not only limits the amount that can remain within both accumulation and retirement phase (i.e. currently $1.6m), but also restricts how much a member can contribute in any given income year. It contains a plethora of caps and thresholds, most of which are indexed annually,[419] that require a major overhaul in order to make the system simpler to both understand and administer.

A key contributor to the complexity of the system is the inconsistency in reference points for the indexation of such caps and thresholds, and in the methodology used (with some based on movements in the CPI and others based on AWOTE changes).

Some of the caps are lifetime caps,[420] which are difficult to administer and rely heavily on maintaining accurate records so as not to exceed the particular cap.

While the concessional contributions cap is theoretically subject to annual indexation, actual increases in the cap rarely eventuate in practice because inflation levels are currently very low and any increases must be in minimum increments of $2,500.[421] In contrast, the annual indexation of the SG maximum contribution base does produce annual increases.

419 Indexation does not necessarily result in an increase in the particular cap or the threshold.

420 Such as the CGT cap amount, which also includes the $500,000 retirement exemption limit.

421 From 1 July 2021, the concessional contributions cap will increase due to indexation for the first time since July 2017 to $27,500. The non-concessional contributions cap will also increase from 1 July 2021 as a result of indexation to $110,000.

This lack of consistency in indexation will, at some point in the foreseeable future, cause individuals whose employers pay SG according to the maximum contribution base to exceed their concessional contributions cap in the absence of an increase in the cap or broader reform of the rules. It is acknowledged that this would not affect a large proportion of the working population.

Designing a system to support vulnerable workers

Once a lifetime cap is set which limits how much a person may have in either accumulation or pension phase, there should be no further restrictions placed on the person in trying to accumulate that amount of money during the accumulation phase by way of contributions (whether concessional or non-concessional).

This is considered to be a timely and sensible policy given the current situation with the COVID-19 pandemic, with superannuation balances being eroded by the severe economic downturn. Individuals should be allowed to rebuild their superannuation balances (without any limits up to a lifetime cap), in order to safeguard and not place an unnecessary burden on the government pension in the future.

This is particularly the case for those who have accessed their superannuation early[422] under the government's COVID-19 economic response package, which has left more than half a million Australians with a nil superannuation balance.[423] The $25,000 cap places an unnecessary limitation on these individuals who now face challenges to rebuild their superannuation balances.

The proliferation of the gig economy in recent years — which may prove even more popular post-COVID-19 as workers are forced to seek alternative income sources — has left many people without regular superannuation support. Most of these workers are genuine contractors who fall outside the meaning of 'employee' for SG purposes, and are left to fund their own retirement through personal contributions. They are typically low-income earners who may not consider contributing to superannuation a high priority, or do not have regular work, particularly throughout the COVID-19 pandemic, and are therefore not in a position to make a $25,000 contribution to superannuation. While their financial circumstances may improve later in their working life, at that time the $25,000 concessional cap places an unnecessary impediment to building an appropriate level of superannuation savings.

It is important to recognise that the reach of the SG regime extends only so far and, increasingly, overlooks those working outside the conventional employee or contractor relationships. Those operating genuinely independent businesses and not paying themselves a salary or wage are effectively outside the compulsory SG regime and may require further education or encouragement to provide for their own superannuation.

There also remains a gender inequality between the average superannuation balance of men versus women. A report commissioned by Australian Super, titled *The future face of poverty is female*, found that:

---

422 There are a range of proposals to allow the early release of superannuation in a wider range of circumstances. These include: (a) a review of the current rules governing early release of superannuation on compassionate grounds and in cases of severe financial hardship — consultation papers were released in December 2017 and November 2018; (b) early access for crime victims — a consultation paper was released in May 2018; and (c) early release for domestic violence victims — an announcement was made on 21 November 2018.

423 See J Norman, "Early access superannuation scheme estimated to hit $42 billion in coronavirus support", *ABC News*, 30 July 2020. Available at www.abc.net.au/news/2020-07-30/early-access-superannuation-estimate-double-coronavirus-payment/12505984.

> … women retire with 42% less super than men. In real terms, if a man retires with $270,710, a woman gets just $157,050.

The report provided some explanations for the gap:

- the gender pay gap — on average, women earn $241.50 a week less than men;
- research shows women are more likely to take time off to care for children, elderly parents or family members with special needs. Superannuation isn't a mandatory part of paid parental leave or carers payments;
- almost half of women work part-time and many chose lower paid work to prioritise their caring responsibilities;
- part-time workers who earn less than $450 a month don't get paid superannuation. This is a particular disadvantage to women who may work multiple jobs. We acknowledge this is proposed to change as a consequence of the federal Budget announcement;
- unpaid caring makes women particularly vulnerable if there is an unexpected life event like divorce or the death of a partner; and
- women live four to five years longer than men with less retirement savings.

How can the superannuation system assist to restore superannuation for those who needed to access their superannuation during the pandemic, encourage those without superannuation support to fund their own retirement and rebalance the gender inequality?

Inadequacy of current concessional contributions cap

The current concessional and non-concessional contributions caps are in stark contrast to the agebased limits which were abolished by the Howard Government in 2007. At their peak, an individual aged 50 years or over could claim a deduction for up to $105,113 (indexed every year). All individuals are now subject to a $25,000 concessional contributions cap.

The current cap is inflexible and fails to acknowledge when individuals are best placed to contribute to superannuation.

To achieve a superannuation balance of $1m, without taking into account capital growth or earnings, an individual would need to contribute $25,000 each year (including SG contributions) for 40 years. It is not realistic to expect a 22-year-old worker to contribute $25,000 a year to their superannuation fund.

Individuals are best placed to contribute to superannuation when they are older, their mortgages are paid off, their children have left home, they have moved into higher-paid roles at work and have, generally, a higher disposable income than younger workers.

Overly complex contributions rules

The plethora of complex rules relating to contributions include the following:

- concessional and non-concessional contributions caps;
- TSB — individuals who have a TSB of $1.6m or more as at 30 June of the previous income year have a non-concessional contributions cap of 'nil';[424]

424 S 292-85(2)(b) of the ITAA 1997.

- excess concessional contributions tax[425] and excess non-concessional contributions tax;[426]
- election to release excess concessional contributions[427] and option to withdraw excess nonconcessional contributions;[428]
- application to disregard excess concessional contributions[429] and excess non-concessional contributions[430] — since 2007, dozens of cases have appeared before the AAT and the Federal Court involving taxpayers seeking the Commissioner's discretion to disregard an excess contribution. Many of these taxpayers cited genuine intent, confusion or a lack of understanding as to how the law operates to explain how the breach of the cap has arisen and why that justified discretion being exercised in their favour. While their circumstances were such that they commonly did not qualify for discretion under the law, they are useful examples of how many taxpayers find the law difficult to navigate;
- carry-forward concessional contributions;[431]
- bring-forward non-concessional contributions;[432]
- contributions arising from structured settlements or order for personal injuries;[433]
- contributions relating to some small business CGT concessions (the 15-year exemption and the retirement exemption) — the retirement exemption has an unindexed limit of $500,000 per stakeholder yet it counts as part of the annually indexed CGT cap of $1,565,000 (for 2020–21);[434]
- downsizer contributions;[435]
- first home super saver scheme;[436]
- deductions for employer contributions;[437]
- reportable employer superannuation contributions;[438]
- notice of intent to deduct personal contributions;[439]
- government co-contributions;[440]
- low-income superannuation tax offset;[441]

---

425 Div 95 of Sch 1 to the TAA 1953.
426 *Superannuation (Excess Non-concessional Contributions Tax) Act 2007* (Cth).
427 Div 131 of Sch 1 to the TAA 1953.
428 Ss 97-20 and 97-25 of Sch 1 to the TAA 1953.
429 S 291-465 of the ITAA 1997.
430 S 292-465 of the ITAA 1997.
431 S 291-20(3) of the ITAA 1997.
432 S 292-85(3)–(4) of the ITAA 1997.
433 S 292-95 of the ITAA 1997.
434 S 292-100 of the ITAA 1997.
435 S 292-102 of the ITAA 1997.
436 Div 313 of the ITAA 1997 and Div 138 of the TAA 1953.
437 Subdiv 290-B of the ITAA 1997.
438 S 16-182 of Sch 1 to the TAA 1953.
439 S 290-170 of the ITAA 1997.
440 *Superannuation (Government Co-contribution for Low Income Earners) Act 2003* (Cth).
441 Ibid.

- spouse contributions tax offset;[442]
- spouse splitting superannuation contributions;[443]
- Division 293 tax;[444]
- no-TFN contributions tax;[445]
- choice of fund rules;[446]
- in specie contributions;[447]
- ATO's SBSCH and commercial clearing houses;
- SG regime, including the SC charge (discussed further below);[448]
- maximum contributions base;[449] and
- salary sacrifice arrangements and SG contributions.[450]

This extensive list is daunting to most taxpayers who find the superannuation rules incredibly difficult to navigate. Many general accounting practitioners and financial advisers similarly find the system challenging to work with.

Many of the caps are indexed inconsistently,[451] some not at all. The various concessionary measures have attempted to cater to a range of personal and familial circumstances and have invariably been designed to target a particular demographic or achieve a policy objective. However, their introduction into the law in a piecemeal fashion has made the system inherently more complex and often without consideration of how the new measure operates in the context of the broader system.

10.3 Transfer balance cap

As outlined above, the TBC limits the amount of capital that an individual can set aside to pay a superannuation income stream. Earnings on such capital are not subject to tax.

Once an individual commences a retirement phase income stream, they obtain a personal TBC which is equal to the general TBC ($1.6m). However, if they do not utilise the full general TBC, they can apply a proportional indexation of their TBC.

Feedback from practitioners on the operation of the TBC rules include that it is inefficient and complex and has the potential to result in unfair outcomes, that the reporting and administration of the TBA is cumbersome, and that taxpayers are subject to a harsh, inflexible penalty framework.

---

442 S 290-230 of the ITAA 1997.
443 Reg 6.44 of the SISR.
444 Div 293 of the ITAA 1997.
445 Subdiv 295-I of the ITAA 1997.
446 Pt 3A (ss 32A to 32ZAA) of the SGAA.
447 See TR 2010/1.
448 S 23 of the SGAA.
449 S 15 of the SGAA.
450 S 15A of the SGAA.
451 Some are based on CPI movements while others use AWOTE.

Transfer balance account

The TBA involves a system of debits and credits, unrelated to general ledger movements, that includes reporting protocols and a penalty system, the excess transfer balance tax where the individual exceeds their TBC.

The one-off nature of the TBA debits and credit system can produce unfair results. A member whose pension balance is reduced because of market forces (e.g. COVID-19 pandemic-related) will not be able to top up their pension if they have fully utilised their TBA, whereas a member whose pension balance has performed well can end up with a pension account balance that exceeds their TBC.

The reporting mechanism of the TBA is cumbersome and administratively inefficient. The arrangements appear to have been developed assuming a high level of data management was a feature of the superannuation system. This is neither the case for superannuation providers nor the ATO. The current system will not operate as intended until information management systems of both superannuation funds and the ATO significantly improve.

The provisions of the consequences framework are inflexible and the Commissioner has limited discretion to apply the law more leniently when appropriate. Individuals who inadvertently breach their TBC, including where there is a reporting mismatch between the superannuation fund and the ATO, are subject to the same penalties that are designed to discourage deliberate non-compliance. This results in a lack of fairness and unnecessary penalties being applied.

Proportional indexation of TBC

The TBC is an inefficient manner in which to limit the amount of tax-free earnings due to the inherent complexity in managing an individual's cap where proportional indexation is used.

The recent indexation of the general TBC from $1.6m to $1.7m from 1 July 2021 has been met with a predictable chorus of criticisms that the proportionate indexation for those who had already commenced an income stream will make the system overly complex. Many of the concerns were first expressed when the TBC rules were introduced in 2017, foreseeing the difficulties that proportionate indexation would bring.

Proportionate indexation of the TBC for certain individuals means that thousands of superannuation fund members will have a different TBC. This complication, together with the inability to access timely TBC data from the ATO, will make it very difficult for advisers to provide accurate advice.

10.4 Age limits and $450/month limit

In the 2021-22 Federal Budget the government announced that the restriction on an individual being unable to contribute to superannuation if they are aged 67–74 unless they satisfy the work test would be relaxed. While employer concessional contributions and non-concessional contributions are to be allowed under this measure without the requirement to satisfy the work test, personal deductible contributions will still require the test to be satisfied.[452] Individuals cannot

452 Reg 7.04 of the SISR.

contribute to superannuation if they are 75 years or older at all, with the exception of downsizer contributions.[453]

It is difficult to understand, with the pressure on Australians to save for their retirement, why the law prevents individuals from being able to contribute to superannuation beyond age 74. Australians should be encourage to provide for their retirement, and with more people living and working longer, the basis for restricting the age beyond which personal contributions are allowed to be made is currently blunt and could be more targeted having regard to personal super balances, for example.

Further, the SGAA does not include salaries or wages paid to part-time employees (less than 30 hours per week) who are aged under 18 for the purpose of determining an employer's SG obligation. This means that part-time and casual workers aged under 18 do not receive superannuation support from their employers.

The limit imposed by s 27(2) of the SGAA, which prevents employees earning less than $450 in a month from receiving employer superannuation support, is outdated and the proposed removal of this threshold announced in the 2021-22 Federal Budget is welcome. There may have been a rationale when the SG regime was first introduced, when contributions were made manually, often by cheque, and small amounts imposed unnecessary compliance costs on employers. But in today's digital world, where employers make contributions electronically using SuperStream and report information through STP-enabled payroll software, there is no longer a reasonable basis for denying the most vulnerable (low-income earning) workers from receiving employer superannuation support.

10.5 Superannuation guarantee regime

Introduced with effect from on 1 July 1992, despite dozens of amendments, the SG law has not been substantially reviewed or overhauled in its 29-year history. A lot has changed since then so now is a good time to review the system to determine whether it is appropriately designed and meeting its objectives.

The following considerations support long-overdue reform of the SG regime:

- the ATO estimates that the SG gap for 2017–18 is 4% or $2.4b;
- an Industry Super report from May 2017 suggests that 2.85 million Australians did not receive their full SG entitlements in 2016–17, missing out on $5.94b. The number of workers who were affected increased by 90,000 in three years (up from 2.76 million) and now affects 31.3% of workers;
- the design of the SG charge dissuades employers who want to avoid penalties or losing deductions for late or unpaid superannuation from coming forward or owning up to shortfalls;
- the notional interest component ends upon lodgment of the SG statement with the ATO, not the payment of the late contribution;
- company directors can be personally liable for unpaid SGC liabilities;

453 Employers are required to make SG contributions for their eligible employees regardless of their age. Individuals aged 65 or over can make downsizer contributions under s 292-102 of the ITAA 1997.

- STP reporting provides greater transparency over non-compliant employers;
- some employers wrongly treat late contributions as simply being non-deductible (without also paying the SGC and lodging SG statement);
- the rate of SG is legislated to increase to 12% by 1 July 2025;
- employers are often confused as to the meaning of ‘OTE’;
- there are perennial issues with correctly classifying workers as contractors versus employees;
- due to annual indexation, the maximum contributions base is within uncomfortable reach of the $25,000 concessional contributions cap; and
- due to the COVID-19 pandemic, many employers in lockdown or with greatly diminished cash flow were not in a position to avail themselves of the SG amnesty which ended on 7 September 2020.

A number of these issues are discussed below.

Harmonisation of superannuation guarantee contribution and charge base to ordinary time earnings

Under the current law, SG contributions are calculated as 10% (from 1 July 2021) of OTE for the quarter. However, the SG charge is calculated by reference to the broader base of an employee’s total salary or wages for the quarter. If an employer does not correctly calculate the amount of SG contributions required or fails to pay those contributions on time, they will have an SG shortfall on which the SG charge is imposed.

The SG shortfall consists of the total of the employer’s individual SG shortfalls for each employee for the quarter, a nominal interest component and an administration component for the quarter.

The requirement for employers to calculate SG contributions and the SG charge on different bases increases compliance costs and complexity for employers. In addition, if an employer miscalculates its SG contributions or pays them late, the requirement to calculate the SG charge based on total salary or wages can result in an SG shortfall.

In some cases, this can be significantly higher than the minimum required SG contribution amount. The SG regime therefore has the potential to impose punitive costs on employers who miscalculate their required contributions or pay their SG contributions late. This makes the SG charge and penalty disproportionate to their level of non-compliance. This can have a significant cost impact on employers. It can particularly impact employers who pay significant amounts of overtime or have other wage components that are not part of OTE. This can result in employees receiving significantly higher contributions than intended by the legislation.

The divergence of the contribution and charge bases also creates significant administrative difficulties for employers in relation to payroll system implementation and configuration. Payroll and payment systems require additional set up and monitoring to facilitate the definitional differences arising from the divergence of the bases.

Superannuation guarantee regime design failure issues

The purpose of the SG regime is to require employers to make SG contributions (originally as part of a wage/super trade off). The purpose of the Part 7 penalty is to discourage non-compliance by employers. The purpose of the nominal interest component is to recompense the employee's superannuation account for the lost earnings arising from the failure of the employer to make the contribution. However, the design of the regime has the opposite effect.

Currently, the nominal interest calculation continues until the SG charge is payable, which is, practically, when the SG statement is lodged. This can be many years after the contribution was paid, irrespective of whether the contribution was made a few months, weeks or even days late.

In addition, Pt 7 of the SGAA makes an employer liable to a penalty equal to double the amount of SG charge payable (i.e. 200% of the SG charge) where they fail to notify the Commissioner of the shortfall. This is highly inconsistent with penalties imposed by the *Fair Work Act 2009* — failure to pay salaries and wages does not attract a 200% penalty.

Given the interaction between the nominal interest component and the Part 7 penalty, the imposition of nominal interest until the date the SG statement is lodged operates as a double penalty. The nominal interest should apply only for the period that the contribution was outstanding (the start of the period for which the nominal interest is charged should continue to be the first day of the quarter). Many employers do not understand the operation of the nominal interest component and fail to realise that paying just one day late but never disclosing this to the ATO can have enormous ramifications. This issue has been raised repeatedly in AAT hearings, but neither the AAT nor the ATO have the jurisdiction to waive, remit or adjust the amount of nominal interest as it is prescribed by the SGAA.[454]

The regime does not encourage employers to disclose historical shortfalls (including those arising in relation to quarters starting on or after 1 April 2018 which fall outside the SG amnesty) or to confirm that shortfalls are ultimately repaid to ensure their employees received all their entitlements. In fact, the regime acts as a disincentive given the array of penalties that can be imposed, including:

- the three components of the SG charge, which, as already identified, require the employer to pay the SG charge on a higher base than OTE and pay nominal interest for a period that can extend well beyond when a late payment is made;
- non-deductibility of the SG charge;[455]
- the general interest charge for paying the SG charge late;[456]
- the 200% Part 7 penalty;[457]
- the Commissioner's inability to remit no more than half of the Part 7 penalty (i.e. no more than 100%, leaving a minimum penalty equal to no less than 100% of the SG charge) in relation to shortfalls from quarters covered by the amnesty;[458]

454 S 31 of the SGAA.

455 There is a widespread misconception that an SG contribution is non-deductible solely because it is paid after the 28th day following the end of the quarter. A late contribution remains deductible under s 290-60 of the ITAA 1997 and is not non-deductible just because it is paid late. The contribution is non-deductible under s 26-95 of the ITAA 1997 when it takes the form of the SG charge (i.e. the employer lodges an SG statement and notifies the Commissioner that they are liable to pay the SG charge).

456 S 49(3) of the SGAA.

457 The Commissioner has discretion to remit all or part of the Part 7 penalty: see s 62(3) of the SGAA and PS LA 2020/4.

458 S 62(4) of the SGAA.

- an estimate of a company's SG charge liability and recovery of the estimated amount with a director penalty notice;[459]
- a direction to pay the SG charge, in relation to which non-compliance is a criminal offence;[460]
- a direction to undertake an SG employer obligations course;[461] and
- the issue of garnishee notices.[462]

An employer who pays the SG contribution just one day late but never discloses the SG shortfall to the ATO is treated the same as an employer who never pays the SG contribution. This is inherently unfair and results in a disproportionate outcome for the employer who makes the SG contribution just one day late.

Timing of contributions

The rules relating to the timing of contributions are confusing and result in unnecessary SG shortfalls. The Commissioner's views on the timing of making of superannuation contributions are set out in TR 2010/1, which explains that a contribution is not taken to be 'made' until it is received by the fund.

This position has resulted in much confusion over the years, given:

- the interaction of payroll cycles;
- STP reporting;
- the deadline to meet SG obligations by the 28th day following the end of the quarter;
- the year-end deadline to ensure that a payment of a contribution is deductible to the employer in a particular income year; and
- the differing treatment of contributions made through the ATO's SBSCH versus commercial clearing houses.[463]

There is a general lack of understanding that contributions are not made until they are received by the fund, causing many employers who base their calculations on the date the payment is made to miscalculate the timing of contributions. Employees can end up with excess concessional contributions as a result where their cap is exceeded due to mistimed employer contributions.[464]

The above issue is compounded by the ATO recently changing the Super Fund Lookup status of a SMSF to 'Regulation details withheld' where the SMSF has failed to lodge its annual return. While primarily an issue between the ATO and the trustee of the SMSF, it has flow-on effects which can result in SG charge liabilities for employers who attempt to make a contribution to the SMSF whose status has been changed to 'Regulation details withheld'. There may be insufficient time

---

459 Divs 268 and 269 of Sch 1 to the TAA 1953.

460 Subdiv 265-C of Sch 1 to the TAA 1953. A failure to comply with the direction is a strict liability offence which is subject to a maximum penalty of 50 penalty units ($11,100), 12 months' imprisonment or both.

461 Div 384 of Sch 1 to the TAA 1953.

462 S 260-5 of Sch 1 to the TAA 1953.

463 See PCG 2020/6.

464 This can particularly arise where the employee has also made a personal contribution or entered into a salary sacrifice arrangement.

before the 28th day following the end of the quarter to redirect the payment to another complying or default fund in order to avoid an SG charge liability arising.

Superannuation guarantee amnesty

The SG amnesty announced on 24 May 2018 became law on 6 March 2020 following the lapsing of the original Bill[465] due to the 2019 federal election and the reintroduction of a second Bill.[466]

The SG amnesty provided a one-off opportunity between 24 May 2018 and 7 September 2020 for employers to self-correct historical non-compliance for quarters starting on or after 1 July 1992 and ending on or before 31 March 2018.

The six-month period of certainty starting when the law was enacted and ending on 7 September 2020 unfortunately coincided with the impact of the COVID-19 pandemic. Many businesses were under significant pressure due to managing JobKeeper payments, adapting to working from home arrangements, dealing with staff downsizing and other challenging issues arising as a result of COVID-19. Accountants and advisers were under enormous pressure to help deliver the government's JobKeeper and cash flow boost assistance to their clients which pushed work on the SG amnesty to one side.

The stage 4 restrictions in Victoria highlight further issues with the deadline. The restrictions prevented the collection and sharing of physical payroll records typically archived at then inaccessible offices or off-site third-party storage areas. Without such records, it was very difficult for some employers to determine whether there are any shortfalls as far back as 1992 and therefore a need to claim the amnesty.

Determining SG shortfalls is a complex and time-consuming task. Qualified personnel are needed to identify and calculate historical superannuation shortfalls. Determining when an employer has an obligation to pay superannuation often requires professional expertise as the SG charge extends beyond the usual employment arrangements to include certain contractors and other workers.

Options

Taxation and the superannuation life cycle

A significant re-examination of the merit of taxing contributions on entry versus taxing withdrawals from superannuation should be undertaken, and whether the tax on superannuation contributions (including Division 293 tax) should be completely eliminated to encourage an increase in superannuation savings.

Consider the merit in taxing excessive benefits on withdrawal by reintroducing a form of RBL. Transitional or grandfathering rules would need to accompany any such change so that any shift back to taxing benefits accounts for taxes previously paid on contributions or earnings under the current regime.

465 Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018.

466 *Treasury Laws Amendment (Recovering Unpaid Superannuation) Act 2020* (Cth).

This is often referred to an exempt-exempt-taxable model, as the taxation falls on the third (i.e. exit) stage of superannuation. This would represent a return to the pre-1987 era, and a departure from the, broadly, taxable-taxable-exempt model that applies today for those in accumulation phase and the taxable-exempt-exempt model that applies for those in pension phase.

An alternative option is to impose tax more equitably across the entire life cycle, rather than weighting the tax burden more predominantly on the contributions phase and, to some extent, on the earnings phase. A combination of taxation models could be considered to ensure the optimal operation of the system.

Superannuation caps and thresholds

The complex array of caps, thresholds and concessionary measures needs a rethink. The inefficiency and complexity is not sustainable in the long term and is the cause of many taxpayers inadvertently breaching the caps or the rules, with severe consequences in terms of their retirement savings or penalties.

It is acknowledged there is a trade-off between simplifying the complexity of the law which has evolved through piecemeal changes over many decades and ensuring that benefits provided to taxpayers in the form of concessionary measures are appropriately targeted.

Reforming the superannuation caps, thresholds and concessionary measures could involve a consideration of the merits of the following:

- adopting a consistent reference point for indexation, such as using AWOTE over CPI;
- adopting a single and consistent methodology for all caps and thresholds;
- consolidating the TSB and TBC into a single lifetime cap which would limit the amount that can remain in the superannuation system and be concessionally taxed;
- a single dollar threshold for other superannuation concessions (currently based on the TSB);
- replacing the contribution limits with a return to a mechanism based on excessive benefits (akin to the former RBL rules); and
- increasing the concessional contributions cap or reintroducing a higher cap for those who are more likely to be able to contribute towards the end of their working lives.

Age limits and $450/month limit

It is questionable whether the work test should prevent those aged 75 and over from contributing to superannuation. The restriction that prevents individuals contributing to superannuation if they are 75 years or older should be removed if they continue to work, perhaps subject to a superannuation balance limitation. The current limitation otherwise sits at odds with other government policy that is designed to prevent age discrimination.

The proposal to repeal the rule in s 28, and the $450 limit imposed by s 27(2), of the SGAA is welcome and will ensure that all employees, regardless of age or income levels, receive employer superannuation support.

Reform of the transfer balance cap

The provision of tax-free benefit payments to individuals in conjunction with tax-free earnings in the superannuation fund while in pension phase led to the introduction of the TBC. This suggests that there may be a case to remove one of these concessions in favour of simplicity and equity.

Reform of the TBC could involve a consideration of the merits of the following:

- modifying the TSB to limit the total amount held in superannuation (including in accumulation) and mandating the excess be withdrawn from superannuation (i.e. any excess over the threshold must be cashed out on retirement);
- possible alternative tax treatment of amounts in excess of a single lifetime cap, such as:
  - subjecting excessive amounts to personal income tax;
  - greater flexibility for the minimum annual payments for superannuation income streams;[467] and
  - potential for penalties for delaying making payments from superannuation;
- a review to determine whether the TBC threshold is set at the appropriate level — should it be lowered or raised?
- whether the current level of the TBC interacts appropriately with the operation of refundable excess franking credits under the imputation system, particularly for SMSFs;
- whether proportional indexation of the personal TBC should be removed to reduce complexity;
- whether access to the general TBC should be available regardless of the commencement date of the income stream;
- a review of the administration of the TBA;
- allowing the Commissioner discretion to amend a penalty for breaches of the TBC in appropriate circumstances; and
- alternative, more appropriate approaches to capping the amount of tax-free earnings within a superannuation fund, such as abolishing the TBC system and transferring the tax management aspect to the taxation of benefit payments. Individuals could then control the level of retirement phase benefits they commence.

Superannuation guarantee regime

A review and rethink of the SG regime is needed to consider how the SG regime could and should be overhauled or replaced with a new set of rules to encourage greater compliance, reduce inefficiencies and ensure that the system is redesigned so that penalties imposed for noncompliance are proportionate to the severity or level of culpability associated with the breach.

Redesigned rules could:

- make it easier for employers to comply;
- be less draconian for employers who pay the SG contribution one day late; and
- more adequately and effectively support a modern, sustainable retirement system.

467 The GFC in 2007 and the COVID-19 pandemic both resulted in legislative amendments to respond to the dramatic change in economic conditions.

Options to harmonise the superannuation guarantee contribution and the superannuation guarantee charge bases

Harmonising the SG contribution and the SG charge bases would make it easier for employers to comply and remove unnecessary differences in the bases. Completely revising the bases by departing from the OTE concept and simply basing the SG obligation on actual remuneration rather than OTE (i.e. what an employee is actually paid).

Alternatively, the SG charge could be simplified by aligning the earnings base for calculating the SG charge (currently total salary or wages) with the earnings base for calculating SG contributions (OTE). This would simplify the superannuation system and make the calculation of the SG charge and penalty more proportionate to the non-compliance.

Harmonisation of the SG contribution and charge base to OTE might be a good place to start. This would reduce compliance costs and complexity for employers and would be easier to administer.

Meaning of 'SG employee'

There are gaps in the current definition of 'SG employee' in s 12 of the SGAA which result in certain workers receiving no superannuation support.

Reform of the meaning of 'employee' for SG purposes could involve a consideration of the merits of the following:

- harmonising the meaning of 'employee' across PAYG withholding, STP reporting, FBT, and payroll tax and WorkCover from a state tax perspective; and
- looking at ways that the rules could be redesigned to provide incentives for employers to provide superannuation support for all workers rather than limiting it to 'SG employees' — this would ensure that those working in the gig economy would receive superannuation support.

Reforming the calculation of superannuation guarantee charge

The consequences under the SG regime should be redesigned, so that the penalty on employers for paying one day late versus abscondment or complete non-payment is proportionate.

Reform of the SG charge could involve a consideration of the merits of the following:

- reforming the calculation of the nominal interest component so that it does not continue to apply to any period following the day on which the SG contribution was actually made (regardless of when the employer lodges an SG statement and notifies the Commissioner) — the nominal interest component should apply from the beginning of the quarter in question until the date on which the late SG contribution is received by the fund;
- provide better incentives for employers to make voluntary disclosures and receive reduced penalties;
- allow the Commissioner similar discretion to remit components of the SG charge as he does for other taxes that the ATO administers, including the ability to grant employers more time to make contributions;
- amend the law so that an employer's SG obligations can be considered satisfied once the employer has made, and can evidence, payment, irrespective of whether the amount is paid

directly to the fund or via the SBSCH or a commercial clearing house thereby removing the inconsistency in treatment of contributions received by the SBSCH and commercial clearing houses;

- in relation to the ATO practice of changing the Super Fund Lookup status of SMSFs, it is clear that the ATO is seeking to manage the risks associated with employers making contributions to non-complying superannuation funds, but perhaps the implications could be mitigated by requiring the ATO to notify employers who contribute to such a fund, ahead of the change in fund status and to allow them the opportunity to redirect the contributions. Additionally, given that the information is available to the ATO through STP reporting, this issue may be managed by requiring the ATO to notify the trustee that such a notice will be provided to employers within, say, 14 days, unless the non-lodgment is rectified; and
- offer another SG amnesty, in light of the unfortunate timing of the previous amnesty coinciding with the impact of the COVID-19 pandemic.

Improve equality in retirement

To address the issues of inequality for women relating to retirement incomes, there are a possible suite of measures that could be adopted, including:

- co-contribution by the government of $1,000 provided for all single women on a matched 2:1 basis, where total assets held in superannuation in the name of the woman is less than $100,000;
- allowing the age pension to be made available to single women who have total superannuation of less than $100,000 from the age of 60;
- providing a $1,000 per year contribution to be made to superannuation for an unpaid voluntary carer;
- modest amendments to the anti-discrimination laws to give a clear legal basis to schemes introduced by companies to provide higher superannuation payments in respect of female employees;
- the opportunity to make catch-up concessional contributions for single women who have had interrupted working arrangements; and
- the opportunity to recognise the family unit for superannuation contribution purposes (i.e. utilising dual thresholds) where one spouse is unpaid or partly paid as a consequence of providing primary care to a dependant.

In relation to the age pension, it would also be worth making the means test for age pension qualification more generous for single women who will invariably have a broader and perhaps longer reliance on the pension.

The Tax Institute acknowledges that the availability of carry-forward superannuation contributions is one opportunity for women to make catch-up concessional contributions where they have experienced interruptions to their work practices. This measure is a step in the right direction but should be supplemented by further targeted measures, such as those outlined above.

Options for reform

- Impose tax using an exempt-exempt-taxable model.
- Improve the operation of the death benefit system and the binding death benefit nomination provision.
- Adopt consistent indexation of all superannuation caps and thresholds.
- Adopt a single and consistent methodology for all caps and thresholds.
- Consolidate the TSB and TBC into a single lifetime cap.
- Tax excessive benefits on withdrawal by reintroducing a form of RBL.
- Increase the concessional contributions cap or reintroduce a higher cap for those who are more likely to be able to contribute towards the end of their working lives.
- Repeal the work test and allow all individuals, regardless of age, to make personal contributions subject to some controls, e.g. by reference to superannuation balances.
- Repeal the age limit that prevents part-time and casual employees aged under 18 years from receiving employer superannuation support.
- Mandate that excess benefits be withdrawn from superannuation on retirement.
- Review the TBC threshold to determine whether it is set at the appropriate level.
- Determine whether the current level of the TBC interacts appropriately with the operation of refundable excess franking credits under the imputation system, particularly for SMSFs.
- Remove proportional indexation of the personal TBC to reduce complexity.
- Provide access to the general TBC regardless of the commencement date of the income stream.
- Review of the administration of the TBA.
- Allow the Commissioner discretion to amend a penalty for breaches of the TBC in appropriate circumstances.
- Harmonise the SG contribution and the SG charge bases.
- Harmonise the meaning of ‘employee’ across employer obligation regimes.
- Provide incentives for employers to provide superannuation support for all workers rather than limiting it to ‘SG employees’.
- Reform the nominal interest calculation so that it applies from the beginning of the quarter in question until the date on which the late SG contribution is received by the fund.
- Allow the Commissioner discretion to remit components of the SG charge.
- Allow the Commissioner to grant employers more time to make contributions.
- Amend the law so that an employer’s SG obligations can be considered satisfied once the employer has made, and can evidence, payment, irrespective of whether the amount is paid directly to the fund or via the SBSCH or a commercial clearing house.

- Cease using an SMSF's Super Fund Lookup status and use alternative methods to improve late lodgment behaviour.
- Make a further SG amnesty available.

Indirect Tax

11. State taxes and indirect taxes

Overview

This section of the *Case for Change* considers the Australian indirect tax landscape, the pervasive issues in those taxes, including the state and federal dichotomy, and potential options for reform. This section also considers a number of direct State taxes.

Federalism and vertical fiscal imbalance

One of the challenges faced by governments in all federations is that over time, the financial costs of providing services tend to shift between the different levels of government. Unless financial adjustments are made, the constitutional responsibilities of one level of government can become misaligned with the capacity of that government to raise revenues needed to meet its obligations.

Federalism in Australia has given rise to a dual system of taxation (setting aside the matter of local government taxes, duties and other charges). The Australian tax system comprises a complex matrix of State and federal taxes, both direct and indirect.

The Commonwealth is limited by the Constitution in its ability to make laws in direct relation to taxation. Section 51(ii) of the Constitution provides that the Commonwealth has the power to make laws with respect to taxation, although essentially only in a manner that does not discriminate between the States or parts of them. The Commonwealth has a practically greater power than the States to impose taxes and raise revenue. However, the States are responsible for a greater proportion of public expenditure. A restricted ability to impose efficient taxes puts the States in the unenviable position of relying on inefficient taxes, such as stamp duty and payroll tax, in order to raise sufficient revenue. This dependency disincentivises the States from reducing or repealing such taxes, compounding the VFI which arises between these levels of government.

A VFI creates inefficiencies, undermines accountability between different levels of government, reduces fiscal transparency and can result in the misallocation of resources. It gives rise to inefficiencies, including through bureaucratic overlap and the cost of administering grants between governments. It undermines government's accountability to the public by severing the nexus between a government's decisions on the degree of services provided and the revenue raised to fund them. It reduces transparency regarding who is responsible for which government services, which, tying in with the issue of accountability, can give rise to unaccountability for funding and operational shortfalls. Inadequate funding of services and uncertainty as to responsibility can lead to a misallocation of resources. Overall, the impact is a slowed responsiveness of governments to the needs of the public. Importantly, this issue has been raised in a number of forums and other bodies have shared these observations, both in relation to the impact of VFI more broadly, and specifically regarding the imbalance between the taxing and spending powers of the Commonwealth and the States.[468]

468 See, for example, comments by the Australian Chamber of Commerce and Industry and the NSW Business Chamber, cited in the Senate, Select Committee on the Reform of the Australian Federation, *Australia's Federation: an agenda for reform*, June 2011, p. 64.

The reform of fiscal federalism is a particularly complex area of governance, with virtually no 'perfect' solutions. In our view, the position put by the Business Council of Australia summarises the situation well:[469]

> Ideally, each Government should raise the funds necessary to fulfil its responsibilities. It is questionable, however, whether Australia's revenue raising system could be so radically adjusted given how far the pendulum has swung in favour of the Commonwealth. Without adjustments, however, it is likely that the States will become increasingly the service deliverers of the Commonwealth's policy agenda.

As outlined above, the States have a limited capacity to raise revenue and the taxes within their remit are largely inefficient. It is acknowledged that some States have access to mining royalties which can provide significant revenue streams. However, even in those cases, the raising of royalties effectively reduces their access to Commonwealth grants.

VFI has existed in some form since the beginning of Federation. This is to be expected in any federation as it recognises the inability of certain states to raise the revenue required to fund essential services that other states may be able to more readily fund for various reasons, including the availability and location of natural resources. This underpins the need for special grants which, when properly administered, ensure that public services such as health care and education are equally available throughout the country. However, there are certain significant issues which arise from the current extent of VFI in Australia's tax system. One such issue relates to the cost of raising revenue. On the one hand, the States do not face all of the real costs (including political) of raising the revenue which they spend as part of it is passed on by the Commonwealth. On the other hand, the States are burdened with more expenditure than they have the means to cover independently. In any case, this VFI leads to less efficient service delivery.

Changes in responsibility for the collection of certain taxes have often been linked to intergovernmental financial relations. These changes have occurred as a result of High Court decisions, State and Commonwealth political decisions, intergovernmental agreements,[470] and broader challenges that may arise socially or politically, such as pressures to fund public expenditure. One thing is clear though — the extent of VFI continues to grow and is becoming increasingly unsustainable. At a high level, the solution must be either for the Commonwealth to assume greater responsibility for the collection of taxes and pass this on to the States so that they may relieve themselves of inefficient revenue sources, or for increased taxing powers to be devolved to, or activated by, the States. While each option gives rise to unique complexities, it is noted that the latter would provide greater certainty of funding to the States without requiring ongoing negotiations with the Commonwealth and the use of complex formulae to determine funding by grants. We consider that this is a fundamental area in which sweeping reform is required, and where the Commonwealth and the States must work together to develop a viable long-term solution.

That arrangements need to be addressed is brought into stark relief by the fact that changes by one state to its own taxation arrangements can, via the arrangements between the States and

469 Business Council of Australia, *Modernising the Australian federation, a discussion paper*, 2006, p. 12, available at www.bca.com.au/Content/101346.aspx, cited in the Senate, Select Committee on the Reform of the Australian Federation, *Australia's Federation: an agenda for reform*, June 2011, p. 66.

470 GST-related intergovernmental agreements are an example, if these are agreed, they are not always implemented (eg Qld, NT and WA continuing to impose business transfer duty).

the Commonwealth relating to the sharing of GST, cause another State's share of GST to be affected.[471] The Commonwealth Grants Commission has noted that:[472]

> If a state increases its tax rate, it will increase the national average rate, increasing the assessed revenue raising capacity of States with a relatively large share of the tax base and reducing their assessed GST requirements.

This, among other acknowledged issues with the current approach to GST sharing, is an impediment to real reform.

11.1 Payroll tax

Overview

Payroll tax is broadly a tax on wages, in cash or in kind, provided by employers to their employees. It was introduced by the Commonwealth in 1941 in order to help fund welfare payments, such as the national child endowment scheme.[473] It initially applied as a 2.5% levy on payrolls. For approximately three decades, the administration of payroll tax was controlled by the federal government as part of its remit over the income tax base. However, in 1971, as a result of lobbying for access to the payroll tax, it was handed over to the States. This occurred in acknowledgment that payroll tax would be essentially the sole growth tax available at the State level.[474]

While initially uniform across the States and Territories, over time, there have been unilateral changes by the States, including increases to the rate, as well as modifications to the applicable thresholds and other rules.

Over a decade ago, an attempt was made to harmonise payroll tax across the country. Notably, in 2007, the Commissioners across all States and Territories committed to harmonising the administration of payroll tax. Since then, amendments have been made to harmonise the various payroll tax regimes across a number of areas, including the availability of certain allowances, the treatment of certain benefits for payroll tax purposes, employee share schemes and grouping.

Since 2009, the States and Territories have implemented largely uniform legislation. In 2010, the Commissioners of all States and Territories signed a Protocol for Payroll Tax Harmonisation between Jurisdictions.[475] These harmonisation initiatives have been successful in part, though significant further work is required to achieve genuine harmonisation.

There are certain significant aspects of payroll tax which remain inconsistent from State to State. Despite the harmonisation attempts noted above, each State administers its own nuanced regime with different criteria for determining an employer's liability, including different tax-exempt wage

471 P Commins, "Victorian budget 2021: land tax grab spills into NSW", *The Australian* 20 May 2021. Available at www.theaustralian.com.au/nation/politics/victorian-budget-2021-land-tax-grab-spills-into-nsw/news-story/5bb738d39909b82f45f8a2aa852bb628?btr=564d3e36c748daa03775826dd77633e6. Accessed 31 May 2021.

472 Commonwealth Grants Commission, *Occasional paper no. 2: GST distribution and state tax reform*; Commonwealth of Australia, 2021, p. 3. Available at www.cgc.gov.au/sites/default/files/occasional_paper_gst_distribution_and_tax_reform.pdf.

473 J Smith, *Taxing popularity: the story of taxation in Australia*, Federalism Research Centre, ANU, 1993.

474 S Reinhardt and L Steel, *A brief history of Australia's tax system*, Treasury, 2006. Available at treasury.gov.au/publication/economic-roundup-winter-2006/a-brief-history-of-australias-tax-system.

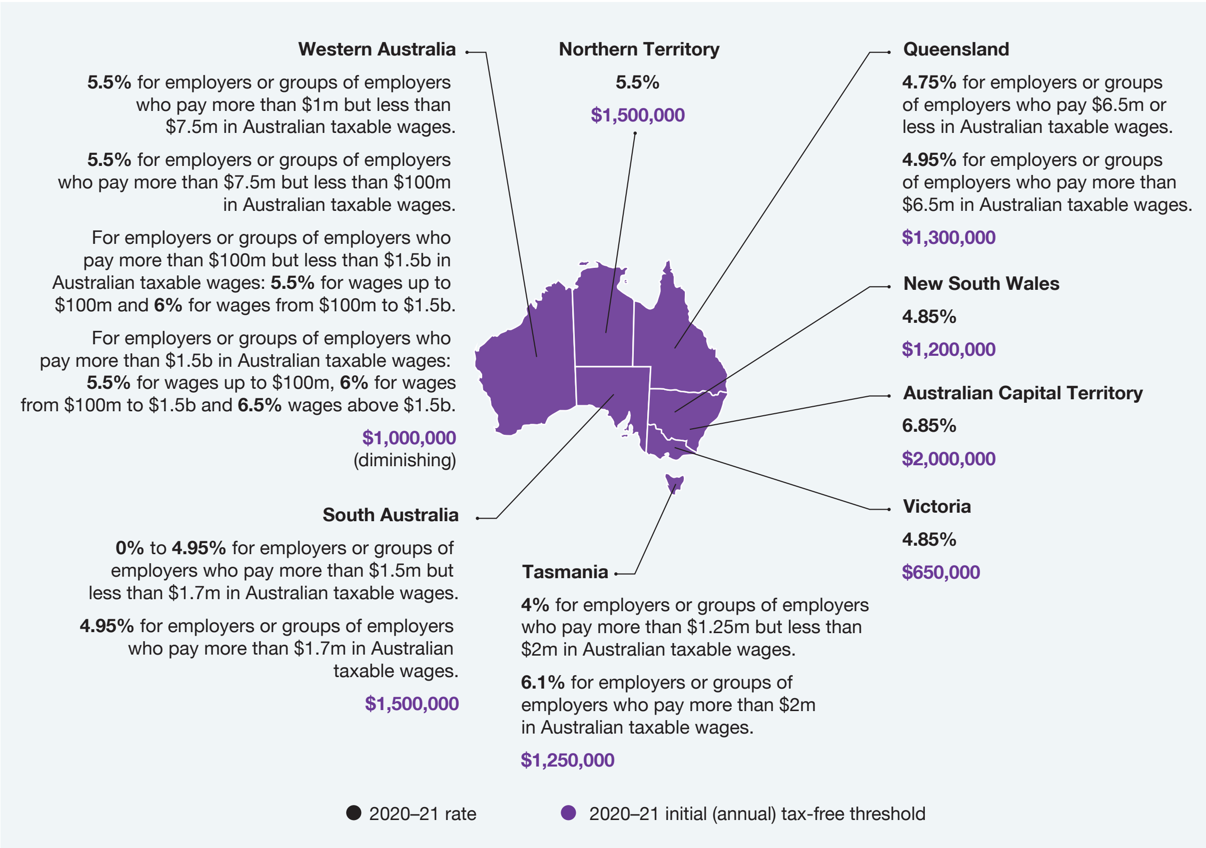
475 Available at www.revenue.nsw.gov.au/help-centre/resources-library/fspt001.pdf.

thresholds, allowable deductions and rates of tax. Aside from certain allowable deductions, the key areas of significant dispersion are the rates and thresholds applied. In terms of administration, while most States and Territories have previously agreed to use jointly issued revenue rulings, this is not yet uniform across the country. In addition, the significant compliance burden imposed on employers must be addressed.

Tax competition between the States as well as lobbying by employers and employer groups have resulted in the payroll tax base being reduced to less than half of the comprehensive labour income tax base. Today, payroll tax is levied at rates ranging from 4.75% to 6.85%. Despite increases to thresholds and reductions to the rate, payroll tax still raises the most revenue for the States and has become the most important state tax in terms of revenue collection, accounting for between 24% to 36% of each State's total revenue.

Figure 13 provides a summary of the payroll tax rates and thresholds across the States and Territories but does not take into account potential variances, such as discounts for regional employers in certain States.

Figure 13. Payroll tax rates and thresholds



Payroll tax contributes more revenue than any other State tax. In 2018–19, it raised approximately 30% ($9.4b) of New South Wales total tax revenue, 37% ($7.0b) of Victorian tax revenue, 25% ($4.16b) of Queensland tax revenue.[476] The OECD reported that, as a direct form of

476 SRO Victoria, *Payroll tax statistics*. Available at www.sro.vic.gov.au/payroll-tax-statistics; Queensland Treasury, *Revenue management*. Available at www.treasury.qld.gov.au/about-treasury/2018-2019-annual-report/service-reports/revenue-management/.

taxation, Australia relies more on payroll tax than other OECD countries in the Asian and Pacific economies.[477]

Payroll tax has a relatively stable base and, as outlined above, it is intended to be a growth tax that provides steadily increasing revenues which are intended to support State budgets throughout economic cycles and to weather unplanned circumstances, such as disaster relief.

Payroll tax (re)design – anomalies and the need for harmonisation

Issue – inconsistent regimes particularly in relation to rates and thresholds

As mentioned above, there are anomalies across the different State payroll tax regimes, most conspicuously in relation to the applicable rates and thresholds. In addition to varying legislative frameworks, the various revenue offices provide different levels of guidance and assurance, all of which can be subject to interpretation.

In some cases, concessions and exemptions are available in one State but not another.[478] Likewise a particular benefit may be subject to payroll tax in one jurisdiction but not another. This means that an employer operating in one jurisdiction may be (dis)advantaged compared to another employer in similar circumstances but operating in a different jurisdiction. It also means that an employer that operates across several jurisdictions is required to keep up with the nuances in each regime.

Options for harmonisation

If it is to be retained by the States, the overarching answer to the majority of issues arising in relation to the payroll tax system is harmonisation. While some level of competition between the States may be healthy, we do not consider that payroll tax (or any tax in a national context) is the appropriate avenue for this.

Consistency across the various payroll tax regimes would level the playing field for Australian businesses and would reduce compliance costs for those employers operating across multiple jurisdictions. This would eliminate one disincentive from expanding a business from a domestic State market to a multi-State or national operation. This promotes productivity, workforce participation and economic growth generally, and is therefore better for the Australian economy as a whole.

We consider consistency across payroll tax regimes would be best achieved through centralised administration by a single body, most likely the ATO. Similar to how the GST is administered by the ATO and GST revenue is collected at the federal level and passed on to the States, it is envisaged that this kind of arrangement could be implemented in relation to payroll tax.

Alternatively, we would recommend that the States and Territories come together and use best endeavours to reach agreement on a genuinely harmonised payroll tax regime, specifically including rates and thresholds. Further, built into any such agreement must be a commitment not to subsequently vary aspects of the system, including interpretative approaches, without prior

---

477 OECD, *Revenue statistics 2020*, OECD Publishing, Paris, 2020. Available at https://doi.org/10.1787/8625f8e5-en.

478 See, for example, Sch 2 to the *Payroll Tax Act 2007* (NSW), Sch 2 to the *Payroll Tax Act 2007* (Vic) and Div 2 of the *Payroll Tax Act 1971* (Qld).

consultation and agreement of the States. This could parallel the arrangements in place in relation to variations to the GST rate and base.

Issue – the meaning and use of the term 'employee'

There is a lack of harmonisation of the definition of 'employee' across the various payroll tax regimes. The result is that employers are burdened with the 'employee versus contractor' dichotomy in yet another aspect of the tax system. To overcome this, employers must generally seek assistance from a tax adviser, noting that this option may lack certainty due to the broad interpretation of payroll tax law and inconsistencies from State to State. Without certainty, employers are exposed not only to potentially significant payroll tax liabilities, but also to penalties and interest.

Option – introducing an all-encompassing concept of a 'worker'

As outlined earlier in this paper, the rapidly changing nature of employment and the labour market has seen the emergence of new work relationships such as the sharing or gig economy. In the context of tax compliance, non-traditional ways of working have introduced a new level of complexity to be carefully considered alongside the traditional dichotomy between an employee and a contractor.

The OECD recently reported that across OECD countries, there is a growing share of workers earning income outside of the traditional employee–employer relationship.[479] This trend is driven by various factors, for example, demographic changes, labour market regulation and the relevant tax system.

The Tax Institute supports reform that ensures that tax policy keeps pace with changes in the labour market. We recommend the adoption of a broad and inclusive concept of a 'worker' to encompass the various classifications (i.e. employee, contractor and non-traditional work relationships resulting from the growing gig economy). Such a term should be defined in legislation and should apply consistently across all Australian taxes and the superannuation system.

This would simplify the suite of employment taxes, both at a State and federal level. Importantly, it would cut red tape associated with the classification of an individual as an employee or contractor (which can be subject to inconsistent interpretation across the various taxes and, in the context of the States, the various regimes). It can also reduce potential opportunities for arbitrage by businesses in their selection of the type of labour contract offered to an individual, or for individuals in their decision to operate as an employee, or an incorporated or unincorporated contractor.[480]

While introducing the concept of a worker is preferable, at a minimum, a harmonised definition of 'employee' should apply not only for the purposes of all payroll tax regimes across the country, but indeed, for all remuneration-based taxes.

Importantly, a harmonised definition (whether implementing the concept of a worker or retaining references to employees as distinct from contractors) should be legislated. This would provide

479 OECD, *Taxing wages 2020*, OECD Publishing, 2020, p. 17. Available at https://doi.org/10.1787/8625f8e5-en.
480 Ibid, p. 16.

greater certainty and consistency than the current approach which relies on the common law definition.

Disincentives to economic growth

Issues

Payroll tax is an additional cost to businesses which play a critical role in supporting the Australian economy by expanding the Australian workforce.

The liability to payroll tax is based on wages paid and is unconnected to profit. This may disincentivise wage growth above the applicable tax-free threshold (considered below). This disincentive is compounded at times where market activity declines. Most recently witnessed throughout the COVID-19 pandemic and the economic recession, businesses that retain workers during difficult times, for the most part, have maintained their payroll tax liabilities despite potentially significant declines in profits. This imposes added pressure on those businesses. From a payroll tax perspective, businesses that retrench staff during such times are left in a better position. This is inconsistent with the government's objective of creating jobs and encouraging economic prosperity.

Besides ad hoc exemptions, such as the reduced rate of payroll tax for regional employers in bushfire affected areas in Victoria, payroll tax regimes across the country generally exclude the impact of economic and natural disasters.

Assuming harmonisation is achieved, questions arise as to the appropriate threshold and rate of payroll tax. A higher rate of payroll tax, while beneficial to the States as a source of revenue, could indirectly result in reduced effective wages for employees, leading to a fall in employment in small and large businesses alike (either because of the cost to business or because of the withdrawal of labour from the market). This must be balanced against the impact of a lower rate which could potentially reduce overall revenue for the States. The same can be said of the threshold.

Options – payroll tax rates and thresholds

Further research and modelling is required to determine the redistribution effects of a higher payroll tax rate reform and whether a reduction in other taxes or an increase in government expenditure, including in the form of transfer payments, could appropriately offset the lower take-home wage for employees.

The alternative is an overall revenue-neutral reform package. This would be achieved through a broader payroll tax base (achieved through lower or nil tax-free thresholds, and reduced concessions and exemptions) and a lower overall rate (for example, potentially between 2.5% to 3.5%). Implementation at the national level with collection via PAYG would have the added benefit of reduced administration and compliance costs (simplicity). In light of the minimal distributional effects, a flow-on outcome would be a reduction in opportunities for distortion.

The Tax Institute is of the view that simplifying and standardising payroll tax regimes through a consistent lower rate and the removal of thresholds is the preferrable option. Compliance costs are significantly reduced where readily available STP data is used, and rebates may potentially be used to further offset costs for certain businesses.

Options – alternatives to payroll tax

The system must be modernised to become more agile for the benefit of taxpayers and the State governments alike. As acknowledged above, payroll tax is currently fundamental to State governments as a significant source of revenue. It plays a critical role in supporting the State budgets and in weathering economic adversity. However, reform is critical to ensure that it allows businesses not only to survive in times of hardship, but also to expand.

Business turnover tax

One alternative to payroll tax is a business turnover tax. A business turnover tax is a relatively simple, presumptive tax that applies to the turnover of a business. Importantly, it does not distinguish between employing and non-employing businesses.

Such a tax imports a significantly lower level of complexity as it operates simply as a designated rate of tax applied annually to the turnover of a business. Unlike an income tax, deductions would not be taken into account, further simplifying its application by eliminating the requirement to determine whether expenses are tax-deductible and how they may be claimed. Given that deductions are not taken into account, the rate of tax would be expected to be lower than standard rates. Given the relative simplicity in the tax base and its application on an annual basis, a business turnover tax would also involve a much less onerous record-keeping and compliance burden as compared to payroll tax.

State income tax

Another alternative is State income tax. While there are a myriad of ways in which a state income tax could operate, such a tax should alleviate existing VFI to some extent.

There are a number of ways to overcome potential double taxation or the risk of creating multiple tax regimes. At the outset, the basis for determining liability could remain under existing income tax laws, primarily the ITAA 1997 and the ITAA 1936. This would avoid the inefficiency of creating new State-based income tax regimes and would ensure a level playing field whereby the same regime continues to apply to all taxpayers.

To prevent double taxation, the federal income tax could be reduced to the extent that a State income tax is imposed. For example, where 30% federal income tax were otherwise payable, if 10% state income tax is imposed, the federal income tax rate would reduce to 20%. It is acknowledged that this would create two layers of income tax, though this could be overcome by requiring lodgment of a single tax return with the tax payable divided among the Commonwealth and the relevant State in the applicable proportions.

It should also be noted that, while there is a degree of harmonisation between the payroll tax (and, indeed, stamp duty, land tax and other) regimes operated by the States and Territories, they are still separate regimes governed by State law, such that replacing them with State-based income tax should not be as significant a change as it may appear on its face.

There are a number of options that could be considered, incorporating one or both of a business turnover tax and a State income tax. These alternatives and some combinations are outlined in Table 12.

Table 12. State income tax combinations and options

	Individual	Business
1.	State income tax	State income tax (akin to federal company tax)
2.	State income tax	Business turnover tax
3.	State income tax	
4.		Business turnover tax

Whether such a tax should apply to individuals only or equally to businesses requires consideration of whether a business turnover tax is feasible. Either a business turnover tax or a State income tax may be viable in isolation, but they may also work in tandem, as suggested in the table above, provided that they are carefully considered to prevent double taxation at the State level and also in the context of existing federal taxes.

There are a number of other factors which require careful consideration, such as the potential disadvantage to smaller States and the compensation mechanism that may be required. We consider that there is value in undertaking further work and assessing these alternatives in greater detail.

Regardless of the option chosen, but particularly if payroll tax is retained, the merits of tax concessions for SMEs, start-up businesses and those businesses affected by unforeseen and extenuating circumstances (such as bushfires, floods or COVID-19) should be considered. While it is acknowledged that many SMEs are exempt from payroll tax by operation of a tax-free threshold, this is generally not the case in Victoria due to the significantly lower than average threshold, and in any case, can be diminished in other jurisdictions by the operation of the grouping rules (discussed below).

Disproportionate compliance and administrative costs

Issue

In addition to an annual return and other ongoing record-keeping requirements, payroll tax returns must be lodged monthly. This compliance burden increases exponentially where an employer operates across more than one jurisdiction. The cost to businesses of managing their payroll tax obligations in each State is significant and can deter businesses from expanding across multiple jurisdictions.

This is exacerbated by the variability of thresholds and rates which, as considered above, also disincentivise business expansion and wage growth even in a single jurisdiction.

Options

The solution to this issue must be found in the administration of payroll tax. Allowing businesses to lodge a single annual return, or, alternatively, for payroll tax to simply be reported on a BAS, would be a significant reduction in the compliance burden on businesses, particularly in the latter case, given that most businesses incurring a payroll tax liability are already required to lodge a BAS.

Further, as outlined above, payroll tax is not an appropriate avenue for competition between the States. Particularly in the current economic climate, the focus of the State and federal governments should be the creation of jobs and economic growth across the entire nation.

By either removing or standardising the tax-free thresholds, and by implementing a single rate, businesses will not be (dis)advantaged for operating in one jurisdiction over another and payroll tax will cease to be a consideration in determining where to employ staff and whether to expand a business.

Complexities relating to grouping

Issues

From a business group perspective, payroll tax is an inefficient and cumbersome tax.

The grouping provisions in the various payroll tax regimes are expansive and broad reaching. Aside from very limited exceptions, the main exclusion rests on the discretion of the relevant Commissioner. Despite harmonisation in this area, the approach taken can vary from State to State. This can give rise to inconsistencies in the application of payroll tax and particularly in the availability of any relevant tax-free threshold.

Further, the compliance costs for a group liable to payroll tax are high. Unless the group is a single lodger group, all members of the group are generally required to lodge returns for essentially the same information (albeit that the threshold may only be claimed by the designated group employer). This burden is compounded where the group operates over multiple jurisdictions.

Options

The business turnover tax discussed above is a holistic option for reform which could address issues arising with regard to grouping for payroll tax purposes, and indeed other aspects of the system. Similarly, a system with no exemptions would obviate the need for grouping as all employing entities would be included in the regime. (This could be coupled with a reduced rate.) Alternatively, there should be a focus on redrafting the legislation in this area, and cutting red tape in terms of the compliance obligations imposed on a group.

11.2 Taxes on land and transfers of real property

Overview

The Tax Institute supports reforms which make the tax system more efficient, fairer and sustainable. In addition to these principles, in the context of land and property, The Tax Institute supports reforms which make housing more affordable for all Australians.

As outlined earlier in this paper,[481] efficiency relates to the extent to which a cost (such as a tax) distorts behaviour, rather than the cost itself. Land can be a highly efficient tax base, capable of delivering sustainable revenue. It is efficient largely because it is immobile and cannot move to escape tax in the same way as other tax bases such as labour or capital. While the cost of the tax may influence the price of the land, it generally does not affect how or the extent to which it is used (subject to the availability of exemptions, considered below).

481 Refer Chapter 1.

When considering mobility, it follows that greater economic growth could be achieved more readily where more revenue is raised from immobile sources, such as land, than from mobile tax bases which have the potential to escape the Australian tax net, for example, by being contracted or offshored. The tangible, immovable nature of land makes it difficult to evade or manipulate the associated taxes by residents and, indeed, non-residents alike.

The efficiency of taxes on land, like any other tax, is, of course, inversely proportional to the level of exemptions and concessional treatment available in respect of certain types of taxpayers or uses of land (for example, residential, commercial, charitable, or primary production). In assessing existing taxes and potential alternatives, governments must be mindful of the potential for exemptions to distort behaviour and, specifically in the context of land, to change how it is used. This part of the paper primarily considers stamp duties on transfers of land and real property, land tax and the potential for new property taxes.

Stamp duties

Stamp duty is a State-based charge, levied on the transfer of certain assets, in this context, real property and land.[482] It is generally payable by the purchaser of the asset and is determined by reference to the higher of the purchase price or, and the market value of the asset. Rates and thresholds vary from State to State, though as a general premise, stamp duty rates increase progressively depending on the asset value.

Table 13 sets out a high-level summary of the maximum duty rates and foreign purchaser surcharges in each State as at February 2021.

Table 13. Maximum duty rates and foreign purchaser surcharges

Jurisdiction	Maximum duty rate	Foreign purchaser surcharges
New South Wales	5.5%	7% premium rate applies to transfers of residential property where the value exceeds $3,101,000.[483] 8% surcharge applies to foreign purchasers of residential property.
Victoria	5.5%	8% surcharge applies to foreign purchasers of residential property.
Queensland	5.75%	7% surcharge applies to foreign purchasers of residential property.
Western Australia	5.15%	7% surcharge applies to foreign purchasers of residential property.
South Australia	5.5%	7% surcharge applies to foreign purchasers of residential property.
Tasmania	4.5%	8% surcharge applies to foreign purchasers of residential property. 1.5% surcharge applies to foreign purchasers of primary production land.
Northern Territory	5.95%	
ACT	4.54%[484] 5%[485]	

482 Which also includes business assets located or taken to be located in Qld, NT and WA.

483 This threshold is subject to indexation each year.

484 Residential rate.

485 Commercial rate which applies for transfer of land and goods with a value more than $1.5m.

Stamp duties are archaic. They are founded on reasons which are simply not relevant or justifiable in today's day and age.[486] Worse still, they distort behaviour. Stamp duties discourage transfers of land and other assets more broadly. In the residential space, this inhibits people from upsizing or downsizing depending on their familial circumstances. It impedes workforce mobility and the ability of people to relocate freely for other purposes. It is one of the major obstacles for first home buyers to enter the property market.

Stamp duties are not commensurate to other economic conditions. Studies have shown that since the 1980s, stamp duty costs have increased approximately three times faster than house prices.[487] Bracket creep is a serious problem in this context with certain States having little or no rate adjustments since the 1980s.[488]

For each of the States, stamp duty is a significant source of revenue. Although the base (essentially land) is immobile and therefore has the potential to be fundamentally efficient, because they are tied to transactions, stamp duties are highly volatile, and the revenues generated are highly dependent on a number of external factors, such as market forces and the extent to which properties are transacted. For example, where there is a surge in property prices, as we periodically experience in many parts of the country, revenues generated from stamp duty will prima facie increase. However, where there is a lack of turnover in the property market, stamp duty revenues suffer. The effect is that while the States can enjoy high revenues in times of peak market activity, those which are particularly reliant on stamp duty as a major source of revenue are especially exposed during periods of economic downturn and slowed market activity. That is, stamp duty is unreliable as a consistent revenue stream.

Land taxes

Land tax is an annualised State tax based on the unimproved value of land as determined by the relevant State Valuer-General where such value exceeds the applicable tax-free threshold.

Table 14 sets out a high-level summary of the general land tax rates in each State as at February 2021.

---

486 The origins of stamp duty date back to 1694 in the United Kingdom. See Inland Revenue (UK) SO6, *A short history of stamp duties*. In Australia, land taxes were introduced by most colonies in the late 19th century, with Victoria leading the way in 1877 (see www.sro.vic.gov.au/history-state-taxation). Transaction taxes such as stamp duties were developed over the course of the 19th century, originally serving as fees for the validation of contracts and probate. See P Tilley, *Early federation reviews and 1942 income tax unification*, Tax and Transfer Policy Institute, working paper 11/2020, September 2020.

487 Housing Industry Association, *Stamp duty watch* report.

488 For example, apart from introducing premium rates and surcharges, NSW has not experienced a rate review since 1985, a time at which the median house price was $70,000.

Table 14. Land tax rates

Jurisdiction	Maximum general land tax rate	Surcharges and other additional rates
New South Wales	2%	2% surcharge for residential land owned by foreign persons.
Victoria	2.25%	2% absentee owner surcharge (all taxable land). 1% vacant resident land for certain parts of Melbourne.
Queensland	2.75%	2% surcharge for absentee individuals, foreign corporations and trustees of foreign trusts (all taxable land).
Western Australia	2.67%	0.14% metropolitan regional improvement.
South Australia	2.4%	2.4% trust surcharge.
Tasmania	1.5%	
Northern Territory	N/A – property activation levy imposed on unimproved capital value of vacant land and certain non-residential properties in Darwin.	
ACT	1.12% plus $1,326 fixed charge.	0.75% surcharge for residential land owned by foreign persons.

Land taxes are much less volatile than stamp duties, although they are still bound, to an extent, to market movements in respect of the value of the land itself. In acquiring land that is liable to land tax, purchasers may factor in the cost of the tax in their pricing. That is, land value reflects the future, after-tax earnings on land, the outcome being that by equalising the after-tax return on land with the return on other investments, land tax does not distort investment decisions.[489]

An important policy consideration is that, as noted above, land tax applies to the *unimproved* value of land. The liability does not take into account the value of buildings or other capital improvements. This means that land tax does not hinder investment or productivity. It does not deter the use of land for particular purposes (subject to the availability of exemptions), nor does it influence a decision to improve the land, other than from perhaps a cash flow perspective.

As noted above, land taxes have the potential to be highly efficient. Land has a broad base, available in a fixed supply. The only real substitute for one parcel of land is another parcel of land. However, existing regimes generally have a narrow base, excluding land used for certain purposes (for example, owner-occupied residential housing). This creates the potential for landowners to determine whether to use land in a taxable or exempt manner. This, in turn, affects the efficiency of the tax as it removes the fixed element of the supply of *taxable* land. It also impacts where the burden of the tax ultimately falls, given that it may be passed on to the users of land (that is, tenants or business owners of the land as part of their cost of production).

In each State operating a land tax, there are a number of exemptions in place which can reduce a taxpayer's liability to land tax, potentially to nil. These include (subject to certain criteria) a person's principal place of residence, primary production land, boarding houses, low-cost accommodation,

489 Henry review, p. 248.

and residential and caravan parks. There are also concessions and exemptions for NFP organisations, retirement villages, aged care establishments, nursing homes and childcare centres.

Options

Property tax

The overarching issue with both stamp duties and land taxes is inefficiency. Stamp duties are unfair in that the burden is borne disproportionately by those who transact in real estate. Land taxes are currently inefficient due to the broad exemptions which remove a significant proportion of land from the tax base.

There are a number of key factors when considering reform in this area. One is establishing a comprehensive base with minimal exceptions. Another is determining the appropriate rate (or rates) at which the tax will be imposed (and the extent to which any thresholds will operate in tandem). Whether or not reform in this area should be revenue-neutral, and how the desired outcome can be achieved, whether in the short, medium or long term. Another important consideration is the potential overlap between a property tax and local government charges, such as council rates and levies. While the real risk here is different levels of government competing for the same base and potential double taxation, the opportunity is the streamlining of regimes which can lead to greater cohesion between different levels of government, thereby further enhancing efficiency. A reform package which takes into account these factors would lend itself to greater efficiency, stability and a fairer outcome for residents.

There are various options for reform in this area, but those which The Tax Institute recommends fall broadly in the scope of property taxes. One somewhat tested option would be to follow recent examples, such as the ACT, which in 2012, commenced a twenty-year gradual shift away from stamp duties, or the recent proposals currently being considered by the NSW Government to replace stamp duties and, where applicable, land tax with a broad-based, annualised property tax.

The Tax Institute has considered a number of potential issues and key aspects of a potential shift away from stamp duties (and land tax) towards a property tax regime.

Housing affordability

A common concern in this context relates to the potential increase in housing prices in the short to medium term, in respect of those properties brought into the new regime. The increase is expected to potentially reflect the stamp duty liability that otherwise would have arisen. Such an increase could exacerbate challenges facing buyers in the current environment with property prices expected to soar over the coming year due to record low interest rates and other factors.

Where financial lenders take into account the ongoing cost of the proposed property tax in determining a borrower’s capacity to service a loan, it is expected to reduce a person’s servicing capacity (due to the reduced after-tax income position resulting from the annual property tax cost) compared to their servicing capacity in the case of a property liable to stamp duty. Subject to whether a person has high cash deposit/low servicing ability or a low deposit/high servicing ability, the overall effect of this should be that a stamp duty purchaser and a property tax purchaser should be able to borrow equivalent amounts with neither category of purchaser worse off in that regard.

The Tax Institute considers that it will be important for governments to undertake comprehensive analyses of the impact of the proposed property tax on property prices, and to communicate those findings and the way in which it may be ameliorated by standard banking assessment rules.

A choice to opt-in

One challenge in the use of property taxes as compared to stamp duties is the ongoing nature of the liability. Stamp duty is an upfront, finite, one-off cost. Property tax (which is essentially a form of land tax), on the other hand, is an ongoing, annualised liability which can continue indefinitely. While the rate of tax can be generally lower (than stamp duties, and indeed existing land taxes) in raising the same revenue, it can mean that, depending on a landowner's holding period, the total tax cost of holding a particular parcel of land can be higher or lower.

Providing taxpayers with optionality between paying stamp duty on the one hand and annualised land tax on the other, at least at the time of introduction of a property tax, is a politically convenient way to transition to property tax. This will allow taxpayers to determine which option will be most suitable for their circumstances, depending on a range of factors including their intentions with respect to the holding period of the relevant property and their financial position.

It is recognised that a right of election may, at least temporarily, result in a more complex two-tiered tax system that will require greater effort to administer. Optionality may also create distortions in the market as some buyers may price assets based on paying stamp duty and others may price assets based on paying property tax. However, if the alternative is an immediate transition to a property tax that leaves sectors of the community without the means to pay (or a transition which applies to all landowners over a set period of time), then, despite its complexity, a two-tier system remains a preferable outcome.

Where the choice to opt-in is only triggered on a transaction in real property, noting the small proportion of properties that transact in a given year relative to the total number of properties in any given State, a two-tiered system is unlikely to be a significant outcome, particularly in the early stages of reform.

Thresholds

While governments need to ensure that their existing revenue base is protected to some extent during a transitional phase, the use of thresholds should be simply that — transitional measures. The use of thresholds introduces a complex third layer to the potentially two-tiered system noted above. Complexity arises in relation to the movement of property values suburb by suburb as they transition and shift between eligibility and ineligibility as market prices fluctuate. Thresholds may also create a distortionary impact on those properties otherwise nearing the said threshold. This may arise, for example, in the context of lending approvals in respect of properties at the margins of the relevant threshold.

Revenue neutrality

Each State will need to consider whether it would have an objective of revenue neutrality or otherwise. From the perspective of taxpayers, a right of election will provide protection for current purchasers, especially those who intend a long-term hold of land, from an unforeseen increase in the tax that they ultimately pay. However, where that choice is irrevocable, the freedom to choose the regime that best suits a particular taxpayer's circumstances will gradually decrease as more properties are opted-in to the property tax system.

If a government's ultimate objective is to bring all properties into a property tax regime, and for the system to be revenue-neutral as compared to the status quo, thorough consideration and justification of the relevant rates will be required to ensure that the tax paid and collected under the new system is, indeed, revenue-neutral. This might necessarily mean that rates will adjusted from time to time, which would lead to further uncertainty for taxpayers at the time of acquiring the land. It must be said, though, that a revenue-positive outcome is not necessarily undesirable, provided that it is part of holistic reform which sees reductions in revenues from other sources.

Concessions and exemptions

A significant issue for consideration in the development of a property tax will be whether the regime should contain any concessions or exemptions akin to those contained within the existing land tax and stamp duty systems. In this regard, consideration should be given to specific industries or entity types, certain types of transfers including those resulting from bequests or other intergenerational transfers, and transfers occurring in corporate reorganisations.

The Tax Institute recognises that the circumstances of farmers and primary production businesses are unique and their ability to pay an annualised tax may vary from year to year depending on external factors. Consideration should be given to the enactment of nuanced averaging measures to support those farmers who choose to opt-in to any property tax regime.

Charities generally enjoy certain longstanding broad exemptions from land tax and somewhat narrower exemptions from stamp duty. From a policy perspective, it would not be desirable to impose a new tax cost on charities. A particular issue arises out of the distinction between exemptions available under the duties law and in respect of land tax. While wide exemptions from land tax generally apply, duty exemptions for charities are usually more limited. In addition, if the transition mechanism is 'opt-in', consider whether it would be desirable for a charitable organisation to 'opt-out' for the time it holds the land and is used for charitable purposes.

An important question, therefore, is whether a property tax scheme would follow that of the existing land tax regime allowing for a broad exemption for charities, or whether it would be more restrictive following the model for stamp duty (or a combination of both). The Tax Institute recommends that where a government considers a property tax reform, they engage with key charitable stakeholders, particularly those whose charitable purposes fall outside the scope of the stamp duty exemption and would be most adversely affected were any property tax exemption to follow the stamp duty model rather than the land tax regime.

Local governments

Increases in land values result in increases in rates payable to local governments. As noted above, this may result in State governments and local governments competing over the same tax base. In addition, one of the key issues here is that certain sectors of society receive relief from rates under longstanding arrangements for those in need (for example, pensioners). The Tax Institute is of the view that the underlying policy for such relief should apply equally to any proposed property tax.

Revenue administration

Apart from the social equity and economic issues arising, in the context of hardship, important considerations arise in the area of revenue administration. Stamp duty is easy to collect and must be funded upfront by a taxpayer seeking to buy a dutiable asset. Revenue collection is, therefore, generally straightforward, given that the tax 'follows the money'. This is not necessarily the case with a land or property tax, especially where the taxpayer is unable to pay.

To provide assurance to prospective purchasers considering opting-in to the new regime, The Tax Institute recommends that the way in which any such scheme will be administered should be set out in detail at the outset. This should include, in particular, the way in which the relevant revenue authority will exercise any discretions to provide relief to taxpayers. In the event that deferred financing is used (eg a reverse mortgage whereby the State takes a charge over the land for unpaid property taxes) which is repayable on death, consider whether such an approach would effectively be taken to be a death tax in disguise.

State-based approach

As for other State-based taxes, a cohesive approach across the States is desirable, though in the case of land and real property, it is less critical. For mobile tax bases such as capital and most labour, there is less justification for competition or inconsistency between the States. However, noting the immobility of land, there is greater freedom for States to dictate their own rates and conditions (including exemptions).

That said, and acknowledging that recent years have seen a greater divergence amongst the States, harmonisation of regimes across States has the benefit of ensuring fairness and consistency for Australians regardless of the State in which they choose to live and/or invest. This could be achieved by intergovernmental agreements between the States or also including the Commonwealth. Regardless of the approach taken, it is important for the federal government to provide support to the States which do choose to embark on the path of reform. Revenue stability will be key to empowering the States to embark on a path of enacting more sustainable revenue sources. This will be beneficial for the Australian people, the States, the Commonwealth and the economy more broadly.

11.3 Resource rent taxes

Overview

The Henry review recommended a broad-based resource rent tax as an effective way to ensure an appropriate return to Australians for the exploitation of Australia's natural resources.[490] In particular, the Henry review recommended that the then existing resource charging arrangements should be replaced by a single resource rent tax administered at the federal level.[491] Among other reasons, this was on the basis that existing arrangements, in particular royalties, provided an insufficient return to the community given that they were unaffected by changes in profits, and the overall distortive effect on investment and production decisions also contributing to the reduction of

490 Henry review, p. 40.

491 Henry review, p. 47.

the return to the community.[492] It was noted that Australia has the world's largest economically demonstrated resource reserves of brown coal, lead, mineral sands (rutile and zircon), nickel, silver, uranium and zinc, and the second largest reserves of bauxite, copper, gold and iron ore (contained iron).[493]

Despite the recommendations made in the Henry review, Australia's existing regimes for the taxation of the exploitation of its natural resources are unsatisfactory. Currently, Australia has only one resource rent tax, being the PRRT, considered below. The short-lived MRRT was introduced on 1 July 2012 in order to tax the gains on certain profits from resources such as iron ore, coal, oil and gas. The Rudd-Gillard Government had initially announced the idea of a broad resource tax on 2 May 2010, in the form of the RSPT. The RSPT was based on recommendations from the Henry review. However, it was subsequently determined that the RSPT would be replaced by the MRRT, which diverged substantially from the Henry review recommendations.[494]

The *Minerals Resource Rent Tax Act 2012* (Cth) was passed on 19 March 2012. Amendments resulted in it commencing on 1 July 2012.[495] The MRRT was a similar style of rent tax to the already existing PRRT but it applied at an effective rate of 22.5%, being a reduced rate derived from the nominal rate of 30% reduced by the extraction factor of 7.5%.[496] It applied to iron ore and coal mining projects with an annual profit above the $75m threshold, and had no refund of excess deductions. As enacted, the MRRT was distinct from that which had been recommended by the Henry review.

For a number of reasons, mining companies opposed the MRRT. Its abolition was promised as part of the Abbott Government's pre-election campaign, and in September 2014, it was repealed by the *Minerals Resource Rent Tax Repeal and Other Measures Act 2014* (Cth).

With the PRRT operating alongside certain State-based arrangements, this is an important area which requires greater consideration. The Tax Institute's overarching recommendation is for the government to reconsider the taxation of economic rents derived from Australia's natural resources. A surcharge or levy, akin to the major bank levy, should be considered. This would be, perhaps, the simplest way to tax economic rents in this industry, ensuring efficiency, a low compliance burden and an appropriate return to the community.

Petroleum resource rent tax

As mentioned above, unique taxes and royalties apply in the mining and natural resources sector. At a very high level, they are broadly charges imposed on a fixed rate per unit that is produced, as well as profit-based royalties. Royalties place a cost on the use and sale of a commodity present on the land, similar to the way in which a road usage or congestion charge would be imposed to reflect costs to a community. In contrast, the PRRT captures the profits made from unique deposits.

492 Henry review, p. 47.

493 Henry review, p. 47.

494 Julia Gillard, Prime Minister, Wayne Swan, Treasurer and Deputy Prime Minister and Martin Ferguson, Minister for Resources and Energy, "Breakthrough agreement with industry on improvements to resources taxation", press release, 2 July 2010; Colin Barnett, Premier, "Resource super profits tax", media statement, 4 May 2010.

495 *Petroleum Resource Rent Tax Assessment Amendment Act 2012* (Cth).

496 Note that the Henry review had recommended a 40% rate.

Until 1975, the main return to Australian society from the extraction of offshore petroleum resources was through petroleum royalties. A crude oil levy was imposed in 1975 by the Commonwealth under the *Excise Tariff Act 1921* (Cth). The levy was introduced in response to dramatic increases in global oil prices in the early 1970s. It was initially imposed at a flat rate per barrel though variable rates, depending on the date of discovery of petroleum deposits, were introduced when price controls on domestic crude oil production were removed in 1978. This was intended to encourage the production of resources in new and remote areas. However, in recognition that the net return would, in some cases, be insufficient to justify investment in certain fields, the variable rates were subsequently replaced by a sliding scale levy in 1983, with a top marginal rate of 87% depending on the quantum produced from a petroleum field. The sliding scale was thereafter restructured with three scales representing different discovery periods, and both its scope and rates gradually reduced. Today, it only applies to offshore petroleum title areas that are out of the scope of the PRRT, though in certain cases, exemptions from the levy apply. As the name would suggest, it applies to crude oil only and not to natural gas.[497]

On 18 April 1984, the federal government announced that offshore petroleum projects developed after that date would be subject to a new resource rent tax and exempt from royalty and the crude oil levy. Three years later, the *Petroleum Resource Rent Tax Act 1987* (Cth) and related legislation were enacted.[498] Although the Act was not passed by Parliament until 1987, it applied retrospectively to exploration permits awarded on or after 1 July 1984 and recognised expenditure incurred on or after 1 July 1979.

One of the objectives of the PRRT was to reduce distortions to offshore petroleum exploration and development while generating an equitable return to society. However, mineral rights have always been a contentious issue between the Commonwealth and State governments, and the PRRT has been no exception.

The PRRT applies at a rate of 40% to the taxable profits of oil and gas projects located in Commonwealth waters, and on the North West Shelf project, which is a shared jurisdiction between Western Australia and the Commonwealth. It no longer applies to onshore oil and gas projects such as those located in Gladstone, Queensland, which are instead covered exclusively by a State-based royalty regime. It has applied to offshore petroleum projects other than the North West Shelf project and the Joint Petroleum Development Area since its introduction. The Bass Strait project has been subject to PRRT since 1990 and, since 2012, the PRRT regime was applied to the North West Shelf project. In 2012, onshore petroleum projects were brought within the PRRT regime, although they were removed from its scope from 1 July 2019. As a result, provisions that related to initial amounts of starting base expenditure and the consolidation single entity rule were repealed. Separately, from that date, new uplift rates have applied to certain categories of carried-forward expenditure.

The PRRT regime has been subjected to significant and detailed reviews, including an independent review by Mr Michael Callaghan AM PSM who issued his final report to the then Treasurer, the Hon. Scott Morrison MP (now Prime Minister of Australia) on 13 April 2017[499] (the Callaghan review). The government responded to the Callaghan review on 2 November

497 M Crommelin, "Governance of oil and gas resources in the Australian Federation", (2009) *UMelbLRS* 8. Available at www.austlii.edu.au/au/journals/UMelbLRS/2009/8.html.

498 *Petroleum Resource Rent Tax Assessment Act 1987* (Cth).

499 M Callaghan, *Petroleum resource rent tax review – final report*, Australian Government, 13 April 2017 (Callaghan review). Available at treasury.gov.au/review/review-of-the-petroleum-resource-rent-tax/final-report.

2018.[500] As part of the government's response, a separate inquiry into the effectiveness of the RPM contained within the PRRT Regulations was commenced by the Australian Treasury.

Among other things, the Callaghan review included recommendations on administration on the grounds that the administration of the PRRT significantly differs from other tax regimes. Notable recommendations related to the choice of functional currency for PRRT purposes, the filing of returns for exploration permits, and also matters such as the availability of substituted accounting periods. These matters and others are considered below. The issues raised in this paper are not exhaustive and we reiterate our recommendation that the government consider other significant issues within the PRRT regime, particularly those raised in the Callaghan review.

Issues and options

The operation and efficiency of the PRRT regime is important to the health of the overall tax system, particularly to give confidence to the Australian community that they are receiving an appropriate share of any profits that attach to a petroleum project on the basis that the petroleum itself is an asset of the Australian people.

Overall, The Tax Institute recommends that the changes proposed in the government's response to the Callaghan review be progressed. The options outlined below will significantly improve the administration of the PRRT regime and provide certainty to PRRT taxpayers and potential investors.

The Tax Institute recommends that there should be consideration of whether the PRRT regime remains fit-for-purpose and the extent to which it may be simplified. We consider that a number of administrative and technical changes should be legislated. Undertaking these amendments will maintain the integrity of the regime, while improving the administrative experience for all users, including taxpayers and the ATO.

Importantly, the amendments outlined below should be legislated. Such changes are relatively simple solutions which will have a significant impact on reducing the compliance burden associated with the PRRT.

Distribution of an appropriate share of profits from petroleum projects

The Callaghan review noted concerns raised by community groups that the PRRT was not providing an equitable return to the Australian community on the development of petroleum resources. The report stated:[501]

> In particular, concern was expressed that PRRT revenue is declining at a time when a number of large LNG projects have or will soon come into production that will result in Australia becoming a leading exporter of LNG. Concerns were also expressed that some large LNG projects may not pay PRRT for decades to come, or may never pay PRRT at all.

500 Treasury, *Government response to the petroleum resource rent tax review*. Available at treasury.gov.au/sites/default/files/2019-03/p2018-t339508-govt-response-PRRT.pdf.

501 Callaghan review, p. 4. Available at treasury.gov.au/sites/default/files/2019-03/R2016-001_PRRT_final_report.pdf.

Functional currency

Issue

There is no ability to choose a functional currency other than that of the ultimate parent entity. If the functional currency of the ultimate parent is not USD, which tends to be the prevailing oil and gas industry currency, significant challenges arise in complying with the regime, particularly given the interactions with the RPM measures in the PRRT Regulations.

There are information limitations placed on taxpayers where participants in a joint venture, in particular the operator of a project, have a PRRT functional currency which differs from other joint venture participants, given that often they do not maintain multiple currency ledgers.

We note that this issue is not limited to MEC groups. This has led to taxpayers being required to enter into individual agreements with the ATO to ensure that compliance resources are not directed to matters of currency conversion. It also results in inefficient systems usage and significant manual processes to manage currency as the taxpayer's ERP systems cannot maintain the information directly.

Option

Reform in this area should allow the flexibility for a PRRT taxpayer to select the currency in which to report. Alternatively, a simple fix in the majority of cases may be to allow the election of USD as well as AUD as the appropriate functional currencies for the PRRT regime. Given that USD is the ordinary reporting currency for the majority of the oil and gas industry, this option is likely to have the desired practical outcome.

While we acknowledge that the ATO have been able to enter into agreements not to direct compliance resources to currency-related matters within the PRRT on the basis that it is considered low risk, this is far from appropriate for a regime with such large spending occurring.

Substituted accounting periods

Issue

Taxpayers who pay PRRT are unable to apply for a substituted accounting period. This forces all such taxpayers to use a 30 June year end. This is the case despite the prevalence of a 31 December balance date in the oil and gas industry. This gives rise to duplication and often necessitates manual intervention to calculate the financial information necessary to prepare a full-year return.

Option

The ability for a taxpayer to select a substituted accounting period consistent with its own statutory reporting period is one of the most fundamental choices within the income tax regime. It enables taxpayers to reduce compliance burdens and align record-keeping and report production within ERP systems. A substituted accounting period has no real impact on the tax collected but merely the administration for the relevant PRRT taxpayer. That it is not currently contemplated by the PRRT regime is an anomaly that should be corrected by a legislative amendment.

It is therefore recommended that the ability to elect a substituted accounting period be legislated.

Filing of returns

Issue

There is generally a significant lag between incurring expenditure and development. This can sometimes be as long as multiple decades (for instance, in relation to the Gorgon project, there was more than 40 years between discovery and production).

There is currently no obligation to lodge PRRT returns for exploration permit spends.

An obligation to lodge a PRRT return arises only when assessable receipts are first recorded by a project. This triggers the review period covering time limits for the Commissioner to issue amended assessment. However, it leads to a scenario where often all the prior years need to be considered shortly after the lodgment of the first PRRT return, including the prior exploration expenditure history, which could have spanned several decades by that stage.

It is far from ideal that reviews/audits of expenditure can be undertaken several decades into the future. Documents must be stored for the future, which is entirely inconsistent with corporate record retention, and transfer pricing which has a seven-year limit. A large portion of such records, particularly historical documents, are held in hardcopy.

From a government perspective, they hold no usable information on the size of expenditure pools, including those which may be transferrable between projects under the PRRT regime. This has led to a significant modelling issue for the Commonwealth Treasury and difficulties arise in attempting to advise the government on anticipated revenue collections over various timeframes.

Option

We consider that it should also be legislated that returns be required to be lodged with the ATO from when a project incurs expenditure, not from when it derives assessable petroleum receipts. This is consistent with the income tax return requirements for carrying on an enterprise. It is also valuable as a data source for the Commonwealth Treasury in modelling and forecasting expenditure information much earlier than it currently obtains it.

While this does give rise to a new administrative obligation on PRRT taxpayers, this should be balanced by a four-year amendment period from the lodgment of a return. It will also provide a longer-term trade-off in the context of security over the historical positions and avoid unduly expensive document retention costs.

Tolling arrangements under the existing PRRT Regulations

Following the boom in greenfield LNG development in Australia, the Australian LNG industry is entering a phase of seeking to maximise the use of existing infrastructure by processing new sources of petroleum through that existing infrastructure.

As existing resources and fields mature, processing capacity will continue to open up in existing LNG plants throughout Australia, providing opportunities to use this capacity to monetise new undeveloped resources.

In many cases, the processing of undeveloped offshore resources through existing infrastructure involves the payment of a processing fee or ‘toll’ from the new resource owner to the facility owner. That is, the owner of the new resource, rather than building a new processing facility, negotiates and enters into an agreement with the owner of existing processing infrastructure to process its gas in consideration for a fee.

Such arrangements could become increasingly common in the industry in the future. It is therefore important to ensure that the PRRT Regulations continue to be fit-for-purpose and compatible with the type of commercial arrangements underpinning future Australian LNG developments, including LNG tolling and other processing arrangements.

While there may be a wide variety of these arrangements, this section of the paper primarily contemplates arrangements for the processing of third party gas through an existing facility, and the payment of a tolling fee. It also assumes that project combination is not available.

It is clear that the processing of third party gas was contemplated in the original design of the PRRT Regulations. As such, the regulations contain provisions relating to 'multiple use' of infrastructure (for example, ss 9, 10 and 43, which operate to ensure that costs are only included in the RPM to the extent that they relate to processing the sales gas of that particular petroleum project). The 2005 explanatory statement[502] also contains some useful commentary as to how the PRRT Regulations should apply to the processing of external petroleum.

Issues

The Tax Institute is of the view that there remains scope to provide far greater clarity and more specific guidance to taxpayers on the specific application of the PRRT Regulations to tolling arrangements which may become prevalent in Australia in the future.

The drafting of the PRRT Regulations would benefit from greater clarity in relation to their application to tolling arrangements, including, for example, reg 6 (When an integrated GTL operation[503] exists) and reg 11 (Participants in an integrated operation).

The current laws and regulations operate clearly and appropriately for existing facility owners. To the extent that the upstream portion of a facility is used to process external petroleum, assessable tolling receipts will be generated by the facility owner. The relevant expenditure incurred in generating those tolling receipts will be deductible.

In relation to the facility owner's own RPM calculation, the existing PRRT Regulations ensure that costs are excluded to the extent that they relate to processing third party petroleum.

However, there is less clarity for new resource owners. From the perspective of new resource owners, the PRRT Regulations would benefit from clarification in a number of areas to provide greater certainty to taxpayers.

The new resource owner is required to calculate PRRT as a separate PRRT project. In doing this, the starting point is to identify the relevant integrated GTL operation under reg 6 of the PRRT Regulations, subregulation (1) of which provides:

502 Explanatory statement to the *Petroleum Resource Rent Tax Assessment Regulations 2005* (Cth).

503 'Integrated GTL operation' is the defined term used in the PRRT Regulations referring to the operations comprising a PRRT project. GTL means 'gas to liquid'.

(1) An ***integrated GTL operation*** exists if there is an operation (the ***overall operation***) in which:

(a) petroleum is, or will be, recovered from a petroleum project; and

(b) sales gas is, or will be, produced from some or all of the petroleum; and

(c) some or all of the sales gas is, or will be, processed into a liquefied product.

Interpreting this definition is critical to identifying the relevant project natural gas, project sales gas and project product of the integrated GTL operation for the purposes of applying the PRRT Regulations.

From the new resource owner's perspective, it is critical that the above definition is interpreted to mean that the relevant 'sales gas' for its integrated GTL project is only the product it has title over and is being produced from its production licence (rather than *all* product processed through the shared facility). In other words, the new resource owner's project should be considered a separate PRRT project from that of the infrastructure owners.

This appears to be the correct interpretation having regard to the intent of the PRRT Regulations and produces logical and reasonable tax outcomes, namely that the new resource owner relies on the upstream and downstream portions of the toll in calculating their RPM price, and calculates their RPM based on their own cost structure. Further, the only tax information required from the facility owner is an upstream/downstream split of the toll and the volumes of gas processed from each source. This information is unlikely to be commercially sensitive and commercial boundaries between the new resource owner and the facility owner are maintained.

An alternative reading of reg 6 (that there is only one integrated GTL project) would include the facility owner as a 'participant' in new resource owner's PRRT project under reg 11. This would therefore require the facility owner's underlying costs to be included in the new resource owner's RPM, which would give rise to a number of issues. In particular, the new resource owner would be required to calculate their RPM based on the detailed underlying capital and operating cost data of the facility owner. This data is generally commercially sensitive and, in some cases, may not be made available by the facility owner. Further, the requirement to provide detailed, confidential cost data could, in many cases, prejudice the prior negotiation of a processing fee/toll.

Options

A focus of any tax reform in this area should be ensuring that the PRRT Regulations are fit-for-purpose and clear to taxpayers for years to come. Care should be taken to ensure that the PRRT Regulations apply clearly and appropriately to all types of arrangement, including arrangements with common owners, or where there is no toll.

Consideration of these matters formed part of Treasury's *Petroleum resource rent tax: review of gas transfer pricing arrangements review*[504] prior to that review being deprioritised at the onset of the COVID-19 pandemic. Achieving greater clarity remains important to providing certainty to taxpayers to support future investment decisions.

504 Available at treasury.gov.au/consultation/c2019-t364690.

The drafting of the PRRT Regulations would benefit from greater clarity in relation to their application to tolling arrangements, and indeed other brownfield development concepts more broadly, which are likely to become more prominent in Australia through the coming years and decades.

The identification of phases could be simplified for tolling arrangements. Regulation 9 of the PRRT Regulations identifies the phase points of an integrated operation. Simplifying a tolling facility to a single upstream phase and single downstream phase would reduce the amount of technical data required to be shared between facility owner and new resource owner. Further, it would better align with the commercial nature of a tolling arrangement, where a service-type fee would typically be paid in respect of processing the new resource owner's product.

Greater clarity in these areas will ensure certainty of outcomes for taxpayers, underpinning further investment decisions in Australia. This clarity is critical in securing future investment in the Australian LNG industry in the face of scarce capital markets. It will also ensure that confidentiality and commerciality can be maintained within the industry without being compromised by onerous information-sharing requirements between projects and taxpayers.

Reversion of production licence

The PRRT regime contains rules to ensure that, as a project progresses from an exploration permit to retention lease to production licence, the relevant expenditure remains attached to the project as the type of interest held progresses. However, the PRRT regime does not contemplate the rare circumstances in which a production licence may revert to a retention lease.

The absence of provisions addressing these circumstances creates uncertainty and a risk of unintended outcomes. The disallowance of deductions for historical exploration expenditure in relation to that project is an example of such an unintended outcome.

There are a number of different types of petroleum titles which a PRRT taxpayer may hold. The most common of these being exploration permits, retention leases and production licences.

As a project or prospect progresses through its life cycle, the type of interest held typically changes as exploration and feasibility work progresses. For example, a retention lease or production licence may be granted over an area previously covered by an exploration permit.

This relationship between licences, permits and leases is acknowledged and built into the PRRT laws through s 4 of the PRRTAA. This provision sets out the circumstances in which various interests will be considered 'related' to each other and 'derived' from one another.

Section 5 of the PRRTAA builds on this by defining what is meant by 'exploration for petroleum in, or recovery of petroleum from, the eligible exploration or recovery area in relation to a petroleum project'. This phrase is critical to determining what constitutes deductible exploration expenditure in relation to the project under s 37.

There have been cases in the industry where, subsequent to a production licence being applied for and granted, a decision is taken not to proceed with the development. In these cases, the taxpayer may apply for the production licence to revert to another type of interest reflecting the stage of maturity to which the project has regressed (typically, a retention lease).

Issue

Section 4 currently only contemplates a project moving forward toward production. It does not contemplate the reversion scenario outlined above. The intention of the PRRT regime suggests that the historical deductible expenditure should continue to remain with the reverted interest.

This deficiency in the PRRT regime was acknowledged in the Callaghan review but has not been remedied. The absence of specific rules addressing reversion creates fiscal uncertainty and a risk of the unintended outcome that the historical spend of that project is no longer deductible.

This uncertainty may significantly impact the economics of projects and therefore the ability to make investment decisions to invest scarce capital to bring new gas to market.

Options

One option for reform is to specifically include reversion scenarios in the operation of ss 4 and 5 of the PRRTAA. This would ensure that the types of changes in title interest in s 4 are comprehensive and broad.

Alternatively, a new provision could be included specifically addressing a reversion scenario. It is envisaged that such a provision would specifically provide that a reverted interest would either be treated as a continuation of the prior production licence where it relates to the same geographical area or would otherwise link the interests, such as through the project combination provisions in s 20 of the PRRTAA.

11.4 Other indirect taxes

Overview

There are a number of other indirect taxes at play both at a State and federal level. As outlined above, a significant proportion of these taxes contribute very little to overall revenue. Many of these taxes are complex to interpret and apply, and give rise to disproportionate administrative and compliance costs both for the respective governments and for taxpayers.

Some examples are considered in this section. We consider this is an area where the governments at both the State and federal level should dedicate time and resources to reassessing the value of such taxes and the various options for reform, whether they may be abolition, simplification, streamlining or otherwise. In circumstances where we have suggested options other than abolition, we consider that further analysis and modelling is required to support any given option.

Issues and options

Luxury car tax

Issues

The LCT is a tax imposed on vehicles, the GST-included value of which exceeds that of certain LCT thresholds (see Table 15). The LCT is payable by individuals and businesses that sell or import the vehicles. The LCT tax amount is calculated and dependent on whether or not the vehicle has already had the LCT paid on it and whether it is being sold or imported. Each method has a different calculation dependent on particular factors in relation to the vehicle, and as such, can have different exemptions or deductions, as well as other rates applied onto it.

Table 15. LCT thresholds

	LCT thresholds	
Financial year	Fuel-efficient vehicles	Other vehicles
2020–21	$77,565	$68,740
2019–20	$75,526	$67,525
2018–19	$75,526	$66,331
2017–18	$75,526	$65,094
2016–17	$75,526	$64,132
2015–16	$75,375	$63,184
2014–15	$75,375	$61,884
2013–14	$75,375	$60,316
2012–13	$75,375	$59,133
2011–12	$75,375	$57,466
2010–11	$75,375	$57,466
2009–10	$75,000	$57,180

Source: ATO website at www.ato.gov.au/rates/luxury-car-tax-rate-and-thresholds/.

The LCT was introduced to Australia on 1 July 2000 among broader tax reform measures including the GST, to somewhat replace some of the regulations of the previous. The WST had been introduced to Australia in 1930 in order to overcome the economic problems of that time, including the Great Depression and reducing customs revenue. The LCT was considered necessary because replacing the WST with a 10% GST meant that vehicles would be taxed at a 10% rather than the previous 22% and 45%.

The LCT was also driven by a policy objective of protecting the Australian car manufacturing industry. The government deemed it inappropriate for the price of luxury vehicles to fall as a result of this change. As such, the LCT was introduced along with the GST, and the WST was abolished. The LCT was initially imposed at a rate of 25% on vehicles above a certain threshold. In 2008, the rate was increased from 25% to 33%, which remains the current rate. The 2019–20 threshold for fuel-efficient vehicles was $75,526 and for other vehicles was $67,525, this threshold was increased for the 2020–21 financial year with values increasing to $77,565 and $68,740, respectively (refer Table 15).[505] The relevant financial year threshold depends on the year that the car was imported, acquired or sold.

There are few exemptions to the LCT. The purchase of certain vehicles is not subject to LCT, including motor homes, campervans, emergency vehicles and commercial vehicles designed mainly for carrying passengers. Vehicles that are imported by endorsed public institutions for the

505 ATO, *Luxury car tax rate and thresholds*. Available at www.ato.gov.au/rates/luxury-car-tax-rate-and-thresholds.

sole purpose of public display are not subject to the LCT. In addition, capped refunds of LCT paid are available to primary producers and tourism operators when eligible vehicles are purchased.[506]

Options

In general, luxury taxes have a narrow base which makes them fundamentally inefficient. They are also ineffective and arbitrary in redistributing wealth.

The LCT served a purpose confined to its history when it was implemented. It is currently the only luxury goods tax imposed in Australia. Other luxury goods that were taxed at a higher rate under the WST were not replaced by special taxes or rates other than the standard GST. The LCT no longer serves its original purpose. It no longer has a protectionist purpose, given the state of the Australian car manufacturing industry, and it no longer acts as a tariff on imported cars.

The LCT may be considered justifiable on the grounds that it is relatively easy to collect and equitable in that it taxes those who are able to afford it. However, it defies horizontal equity in that people in the same economic situation pay different amounts of tax depending on their choice of vehicle. This is increasingly problematic in the current landscape, and will become more problematic in the future with the increase of electric vehicles on the market. Electric vehicles are generally more expensive than comparable fuel-powered vehicles. This means that they are more likely to attract LCT. This exponentially increases the upfront cost of buying an electric vehicle compared to fuel-powered vehicles. Implementing or maintaining measures which disincentivise environmentally sustainable practices, such as the use of electric vehicles, seems an anachronism in the present day.

The LCT also goes against vertical equity as people may become liable for the LCT due to the kind of vehicle required. For example, a small sports car may attract the same LCT as a minivan required by an average family as a means of transport.

The Tax Institute supports the abolition of the LCT and recommends that other vehicle taxes should be replaced by more efficient user road charges (considered below). As noted in this report, Australia currently does not have a cohesive climate change policy, nor related policy in relation to environmental sustainability. There are a number of existing systems in place around the world from which Australia may gather learnings and inspiration. For example, Norway operates a motor vehicle purchase tax system which imposes a progressive rates tax on three criteria, being weight, engine capacity and the CO2 emissions of a vehicle. A similar model could be replicated in Australia with the added benefit of addressing the environmental impact, though further consideration of the potential alternatives is required.

Motor vehicle taxes

During the 1920s, all States adopted a tax on motor vehicles, originally deemed a luxury levy. Over time, due to motor vehicles becoming more commonplace, the tax became a significant source of revenue as a mass consumption levy. At its peak, the motor vehicle tax accounted for almost 20% of State taxation revenue.[507]

Today, the States impose a number of different motor vehicle-related charges, including transfer fees, motor vehicle tax, stamp duty on vehicle transfer and driver's licence fees.

---

506 Treasury, *Tax benchmarks and variations statement, 2020*, January 2021. Available at treasury.gov.au/sites/default/files/2021-01/145906_2020-tbvs.pdf.

507 J Freebairn, M Stewart and P Liu, *Reform of state taxes in Australia: rationale and options*, Melbourne School of Government, p. 23, July 2015. Available at apo.org.au/sites/default/files/resource-files/2015-07/apo-nid56198.pdf.

These State-based taxes apply in addition to GST and the fuel excise, which are levied by the Commonwealth.

New technologies and lifestyle changes are affecting travel and the demand on infrastructure. Cars are becoming more fuel efficient, electric vehicles are becoming more popular, and the use of ride- and car-sharing services is increasing. The COVID-19 pandemic and the resulting various periods of lockdown have presented governments and Australians with the opportunity to reassess their attitudes to working remotely or on-site, public transport, travel and their associated behaviours.[508] These changes, while positive in many ways, have resulted in a decline in traditional government revenues funded out of motor vehicle registration duty.

Duty on certificates of registration of motor vehicles applies to both new vehicles on initial registration and transfers of ownership of motor vehicles.[509] Duties apply at differential rates depending on what kind of vehicle is being registered. They are fixed charges that do not vary with the amount of time spent on the road or the wear and tear inflicted on the road networks.

The Commonwealth Government's fuel excise scheme effectively operates as a road tax. Drivers of older or larger vehicles with higher fuel consumption pay more per kilometre to use the same stretch of road as drivers of newer, smaller and more fuel-efficient vehicles. Further, electric vehicle drivers use the same road at very little cost. Fuel excise revenue has experienced structural decline as vehicles have become more fuel efficient. This trend is expected to continue as electric and other low-emission vehicles become more common.

Together, the portion of revenue generated by these taxes exceeds that of the aggregate spent by the three levels of government, federal, state and a portion of local, on the investment and maintenance of roads. However, while these charges are effective in taxing the use of motor vehicles, other areas of road use are poorly regulated, such as congestion, pollution and road damage.

It should also be noted that motor vehicle taxes are regressive taxes and can be particularly onerous for low-income households.

Options

Undoubtedly, there may be tension between current regimes that effectively result in lower ongoing taxes on electric cars and higher taxes on traditional petrol or diesel cars. The Tax Institute supports achieving a balance that allows for a sustainable tax system for motor vehicles. However, to the extent that consumers move towards low emissions and electric vehicles, as outlined above, these trends should not be discouraged as a result of taxation policies. The Tax Institute also recommends that the States and Commonwealth consider how these issues are addressed in other cities across the world. Particularly in the context of congestion charging, there are a number of cities which operate a system of congestion charging, including London, Stockholm, Milan, New York, Singapore and parts of the US.

508 Federal Financial Relations Review (David Thodey, AO, Chair), *NSW review of federal financial relations – supporting the road to recovery*, draft report, NSW Treasury, July 2020, pp. 82-83.

509 See, for example, Ch 9 of the *Duties Act 1997* (NSW).

Rationalisation of taxes on motor vehicles

The Tax Institute considers that there is merit in considering a State-based road user charge for the use of vehicles on roads and other associated services.[510] Another potential reform could be the implementation of a State tax on vehicles which would combine stamp duty along with registration fees and charges into a single annual fee that would apply equally to all motor vehicles.

Congestion charges

During peak hours, congestion on major roads is a market failure that is often not accounted for. Congestion costs could be calculated taking into account the location and time of day. Technologies such as e-tags, hubometers and geographic information systems would be some modern technologies that are available for use at relatively low costs.

A simple change to address congestion could be to vary the toll rate for congested toll roads depending on the time of day. This reform could be even further improved by implementing a toll rate that is regularly revised through the constant use of new information, and this information could potentially be readily available to motor users through the use of apps or a similar technology.

Any fee implemented would need to take into account the marginal social cost. Modern technology allows for a low marginal cost over a period of time where such a fee is set at a rate that is marginal to the external cost of congestion. However, the use of such technology brings with it other risks and factors for consideration outside of the realm of the tax system, including privacy.

Pollution charges

It is difficult to measure the effects of pollution by a single vehicle as it can have localised effects, such as fog or particles, as well as global effects, such as contribution to the problem of greenhouse gases. As such, a tax that is instead imposed on the principal input that results in the pollution, such a petroleum products, may be an option. It is envisaged that the rate of the tax would be reflective of the marginal external cost of pollution.

It is noted that through the Clean Energy Future package of 2012–14, the Gillard Government introduced a carbon tax. Setting aside the exemptions which had applied, and the political tensions which ultimately lead to its repeal, the carbon tax is an example of holistic reform with effect beyond the tax system alone. Some form of carbon pricing regime and a coherent policy addressing climate change is critical to ensure not only the sustainability of Australia's tax system, but also our environment.

Excise and customs duties

Excise duty, under Australian law, is applied to the manufacturing of domestic petroleum fuels, alcoholic beverages (excluding wine), tobacco products, crude oil and certain biofuels. Equivalent duties such as customs duties and tariffs are imposed on imported products with the objective of protecting domestically produced goods and services.

---

510 See, for example, Thodey report, p. 85.

As a revenue source, excises (and their equivalents) have remained relatively steady, but there has been a decline over time in their significance in direct relation to the proportionate amount of overall tax revenue. For example, in 1909, they accounted for an entire three-quarters of total tax revenue, but in 2003–04, they only accounted for 8.5% of total tax revenue.[511] Over this period, custom duties have seen a greater decline than excise duties, which is reflective of the fact that domestic goods are being produced in larger quantities and the decline in taxes applied to imports. Australian tariffs have also seen an increased reduction in order to increase economic efficiency in certain import industries that were deemed uncompetitive and to meet free trade agreements and World Trade Organization obligations.[512]

Alcohol duties and wine equalisation tax

Issues

While some excises are relatively efficient, others, such as the taxation of alcohol, are highly complex. Alcohols, such as beers and spirits, are taxed on the basis of their alcohol content, also known as volumetric taxation. Different rates are applied depending on the type of alcohol that is being taxed, the content and concentration of the alcohol, and whether it is packaged or draught (such as for beer).

Unlike other alcohol, wine is taxes on the basis of its value under the WET. The WET was introduced as part of the 2000 tax reforms, again in response to the objective of replacing the WST. It was implemented to ensure that the retail price and revenue from the wine tax would remain stable after the removal of the WST.

The WET is applied to the sale of all domestic and imported wine within Australia, at a rate of 29%. It does not apply to exported wine. In addition to the WET, the GST is also applied to the sales and importation of wine into Australia.

Like other alcohol taxes, the WET is complicated to calculate. This is because the law requires taxpayers to take into account, among other things, the type of wine product, the point of sale, and the application of any exemptions. The WET applies specifically to certain sales of portable alcohol called wine that contain an ethyl alcohol content higher than 1.5%, at a rate of 29%.

All other alcoholic beverages that contain a higher than 1.5% by volume content of ethyl alcohol are not taxed by reference to the WET but are instead taxed under the excise duty or customs duty (noted above). This two-tier system of indirectly taxing alcohol elevates the consumer price of purchasing and consuming alcohol beyond what it would be under the GST alone. It has an important public policy objective of taking into account the cost of alcohol consumption and offsetting the direct and indirect public cost of alcohol abuse while generating revenue.

The WET includes numerous different technical definitions that differentiate wine from other alcoholic beverages. For example, the definition of 'wine' includes grape wine, a grape wine product, a fruit or vegetable wine, cider or perry, mead and sake, unless they contain 1.15% per volume of ethyl alcohol (in which case, they are subject either to excise duty if manufactured in

---

511 S Reinhardt and L Steel, *A brief history of Australia's tax system*, Treasury, 2006. Available at treasury.gov.au/publication/economic-roundup-winter-2006/a-brief-history-of-australias-tax-system.

512 See The Centre for International Economics, *Final report: Australian trade liberalisation – analysis of the economic impacts*, October 2017; and Joint Standing Committee on Treaties, *Who's Afraid of the WTO? Australia and the World Trade Organisation*, report 42, September 2001.

Australia, or customs duty if imported). Each of these beverages also has a number of regulations to which it is also subject.

The WET is also a regressive tax. As income rises, the percentage of a consumer's income that is taxed as WET for a bottle of wine decreases, an effect that is compounded by the applicable GST. The effects of the ad valorem aspects of the GST and the WET may be somewhat mitigated by lower-income consumers purchasing lower costing wine, but this does not resolve the vertical inequality.

Options

There are a number of potential options in this area. As outlined above, The Tax Institute strongly recommends the government reassess the policy behind the vast number of inefficient taxes which do not comprise a significant proportion of revenue. Where possible, these taxes should be abolished. Where any such taxes are deemed necessary, for example, to drive behavioural change, we recommend that there be adequate consideration given to ways in which such taxes may be redesigned or simplified to improve consistency, reduce compliance costs and, where relevant, to encourage economic growth.

At least in the context of alcohol, though potentially even more broadly, a single rate may be an option to reduce complexity. However, if a standard rate is supplemented by an array of exemptions or exceptions, this may give rise to a different kind of complexity which would defeat the purpose of achieving simplicity. This may be addressed by having fewer exemptions or by implementing a dual-rate system. In the case of wine, a volumetric tax, similar to the tax applied to other alcohols, may be a potential option as it would result in the tax amount remaining the same regardless of the price of the product.

We also note that in the context of alcohol, reduced rates which are more closely in line with international competitors may encourage growth in this industry, and would support small-to-medium Australian brewers, distillers, winemakers and others in this industry. This must of course be balanced with the behavioural and health considerations in relation to alcohol consumption.

Insurance levies

Issues

Insurance levies are taxes on a narrow base of products and vary from State to State, some of which operate more than one kind of insurance tax. Some examples are stamp duty on general and life insurance, private health insurance levies and emergency service levies. Depending on the State, general insurance duties can range from 6% to 11% of the premium payable. There are exemptions in each State, which include exemptions for annuities, hospital and medical benefits, as well as workers compensation.

Insurance taxes are undeniably inefficient. They drive up premiums and discourage consumers from obtaining sufficient insurance cover. Where taxes make insurance less affordable, as with any other goods or services, it is low-income households that are most adversely affected and, in these cases, most likely to be under-insured or uninsured. This exacerbates exposure to loss in adverse circumstances.

Insurance taxes are also inequitable as there is generally no connection between the purchase (or the purchasers) of insurance and the distribution of benefits from government expenditure.

Options

The Tax Institute considers that there is no sound basis for applying a special levy to insurance rather than, or in addition to, the GST as it applies to other goods and services. This view was outlined in the Thodey report commissioned by the NSW Government and has been recommended in other reviews of this area of the Australian tax system.[513]

The option here is, in our view, straightforward. Insurance levies should be abolished. Insurance products should simply be subject to GST in the same way as other goods and services. Revenue otherwise generated from insurance levies should be sought from other taxes as part of a holistic package of reforms.

Options for reform

- Consider a broad-based property tax model as part of a reform package as this would spread the burden of tax collection across a broader base (and not merely as a result of transfers of land).
- Gradually abolish stamp duties.
- Allow for protective provisions for those who have paid duty either via:
  - an 'opt-in' approach (such as the approach contemplated by the NSW Government[514]); or
  - commencement of taxation of relevant transactions from a retrospective date.
- Ensure rates are balanced as a sustainable revenue source for the governments and affordable for landowners, taking into account particular sectors which may be more adversely affected by an annualised cost than others (for example, low-income earners and pensioners).
- Maintain certain exemptions and concessions, and provide deferred payment and hardship arrangements where necessary.
- Move towards a tax system that more efficiently taxes wealth, with higher rates for more expensive properties.
- Governments should unite and apply a coordinated approach to ensuring a stable source of revenue for the States.
- Centralise the collection and administration of payroll tax, akin to the arrangement in respect of GST.
- Abolish payroll tax and replace with a business turnover tax and/or state-based income tax.

513 Thodey report, p. 65. See also, Henry review, p. 51; and Campbell Inquiry.

514 The Hon. Dominic Perrottet MP, NSW Treasurer, *NSW Budget statement 2020-21 Budget paper no. 1*; see also NSW Government, *The NSW Budget 2020-2021: buying in NSW, building a future; creating jobs and securing our future*, consultation paper, November 2020.

- If payroll tax is to be retained:
  - harmonise and lower rates, and eliminate thresholds across the States;
  - revisit complex aspects of the legislation, such as in respect of grouping; and
  - reduce the compliance burden, such as by reporting via BAS/STP data.
- Legislate a broader concept of a 'worker' for all employment tax purposes.
- Review and reassess the value of the vast majority of taxes which immaterially contribute to overall revenue:
  - abolish inefficient taxes; and
  - simplify and streamline other taxes which, although generating little revenue, may serve a public policy purpose.

12. Reshaping the GST for the future

Overview

Understanding the GST

The GST is a broad-based tax levied on the sale of goods and the provision of services. It is a form of VAT, whereby the 'value added' is broadly the difference between the sale price of a good or service and the cost of the inputs used to create that good or service. In most instances, the final consumer bears the full burden of the GST. In Australia, GST is imposed at a rate of 10% of the final price of goods and services, subject to a broad range of exemptions and exclusions relating to, among other things, food, health, education, rent, childcare and financial services.

Background to the introduction of the GST in Australia

The GST was introduced by the Howard Government through the enactment of the GST Act and took effect from 1 July 2000.

The GST replaced the federal WST and various state taxes in an attempt to address a number of issues under the WST regime including, among other things, the WST's relatively small and shrinking revenue base, the inequitable incidence of the WST, and certain constitutional and political problems with regard to state taxation and fiscal relations between the Commonwealth and the states.

However, the main reason for the introduction of the GST was to improve how the State governments funded public services and public infrastructure.[515] More specifically, the GST was introduced to establish a stable, predictable revenue source for the States and Territories, which would grow with the size of Australia's economy. Unfortunately, in the two decades since its introduction, the GST has far from achieved this.

While in the 20 years since its introduction, there has been a myriad of amendments to the GST law, there have been no substantive changes to the GST in that time. Overtly omitted from the Henry review in 2009, a comprehensive review of the GST regime and meaningful changes are well overdue, and must be considered as part of a serious tax reform agenda.

Issues

12.1 Recovering from the events of 2020

Holistic tax reform which supports Australia's economic recovery in the wake of the COVID-19 pandemic and the bushfires and floods, which have had a resounding impact throughout the country, must include a comprehensive review of the GST regime.

515 The Australian Government, *GST distribution review: final report*, Canberra, 2012.

Consumption tax revenues are affected by macroeconomic and policy changes, including changes in the level and composition of expenditure and the rate and base. During times of economic downturn, these variables impact consumption tax revenues. The OECD has undertaken studies analysing the drivers of change in consumption tax revenues during periods of economic downturn.[516] The GFC was used as a case study to provide learnings as to how the COVID-19 pandemic may affect tax revenues. The study noted that during the GFC, tax revenues in OECD countries fell considerably, with most countries experiencing the lowest point in their tax revenues as a share of GDP for several decades.

However, revenues from consumption taxes were typically less affected and have been viewed as more stable over time than revenues from other bases such as corporate income.[517] As noted in this report, with Australia being one of the exceptions, most OECD countries place considerable reliance on consumption taxes as a main source of revenue. It has therefore been considered important, by the OECD, to identify drivers of change in consumption and consumption tax revenue. The importance is heightened in the context of the various COVID-19-related relief packages provided around the world.

Consumption tax regimes like the GST are vulnerable to economic downturns, particularly when the downturn directly affects private consumption, as has been the case in the COVID-19 pandemic. While consumption levels during the GFC remained reasonably stable, consumption tax revenues declined considerably due to increases in government and public service consumption and a shift in the kind of consumer spending being undertaken towards exempt or concessionally taxed goods and services.[518] In many ways, consumption patterns have not reverted to pre-GFC levels and this has left consumption tax systems around the world more susceptible to economic downturn.[519] It is expected that the COVID-19 pandemic is likely to have a greater impact on consumption tax revenues than the GFC, given its more direct impact on consumption (for example, as a result of various lockdowns and forced business closures).

During the height of the COVID-19 pandemic (which remains ongoing for many countries) when consumers were requested or required to remain at home, consumer spending in OECD countries declined considerably.[520] In major advanced economies, consumer spending is projected to have decreased by up to one-third during this period. This has had a direct and immediate impact on consumption tax revenues, even taking into account possible increases in online consumption.[521]

While the extent of the impact of the (as yet ongoing) COVID-19 pandemic on GST revenue is not yet known, what is clear is that it has caused significant uncertainty about the future including trends in consumption. While it is acknowledged that the present environment has not had a

516 OECD, *Revenue statistics 1965–2019, Consumption tax revenues under COVID-19: lessons from the 2008 global financial crisis*, p. 38.

517 H Simon and M Harding, "What drives consumption tax revenues?: Disentangling policy and macroeconomic drivers", OECD *Taxation working papers*, no. 47, OECD Publishing, Paris, 2020. Available at https://dx.doi.org/10.1787/94ed8187-en, cited in OECD, *Revenue statistics 1965–2019, Consumption tax revenues under COVID-19: lessons from the 2008 global financial crisis*.

518 OECD, *Revenue statistics 1965–2019, Consumption tax revenues under COVID-19: lessons from the 2008 global financial crisis*, p. 49.

519 Ibid.

520 Ibid, p. 50.

521 OECD, *Evaluating the initial impact of COVID-19 containment measures on economic activity*, 2020. Available at https://read.oecd-ilibrary.org/view/?ref=126_126496-evgsi2gmqj&title=Evaluating_the_initial_impact_of_COVID-19_containment_measures_on_economic_activity.

negative impact for all sectors, undoubtedly, GST revenue overall will be affected in the short term by changes to the level and composition of household spending, as well as by the impact of the pandemic on the relative prices of products, including through the exchange rate.[522] While a short term impact may be accepted, the greater concern is that changes in consumption patterns will have an impact into the medium and longer term, paving the way for an untenable future.[523]

Also, when assessing the long-term impacts of the pandemic, an important variable is the impact of halted migration (and tourism), although this is expected to be somewhat mitigated by a corresponding reduction in GDP. Lower net immigration in 2019–20 and 2020–21 due to restrictions on international travel is likely to permanently reduce Australia's population compared to pre-COVID assumptions. This is expected to cause a flow-on decline in household consumption and therefore GST revenue over the longer term.[524]

The GST has an important role to play to facilitate Australia's fiscal recovery in the wake of the COVID-19 pandemic. The government must give due consideration to the impact of the GST regime on the resilience of the broader tax system and its ability to generate revenue in the future, particularly in periods of economic downturn which may or may not be predicted. This involves a review of GST policy specifically, in addition to broader policy considerations.

Rebalancing the tax mix and addressing the potential inequity of GST reform

A necessary part of the broader consideration of rebalancing the tax mix is the impact on particular sectors of such a shift. Low-income households spend a higher proportion of their income on consumption than high-income households. While higher income earners spend more on goods and services that attract GST in absolute terms, as a proportion of total income, the spend, and therefore impact of any reform, is greater for lower income earners. This is exacerbated by the current concessions and reliefs in respect of GST being poorly targeted and not providing genuine relief to those who are in most need.

Reforms broadening the GST base or increasing the GST rate may therefore result in the GST having a greater impact on the income of individuals, particularly for low- to middle-income earners. The solution to this is not inaction, but rather, better engagement with the transfer system. The transfer system should be used to deliver transfer benefits to those who experience hardship as a result of the operation or reform of the GST regime. This should be the case as in any other cause of hardship, concessions and relief from which are generally delivered through the transfer system.

It is also important to note that, while too often the GST debate is solely focused on the domestic impact, there is an important international aspect. While some exports result in no GST being collected, tourism is one of the more obvious examples where GST is collected from non-residents, subject to very limited exemptions. That is, given tourism is one of Australia's largest industries, GST broadens the population (base) from which tax can be collected. For example, Queensland alone is three times the size of France, yet we have an Australia-wide

---

522 PBO, *Structural trends in GST*, p. 4.

523 Ibid.

524 Ibid.

population that is one-third of that of France. Despite the relatively smaller population, we still require infrastructure across that expanse of land. That infrastructure is largely funded by government revenue generated by taxes, including the GST.

Taxing private consumption while tourists are visiting Australia makes sense given that they use and enjoy the goods and services while they are here. By increasing the GST rate and/or broadening the base, additional revenue can be generated from tourist consumption in Australia, not only from consumption by Australians. This supports a genuine rebalancing of the tax mix. The potential reforms in this regard that are suggested below do not exceed OECD averages and are in no way extreme that they could be expected to deter tourism. It is also noted that such consumers would not benefit from the transfer system, ensuring that any additional revenues generated from this sector can be redistributed as required.

To view an expansion of the GST, whether in terms of the base or rate, or a combination of both, as undesirable or a negative step is both short-sighted and misdirected. An increase in any aspect of a tax is often met with apprehension and objection. Often, this is because it is considered in isolation, and marketed solely as a further burden on taxpayers without consideration of the underlying need for the revenue sought to be collected. Indeed, the GST, in particular, has long been considered political ‘kryptonite’, for which there has not been the political will to address its shortcomings. However, failure to listen to expert advice and courageously act on it not only undermines the will of the Australian people, it also undermines their future.

For this reason, potential options for reform must not be considered or implemented in isolation. Rather, they must be considered as part of a holistic package of measures, in conjunction with other mechanisms that will address such undesirable outcomes, some of which are considered below.

Broad exemptions from GST

There is a long list of items that are in some way exempt from GST. Originally, such exemptions were introduced for reasons including equity (that is, the disinclination to tax goods that comprise a significant proportion of consumption by low-income households) and administrative ease (that is, excluding items that are administratively complex to reduce the compliance burden both for taxpayers and the ATO alike). Fresh food is an example of the former, and financial services fall into the latter category. External factors were also relevant in some cases, particularly in relation to education, childcare services and healthcare services, where consumption in those areas has the effect of encouraging economic growth and increasing productivity. However, the rationales for the existing exemptions have not always proven true, nor are they the only way to achieve their underlying objectives.

An item may be exempted from attracting the full rate of GST in one of two ways. A GST-free item does not attract any GST on the final supply of the good or service, and any GST paid on inputs in relation to that item may be claimed back as a tax credit. Distinct from GST-free items are input taxed items. Like GST-free goods and services, input taxed items have no GST imposed on the final supply of the relevant good or service, but producers are unable to claim refunds for any GST that is paid on inputs. This means that there is some GST levied on the item through the production and distribution chain. Input taxed items include residential rent and financial services, as well as products from businesses with a turnover of less than $75,000 or NFP organisations with turnover of less than $150,000.

In the *Tax benchmarks and variations statement*, Treasury identified the following categories as the main areas giving rise to forgone revenue:

- fresh food;
- education;
- health (including drugs and medicinal preparations, medical aids and appliances, medical and health services, residential care, community care and other care services, and private health insurance);
- childcare services, water, sewerage and drainage services; and
- financial supplies (including financial acquisitions threshold (input tax credits), input taxed treatment and reduced input tax credits).[525]

Other exemptions and reliefs apply to, among other things: diplomats, diplomatic missions and approved international organisations; boats for export; tourism (including global roaming by visitors to Australia, tourist refund scheme for goods taken out of Australia, domestic travel as part of an international arrangement, and travel agents arranging overseas travel); religious services; supplies of farmland; general registration thresholds; simplified accounting methods; precious metals; and cross-border transport supplies.

Disproportionate compliance burden

One of the fundamental problems with the current GST regime is the associated disproportionately high compliance burden. Like any consumption tax, the GST has the potential to be straightforward and extremely efficient. However, the broad exemptions noted above are a key example of where the existing regime has gone too far down the path of equity at the expense of simplicity. The decisions to treat particular goods and services as taxable or exempt have not been founded in sound tax policy, but rather have been determined for political reasons. This approach dates back to the formative period prior to the enactment of the GST.

Sweeping exemptions are problematic in their own right, but exemptions from certain taxable goods and services, such as in the case of food, not to mention carveouts from exemptions, only add to the confusion for taxpayers and cloud the system. In another example, financial services is prima facie input taxed. However, many entities have GST-free international transactions added to which there are the peculiarities associated with reduced input tax credits which, together, creates additional complexity. These complexities increase the cost of understanding and complying with the GST. It also makes it more difficult to administer the GST with ambiguity being cause for disputes. These costs are borne by individuals, SMEs and large businesses alike.

It is time to depoliticise the debate. The GST compliance burden must be reviewed and alleviated. This must be done in consideration of the entire GST regime, including its many exemptions and, indeed, in the context of broader, holistic tax reform.

525 Treasury, *Tax benchmarks and variations statement 2019*, 2020. Available at treasury.gov.au/sites/default/files/2020-01/complete_tbvs_web.pdf.

Declining GST-to-GDP ratio

As noted above, the GST was intended to be a growth tax. However, empirical data proves that the GST has not kept up with the growth of the economy over the past 20 years.[526] In fact, there has been a decline in GST revenue relative to the size of the economy.

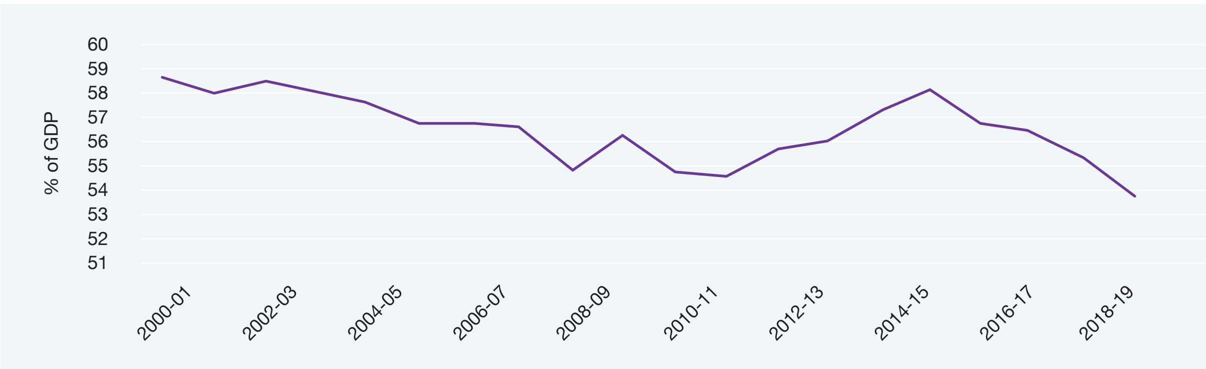
GST revenue increased from $28.5b in 2000–01 to $64.6b in 2018–19, being a 130% increase. In that same time period, the size of the economy, as measured by GDP, increased by 180%. This shows that the GST-to-GDP ratio has declined from its peak at 4% in 2003–04 to 3.3% in 2018–19.[527]

Factors which have contributed to this decline include unequal price growth in items subject to GST compared to GST-free items, a decline in household spending, increases in spending on GST-free items such as health services and education, and the significant impact of the exchange rates. If these trends continue, the PBO has estimated that the GST-to-GDP ratio will likely decline further to 3.2% in 2030–31. This is equivalent to a shortfall of up to $24b compared to the early 2000s.[528]

Decline in household spending on GST-applicable items

Household spending is the single largest component of the economy. However, in recent decades, household consumption has contributed far less to economic activity. This is largely attributable to an increase in the share of mining exports and an increase in income savings behaviour.[529] As can be seen from Figure 14, over the past 20 years, notwithstanding the sharp increases in 2008–09 and between 2010–11 and 2014–15, the rate of decline of household expenditure has been fairly steady.

Figure 14. Household final consumption expenditure as a share of GDP



Source: ABS, *Australian system of national accounts*, 2019–20 financial year.

In terms of expenditure, household spending comprises both GST-applicable and GST-free items, the latter category most notably including fresh food, health, education and rent. Data suggests that there has been a downward trend in the share of household spending which attracts GST.[530]

526 PBO, *Structural trends in GST*, p. 1.
527 Ibid, p. 2.
528 Ibid, p. 1.
529 Ibid, p. 1.
530 Ibid, p. 5.

According to the ABS, household expenditure subject to GST declined by 6% from its peak at 65% in 2003–04 to 59% in 2018–19. This decline is largely due to changes in the composition of household consumption. In particular, younger generations are allocating an increasing proportion of their income to rent and education, while households aged 65 and over are spending an increasing amount on medical goods and health services. Further, data shows that while Australians are still buying more goods and services that attract GST than those that do not, spending on GST-free goods and services has increased due to considerably faster price growth in those categories (discussed below).[531]

Uneven price growth in items subject to GST compared to GST-free items[532]

Since the introduction of GST, the value of household spending on GST-free items has doubled, while items subject to GST have increased by only one-and-a-half times.[533] The divergence is even greater considering that the price of GST-free goods and services, such as rent, health and education, has increased considerably faster than the price of items subject to GST. In fact, various goods and services subject to GST, including, among other things, retail (such as apparel) and vehicles, have experienced little, or even negative, price growth since the early 2000s. This is the case despite the Australian dollar having appreciated over time. The exception to this are utilities and tobacco, which have both experienced rapid price growth at rates faster than GST-free items.[534] In the case of tobacco, price increases have largely been driven by staged increases in tobacco excise rates.[535] In part, this price growth has offset the weak price growth of other items subject to GST. Whether the absence of GST on some goods and services encourages consumption of those goods and services (and that increase in demand causes price increases) or not is questionable. Nonetheless, fewer exemptions can provide greater transparency of price changes.

Over-reliance on GST revenue by State governments

The GST is levied by the Commonwealth and the revenue is then paid to the States and Territories under s 96 of the Commonwealth Constitution as a general revenue grant. This arrangement is given effect by the *Intergovernmental Agreement on Federal Financial Relations*, an intergovernmental agreement which was signed by the Commonwealth and all State governments in 1999. A copy of the agreement is set out in Sch 2 to the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999* (Cth). Importantly, s 11(1) of that Act provides that the GST rate and base are not to be changed without the unanimous agreement of all states, and requires that any such changes should be consistent with the following principles: (a) maintaining the integrity of the GST base; (b) administrative simplicity; and (c) minimising compliance costs for taxpayers.

The GST comprises the states' largest source of revenue. In 2018–19, the GST accounted for 22% of NSW's revenue expenditure, while for other states, it provided between 10 and 45% of

531 Ibid, p. 7.

532 Ibid, p. 1.

533 Ibid, p. 7.

534 Ibid, p. 8.

535 J O'Bannon and J Clark, *Tobacco excise: historical trends and forecasting methodology*, Treasury Working paper, 2019, cited in PBO, Structural trends in GST, p. 8.

revenue expenditure.[536] The significance of GST revenue is compounded by the fact that the states have limited capacity to raise revenue through other taxes and duties. In addition to the GST, the balance of revenue derived by the states (aside from revenue generated from their own state taxes) takes the form of various Commonwealth Government grants.

The distribution of GST to the states is based on the principle of horizontal fiscal equalisation with the intention that each State has the same fiscal capacity to provide public infrastructure and services. Operation of the GST was intended to resolve, to some degree, the VFI between the Commonwealth and the States and Territories. VFI manifests in this context where the states are committed to greater expenditure than they can manage through revenue they raise independently (for example, through state taxes, duties and other levies). As outlined above, given that there is less household spending on GST-applicable goods and services, the Commonwealth is collecting less GST now, and consequently distributing less GST revenue to the States and Territories.

Continued erosion of the GST revenue base will amplify, rather than rectify, VFI. Erosion of GST revenue has adverse implications for State budgets, limiting their ability to deliver frontline services and fund infrastructure that will produce long-term benefits for Australians, or that is necessary to assist in the recovery of the economy from the impact of the COVID-19 pandemic.

States and Territories may request that the Commonwealth provide greater transfer or grant funding, both generally and for specific purposes, to make up for the shortfall in GST revenue. However, this is neither a simple nor a sustainable solution, and in any case, relies on the Commonwealth having alternative resources to provide the support requested. If the GST is not reformed effectively to increase the overall revenue it generates, the Commonwealth will need to consider alternative means to support the States and Territories. Insufficient GST revenue means that the states may also need to resort to increasing debt or raising other taxes. This perpetuates existing issues in the state tax landscape and is not a long-term solution at the state or federal level.

Options

12.2 Potential strategies for GST reform

Any consideration of reform of GST must be tempered with the experience of most other countries that reform of the base, in particular, has been rare. Add to that the peculiar arrangement in Australia that the inter-governmental agreement creates an environment such that any change to GST is next to impossible (see below). While these considerations are important, it would be contrary to the intent of both this paper and the profession to simply resign oneself to the current flawed system.

GST reform must be part of a broader, holistic package of reforms involving changes to income and corporate taxes, and the transfer system. As indicated throughout this paper, reform will be most effective where it is delivered as a package of measures for the overall benefit of all Australians. It must be acknowledged that certain aspects of any such package may advantage certain sectors of society, while other aspects may disadvantage those same groups in comparison to the status quo. However, the overriding objective must be a system that is an

536 *NSW Review of Federal Financial Relations: Supporting the road to recovery*, draft report, July 2020, p. 30.

overall improvement on our current framework, and one which can see us through for years to come.

Revisiting the framework for cooperation and consultation between the states and the Commonwealth

The *Intergovernmental Agreement on Federal Financial Relations* prescribes that any change to the GST framework, and specifically to its rate or base, requires the unanimous support of the Commonwealth, States and Territories. The Agreement was originally intended as an instrument of political expediency which would support a fair outcome for all of the states. However, in the present reality, it has served as a hurdle to genuine reform despite changes in the economy and shifts in consumption patterns. The Tax Institute considers that, particularly in relation to the restrictions on amendments to the tax base and rate, the Agreement has become outdated and out of step with our economic reality. Its purpose and continued operation should be reconsidered. This will only be overcome by bona fide cooperation between the federal and state governments.

It is therefore critical that the states and Commonwealth work together to reach a mutually beneficial agreement on the way forward. This should take into account not only for reforms required now, but also the scope to improve flexibility in the future. Political tensions between certain states and between the states and the Commonwealth for various reasons may be acknowledged, but cannot justify inaction. GST reform is in the best interests of the government at all levels, and the Australian people. Strong political will is critical and leaders must demonstrate that they have, at the forefront of their decision-making, the best interests of the Australian people.

Failing state and federal governments being capable of agreement, it is possible for the Commonwealth to consider GST-like taxes that could do the work the collective politic may be reluctant to do. For example, a Commonwealth only GST/VAT could be imposed alongside the existing system. Alternatively, a cash-flow tax could be imposed that would operate like a GST. It may be sufficient for the Commonwealth to threaten such an approach to get the states to the table.

Addressing inequity and countering the regressive effect of consumption tax

It is critical to address inequities arising from potential reforms by instilling community confidence in mechanisms of redress. In this aspect of reforms, it would be ideal for low- and middle-income earners to be better off on a net basis, though an overall neutral outcome for this sector of society should be a minimum standard. Practically, it is envisaged that, in respect of GST reform, at least the bottom two (if not, three) quintiles of households should be fully compensated for their increased GST payments.

One method of redress would be increasing income support payments for lower to middle-income earners. This may be achieved by providing direct annual transfer support payments to households with lower income tax earnings, rather than higher income households which benefit from income tax reductions. For the most part, transfer payments, such as the family tax benefits, NewStart and the age pension, are already means tested. While transfer payments are indexed and capture increased costs of goods and services, depending on the scale of reform considered, additional compensation is likely to be necessary to ensure low-income households are not worse off than under the current system. Where compensation is delivered through the transfer system, it will be necessary for there to be agreement for this outcome between the state and federal governments given that GST revenue (and any increases thereto), while collected by the Commonwealth, accrues and is paid to the states, whereas transfer payments remain within the remit and budget of the federal government. That is, not all of an increase in GST can simply go to the states; it will be necessary for compensation and related tax relief to be taken into account first.

Importantly, unlike existing concessions, compensatory mechanisms should be appropriately targeted. Where the GST base is broadened to encompass goods and services currently outside the scope of the GST, this requires consideration of the sectors most adversely affected by such changes. For example, if health-related goods and services are brought within the ambit of the GST, consideration should be given to providing relief to the elderly, being the group which spends the most on such items and therefore most likely to be adversely affected. Likewise, where childcare is brought within scope, families should be provided with some support. Families and young adults, in particular, should similarly be provided with additional support in the case that education becomes subject to GST, given that they comprise the sector of society that would be most affected by such a change.

While shifting reliance from income taxes to consumption tax has an array of benefits as highlighted above and considered throughout this paper, for the purposes of compensating low- to middle-income households, cuts to personal income tax rates are unlikely to have a material impact. This is because, under the existing personal income tax regime, the tax-free threshold and range of tax offsets and concessions available to low- and middle-income earners mean that the majority of households comprising the two lowest income quintiles are likely to already pay very little personal income tax, if any. This is further support for providing compensation through the transfer system rather than the personal income tax regime.

Alternatively, different tax rates may be applied to different classes of goods and services (discussed further below).

Regardless of the option chosen to overcome potential inequity arising from GST reform, it will be critical to educate the community on the changes and true impact thereof, as well as the methods of compensation available to those to whom it is applicable. It will be equally important to implement safeguards to ensure that any such compensatory mechanisms are not eroded over time. Further, transitional arrangements and one-off adjustments may be useful to allow individuals and businesses adequate time to adjust to the changes.

12.3 Options for reform – broadening the GST base and increasing the GST rate

Over the last decade, there have been numerous calls to expand the GST rate or base.[537] Broadening the GST base and/or increasing the rate may raise the amount of GST revenue collected, leading to GST becoming a greater part of the tax mix.

537 See, for example, the Lambert tax review (2011), which proposed an expansion of the GST base to include health, education and fresh food; the Greiner, Brumby and Carter review (2012); and the National Commission of Audit (2014), cited in the Thodey report, p. 32.

While a single rate is simpler to administer, most countries employing a consumption tax model operate tiered rates. Australia falls within this majority (given that a reduced rate of zero for some goods and services is taken to be a separate tier). In fact, in 2018, only two OECD countries did not have at least one reduced rate (including a reduced rate of zero).[538] The European Union sets a minimum standard rate of 15% and permits two reduced rates of not less than 5% for a limited list of goods and services.[539]

Modelling has demonstrated the revenue outcomes for several variations of base and rate increases. Without increasing the GST rate from 10%, broadening the base to include some of the main items currently exempt from GST could increase revenue by $21b. Alternatively, an increase of only 2.5% (equalling a GST rate of 12.5%) applied to the existing base would increase revenue by $14b. If the base is broadened to include some of the main items currently exempt from GST and those items are taxed at a lower rate of 5% with the existing base being taxed at 12.5%, the revenue potential is $25b. Where all items attracting GST, including those currently exempt items, are taxed at 12.5%, the revenue increase is $40b.[540] In either case, the modelling demonstrates that even a slight change can have a significant impact on the revenue generated.

Option 1: Broadening the GST base – 10% GST imposed on a broader base (including fresh food, health and education)

The six most significant classes of GST-free or exempt items are fresh food, health, education, rent, childcare and financial services. Broadening the GST base to include some, if not all, of these categories may be an effective means to counteract declining GST revenue.

Importantly, while some behavioural change may be expected to follow an increase to the GST rate, studies have shown that spending on GST-exempt goods and services (particularly fresh food, health and education) is not materially affected by their price relative to other goods and services.[541]

Further, broadening the GST base would result in a GST framework which is simpler and more efficient. Studies undertaken by The Grattan Institute have demonstrated that:[542]

> A broader based tax may have lower administrative costs as businesses which deal in both exempt and non-exempt goods simplify their accounting. Having fewer 'grey lines' between exempt and non-exempt categories reduces opportunities for tax avoidance and lobbying by rent-seekers for exclusion of particular goods.

Fewer exemptions result in a system that is cheaper to administer in the long run. This is true of the New Zealand GST system which has almost no exemptions.[543] Compliance becomes easier as taxpayers can understand the scope of the provisions without requiring higher levels of professional tax advice to determine whether particular consumption is within or outside of the scope of the GST. Ultimately, having fewer exemptions would also reduce the distortions and

---

538 OECD, *Consumption tax trends*, 2018. Available at www.oecd.org/tax/consumption-tax-trends-19990979.htm.

539 Ibid, p. 43.

540 www.pwc.com.au/tax/assets/tax-reform/2020/how-gst-reform-can-help-reboot-prosperity-for-australia-july2020.pdf.

541 J Daley, D Wood, H Parsonage and B Coates, *A GST reform package*, Grattan Institute, 2015.

542 Grattan Institute, *Balancing budgets: tough choices we need*, 2013, p. 51.

543 S Eslake, *The tax reform challenge*, Australian Parliamentary Library Lecture Parliament House, Canberra, 21 September 2011, p. 4.

complexities that arise from applying the existing GST framework. It would helpfully eliminate the need to determine, for example, "whether Italian mini ciabatta is a 'cracker' (and therefore subject to GST) or 'bread' (and therefore exempt from it)".[544]

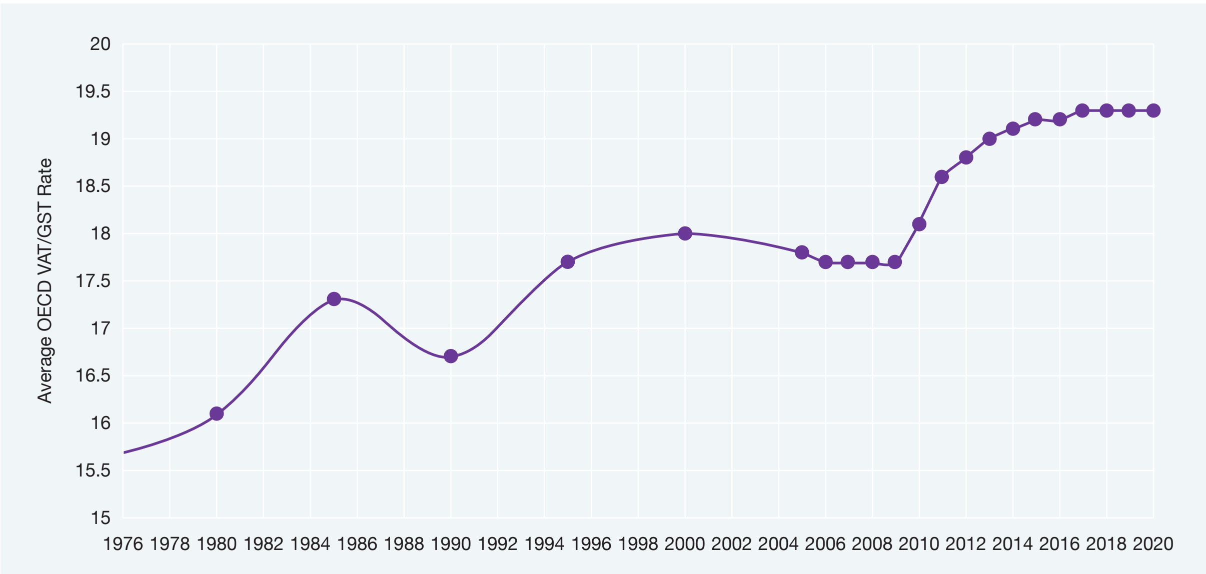
While fewer exemptions may have a greater impact on certain sectors of society, such as low- to middle-income earners, we consider that the most appropriate way to address any perceived inequity in the application of the GST regime is through the transfer system. By doing so, the problem of poorly targeted concessions is reduced, if not eliminated, and those households that are adversely affected are more directly compensated.

Option 2: Increasing the GST rate – a 12.5% to 15% rate of GST imposed on the existing base (without broadening the base)

The percentages suggested below are examples only. Further consultation and comprehensive modelling should be undertaken before a rate is determined, regardless of the option to be pursued.

Where a tiered rate system is applied to the current base, there should not be a substantial increase in administrative complexity as there will be no additional work required to determine whether an item is within scope, but rather, merely another calculation based on a different rate.

Figure 15. Evolution of standard VAT rates – OECD average 1976–2020

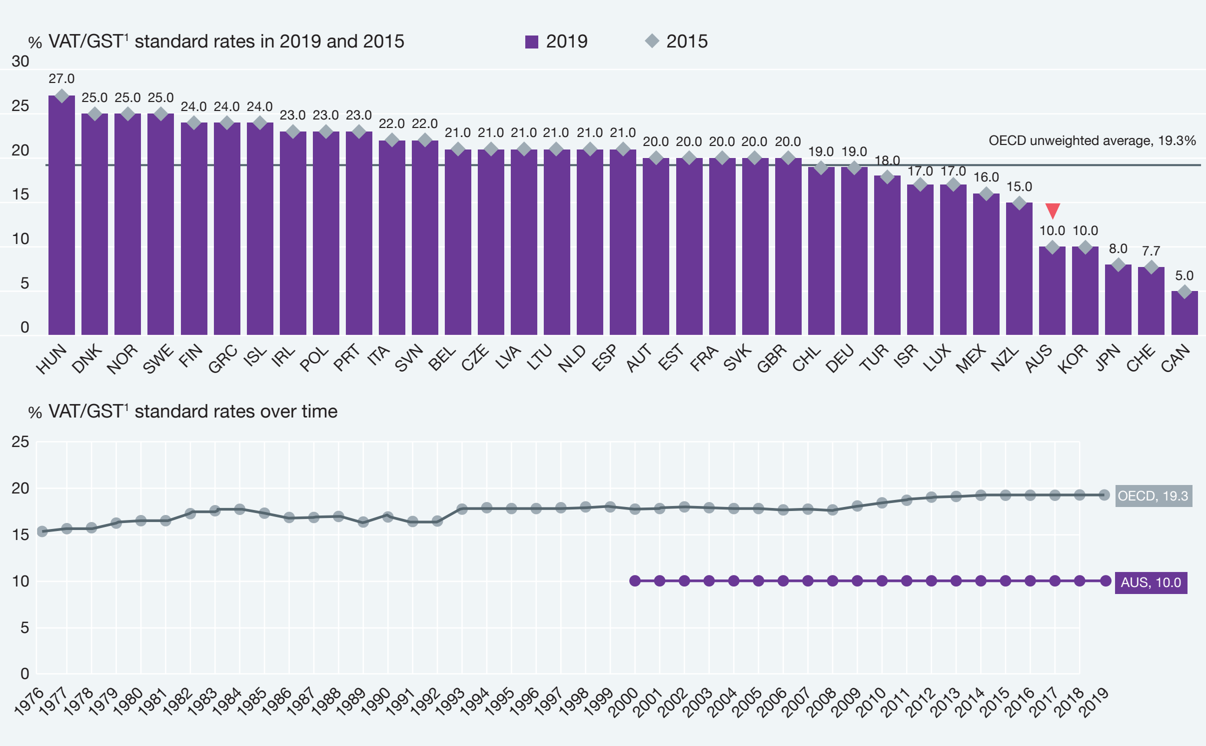


Source: OECD, *Consumption tax trends 2020: VAT/GST and excise rates, trends and policy issues.*

In 2020, standard VAT/GST rates across OECD countries stabilised at the record level of 19.3% (see Figure 15). As illustrated (in Figure 16), compared to other OECD countries, Australia, continues to have one of the lowest rates of VAT/GST. Worse still, since the introduction of the GST in 2000, there has not been a single change in the rate, whereas at least 23 OECD countries have increased their VAT rate, on average, by 2.4%. Most countries have done so in response to economic pressures caused by financial crises.

544 Australian Parliamentary Library Lecture Parliament House, Canberra, 21 September 2011, Justice Richard Edmonds referring to *Lansell House Pty Ltd and Perfek Pty Ltd v FCT* [2011] FCAFC 6, cited by S Eslake, *The tax reform challenge*, p. 4.

Figure 16. Standard VAT/GST rates across OECD countries and over time



1. VAT/GST refers to value-added tax/goods and services tax.
Source: OECD, *Tax database*, 1 January 2019.

Increasing Australia's GST rate may be an effective means to counteract declining GST revenue. As outlined above, a general increase to Australia's GST rate across all goods and services currently subject to GST should not be materially more or less efficient or costly to administer if it is to apply to the existing base.

Option 3: Broadening the GST base and increasing the GST rate (see below variations)

Other potential options for reform comprise a combination of both broadening the GST base and increasing the GST rate. Some examples are proposed below. Again, the percentages suggested below are examples only. Further consultation and comprehensive modelling should be undertaken before a rate is determined, regardless of the option to be pursued.

Option 3(a): a 12.5 to 15% rate of GST is imposed on the existing base and also equally on health and education.

Option 3(b): a 12.5 to 15% rate of GST is imposed on an even broader base (including fresh food, health and education) in addition to the existing base.

Option 3(c): a tiered system imposing GST at 5% for currently exempt goods and services and increasing the rate on currently non-exempt goods and services to 12.5 to 15%.

Whichever of these options is pursued, as noted previously, there will need to be appropriate compensation through the transfer system and a reduction in income tax rates to compensate low- and middle-income earners.

12.4 Specific areas for reform

There are certain aspects of the GST regime which contain unique issues and which we consider merit specific attention. These issues are not intended to be an exhaustive list of shortcomings within the current GST regime, but rather examples of certain areas where particular issues manifest and bespoke solutions may be required.

Financial services – issues and options for reform

Full taxation of financial services under the GST Act

In recent years, the big four Australian banks have obtained an average return on equity of 15%.[545] This is significantly higher than average returns achieved by the major banks in most advanced economies.

In Australia, as is generally common international practice in respect of other GST/VAT regimes, the financial services sector receives concessional input taxed treatment under the GST. The Treasury has estimated that the financial services sector will receive net tax concessions of approximately $12.4b from 2019 to 2022. This, of course, extends beyond the big four banks, though they are the major players in the industry. The major bank levy only partly offsets the cost of these GST concessions. While financial services are input taxed largely for the purposes of administrative ease, this is a significant lacuna in potential GST revenue and redress must be considered.

There are several potential options for reform in this area.

Removal of concessional GST treatment for financial services

The lending and deposit-taking activities of the banking sector give rise to unique challenges in bringing financial services within the scope of the GST. While GST can be readily applied to bank fees, banks earn a large proportion of their income from the margin between their lending and deposit rates. It is not feasible to allocate such revenue to individual transactions so as to be able to apply GST in the usual way.

For this, essentially administrative, reason, most financial services are input taxed. This means that GST is not applied to the revenue generated from interest margins and input tax credits are denied for the GST attached to the inputs used in generating that revenue.[546] The result is a significant anomaly compared to other sectors of the economy.

Over the years, there have been numerous proposals to remove this tax concession by applying GST to financial services in a different manner. One such way is an SFT.[547] An SFT does not require an allocation of GST to revenue attributable to individual transactions. Rather, it involves taxation of revenue from the interest margin income of banks, broadly on a bank-by-bank basis. It is noted that a similar approach applies to the collection of GST from gambling, whereby GST is allocated to the difference between money received and money paid out on an enterprise-by-

---

545 Wilkins, Gardner and Chapman, 2016, cited in C Murphy, *GST and how to tax Australian banking*, Crawford School of Public Policy, Australian National University, p. 1.

546 Australia has adopted an additional layer of complexity through the use of reduced input tax credits for certain acquisitions by financial services entities.

547 M Evans, *GST equivalent taxation of financial services (supplementary financial tax)*, report to the South Australian Department of the Premier and Cabinet, 2015.

enterprise basis.[548] An SFT ensures that, while interest margins are fully taxable, banks would receive full input tax credits, like other providers of fully taxable goods and services.

One shortcoming of the SFT, as originally proposed, is that it applies with respect to both household and business uses of financial services. This is contrary to the general approach under the GST regime, whereby registered business customers are able to claim GST input tax credits which effectively reduce their GST burden. The model of businesses claiming input tax credits is not feasible under the SFT, because it is not allocated to individual customers.

However, if the SFT were to be charged to each financial institution at a discounted rate to proportionately reflect tax collected in relation to household (and not business) use, the SFT could operate as a purely consumption-based tax. For example, if 40% of the margin-based income of a financial service provider were attributed to business customers, the SFT rate would be discounted from 10% to 6% (assuming the current GST rate of 10% were to remain in place).[549]

This proposal can be compared to the New Zealand GST regime, which features such discounted rates. In this context, in New Zealand, GST input tax is applied, but discounted to reflect the business customer share of services. New Zealand grants input tax relief determined by reference to business-to-business financial supplies. It has adopted a broad definition of financial services, akin to the EU model. The GST treatment of financial services between GST-registered entities changed in 2005 from input taxation, whereby no GST was applied and no input tax credits were claimed, to GST-free treatment, whereby no GST applies and input tax credits may be claimed. The impetus for the reform was the flow-on effect arising from embedded GST in business-to-business transactions.[550] The rules allow an additional input tax deduction for financial service providers by reference to the taxable status of the recipient of the relevant financial supply. While the approach does not impact the amount of output tax paid, by treating financial supplies as GST-free and not input taxed, financial service providers qualify for higher input tax relief.

The approach adopted in New Zealand reduces the GST cost to financial institutions to the extent that their customer base includes other GST-registered businesses. By reducing GST costs at the intermediate level of production, it improves efficiencies but does have the effect of reducing revenues.[551] To the extent that full relief is available because the financial institution is GST-free, the bias in favour of self-supply is eliminated and efficiency is increased.[552] However, the relief from the cost of GST on inputs for financial institutions does not necessarily flow through to the recipients of the relevant supply in the form of a reduced price.[553]

Financial institutions that operate at the household level incur a higher cost structure compared to those at the wholesale level. As a result, there would generally be distortions that occur due to lower rates of return, assuming that the input tax costs cannot be passed on to those households.[554] Further, the New Zealand system imposes GST costs on outsourcing (whether domestically or offshore) to the extent that the financial institution cannot access

548 C Murphy, *GST and how to tax Australian banking*, Crawford School of Public Policy, Australian National University, p. 4.

549 Ibid.

550 NZ Internal Revenue Department, *GST & financial services, a government discussion document*, Policy Advice Division of the Inland Revenue Department of NZ, October 2002, p. 15.

551 M Evans, *GST equivalent taxation of financial services (supplementary financial tax)*, report to the South Australian Department of the Premier and Cabinet, 2015, p. 17.

552 Ibid.

553 Ibid.

554 Ibid.

business-to-business relief. This means that, for financial service supplies to households, self-supply and offshore competition distortions remain.

In terms of administrative feasibility, in principle, this kind of apportionment should be no more complex than other kinds of apportionment. This is not to say that existing methods of apportionment have been easy to come by, let alone to achieve consensus. However, there is a breadth of ATO guidance in this area, from which learnings may be drawn.[555] And, indeed, given that many New Zealand institutions are subsidiaries of Australian financial service providers, it is expected that there would be learnings and experience that could be carried across.[556]

Implementation of an SFT requires a clearly defined tax base, being, the interest margin income of banks. Given that the GST is a cash flow-based tax, one option for defining the tax base is a cash flow measure of income from financial intermediation.[557] In these circumstances, the cash flow is equal to the inflows from new deposits and interest received on loans, net of the outflows from new loans and interest paid on deposits.[558]

Alternatively, an accrual measure of income from financial intermediation could be implemented. The premise of this method is that financial service providers generate income by charging more than a reference rate for loans, while paying less than the relevant reference rate for deposits.[559]

To reduce complexity, the tax base could be limited to only interest income from loans net of interest payments on deposits. However, this ignores the cost of funding any gap in the difference between the value of loans and the value of deposits, whether through debt and/or equity, which is taken into account under the first two approaches.[560]

Successful implementation of an SFT would therefore require inclusion of discount rates to reflect the business customer share of services, effectively, accommodating for the input tax credit. It would also require a clear definition of the tax base, that is, the interest margin income of banks.

In addition to introducing substantial operational and compliance obligations for financial institutions, an overarching concern relates to the passing on of costs. While the economic impact of taxing the consumption of financial services is uncertain as it is largely untested, it is likely that customers of financial service providers will bear the ultimate cost, rather than the financial institutions themselves. This is because costs including the additional GST revenue, and potentially related expenditure such as in relation to compliance costs, are likely to be passed on to customers. This may also have a broader impact on the availability of credit. The relative incidence of such a change should be carefully considered and comprehensively modelled.

---

555 ATO, GSTR 2006/3 – Goods and services tax: determining the extent of creditable purpose for providers of financial supplies, 18 December 2019; ATO, GSTR 2002/2 – Goods and services tax: GST treatment of financial supplies and related supplies and acquisitions, 17 December 2014; ATO, GSTR 2008/1 – Goods and services tax: when do you acquire anything or import goods solely or partly for a creditable purpose?, 11 December 2013; ATO, GSTR 2006/4 – Goods and services tax: determining the extent of creditable purpose for claiming input tax credits and for making adjustments for changes in extent of creditable purpose, 22 January 2020; ATO, GSTR 2003/9 – Goods and services tax: financial acquisitions threshold, 11 December 2013; ATO, GSTR 2004/1 – Goods and services tax: reduced credit acquisitions, 30 May 2018. See also www.ato.gov.au/Business/GST/In-detail/Your-industry/Financial-services-and-insurance/GST-and-financial-supplies/?page=5#Apportionment.

556 M Evans, *GST equivalent taxation of financial services (supplementary financial tax)*, report to the South Australian Department of the Premier and Cabinet, 2015, p. 38.

557 C Murphy, *GST and how to tax Australian banking*, Crawford School of Public Policy, Australian National University, p. 4.

558 Ibid, p. 5.

559 Ibid, p. 5.

560 Ibid, p. 5.

Luxury items – issues and options for reform

Imposing a higher GST rate for luxury items (compared to basic items) could raise additional GST revenue without exacerbating the impact of a rate increase on low- to middle-income earners, as discussed above. On the contrary, depending on how a tiered rate system is structured for basic versus luxury items, a tiered system has the potential to lessen any regressive effect of the GST. Nonetheless, it must be acknowledged that differentiated rates generally, flies in the face of simplification of the tax system more broadly.

Luxury items may be considered, broadly, as those items that are non-essential. However, without adequate consideration, introducing a tiered system of this kind could introduce a higher degree of complexity into the tax system. As a starting point, this is envisaged to encompass luxury cars and other vehicles (not necessarily the same as for FBT purposes), high-end electronics, and alcohol and tobacco, rather than the kinds of products stocked in supermarkets or similar avenues. In the case of luxury cars, it should be noted that the existing rules in this area are implicitly archaic in that they become particularly problematic in the context of electric vehicles, which were not contemplated at the time such provisions were introduced. Since electric vehicles are generally more expensive than the equivalent fuel-powered cars, they are therefore more likely to attract LCT, in addition to standard upfront costs like GST and duty. This makes the upfront cost of an electric vehicle potentially far more than a fuel-powered car, despite the electric car not necessarily having any 'luxury' characteristics.

In the context of food, it is acknowledged that there may be some types of food found in supermarkets or their equivalents which are relatively expensive and could potentially fall into the 'luxury' category. However, we are of the view that simplicity should prevail over any risk of leakage in this regard. This is particularly important in the context of food given the high level of complexity and associated compliance burden surrounding the categorisation of food.

It is noted though that, given that this level of differentiation for the purposes of a tiered rate system is not currently a feature of the GST regime, there is currently insufficient reliable data on consumption patterns in respect of particular items which would fall at various points on the spectrum from basic to luxury. Further comprehensive research is required to appropriately categorise items and to inform a suitable rate structure.

Options for reform

- Establish a non-partisan, independent tax policy and reform commission to undertake a comprehensive review of the Australian tax system at the state and federal levels and to manage a process of tax reform, including the development of underlying tax policy.
- As part of a holistic package of reform which shifts reliance away from personal and corporate income taxes:
  - increase the GST rate by at least 2.5% from 10% to 12.5% with a view to future incremental increases to align more closely with the OECD average; and
  - broaden the GST base to include goods and services currently exempt or otherwise GST-free, at a minimum at a lower rate, otherwise at a single rate as suggested above.

Policy and Administration

13. Tax policy development and tax administration

Overview

While the principles and details of tax reform have been covered across previous chapters, key to ensuring that the tax system is and remains fit for purpose is the way in which tax policy is developed, implemented and ultimately administered.

There are great opportunities to improve the policy development, implementation and administration of our tax laws. Fundamentally, improvements in policy development and tax administration will improve trust in the overall system and result in improved support of, and compliance with, the tax system.

It is noteworthy that responsibility for the tax system is not only confined to the various Treasury departments and revenue agencies, but also to those who are charged with monitoring the operation of the system; at the federal level, this not only includes the Auditor-General, but also the Ombudsman, the IGTO, and the ASBFEO. It would be desirable to improve the clarity of the roles of various agencies that have been established to monitor revenue agencies or advocate on behalf of users of the system, improve coordination between such agencies and potentially rationalise their various remits.

The failure to engage and consult deeply on tax, to seek and obtain the best advice from experienced experts, and the failure to maintain our tax laws has meant that we are saddled with some of the most difficult tax laws to comply with and to administer. Highly detailed provisions seeking to nail down every possible permutation or set of circumstances has resulted in often impenetrable laws.

The administration at both state and federal levels have been often inadequately resourced to ensure that users of the system are able to as easily engage and meet their obligations as they might. For example, while great strides have been made to enhance online interactions, there is still enormous room for improvement. Agencies are sometimes saddled with additional expectations and initiatives from government without the resources necessary to properly execute those initiatives.

Similarly, agencies need to be able to contribute to the policy of administration so that the relevant laws governing the operation of those agencies are suitable to allow for efficiency improvements that respond to community needs and expectations.

13.1 Tax policy development

Traditionally, governments have jealously guarded the development of tax policy as their domain. While it is true that policy is ultimately the decision and responsibility of government for which they will be accountable, this does not preclude seeking and taking good advice. That advice has, until recently, been the role of the public sector, in particular, Treasury. While there have been comments by the current Prime Minister about the role of governments versus the public sector in relation to policy,[561] this has not prevented, since that time, the government seeking and relying on the advice of experts — in particular, in determining the health responses to the COVID-19 pandemic. That is appropriate and to be applauded. In fact, it should represent the model for all areas of government, but especially tax. It is experts who can unfold the details and consequences of particular policies. A better way of capturing that specialised knowledge and engaging with it must be found or else Australia will continue to be hampered by excessively complex law and unnecessary red tape.

The Tax Institute has observed that one state government recently set a new model for engagement in the development of new laws. After suggesting that a new policy should be looked at, and before committing to any particular outcome, the government set up a public process to engage as many views as possible, as well as establishing a public education campaign. Professionals were engaged in the design of the policy both through invitations for submissions as well as individual and group discussion forums. Having listened to the various stakeholders, there was a process of settling the principles of the policy. While the process is not complete at the time of writing, further consultation has been suggested before finalising the form of legislation and drafting instructions. Such an approach would be most welcome and avoid the unintended consequences that often arise from hastily prepared drafting instructions.

This level of consultation at all the important stages of law development should represent the new benchmark.

13.2 Tax administration

In 2004, the OECD published a guidance note for its member countries to manage and improve tax compliance in their respective jurisdictions.[562] A taxpayer's compliance is measured on the basis that they meet the OECD's four pillars of compliance, namely: registration, lodgment, correct reporting and on-time payments. The ATO oversees these compliance requirements and reports on them annually in the Commissioner of Taxation annual report.[563] This section analyses the methods used by the ATO to measure these compliance requirements and suggest improvements wherever possible.

It is worth noting that the Federal Commissioner of Taxation has additional roles. The Commissioner is also the Australian Business Registrar. This role will become even more important with the transfer of certain operational functions from the ASIC to the ATO and the introduction of director identification numbers.

Further, the Commissioner is also the accountable authority for both the TPB and the ACNC. While each of these bodies is run independently of the ATO, parliament has determined that the funding for those two organisations should be part of the budget of the ATO. One suspects that as each of these agencies grew out of the ATO, it was perceived to be simpler to leave existing arrangements in place. Theoretically, it may have been seen as alleviating the agencies from certain administrative detail, but it has resulted in levels of duplication and potential perceptions

561 Prime Minister's speech to the Institute of Public Administration, Parliament House, Canberra, 19 August 2019. Available at www.pm.gov.au/media/speech-institute-public-administration.

562 OECD, *Compliance risk management: managing and improving tax compliance*, OECD Publishing, 2004. Available at www.oecd.org/tax/administration/33818656.pdf.

563 ATO, *Commissioner of Taxation annual report 2019-20*. Available at www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_Report_2019-20/annual_report_2019-20.pdf.

of a lack of independence. The government recently accepted a proposal that the TPB should become a separate agency and receive its own specific appropriation from the government.[564]

13.3 Registration

Registration for individuals

Registration refers to ensuring that all individuals who are required to participate in the tax and superannuation system are registered in the system. The ATO reported that for the 2019–20 financial year, there were 106% of individuals registered on the ATO client register.[565]

The ATO compares active individual clients (aged 15–64) in their client register to the ABS estimated resident population of the same age group, as this is the assumed working age population. The proportion is above 100% as the ATO's definition of 'resident' for tax purposes captures a greater number of people than the ABS estimated 'resident' population'. In saying this, there are still individuals who should not be in the system but are still registered, and those who should be registered but are not. There are also those individuals who are determined to remain outside the system and never register for a TFN. Therefore, the question is whether the system of registration that we have in Australia is still an adequate measure of ensuring that individuals are registered in the system.

As to the inactive individuals, the ATO state on their website that clients who no longer need a TFN can be identified as inactive and have their record secured. This is usually done if the client is deceased, has departed the country or their visa has expired.[566] According to the ATO annual report,[567] the ATO has difficulties identifying and deactivating TFNs for expatriates as they do not currently receive information relating to expatriates leaving the country. Therefore, there are unused TFNs within the system.

Registration for companies and other entities

The ATO states on their website that they are confident that large corporate groups which should be registered in the system are registered.[568] The ATO measures the proportion of companies registered in the system by comparing the number of companies registered by the ATO to the number of companies registered by the ASIC.[569] For the 2019–20 financial year, 66.1% of the companies are registered in the ATO client register.[570] Currently, not all companies are active such that they require a TFN, even though they will automatically be issued with an ACN on registration.

564 Government response to the Review of the Tax Practitioners Board, November 2020, recommendation 3.1. Available at treasury.gov.au/sites/default/files/2020-11/20201117-governmentresponse.pdf.

565 ATO, *Commissioner of Taxation annual report 2019-20*, p. 36. Available at www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_Report_2019-20/annual_report_2019-20.pdf.

566 ATO, *Reactivating inactive client records*. Available at www.ato.gov.au/Tax-professionals/Prepare-and-lodge/In-detail/Reactivating-inactive-client-records/. Accessed 23 January 2021.

567 *Commissioner of Taxation annual report 2019–2020*, p. 39. Available at www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_Report_2019-20/annual_report_2019-20.pdf.

568 ATO, *The OECD four pillars of compliance*. Available at www.ato.gov.au/General/Tax-and-Corporate-Australia/In-detail/The-OECD-four-pillars-of-compliance/. Accessed 21 December 2020.

569 Ibid, p. 39.

570 ATO, *Commissioner of Taxation annual report 2019-20*, p. 36. Available at www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_Report_2019-20/annual_report_2019-20.pdf.

Currently, while tax entities such as trusts and partnerships can apply for a TFN and otherwise register with the ATO, there is no register of such 'entities' that provides a basis for comparison that would give confidence of the right number of entities being registered. While there are other incentives in the system (e.g. penal WHT rates) for registration with the ATO, there is no way of knowing whether all such entities are appropriately registered. Separately, it is noted that the (OECD expects that countries that are part of the Global Forum on Transparency and Exchange of Information for Tax Purposes meet the "standards on ensuring that law enforcement officials have access to reliable information on who the ultimate beneficial owners are behind a company or other legal entity so that criminals can no longer hide their illicit activities behind opaque legal structures".[571]

Such actions would give greater assurance that all non-individual entities who should be in the system are registered, and those who have not been active are deactivated.

13.4 Lodgment

Lodgment refers to the proportion of activity statements and income tax returns lodged on time. Only 74.6% of activity statements were lodged on time in the 2019–20 financial year compared to the ATO's 78% end-of-year target.[572] The ATO suggests that the bushfires in early 2020 and the effects of COVID-19 affected the lodgment of small businesses. Small businesses make up the largest volume of activity statements, and so any change in lodgment behaviour impacts the overall performance of lodgment compliance.

In regard to income tax returns, the lodgment performance for the 2018–19 financial year finished at 83.9%, which is 0.9% more than the ATO's target of 83%. The increased on-time lodgment of tax returns was due to improvements in the ATO's end-to-end strategies, such as an increase in the timeliness and quantity of pre-filled data and sending tax time messages.

There are short- and long-term issues in this context. Firstly, in an increasingly connected and online world, is 'lodgment' an antiquated notion that might be superseded over time? For example, could the automatic exchange of data get to a level where the ATO has sufficient confidence in the information available to allow the ATO to present back for verification to a taxpayer the relevant information on a periodic basis obviating the need for a BAS and income tax returns? Could the artificial construct of a tax year be abolished such that tax is in real time both in reporting/verification and payment (see below)? Indeed, if it were possible to get the right level of data, the ATO could assess in a highly automated way. This then calls into question the current settings of self-assessment which were designed in a low-data era with the object of pushing responsibility for 'getting it right' onto taxpayers and their advisers. With higher levels of confidence in the data, the responsibility could shift back to sophisticated ATO systems that could allow a reversion to a full assessment environment. This would mean a lower risk of penalty for taxpayers and a greater confidence in the finality of tax affairs.

---

571 OECD press release, "New Beneficial Ownership Toolkit will help tax administrations tackle tax evasion more effectively", 20 March 2019. Available at www.oecd.org/tax/new-beneficial-ownership-toolkit-will-help-tax-administrations-tackle-tax-evasion-more-effectively.htm.

572 ATO, *Commissioner of Taxation annual report 2019-20*, p. 39. Available at www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_Report_2019-20/annual_report_2019-20.pdf.

It should be noted that STP already represents the mechanism to provide updates to the ATO of data available in employers' payroll systems — salary and wages, allowances, superannuation contributions, etc. The same principles for data sharing could be implemented to get real time data about the business' income and expenses, either directly from the business itself or from reliable third party sources such as banks, business customers and suppliers. Other countries, such as Brazil and Russia, have adopted models of invoices requiring a government identification or verification. This should be investigated as to how far it would assist, both in reducing the compliance burden of lodgment as well as supporting correct reporting (see below).

Accordingly, it should be a longer term aim to remove the lodgment requirement from the Australian tax system. This should not be taken to equate to removing interaction with the system. Rather, an integrated and online system should interact with taxpayers electronically and in real time with verification built into processes. While the ATO believes it has made great strides on pre-fill, there is still considerable opportunity to improve both the quality and range of information that is made available. It has been observed that not all pre-fill information is accepted by taxpayers.

Secondly, in the shorter term, there should be steps taken to simplify and integrate the sharing of data that reduces the compliance cost on taxpayers in preparing statements for the ATO where the data could be collected and presented to taxpayers for verification and finalisation. For example, there could be automatic upload of business accounting data through the use of application programming interfaces built into accounting software.

If that is so, then it may raise the concern that the quality of the data needs to be improved. Further, the range of data available can be extended through cooperation with taxpayers and the development of data protocols. However, this must be coupled with the ATO building levels of trust with the community that give confidence that the data provided will be used appropriately and not as a tool to penalise taxpayers.

13.5 Correct reporting

The term 'correct reporting' refers to ensuring that the correct income and expenditure has been reported and that there is no under-declaring of income nor over-claiming of expenses. The ATO seeks to 'assure' itself that correct reporting has occurred through verification and assurance reviews. Some of that work relies on third party data being reported that allows the ATO to pre-populate returns, and some data is used to verify or test reported income and expenses after a taxpayer lodges a return.

The ATO reports on its understanding of the level of correct reporting by taxpayers through the use of measures such as 'tax assured' and 'tax gaps'. According to the ATO, the estimated overall net tax gap for the 2017–18 financial year is 6.9% or $31.2b.[573] This means that the ATO collected 93% of the tax revenue it expected to collect, which is mostly from voluntary compliance. That there was such a high level of voluntary compliance is an asset that should be valued by the Australian community.

573 ATO, *Commissioner of Taxation annual report 2019–20*, p. 62. Available at www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_Report_2019-20/annual_report_2019-20.pdf.

Nonetheless, as referred to above, there are options to improve correct reporting in conjunction with improvements in lodgment. One significant opportunity for improvement is increasing the amount of information available as pre-filled data. For example, there is no automated reporting for rental property investments. Working with the real estate industry, standard reporting could be established such that automated and even regular reporting could be made directly by agents to the ATO. This would engage extended use of TFNs to streamline reporting and matching. Given the high levels of investment property ownership, this is the next logical extension of investment income reporting to complement the existing dividend, interest and managed fund reporting that is currently available. While certain expenses may not be captured in the real estate agent's report, such as interest on loans, it might be possible to work with financial institutions to receive that data set.

The point of such initiatives is to apply resources to helping people report correctly up front rather than chase omissions after lodgment. This is a better application of resources and is likely to improve attitudes towards compliance with the tax system.

Additionally, it is already the case that certain data received by the ATO is shared in real time with other agencies. It would appear that problems of the past of incorrect use of data by other agencies is being overcome by the proper use of STP data. Similarly, data reported by other new means, as suggested above, could be shared with other agencies to reduce the burden on businesses of reporting the same information multiple times (sometimes referred to by government as a 'tell us once' principle).

Self-assessment and rulings

Correct reporting is reliant, in part (and ironically), on self-assessment. That Australia enjoys high quality self-reporting is reflective of a culture of adhering to positive societal norms and expectations.[574] That self-assessment is backed up by automated checks and audits.

An important feature of the introduction of self-assessment was the ability of taxpayers to gain certainty in their tax affairs by asking the Commissioner to provide a ruling that he could be bound by. This gave rise to a regime that governs both private rulings (applying to a particular taxpayer in connection with a particular arrangement) and public rulings (applying to all taxpayers in particular circumstances).

The private rulings system is often criticised as being slow and resource-intensive. Rather than making reasonable and obvious assumptions, taxpayers are often asked for very detailed information. There seems to be a lack of appreciation that the private ruling issued can only be relied on based on its terms and the description of the arrangement. Any departure from the described arrangement makes the ruling otiose.

Should a taxpayer be dissatisfied with a private ruling, they have a right to object and appeal against that ruling. However, if circumstances change in any material way, that ruling is no longer binding. Nonetheless, the objections officer, the AAT and the courts are limited to reviewing the Commissioner's ruling on the original arrangement; there is no flexibility to update the facts of the arrangement to reflect any changed circumstances.

---

574 This can be seen, for example, in the way in which Australians generally followed restrictions imposed in connection with controlling the COVID-19 pandemic.

Similarly, the development of public rulings often takes in excess of a year. Sometimes the ruling has been prepared on the basis of a need for clarity in the law on an industry practice and it has been initiated by representatives of the industry. When a draft ruling is issued for comment, it has often been the subject of a significant internal process. These delays mean that taxpayers are left uncertain as to the position the ATO is to adopt and what approach they should take in lodging returns.

One suspects that the delays in the development of public rulings and the response to requests for private rulings can partly be found in inadequate resources being applied to those areas of the ATO that need to deal with these.

Further, the rulings system has been designed in a way that the Commissioner can only 'rule' on his interpretation of the law. This precludes ruling on the way in which the Commissioner may apply his resources to enforcing the law. This is a distinct difference to the position prior to the introduction of a formal rulings regime wherein the Commissioner would issue 'rulings' on both his view of the law and how taxpayers and his officers should approach the practical application of the law.[575] To overcome this, the ATO issues other 'products', such as practical compliance guidelines. These, of course, are non-binding, leaving taxpayers hoping that the Commissioner will be administratively bound by guidance.

The ATO also issues other guidance material that does not constitute a binding ruling — fact sheets, practice statements, taxpayer alerts and other material published on the website are examples. A taxpayer following such guidance gets no comfort that their tax position is certain. There are a number of possible solutions to some of these conundrums:

- abolish the current rulings regime and revert to a broader regime that existed pre-1992 (there is no guarantee, however, that this will result in more frequent or better rulings);
- make all advice (including all other 'products') issued by the Commissioner binding on the ATO; or
- if the current system is to be retained, provide for objections and appeals to be able to consider revised arrangements substantially the same as the original arrangement ruled on.

However, each of these solutions needs to be considered in the context of the self-assessment system itself. As noted above, serious consideration should be given to a full assessment system, once adequate data is available to provide taxpayers with a substantially complete return and other recommended changes in this paper are made (including the treatment of work-related expenses).

Education

Educating the community about the tax and superannuation systems will increase their understanding of meeting their tax commitments, which eventually leads to correct reporting. The ATO has a number of education programs which aim to educate in Australian schools. For example, the ATO offers free school webinar presentations for students about how the Australian tax and superannuation systems work, such as 'Paying it Forward' for primary schools and 'Tax, Super + You' for secondary school students. The ATO also arrange an annual Tax, Super + You competition (although, due to COVID-19, it was cancelled in 2020).[576] However, the support

575 See the "TR series" of rulings issued prior to 1992.

576 ATO, *Tax, super + you*. Available at www.taxsuperandyou.gov.au/competition. Accessed 10 January 2021.

that the ATO makes available to teachers is only effective if it is used. Currently, state education authorities do not mandate tax education as a component of the curriculum. It is up to teachers to pick up the material and incorporate them in relevant subjects. It would be beneficial to the tax system if this education was mandatory such that students left school with an understanding of the tax system as a public good.

Similarly, courses can be developed at TAFE and universities to provide both business ethics education (and the responsibility to make a contribution to the community through taxes) as well as direct education about how to interact with the tax system.

13.6 On-time payments

On-time payments is the proportion of tax liability paid on time by value, which was 88.7% in the 2019–20 financial year. This was a 1.2% decrease from the previous financial year.

While it is clear that the majority of taxpayers who had the capacity to pay continued to meet their obligations, there is a large stock of debt on the ATO's books. In excess of 60%[577] of that debt relates to small business. When small businesses get into cash flow trouble such that they become indebted to the ATO, it is likely that they are not making a profit and they have an income tax liability. That is, much of that debt is not the tax on the business itself, but rather the tax that the small businesses were paying on behalf of others; namely, GST and WHTs. This is the money of customers and of employees that the business is holding and is obliged to forward to the government on behalf of those customers and employees.

Currently, a significant proportion of new businesses fail in the first five years.[578] Anecdotally, it is suggested that cash flow is one of the major issues facing small business and a significant factor in failure rates. The current settings in the tax system are not best suited to managing cash flow. Most tax obligations are periodic, not real time. Even when real time or more regular reporting of their tax-related activity is required of businesses, it is not always matched by associated payment obligations. It is axiomatic that where payment occurs at the same time as receipt or payment of the balance of the money, there is less likelihood of default and real time cash flow management. This is the principle upon which tax withholding occurs — whether in relation to the payment of interest or wages, or other obligations. However, by not requiring the withholding agent (employer/business) to immediately pass that withholding on to the ATO, the risk of cash flow management is shifted to the business/employer. This is an area that should be examined to improve on-time payments across the system.

Additionally, e-invoicing can be utilised in the coming years. In the recent Budget 2020–21, the Australian Government announced its intention to accelerate e-invoicing. The government provided funding to the ATO until June 2022 in its role as the Peppol Authority with the aim of encouraging the adoption and assisting with implementation of Peppol e-invoicing.[579]

---

577 *Commissioner of Taxation annual report 2019–2020*, p. 194.

578 Estimates vary from as high as 80% to as low as 40%. In its December 2020 report *Small business counts – December 2020*, the Australian Small Business and Family Enterprise Ombudsman, using ABS data, estimated that the survival rate over four years for non-employee businesses is around 60% (or a failure rate of 40%). This is one of the more conservative estimates. Available at www.asbfeo.gov.au/sites/default/files/ASBFEO%20Small%20Business%20Counts%20Dec%202020%20v2.pdf.

579 Treasury, *Options for mandatory adoption of electronic invoicing by businesses – November 2020*, p. 9. Available at treasury.gov.au/sites/default/files/2020-11/c2020122716.pdf.

E-invoicing allows the digital exchange of invoices between a supplier and a buyer's software systems, similar to being able to make a phone call to another phone regardless of the phone's model, brand or carrier. E-invoicing reduces the occurrence of human errors associated with traditional invoicing, such as lost invoices and incorrect invoices, which cause delays in payment. E-invoicing will provide a good opportunity for small to large businesses to manage their GST credits and GST payable in real time. This information could be collected by the ATO to automate GST reporting.

13.7 The Australian Taxation Office

The ATO has proven to be an efficient, and often relied upon, administrator. This has been most evident in the design and administration of the government's response to COVID-19.

In particular, the ATO has been able to show its ability to deal with a crisis and to respond to the needs of the community or the government of the day. It has been able to marshal and redirect its resources to such ends. Importantly, it has a connection with most adult Australians directly and with all Australians indirectly (think collection and payment of GST, for example). That relationship is often intermediated by an army of tax professionals much larger than the resources of the ATO itself.

Nonetheless, the ATO has been the subject of criticism in certain areas of its administration. While some of such criticism may be unjustified or poorly researched, all criticism should be welcomed as an opportunity to reflect and determine how things can be done better. Similarly, where performance data shows significant gaps or issues, it should be readily published together with remediation plans to improve performance in those areas. It would appear that not all areas of performance are consistently reported on and the impression may be left that the reason for such omissions is that there is underperformance in those areas.

This chapter, in the light of such criticism, seeks to consider improvements to tax administration.

13.8 State revenue authorities

It has been the observation of members of The Tax Institute that interact with state revenue authorities that, for whatever reason, they tend to trail the ATO in technological advances and taxpayer-focused administration. While there is evidence of changes in this area (for example, the NSW government's citizen-centric 'Services' initiative), it has been slow and sporadic (cf. the requests made to the Queensland Government for the establishment of a discrete website for the Queensland State Revenue Authority).

On the other hand, some of the state revenue authorities often have a much more open and engaging approach when designing tax changes than their federal counterparts, genuinely seeking to explore the circumstances surrounding businesses or arrangements that are to be taxed and looking for efficient, lower compliance cost approaches. Unfortunately, this is not consistent even across the state authorities.

13.9 Funding

Anecdotally, it is understood that the state revenue authorities are poorly funded by comparison to the ATO. This is not to suggest that the ATO is overfunded (in fact, quite the contrary when international comparisons are made[580]), but rather that the state revenue authorities should have their funding reviewed with the objective of ensuring that the 'service' side of the organisation is adequately funded. Those services include support for the administrator objectives of registration, lodgment, correct reporting (and the right support for that) and payment.

The funding model for the ATO has been the subject of meeting political objectives of the relevant government at the time (this applies to both sides of politics) as well as a 'one size fits all' approach to so-called efficiency dividends.

In the latter case, the logical end position of efficiency dividends is that funding of an agency continues to be reduced until it must be so efficient that it ceases to exist. That the concept continues to be applied is an indictment on those that seek to pursue it. True efficiency will come from investing the right kind of resources to achieve the types of services and deliver the results that the community expects. While there should never be an open cheque book for an agency, stable funding and clear objectives based on commercial concepts of zero-based budgeting should ultimately result in the right funding to achieve the right outcomes.

In relation to political objectives, this is best illustrated by the funding of a significant part of the ATO being on four-year cycles. That is, while part of the ATO's funding is stable on an ongoing basis (subject to the aforementioned efficiency dividends), a significant portion of funding is based on 'programs', such as the Tax Avoidance Taskforce. This allows governments to 'announce' new funding for the ATO, whereas what is happening in truth is that previous similar short-term programs are replaced by new short-term programs. Whether this is the best use of that funding is seldom questioned. Further, significant parts of the bureaucracy must spend time reporting on the specially funded programs as well as apply for a new program lest the thousands of auditors employed for those programs be made redundant. That a better way of collecting tax might exist is overlooked in this process. Such improvements to tax collection must seek to scrounge some funding out of what is left of the regular part of the allocation to the agency.

Certainty and consistency of funding would allow for investment by the ATO in appropriate responses to emerging approaches to tax administration, investment in the right technologies and allow focus on the true efficiencies relevant to a modern economy. For example, rather than just funding audit programs that increase the burden on taxpayers in order to generate revenue, a better approach might be to invest in technology and data collection and curation that allows greater support of taxpayers in getting their affairs correct up front and meeting their obligations in a timely manner. This would be much more valuable to the system and the government having the added benefit of building trust in the system.

580 Determined through calculations by The Tax Institute based on proportion of revenue officers at national levels compared to population size.

13.10 Organisation of the Australian Taxation Office

The ATO is organised into five major groups, each headed by a member of the ATO executive.[581] Two of those groups represent the 'support' functions of the ATO — technology, human resources, finance, etc — and cover approximately 5,300 people (employees and contractors) in total. The more 'front line' areas of the ATO are contained in the remaining three groups — Client Engagement (approximately 8,000 people), Service Delivery (approximately 6,700 people) and Law, Design & Practice (just over 1,000 people).[582]

Audit focus

Within these groups, ATO officers are devoted to different activities. However, because of the ATO funding method mentioned above, a significant proportion of the Client Engagement staff are devoted to audit activities. Given the relatively high levels of compliance in the Australian taxpaying population as often noted by the ATO itself, one might think that the emphasis of the ATO should be less about 'catching' those who make mistakes and more about putting in place the infrastructure to support better education and participation, more accurate reporting (through better collection and presentation of data to taxpayers) and better collection mechanisms. Supported by a better funding model, this should be the direction the ATO takes.

Objections and appeals

There have been reports by the IGTO over several years that have called for a separation of the appeals and objection function from other parts of the ATO and even the creation of a further Second Commissioner role to head that. It is noted that there have been changes to make the appeals and objection function independent of the rest of the ATO, and it is not clear if further separation is warranted or would be of value. Further, as is apparent from the problems arising from the current funding model, hard coding the organisation of the ATO into legislation is likely to create an inflexible structure that will not be focused on reducing such objections and appeals through better management of cases up front, rather than trying to solve them after something has gone wrong.

Disputes are costly for all involved. Not only is there the monetary and opportunity cost there is also the emotional cost. While the ATO, in particular, has instituted alternative dispute resolution practices, this overlooks the need to prevent disputes from occurring in the first place. Often processes can be designed to meet measures of timeliness or revenue targets to the detriment of getting the right result, with the attendant outcome of often protracted disputes.

Trust

As has been noted earlier in this paper, Australians have a relatively high level of voluntary compliance with the tax system. This is a valuable commodity in our system. However, it is a mistake to automatically equate that compliance with trust.

---

581 See the ATO organisational chart at www.ato.gov.au/uploadedFiles/Content/CR/downloads/n75148_ATO_organisational_structure.pdf.

582 ATO, *Annual report 2019–20*, table 4.13. Available at http://www.ato.gov.au/about-ato/commitments-and-reporting/annual-report-and-other-reporting-to-parliament/annual-report.

A fundamental asset of any tax system is the trust that the community has in its tax administrator. However, despite the relatively high levels of voluntary compliance, there is, anecdotally, a lack of trust between the administrator and taxpayers which is reflected in audit and debt collection approaches and efforts, and which adds to the compliance costs imposed on taxpayers. Those anecdotes are borne out in the media reports of particular cases and in reports by the IGTO and the ASBFEO. Additionally, that lack of trust is in stark contrast to what is expected of ATO officers under the Taxpayer Charter, in particular, the expectation that ATO officers will treat taxpayers "with courtesy and respect and … as being honest".[583] Excessive requirements for detailed information, requests for written responses to questions answered in interview and increased levels of reporting impose heavy burdens on taxpayers. There have even been instances of auditors requested that a taxpayer provide evidence that something did not occur. Disproportionate expectations on small business to have systems and processes in excess of what is normal commercial practice and auditors approaching taxpayers on the basis that the business is hiding something, similarly impose high compliance costs. Unsurprisingly, behaviours from auditors that indicate a lack of trust in the taxpayer tend to elicit equivalent lack of trust in the auditors and the audit process.

Lack of trust, desire for certainty and fairness or a fair go is also arguably the greatest underlying reason for the current state of the law. in recent decades, there has been a demand from users of all kinds that the law be clear in what it covers so there is no danger of 'unintended consequences'. The truth that is now apparent is that such detail simply leaves new gaps or areas of uncertainty. Moreover, it often meant that the law operated in a way that is contrary to normal business and commercial practices, thus adding to the compliance burden. At its core, the two sides of this approach reflected a complete lack of trust: a lack of trust in taxpayers and their advisers, a lack of trust in the administrators and a lack of trust in the judiciary. In Australia, that era, we would like to think, has come to its necessary end. While trust has not yet been fully restored, we would venture to say that it is re-emerging. Where there is trust, there can be a new and principled approach to the way law is drafted. This should mean simpler law. It should mean law that is adaptable to changing circumstances and new and emerging ways of doing business.

Second Commissioners

As will be evident from the above, the members of the executive consist of group heads that are both Second Commissioners and Deputy Secretary equivalent roles. This gives rise to some level of confusion, as does the naming convention of Second Commissioners. Further, Second Commissioners are statutory appointments which attracts a process that includes ministerial, cabinet and Governor-General approval. This adds considerably to the process of appointing people to that role as is evidenced by the fact that, at the time of writing, there has been a Second Commissioner vacancy for some 18 months. This creates instability both for the ATO and for those that deal with the ATO. Consideration should be given to alternative arrangements and naming conventions of the roles reporting to the Commissioner.

13.11 Tax policy development

When viewed as a whole, parts of the Australian tax system are highly principled, whereas other parts are highly detailed. That said, there are no current structures in place to allow for efficient,

583 ATO, *Taxpayers' charter*. Available at http://www.ato.gov.au/about-ato/commitments-and-reporting/taxpayers--charter.

regular system maintenance in either case. This, coupled with an increasing lack of confidence in existing political processes to drive effective tax reform, lends itself to an unsustainable tax system.

There have been countless reviews of various aspects of the Australian tax system. However, recommendations are disproportionately implemented. This is inefficient in itself. The Tax Institute is of the view that it is time to reconsider who should be managing tax reform and who should be tasked with maintaining the tax system on an ongoing basis. An independent, bipartisan commission, whether existing or newly formed, could be charged with this task, to alleviate the pressure on government and to reduce opportunities for political influence in the establishment of good tax policy and law. Not only could such an organisation consider and deliver genuine tax reform, it would also have the scope to consider the kinds of reviews that should be pursued and to determine the regularity and extent of system maintenance that should be undertaken.

A starting point could be the implementation of a new tax policy development structure similar to the UK, which has adopted a five-year corporate plan. Any review or plan should include clear objectives and terms of reference which align with those objectives. This would ensure that it is approached with a clear understanding of the input to be sought from relevant stakeholders and the priorities to be set. Agreed timeframes would ensure that a review remains on track and that outcomes or objectives are delivered as expected. The development of supporting guidance in relation to any newly developed policy or law should be taken into account in terms of a broader plan and should follow a similar framework, including agreed timeframes for the delivery of outcomes, an assessment of prioritisation and a clear framework for consultation, including the level of involvement to be provided by stakeholders.

Other important factors include transparency and a broad understanding of the structure and purpose of the tax system. Any of the options considered above must be coupled with initiatives to build trust between taxpayers and the ATO, and reductions in red tape to reduce administrative costs and compliance burdens. Importantly, improved communication between government data collectors to ensure that the role of tax practitioners and advisers is efficient and simplified is fundamental. This is particularly relevant, for example, in the context of STP, and the modernisation of business registers.

13.12 Other bodies: the Inspector-General of Taxation and Taxation Ombudsman, the Board of Taxation and the Australian Small Business and Family Enterprise Ombudsman

Each of the IGTO and ASBFEO plays, a role as both scrutineers of the ATO and as advocates on behalf of specific taxpayers or taxpayer groups. While those roles are valuable to the community, there is sometimes confusion as to where each of these bodies should operate and how they interact with more general scrutineers such as the Auditor-General and the Commonwealth Ombudsman.

Additionally, those bodies are not sufficiently resourced to undertake strongly evidenced-based reports of performance. Reports are often, by their nature, hampered by detailed data and rely on anecdotes and trends arising from smaller samples of cases. Consideration could be given to these bodies working with the Auditor-General to guide this valuable work and to improve the review of broader data that would enhance the efficacy of these reports.

The Board plays a unique role in reviewing the operation of legislation to determine if it is meeting its policy objective and to recommend improvements to the law. This is valuable work, but is often undertaken on the basis of referrals from ministers or through the representations of particular groups or bodies representing sections of the taxpayer population. Consideration should be given to a more structured role for the Board to review all new legislation within five years of its introduction.

Options for reform

- Improve consultation on policy development, drafting of law (including instruction to the Office of the Parliamentary Counsel) and interpretational issues before legislation is drafted.
- Clarify and honestly state the objective of legislation.
- Greater use of well thought out principles-based legislation.
- Better and more flexible funding of revenue agencies.
- Ensure that there is 'warts and all' reporting of revenue authority performance.
- Redesign processes to prevent disputes arising in the first place.
- To address shortcomings in the registration of individuals, issue TFNs to individuals from birth, or as they arrived as a resident or on a working visa.[584]
- Through cooperation with state and federal agencies, it would be possible for the ATO to identify those cases where it would be appropriate to deactivate TFNs. For example, consideration may need to be given to those cases of permanently departing individuals (whether or not citizens or tax residents) whether the individual may continue to derive Australian-sourced income or whether it is likely that the individual may return in the future (e.g. citizens).

In relation to the rulings system and, either concurrently or separately, in the context of the adoption of a full assessment system:

- make all advice and other 'products' issued by the Commissioner binding on the ATO (with appropriate requirements to ensure that the ATO continues to issue guidance at its current rate or higher);
- if the current rulings system is to be retained, provide for objections and appeals to be able to consider revised arrangements substantially the same as the originally arrangement ruled on; or
- increase ATO resource allocation to private and public rulings.

584 This would require cooperation with the various States and Territories who maintain the registers of births, deaths and marriages. In New Zealand, IRD numbers can be issued as part of the online process of registering a child's birth with the Department of Internal Affairs. As for the other taxpayers, New Zealand's Inland Revenue requires the specific identification information and confirmation of tax residence to prevent identity theft, double-ups and fraudulent behaviours.

Amongst the options to increase confidence in the system:

- working with state government agencies to establish an appropriate register of all partnerships and trusts; and
- all companies, trusts and partnerships could be simultaneously issued with an ACN/ABN and TFN upon incorporation/creation.
- Clarify the roles of scrutineers. Support the work of the IGTO and ASBFEO through the expertise of the Auditor-General.

\

Acknowledgments

The Tax Institute acknowledges the efforts of its Tax Policy and Advocacy team as the primary drafters of this *Case for Change*. This paper would not have been possible without the contribution and support of other teams within The Tax Institute, throughout The Tax Summit: Project Reform event series, to bring it to life.

The Tax Institute contributors

Peter Godber, President, CTA	Russell Mort
Andrew Mills, CTA (life)	Martin Wilkins
Scott Treatt, CTA	Lara Biggs
Prof Bob Deutsch, CTA	Jamie Barbour
Robyn Jacobson, CTA	Nicole Welch
Julie Abdalla, FTI	Mei Lam
Angie Ananda, FTI	Kelly Emmerton
Michelle Ma	Zoe Wender
Sharon Kells	Angela Thangavelu
James Paterson	Britney McIlvain
Leanne Carter	Kathy Xu
Cherish Renshaw	Destelle Taylor
Tara Grimm	Kirsty Ferguson
Natalie La Rosa	Carla Reddy
Charlotte Bernasconi	Louisa Bruce (editor)

The Tax Institute acknowledges the valuable contributions of the following student volunteers in assisting with initial research and drafting of various aspects of this paper.

Student volunteers	Organisation
Kiara Di Carlo	UNSW
Stephanie Douvos	The University of Melbourne
Prasanna Nidumolu	The University of Melbourne
Regina Nunag	Curtin University
Aarushi Verma	UNSW
Todd Whiting	Queensland University of Technology

The Tax Institute also humbly acknowledges the following people who have generously given of their time and contributed in one of many ways to The Tax Summit: Project Reform series of events and this *Case for Change*. The Tax Institute also gratefully acknowledges the government officials and revenue officers who have contributed to this process but could not be named below.

Individual	Organisation
Paul Abbey	PwC
Adrian Abbott, CTA	Abbott Group
Chris Aboud, CTA	Greenwoods & Herbert Smith Freehills
Jonathan Ackerman, ATI	Ackerman Consulting
Matthew Addison	Institute of Certified Bookkeepers
Mary Aldred	Franchise Council Australia
Debra Anderson, ATI	Anderson Tax & Consulting
Heidi Armin-Grimm, FTI	Deloitte
Thomas Arnold, CTA	Ground Floor Wentworth Chambers
Kym Bailey, ATI	JBWere
Melanie Baker, CTA	Victorian Bar
Paul Banister, CTA	Grant Thornton
Denis Barlin, CTA	Wentworth Chambers
Andrew Barrah, FTI	Grant Thornton
Paul Bartley, FTI	Bartley Partners
Steven Batrouney, ATI	Deloitte
Noel Beharis, CTA	Beharis & Co
Chris Bevan, CTA	Wentworth Chambers
Celeste Black	The University of Sydney
Cameron Blackwood, ATI	Greenwoods & Herbert Smith Freehills
Richard Bobb, CTA	Encountr Tax Advisory
Wayne Bolin, CTA	MGI Joyce | Dickson
Simon Bowden, CTA	Jones Day
Craig Bowie, CTA	MinterEllison
Louise Boyce, CTA	Squire Patton Boggs
Prof Robert Breunig	Tax and Transfer Policy Institute
Phil Broderick, CTA	Sladen Legal
Stephanie Bruce	Curtin University
Lynda Brumm, CTA	PwC
Neil Brydges, CTA	Sladen Legal
Daniel Butler, CTA	DBA Lawyers

Individual	Organisation
Shaun Cartoon, FTI	Arnold Bloch Leibler
Donovan Castelyn, CTA	Curtin University
Jinny Chaimungkalanont	Herbert Smith Freehills
Daniela Chiew, FTI	KPMG
Anna Chong, CTA	KPMG
Simon Clark, CTA	KPMG
Brendan Coates	Grattan Institute
Graeme Colley	SuperConcepts
Anne Collins	Glencore
Andrew Compton, CTA	Frasers Property Australia
Leanne Connor, CTA	WGC Business Advisors
Michael Cosgrove	New Chambers
The Hon Peter Costello MP AC	Former Federal Treasurer
Rev Tim Costello AO	Community Council for Australia
Bridgid Cowling	Arnold Bloch Leibler
Jane Crisp, CTA	KPMG
Neal Dallas, CTA	McInnes Wilson Lawyers
Minh Dao, CTA	KPMG
Thalia Dardamanis, CTA	UniSuper
Michelle de Niese	Corporate Tax Association
Aldrin De Zilva, CTA	White & Case
Catherine Dean, CTA	KPMG
Nathan Deveson, CTA	MinterEllison
Michael Dirkis, CTA	The University of Sydney
Julie Dolan	KPMG
Frank Drenth	Tax & Super Australia
Sarah Dunn	KPMG
Tracey Dunn	RSM Australia
Joanne Dunne, CTA	PwC
Teresa Dyson	Former Chair of Board of Taxation
Neil Earle, CTA (Life)	DFK Benjamin King Money
Yasser El-Ansary	Australian Investment Council
Paul Ellis, CTA	EY
Rt Hon Sir Bill English	Former Prime Minister & Treasurer of New Zealand
Linda Farmer, CTA	Grant Thornton

Individual	Organisation
Ken Fehily, CTA	Fehily Advisory
John Findley	Self Employed Australia
Michael Flynn, CTA (Life)	Owen Dixon Chambers West
Steve Ford, CTA	PwC
Ross Forrester, CTA	Westcourt
John Fowler, CTA	Macquarie Group
Lyn Freshwater	BNR Partners
Andrew Fricot	Payroll Tax Solutions
Rosheen Garnon, CTA	Board of Taxation
Glen Gaspar, CTA	Shell
Bastian Gasser, ATI	MinterEllison
Craig Gibson	Macpherson Kelley
Nicole Gordon, CTA	MinterEllison
Leo Gouzenfiter	Pitcher Partners
Viva Hammer	Joint Committee on Taxation
Clint Harding, CTA	Arnold Bloch Leibler
Nick Heggart, CTA	Greenwoods & Herbert Smith Freehills
Edward Hennebry, FTI	Sladen Legal
Dudley Heywood, CTA	Scentre Group
Ross Higgins, CTA	Mills Oakley Lawyers
Paul Hockridge, CTA	Mutual Trust
George Hodson, CTA	Thomson Geer
Prof Richard Holden	UNSW
Denise Honey, CTA	Pitcher Partners
Andrew Howe, CTA	Greenwoods & Herbert Smith Freehills
Peter Hyman, ATI	INPEX
Tony Ince, CTA	RSM Australia
Morag Ingham, CTA	Grant Thornton
Paul Ingham	Coleman Ingham
John Ioannou, CTA	Macpherson Kelley
Simone Jacobson	Dawson Chambers
Dr Julianne Jaques, CTA	Victorian Bar
Linda Jing, CTA	Hayes Knight
James Jobson, CTA	Portoria
Ron Jorgensen, CTA	Thomson Geer

Individual	Organisation
Elinor Kasapidis	CPA Australia
Dr Ann Kayis-Kumar	UNSW
Bill Keays, CTA	Keays & Associates
Greg Kent, CTA	PwC
Chris Kinsella, CTA	MinterEllison
Costa Koutsis, CTA	Ashurst
Damian Kyloh	Australian Council of Trade Unions
Hugh Lam, CTA	Commonwealth Bank of Australia
Ross Lambie	Australian Chamber of Commerce and Industry
Brian Lane	EY
Mark Latham, ATI	Deloitte
Craig Latham, CTA	ASBFEO
Angela Lee, ATI	Victorian Bar
Jenny Lee, ATI	KPMG
Jonathon Leek, CTA	Deloitte
Ryan Leslie, ATI	Greenwoods & Herbert Smith Freehills
Sam Lo Ricco, CTA	Nuwaru
Damien Lockie, CTA (Life)	SLCA
Michael Lorimer, CTA	MCG Wealth
Elizabeth Lucas, ATI	Grant Thornton
Maria Lui, CTA	Mutual Trust
Ross Lyons, CTA	Minerals Council of Australia
Amrit MacIntyre, CTA	Baker McKenzie
Suzanne Mackenzie, CTA	Bar Chambers
Jonathan Malone, CTA	PwC
Geoff Mann, CTA	Ashurst
David Marks QC, CTA	Queensland Bar
Alison Marshall, CTA	PwC
Marg Marshall, CTA	WLF Accounting & Advisory
Paul McCartin, CTA	PwC
Adam McCissack	Business Council Australia
Peter McMahon	Baker McKenzie
Heydon Miller, CTA	Orange Chambers
Seema Mishra, CTA	Norton Rose Fulbright
Annalie Mitchelson	PwC

Individual	Organisation
Mark Molesworth, CTA	BDO Australia
David Montani, CTA	Nexia
Fiona Moore, CTA	EY
Annette Morgan, CTA	Curtin University
Nicholas Most, CTA	EY
Rachael Munro, CTA	PwC
Chris Murphy	ANU
Peter Murray, CTA (Life)	Hall & Wilcox
Adam Musgrave	EY
Tim Neilson, CTA (Life)	White & Case
Robert Ngyuen, FTI	Deloitte
Matthew Nicholls, CTA	BAE Systems Australia
Rae Ni Corraidh, CTA	Knowledge Shop
Andrew Noolan, CTA	Brown Wright Stein Lawyers
Andrew Nutman, CTA	ShineWing Australia
Andrew O’Bryan, CTA	Hall & Wilcox
Prof Ann O’Connell	The University of Melbourne
Kevin O’Rourke	O’Rourke Consulting
Jonathan Ortner, FTI	Arnold Bloch Leibler
Nathan Papson, CTA	Papson Legal
Langdon Patrick, CTA	KPMG
Hugh Paynter, CTA	Herbert Smith Freehills
Chris Peadon, FTI	New Chambers
Barbara Phair, CTA	Ashurst
Joel Phillips	Victorian Bar
Dr Mark Pizzacalla, CTA	BDO Australia
Fabrizio Porcaro, CTA	Porcaro Lawyers
Anthony Portas, CTA	Rio Tinto
Michael Potter	Financial Services Council
Damian Preshaw, CTA	Damian Preshaw Consulting
Vanessa Priest, FTI	Baskin Clarke Priest
Tony Principe, CTA	ShineWing Australia
George Psarrakos, CTA	Mutual Trust
John Randall, CTA	Super Decoder
David Raphael	Four St James

Individual	Organisation
Ian Raspin, CTA	BNR Partners
Tracey Rens, CTA (Life)	Deloitte
Pete Rhodes, ATI	Aristocrat
Chris Richardson	Deloitte Access Economics
Andrew Rider, CTA	New South Wales Bar Association
Ian Roberts, ATI	Sunsuper
Premila Roe, CTA	BHP
Marc Romaldi, CTA	WRP Legal Advisory
Roseanne Ross, ATI	KPMG
Prof Kerrie Sadiq, CTA	Queensland University of Technology
Bernard Salt	The Demographics Group
Jemma Sanderson, CTA	Cooper Partners
Seema Sandhu, ATI	Clayton Utz
Ishita Sethi	Second Floor Selborne Chambers
Andrew Shead, ATI	Tinworth Co
Katerina Siamatas, CTA	Crowe Horwath
Chris Sievers	Victorian Bar
Kimberley Simpson, CTA	Cochlear Limited
Associate Prof Mathias Sinning	ANU
Dianne Sisak-Penjalov, CTA	EY
Greg Smith	Former Head of the Treasury Budget and Revenue Group
Paul Sokolowski, CTA	Arnold Bloch Leibler
Steve Southon, ATI	NAB
Steven Stern, CTA	Victoria University
Prof Miranda Stewart, CTA	The University of Melbourne, and ANU, Tax and Transfer Policy Institute, Crawford School of Public Policy
Pero Stojanovski	Business Council Australia
Vicki Stylianou	Institute of Public Accountants
Niv Tadmore, CTA	Jones Day
Linda Tapiolas, CTA	Cooper Grace Ward Lawyers
Amelia Teng	Deloitte
Johanne Thomas, CTA	Deloitte
Ellen Thomas, ATI	PwC
Robyn Thomas, ATI	Balazs Lazanas & Welch
Paul Tilley	ANU, Tax and Transfer Policy Institute, Crawford School of Public Policy

Individual	Organisation
Simon Tisher, CTA	Victorian Bar
James Trainor, CTA	BDO Australia
Jerome Tse, CTA	King & Wood Mallesons
Sam Ure, FTI	Victorian Bar
Prof Richard Vann, CTA	The University of Sydney
Sylvia Villios, CTA	The University of Adelaide
Mariana von Lucken, CTA	HLB Mann Judd
Thomas Walker	Think Forward
Chris Wallis, CTA	Victorian Bar
Prof Michael Walpole, CTA	UNSW
Grant Wardell-Johnson, CTA	KPMG
Graham Warren, CTA	Greenwoods & Herbert Smith Freehills
Neil Warren, CTA	UNSW
Michael Wells, CTA	7 Wentworth Selborne
Liz Westover, FTI	Deloitte
Peter White, CTA	EY
Sue Williamson, CTA (Life)	Holding Redlich
Cristina Wolters, CTA	Transurban
Jenny Wong, CTA	KPMG
Ka Sen Wong, CTA	Allen & Overy
Yan Wong, ATI	Grant Thornton
Elizabeth Wong, CTA	Envision Consulting Group
Angela Wood, CTA	KPMG
Danielle Wood	Grattan Institute
Tim Wood	Shell
Chris Wookey, CTA	Chris Wookey Chartered Accountant

Appendix

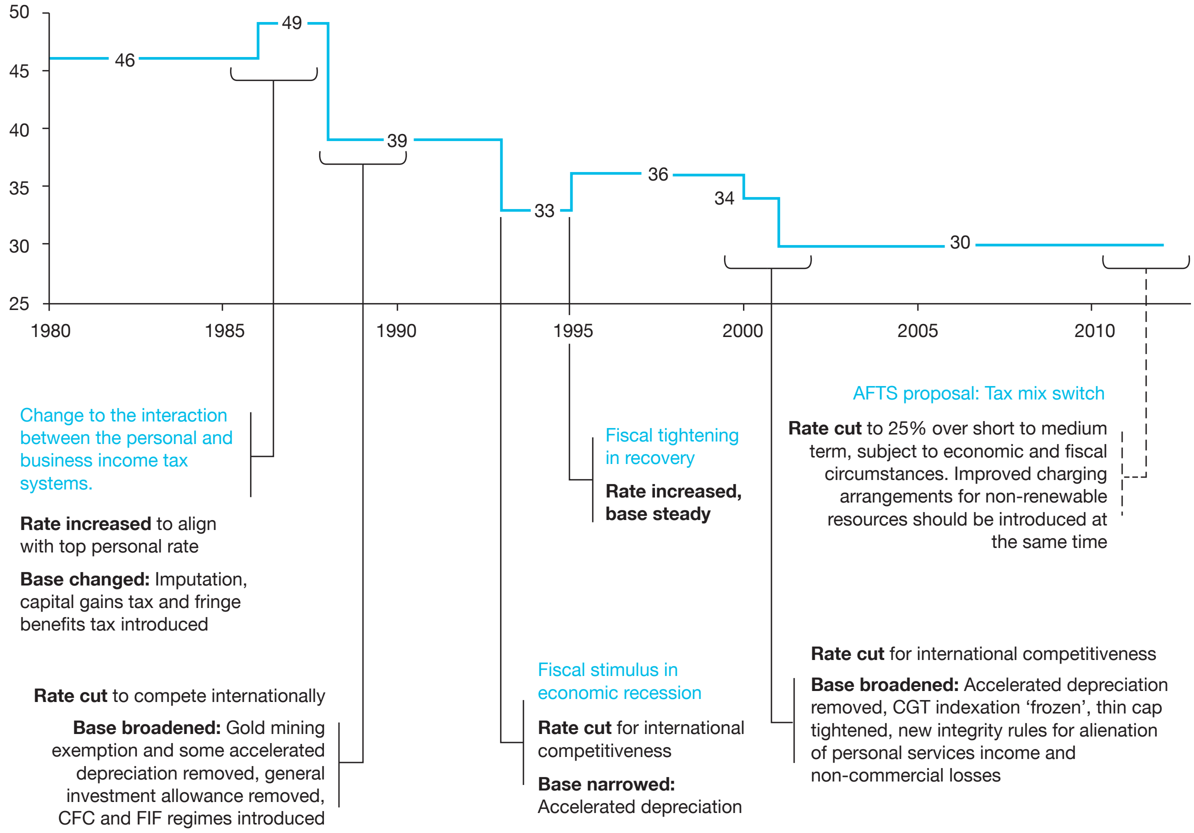
Corporate tax rate — historical note

Company tax rate from 1979–80 to 2012–13

As a historical note, Figure 17 sets out Australia's company tax rates from 1979–80 to 2012–13. Over the past three decades, there has been a general propensity by the government of the day to reduce the company tax rate since it peaked at 49% in the late 1980s.

The legislative amendments ensure that this downward trend will continue for at least another year.[585]

Figure 17. Company tax in Australia – the how and why of company tax rate changes (1980 to 2013)



Source: Treasury, *Business tax working group – consultation guide,* June 2012.

585 The corporate tax rate for base entities reduces from its current rate of 26% to 25% from 1 July 2021.

Company income tax rate changes – 1915 to 2001

Table 16 sets out the changes in the company tax rate from 1915 to 2001.

Table 16. Company income tax changes, 1915 to 2001

Year	Company tax rate	Notes on tax base
1915	7.4%	A company was taxed on its undistributed profits (deduction allowed for income distributed to shareholders).
1922		Tax applied to all profits (not just undistributed profits). Rebate provided for all dividends.
1940	 47.5% 45%	All rebates for distributions of profits to shareholders were removed: • public company; • private company.
1948–1972	47.5% 45% 42.5%	• Public company. • Private company. • Lower rate of 42.5% applied to initial income (first $10,000 of profits in 1974).
1973–1977	45%	Private and public company income tax rates aligned.
1979	46%	
1986	49%	Company tax rate aligned with top individual marginal tax rate. Foreign tax credit system replaced the general exemption for foreign earnings – credit allowed for foreign tax paid on foreign income up to the amount of Australian tax payable on the foreign income.
1987		The classical system of company taxation replaced by dividend imputation.
1988	39%	
1993	33%	
1995	36%	
2000	34%	Refundable imputation credits introduced.
2001	30%	

Source: Table 5, Parliamentary Library Bills Digest no. 22, 2017–18, 1 September 2017, Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017; and S Reinhardt and L Steel, *A brief history of Australia's tax system,* 4 September 2006.

Company income tax rate changes – 2015 to 2021

Table 17 sets out the changes in the company tax rate from 2015 to 2021.

Table 17. Company income tax rate changes – 2015 to 2021

Year	Company tax rate	Entity type
2015–16	28.5%	• SBE (aggregated turnover[586] less than $2m)
	30%	• CTE (non-base rate entity)
2016–17	27.5%	• SBE (aggregated turnover less than $10m)
	30%	• CTE (non-base rate entity)
2017–18	27.5%	• Base rate entity (aggregated turnover less than $25m)
	30%	• CTE (non-base rate entity)
2018–19	27.5%	• Base rate entity (aggregated turnover less than $50m)
	30%	• CTE (non-base rate entity)
2020–21	26%	• Base rate entity (aggregated turnover less than $50m)
	30%	• CTE (non-base rate entity)
2021–22	25%	• Base rate entity (aggregated turnover less than $50m)
	30%	• CTE (non-base rate entity)

586 S 328-115 of the ITAA 1997.

THE TAX INSTITUTE

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge and learning. We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.

AUSTRALIAN TAX
RESEARCH FOUNDATION

About Australian Tax Research Foundation

The Australian Tax Research Foundation is an independent not-for-profit organisation administered by The Tax Institute. Its aim is to research taxation at all levels of government with a view to arriving at systems which are simple, fair and efficient.

thetaxinstitute.com.au