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Pre-budget submission 2017-18

JANUARY 2017

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THE MARK OF EXPERTISE

19 January 2017

Mr Matthew Flavel
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Budget Policy Division
The Treasury
Langton Crescent
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By email: matthew.flavel@treasury.gov.au

Dear Mr Flavel,

2017-18 Federal Budget Submission

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the 2017-18 Federal Budget.

We note from the media release issued by the Minister for Small Business, the Hon Michael McCormack MP, inviting submissions for the 2017-18 Federal Budget[1], that the Government is committed to economic growth, job creation and working towards returning the Budget to balance.

With these elements in mind, The Tax Institute submits that the 2017-18 Budget should address complexity in the tax system to ensure Australia has a tax system that can simply, fairly and efficiently support the Budget objectives.

Priority Matters

1. General

The Tax Institute believes that the right tax system for Australia's future will stimulate productivity and economic growth. To achieve this, complexity and impediments to growth need to be removed and a simpler, fairer and more efficient tax system needs to be designed. The current tax system is very complex with a variety of taxes applying

[1] Media release 9 December 2016: http://mfm.ministers.treasury.gov.au/media-release/027-2016/

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to a range of different bases. Taking a piecemeal approach to reviewing small segments of the system to address the complexities in those areas only contributes on a minor scale to remedying the system. As such, a holistic approach to addressing complexity in the tax system is required.

The Tax Institute remains of the view that a comprehensive overhaul of Australia's tax system along the lines of the Government's 2015 Tax White Paper process is required to deliver fundamental tax reform. In the absence of such a process, we consider that the Government should utilise the opportunity that the annual Federal Budget provides to address the issue of complexity.

The Tax Institute endorses the pursuit of a tax system with simpler and fairer taxes. We endorse both simplicity and fairness as objectives, though in practice a variety of ideas about 'fairness' exist, not all of which are easy to reconcile with simplicity. The Tax Institute also supports in principle the aspiration for 'lower' taxes but recognises the difficulty in achieving this in the short to medium term given the current budget deficit.

If all levels of government are to continue to spend at anywhere near the levels to which we have become accustomed, the tax system will have to deliver a large, reliable and sustainable flow of revenue for the foreseeable future, which will assist with returning the Budget to balance.

Please refer to Appendix B for some areas of the tax law that need to be reviewed due to complexity or inequity. We would be pleased to work closely with Treasury to develop proposals to address these matters or any other matters when expert input would be of assistance to Treasury.

2. Reducing complexity – the key to better tax law for the future

a) Overview

Australia has a very complex tax system. The causes and drivers of complexity in the system are numerous. They include unclear policy intent including uncertainty about interactions between different parts of the law, exceptions (in the form of exemptions and concessions) from the main rules, and the inclusion of integrity rules together with uncertainty around the application of the general anti-avoidance rules to safeguard policy objectives.

Some of this complexity arises during late stages in the law design consultation process, such as at the time the exposure draft legislation is prepared, where Treasury is already advanced in its thinking on an issue and is required to revisit work already undertaken to address issues raised in consultation. This leaves Treasury in the position of having to re-write parts of the exposure draft or include additional provisions to address issues raised by stakeholders. Often, there are time pressures so 'quick

fixes' are made to the exposure draft (if at all) and may not be properly thought through[2].

A clear lack of resourcing in Treasury and the Office of Parliamentary Counsel to handle the raft of tax law changes is also a significant factor, causing delays, in some cases up to years, before tax law changes are made following the announcement of new tax policy.

The level of guidance the ATO is required to issue after a law change is a strong indication of the complexity of the law. The ATO's willingness to provide guidance is welcome, but the abundance of guidance, including in both binding and non-binding forms, illustrates the fact that Australian tax law is not easily understood in the absence of guidance. Other measures of complexity include the number of exemptions or exceptions to the core rules and the extent of amendments required post enactment. While we commend the Government for committing to a Regulatory Reform Agenda[3], continuous reviews of parts of the tax law and, in our view, an absence of Government action on the recommendations from those reviews, contribute to uncertainty as well as having announced un-enacted measures remaining outstanding for long periods of time.

We acknowledge the significant amount of work that the current Government has done to clean up an extensive list of un-enacted measures, including to address implementation of measures from the 2016-17 Budget, and strongly advocate that the Government does not allow such a position to arise again.

The Tax Institute recommends that complexity in the Australian tax system be reduced by implementation of improved processes around policy development and law design, including the development of an agreed procedure for tax law consultation as discussed below.

b) System-wide approaches to reduce complexity

The Tax Institute is of the view that complexity in the Australian tax system can be reduced by implementation of better processes around policy development and law design. We recommend the Government consider implementing the processes (or similar) discussed below.

[2] At the time of writing, the process for adopting the OECD proposals for Mandatory Disclosure is currently underway – in an effort to get the law drafted, minimal information is intended to be included in the draft law with a heavy reliance on explanatory material and guidance from the ATO to explain the application of the law. Also, a 24 hour timeframe was given to review a revised exposure draft pertaining to the measure to apply GST to low value goods imported by consumers, a measure which has extensive administrative implications.

[3] Budget Paper No. 2 2016-17 Part 2: Expense Measures, 'Regulatory Reform Agenda – implementation'

i) Improving policy development and law design

Many of the issues that give rise to complexity in the tax system could be resolved at the early stages of policy development and law design. We recommend the development of a framework in which the relevant parties are involved as part of the policy development stage and that as many issues as possible are considered prior to any exposure draft law being prepared.

The 'relevant parties' include the policy arm of Treasury, the administrator (ATO), the drafters, and relevant tax practitioner, business and community representatives. Each of these stakeholders has a valuable contribution to make at the embryonic stage of policy development.

Whilst acknowledging that steps have been taken over the last few years to improve consultation in the development of tax policy and the design of the law, including the development of contemporaneous guidance by the ATO, The Tax Institute is of the view that more needs to be done to reduce complexity in the tax system. Complexity will be reduced through having better resourced teams with relevant skills and knowledge and sufficient capacity to properly focus on issues during the policy development and law design stage. These issues include interactions between different parts of the law, the need for concessions and exemptions to the main rules and the need for integrity rules.

A change to the policy development and law design process of this nature would reduce complexity and improve the quality of new law as a lot of the issues that traditionally come up at later stages of consultation would be addressed a lot earlier within the context of the broader scheme of the law change.

ii) Improving the consultation process

Further to the policy development and law design recommendations, the Government should develop an agreed procedure around consultation with all relevant stakeholders on matters of significant tax policy change to be followed, in all cases, as rigorously as possible.

A major contributing factor to complexity in Australia's tax system is the recent history of developing tax policy 'on the run' where an announcement is made about a new tax policy, with a relatively short timeframe to enact it[4]. Tax law measures are also announced to address specific issues only[5] and are not necessarily thoroughly considered, particularly in terms of the context of the whole system. There is a sense that law change is constant, and it is difficult to keep up with all potential changes.

[4] For example, the Superannuation Reform package from the 2016-17 Budget where very little time was made available for stakeholders to comment on the exposure drafts.

[5] For example, the proposal to develop a 'diverted profits tax' in April 2015 which has taken up to December 2016 before the exposure draft has become available. At the time of writing, the revised exposure draft for this measure was subject to an expedited review.

Tax policy development in New Zealand could serve as a good model for Australia. Since the 1990s, New Zealand has operated a tax policy process called the 'generic tax policy process' that applies to tax law changes. This process sets a clear expectation around, and provides a sufficient amount of time for, thorough consultation. It ensures that well-considered tax legislation is introduced into the New Zealand parliament and that New Zealand tax policy is well-developed, and has involved the right stakeholders, prior to reaching the draft law stage.

The result is a positive and increased level of engagement in the policy process, and a greater level of understanding of tax policy intent. Retrospective law changes are also extremely rare, and this reduces uncertainty and complexity.

In its review of the tax consultation process[6], the Board of Taxation made a number of recommendations to improve Australia's tax consultation processes based on the New Zealand experience.

Subsequently, a further review was conducted by the Tax Design Review Panel. In its report[7], the Panel also recommended a number of changes to Australia's tax law design. Those changes were, in broad terms, consistent with the generic tax policy process advocated by the Board of Taxation, although not completely. This was noted by the Board of Taxation in its subsequent report in 2011.[8]

A number of changes have been implemented following the Tax Design Review Panel report which have improved the system (such as the publication of a forward tax policy programme, though this has since ceased). However, as the Board of Taxation noted in 2011, there is still an inconsistent process of consultation and a lack of quality in consultation,[9] a degree of lack of engagement from taxpayers, and there are still problems in the system. The Board of Taxation recommended a clear and consistent generic tax policy process be adopted and announced openly.

We recommend that the Government revisit the recommendations made by the Board of Taxation and the Tax Design Review Panel, and in particular draw on the New Zealand experience, to design a similar framework for Australia to apply when tax policy changes are being considered. Such a framework should include an agreed timeframe for consultation applied in *all* but extremely rare situations and set procedures for thorough development of tax policy. There should be a commitment to avoid retrospective law change. This framework should alleviate some of the issues

[6] Board of Taxation *Improving Australia's Tax Consultation System* Report, February 2007

[7] *Better Tax Design and Implementation: A Report To The Assistant Treasurer And Minister For Competition Policy And Consumer Affairs,* 30 April 2008

[8] Board of Taxation *Post-Implementation Review of the Tax Design Review Panel Recommendations* December 2011.

[9] For example recent complex legislative changes to the managed investment trust regime provided only *two weeks* to provide submissions. Sometimes only particular stakeholders are even involved in consultation, rather than the wider taxpayer community. Another recent example, while the proposed amendments were not significant in number, the Exposure Draft to the *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017* was released on 20 December 2016 with submissions due 13 January 2017 effectively ignoring the Christmas holiday leave period for most professionals.

that add complexity to tax law, such as making multiple amendments to new laws subsequent to their enactment to address unintended consequences that are not considered prior to enactment.

iii) Better articulation of the reasons for revenue law changes

The Government should articulate the reasons for revenue law changes to ensure all stakeholders understand why a certain change is proposed to be made. This will contribute to ensuring unnecessary changes are not made to the revenue law.

It is generally a true proposition that stakeholders are less resistant to change where clear and compelling reasons for that change are articulated. For example, the considerable hostility in the tax community towards the trust loss provisions[10] was caused in large part by the apparent policy inconsistency of introducing the measures to correct the alleged 'anomaly' of not having loss measures for trusts like those for companies, but denying most trusts the benefit of a 'same business test' apparently on the grounds of 'significant difference' between the tax position of trusts and companies.[11] More recently, the government appears to promote certain anti-avoidance measures by reference to the asserted desirability of conformity with OECD actions[12], but despite OECD criticism of countries taking unilateral action[13] the Government persists with the proposed introduction of the so-called 'diverted profits tax', which is not part of any OECD endorsed proposal. Mixed signals of this sort are detrimental to public confidence in the tax system.

iv) Regular technical changes

Introduction of a regular scheduled omnibus bill to address changes, including minor technical changes to tax law that inevitably arise, should also be put in place. This could address matters such as drafting errors, minor technical deficiencies that do not have policy implications and issues that have been identified on the Tax Issues Entries System. This would provide certainty that the minor (yet necessary) legislative fixes will be addressed within a certain timeframe.

In addition, omnibus bills would reduce the sheer number of bills that the Parliament would need to consider, and a standardised schedule and consultation process would encourage greater participation in commenting on tax law changes, and would enhance understanding of the policy intent of law changes. We also recommend that

[10] Schedule 2F, *Income Tax Assessment Act 1936* (Cth)
[11] Both rationales appear, at different places, in the November 1997 Senate Economics and Legislation Committee's report on the *Taxation Laws Amendment (Trust Losses and other Deductions) Bill*.
[12] See the Treasurer's media release of 6 October 2015 in relation to the OECD Report on Base Erosion and profit Shifting: http://sjm.ministers.treasury.gov.au/media-release/003-2015/
[13] OECD/G20 Base Erosion and Profit Shifting project explanatory statement 2015 final reports (2015) at paragraph 24.

the Treasury Tax Consultation Characterisation Matrix[14] be reconsidered as to its effectiveness in terms of the quality of tax policy consultation in Australia.

We note that issues will be drawn from the Board of Taxation's 'Sounding Board' to populate the Regulatory Reform Bill that we understand the Government intends to table regularly. This Bill could also include any minor legislative fixes that may be required.

c) Rewrite of tax law

Significant uncertainty and complexity in the tax law could be resolved with completion of the rewrite of the *Income Tax Assessment Act 1936* (Cth). Having two co-existing income tax assessment acts creates difficulty for taxpayers and advisers to navigate the tax law and an unnecessarily excessive amount of legislation to contend with. There is little value in a partly completed rewrite. We recommend dedicated resources be allocated to complete this project that is nearing 20 years in the making. It is very important that the rewrite process also includes, as a principle, plain English drafting and seeks to alleviate some of the complexity of the current drafting.

We also recommend that Schedule 1 of the *Taxation Administration Act 1953* (Cth) be written into the main body of this (or another appropriate) Act. It is difficult to understand why operative provisions are in a Schedule. This adds to confusion. Ordinarily, taxpayers look for the operative provisions in the main body of the legislation and as such, the operative provisions in Schedule 1 should be relocated to the main part of the Act.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

Matthew Pawson
President

[14] http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Economic-Roundup-Issue-2/Economic-Roundup/Tax-policy-formulation-in-Australia.

Appendix A

About The Tax Institute

Our members lead the way in tax.

The Tax Institute is Australia's leading professional association and educator in tax providing the best resources, professional development and networks. With over 12,000 members, our mission is to educate and build expertise in tax and to raise the status of the tax profession.

Our growing membership base includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate tax content.

We are committed to propelling members onto the global stage with over 7000 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. The Tax Institute has evolved and become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and the taxpayer today.

More than seven decades later, our values, friendships and the unselfish desire to learn from each other are central to our success. The Tax Institute is known for its 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.

Appendix B

Example areas of Complexity

1. Standard deduction for employee work-related expenses

The Tax Institute supports Recommendation 11 of the Henry Review[15] and recommends that, as a first step towards simplification, the Government should consider introducing a standard deduction for work-related expenses, while retaining the ability to claim actual expenses with full substantiation above a nominated threshold. A change in this area will be significant for individual taxpayers and is a positive step towards alleviating the compliance burden for many individual taxpayers. This would also help simplify tax matters for many individuals.

To assist with administration, the standard deduction could be factored into the 'Tax Tables' the ATO issues, which employers use to determine how much tax to withhold from salary and wages via the Pay As You Go Withholding system. Automatically factoring in the standard deduction to amounts of tax withheld from employees would help to alleviate the compliance burden for individuals.

The Tax Institute considers that, in the short term, the introduction of a standard deduction would make it much simpler for employees to comply with their individual tax obligations. Employees with expenses above the standard deduction threshold should also be provided with the option to claim their actual expenses properly substantiated should they wish. This is in line with the current trend towards simplifying compliance for individual taxpayers with initiatives such as 'MyTax'.

2. Fringe Benefits Tax System

Fringe Benefits Tax (**FBT**) is a very comprehensive and highly prescriptive tax. There has not been any substantive review of the FBT policy and law since it was enacted in 1986. Based on our members' experience, there is a significant amount of work required to administer a wide range of benefits where a majority of revenue comes from only a few benefits e.g. car fringe benefits.

There are two fundamental concerns with the operation of the current FBT system: the inequity caused by the application of tax at a rate equivalent to the highest marginal tax rate and the significant administration costs associated with the level of complexity inherent in the system. There are also a number of concessions that are made available under the FBT targeted at specific situations or specific taxpayers that may no longer be appropriate, for example exemptions for newspapers and periodicals used for work (section 58H of the *Fringe Benefits Tax Assessment Act 1986* (Cth)) and safety awards (section 58R).

[15] *Australia's Future Tax System – Report to the Treasurer* (Dec 2009)

a) Inequity of the applicable FBT rate

The inequity of the FBT rate can be illustrated by comparing the total cost of paying a cash bonus to the total cost of providing an equivalent non-cash benefit such as a gift card. For example, if an employee whose marginal tax rate is 39% (including Medicare levy) is paid an after-tax cash bonus of $5,000, the cost to the employer is $8,197 (being the gross pre-tax amount to achieve an after-tax cash amount to the employee of $5,000). However, if the employee is to be provided with a $5,000 gift card, the cost to the employer is $9,804 (being $5,000 cost of the gift card plus $4,804 FBT). The difference in cost of $1,607 in this example arises because the cash bonus is taxed at the employee's actual marginal tax rate of 39%, whereas the non-cash benefit is taxed (via FBT) at the top marginal rate of 49%.

b) Administrative costs of FBT

The complexity of the FBT rules is such that very few employers would be able to prepare an FBT return accurately without the assistance of a registered tax agent. The costs to taxpayers of engaging external advisers for assistance are compounded by the amount of time that must be spent in analysing all manner of transactions that might potentially give rise to fringe benefits, in valuing the different types of fringe benefits using complex rules and in agreeing on positions to be taken on unclear areas of the law.

The ATO has consistently declined to provide clear guidance on various terms that affect whether benefits are subject to FBT, such as the term 'minor, infrequent and irregular' which is part of the definition of exempt car benefits. Accordingly, the lack of clarity leads to different taxpayers and their advisers making different subjective judgements about what falls into or outside of the FBT regime. This leads to inconsistent outcomes as some will decide on a higher threshold for inclusion in the FBT regime, whereas others will decide on a lower, more conservative, threshold.

The Tax Institute recommends the Government address the inequity in the FBT system caused by the application of tax at a rate equivalent to the highest marginal tax rate and the significant administration costs in the current system.

3. Small Business CGT Concessions

The current small business CGT concessions are very complex in nature. The provisions are so complex that it is difficult for a small business to confirm that they qualify for a concession under the rules. As such, this area should be a focus for reform.

The original purpose for introducing these concessions was to assist small business owners to prepare for retirement. Many small business owners rely on their small business as a vehicle to fund their retirement absent available resources to put into superannuation because they instead reinvest in their business.

The cost of complying with these rules is very high. Seeking advice on whether the concessions apply can prove too costly for some taxpayers due to the complexity of the rules. The concessions are also an area regularly subject to audit activity.

The rules are intended to provide a simple tax concession to small businesses, but they have become so complex that taxpayers often find it is not worth their while trying to determine if the concessions apply or find they do not apply.

The policy intent for providing these concessions should be reviewed with a view to simplifying the rules and making them easier to apply and to ensure they operate to provide relief to small business owners as intended. In the context of any review of these concessions, we do note that the retirement and rollover concessions (or something similar) should be retained.

4. Loss Integrity rules

Australia has some of the world's most complicated loss integrity rules, many of which were put in place prior to tax consolidation and deal with problems that have largely been resolved by more recent developments. These rules need to be considered in many circumstances including corporate restructures and can impede potential efficiency-driven restructures.

It does not seem appropriate, for example, that due to a change in ownership of a large corporate group which happens to have losses, without a real change of control, that the losses are disallowed unless a same business test is met.

As such, we query the appropriateness of the 'continuity of ownership[16]' and 'same business' test rules as they currently apply given their current restrictiveness and whether the integrity concerns the rules sought to address are still at issue following recent amendments to corporate taxation (for example the introduction of consolidation). In the event the Government determines loss integrity measures are still required, we recommend a simpler set of rules be implemented in place of the current complicated tests. For example, there may be scope to simplify the same business test by providing one test to determine if the same business has been maintained rather than three (the 'same business test' in section 165-13, the 'new transactions' test in section 165-210(2)(b) and the 'bad debt deductions' test in section 165-126).

In addition, we query the appropriateness of the complex trust loss rules, particularly as there are no concessional ownership tracing rules available for trusts nor is there an alternative 'same business' test for most trusts.

We support the concept of a 'loss carry-back' measure and that the Government should consider reintroducing a form of 'loss carry-back' measure. Such a measure will ensure that, within limitation, the tax system will impose the same overall tax liability regardless of the tax year in which a company produces its income or loss, acting as a natural regulator for both business and Government by smoothing tax collections.

[16] In particular, the loss duplication rules contained in Division 165-CC and Division 165-CD of the *Income Tax Assessment Act 1997* (Cth)