Ref: AMK:lg

19 December 2019

**﻿**

The Treasury
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 ***By Email:***  *prebudgetsubs@treasury.gov.au ﻿*

Dear ﻿Sir/Madam

**2020-21 PRE-BUDGET SUBMISSION**

# Introduction

We refer to the media release issued by the Minister for Housing and Assistant Treasurer, the Hon Michael Sukkar MP, on 30 September 2019 requesting submissions to be made to the Commonwealth Government on priorities for the 2020-21 Budget.

In particular, we also refer to the Assistant Treasurer’s address to the Institute of Public Accountants 2019 National Congress where it has been reported that Treasury is considering a range of tax incentives or options to encourage investment from small and medium enterprises (“**SMEs**”) to grow their businesses and create jobs. We thank you for this opportunity to provide our pre-budget submission.

Pitcher Partners specialises in advising clients in what is commonly referred to as the middle market. The middle market is a diverse group of taxpayers comprising of privately-owned entities and their owners, regardless of their size. Accordingly, the middle market covers a broad spectrum of entities and individuals, ranging from closely held listed companies to family operated businesses. Naturally, the Assistant Treasurer’s comments are of significant relevance to our core client base.

# General policy statement

Following the 2019-20 Budget which forecast a return to a cash surplus of $7.1 billion for the 2019-2020 financial year and $45 billion of surpluses over the forward estimates period, Treasury is presented with an opportunity to consider long-term structural tax reform under a more stable fiscal environment. Importantly, this remains so despite the downward revision to the underlying cash surplus to $23.5 billion in the Mid-Year Economic and Fiscal Outlook for 2019-20 (“**MYEFO**”).

Despite the forecast return to surplus, our clients remain cautious in their outlook regarding the economy. The unanimous and consistent feedback we hear is that with global economic uncertainty and headwinds are in the offing there is a natural tendency for business to be conservative in making investment decisions. For this reason, the recent cuts to personal income taxes, although welcomed, are unlikely to meet the Government’s overall objective of stimulating business growth and job creation. Instead, these may merely result in reductions in personal debt or the consumption of imported goods.

We fully support the Assistant Treasurer highlighting the Government is seeking to reform the tax system to provide better support for SMEs to grow their business and create jobs.

To this end, we believe that the Government has a golden opportunity to focus on three important areas to meet these objectives being: (1) increase the competitive capacity of Australian business through investments in science, education and innovation; (2) funding critical longer-term infrastructure projects; and (3) reducing compliance costs for the middle market and ordinary salary and wage earners by way of significant simplification of the tax system.

# Specific policy statements

## Stimulating domestic business opportunities

The middle market is a significant contributor to our economy. Based on the latest Australian Taxation Office (“**ATO**”) statistics released for the 2016-17 income year, approximately 55.71% of all salary and wages are paid by private groups, as compared to 42.98% being paid by public and other groups. Furthermore, approximately 41.08% of total corporate tax is collected from privately owned businesses.[[1]](#footnote-1)

The Government has highlighted the importance of this significant contribution by private groups and the SME sector. To support this important segment of the economy, we would encourage the Government to introduce of specific measures that would continue to assist the middle market over the coming years and to ensure that the middle market avoids suffering from a potential economic downturn that may occur.

We would encourage the Government to consider both tax and non-tax policies. We have outlined specific tax policies below at Section D.

Certain non-tax policies that are aimed at supporting the middle market could include: (a) programs and investment aimed at increasing the skill levels of our domestic work force; (b) measures that may reduce the attractiveness of offshoring and increase the attractiveness of using local employment; (c) incentives and spending on technology projects that could help to improve Australian agriculture practices; (d) targeted import replacement and improvement in self-sufficiency programs in areas where we export raw materials and repurchase as finished goods; (e) spending and other incentives that will help to ensure continued strong growth in some of our key industries, including the construction industry, tourism, education and financial services.

Such policies should be supported by a reduction in the compliance costs for the middle market and salary and wage earners. We note the comments in MYEFO regarding deregulation of Australian business and would welcome Government efforts to tackle increasing compliance costs associated with regulatory burden. To this end we believe that there is significant scope to simplify the tax system for the majority of taxpayers.

##  Population growth and infrastructure

There are a number of key current infrastructure-related concerns in Australia.

The first is that most States are suffering from the effects of an energy crisis, as well as water shortages and drought. We believe that it is now opportune for the Government to create policies and increase expenditure with respect to energy infrastructure to deal with growing population, as well as direct expenditure policies dealing with energy, water shortages and drought.

The second is that a number of our capital cities are also struggling with transport-related infrastructure issues. Our major cities have struggled to keep up with population growth, as congestion becomes a significant political issue. We believe it is opportune for the Government to commit to working with the States to deliver larger transport infrastructure projects that will seek to address these issues. Long-term projects could include the airport rail link in Melbourne, the Sydney to Melbourne rail link, the East / West freeway link, etc. It is also opportune to fast track a number of current transport-related projects and we are pleased that the Government has highlighted increased spending on infrastructure as a key focus in MYEFO.

Finally, as a supportive measure, the Government should also consider committing to the significant development of regional centres in each of the States, linked to an appropriate infrastructure program, with the aim of reducing congestion to ease the burden on Australia’s cities, coupled with encouraging investment and job creation.

In addition to Government spending measures, we have also outlined a number of specific tax measures that could be used to assist in encouraging investment in energy and water infrastructure (both debt and equity funding) so that private investment in such assets may become feasible (see our detailed comments at Section D below).

## Tax law amendments

Consistent with our comments above, we believe that, outside of specific Government spending programs, a number of coherent tax policies could be announced in the budget that would help support the programs outlined in Sections C1 and C2 above.

Our recommendations with respect to tax reductions and tax concessions are in line with the Government’s stated policy of maintaining a sustainable tax burden, consistent with the economic growth objective, by virtue of maintaining the tax-to-GDP ratio at or below 23.9% of GDP.

# Tax law proposals

## Infrastructure bond concessions

We would encourage the Government to consider providing incentives to allow for the investment in infrastructure assets in the short-to-medium term, particularly in the energy, water and transport sector. We recommend consideration be given to providing certain tax concessions to encourage investment in those critical areas.

This recommendation would be targeted at providing domestic tax concessions only, rather than concessions to foreign investors. This would potentially encourage significant investment by domestic superannuation funds into infrastructure projects (being a significant source of potential funding) and may provide alternative investment and return options to domestic superannuation funds as compared to franked dividends. It would also likely encourage investment by high wealth individuals into a new asset class.

We have outlined three potential tax incentives below that could be provided to encourage infrastructure projects in Australia. We believe that these policies would help to encourage domestic private investment in desired infrastructure projects and would also assist in stimulating economic activity over the medium-to-long term.

Infrastructure bonds

The first could consist of providing concessional taxation treatment for interest derived on debt interests used to finance approved infrastructure projects (“**Infrastructure Bonds**”) that meet certain criteria (e.g. treating interest as being exempt income). These could consist of long-term debentures (e.g. 5 to 10 years) that provide a tax concession in relation to the derivation of interest from holding such bonds. In line with monitoring the budgetary cost, the Government could cap the annual tax concession on interest income derived for each individual investor (or each individual member of a superannuation fund) in a similar manner to the Early Stage Investment Company (“**ESIC**”) provisions contained in Division 360 of the *Income Tax Assessment Act 1997* (“**ITAA 1997**”).

There would also be a number of provisions that could be used for identifying qualifying infrastructure projects. For example, former Division 16L of the *Income Tax Assessment Act 1936* (“**ITAA 1936**”) contained rules on identifying infrastructure and the kinds of infrastructure facilities (such as land transport or electricity generation). Furthermore, the concept of a “designated infrastructure project” could be borrowed from Division 415 of the ITAA 1997.

MIT concessions to resident investors

The second could consist of providing concessional tax treatment for returns paid by a managed investment trust (“**MIT**”) to Australian resident investors, where the fund invests in certain infrastructure assets.

There are a number of examples of this type of concession targeting a particular asset class through a MIT. For example, MITs that invest in clean buildings provide non-resident investors with a reduced withholding tax.[[2]](#footnote-2) There are also concessions provided to investors in affordable housing projects. This measure could help to promote domestically funded infrastructure projects.

Capital allowance concessions

Finally, a tax concession could consist of providing concessional depreciation rates for certain infrastructure assets, where they are treated as depreciating assets rather than capital works. This could result in a depreciation rate increase from a 2.5% on a straight-line basis (i.e. over 40 years) to an accelerated statutory effective life.

A specific infrastructure capital allowance deduction could be integrated into the existing Division 415 of the ITAA 1997 which deals with designated infrastructure projects and provides for special treatment in relation to tax losses and bad debts.

## Introducing a new capital allowance for certain industries

To reinvigorate and encourage investment in certain specific, strategic, key industries in Australia, we recommend the Government consider a next level asset write off concession that is linked to capital investment.

Attracting investment in capital intensive industries is often difficult, due to the significant cost of upfront investment. We believe that there is an opportunity to address this by providing certain start-up concessions targeted at middle market taxpayers operating in certain industries.

We believe that key industries for Australia, that could fall into this category, include the Australian agricultural industry; import replacement industries; education; and the construction industry.

There are numerous ways in which this policy could be implemented:

Certain asset classes could be given a statutory effective life in the capital allowance provisions.

Alternatively, such a capital allowance provision could be labelled as “capital investment” rules and could be limited to those taxpayers that are private companies only that satisfy the lower corporate tax rate threshold (i.e. with less than $50 million turnover on an aggregated basis). The rules could be limited to certain assets (capital intensive assets), with qualifying expenditure on such assets capped at up to $2 million (total investment cost). The write off concession could be spread over a short-term period (e.g. a 3-year period).

Encouraging investment in these industries, through tax concessions on capital intensive assets, will help to promote and stimulate new business opportunities for SMEs.

## Access to foreign capital

The Government can help to stimulate investment and job growth in the middle market by improving access to foreign capital for SME borrowers who often face difficulty in obtaining finance to expand their business operations. This can be achieved by providing concessions relating to interest withholding tax for loans to such businesses and would complement the Government’s Australian Business Growth Fund and Australian Business Securitisation Fund which seek to fill gaps in the financing of such entities.

In the absence of any published data on non-resident withholding taxes it is not possible to determine their significance as a source of revenue for the Government.[[3]](#footnote-3) However, it is well known that, while interest withholding tax is a tax on the non-resident lender, in many cases that tax is passed on as a cost to the borrower.

The ATO’s most recent statistics for companies[[4]](#footnote-4) reveal that 4,958 companies reported total interest payments overseas of $39.3 billion; an average of $7.9 million per company. Assuming the total amount were subject to interest withholding tax and that the cost of that tax was borne by the borrower, the average additional after-tax[[5]](#footnote-5) cost to those business would be $553,000.

We would recommend that the Government consider providing an exemption to interest withholding tax for foreign lenders to SME borrowers conducting business activities (e.g. loans to those entities with an aggregated turnover of less than $50 million that would qualify as base rate entities within the meaning of section 23AA of the *Income Tax Rates Act 1986*).

## Education

The recent changes to the taxation of MITs and certain stapled structures[[6]](#footnote-6) involved various debates about the treatment of property held by MITs used to provide student accommodation, with concessionary withholding tax rates for income from such assets ultimately removed from the final version of the legislation passed by both Houses.

Paragraph 1.11 of the Supplementary Explanatory Memorandum to the amending legislation explains that the rules applying to such property will be the same as any other kind (i.e. rental income will be non-concessional MIT income if the premises are residential premises that are not commercial residential premises). Accordingly, the better view is that most student accommodation will not likely qualify for MIT concessional withholding tax rates.

To support Australia’s education sector and to encourage investment in providing education facilities, both for foreign and domestic students, we believe the Government should reconsider amending the non-concessional MIT income rules to include specific rules for the treatment of residential premises mainly used to provide student accommodation. We believe that this would encourage build for rent facilities for student accommodation and would encourage further jobs and investment in our education sector.

## Commercialisation phase of innovation entities

At present, the tax system provides concessions for pre-investment in innovation (i.e. the Research & Development Tax Incentive) and supports innovation during the early stages of a start-up entity’s life cycle (e.g. through incentives such as those relating to ESICs and Early Stage Venture Capital Limited Partnerships (ESVCLPs)).

However, there are little or no concessions available for the post-innovation stage of a company’s life cycle, which can result in innovating ideas created in Australia being taken offshore to be commercialised. The existing regimes may not provide the relevant incentives for successful start-ups to remain in Australia to grow their thriving businesses. This means fewer jobs for Australia.

In order to address this, the Government should consider introducing measures that complement our existing regime, which support start-up businesses during the early stages of the commercialisation process to keep innovation onshore.

There would be many policies that could be implemented during the commercialisation phase. For example, a reduced corporate tax rate during the initial period of exploitation (e.g. the first four taxable years post the entity qualifying as an ESIC). This rate could be lower than the current base rate entity rate, which would likely apply to ESICs, (e.g. a 50% tax rate discount to allow such entities to reinvest more of their earnings into working capital to fund growth and job creation).

By utilising the definition of an ESIC, we believe that this would further encourage early stage entities and innovation in Australia. Furthermore, providing a tax rate discount for four years after the entity becomes taxable (i.e. after all tax losses are utilised) would help to encourage investment of the after taxed profits in the business and would discourage the payment of dividends to the owners.

We believe that this is one significant area that is currently missing from our “innovation” package and is something that should be seriously considered by the Government for the 2020-21 budget.

## Automatic tax returns for salary and wage earners

The ATO has estimated the net tax gap for individuals not in business to be 6.4% or $8.4 billion for the 2015-16 financial year. For the purposes of this estimate, there were around 10.5 million individuals lodging tax returns who were not in business in 2015–16. Most of these taxpayers used an intermediary to help prepare their tax return, with around 67% lodging tax returns through a tax agent in 2015–16.

The ATO’s analysis indicates that work-related deductions are the main contributor to the net tax gap, making up 48% or $4 billion. The ATO indicates that the two most common contributing factors are deductions being claimed where there is no connection to income earned or no substantiation offered to support the deduction. These factors were evident in several cases decided in the last twelve months.

While there will obviously be an element of deliberate evasion, the complexity of the rules relating to work-related deductions must bear some of the responsibility for the gap. For example, recently released draft taxation rulings TR 2019/D4 and TR 2019/D7 highlight the extensive range of issues that need to be considered by employees who should, as a general rule of thumb, have less sophisticated tax affairs.

Far too much time and cost are wasted in the area of the deductibility of work-related expenses including navigating the tax legislation and administrative guidance, the creation of such guidance and ATO administration, keeping and maintaining records and dispute resolution with the ATO. Despite all of this, this area is still a major source of non-compliance. Taxpayers and tax agents may also rely on non-detection and take a very liberal view about deductibility of certain items that individually may be small but collectively add up to a significant cost to revenue. This undermines the integrity of the tax system as a whole which relies primarily on self-assessment and voluntary compliance to function effectively.

In light of the above, we recommend that consideration be given to reforming the tax obligations for individuals not in business so that individuals whose income is predominantly from employment will not need to consider the deductibility of work-related expenses and no longer need to prepare income tax returns.

Using the system currently operating in New Zealand as a model, a reformed regime might involve:

Deeming an individual not in business to have lodged an income tax return based on information set out in a pre-fill report provided by the ATO unless the individual notifies the ATO of amendments required to correct or complete the information contained in the report.

Deeming an assessment to have been made where the individual confirms that no amendments are required to the information contained in the report.

Further consideration would need to be given to individuals who, while not in business, might need to be excluded from such a regime for other reasons. Such reasons might include individuals who receive interest or dividend income above a threshold amount (see our comments regarding investment income below), participants in employee share schemes and individuals with a HELP debt.

An essential element for the success of such a regime would be the denial of deductions for work-related expenses. Based on the latest ATO Statistics, the average work-related expenses for individuals who return income from salary and wages was $2,487. At the average marginal rates for those individuals, the average tax saving was approximately $930 per person.

The “compensation” for denying such deductions could be a further change in the personal marginal tax rates over and above those already announced by the Government or an increase to the Low and Middle Income Tax Offset to ensure that the measure is appropriately targeted.

Such a measure could still allow such costs to reduce fringe benefits tax (“**FBT**”) exposure for employers where the costs would be otherwise deductible to the employees under existing principles. This would limit any tax benefit for work-related expenses to those provided by employers (e.g. work-related travel) and reduce the number of taxpayers who have to consider and deal with such items.

An exemption could also be provided to those covered by the regime for an amount of interest or dividend income (similar to the NZ regime). Alternatively, a special tax rate could be applied to interest income to encourage savings. This alternative could be consistent with the May 2010 Australia’s Future Tax System Review Final Report which suggested a 40% discount on household savings income (i.e. a top marginal tax rate of 28.2%). However, a resident withholding tax rate (of say 20%) could apply for those that are otherwise within the regime and for income exceeding the exemption limit.

While these policies would require further consideration, we note the following:

The Taxation Statistics 2016-17 indicate that the average amount of interest returned by individuals was $927.

New Zealand provides such a concession for NZ$200 of investment income not otherwise subject to resident withholding tax.

## Division 7A and the proposed start date

The Government is aware that significant concern was created in the middle market through the release of the Treasury Consultation Paper on “Targeted amendments to the Division 7A integrity rules) in October 2018 on the future of the proposed Division 7A[[7]](#footnote-7) amendments. In particular, the Treasury Paper proposed to change the direction of the reform to Division 7A in a manner that would penalise business taxpayers, while continuing to propose a start date of 1 July 2019.

The Government listened to feedback from stakeholders and, as part of its 2019-20 Budget, announced that any changes to Division 7A would be delayed from
1 July 2019 to 1 July 2020. The Budget Papers stated that this delay would provide the Government *“additional time to further consult with stakeholders on these issues and to refine the … implementation approach, including to ensure appropriate transitional arrangements so taxpayers are not unfairly prejudiced”.*

With less than six months to the revised start date and no further consultation having occurred or guidance made available, affected taxpayers are again in the unenviable position of trying to operate in a vacuum.

We strongly urge the Government to take the opportunity to again defer the start date of any changes to at least 1 July 2021. Due to the significant changes proposed and the impact that the changes will have on middle market financing, we believe that a minimum of at least 12 months is required for taxpayers to prepare for the changes. We would therefore strongly recommend that a permanent deferral be announced and that the mandatory start date be no sooner than 12 months after the provisions receive the Royal Assent.

## Division 7A and broader policy review

As outlined in our Tax White Paper submission in 2015, significant compliance issues occur due to differences in the tax treatment of entity structures and income types, in particular, for trusts and companies.

Business in the middle market in most cases simply wish to be able to accumulate and reinvest business income at corporate rates but also be able to access the 50% CGT discount should they eventually sell their business. This leads to the use of complex structures combining companies (which provide access to a lower tax rate for reinvested income) and trusts (which allow for the CGT discount to flow through to individual beneficiaries) and constant monitoring of intra-group loans to ensure compliance with Division 7A and other issues such as ensuring interest deductibility.

Holistic reforms are warranted to significantly reduce the complexity of the tax system for SMEs, the costs of compliance and the prevalence of tax-driven structures.

We would therefore encourage the Government to reconsider differences between trusts and companies with a view to removing tax as a key reason why one structure is preferred over another. That is:

Examining whether trusts should be able to accumulate active business income without penalty rates of tax applying. Allowing this would remove the need for trusts to distribute to corporate beneficiaries and enable a business trust to reinvest after-tax profits.

Examining whether certain passive income derived by companies and trusts could be subject to the same taxation treatment. For example, by allowing capital gains, interest and dividend income to flow through a company and taxed at individual marginal tax rates.

Further examining the Board of Taxation’s previous recommendation that would allow a trust to “tick the box”. This recommendation would result in the trust forgoing the CGT discount, but alternatively being able to borrow from corporate entities without needing to comply with Division 7A. In effect, this recommendation would treat trusts in a similar manner to companies.

We would urge the Government to defer the start of any changes to Division 7A so that appropriate structural policy changes can be made. While Division 7A requires amendment, we believe that the system is capable of continuing to apply with integrity for the foreseeable future. Accordingly, our recommendation would be to hold off on Division 7A changes and explore systemic solutions to trust taxation together with Division 7A.

## Further consideration of the dual income tax system

We have previously advocated for the Government to consider aspects of a dual income tax system to remove tax biases caused by the choice of structure adopted by taxpayers. We note that our proposals have recently been the subject of an academic paper[[8]](#footnote-8), which agrees that tax neutrality could potentially be achieved through a greater alignment of the individual marginal tax rates with the tax rates applying to businesses.

We would strongly recommend that the Government consider these proposals, which encompass many of the ideas outlined in Section D8. That is, consideration of the overall taxation of investment income (i.e. capital gains and interest income, by adjusting the tax applicable on these items at a discount of 40% to the ordinary tax rate) coupled with the taxation of business income at a single corporate tax rate and the removal of complex tax concessions.

We believe that these proposals could have a significant effect of simplifying the income tax system for SMEs.

## Small business concessions

Consistent with our views contained in Section D9, we support simplification of the various small business concessions in line with the Board of Taxation’s Final Report to the Treasurer following its Review of Small Business Tax Concessions.[[9]](#footnote-9)

The Report recommended that the three main concessions could be collapsed into one CGT exemption subject to a cap and the definition of a small business CGT entity can be aligned with ordinary small business entities (i.e. those with an aggregated turnover of no more than $10m).

We believe that this could be simplified further by providing the one CGT exemption for the sale of assets, shares or units which would allow for contributions to superannuation to be made outside of the regular caps (up to the pension cap, presently $1.6 million). This would enable middle market entrepreneurs to be able to fund their retirement in the superannuation environment using the proceeds of sale of their business where they may have been unable to do so during the operation phase of their business.

## Fixing the uniform capital allowance regime for intangible assets

The recent High Court decision in *Commissioner of Taxation vs Sharpcan Pty Ltd* [2019] HCA 36 (“***Sharpcan***”) has highlighted significant deficiencies in the capital allowance provisions in Division 40 of the ITAA 1997 for business taxpayers*.*

The Court concluded that the costs of acquiring statutory licences from the Victorian government incurred by a hotel business to operate gaming machines at its premises for a period of 10 years were not general deductions for the reason that they were outgoings of capital. The taxpayer was also unsuccessful in claiming a tax deduction over five years under section 40-880 as “blackhole expenditure”. For tax purposes, the costs were simply allocated to a CGT asset being the relevant statutory licences which would ultimately end and only provide the taxpayer with a capital loss on expiry.

This case highlights that many such cases will result in an “all or nothing” outcome whereby such costs will be immediately deductible in full or never deductible. Such binary outcomes are inconsistent with what may otherwise appear to be the fair and logical treatment of such capital expenditure relating to assets with a limited effective life which will ultimately decline in value to nil (e.g. a tax deduction spread over the life of the relevant licence, being 10 years in the case of *Sharpcan*). This may have the effect of distorting pricing and stifling investment. For example, taxpayers may decrease their bids for such licences to take into account the net present value of tax savings forgone if the cost is not deductible for tax. Effectively, this would simply protect the revenue base of the Commonwealth government at the expense of a state or local government (or a different department of the Commonwealth government).

It should not be the case that such arrangements result in extreme outcomes of full up-front deductibility or capital loss on expiry. Costs of this nature incurred by business taxpayers should at the very least be deductible over the life of the wasting asset if capital in nature.

Currently, there are only eight categories of intangible assets which are considered depreciating assets for tax purposes.[[10]](#footnote-10) We believe that the uniform capital allowance rules can be extended to cover or statutory or other licences that are required by business taxpayers. In such cases, a deduction should be claimable for capital expenditure relating to such licences over their ordinary life. Additionally, the Government could consider reforming the “goodwill” exception in section 40-880,[[11]](#footnote-11) the extremely limited nature of which was highlighted in *Sharpcan*, so that such costs can be deductible over five years under the “blackhole expenditure” provisions.

Any reforms could also extend to capital costs incurred by business taxpayers in securing government contracts with limited effective lives. Most of the recent significant tax cases on the issue of whether expenditure is capital in nature have related to costs paid to Government entities for certain projects or under statutory licensing regimes.[[12]](#footnote-12)

Reforms in this area would also go a long way to removing the regulatory burden for businesses as the issue of whether expenditure is incurred on revenue or capital account is one of the most complex and uncertain areas in the tax law where items do not clearly fall into one category or the other.

## Superannuation incentives

Numerous changes have been made to the superannuation system over recent years which have had the effect of significantly reducing the attractiveness of using the superannuation system to fund retirement.

We highlight our belief that the changes have gone too far with no incentives left in the system to attract taxpayers to contribute to super above the compulsory contribution rate. Some of these policies include the reduced deductible contribution cap of $25,000 per year, the $1.6 million pension cap, and the 30% contribution tax rate applicable to individuals deriving more than $250,000 of taxable income per annum.

We are concerned that the outcome of these significant policy changes, which collectively eliminate most of the voluntary savings incentives from the super system, will be to discourage retirement savings from those taxpayers with the capacity to save. Over time, we believe that this will create a new class of taxpayer with insufficient savings to self-fund their retirement who will qualify for, and need to rely on, the age pension. Alternatively, individuals may be forced to fund their retirement through a trust or corporate vehicle that is not subject to the same level of regulation as the superannuation industry which may lead to riskier investments including those funded by significant levels of debt.

We would strongly encourage the Government to reintroduce voluntary savings incentives back into the system as well as encouraging middle income earners to use those incentives to self-fund their retirement.

Policies could include increasing the deductible contribution cap from $25,000 to $50,000; pooling thresholds and limits within families (e.g. allowing couples twice the pension cap that can be used between the couple in any way they choose, twice the deductible contribution limit that again can be used between a couple any way they choose; increasing both the total superannuation balance threshold where non-concessional contributions are prohibited and the transfer balance cap amounts from $1.6 million to double those amounts; increasing the threshold where the 30% contributions tax rate applies to at least $300,000 and indexing that threshold to wages growth). We acknowledge that there would be strong community support for limiting the above-mentioned concessions such that they do not substantially benefit high wealth individuals.

We are also concerned with the significant complexity that now exists in the system with the number of different rates and thresholds that now exist and particularly with the introduction of limits on non-concessional contributions and pensions.

We would support a wholistic review of the superannuation system to better align the systems objectives with the goal of accumulating wealth for retirement, reintroducing voluntary saving incentives and reducing system complexity.

## Environmental policies

Environmental issues and Governmental policies on such issues are currently of significant importance and interest to the younger electorate. We believe that the Government could seek to introduce a number of simple tax-related measures that would encourage investment by business taxpayers in environment related businesses that would help to proactively address issues of climate change.

Small and simple changes would go a long way in making it feasible for businesses to be able to run and operate environmentally friendly businesses. These proposals would constitute minor reforms. We highlight three examples of these minor reforms that we believe would have a negligible cost to revenue but would go a long way in promoting reductions in emissions.

Carbon sink forest amendments in Subdivision 40-J

Simple amendments can be made to the carbon sink forest regime contained in Subdivision 40-J of the ITAA 1997 so that a MIT is able to invest indirectly in a company that conducts such a business. The amendments would not allow the MIT to conduct the business, but instead would allow the MIT to own shares in a company that whether that shareholding is a controlling or non-controlling interest. This small change would enable carbon sink forests to be able to access capital and thus for businesses to invest in such projects.

We believe that the current exclusion contained in sections 40-1005 and 40-1010 is intended to stop “timber” like investment schemes in carbon sink forests, whereby deductions could potentially flow to investors in such products. Accordingly, our proposal would retain integrity on this issue by limiting the exception to “an investment in shares”.[[13]](#footnote-13)

We note the current exclusion is an anomaly contained in Subdivision 40-J that is stifling investment in this area. As this change would simply promote access to finance and investment in this new business activity, we do not see this as being a cost to revenue (as currently these business opportunities would not be entered into).

Carbon sink forests and primary production business

While we believe that the operation of a carbon sink forest is currently included in the definition of a primary production business (i.e. as this involves “cultivating and propagating plants”) the ATO have taken a strict view that such activities are not primary production.[[14]](#footnote-14), [[15]](#footnote-15)

As the ATO have publicly stated this view, a number of inadvertent tax consequences can occur due to this conclusion. For example, where a primary production business incurs fencing costs, these can be deducted in the year incurred under Subdivision 40-H of the ITAA 1997. However, where a carbon sink forest is not treated as a primary production business, such costs can be treated as capital works that can only be depreciated under Division 43 at 2.5% per annum.

This outcome seems inequitable and at odds with Government policy seeking to encourage the supply of Australian Carbon Credit Units. We note that “tree felling” is also covered by the definition of “primary production”. Whilst both activities involve trees and are farming orientated, the activity that has a greater detrimental impact on the environment (i.e. felling) appears to be given more favourable tax treatment.

We would strongly encourage the Government to consider a simple change to the definition of primary production to explicitly include the operation of a carbon sink forest. Such change would provide certainty on this issue and would also encourage further investment in carbon sink forests.

Fringe benefits tax and employee contributions to emissions

Currently car-related running costs for FBT purposes (in determining the employee’s “recipient’s contribution”) include petrol, but do not include the cost of acquiring carbon offsets to offset carbon emissions generated by use of the car.

A simple change to the *Fringe Benefits Tax Assessment Act 1986* (“**FBTAA**”) could allow such payments to be included as a recipient’s contributions to reduce the taxable value of a car fringe benefit. This would encourage and promote an active trading market for carbon credits, especially in the area of car fleets.

We note that employees can currently reduce their emissions without incurring FBT through a gift deductible donation to a charity (such as GreenFleet). Such donations similarly occur to offset an employee’s carbon footprint. Any donations made by employees, via their salary packaging arrangements, to entities with DGR status to offset vehicle emissions does not raise any FBT revenue for the Government (since they qualify for the exemption contained in subsection 148(2A) of the FBTAA). Accordingly, expanding the range of service providers will not give rise to a revenue cost, but instead will simply help to promote more entities involved in carbon related business.

We believe that this is a minor policy change that would have no revenue cost and a huge potential upside for creating new and different business opportunities.

## Addressing the cost of domestic employment

Over time there has been a significant and continual trend of replacing domestic employment with foreign outsourced or offshored employment. We believe that the Government has a great opportunity to seek to address this and to implement policies that could help to bring jobs back to Australia.

For example, the Government could announce a substantive reduction or the elimination of payroll tax (being a regressive tax), which could be achieved through a Government led COAG agreement with the States. In our view, this would support greater business activity and would help to provide an incentive to increase domestic employment. The Government could also look at measures that encourage local business to use local employment as compared to offshoring, which could range from certain incentives (e.g. tax reductions) to discouraging outsourcing (e.g. withholding on offshore payments).

## Hybrid mismatch rules and exclusions for SMEs and individuals

We recommend that the Government consider providing an exclusion for individuals from the recently introduced hybrid mismatch rules contained in Division 832 of the ITAA 1997.

These measures are extremely complex and predominantly targeted to sophisticated arrangements entered into by multinational groups seeking to exploit the differences in tax regimes between two countries. The ATO states on its website[[16]](#footnote-16) that:

The hybrid mismatch rules which received Royal Assent on 24 August 2018, are designed to prevent multinational companies from gaining an unfair competitive advantage by avoiding income tax or obtaining double tax benefits through hybrid mismatch arrangements.

However, the reality is that the measures which have no *de minimis* may apply to individuals or SMEs who derive minor amounts of foreign source income. In particular, the deducting hybrid provisions apply where an individual owns foreign property or derives employment income during an overseas secondment. In our experience, applying the measures to individuals is often far more complex than other entities given that one has to consider the rate of tax payable an entity when determining the extent of any deduction being denied. For individuals who do not pay tax at a flat rate, this quickly becomes an extremely complex exercise requiring iterative calculations to be performed.

Consistent with the recommendation of introducing automatic tax returns for most individuals and removing the compliance burden affected the middle market, we believe that individual should be exempt from measures of such extreme complexity. The reality is that there would otherwise be a significant amount of non-compliance due to the lack of awareness or understanding of the hybrid mismatch rules and their potential impact on individuals.

Tax integrity measures that are very complex commonly provide de minimis exemptions to reduce the compliance burden for less sophisticated taxpayers.[[17]](#footnote-17) If the Government is concerned that certain high wealth individuals may be taking advantage of hybrid mismatches then the exemption could be set with certain limitations.

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We would be more than happy to discuss any aspect of this submission with you and provide you further thoughts on any of our recommendations. Please contact either Leo Gouzenfiter on (03) 8612 9674 or me on (03) 8610 5170.

Yours sincerely

A M KOKKINOS
Executive Director

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1. ATO statistics 2016-17. [↑](#footnote-ref-1)
2. Although the CGT concession applies to non-residents, we are only highlighting this an example of a concession provided to a certain type of asset through an MIT. [↑](#footnote-ref-2)
3. We note Table D1 of MYEFO forecasts exemptions from interest withholding tax on certain securities as a cost to revenue of $2.36 billion a year. [↑](#footnote-ref-3)
4. ATO Taxation Statistics 2016-17: Companies: Table 1. [↑](#footnote-ref-4)
5. Assuming an applicable corporate tax rate of 30%. [↑](#footnote-ref-5)
6. As contained in the *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Act 2019* [↑](#footnote-ref-6)
7. Division 7A of Part III of the ITAA 1936. [↑](#footnote-ref-7)
8. Barbara Trad and Brett Freudenberg, ‘A Dual Income Tax System for Australian Small Business: Achieving Greater Tax Neutrality?’ (2018) 20(1) *Journal of Australian Taxation,* Article 3. [↑](#footnote-ref-8)
9. The Board of Taxation, Review of Small Business Tax Concessions: A Report to the Treasurer (2019). [↑](#footnote-ref-9)
10. Subsection 40-30(2) of the *Income Tax Assessment Act 1997*. [↑](#footnote-ref-10)
11. Subsection 40-880(6) of the *Income Tax Assessment Act 1997*. [↑](#footnote-ref-11)
12. *Sharpcan*; *Ausnet Transmission Group Pty Ltd v FCT* [2015] HCA 25; *FCT v Citylink Melbourne Ltd* [2006] HCA 35; *FCT v Star City Pty Ltd* [2009] FCAFC 19; *Jupiters Ltd v DFCT* [2002] FCAFC 206. [↑](#footnote-ref-12)
13. Tax deductions therefore cannot flow through the trust. Furthermore, as Division 6C would tax the MIT as a company, tax benefits would not flow through to investors. [↑](#footnote-ref-13)
14. <https://www.ato.gov.au/Forms/Information-for-primary-producers-2018/?page=5> [↑](#footnote-ref-14)
15. <https://www.ato.gov.au/rba/content/?ffi=/static/rba/content/1013032138063.htm> [↑](#footnote-ref-15)
16. <https://www.ato.gov.au/General/New-legislation/In-detail/Other-topics/International/Implementation-of-the-OECD-hybrid-mismatch-rules/> [↑](#footnote-ref-16)
17. For example, see Subdivisions 165-CC and 165-CD relating to unrealised company losses and Part 3-95 relating to the value shifting rules. [↑](#footnote-ref-17)