Australian Government

Re:think

Tax discussion paper

March 2015

Better tax system, better Australia

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Better tax system, better Australia

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Manager
Publishing Unit
The Treasury
Langton Crescent
Parkes ACT 2600
Email: medialiaison@treasury.gov.au

Foreword

Australia has experienced nearly a quarter of a century of uninterrupted economic growth. As a result, Australians continue to have some of the highest living standards in the world.

Over the next few decades, the challenge for Australia is to maintain and improve standards of living through economic growth. The recent Intergenerational Report shows that continuing steps to boost productivity and encourage higher workforce participation will be critical to driving future economic growth.

Tax reform is a key part of the Government's policy agenda to build jobs, growth and opportunity.

Last year, the Government abolished the carbon and mining taxes, which were a drag on growth. We also announced changes to the taxation arrangements for employee share schemes to provide generous incentives for new start-ups.

This year, we will deliver a package for small business to expand opportunities for Australian businesses and workers.

The Government is committed to ensuring that everyone is paying their fair share of tax. This year, we are continuing to work with the G20 on the modernisation of international tax rules to address tax avoidance by multinational companies.

But that is just the start. We want to have an open and constructive conversation with the community on how we can create *a better tax system that delivers taxes that are lower, simpler, fairer*.

To deliver lasting, workable reforms, the community needs to be on board and engaged in the conversation. That's why the Government is committing to a comprehensive and inclusive process. Releasing this tax discussion paper marks the start of what we hope will be a broad conversation about the current tax system and the issues confronting it. All are encouraged to take part. This conversation will support the development of a tax system to build jobs, growth and opportunity — a better tax system to deliver taxes that are lower, simpler, fairer.

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Executive summary

Over the last 40 years Australian governments have initiated many reviews of the tax system. Those reviews have shaped the taxes we have today. But as the world continues to change, our tax system is confronted with new challenges. These challenges invite us to think creatively about the kind of tax system that will enable us to better realise the opportunities before us. In commencing this tax review, the Government will be considering every worthwhile idea, even if it does not fit neatly with the existing set of major taxes we now have. Through this tax review we will develop a better tax system that delivers taxes which are lower, simpler and fairer. A tax system that encourages productive endeavour.

The Government wants to involve the Australian community in a national conversation on tax reform

The time for a national conversation on tax reform is now. This discussion paper begins our formal government process for considering future directions for Australia's tax system. It provides information about the challenges the tax system faces, the way it currently operates, identifies potential opportunities for reform and points to some of the trade-offs that would need to be considered.

We need to keep the economy growing to safeguard our way of life. Australia has experienced nearly a quarter of a century of uninterrupted economic growth. The challenge going forward is to keep the economy growing. The recent Intergenerational Report shows that continued steps to boost productivity and encourage higher workforce participation will be critical to driving future economic growth. Changes to our tax system could foster new opportunities for businesses and workers and promote economic growth. Indeed, some argue that comprehensive tax reform could promote economic growth more than any other area of government policy.

Our tax system needs to support the modern economy. The world economy has been dramatically transformed in recent decades. Financial deregulation, the growth of multinational companies using global supply chains and the increasing digitisation of global commerce have been overwhelmingly positive developments for Australia, but do pose substantial challenges to the tax system, including by driving global tax avoidance activities. Likewise, bracket creep, which pushes people on to higher tax rates with rising incomes over time, is a growing problem that impacts on workforce participation. The tax system needs to adapt to these challenges.

The Government's review of roles and responsibilities across the Federation provides a once-in-a-generation opportunity to examine the whole of the tax system. The White Paper on the Reform of the Federation is considering options to achieve a more efficient and effective federation, which supports Australia's growth and living standards. Any changes to roles and responsibilities of the Commonwealth and states and territories may have revenue and tax implications. The white paper processes on Australia's Federation and taxation are proceeding in tandem and, as such, provide a unique opportunity to inform a system-wide approach to taxation.

The Government is committed to a better tax system to deliver taxes that are lower, simpler, fairer

The tax system raises the revenue required to fund public services. A good tax system achieves this purpose without imposing unnecessary costs on the economy and as simply and fairly as possible.

There is evidence that the economic costs of revenue-raising in Australia are higher than they need to be. Australia has a higher reliance on income taxes, including tax raised from company income, than most other comparable countries. State and territory governments rely considerably on taxes that impose high economic costs, like stamp duties. Treasury research estimates that each additional $1 collected by way of company income tax reduces the living standards of Australian households by around 50 cents in the long run because of reduced investment. This impedes Australia's productivity and, in turn, reduces opportunities for better paying jobs.

There are opportunities to simplify the tax system. Our tax system is too complex, with significant resources spent on tax compliance and tax management activities. The reasons for this complexity are multifaceted. One reason is the prevalence of tax concessions aimed at assisting particular groups. Another reason is the regular 'patching' of the law to fix narrow problems or provide certainty for taxpayers and transactions without fully considering consequences for the system as a whole. Overly risk-averse attitudes from policy advisers and administrators, combined with complex legislative drafting styles, have also led to complexity. Governance arrangements should ensure tax design and administration practices minimise unnecessary complexity and support the implementation of sound tax policy.

There are opportunities to improve the fairness of the tax system. Our tax and social security (transfer) systems are already highly progressive, which is intended to contribute to fair outcomes. Nonetheless, interactions between the tax system and the transfer system can discourage workforce participation for some people. In addition, our relatively high top marginal tax rate and the gap between the top marginal tax rate and the company tax rate results in tax planning and avoidance. Tax concessions need to be well justified to ensure the fairness of the tax system.

The tax treatment of savings is very complex and distorts savings choices. Tax on savings should give people the incentive to save for the future. However, some savings are taxed at full marginal rates (for example, bank accounts) while others are not (for example, superannuation). This can affect people's choices about how to save without necessarily doing much to increase savings overall.

Transitional arrangements are important. While tax reform needs to be focused on the long term, the impacts of the transition process from existing policy to new policy needs to be understood and carefully addressed so that changes balance the interests of different groups. Tax changes can impact negatively on individuals and businesses, for instance, when they have made long-term decisions based on previous arrangements. Some tax changes can also have significant implications for system administration and government budgets.

Joining the national conversation on tax reform

Responding to the discussion paper

Effective tax reform requires a comprehensive and transparent national conversation between the community and the Government.

- In opening this conversation, the Government will:
  - Focus on ideas rather than prescribing solutions. Solutions can start to be considered as part of the options (green) paper in the second half of 2015.
  - Focus on *how* revenue is raised, not just how much. The Government's goal is to deliver lower, simpler, fairer taxes.
  - Rule nothing in or out. Options can start to be ruled in or out as part of the options (green) paper.

Community engagement is critical for sustainable change

Who pays tax and how much of the burden they bear are fundamental questions for a community to consider. Meaningful tax reform can only occur if the community takes part in a genuine conversation — both directly and through our Parliament. This conversation needs to cover the challenges Australia's tax system faces, the opportunities for reform and the trade-offs to be considered.

To build trust and ensure transparency this national conversation must be inclusive

There will be many opportunities for a reform debate, with many ways for you to participate. This discussion paper sets out how the tax system operates now and the opportunities and challenges it faces. You are urged to respond to its questions. The Government will incorporate those views in an options (green) paper, due in the second half of 2015. Again, you can respond, before the Government then sets out its reform proposals in a white paper, and takes them to the next election in 2016.

How to join the conversation

To join the conversation, go to the 'better tax' website www.bettertax.gov.au.

The formal submissions process for this discussion paper starts now. You have until Monday 1 June 2015 to lodge your formal submission at the website.

If you have any questions or comments, you are welcome to contact the Tax White Paper Task Force at bettertax@treasury.gov.au or at:

Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

Shaping your contribution

Some of you will have specific sector-based issues you wish to explore, while others may have interests and views that span a broader set of issues. Further, you should not be limited by the issues or questions contained in this discussion paper. The Government is keen to hear from all interested parties on any issues regarding the tax system, including views on tax matters raised in other review processes, such as the Financial System Inquiry, Productivity Commission inquiries, the Competition Policy Review and the White Papers on Federation, Agricultural Competitiveness and Northern Australia.

1: Challenges for Australia's tax system

Overview

This chapter sets out the major challenges that confront the Australian tax system.

Key points

- Australia's tax system faces challenges from a changing world.
- The tax system needs to support improvements in productivity and encourage workforce participation.
- Tax reform offers one of the biggest opportunities to improve productivity and foster jobs, growth and opportunities.

1.1: Australia's tax system faces challenges from a changing world

In recent decades, changes in the global economy have put strain on tax systems around the world and Australia has been no exception. Key factors include technological change (particularly the rise of the digital economy), highly mobile investment and greater labour mobility. These developments pose two critical issues for tax systems: they can weaken the ability of tax systems to raise revenue from traditional tax bases and they can increase the economic costs of taxation, dampening economic growth.

Technological change is particularly significant for the taxation of income, especially corporate income. Multinational firms operate across many jurisdictions, much of their value is intangible and the location where value is added can be difficult to determine. The digital economy also facilitates greater personal importation of goods and services, placing pressure on the indirect tax bases.

As the mobility of capital increases, Australia's high corporate tax rate can deter investment, ultimately leading to lower wages and prosperity. High effective marginal tax rates (including through the interaction with the transfer system) can also deter workforce participation or lead to tax planning activities as individuals seek to reduce their tax burden.

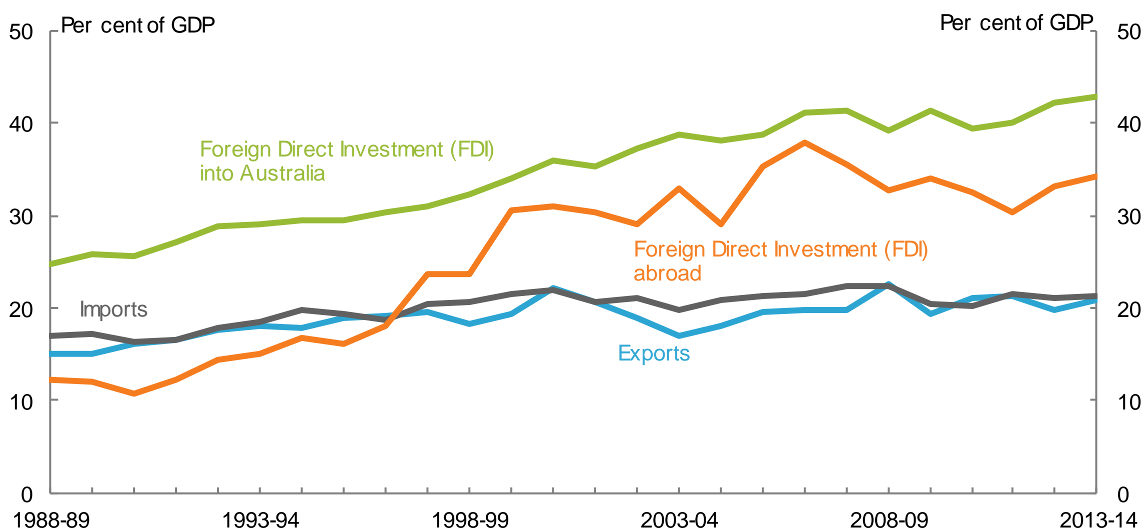
Australia also faces the prospect of a period of below-average income growth as the terms of trade decline and global economic growth remains subdued, relative to the years leading up to the global financial crisis. Tax reform offers an opportunity to significantly improve productivity and foster jobs, growth and opportunities.

Globalisation provides opportunities for a more prosperous future, but also challenges Australia's tax system

Over the past 50 years, the economic environment in which the Australian tax system operates has changed dramatically. In the 1950s, Australia generated substantial income from wool and other agricultural commodities, the economy was encircled by a comprehensive tariff wall, the financial sector and the flow of capital were heavily regulated, and the manufacturing sector was a major employer.

Today, developed economies, including Australia's, have become increasingly open to international trade and investment (see Chart 1.1). Financial deregulation, the growth of multinational companies utilising globally dispersed supply chains and the increasing digitisation of global commerce have opened the Australian economy to the world. This has had an overwhelmingly positive influence by increasing business efficiency and living standards and driving economic growth. However, these changes have also transformed the environment in which tax systems operate, especially for capital importing countries such as Australia.

Chart 1.1 Trade and foreign direct investment as a share of GDP



Source: Australian Bureau of Statistics (ABS) 2014, *Australian System of National Accounts 2013-14*, cat. no. 5204.0, ABS, Canberra.

Historically, large companies tended to be locally based and engaged in production (such as manufacturing) primarily for domestic or regional markets. Now, technology allows large companies to supply global markets using internationally integrated supply chains. This means that production can be located where costs are lowest. It is now normal for multinational companies to: have their investors reside in one country; manufacture products in another; locate their marketing and product development in a third country; and supply customers in a fourth.

A leading indicator of change is that multinationals are investing increasing economic value in intangible assets, such as intellectual property. Investment in intangible assets (such as patents, trademarks, copyrights, goodwill and branding) has been growing at around 1.3 times the rate of tangibles since 1974-75.[1] The inherent difficulty in valuing unique intellectual property and the ease with which intellectual property can be relocated present particular challenges for identifying which jurisdictions have the right to tax the value or 'income' generated by these assets.

Similarly, financial markets are increasingly globally integrated, and the international flow of capital has become less restricted and more mobile. Technology has also allowed new business models to evolve that have substantially changed the way businesses and consumers interact. New ways of transacting, including crypto-currencies such as bitcoin, were not contemplated when the current tax system was designed.

These developments make determining the appropriate tax outcome for a particular company in a specific country difficult and raise concerns about the ability of companies to relocate profits to minimise their tax.

Australia has been active in ensuring companies are taxed appropriately in Australia, including through some of the toughest integrity rules in the world and the compliance efforts of the Australian Taxation Office (ATO) working with counterparts overseas. Australia has also played a leading role with the G20 and the Organisation for Economic Cooperation and Development (OECD) in seeking to reshape global rules to better counter inappropriate multinational tax planning.

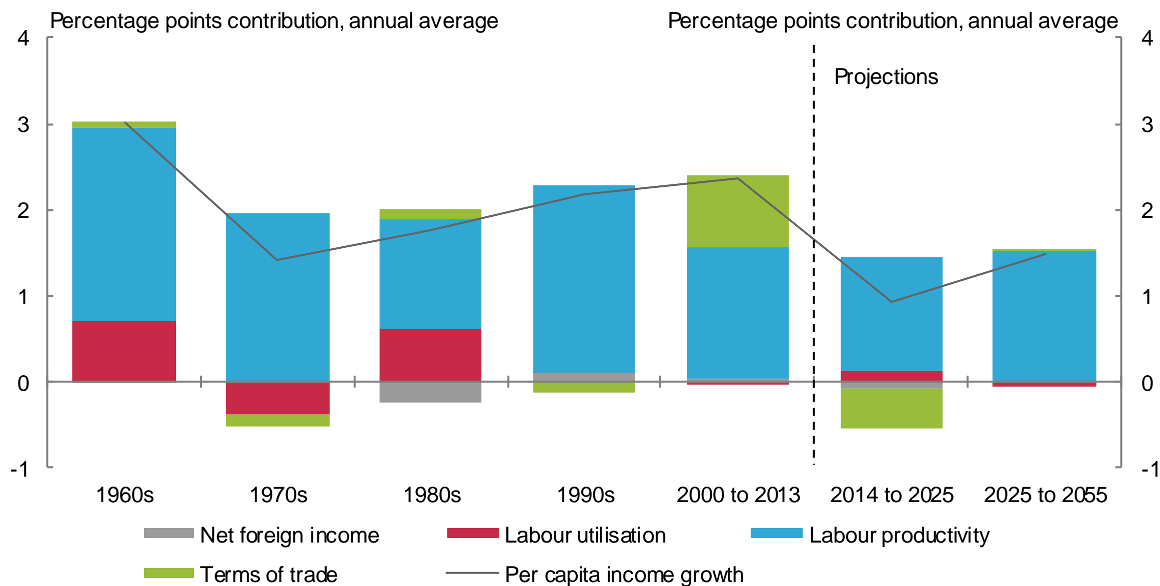
Australia's tax system needs to support higher productivity and encourage workforce participation

Australia's growth over the past decade has been supported by increased demand for commodities, predominantly from Asia. This has resulted in unprecedented investment in the resources sector, the record terms of trade, higher average incomes and improved living standards. The benefits of the mining boom have been spread across the economy as a result of downstream investment, employment growth in industries supporting the mining sector and greater purchasing power for Australian households as a result of record terms of trade.

However, recently slower growth in Asia, falling commodity prices and a lower terms of trade, as well as resource projects shifting from development into production, mean the mining sector is no longer driving national income growth to the same extent as previously. In the absence of improvements in other drivers like labour utilisation and national productivity, annual growth in incomes is likely to fall to around one per cent over the next decade, less than half the rate to which Australians are accustomed (see Chart 1.2).

1 Barnes, P and McClure, A 2009, *Investments in Intangible Assets and Australia's Productivity Growth*, Productivity Commission Staff Working Paper, Canberra.

Chart 1.2 Sources of growth in real national income per person



Source: ABS 2015, *Australian National Accounts*, cat. no. 5206.0, ABS, Canberra and Treasury

Corporate tax rates that are increasingly uncompetitive will make it harder for Australia to continue to attract necessary investment. Ongoing investment in Australia is one of the key drivers of labour productivity and growth. Furthermore, high corporate tax rates increase the incentives for companies to engage in tax planning, such as profit shifting.

Australia's population is also expected to grow and change over the next 40 years. Projections in the recent Intergenerational Report show that the number of Australians aged 65 and over is expected to more than double by 2055. In turn, the number of people aged between 15 and 64 for every person aged 65 and over is projected to fall from an estimated 4.5 people today to a projected 2.7 people in 2055. This change in our demographic structure will have important implications for the tax base, as well as the ability of future governments to deliver services at the standards expected by the community.

The proportion of the population participating in the workforce is expected to decline as a result of population ageing. By 2054-55, the participation rate for Australians aged 15 years and over is projected to fall to 62.4 per cent, compared with 64.6 per cent in 2014-15. The recent Intergenerational Report projects that gradual declines in participation rates will slightly slow the rate of economic growth.

Bracket creep and higher personal income taxes can reduce participation incentives for some people (see chapter 2). Over time, unchecked bracket creep could potentially reduce workforce participation and the opportunities afforded to the community by higher participation rates.

Tax reform offers one of the largest opportunities to improve investment and productivity and help maintain and improve growth in standards of living

The recent Intergenerational Report shows that Australia can continue to build prosperity and improve growth in living standards over the next 40 years. Real growth in GDP is projected to average 2.8 per cent a year going forward, compared to an average of 3.1 per cent a year over the past 40 years.

Continued steps to boost productivity and encourage higher workforce participation will be critical to driving this economic growth. There is a range of measures that governments can pursue to enhance productivity and help position Australian businesses to be flexible, competitive and robust in the face of dynamic global conditions. Some opportunities will be considered as part of the Competition Policy Review and the Productivity Commission's inquiry into Australia's workplace relations framework.

Changes to our tax system could also foster new opportunities for businesses and workers. Indeed, some argue that comprehensive tax reform could promote economic growth more than any other area of government policy.

The potential for productivity enhancing tax reforms exists at all levels of government in Australia. Aligning the processes for the reform of Australia's tax system with the reform of Australia's Federation provides a once-in-a-generation opportunity for change.

Discussion questions:

1. Can we address the challenges that our tax system faces by refining our current tax system? Alternatively, is more fundamental change required, and what might this look like?

2: Australia's tax system

Overview

This chapter surveys Australia's current tax system at both the federal and state levels and how it compares internationally. It considers: how costs imposed by the tax system affect economic growth and living standards; the challenges of complexity; and the importance of fairness in maintaining an effective and sustainable tax system.

Key points

- A good tax system raises the revenue needed to finance government activities without imposing unnecessary costs on the economy. Tax reform is about how revenue is raised, not just about how much.
- Australia's overall tax burden is relatively low compared to other developed countries. The Australian Government raises around 81 per cent of total tax revenue in Australia. State and territory governments receive 45 per cent of their revenue through transfers from the Australian Government, including all GST revenue.
- Australia relies heavily on income taxes, particularly company income tax, compared to other developed countries as well as our Asian competitors. Australia's reliance on income taxes remains much the same as it was in the 1950s, despite changes in the economy, and is projected to increase further, largely as a result of wages growth leading to individuals paying higher average rates of tax (bracket creep).
- Economic modelling suggests that the taxes with particularly high costs to economic growth are company tax and stamp duties. The benefits of reducing the economic costs of taxation are spread throughout the economy, including to workers through higher wages.
- Complexity and compliance costs have many drivers and are a growing problem in the tax system. Tax compliance costs are in the order of $40 billion per year. Approaches to tax design and governance practices will need to change if complexity in the tax system is to be reduced.
- Australia's tax and transfer systems are highly progressive, which supports fairness. High effective tax rates, including as a result of targeting in the transfer system, can reduce participation incentives for some groups. Bracket creep exacerbates this problem.
- Tax settings for savings should give people the incentive to save for their future, but differences in the taxation of alternative savings vehicles affects savings choices.

2.1: Opportunities for a better tax system to deliver taxes that are lower, simpler, fairer

Like any tax system, Australia's tax system is fundamental to raising the revenue that finances the activities of government at the Australian Government and state and territory government levels. These activities include important public services like health, education, infrastructure and national defence, as well as the social safety net that supports our society's most vulnerable.

A good tax system achieves this purpose without imposing unnecessary costs on the economy. For this reason, tax reform is not just about how much revenue is raised but how it is raised. This includes appropriately balancing the principles of fairness, efficiency and simplicity (Box 2.1).

While Australia's tax system has served the nation well over the decades, it is increasingly outdated. The changing global environment, costs associated with complexity and the need to raise revenue to fund the activities of government in a more efficient and fair way mean the tax system is under increasing strain.

There are opportunities to make a better tax system to deliver taxes that are lower, simpler, fairer. This will help to raise, rather than hold back, Australian living standards.

Box 2.1: Principles for tax systems

It is accepted that a well-designed tax system will meet its revenue raising objective, while balancing the core principles of equity, efficiency and simplicity:

- *equity* — fairness in the distribution of the tax burden;
- *efficiency* — economy in tax collection so as to have the lowest possible cost over and above the revenue that is raised; and
- *simplicity* — the tax system should be easy to understand and simple to comply with.[2]

Other principles could usefully be added to this list. For example, the UK House of Commons Treasury Committee's *Principles of tax policy* added procedural principles to this list.[3] These include certainty, stability and proper consultation and review. The Henry tax review emphasised the importance of sustainability, where this is the ability to meet the changing revenue needs of governments, and consistency across tax laws and treatments.[4]

2 Asprey, K (Chairman), Lloyd, J, Parsons, R and Wood, K 1975, *Taxation Review Committee — Full Report (The Asprey Review),* AGPS, Canberra, pages 12-15.

3 House of Commons Treasury Committee 2011, *Principles of tax policy*, The Stationery Office by Order of the House, London.

4 Australian Government 2010, *Australia's Future Taxation System Review (Henry Tax review),* Australian Government, Canberra, page 17.

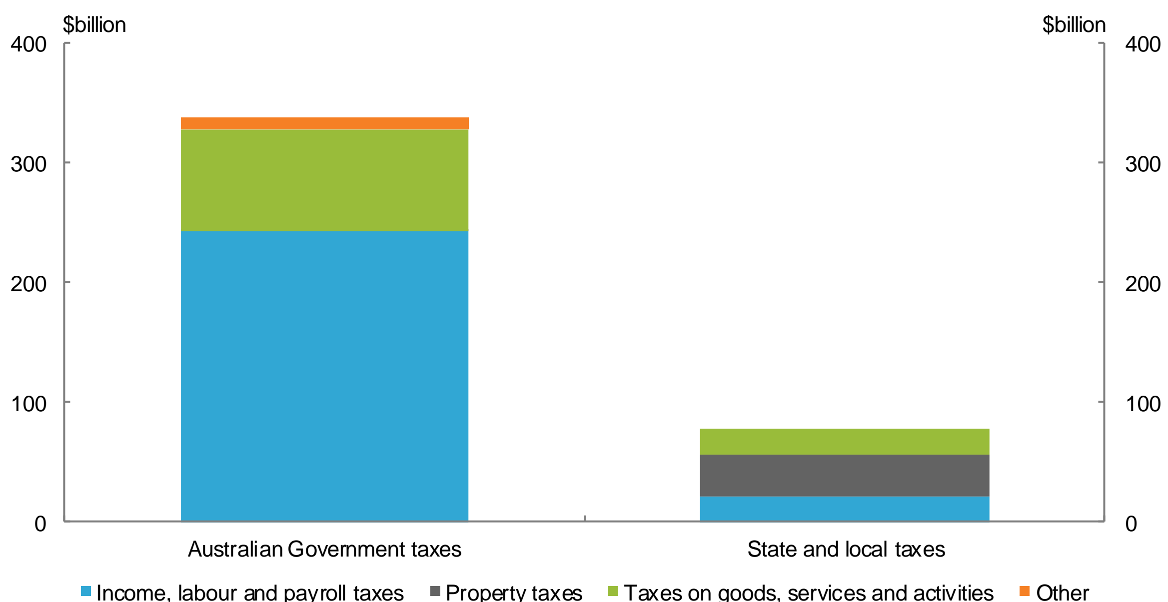
2.2: Australia’s current tax system

Like many other countries with a federal system, the Australian Government raises the majority of revenue

Both the Australian Government and state and territory governments (including local governments) have responsibility for raising revenue in Australia, by means of their control of particular tax bases.

While Australian tax revenue is drawn from more than 100 different taxes, most revenue is collected from just a few taxes.[5] In 2012-13, the federal Government collected around 81 per cent of tax revenue in Australia, mainly from income taxes levied on individuals and corporates (Chart 2.1). State and territory governments collected around 15 per cent of tax revenue, largely through payroll taxes and property taxes (especially stamp duties). Local governments collected around 3 per cent of tax revenue through municipal rates. The tax rates, thresholds and exemptions for state and local government taxes vary across jurisdictions.

Chart 2.1 Composition of Australian and state and local taxes, 2012-13



Note: Under the *Australian System of Government Financial Statistics,*[6] royalty income is not a form of taxation and is included in the property income category along with interest income and dividends. Federal ‘Taxes on goods, services and activities’ includes the goods and services tax revenue.
Source: Australian Bureau of Statistics (ABS) 2014, *Taxation Revenue, Australia, 2012-13*, cat. no. 5506.0, ABS, Canberra.

5 Australian Government 2010, *Australia’s Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra.

6 ABS 2006, *Australian System of Government Finance Statistics: Concepts, Sources and Methods, 2005,* cat. no. 5514.0.55.001, ABS, Canberra.

In 2013-14, state and territory governments (excluding local governments) generated around 31 per cent of their total revenue from the taxes they administer. The states and territories received around a further 45 per cent of their revenue from the federal Government by way of specific purpose payments and general revenue assistance, including all GST revenue.[7] The remainder of state and territory revenue comes from other sources, including the sale of goods and services and royalties.[8]

The situation where the states and territories rely on funding transfers from the federal Government to meet their expenditure responsibilities is referred to as vertical fiscal imbalance (VFI).

Australia has a relatively low tax burden compared to other developed countries

Australia's aggregate tax burden is relatively low compared with other developed countries, but higher than some of our major regional trading partners, at around 27.3 per cent of GDP in 2012 (Chart 2.2).[9] This is a product of Australia's smaller overall size of government compared to many of its developed counterparts and that it is only one of two developed countries that do not levy specific social security taxes (the other being New Zealand).

Australia's compulsory superannuation system — the superannuation guarantee — is sometimes equated to a social security tax. However, as it is paid directly into private superannuation accounts (currently set at 9.5 per cent of an employee's ordinary time earnings) rather than to the government, it does not meet the definition of a tax.[10]

The Government's budget projections incorporate a cap on Commonwealth taxation at 23.9 per cent of GDP (which, the 2014-15 MYEFO 2014-15 projected to be reached in 2020-21).

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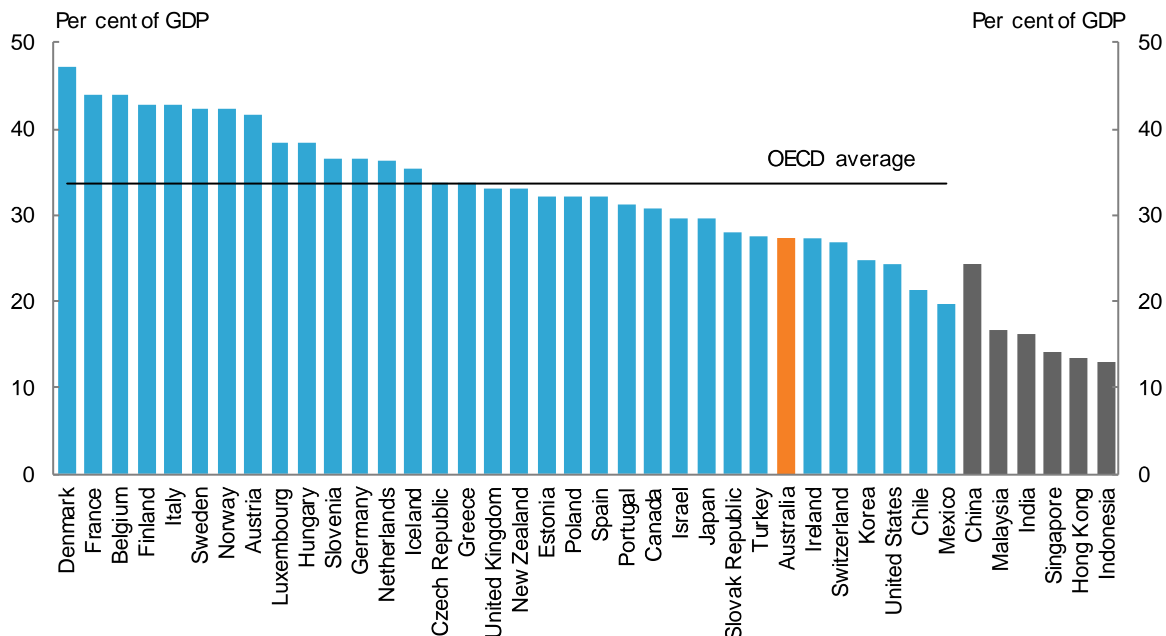
7 Treasury calculations using State and Territory Final Budget Outcomes (or equivalents). See Chapter 8 for full bibliographic details.

8 Unlike taxes, which are unrequited transfers, royalties are a charge for the right to extract a mineral resource and, as such, are not classified as taxes.

9 In this discussion paper, comparisons with other developed countries generally utilise data from the Organisation for Economic Cooperation and Development (OECD).

10 The OECD defines a tax as a compulsory and unrequited transfer to government. See the OECD's glossary of tax terms: www.oecd.org/ctp/glossaryoftaxterms.htm.

Chart 2.2 Total tax revenue as a percentage of GDP, for OECD and selected Asian economies, 2012



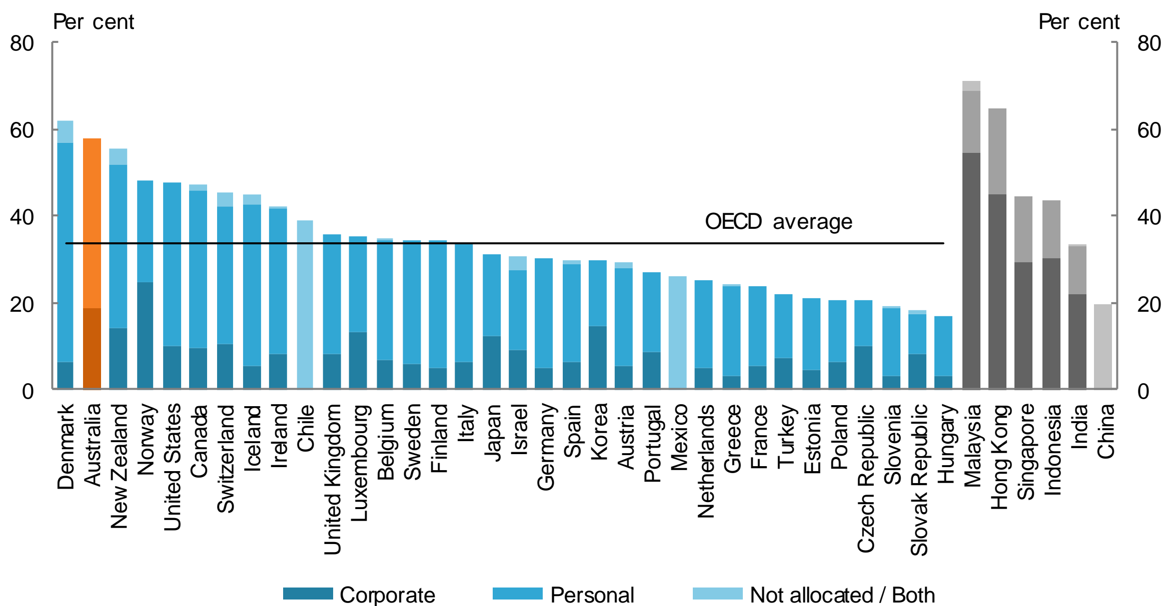
Note: Tax-to-GDP statistics for China, Hong Kong, Singapore and India have been prepared using the IMF's Government Finance Statistics and are not directly comparable to OECD statistics. Unlike the OECD, the IMF does not classify social security contributions as a tax. To improve comparability with OECD statistics, tax-to-GDP ratios for China, Hong Kong, Singapore and India are calculated using IMF data but inclusive of social security contributions. Statistics for China are for 2011 and for India are for 2011-12.
Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris; OECD 2014, *Revenue Statistics in Asian Countries: Trends in Indonesia and Malaysia*, OECD Publications, Paris; International Monetary Fund (IMF) 2014, *Government Finance Statistics Yearbook*, viewed 21 January 2015: http://elibrary-data.imf.org; IMF 2014, *India Country Report* No. 14/57, viewed 22 January 2015: www.imf.org/external/pubs/ft/scr/2014/cr1457.pdf.

Australia relies more on corporate and individuals income taxes than other developed countries

Australia has a comprehensive framework of broad-based taxes. Taxes levied on income from inputs to production (that is labour, capital and land) include individuals income tax, company income tax, tax on superannuation funds, land tax, and resource rent taxes.

Australia relies more heavily on income taxes on company and individual income (often termed 'personal income tax', including by the OECD) than other developed countries (Chart 2.3). Income tax levied on individuals comprised 39.2 per cent of total tax revenue in 2012, while corporate taxes comprised 18.9 per cent of total tax revenue in 2012, among the highest in the developed world and significantly higher than some key regional competitors.

Chart 2.3 Taxes on corporate and personal income as a percentage of total taxation, for OECD and selected Asian economies, 2012



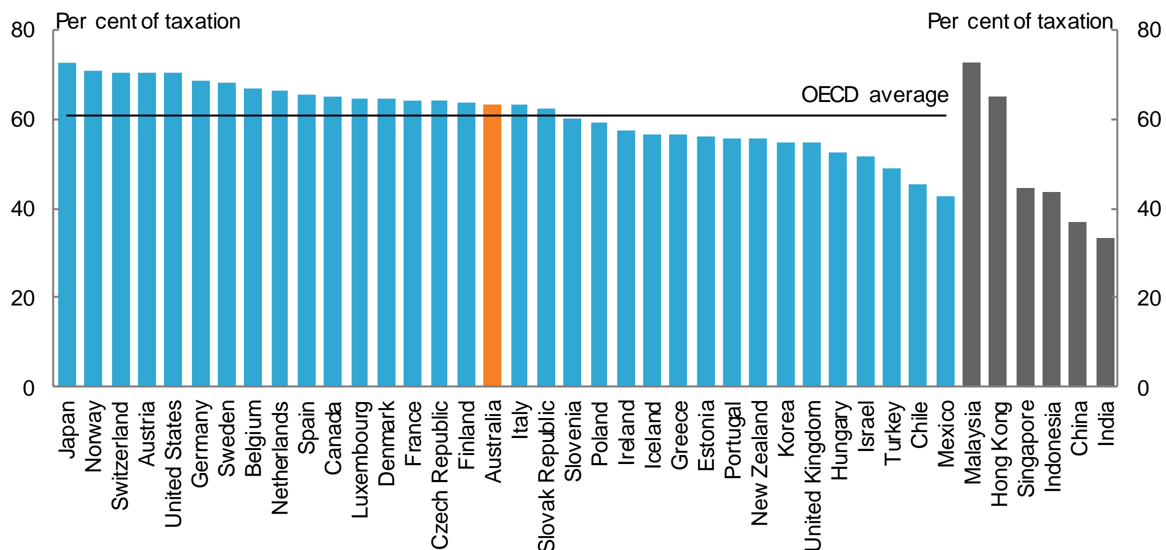
Note: Taxes on income are based on the OECD (series 1000) and IMF classifications (series 11). Estimates for China, Hong Kong and Singapore have been prepared using the IMF's Government Finance Statistics, while estimates for India have been prepared using the CMIE database. These estimates are not directly comparable to OECD statistics. Unlike the OECD, the IMF does not classify social security contributions as a tax. To improve comparability with OECD statistics, total taxation estimates are prepared using IMF data but inclusive of social security contributions. Statistics for China are for 2011 and for India are for 2011-12.
Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris; OECD 2014, *Revenue Statistics in Asian Countries: Trends in Indonesia and Malaysia*, OECD Publications, Paris; IMF 2014, *Government Finance Statistics Yearbook*, viewed 21 January 2014: http://elibrary-data.imf.org; IMF 2014, *Government Finance Statistics*, Mimas, University of Manchester, viewed 21 January 2015: http://ukdataservice.ac.uk/help/get-in-touch.aspx; Treasury calculations using CMIE 2014, viewed 23 January 2015: http://economicoutlook.cmie.com.

Unlike most other developed countries, Australia does not levy social security contributions. Compulsory social security contributions tend to be levied at a flat rate on earnings, unlike the progressive tax rate scale applied to income earned by individuals. In OECD countries, social security contributions on average comprise one quarter of total taxation, but make up over 40 per cent of total taxation in some countries (such as Japan and the Netherlands).

Although Australia does not have any compulsory social security contributions, the states and territories do levy payroll tax on employee remuneration above a threshold. This is another form of direct taxation. Although Australia relies more on payroll tax than other OECD countries, this only comprised five per cent of taxation in Australia in 2012.

Direct forms of taxation — individuals and corporate income taxes, compulsory social security contributions plus payroll taxes — comprise around 63 per cent of taxation in Australia. This compares to the OECD average for direct taxes of 61 per cent (Chart 2.4).

Chart 2.4 Direct taxes as a percentage of total taxation, for OECD and selected Asian economies, 2012



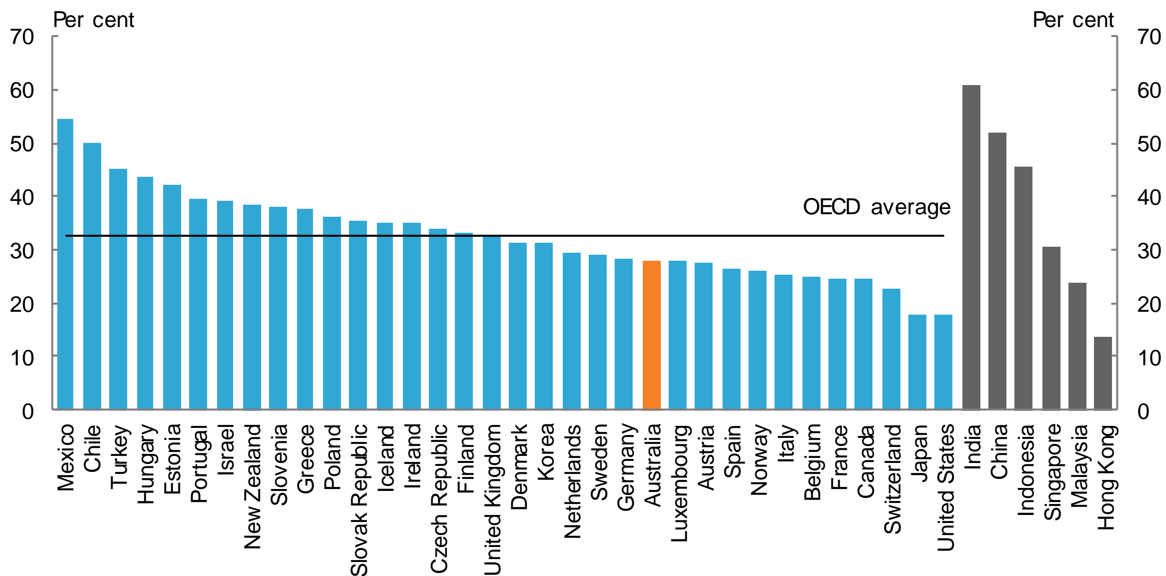
Note: Direct taxes include personal and corporate income taxes (OECD series 1000), social security contributions (OECD series 2000) and payroll and workforce taxes (OECD series 3000), but does not include other compulsory non-tax payments (such as the Superannuation Guarantee). Estimates for China, Hong Kong and Singapore have been prepared using the IMF's Government Finance Statistics, while estimates for India have been prepared using the CMIE database. These estimates are not directly comparable to OECD statistics. Unlike the OECD, the IMF does not classify social security contributions as a tax. To improve comparability with OECD statistics, direct and total taxation estimates are prepared using IMF data but inclusive of social security contributions. Statistics for China are for 2011 and for India are for 2011-12.

Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris; OECD 2014, *Revenue Statistics in Asian Countries: Trends in Indonesia and Malaysia*, OECD Publications, Paris; IMF 2014, *Government Finance Statistics Yearbook*, viewed 21 January 2014: http://elibrary-data.imf.org; IMF 2014, *Government Finance Statistics*, Mimas, University of Manchester, viewed 12 March 2015: http://ukdataservice.ac.uk/help/get-in-touch.aspx; Treasury calculations using CMIE 2014, viewed 23 January 2015: http://economicoutlook.cmie.com.

Taxes on consumption include the goods and services tax (GST), tariffs and customs duties levied on imported goods and excise levied on the domestic consumption of particular products (such as fuel, alcohol and tobacco). Australia has a lower reliance on consumption taxes than most developed countries (Chart 2.5).

State and territories also levy a range of property taxes, including stamp duties and land tax. Taxes on property comprise around 9 per cent of taxation in Australia in 2012, compared to the OECD average of around 5 per cent.

Chart 2.5 Consumption taxes as a percentage of total taxation, for OECD and selected Asian economies, 2012



Note: Taxes on goods and services are based on the OECD (series 5000) and IMF classifications (series 14). Estimates for China, Hong Kong and Singapore have been prepared using the IMF's Government Finance Statistics, while estimates for India have been prepared using the CMIE database. These estimates are not directly comparable to OECD statistics. Unlike the OECD, the IMF does not classify social security contributions as a tax. To improve comparability with OECD statistics, total taxation estimates are prepared using IMF data but inclusive of social security contributions. Statistics for China are for 2011 and for India are for 2011-12.
Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris; OECD 2014, *Revenue Statistics in Asian Countries: Trends in Indonesia and Malaysia*, OECD Publications, Paris; IMF 2014, *Government Finance Statistics Yearbook*, viewed 21 January 2014: http://elibrary-data.imf.org; IMF 2014, *Government Finance Statistics*, Mimas, University of Manchester, viewed 21 January 2014: http://ukdataservice.ac.uk/help/get-in-touch.aspx; Treasury calculations using CMIE 2014, viewed 23 January 2015: http://economicoutlook.cmie.com

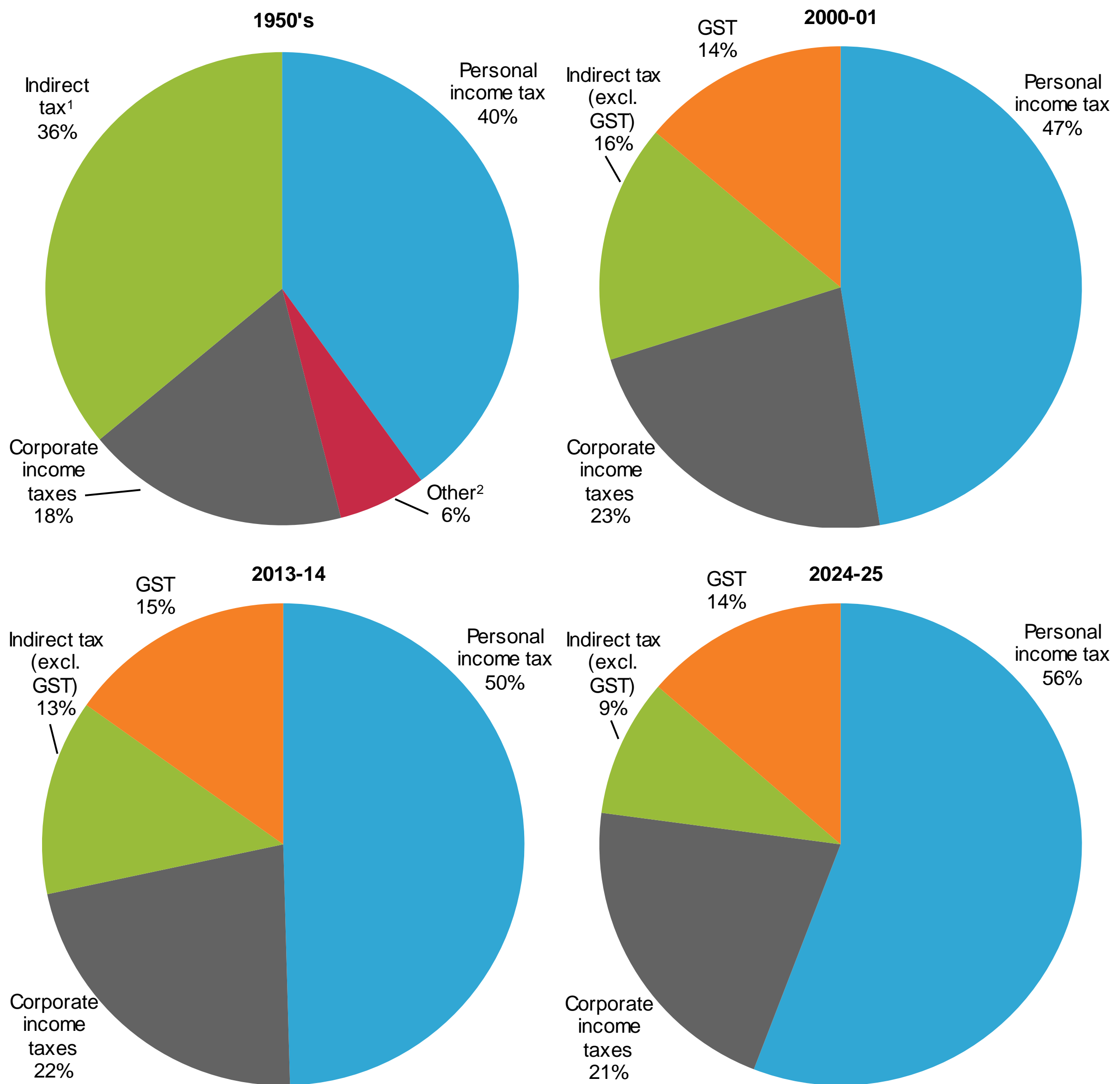
The overall tax mix has not changed much over the last few decades while economic circumstances have changed significantly

At the federal level, Australia's overall tax mix has consistently favoured individuals and corporate income taxes (Chart 2.6). The average tax mix through the decade of the 1950s was weighted towards income taxes (60 per cent of tax receipts). Income taxes now contribute around 70 per cent of tax receipts, noting that some of the increase is because of economic factors, such as corporate profitability, rather than policy changes. Income tax reform in recent decades has focussed on broadening the income tax bases and lowering income tax rates, while indirect tax reform has reduced reliance on sales taxes and customs duties in favour of the GST. Policy changes have not, however, materially changed the overall mix of income tax compared to indirect tax.

Based on existing policy settings, Australia's reliance on individuals income tax is projected to increase further over the next decade, largely as a result of wages growth leading to individuals paying higher average rates of tax, known as 'bracket creep' (Box 2.2).

As noted in Chapter 1, changes in the global economy mean that the flow of financial capital and labour is becoming increasingly sensitive to Australia's tax settings.

Chart 2.6 Composition of Australian Government taxes over time



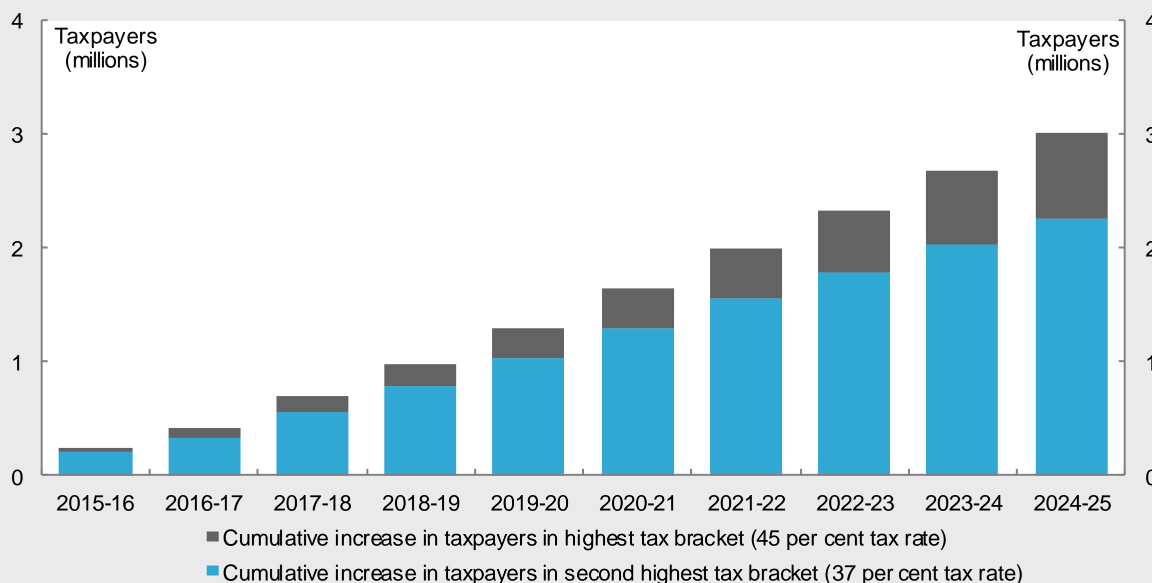
Note 1: On average in the 1950s, customs duties made up around 25 per cent of indirect tax compared with 10 per cent in 2013-14.
Note 2: For the 1950s, ‘Other’ includes payroll tax, land tax, estate duty, entertainments tax, gift duty and gold tax.
Source: Reserve Bank of Australia 1997, *Australian Economic Statistics 1949-50 to 1994-95*, Occasional Paper Number 8, viewed 10 December 2014: www.rba.gov.au/statistics/frequency/occ-paper-8.html; Australian Government 2014, *Budget 2014-15 — online supplementary tables,* Australian Government, Canberra, viewed 10 December 2014: http://budget.gov.au/2014-15/content/bp1/html/bp1_bst5-06.htm; and Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra; and Treasury estimates.

Box 2.2: Bracket creep

Progressivity in the individuals income tax system is delivered by applying higher marginal rates of tax at different income thresholds. These thresholds do not automatically keep pace with inflation or wages growth. Bracket creep (also called fiscal drag) refers to the fact that taxpayers will face higher average, and sometimes marginal, tax rates over time even if their income has only increased by inflation.

Between 2014-15 and 2024-25, the percentage of taxpayers in the top two tax brackets (that is, with taxable income in excess of $80,000) is estimated to increase from around 27 per cent to 43 per cent under current policy settings. It is estimated that over 2 million more taxpayers will be in the third income tax bracket (taxable income from $80,000 to $180,000) in 2024-25, compared to 2014-15. There is also estimated to be around 750,000 more taxpayers in the fourth tax bracket (taxable income above $180,000) in 2024-25 compared to 2014-15 (Chart 2.7).

Chart 2.7 Estimated cumulative increase in taxpayers in third and fourth tax brackets, relative to 2014-15



Note: Tax rates exclude Medicare Levy and Temporary Budget Repair Levy.
Source: Treasury estimates.

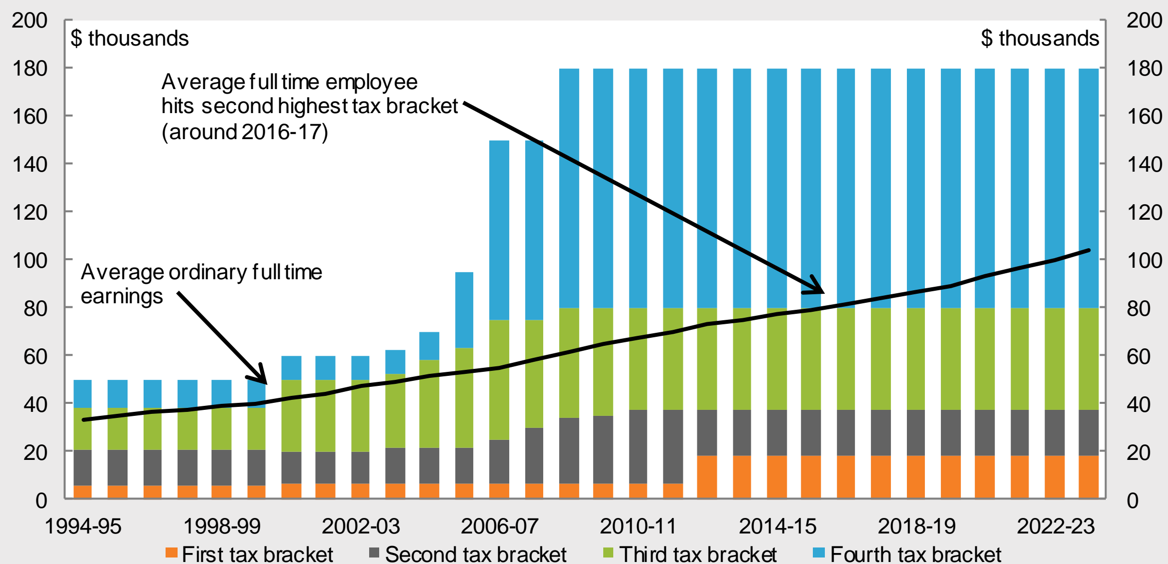
While bracket creep exists because of the progressivity of the individuals income tax system, unchecked bracket creep affects lower and middle income earners proportionally more than higher income earners.

For example, average ordinary full-time earnings were around $75,000 in 2013-14, and are expected to be around $104,000 in 2023-24 (see Chart 2.8). Someone on average full-time earnings therefore had an average tax rate of 22.7 per cent in 2013-14, increasing to 27.4 per cent by 2023-24. By contrast, someone with only half that income earned $37,500 in 2013-14, increasing to $52,000 in 2023-24. However, their average tax rate will increase from 10.3 per cent to 17.8 per cent. Someone earning twice the average full-time wage is on $150,000, increasing to $208,000 in 2023-24, but their average tax rate will only increase from 30.5 per cent to 34.3 per cent.

Box 2.2 con't

For some people, particularly those on relatively low incomes, bracket creep can reduce incentives to work. At higher incomes, bracket creep increases the incentives for tax planning and structuring, and even overseas relocation. Bracket creep is therefore not just an issue because of its effect on progressivity, but because over time it exacerbates the other problems in the individuals income tax system.

Chart 2.8 Personal income tax rates and the effects of bracket creep



Source: Australian Bureau of Statistics (ABS) 2014, *Average Weekly Earnings, Australia, May 2014*, cat. no. 6302.0, ABS, Canberra and Treasury calculations.

2.3: Costs imposed by the tax system affect economic growth and the living standards of Australians

Recent research supports the importance of tax settings for economic growth.[11] Greater global economic integration means that investment and highly skilled workers have become more mobile. If tax settings are too high, Australia will be a less attractive place to invest and work and this will affect growth in Australians' living standards.

Other countries in a similar position to Australia, with a limited capacity to influence global capital markets, have generally sought to reduce the economic costs of taxation by having lower taxes on mobile factors of production (especially capital investment).

11 OECD 2010, *Tax Policy Reform and Economic Growth*, tax policy studies no. 20, OECD, Paris.

The tax system imposes economic costs by distorting the decisions of individuals and entities

All tax systems impose economic costs by altering the decisions of individuals and entities and compliance costs associated with meeting tax obligations and administering the system.

Tax systems impose economic costs by changing relative prices, which influence decisions individuals and entities make to work, save, invest and employ. Different types of activities are taxed at different rates in the tax system, which means that taxes discourage some activities while encouraging others. These tax-induced changes have costs to both the economy and households.

In general, taxes have a greater impact on behaviour and, hence, a greater cost to economic growth and household living standards, where the tax is levied at a high rate and/or when it is easier for a person or entity to reduce tax by changing behaviour.

Taxes applied to narrower economic bases due to exemptions and concessions have to be set at higher rates to raise the same amount of revenue compared to taxes applied across broad bases. Generally, a tax applied at a higher rate on a narrower base will have higher economic costs than if applied more broadly at a lower rate.

Modelling suggests that some taxes with high costs to economic growth and living standards are company tax and stamp duties

Recent Treasury modelling of the major taxes in Australia suggests the taxes with high long-term costs for living standards (measured as the 'marginal excess burden'[12]) are company income tax and stamp duties (Chart 2.9).[13] Company income tax has a high marginal excess burden because of the relatively high company tax rate of 30 per cent in Australia, combined with the high level of mobility of the underlying tax base. Conveyancing stamp duties also have a high excess burden because they discourage the exchange of residential and business properties. Other modelling also suggests that insurance duties have fairly high costs because they discourage some households from taking out appropriate levels of insurance.[14]

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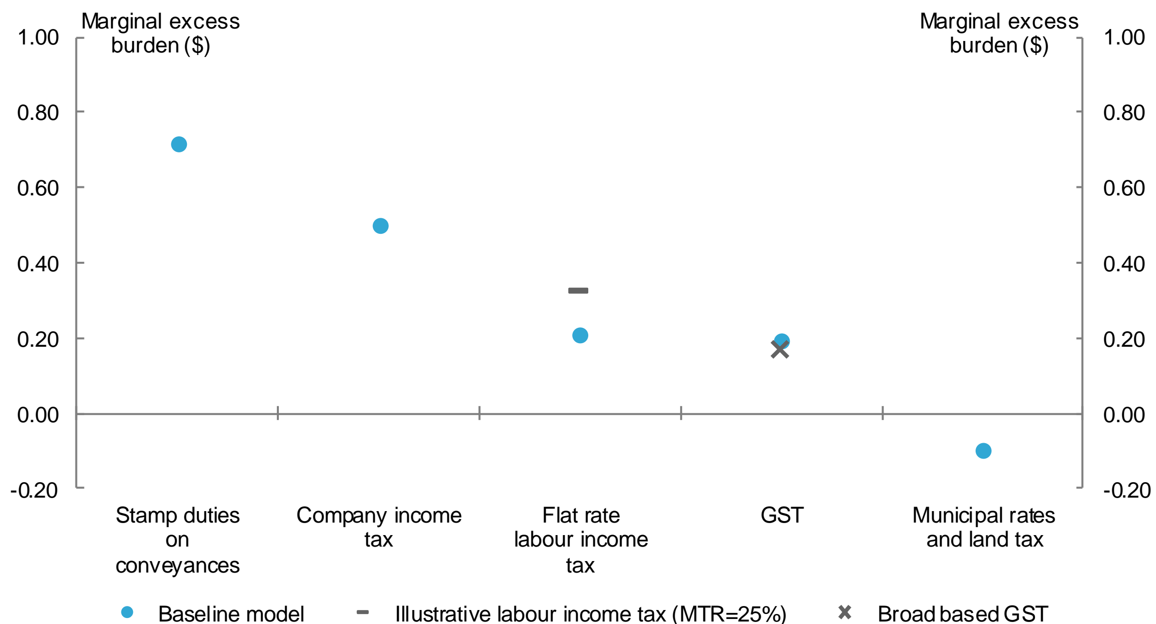
12 The 'marginal excess burden' is a measure of some of the economic costs associated with a tax on the aggregate welfare of Australian households. In particular, the measure examines the impact of raising an additional $1 of revenue on the level of consumption of goods and services by households, as well as time for leisure.

13 Cao, L, Hosking, A, Kouparitsas, M, Mullaly, D, Rimmer, X, Shi, Q, Stark, W, and Wende, S, forthcoming, *Understanding the economy-wide efficiency and incidence of major Australian taxes*, Australian Treasury working paper, Treasury, Canberra.

14 KPMG Econtech 2010, *CGE analysis of the current Australian tax system — Report for the Australia's Future Tax System review*, KPMG Econtech, Canberra; KPMG Econtech 2011, *Economic analysis of the impacts of using GST to reform taxes — Report for the CPA Australia*, KPMG Econtech, Canberra; and NSW Treasury 2012, *NSW Financial Audit 2011 (Lambert review)*, Volume 2, Chapter 13, NSW Treasury, Sydney.

Chart 2.9 Long-run modelling estimates of the marginal excess burden of some of Australia's taxes



Note: Marginal excess burdens were estimated using a long-run CGE model of the Australian economy and tax system. Australian households are captured as a single economic unit in this model. The labour income tax is modelled as a stylised flat tax on labour income only. An out-of-model calculation for a marginal tax rate (MTR) of 25 per cent is presented as an illustration of an average taxpayer in 2011-12. Transfer payments are not captured in this model. For more information on this modelling, as well as analysis of a stylised capital component of individuals taxation, see the Australian Treasury working paper forthcoming, *Understanding the economy-wide efficiency and incidence of major Australian taxes.*
Source: Treasury estimates.

The GST and taxes on labour, particularly through the individuals income tax system, have a medium marginal excess burden. These taxes affect the decisions people make about how much time they spend in paid employment (and, in turn, the amount of goods and services they can consume with this income, or save) versus leisure or unpaid work at home.

Individuals income tax on labour is sometimes assessed as having higher economic costs than the GST because of the progressive rates scale. A key feature of a progressive individuals income tax system is that marginal tax rates are higher than average tax rates. When combined with means-tested assistance in the transfer system, this can lead to high effective tax rates, which can reduce the immediate rewards for work. Effective tax rates can affect workforce participation decisions. The current individuals income tax scales will lower living standards over time as more taxpayers fall into higher income tax brackets.

Modelling also suggests that broad-based land taxes, such as municipal rates, have a low economic cost (Chart 2.9). This is because land is immobile (unlike other capital) and cannot be moved or varied to avoid tax. The model applies this assumption to both domestic and foreign ownership of land. Land taxes paid by foreign and domestic landowners are only redistributed to the domestic households, providing a benefit to Australian households and

generating a negative marginal excess burden for a broad-based land tax shown in the chart.[15]

The benefits of reducing the economic costs of taxation are spread throughout the economy, including workers

A tax system that relies too heavily on inefficient taxes, uncompetitive tax rates and poorly targeted or ineffective concessions will impose significant economic costs on the economy. These costs fall disproportionately on less mobile factors of production, including domestic labour.

An important consideration for designing the tax system is who actually bears the economic costs of taxation — commonly referred to as the 'incidence' of a tax. The legal incidence and economic incidence of a tax are often not the same, and the distribution of the economic incidence can have a significant impact on the economy.

Many taxes are legally required to be paid by companies and other entities, such as superannuation funds. However, the final economic incidence of these taxes often falls elsewhere. This occurs when the entity legally responsible for paying a tax can pass the cost of that tax to individuals as workers, consumers and investors, for example, by charging higher prices for goods or services or offering lower wages to employees.

Recent research by the Treasury[16] indicates that, in the long run, much of the burden or incidence of company tax falls on Australian workers. This is because, over time, the amount of capital investment in Australia (for example, the construction of buildings and purchase of equipment for production) is affected by the company tax rate. Lower amounts of capital investment in the Australian economy will reduce the output or productivity of labour and, in turn, reduce the real wages of workers.

Transference of the cost of a tax through the economy forms the basis of the 'marginal excess burden' measure of the economic cost of taxes on the welfare of Australian households (Chart 2.9).

The high economic cost of some taxes, combined with the distribution of those costs through the economy, has prompted a policy response internationally. Many countries, including the United Kingdom and Canada, have reduced their company tax rate in recent years and strengthened their integrity rules to counter multinational tax planning (Chart 2.10). Consequently, while Australia's integrity rules are strong, our company tax rate of 30 per cent is now significantly above the average rate of other countries, particularly our Asian neighbours, with whom we compete for foreign investment.

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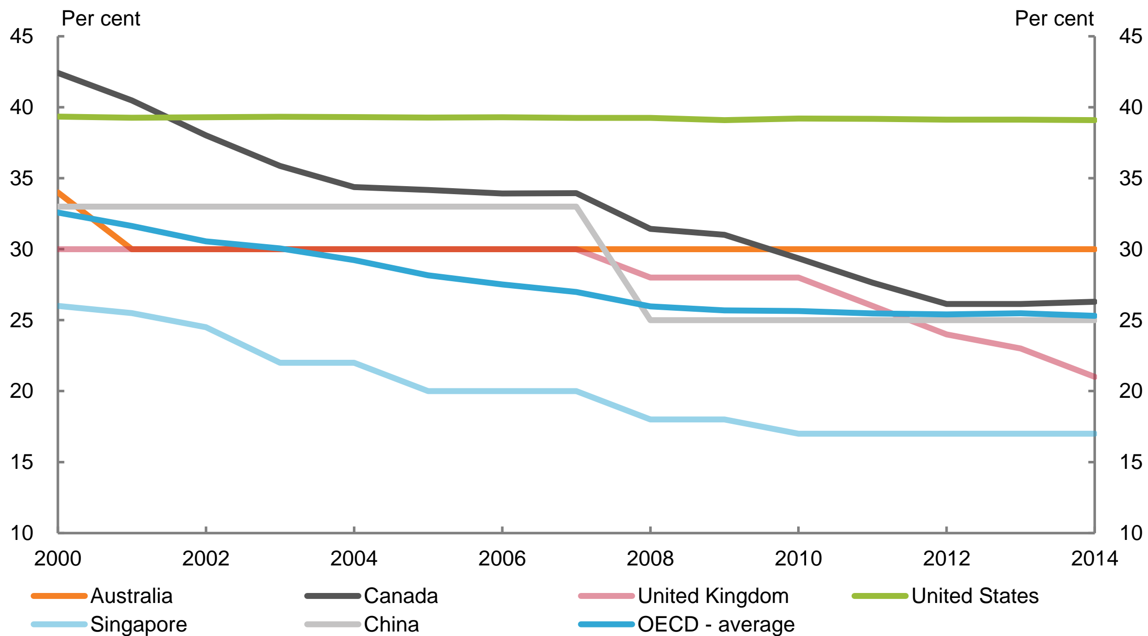
15 Independent Economics also recently estimated a similar marginal excess burden for a broad-based land tax. See Independent Economics 2014, *Economic impacts of negative gearing of residential property — report for the Housing Industry Association*, Independent Economics, Canberra.

16 Cao, L, Hosking, A, Kouparitsas, M, Mullaly, D, Rimmer, X, Shi, Q, Stark, W, and Wende, S, forthcoming, *Understanding the economy-wide efficiency and incidence of major Australian taxes*, Australian Treasury working paper, Australian Treasury, Canberra; and Rimmer, X, Smith, J, and Wende, S 2014, 'The incidence of company tax in Australia', *Economic Roundup*, issue 1, 2014, Australian Treasury, Canberra, pages 33-47.

Chart 2.10 Trends in corporate tax rates in selected economies



Source: OECD 2014, *Tax Database — Taxation of Corporate and Capital Income*, OECD, Paris, viewed 5 December 2014: www.oecd.org/ctp/tax-policy/Table%20II.1-May-2014.xlsx; KPMG 2014, *Corporate tax rates table*, viewed 5 December 2014: www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx; and KPMG 2007, *Hong Kong Tax Competiveness Series: Corporate Tax Rates*, viewed 5 December 2014: www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/corp-tax-rate-0707.pdf; KPMG 2006, *KPMG's Corporate Tax Rate Survey, An international analysis of corporate tax rates from 1993 to 2006*, viewed on 21 January 2015: www.lib.uwo.ca/files/business/KPMGCorporateTaxRateSurvey.pdf.

2.4: There are opportunities to reduce the high costs of taxation due to complexity

A certain level of complexity is an inevitable part of any nation's tax system, reflecting the inherent complexity of the modern economy and society. The complexity of Australia's tax system continues to increase and is becoming a problem in its own right.

Complexity in the design of the tax system is a major driver of costs to individuals and entities, particularly compliance costs as taxpayers interact with the system and administration costs. Complexity also increases uncertainty and risk for taxpayers and can undermine trust in the system.

While it is broadly agreed that Australia's tax system is complex, there is no single measure of complexity. As such, administration and compliance cost estimates are often used as a proxy. The costs of administering the tax system at the Commonwealth level (including the GST) were around $3.6 billion in 2013-14.[17] The Australian Taxation Office (ATO) estimates

17 Australian Taxation Office (ATO) 2014, *ATO Annual Report 2013-14*, ATO, Canberra, viewed 5 December 2014: http://annualreport.ato.gov.au/01-overview/commissioners-review.

that total tax compliance costs are in the order of $40 billion per year.[18] Around 72 per cent of Australian tax filers engaged a tax agent to assist them in meeting their tax obligations for the 2011-12 income year.[19] These costs represent resources diverted from other more productive or enjoyable activities.

Tax compliance costs have multiple drivers

Changes in global business models and multinational tax planning are major drivers of complexity in tax policy design, in part because they threaten the revenue-raising capacity of tax systems. Complexity has also increased as new treatments and concessions are added in a piecemeal fashion, usually to assist a particular group or otherwise correct for an unintended outcome. Although these measures are meant to provide benefits, efforts to carefully target concessions often impose substantial compliance costs on taxpayers.

Complexity acts as an additional drag on the Australian economy when the costs of taxation arrangements outweigh their intended benefits. Reducing unnecessary complexity would clearly provide benefits to the economy. The Government's deregulation agenda seeks to address compliance costs directly by reducing the amount of regulation individuals and entities must comply with, including by simplifying particularly complicated areas of law, such as taxation law.

Of course, the impacts of complexity are broader than just compliance and administration costs. Individuals may alter investment decisions based on the tax treatment of particular activities. In the business context, this can manifest as a business choosing a particular business structure (or combination of structures) to achieve a particular tax outcome.

Individuals and entities willing to engage with complexity in the tax system can structure their affairs so as to minimise their tax liability. This can involve using different legal forms or structures to take advantage of opportunities presented by concessions or gaps in the structure of the law. Economically similar activities may end up being taxed differently, depending on professional advice or choice of legal structure. Tax planning of this nature is usually more accessible to higher-income taxpayers, which can contribute to perceptions that the tax system is inequitable.

Approaches and practices will need to change to reduce complexity in the tax system

There are limited opportunities for a holistic, 'first principles' consideration of the tax system, including whether its fundamentals are still relevant. Historically, successive tax reviews have focused on the need to reduce the complexity of the tax system. This focus tended to diminish once the review process was complete. Substantial and enduring progress towards reducing complexity has remained elusive for a range of reasons, including the trade-offs involved.

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18 ATO analysis of commissioned Newspoll survey data relating to the 2011-12 tax year, to be presented at a forthcoming conference in 2015.

19 ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

Minimising tax complexity requires a broad change in attitudes and practices, including community acceptance that, while a reduction in complexity is likely to deliver substantial benefits for taxpayers as a whole, solutions are also likely to entail costs for some.

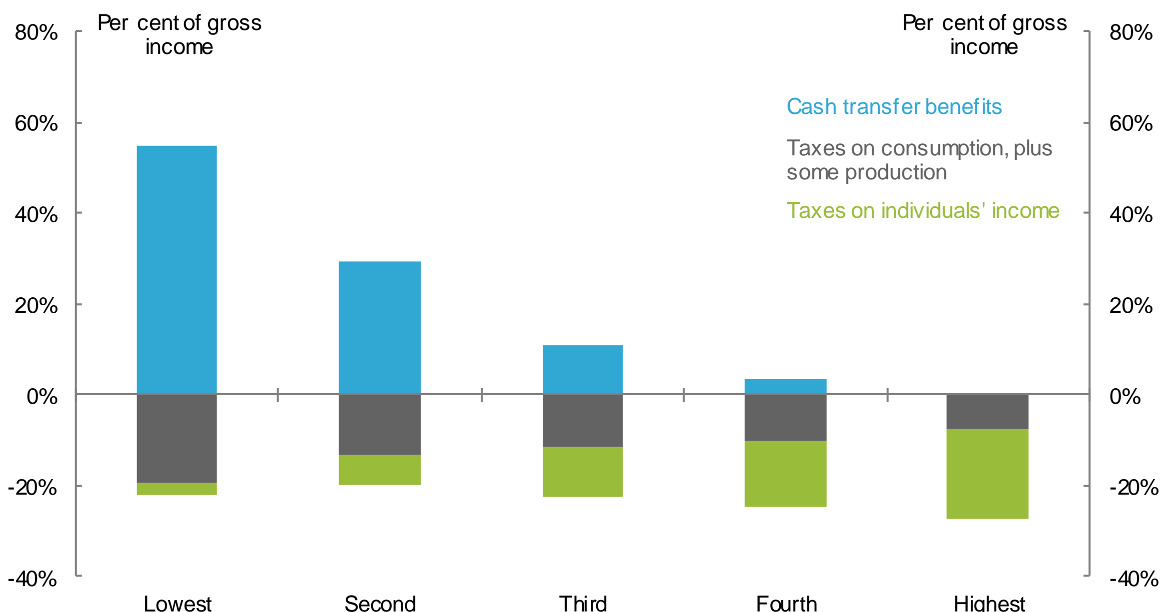
2.5: Tax systems need to be accepted as fair to be effective, sustainable and credible

To be sustainable, a tax system must be accepted by the community as fair. There is general acceptance (not just in Australia but around the world) that taxpayers with a greater ability to pay tax should pay more tax (vertical equity) and that taxpayers in economically similar situations should pay similar amounts of tax (horizontal equity). The progressivity of a tax system refers to the extent to which those with a greater ability to pay are expected to pay more. Progressivity in the tax system operates alongside the transfer system to deliver on income redistribution goals.

Australia's tax and transfer systems are highly progressive

Australia's tax and transfer systems are highly progressive. Progressive individuals tax rates and thresholds underpin the overall progressivity of the tax system (Chart 2.11).

Chart 2.11 Transfer payments and taxes as a percentage of gross income by household income quintile, Australia, 2009-10



Note: Taxes on income include individuals income tax plus the Medicare levy and Medicare levy surcharge. Taxes on production include taxes payable on goods and services; taxes and duties on imports; and taxes on the ownership or use of land, buildings or other assets used in production or on labour (but not taxes on corporate profits or other business income). Transfer payments and taxes are expressed as a percentage of household gross income, which is before income tax and includes social assistance benefits received in cash. Household quintiles are defined according to equivalised disposable household income.
Source: Treasury calculations using ABS 2012, *Government benefits, taxes and household income, Australia, 2009-10*, cat. no. 6537.0, ABS, Canberra.

Progressivity is also illustrated by the 'tax wedge' for different households, where the tax wedge is the difference between the labour costs to an employer (effectively the 'pre-tax' wage) and the household's net take-home pay (after subtracting tax and adding transfer payments). In Australia, the tax wedge is low at low levels of income, reflecting low tax rates and any transfer payments received. As household incomes increase, the tax wedge becomes larger, reflecting the imposition of higher rates of tax and the withdrawal of transfer payments.

Chart 2.12 shows that the increase in the tax wedge between a low-income household and a high-income household (the 'tax wedge progression') is much higher in Australia than the OECD average. The tax wedge progression for a single person with no dependants is high in Australia, which demonstrates the progressivity of the individuals income tax system (Chart 2.12, top chart). Countries with lower tax wedge progression have flatter tax schedules. Unlike some European countries that have universal payments for families with children, assistance in Australia is targeted, leading to an even higher tax wedge progression for families with children (Chart 2.12, bottom chart).

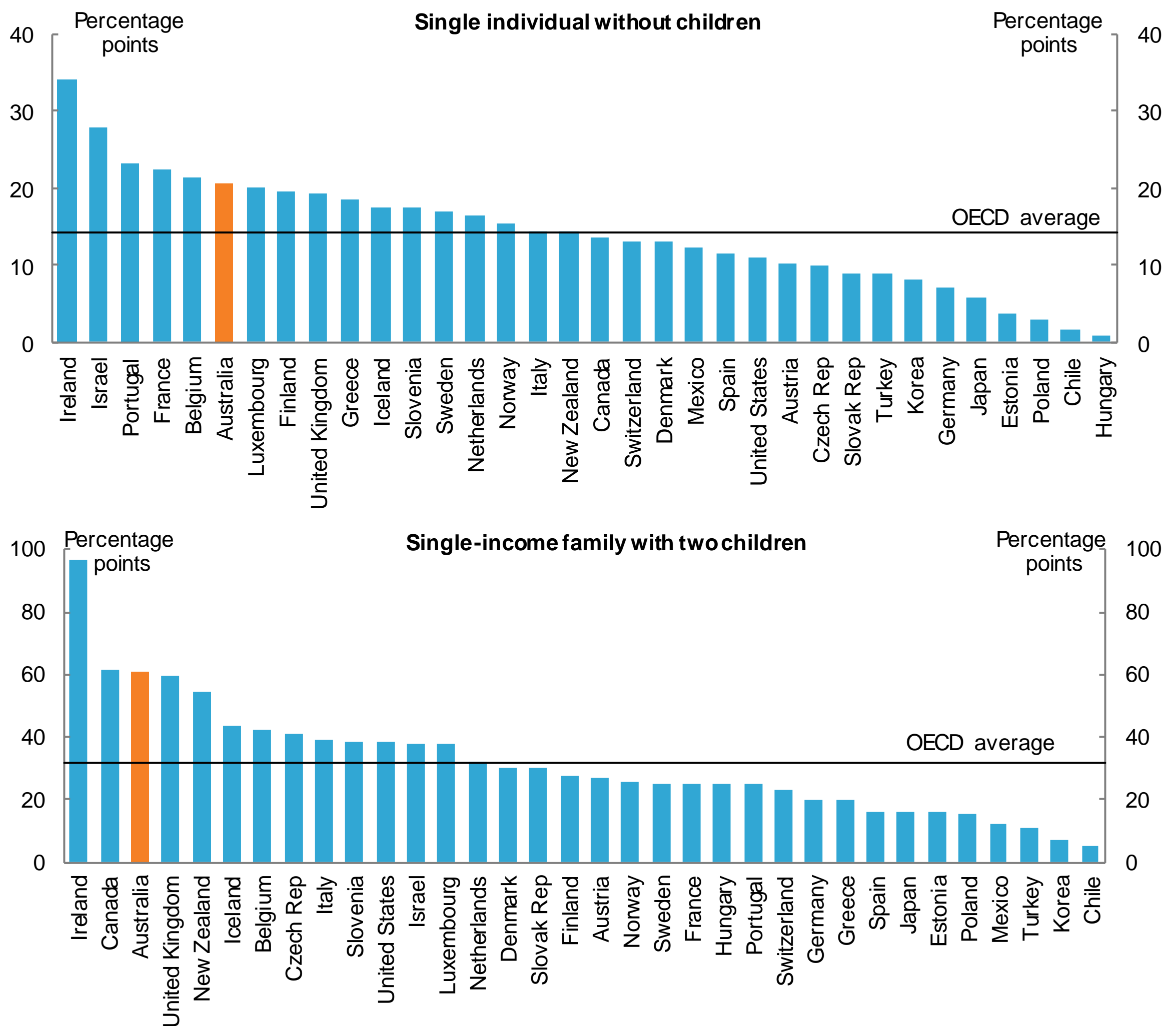
The progressivity of Australia's tax system is a consequence of increasing individuals tax rates as incomes rise and the absence of flat-rate social security contributions (which are levied in many other countries).

The tax system also provides that individuals earning below $20,542 do not pay any tax (taking into account the tax-free threshold and low-income tax offset). Single seniors who receive the seniors and pensioners tax offset have an effective tax-free threshold of $32,279. This system means that the average tax burden in Australia is lower than other similar countries. A single average wage earner in Australia faces an average tax burden of 27 per cent. In comparison, the average tax burden in Canada, the UK and the US is around 31 per cent.[20]

Many jurisdictions apply a flat-rate social security contribution, levied on an employee's wages, that is notionally allocated to pay for unemployment and aged care allowances over a person's lifetime. Social security contributions, as a flat rate tax, have a greater impact on the discretionary spending options of low income earners. Australia does not apply a separate social security contribution. Instead, pension costs are funded from Australia's main revenue stream and supplemented by the private superannuation system.

20 OECD 2014, *Taxing Wages*, OECD, Paris, viewed 21 November 2014: www.oecd.org/tax/tax-policy/taxing-wages.htm.

Chart 2.12 Average tax wedge progression, OECD countries, 2013



Note: The average tax wedge progression is the percentage point difference between the average tax wedge of an individual (or family) earning 250 per cent of average wages and the average tax wedge of an individual (or family) earning 50 per cent of average wages. The average tax wedge progression includes the effect of employee and employer social security contributions, payroll taxes and cash benefits.
Source: Treasury calculations using OECD 2014, *Taxing Wages*, OECD, Paris, viewed 3 December 2014: http://stats.oecd.org/.

A trade-off for Australia's low average individuals' tax burden is that the statutory and effective tax rates produced by the interaction between the tax system and tightly targeted transfer system are comparatively high by international standards. For example, a single person in New Zealand earning NZ$40,000 a year would pay 18.95 cents in tax on their next dollar of income and pay NZ$6,600 in tax for the year.[21] In Australia, someone earning A$40,000 would pay 36 cents in tax on their next dollar of income, yet pay annual tax of only A$4,947.[22]

21 Includes Accident Compensation Corporation earner's levy.

22 Includes Medicare levy and low-income tax offset.

High effective tax rates can reduce participation incentives for some groups

The combined effect on a person's earnings of income tax and the withdrawal of means-tested tax offsets and cash transfers in the welfare system is reflected in their effective tax rates. High effective tax rates can alter individuals' decisions about whether, and how much, they work.

The impact of high effective tax rates on individuals' decisions is most pronounced at lower levels of income and for particular groups like secondary earners, sole parents and those transitioning from income support into work. High effective tax rates can have economic consequences, and can also be seen as unfair where they excessively reduce returns from working.

Perceptions of fairness also underpin wider confidence in the tax system

Confidence in the tax system can be eroded when people think others are not paying their fair share of tax. This can be due to concerns over concessions, aggressive tax avoidance or tax evasion activities. Maintaining confidence is particularly important given our reliance on self-assessment, which in the first instance asks individuals and entities to calculate their own tax liability. Effective tax design and administration are important in maintaining high levels of compliance and confidence in the system.

Box 2.3: Perspectives on fairness in the tax system

Fairness is an important consideration for widespread acceptance and sustainability of the tax system. While fairness, or equity, is widely accepted as a fundamental design principle for the tax system, views about what this means in practice are very diverse. Similarly, there is no universally accepted benchmark for assessing the extent to which the tax system delivers equitable outcomes.

Most people consider that high-income earners should pay more tax than lower-income earners, both in dollar and percentage terms. Much of the controversy around tax fairness stems from disagreement about the extent to which the *percentage of income paid in taxes* should rise with higher levels of income.

Perspectives on equity are reflected in the different ways taxes can be structured: proportionally, progressively or regressively.

A *proportional tax* is one where the average tax rate is *constant* for all levels of the tax base. In these cases, the marginal tax rate equals the average tax rate. The GST, which has the same tax rate for all goods and services falling within its base, is an example of a proportional tax.

A *progressive tax* is one where the average tax rate *rises* as the tax base rises (because of increasing marginal tax rates). Australia's individuals income tax system is an example of a progressive tax.

A *regressive tax* is one where the average tax rate *falls* as the tax base rises (and the marginal tax rate is below the average tax rate).

Box 2.3 con't

Just as the economic growth effect of tax reform is considered from the lens of the whole tax system (including individuals tax, fringe benefits tax, superannuation and so on) and the transfer system, the fairness of the tax system should also be assessed on a system-wide basis. For example, reforms that result in taxpayers in similar economic circumstances having similar tax liabilities (also called horizontal equity) are likely to make the system as a whole fairer, even when they have no impact on progressivity in the system.

Fairness in the tax system (and also the transfer system) is often assessed according to how much an individual pays in tax (and receives in benefits) relative to their current income. However, as people's incomes tend to change over their lives, an alternative perspective on fairness is taxes paid (and benefits received) relative to a person's lifetime income. Currently, there is limited data on tax and transfer outcomes for individuals and households over the lifecycle.

Questions of fairness or equity also arise when tax laws change with negative impacts for individuals or entities that have made decisions based on the previous policy.

To address these issues, special arrangements are often put in place temporarily to assist with a smooth transition. In some cases, 'grandfathering' allows past arrangements to be applied indefinitely in existing situations, with the new arrangements applying to all future cases. While grandfathering arrangements can assist those who are negatively affected by a tax change, they can also be a source of enduring complexity in the tax system.

Tax on individual savings should give people the incentive to consider their future, but different types of savings are taxed differently, which affects savings choices

Most forms of private savings are taxed at lower rates than labour income. Taxing savings at lower rates than labour income can reduce or remove the negative effects of inflation on incentives for individuals to save for their future.

Australia's tax system treats alternative forms of saving differently. At one end of the spectrum, savings held in the family home are taxed at average effective tax rates approaching zero.[23] At the other end of the spectrum, savings held as financial deposits are taxed at full marginal rates, without any recognition for the costs of inflation.

The policy rationale for these differences is not always clear and can distort taxpayers' savings decisions. This has implications both for efficiently allocating savings in the economy and distributing risk across households.

23 This is because any capital gain from the family home and the benefit the household receives compared to a corresponding household living in a rental dwelling (commonly referred to as 'imputed rent') are not taxed.

Discussion questions: Australia's tax system

2. How well does Australia's utilisation of its available taxes align with the evolving structure of Australia's economy and changes in the international economy?
3. How important is it to reform taxes to boost economic growth? What trade-offs need to be considered?
4. To what extent should reducing complexity be a priority for tax reform?
5. What parts of the tax system are most important for maintaining fairness in the tax system? Are there areas where fairness in the tax system could be improved?

3: Individuals

Overview

This chapter gives an overview of Australia's individuals income tax system and issues arising in the current system that may present scope for reform.

Key points

- Individuals income tax is the single most important source of government revenue and has consistently raised around half of the Australian Government's tax receipts since the 1970s. It continues to be a stable and predictable source of revenue to this day.
- Individuals income tax thresholds are not automatically indexed to inflation. This results in bracket creep, which increases the reliance on individuals income tax over time. Unchecked bracket creep can also exacerbate any issues inherent in the individuals income tax system.
- For many people, individuals income tax does not significantly alter their workforce participation. However, it can be more distorting for particular groups of taxpayers, such as low-income earners or the second income earner in a family, or high-income earners with the ability to plan their tax affairs.
- Australia's individuals income tax regime is very progressive compared to other countries. We have relatively low average rates of tax at low levels of income, but we have relatively high marginal tax rates at medium and high levels of income.

3.1: Overview of the individuals income tax system

What is individuals income tax?

Individuals income tax refers to the tax that people pay on their personal income, less any expenses (called deductions) incurred in generating that income. Examples of personal income include salary and wages; rent, interest, or net capital gains from investments; distributions from a trust or partnership; and returns generated from carrying on an unincorporated business.

Deductions for costs incurred in producing assessable income recognise that different people incur different costs in producing income. Examples of such costs include: work-related expenses (such as purchasing and cleaning uniforms, self-education expenses and motor vehicle expenses); interest repayments on loans used to purchase investments; and expenses incurred in carrying on a business.

Income that is subject to tax in the individuals income tax system is called ‘taxable income’. The amount of tax that people pay on their taxable income is primarily determined by the schedule of marginal rates and thresholds. It can also be either increased by levies or reduced by any concessions or offsets for which a person is either liable or eligible.

Individuals may also receive non-cash remuneration from employers, called ‘fringe benefits’, such as the use of a car or accommodation, as part of an employment relationship. These are taxed in the fringe benefits tax (FBT) system, rather than in the individuals income tax system. While FBT is levied on and paid by employers, it relates to the non-cash payments received by employees. FBT is discussed separately under ‘overview of the fringe benefits tax system’ below.

Rates and thresholds

Australia’s individuals income tax schedule is progressive, with a high tax-free threshold followed by increasing tax rates at subsequent thresholds (see Table 3.1). The rate specified at each tax bracket is the ‘marginal’ tax rate, which is the amount of tax payable on a taxpayer’s next dollar of taxable income, not the ‘average’ tax rate on that person’s entire taxable income (see Chart 3.1).

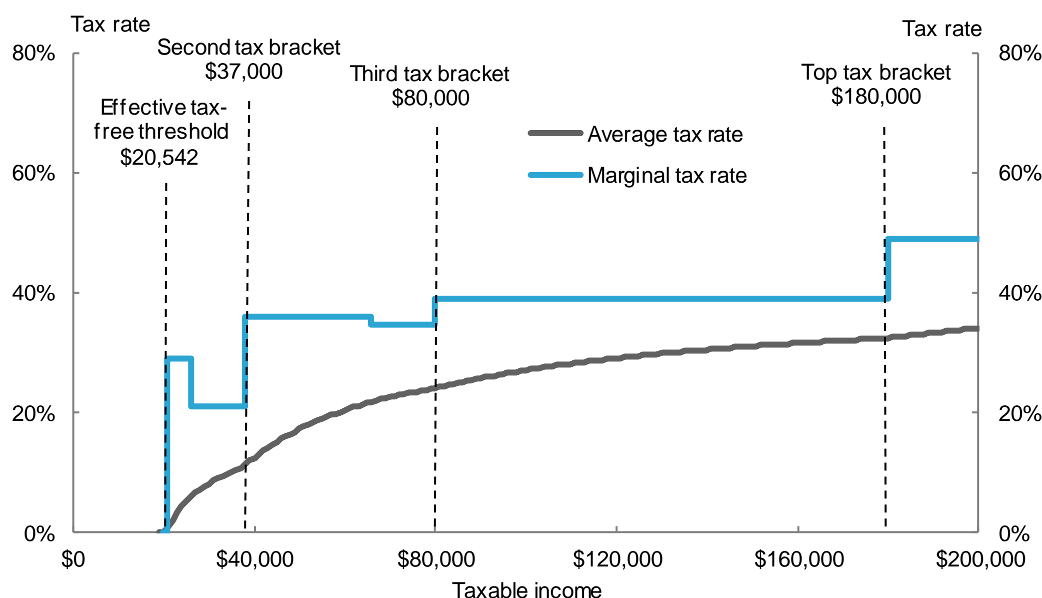
Table 3.1 Schedule of marginal rates and thresholds, 2014-15

Taxable income	Tax on this income
$0—$18,200	Nil
$18,201—$37,000	19 cents for each $1 over $18,200
$37,001—$80,000	$3,572 plus 32.5 cents for each $1 over $37,000
$80,001—$180,000	$17,547 plus 37 cents for each $1 over $80,000
$180,001 and over	$54,547 plus 45 cents for each $1 over $180,000
The maximum low-income tax offset (LITO) of $445 is available for individuals with income below $37,000. These people have an ‘effective tax-free threshold’ of $20,542. The Medicare levy of 2 per cent also separately applies to most taxpayers’ total taxable income. The Temporary Budget Repair Levy is payable at a rate of 2 per cent on taxable income over $180,000 between the years 2014-15 and 2016-17.	

Someone with taxable income of $85,000 would face a marginal tax rate of 39 cents on their next dollar of income (the statutory rate of 37 per cent and the Medicare levy of 2 per cent). But their average tax rate would be much lower: 24.8 per cent, or $19,397 in tax and $1,700 in Medicare levy as a proportion of their taxable income of $85,000.

The tax thresholds are not indexed, which means that they do not automatically keep pace with either inflation or wage growth. As discussed in Chapter 2, this leads to bracket creep, which erodes the value of tax cuts and reduces the progressivity of the tax system over time. To address this, governments need to periodically give further tax cuts to maintain the rewards for effort, which in turn keep from discouraging workforce participation or from encouraging tax planning and structuring. These considerations are discussed further in section 3.3 of this chapter.

Chart 3.1 Average and marginal tax rates, 2014-15



Notes: The rates shown are for a single person with no dependants who does not receive any Australian Government transfer payments. Marginal tax rates take account of the statutory rates shown in Table 3.1, as well as the Medicare levy of 2 per cent, the Temporary Budget Repair Levy (an additional 2 per cent on taxable income in excess of $180,000 per year) and the LITO. The LITO brings the effective tax-free threshold to $20,542. The 10 percentage point increase in marginal tax rates between $20,542 and $25,677 is due to the phase-out of the Medicare levy low-income concession. The 1.5 percentage point increase in marginal tax rates between $37,001 and $66,667 is due to the phase-out of the LITO.

Concessions

Concessions refer to the treatment of income that may be exempt from tax or taxed at less than full marginal rates. Australia has a broad individuals income tax base, with relatively limited concessions on labour income, although there is concessional treatment for income from saving (such as superannuation or capital gains — Chapter 4) and income from carrying on a business (such as capital gains tax concessions targeted to small business — Chapter 6).

Levies

In the Australian tax system levies are generally linked to funding a particular government expenditure. Temporary levies are sometimes imposed to raise revenue to meet a particular need. The main permanent levy in the individuals income tax system is the Medicare levy. It is similar to the social security contributions used in other countries because it is applied at a flat rate on a person's entire taxable income. Low-income individuals and households may pay a reduced amount of the Medicare levy or no Medicare levy at all. Singles with no

dependants do not pay any Medicare levy until their taxable income exceeds $20,542.[24] Above this threshold, the concession is withdrawn at a marginal rate of 10 per cent (shown in Chart 3.1) until the Medicare levy is fully phased in by $25,677. This ensures that lower-income earners do not face the full rate of Medicare levy suddenly when they reach the threshold, but that it is gradually phased in.

Although the Medicare levy was directly tied to the introduction of Medicare in 1984, it is not formally hypothecated to the costs of the Medicare scheme. In 2013–14 it raised around $10.3 billion in revenue.[25] This only partially offsets total Australian Government expenditure on health, which for 2013-14 was $64 billion,[26] or Australian Government expenditure on Medicare services, which for 2013-14 was $19.3 billion.[27] The rate of the Medicare levy was recently increased by half a percentage point to 2 per cent from 1 July 2014 to help fund the introduction of the National Disability Insurance Scheme (NDIS). All additional revenue from the increase in the Medicare levy for ten years will go directly toward funding the NDIS.

Offsets

Tax offsets are concessions that reduce a person's tax liability. If someone does not have a tax liability (for example, because their taxable income falls below the tax-free threshold), then they generally cannot benefit from offsets.

The main tax offset that is a structural part of the individuals income tax system is the low-income tax offset (LITO). The LITO is available in full for individuals with taxable income up to $37,000, then withdrawn gradually after that. Combined with the $18,200 tax-free threshold, people do not begin to pay tax until their taxable income exceeds $20,542 (their *effective* tax-free threshold). The benefit from the LITO is fully withdrawn for people with taxable income in excess of $66,667.

The number of tax offsets in the individuals income tax system has been reduced over time. Of those that remain, the seniors and pensioners tax offset (SAPTO) and the beneficiaries tax offset (BENTO) exist in order to ensure that recipients of Australian Government pensions and allowances respectively do not pay any tax on those pensions or allowances. Other tax offsets continue to be available in order to deliver assistance to particular groups of taxpayers, such as: the zone tax offset; the net medical expenses tax offset; the dependent (invalid and carer) tax offset; and the employment termination payments tax offset.

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24 Couples, families with children, senior Australians and recipients of Australian Government pensions and benefits may have higher amounts of taxable income before they begin to pay the Medicare levy. In addition, certain groups are exempt from paying the Medicare levy, for example blind pensioners and defence force personnel.

25 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

26 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

27 Australian Government 2014, *2014-15 Budget: Budget Strategy and Outlook Paper No. 1*, Australian Government, Canberra.

How important is individuals income tax as a revenue source for government?

Individuals income tax is the single largest Australian Government revenue source and has consistently raised around half of the Australian Government's tax receipts since the 1970s. As employment and wage growth tends to be relatively steady, individuals income tax is a stable revenue source. To address bracket creep and maintain the rewards for effort, governments over recent decades have generally lowered rates or raised thresholds to deliver tax cuts from time to time, keeping the proportion of revenue raised from individuals income tax relatively stable.

Who pays individuals income tax?

The unit of assessment for individuals income taxation in Australia is the individual. This means the progressivity of the individuals income tax system applies to taxable income in the individual's hands, but not necessarily to a household's taxable income (Box 3.1). This is different from the objectives of the transfer system where assistance is generally targeted based on the needs of a household, although certain tax concessions mirror assistance provided through the transfer system and adopt similar principles for targeting assistance.[28]

12.6 million Australians lodged an income tax return for the 2011-12 income year, of which 9.8 million Australians were net taxpayers.[29,30] The higher number of people lodging tax returns is due to a range of factors, including having too much tax withheld during the year (and receiving a refund upon assessment of the tax return); lodging a tax return to claim deductions that reduce taxable incomes or offsets that reduce tax liabilities; or carrying forward losses from earlier tax years that reduce taxable incomes.

Australian residents pay tax on their 'world income' which includes income sourced in Australia, as well as foreign-sourced income (generally less a credit for any tax paid in the foreign country). Non-residents are generally subject to Australian tax on their Australian source income.[31] Given increased globalisation and digitisation, concepts of 'source' or 'residency status' may not always be straightforward, particularly for taxpayers with complex income arrangements, or taxpayers who cross borders frequently.

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28 These include the Medicare levy low-income thresholds, the seniors and pensioners tax offset, the net medical expenses tax offset, and the dependent (invalid and carer) tax offset.

29 Australian Taxation Office (ATO) 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

30 'Net tax paid' does not take account of any transfer payments a person may be eligible for, such as Family Tax Benefit, Child Care Benefit.

31 This treatment applies in the absence of a tax treaty between Australia and another country. Australia currently has tax treaties with over 40 countries, which are intended to prevent double taxation and minimise tax evasion.

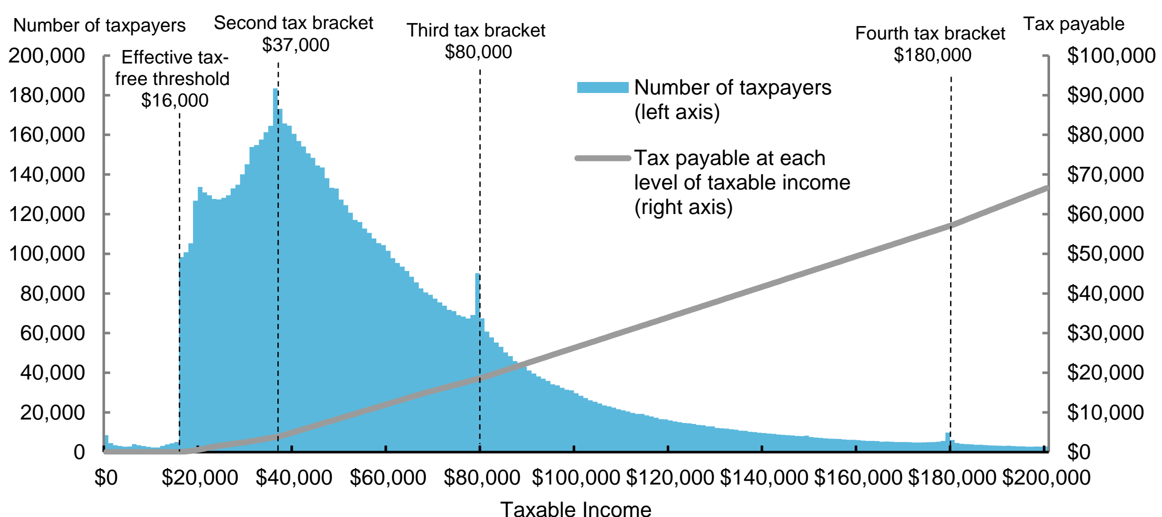
Box 3.1: Progressivity and the income of a household

Using an individual as the unit of assessment means that a couple with total taxable income of $100,000 would have different tax outcomes depending on who earns how much of that total income.[32] At one extreme, it may be a single-income couple with one person earning $100,000 and paying tax of $26,947 — an average tax rate of 26.9 per cent for the couple. At the other extreme, each member of the couple may earn $50,000 and each pay tax of $8,547 — an average tax rate of 17.1 per cent for the couple.

This tax outcome is sometimes criticised as 'unfair' as households with the same income pay different amounts of tax. However, taxing the individual improves the reward for effort for the secondary earner because they get a tax-free threshold, rather than facing the primary earner's marginal rate on their first dollar of income.

The costs and benefits of using the household as the unit of assessment depend on how the tax thresholds are designed. If household tax thresholds were the same as individual tax thresholds, there would be no change for the single-income couple, while the double-income couple would pay more tax. If household tax thresholds were double individual tax thresholds, there would be no change for the double-income couple, while the single-income couple would pay less tax. If household tax thresholds were higher than, but less than double individual tax thresholds, the single-income would pay less tax, while the double-income couple would pay more tax.

Chart 3.2 Who paid individuals income tax, 2011-12



Note: The chart shows the number of tax filers who paid net income tax in thousand dollar taxable income brackets up to $200,000. Tax payable is calculated by applying the individual income tax rate scale, LITO and the Medicare levy to taxable income.
Source: Treasury calculations using administrative data from 2011-12 tax returns for individuals.

Chart 3.2 shows the distribution of taxpayers across different taxable income levels. In 2011-12, most individual taxpayers had taxable income below the third threshold of $80,000. However, the largest amounts of income tax are paid by individuals who have higher taxable

32 The example discussed in this box does not take account of the transfer system or any assistance the secondary earner may be entitled to if they have caring responsibilities.

income. Table 3.2 shows the number of individual tax filers with taxable income in each of the tax thresholds. In 2011-12, around 27 per cent of individuals had taxable income above the effective tax free threshold and below the $37,000 threshold and paid around 4 per cent of the total share of individuals income tax. At the top end, around 2 per cent of individuals had taxable income above the $180,000 threshold and collectively paid around 26 per cent of total individuals income tax.

As the tax thresholds are not indexed, bracket creep means that the proportion of individuals in the higher tax brackets will increase over time. For example, the percentage of taxpayers with income between $80,000 and $180,000 is expected to be around 23 per cent in 2014-15, and increase to 25 per cent by 2016-17.

Table 3.2 Individuals income tax by tax bracket, all individual tax filers, 2011–12

Taxable income band	Marginal income tax rate	Individuals — no.	Individuals — %	Net income tax — $b	Net income tax — %
$16,000 or less	0%	2,307,735	18.3	0.0	0.0
$16,001 — $37,000	15%	3,453,310	27.3	5.3	3.7
$37,001 — $80,000	30%	4,745,935	37.6	47.4	32.8
$80,001 — $180,000	37%	1,836,900	14.5	54.0	37.4
$180,001 and over	45%	292,500	2.3	37.7	26.1
TOTAL	n.a.	12,636,380	100.0	144.4	100.0

Note: The effective tax free threshold in 2011-12 was $16,000, after including the low-income tax offset. Totals are for those individuals lodging a tax return for that year.
Source: Treasury estimates using income tax returns for resident individuals for 2011-12.

What impact does individuals income tax have on economic growth and living standards?

As with all taxes, the imposition of tax on individuals income can adversely affect behaviour. This may be seen in people's decisions about how much, and where, they work and earn. Additionally, while there may be little impact on direct economic activity, it can also be seen in the way people choose to structure the way they save, invest or carry on a business (see Chapters 4 and 6). As shown in Chart 3.2, the distribution of taxpayers across the taxable income scale clusters around the tax thresholds, suggesting some people respond to increasing marginal tax rates. Compared to taxes with a relatively significant impact on economic growth and living standards (such as company tax), individuals income tax is usually considered to have a comparatively moderate impact on the behaviour of most people, and relatively minor adverse impacts on economic growth and living standards. However the impact on workforce participation (see section 3.3) should not be ignored, particularly in the context of an ageing population.

While individuals income tax raises significant revenue across taxpayers with middle incomes with relatively little impact on their behaviour, it can create greater distortions and lead to greater adverse effects for taxpayers at the lower and higher ends of the income scale. Generally this is due to the interactions that the individuals income tax system has with other parts of the tax and transfer system. Relatively low-income taxpayers, particularly the secondary (or lower) earner in a couple, may receive transfer payments that are withdrawn as their income increases and at the same time they begin to pay tax, reducing the immediate reward for work. At higher incomes taxpayers have greater capacity to legitimately structure their affairs to minimise the amount they pay and some may be more internationally mobile. These issues are discussed further in Section 3.3 of this chapter.

Discussion questions:

6. What should our individuals income tax system look like and why?

3.2: Overview of the fringe benefits tax system

What is fringe benefits tax?

FBT is payable on the 'taxable value' of fringe benefits provided to an employee by their employer in respect of their employment. The FBT rate is set at the top marginal tax rate plus the Medicare levy. It is currently 47 per cent, and will increase to 49 per cent from 1 April 2015 for a period of two years to reflect the imposition of the Temporary Budget Repair Levy.

A fringe benefit is anything (other than salary and wages) provided by an employer to an employee. This includes making a car available for an employee's use or paying an employee's home power bill. The breadth of the system means several exemptions are required to minimise the compliance costs of valuing very minor benefits. For example, allowing an employee to use office property on business premises — the office phone for a personal call or the office computer to send a private email — is an exempt benefit. Fringe benefits are not included in the employee's assessable income for individual income tax purposes, but the value of benefits required to be reported is relevant to a number of income definitions used to means test transfer payments and tax concessions.

The taxable value of fringe benefits is determined by applying a range of different valuation methodologies, some of which provide concessional treatment (for example, on motor vehicle fringe benefits). Certain employers in the not-for-profit sector have scope to offer a greater range of concessional or exempt fringe benefits (also see Chapter 7).

How important is fringe benefits tax as a revenue source for government?

FBT was introduced as an integrity measure to ensure that all forms of remuneration paid to employees bear a fair measure of tax. While it only raised around $4.3 billion in revenue in 2013-14 (or about 1.2 per cent of total Australian Government tax revenue),[33] it plays an important role in preserving the integrity of the individuals income tax system.

Who pays fringe benefits tax?

The legal incidence of FBT rests with the employer, but the economic incidence will vary depending on the extent to which the employer is able to effectively pass the tax through to the employee. Employees who receive fringe benefits through a salary sacrifice arrangement almost always bear the full economic incidence of FBT because they usually opt into these arrangements. In the long run, the economic incidence of FBT is generally expected to be on the employee.

Only Australia and New Zealand impose FBT on employers, with all other countries taxing fringe benefits in the hands of employees and using far fewer valuation rules, concessions and exemptions. The administration of the FBT system can be complex for employers. While FBT is paid by the employer, employers currently need to attribute certain fringe benefits to individual employees, and report the value of these fringe benefits on individual employee payment summaries. This is because some fringe benefits are included in income tests for transfer payments, taxes and tax concessions the employee may be eligible for.

Discussion questions:

7. What should our fringe benefits tax system look like and why?

3.3: Issues in the individuals income and fringe benefits tax systems

Over recent decades there have been significant reforms to Australia's individuals income tax system. They have included the introduction of capital gains tax and FBT in the mid-1980s; integrity measures like the introduction of non-commercial loss rules and expanded definitions of income to better target concessions in the 2000s; and the recent abolition of poorly targeted concessional tax offsets.

Nevertheless, there may still be scope for further reforms of our individuals income tax system given the impact that the individuals income tax system can have on economic

33 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

growth and living standards. This section discusses some of the issues that may warrant further consideration. Some of them arise from competing objectives and interactions with the transfer system. Others come from features of the tax system that may no longer be appropriate to a modern economy and societal expectations.

Bracket creep

As discussed in Chapter 2, bracket creep erodes the real rewards for effort over time, and exacerbates existing disincentives to participate in the workforce and the incentives for tax planning and structuring. While it is important for governments to address the impact that unchecked bracket creep can have, it is also important to consider the features inherent in the current design of the individuals tax system that reinforce the need to hand back bracket creep in the form of tax cuts.

Governments have responded to these issues by adjusting the thresholds periodically and providing tax cuts. As discussed below, it is important that barriers to workforce participation are limited in order to protect Australia's living standards as our population ages. While other factors in the tax and social security systems may also contribute to potential work disincentives, bracket creep is an important consideration in maintaining reward for effort and the integrity of our tax system.

Discussion questions:

8. At what levels of income is it most important to deliver tax cuts and why?

Implications for labour supply

Potential workforce participation disincentives

Australia's workforce participation rates,[34] particularly female participation rates, are lower than most comparable Organisation for Economic Co-operation and Development (OECD) countries. For example, while the participation rate of women between the ages of 15 and 64 in Australia has increased from 65.3 per cent in 2000 to 70.5 per cent in 2013, Australia is ranked 13th of the 34 OECD countries for female participation.[35] With an ageing population leading to a higher proportion of the population in retirement it will be important to ensure that barriers to participation are minimised.

An unavoidable feature of the progressivity in the individuals income tax system, combined with targeted assistance in the transfer system, is the creation of high effective tax rates that reduce the immediate rewards for work. A person choosing to pick up an additional shift may pay more tax on that income or receive a smaller amount of any means-tested transfer

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34 To be counted as participating in the workforce, a person must either be working or actively be looking for work.

35 OECD 2014, *Labour Force Statistics*, OECD, Paris, viewed 11 November 2014: http://stats.oecd.org/Index.aspx?DataSetCode=LFS_SEXAGE_I_R.

payment they are eligible to receive. Effective tax rates are the proportion of any increase in income that is lost to tax or the withdrawal of transfer payments and may reduce incentives to work.

Reducing effective tax rates is not straightforward because reducing the rate at which payments are withdrawn, or removing targeting altogether, would extend assistance to higher income levels. Alternatively, removing taper rates while still preserving targeting would mean that people would face abrupt losses of entire payments. Further, effective tax rates capture the withdrawal of the transfer payment itself, but do not reflect the abrupt loss of any associated benefits which only happens when a person loses their very last dollar of payment.

Given the complexity of the interactions between various components of the tax and transfer systems it is possible that some people do not have a good understanding of how their participation decisions affect their disposable incomes. The two systems have different units of assessment, different periods of assessment and reconciliation, and differences in the timeliness of assistance. It is therefore difficult to say how important effective tax rates actually are in driving participation decisions at the margin, although it is likely that most people are broadly aware of the impact of substantial changes to the numbers of hours they work.

The extent to which someone's workforce participation is influenced by effective tax rates also depends on the particular circumstances of the individual and their household. The groups most likely to respond to high effective tax rates include the unemployed and lower-income earners (who often work part-time).[36,37] Primary care givers, such as parents with young children, are also relatively responsive to effective tax rates but they also respond to other costs associated with working, such as child care — particularly if they are single parents or the secondary earner in a couple.[38] Another consideration is access to public housing.

Decisions about whether or how much to work can also be driven by non-financial considerations, such as the intrinsic value people place on either their work or on their roles outside work. People may also value the potential longer-term benefits of attachment to the workforce (such as implications for future promotions or pay increases) and weigh these against the function they wish to perform outside work, such as caring. These issues are being considered as part of the Government's families package.

In the absence of any changes to payments or assistance, and all else being equal, targeting tax cuts at the lower end of the income spectrum should generate a higher participation response than if the same value of tax cuts were delivered at higher incomes. This is because relatively low-income individuals are more likely to be working part-time or on a casual basis (as shown in Chart 3.3), and be more responsive to changes in disposable

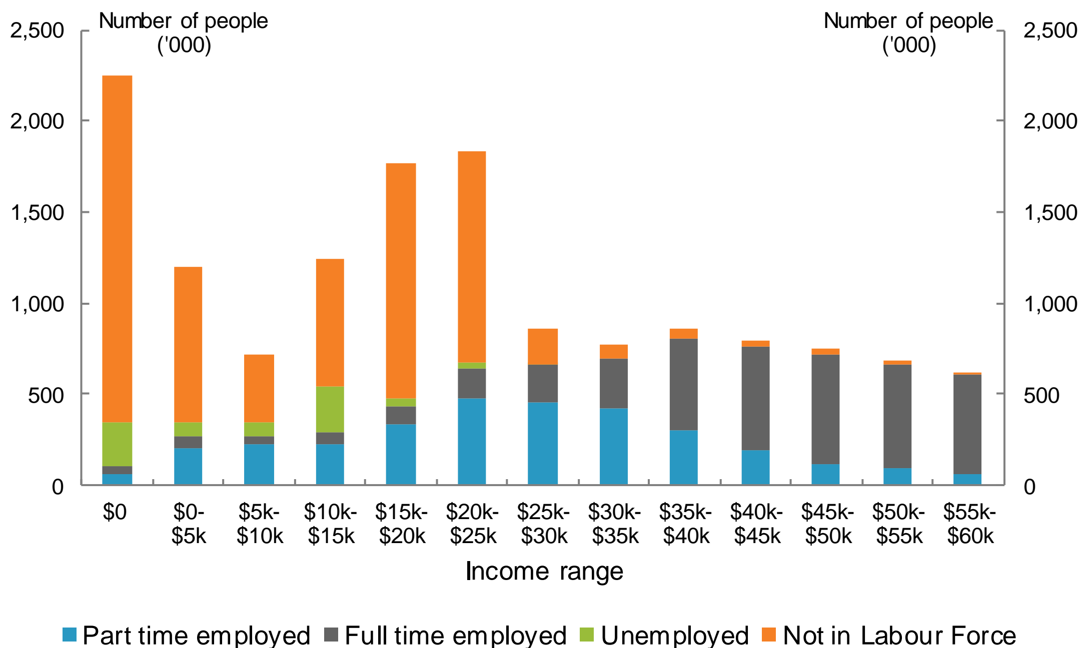
36 Dockery, M., Ong, R. and Wood, G. 2007, 'Welfare traps in Australia: Do they bite?' Paper presented to the HILDA Survey Research Conference, 19-20 July Melbourne.

37 OECD 2011, *Taxation and Employment*, tax policy studies no. 21, OECD Paris, pages 34-35.

38 Blundell, R., Dunanc, A. and Meghir, C. 1998. 'Estimating labor supply responses using tax reforms', *Econometrica*, 66:4:827-861; Dandie, S. and Mercante, J. 2007, *Australian labour supply elasticities: Comparison and critical review*, working paper no. 2007-04, Australian Treasury, Canberra.

income. In addition, the same dollar value increase or decrease (which would be a bigger proportion of earnings at relatively low levels than at the higher end) will potentially provide a bigger incentive for increased workforce participation.

Chart 3.3 Employment status by taxable income, 2014-15



Source: Treasury estimates using Treasury's version of STINMOD

Discussion questions:

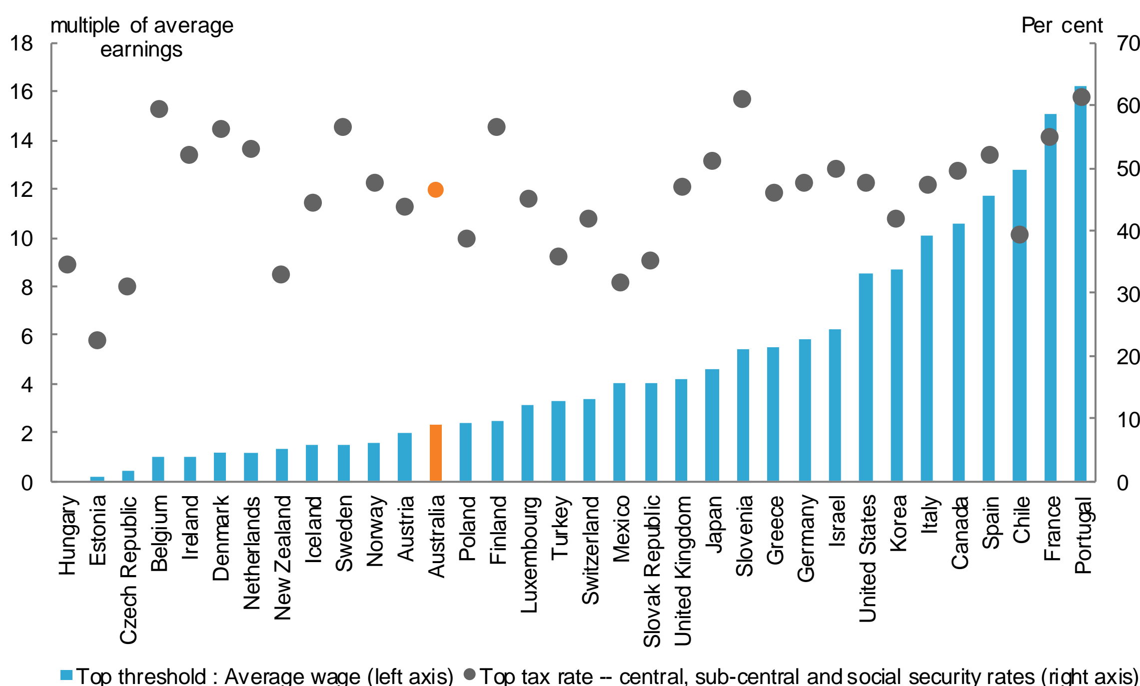
9. To what extent does taxation affect people's workforce participation decisions?
10. To what extent are the interactions between the tax and transfer system straightforward for the people who deal with both systems?

International labour mobility

Labour is typically less mobile than capital, but it is not perfectly immobile. Australia has a higher top marginal tax rate than several key countries in our region. The rate itself is relatively similar to other OECD countries once any state or provincial income tax rates that apply in other countries are included in the comparison. That said, Australia's top marginal tax rate takes effect from a threshold of around 2.3 times the average wage — a relatively low income threshold compared to other OECD countries, such as the UK at 4.2 times the average wage, the US at 8.5 or Canada at 10.6 (Chart 3.4). However, tax is only one factor affecting the decisions of workers who are mobile. Other reasons include salary potential; quality of life; language and culture; family and social connections; and immigration restrictions.

Empirical evidence on the extent to which income tax rate differentials drive migration is limited. What is available for other countries suggests that tax rate differentials have only a small impact on migration, but that where there is an impact, it is generally larger for highly skilled, or for younger, highly educated workers.[39] In Australia, younger workers may be making income contingent repayments on higher education contribution scheme (HECS) or higher education loans programme (HELP) debts which can add up to eight percentage points to amounts withheld from their salary during the year.

Chart 3.4 Top marginal tax rates comparison, OECD countries, 2013



Note: Numbers for Australia are for 2013-14. Australia's top marginal tax rate for 2014-15 has increased to 49 per cent (45 per cent top statutory personal income tax rate plus 2 per cent Medicare levy plus 2 per cent Temporary Budget Repair Levy).
Source: OECD 2014, *Tax Database — Personal Income Tax Rates*, OECD, Paris, viewed 24 November 2014: www.oecd.org/ctp/tax-policy/tax-database.htm#pird.

As at 2010, 16 OECD countries offered concessions on individual income tax and/or social security contributions to attract 'knowledge workers', researchers, managers or specialists — including incentives targeted at encouraging residents who currently live in other countries to return home.[40] Some countries also provide concessions on employee remuneration in the form of shares or options to assist start-ups to attract employees.[41]

People at the higher end of the income scale face higher tax rates and have greater capacity to meet the costs of relocating. The emigration of skilled workers, who generally have high earning potential is sometimes viewed as a cost to the economy, characterised as 'brain

39 OECD 2011, *Taxation and Employment*, tax policy studies no. 21, OECD, Paris, pages 128-129.
40 OECD 2011, *Taxation and Employment*, tax policy studies no. 21, OECD Paris, page 137.
41 In Australia last year, the Government announced it will reform the tax treatment of employee share schemes in part to improve the competitiveness of innovative firms in Australia looking to attract and retain high-quality employees in the international labour market (discussed further in Chapter 5).

drain' associated with the loss of returns on investment in human capital. However, workers who temporarily leave Australia and then subsequently return can bring back new skills, knowledge and networks, with positive flow-on benefits for innovation and growth.

Discussion questions:

11. How important is tax as a factor influencing people's decisions to work in other countries?

Balancing competing objectives

One of the pressures on the individuals income tax system is that it is expected to raise revenue as simply as possible, while also being economically efficient and delivering fairness with a progressive schedule of rates and thresholds. There can be a trade-off between simplicity and fairness in particular, and a balance between these objectives must therefore be managed. For a given amount of revenue the broader the base, the lower the rates required — this combination could potentially satisfy all three objectives.

Tax planning and progressivity

Progressivity in the individuals income tax system is delivered through the schedule of marginal rates and thresholds, which apply to a person's taxable income. These headline rates and thresholds create an expectation that people on high incomes pay a higher average tax rate than people on low incomes. At the same time there are features of the tax system that can produce outcomes that diverge from the headline rates (for example, Chart 4.1, which shows the tax outcomes associated with different forms of saving). These features may exist to encourage particular behaviours (for example, high effective tax-free thresholds can improve the immediate rewards for work, and concessionally taxed superannuation can improve retirement income adequacy), or to reduce complexity or compliance burden (for example, allowing a 50 per cent capital gains tax discount instead of indexation and averaging arrangements).

Some people may not give any thought to these features of the tax system when they conduct their affairs. Others may legitimately plan their affairs to take maximum advantage of these features, so that the amount of tax they pay is less than the amount that would otherwise be determined by the headline rates and thresholds. This can affect perceptions of fairness of the individuals income tax system, particularly since the parts of the tax system that create the incentives for tax planning are not as well understood as the headline rates and thresholds.

'Tax planning' refers to the use of legitimate, legal strategies to reduce the amount of tax paid[42] and can allow some people to reduce the amount of tax they pay without reducing their actual income. Tax planning in the individuals income tax system can come from reducing assessable income or claiming deductions. It can also involve income splitting,

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42 This is distinct from 'tax evasion', which is non-compliant behaviour (such as not declaring income).

where income is attributed to more than one individual, or is distributed across more than one income year, in order to take advantage of more than one tax-free threshold. The benefits of common, legitimate tax planning strategies arise from a number of features of the tax system, including high effective tax-free thresholds; the difference between marginal tax rates and the company tax rate; the capital gains tax discount; the tax treatment of superannuation; and concessions or exemptions in the fringe benefits tax system.

Box 3.2: Income definitions

A number of the concessions and offsets administered through the tax system are targeted using means tests that use an expanded definition of income. There are several different definitions of income used for this purpose in the individuals income tax system.

Each definition seeks to better reflect a person's means by taking account, in some way, of some or all of: voluntary superannuation contributions; fringe benefits; net investment losses (rental and financial); foreign income; and government payments that are exempt from tax.

Currently, none of the income definitions used in the individuals income tax system include the capital gains tax discount, the value of exempt fringe benefits, or tax-free superannuation. As information about these is not collected for tax purposes, it is difficult to determine the extent to which they are used by people at different income levels.

The number of income definitions, and the extent to which they vary, adds significant complexity to the tax system — particularly for people trying to work out their eligibility for multiple concessions or offsets.

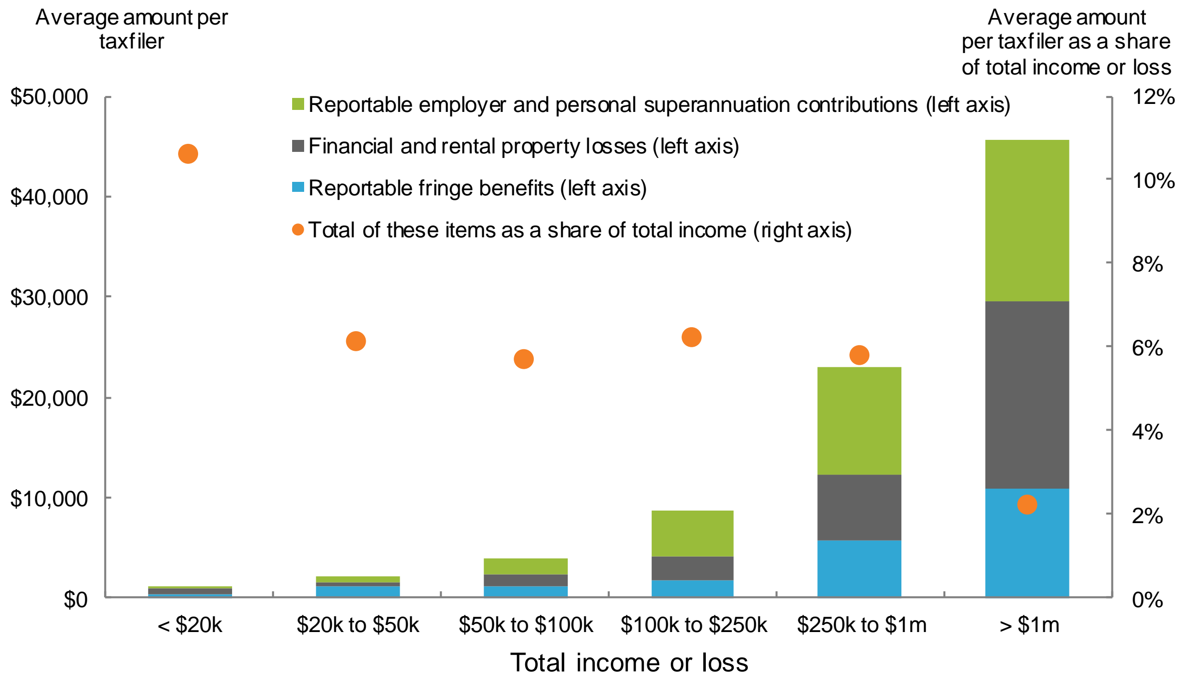
A further source of compliance burden arises when income tests are applied based on the income of a couple, which must be administered through the individuals income tax system that is designed using the individual as a unit of taxation.

While taxable income by definition determines the amount on which tax is paid, some of the concessions in the tax system are means tested using expanded definitions of income, which are designed to reduce the benefits from tax planning. Over time, these income definitions have evolved to better reflect an individual's means (Box 3.2). Requiring taxpayers to report additional items adds to compliance burden. However, these income definitions better target assistance and collect data that can give an indication of the use, by income level, of certain concessions that would otherwise not be required to be reported by an individual.

Reducing assessable income and maximising deductions

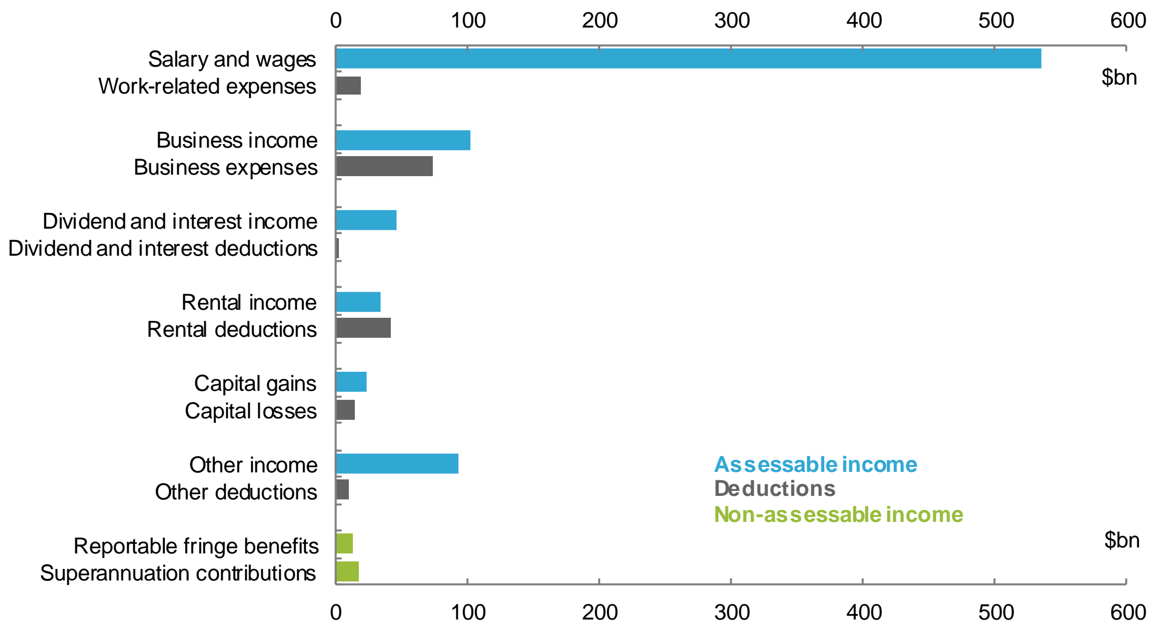
One way employees can reduce their tax liabilities is by reweighting their remuneration away from wages towards concessionally taxed superannuation contributions (up to a prescribed cap), or to fringe benefits that are concessionally taxed or exempt from tax. Another way is to apply losses from other activities to reduce the amount of tax payable on wage or salary income. Unsurprisingly, the use of these approaches is higher among people on higher assessable incomes, but not disproportionately so (see Chart 3.5). It is difficult to draw any conclusions on the implications this may have for the progressivity of the individuals income tax system, as greater use of fringe benefits or superannuation would reduce assessable and taxable income. Further, the data is sourced from the individual income tax return, and therefore does not reflect the use of unreported or exempt fringe benefits.

Chart 3.5 Use of concessions and losses, by total income, 2011-12



Source: Treasury estimates based on ATO 2014, *Taxation Statistics 2011-12,* ATO, Canberra.

Chart 3.6 Major sources of income and deductions, 2011-12



Notes: 'Business income' and 'business deductions' are income earned and deductions incurred by individuals carrying on a business (for example, as a sole trader). 'Other income' includes distributions from partnerships and trusts; taxable Australian Government transfer payments; and allowances, benefits, earnings and tips. 'Other deductions' includes charitable donations and the cost of managing tax affairs. 'Superannuation contributions' includes reportable employer superannuation contributions and personal superannuation contributions, but not superannuation guarantee contributions. 'Reportable fringe benefits' does not fully reflect remuneration in the form of fringe benefits as, among other things, it does not include fringe benefits below the $2,000 threshold (that are not required to be reported) or fringe benefits that are exempt from tax.
Source: ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

People can also reduce their taxable income by claiming deductions, although there is generally only a tax planning benefit from claiming deductions that provide a private benefit. In the case of work-related expense deductions the tax planning benefit is limited by the requirement that these expenses should generally be apportioned based on how much is for private use. There is generally greater scope to claim legitimate deductions related to income from savings or from carrying on a business. Business or investment deductions usually make up a greater share of the income they are linked to, compared to work-related expense deductions and wage and salary income (Chart 3.6).

Income splitting

Outside of the individuals income tax system, people may be able to use entities such as trusts or private companies to 'income split'. The potential benefits from income splitting arise from the progressivity and effective tax-free thresholds in the individuals income tax system (Box 3.3). Legitimate income splitting is not straightforward to do. This is because the general anti-avoidance rule and other integrity rules in the tax law are intended to counter schemes that have a 'dominant purpose' of avoiding tax, even though they comply with the technical requirements of the tax law. For example 'personal services income' is the reward for someone's personal efforts or skills and should be taxed according to that person's marginal rates. A special tax regime for personal services income exists to prevent people from reducing their tax by shifting this income to another person or entity (such as a company).

A further incentive for tax planning is the difference between the marginal rates in the individuals income tax system and the company tax rate, which can allow incomes to be split between individuals to take advantage of different personal marginal rates of tax, and further, allow tax to be deferred by retaining profits in a company structure. This can increase the incentives to carry on a business through, or hold wealth in, private companies. However, there are integrity provisions aimed at preventing private companies from making distributions of profits to shareholders without paying additional tax through the personal income tax system. Income splitting is discussed further in Chapter 6.

Box 3.3: Income splitting

Going back to the single-income couple in Box 3.1: if the $100,000 is their only income and they are able to legitimately income split, they could distribute the $100,000 equally between them, so that their average tax rate is 17.1 per cent as a couple, compared to 26.9 per cent above.

If the couple has children or other family members, they could benefit further by distributing the income to them as well. For example, if they have two children over the age of 18, they can distribute $25,000 to each member of the family, and each pay tax of $1,293, or an average tax rate of 5.2 per cent.

If the children are under 18, then there is little benefit in distributing more than $416 to each child as the rate of tax on a minor's 'unearned' income (that is, other than income from working) is deliberately high in order to discourage income-splitting to, or holding assets in the name of, minors.

Discussion questions:

12. To what extent is tax planning a problem in the individuals income tax system? Are existing integrity measures appropriate?
13. What creates incentives for tax planning in the individuals income tax system? What could be done about these things?

Targeting assistance in the tax system

Direct assistance, like income support payments or family assistance, is delivered through the transfer system. The tax system generally cannot deliver tax assistance to people with the lowest taxable incomes because they do not pay any tax.[43] Tax offsets are the main delivery mechanism for assistance but, as the tax and transfer systems have evolved over time the extent to which some of the remaining offsets are appropriate is questionable.

Structural offsets

Some transfer payments are taxed, others are not. Recipients of Australian Government transfer payments that are taxed are eligible for either the SAPTO or the BENTO (on top of the LITO). This is so that maximum rate payment recipients effectively do not pay tax on their payment income, but delivering this outcome through offsets is a confusing arrangement and is not transparent about their actual tax outcome. As a result, some payment recipients may believe they are being unfairly taxed on their Australian Government payments when in fact they are not. Further, the current effective tax-free threshold of $20,542 is higher than or only slightly below the maximum rate of many benefits and pensions. Maximum rate payment recipients, for whom these offsets were created, therefore receive little or no benefit from structural tax offsets.

The SAPTO and BENTO now provide the greatest benefit to people who have some private income as well as some payment income. This can smooth the transition for a person who is moving from income support to working. However, it means that people who have some transfer payment income pay less tax than someone who only has income from working (Box 3.4). Addressing this issue is not straight forward. Exempting transfer payments from tax altogether entails greater transparency for maximum rate payment recipients, and may mean that some of them no longer need to deal with the tax system. However, doing so would come at a cost, and would worsen the outcome that structural offsets can create.

43 The tax system can be used to administer assistance related to other programmes, such as the private health insurance rebate.

Box 3.4: Tax outcomes — with and without structural offsets

In 2014-15, a student receiving the full rate of Youth Allowance receives $10,936.[44] If they also work part-time to earn the maximum allowable private income (for a Youth Allowance recipient) of $10,946 per year, then their total taxable income is $21,882. Because their tax liability before offsets and Medicare levy is $700 and they are entitled to $445 of LITO and $740 of BENTO, they pay no tax.

Someone who earns $21,882 without any government payments would also have a tax liability of $700 before offsets and the Medicare levy. However, since they do not receive any direct government assistance, they are only eligible for $445 of LITO, which leaves them with a remaining tax liability of $255.

Concessional offsets

Concessional offsets provide assistance to certain groups of taxpayers, but their delivery may be less effective than the assistance provided by the transfer system. People generally need a tax liability to benefit from offsets, and assistance is generally payable after assessment of tax returns rather than during the year. Some people may not know that they benefit from offsets, as offsets may be claimed on their behalf by a tax agent or calculated by the Australian Taxation Office. Further, the amount of assistance available through concessional offsets is often not adequate to fully assist people in genuine need throughout the year. For these reasons many concessional offsets have been abolished in recent years.

The remainder of the concessional offsets to which more of these issues apply are the dependent (invalid and carer) tax offset, zone tax offset, net medical expenses tax offset, and employment termination payment tax offset. The dependent (invalid and carer) tax offset is available to taxpayers who contribute to the maintenance of a dependant who is unable to work due to a carer obligation or a disability. The maximum value of assistance provided by the dependent (invalid and carer) tax offset (around $2,500) is significantly less than the direct assistance provided through the transfer system to carers or people with disabilities. The maximum value of net medical expenses tax offset a person can receive is 20 per cent of the amount by which their eligible expenses exceed $2,162, which means a person must first incur the expenses during an income year, and then determine whether they can receive any assistance upon assessment of their tax return.

The employment termination payment tax offset was originally intended to concessionally tax lump sum payments made on termination of employment, as a form of tax smoothing and retirement income support. Over time its purpose has become less certain. The introduction of the superannuation system has superseded the offset's retirement income objective, and the introduction of a maximum cap on the amount of offset a person can receive limits the extent to which it can actually smooth the effects of lumpy income.

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44 This rate is for a single student under the age of 18 with no children, who is required to live away from their parental home to study, undertake training, or look for work. The amount is the annual average for 2014-15.

In the case of the zone tax offset, submissions to recent inquiries suggest that it may no longer meet its original policy intent. As the zone tax offset is administered based on geographic boundaries that were last updated in 1981, some people question whether the areas within the zone are truly those with the highest living costs or remoteness. Further, in a recent report tabled by the House Standing Committee on Regional Australia in February 2013,[45] some of the submissions raised the concern that 'fly-in, fly-out' workers should not receive the zone tax offset. This was on the grounds that fly-in, fly-out workers tend to spend and invest their money where their families reside, and do not necessarily incur the higher costs of living in the zone.

Discussion questions:

14. Under what circumstances is it appropriate for assistance to be delivered through tax offsets?

Compliance burden

Work-related expense deductions

Compared to some other countries, Australia's tax system is relatively generous in respect of work-related expense (WRE) claims, which are widely utilised. In 2011-12, around 8.5 million people claimed WREs totalling nearly $19.4 billion,[46] although around 38 per cent of tax filers had claims of less than $500. Under Australia's approach individuals are able to claim a broad range of WREs against their assessable income as long as they are used for work. To reduce compliance burden and allow greater use of pre-filled income tax returns, Australia has in the past considered, but not proceeded with, a 'standard deduction' on WREs (Box 3.5).

The approaches of some other countries are more prescriptive or limited. For example, the United Kingdom specifies a tighter nexus on WREs and limits deductions to those that are incurred wholly, exclusively and necessarily in the performance of an employee's duties, although the compliance burden associated with substantiating deductions remains. New Zealand 'cashed out' WRE deductions in the late 1980s by providing income tax cuts in exchange for disallowing WRE deductions. This has been a major driver of compliance savings by reducing the number of people needing to file a tax return — in the 2012 tax year around 1.25 million individual tax returns were filed in New Zealand[47] out of an estimated 3.3 million individual tax payers.[48]

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45 House of Representatives 2013, *Inquiry into the use of 'fly-in, fly-out' (FIFO) workforce practices in regional Australia,* Standing Committee on Regional Australia, Canberra.

46 ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

47 Inland Revenue Department of New Zealand 2014, *Returns Filed 2004 to 2013*, Inland Revenue, viewed 1 December 2014, www.ird.govt.nz/aboutir/external-stats/tax-returns/returns-filed/.

48 The Treasury (New Zealand) 2012, *2012 Budget Key Facts for Taxpayers: Who pays income tax … and how much?*, New Zealand Government, viewed 1 December 2014: www.treasury.govt.nz/budget/2012/taxpayers/02.htm.

Despite the compliance burden associated with WRE deductions in Australia they are valued by those who claim them. Tightening the arrangements for WRE deductions in Australia would require careful consideration of how to manage legitimate expenses incurred by employees. In some cases, the expense could be met by an employer providing the necessary item (for example, uniforms or protective equipment), and then having the item returned if the employee leaves. In other cases, this is less straightforward, such as with self-education expenses where the benefit is embodied in the employee's human capital. These arrangements would also need to be coordinated with the FBT regime so that employers could provide employees with things that may no longer be 'otherwise deductible' without attracting FBT on those things.

It is also possible that the existing arrangements for self-education expense deductions are somewhat restrictive, particularly when structural change in the economy makes re-training more important to meet ever-changing labour demand needs. This is because self-education expenses may only legitimately be claimed if they maintain or improve the specific skills or knowledge required in someone's *current* employment. Someone working in one occupation, who is seeking to retrain or reskill so that they can transition to another occupation, generally cannot deduct that expenditure. However, any loosening of this eligibility could lead to problems with compliance.

Box 3.5: A standard deduction for WREs

Given the high proportion of taxpayers who incur a relatively low total value of legitimate WREs, a 'standard deduction' could provide significant compliance savings. Rather than substantiating WRE expense claims with receipts, these taxpayers could instead choose to 'tick a box' to claim a standard deduction at a set amount (for example, $500).

While it could deliver a simplicity benefit, a standard deduction would come at significant cost — people who do not currently have any WRE deductions could reduce their taxable income by the value of the standard deduction.

Discussion questions:

15. To what extent do our arrangements for work-related expense deductions strike the right balance between simplicity and fairness? What could be done to improve this?

Fringe benefits tax

Australia's FBT system was designed to fill a perceived gap in the income tax base. However, the imposition of highly prescriptive rules to cover every possible fringe benefit provided by an employer to an employee means that it is highly complex. Further, much of the complexity in FBT arises when working out who is not liable and which fringe benefits are exempt or excluded from FBT reporting requirements.

As with the offsets in the individuals income tax system, some of the concessions and exemptions in the FBT system may not be well targeted. For example, the use of child care services provided for the benefit of employees on an employer's business premises is exempt from FBT. This can create inequities in the provision of child care services as not all employers are likely to be able to provide such services. Further, the largest benefits go to individuals on the top marginal tax rate. Another area of concern is the FBT concessions for remote area housing and exemptions for transporting fly-in, fly-out employees. Some longer-term residents of rural and remote areas claim that this encourages fly-in, fly-out arrangements, which can contribute to higher rents.

The complexity of Australia's FBT system may be exacerbated by the fact that the legal incidence rests with employers. Three taxing systems apply to each fringe benefit (FBT, income tax and GST), and several methodologies are available to employers in calculating the FBT liability in relation to certain fringe benefits. This adds unnecessary compliance costs for employers, with FBT forms taking 12 hours on average to complete, compared to two hours on average for a business activity statement or six hours on average for a superannuation return.[49]

Discussion questions:

16. To what extent does our fringe benefits tax system strike the right balance between simplicity and fairness? What could be done to improve this?
17. To what extent are the concessions and exemptions in the fringe benefits tax system appropriate?

49 ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

4: Savings

Overview

This chapter outlines the tax treatment of domestic savings, and highlights a number of efficiency and equity issues in the current arrangements.

Key points

- Australia's current tax system taxes savings differently depending on the form of the saving. The result is that more savings are held in superannuation and housing than would otherwise be the case.
- The effect of the tax system on the aggregate level of domestic savings is uncertain. The effect of tax on domestic savings is unlikely to significantly affect the aggregate level of investment in Australia (which is determined largely by the decisions of foreign investors). This suggests that taxing income from savings (at least to a point) is a relatively efficient way of raising revenue. However, some level of concessional tax treatment for savings may be warranted to reduce any disincentives to save.
- Taxing savings income also has distributional effects, in part because higher income individuals have a greater capability to save in lower taxed savings vehicles. However, distributional judgments must take into account the full amount of any income support received, such as the Age Pension.

4.1: What is the general tax treatment of income from savings?

How income from domestic savings is taxed depends on various factors, including the form in which the savings are held.[50] In general, income from work (that is, labour income) is subject to full income tax. If an individual places their after-tax income in a bank account, purchases shares or uses it to make a deposit on a house, the tax treatment of the income earned from these savings varies significantly. Interest, rent and dividend income is subject to tax at full marginal rates, while income from capital gains on shares is subject to a discount (50 per cent for individuals) and capital gains on a family home are fully exempt from tax. Superannuation is subject to yet another tax treatment.

50 The term 'savings' refers to stock of assets while 'saving' refers to an increase in the stock of savings.

Australian households save primarily through home ownership (43 per cent of total household assets), superannuation (15 per cent of total household assets), and other property, including investment property (15 per cent of total household assets).[51] Other popular vehicles for savings include shares, bank accounts and debt instruments, as well as trusts and company structures.

Taxation of income from domestic savings is a small but important revenue base for the Commonwealth. In 2013-14, receipts from superannuation alone raised $6.1 billion and made up 1.8 per cent of Commonwealth receipts.[52] In 2011-2012, capital gains tax (CGT) from individuals raised around $3 billion, while taxes paid on interest and dividend income for individuals yielded around $7 billion.[53]

4.2: What principles should underpin the tax treatment of income from savings?

The appropriate tax treatment of savings is contentious. The first point of contention is whether income from savings should be taxed more concessionally than other forms of income, such as labour income.[54]

The main argument against taxing income from savings is that this can effectively amount to a double taxation of saving (once when it is earned, then again when it earns a return). This can create a bias against saving for future consumption. There is also an argument that some of the return from savings simply reflects inflation, which is not 'income' in a real sense as it offsets the loss of value to maintain purchasing power. Arguments of this nature are often used to suggest there should be little or no tax on income from savings.

Another argument, used in relation to taxing retirement incomes more lightly, is to address 'life-cycle myopia'. This is where individuals may not save enough for retirement because it is too far in the future for them to see clearly, and therefore they need encouragement to save to achieve a higher standard of living in retirement.

There are, however, several arguments for imposing at least some tax on income from savings.

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51 Australian Bureau of Statistics (ABS) 2013, *Household Wealth and Wealth Distribution, Australia, 2011–12*, cat. no. 6554.0, ABS, Canberra.

52 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

53 Australian Taxation Office (ATO) 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

54 See for example: Banks, J, and Diamond, P 2010, 'The Base for Direct Taxation', in Mirrlees J, Adam, S, Besley, T, Blundell, R, Bond, S, Chote, R, Gammie, M, Johnson, P, Myles, G, and Poterba, J 2010, *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for Institute for Fiscal Studies, Oxford; and Sørensen, P B 1994, 'From the Global Income Tax to the Dual Income Tax: Recent Reformers in the Nordic Countries', *International Tax and Public Finance*, vol. 1, no. 1, pages 57-79.

First, every tax discourages some economic activity. Taxing income from savings concessionally means other taxes (for example, on labour income) need to be higher to maintain the same level of revenue overall. This requires an assessment of the relative economic costs of alternative taxes.

Empirical evidence suggests the behavioural response to taxing savings is uncertain[55] and may not be significant.[56] This implies that the economic cost of taxing income from savings (at least to a point) is not large. Therefore, applying some tax on income from savings is likely to improve the efficiency of the overall tax system.

Second, exempting or providing concessional taxation treatment of income from savings creates incentives to minimise tax by artificially 'converting' labour income into income from savings.

Third, income from savings contributes to a person's ability to pay tax. Further, individuals with higher incomes tend to have higher levels of income from savings.

Taxing the income from savings more lightly than labour income is a way of striking a balance between these competing considerations. For example, it can help address the effects of inflation (by reducing tax on the part of the return that simply reflects the saved money maintaining its real value), while ensuring that some tax revenue is raised so that other tax rates can be lower.

The second point of contention is the extent to which different forms of income from savings should be taxed differently. Different tax treatment can have an effect on the form in which savings are held.[57] More favourable tax treatments for some assets may lead households to engage with a different risk-return profile than they otherwise would. An OECD literature review concluded that low-income individuals may respond to tax incentives with new saving. High-income individuals are more likely to divert savings to more tax-preferred savings,[58] likely resulting in some change in the risk-return profile of their savings portfolios. The Financial System Inquiry found that, to the extent that tax distortions direct savings to less productive investment opportunities, a more neutral tax treatment would likely increase productivity.[59]

A third point of contention is whether the tax treatment of income from savings has a distortionary effect on the real allocation of investment in the Australian economy.

It is probable that there is some effect on investment, particularly in Australia's real estate market, where investment is primarily domestic. If this is the case, any additional savings in housing would amount to additional investment in housing and, given housing supply constraints, lead to increased house prices.

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55 Johansson, A, Heady, C, Arnold, J, Brys, B and Vartia, L 2008, *Tax and economic growth*, working paper no. 620, OECD, Paris.

56 New Zealand Treasury Savings Working Group 2010, *The Effect of Tax Incentives on Retirement Savings*, working paper, New Zealand Treasury, Wellington.

57 Poterba J M 2002, 'Taxation, risk-taking, and household portfolio behaviour', in Auerbach, A, and Feldstein, M 2002, *Handbook of Public Economics Volume. 3*, North-Holland, Amsterdam, pages 1109–1171.

58 OECD 2007, *Encouraging savings through tax preferred accounts*, tax policy studies no. 15, OECD, Paris.

59 Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

It is important to note that, although taxes may affect the allocation of savings, they are unlikely to affect significantly the overall level of investment in the economy. If taxes on income from domestic savings are raised, but not taxes on income from foreign investment in Australia, it is likely that total investment in Australia would be largely unaffected, as foreign savings would be expected to replace the fall in domestic savings. As such, there would be little effect on the level of overall investment in Australia.

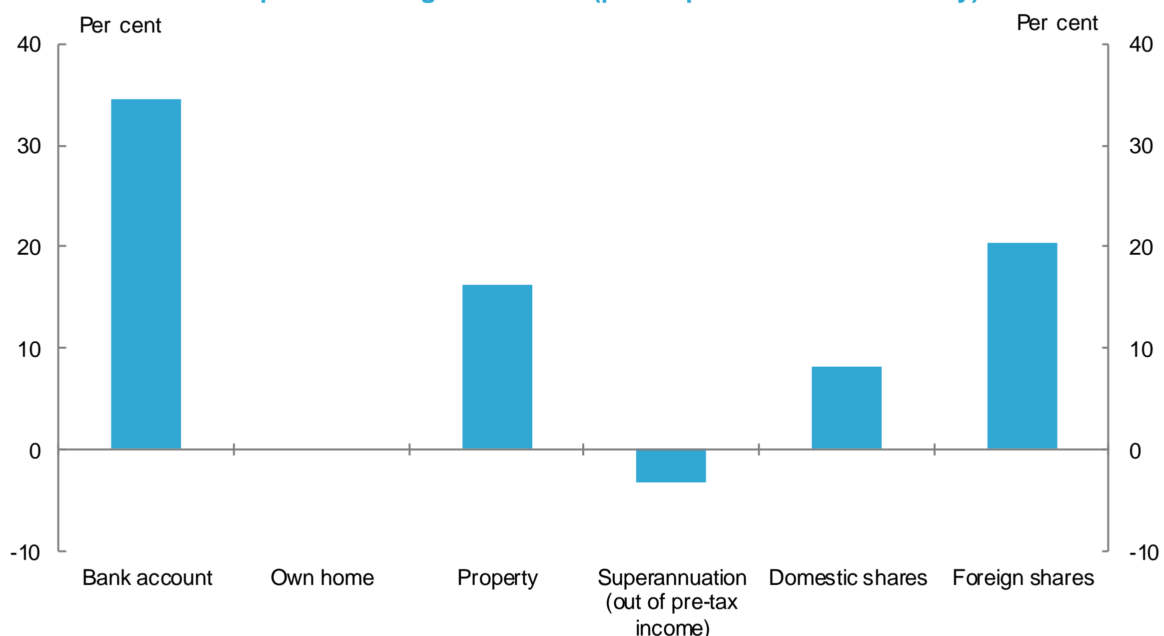
Furthermore, if individuals are saving through financial intermediaries (for example, banks or superannuation funds), then to the extent that those intermediaries' investment profiles are similar, there will be a muted effect on the pattern of investment.

Finally, it is also worth noting that differential tax treatments may also have distributional effects. Higher-income earners tend to be more capable of taking advantage of more favourable tax treatments (like superannuation), while those with the lowest ability to pay tend to save more in the more heavily taxed vehicles (such as bank accounts).

Current tax treatment of key savings types

In Australia, the varying tax treatments of different vehicles, physical assets and types of savings income have led to wide disparities in their effective marginal tax rates, which show the actual tax paid as a proportion of the nominal pre-tax return. The outcomes of these different treatments are illustrated in Chart 4.1.

Chart 4.1 Nominal effective marginal tax rates by savings vehicles for an individual on 32.5 per cent marginal tax rate (plus 2 per cent Medicare levy)[60]



Assumptions: 6 per cent nominal return (except shares, which assumes 6 per cent after company tax); assets are all held for 25 years, and for rental property, 50 per cent of the return is attributable to capital gain and 50 per cent to rental income and superannuation contributions do not exceed the prescribed contribution caps. No assets have been negatively geared. The own home has a nominal effective marginal tax rate of zero, as it is purchased out of after-tax income, but subsequent returns on it are not taxed. Bank accounts, property and shares also use after-tax income but their returns are taxed depending on the vehicle. The nominal effective

60 While the chart looks at nominal effective marginal tax rates the same relativities would apply for real effective marginal tax rates, albeit with higher rates. Real effective tax rates incorporate the effects of inflation.

marginal tax rate for superannuation is negative because contributions to superannuation are made pre-tax and are only taxed at 15 per cent. For example, $100 of pre-tax labour income would result in a super contribution of $85 (after 15 per cent tax) but an individual would only receive $65.50 if they put it into other saving vehicles because of the application of their marginal tax rate (34.5 per cent in this case).

Bank accounts and debt instruments

Bank accounts and debt instruments are subject to tax at full marginal rates, with no allowance for inflation. This treatment is consistent with most other countries, although some provide exemptions for particular types of interest income. For example, the US provides an exemption for interest earned on bonds issued by US states and municipalities for particular purposes. The UK and Japan have developed methods to exempt the interest earned on certain types of bank accounts from taxation.[61]

While introducing a general discount on income from bank deposits may be desirable to address the impact of inflation, doing so would introduce an asymmetry between the tax imposed on interest income earned from bank deposits and the deduction allowed for interest repayments on borrowings used to purchase an asset that generates income, leaving the system open to arbitrage. Given this asymmetry, introducing such a discount would require careful consideration.

Discussion questions:

18. What tax arrangements should apply to bank accounts and debt instruments held by individuals?

Shares, private companies and trusts

Investment in equities (or company shares) generally produces two types of income: dividend income from business profits; and capital gains from changes in the value of the share. Both of these are subject to individuals income tax to some extent.

The tax system may encourage Australian households to invest more of their savings in companies, particularly Australian companies, than they would otherwise.

There are three key reasons for this. First, CGT is generally paid on 50 per cent of the gain (Box 4.1). This discourages saving in instruments such as bank deposits, and supports saving in capital assets such as equities or property. Second, because the imputation system only benefits Australian shareholders, it has the effect of increasing the return for Australian shareholders in Australian equities (for a more detailed explanation see Chapter 5 — Business). Finally, because Australian households do not receive imputation credits for foreign company tax paid, they may face an extra layer of tax on savings in foreign equities

61 Warburton AO, R E, Hendy, P 2006, *International Comparison of Australia's Taxes*, Australian Government, Canberra.

(subject to tax treaties) compared to Australian equities. These factors may also have effects on the broader financial system as noted recently by the Financial System Inquiry.[62]

Many companies use retained earnings as an easily accessible source of funds for new investments. However, retention of earnings within private companies also allows for the payment of any additional tax on dividends to be delayed. This can be a preferred means of saving for individuals facing marginal tax rates higher than the corporate tax rate.

In addition to benefits from this delay, in some cases dividends can be made in periods when an individual's income from other sources is lower to ensure that dividends are taxed at relatively low marginal tax rates. For example, an investor who is close to retirement but is on the top marginal tax rate, may structure their affairs so that dividends are paid after they retire with a lower marginal rate. Alternatively, if dividends are not paid and earnings are retained indefinitely in a company, individuals can access these funds by selling shares in the company and receiving a 50 per cent discount on capital gains (this is discussed further in Chapter 6 — Small business).

Australian households can also use discretionary trusts to save. Discretionary trusts offer tax advantages to groups of individuals who share the income from savings, and the trustee of a discretionary trust usually has complete discretion to choose which beneficiaries receive distributions from the trust in any particular year. This can provide tax benefits if beneficiaries have different levels of income from other sources.

A common example is a small family business, operated through a discretionary trust. The trustee of the trust can decide each year which family members should receive distributions of income or capital from the business. This typically results in all beneficiaries paying less tax than if all of the business income were taxable in the hands of a single taxpayer business owner or if a corporate structure was used (Box 3.3 on income splitting in Chapter 3).

Discussion questions:

19. To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?
20. To what extent does the dividend imputation system impact savings decisions?

62 Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

Box 4.1: Capital gains tax explained

Capital gains tax (CGT) is a form of income tax that is levied on an individual's 'net capital gains' at their relevant marginal tax rate.

CGT is payable on a realisation basis. An individual needs to trigger a capital gains event (such as by selling an asset) to realise a capital gain or loss. A capital gain or loss is the difference between what it cost an individual to acquire the asset and the proceeds from realising the asset (i.e. sale proceeds). If a net gain is realised, the net gain forms part of the individual's taxable income for that year, which is subject to income tax. If a net loss is realised, the individual can use it to reduce other realised capital gains in the current income year (if they have any), otherwise they can carry it forward to apply against future capital gains.

CGT is subject to a number of exemptions and concessions (see also Chapter 6 — Small Business). Most importantly, individuals can generally discount a realised capital gain by 50 per cent if they have held the asset for more than a year. The 50 per cent discount was introduced in 1999. This replaced the arrangement that had been in operation since 1985 whereby the capital gain to be included in taxable income could be adjusted for price inflation (CPI) since purchase to ensure only real gains were subject to tax.

Investment properties

The tax treatment of investment properties is the same as it is for investment in any asset that produces a mix of current income and capital gain. That is, the rental income is taxed at the individual's marginal tax rate as it is earned, while generally only half of the capital gain is taxed, and only when the property is sold (or realised in some other way).

Investment properties are the third most popular saving vehicle after the family home and superannuation. Many of the reasons people invest in housing over other assets have little to do with the tax treatment. However, the role of the tax treatment in driving investment in real estate and the impact that this has on housing supply and affordability is a contentious issue. One issue that is contested is the role that 'negative gearing' (Box 4.2) plays in driving investment in rental properties.

Box 4.2: Negative gearing

A property is said to be negatively geared when the mortgage interest repayments exceed the net income from the property (rental income minus other deductible expenses such as property agent fees, insurance, gardening, land tax and depreciation). In these circumstances the taxpayer can apply this ‘loss’ against their other income, such as salary and wages. This strategy is only financially effective where the taxpayer expects a future capital gain more than offsetting this ‘loss’. Generally only 50 per cent of that capital gain is subject to tax upon realisation, which the Financial System Inquiry’s final report noted could encourage ‘leveraged and speculative investment’ in housing.[63]

Negative gearing does not, in itself, cause a tax distortion, but it does allow more people to enter the market than those who might have had the equity alone to do so. Purchasers can make bigger investments in property by borrowing, in addition to using their own savings. This behaviour is encouraged by the CGT discount, as larger investments can result in greater capital gains and therefore benefit more from the CGT discount.

Contrary to popular perception, negative gearing is not a specific tax concession for taxpayers with investment properties — it is simply the operation of Australia’s tax system allowing deductions for expenses incurred in producing assessable income (Chapter 3 — Individuals). Expenses incurred in producing income from other types of investments are also generally deductible. This includes interest costs incurred when borrowing to purchase assets like shares. In 2011-12, around 285,000 individuals deducted a total of nearly $1.4 billion for expenses incurred in earning dividend income.[64] (See chapter 6 for a comparison with the tax treatment of non-commercial losses.)

However, investment properties constitute a substantial proportion of the total value of negatively geared assets. Chart 4.2 shows that deductions claimed for investment properties as a proportion of gross rental income have increased over the last 15 years and are now greater than gross rental income.

Chart 4.3 shows the proportion of tax filers with negatively geared investment property, and indicates that the majority of tax filers with negatively geared properties fall into the middle income bands. This largely reflects the distribution of taxpayers across taxable income bands — with the majority of taxpayers at the low to mid-point of the income distribution (for more information on the distribution of taxpayers across taxable income bands Chart 3.2, Chapter 3 — Individuals). Chart 4.3 also shows that the proportion of tax filers with negatively geared properties increases as taxable income increases.

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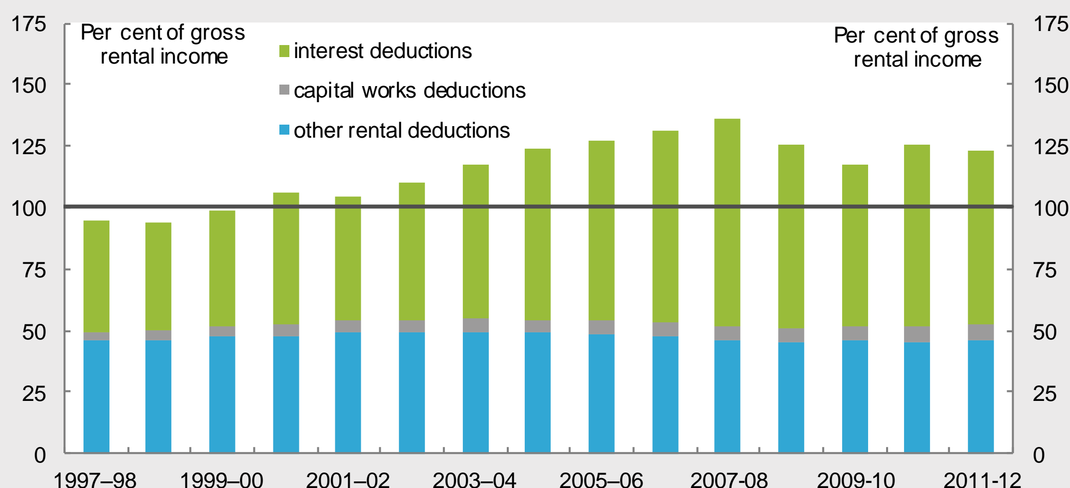
63 Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

64 ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

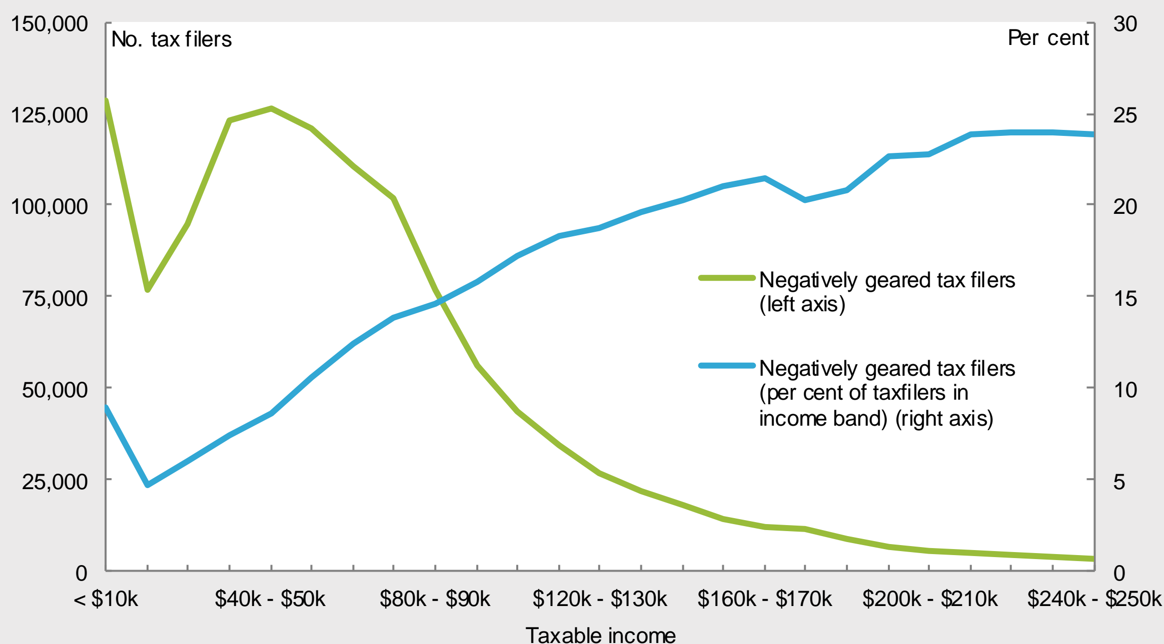
Box 4.2 Cont'd

Chart 4.2 Expenses claimed for investment properties over time, as a percentage of gross rental income



Source: ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra

Chart 4.3 Proportion of tax filers with negatively geared investment properties, split according to taxable income,[65] 2011-12



Source: Treasury calculations using administrative data from 2011-12 tax returns for individuals

65 It is important to note that taxable income is total income less any deductions (for example, interest deductions) and any exempt income (for example superannuation benefits). For tax filers claiming a rental loss, their taxable income would be less than their total income.

Box 4.2 cont'd

Allowing investors to claim deductions for interest expenses ensures consistent tax treatment between debt and equity financing, as is illustrated in the stylised example below.

Let us say two individuals both earn a salary of $90,000. One has equity of $100,000 and decides to use this money to invest in a one-bedroom unit worth $200,000. The other individual also invests in a one-bedroom unit worth $200,000, but borrows the entire $200,000.

Both individuals receive $10,000 in annual rent from the property, which is subject to tax at their marginal rates (39 per cent, including the Medicare levy).

The individual who borrowed the full $200,000 to purchase the property faces an interest rate of 6 per cent on the mortgage, or $12,000 per year. As the interest payments can be deducted from assessable income, the tax liability can be reduced by $4,680 (amount of the deduction multiplied by the marginal tax rate).

The individual who funded 50 per cent of the property with equity has a smaller borrowing of $100,000, and therefore faces interest expenses of $6,000 per annum. This reduces the tax liability by $2,340. However, because they have used equity, they forgo the earnings that would have otherwise received and which would have been subject to tax. Given an earnings rate of 6 per cent[66] and the individual's marginal tax rate of 39 per cent, this equates to income of $6,000 forgone and so $2,340 less tax paid. This means, in total, this individual has reduced the tax liability by $4,680.

This illustrates that any tax advantage for individuals investing in property does not come from borrowing.

The potential tax advantage comes on the income side from the taxation of the capital gain earned from the asset. If the individual realises a capital gain when selling the property, only 50 per cent of this income is included in their taxable return. In this situation, the effective tax rate on the investment is lower than their statutory rate (in this case, their statutory rate is 39 per cent). This is not a result of the gearing but of the taxation of the capital gain.

Discussion questions:

21. Do the CGT and negative gearing influence savings and investment decisions, and if so, how?

Owner-occupied housing

A dwelling is both a consumer durable — a house provides benefits over time like a washing machine or a television — and also a savings vehicle. Australian households hold 43 per cent of total household assets in the value of the family home.[67] Of the 7.8 million

66 This example assumes that the return on equity is the same as the cost of debt. The observation that any tax advantage from investing in property or other assets derives from the CGT treatment, and not from the deductibility of any interest on borrowings, is not materially affected if those rates differ.

67 ABS 2013, *Household Wealth and Wealth Distribution, Australia, 2011-12*, cat. no. 6554.0, ABS, Canberra.

households living in private dwellings in Australia in 2011, 5.2 million or 67 per cent owned their own home (with or without a mortgage) and a further 2.3 million were renting either privately (25 per cent) or in social housing (5 per cent).[68]

Like most other OECD countries, Australia taxes owner-occupied housing more favourably than other types of investment (including dwellings purchased purely for investment). Both the 'imputed rent' — in other words, the value of housing services a home owner receives from their own home — and capital gains on the property are exempt from income tax; Chart 4.1 accordingly shows the effective tax rate of zero. This makes it an attractive vehicle for saving. The primary home is also exempted from the means-test for transfer payments.

While the family home is exempt from paying land tax, it is subject to stamp duties and municipal rates levied by local and state governments (Chapter 8 — GST and state taxes).

Given the central importance of the home for Australian families, there is a strong consensus that it would not be appropriate to tax either the imputed rent on owner-occupied housing or capital gains derived from it.

Superannuation

Pre-tax contributions to superannuation are more concessionally taxed than other forms of savings for many, but not all, taxpayers. This, in part, reflects that these savings have restricted access until retirement. Because superannuation contributions and earnings are generally taxed at flat rates, the level of concessionality differs depending on the individual's marginal tax rate.[69] Those with high incomes receive the greatest tax discount relative to their marginal tax rates, and will generally save a higher proportion of their income. As such they will receive the largest aggregate level of tax expenditure, measured against a benchmark of full nominal income taxation. However, the policy merit of this level of tax concessionality has to be judged taking into account Australia's full retirement income support arrangements, including the means-tested Age Pension.

There are two common public policy arguments for the concessional tax treatment of superannuation. First, for many people, saving through superannuation is compulsory (the current Superannuation Guarantee rate is 9.5 per cent of an employee's ordinary time earnings). A lower rate of taxation can be justified as individuals cannot choose to save less. On the other hand, tax concessions are generally provided to encourage people to undertake more of an activity or behaviour, which is not the case with compulsory savings for retirement.

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68 Australian Institute of Health and Welfare (AIHW) 2013, *Australia's welfare*, no. 11. cat. no. AUS 174, AIHW, Canberra. Note: the remaining 3 per cent either had an 'other' tenure type or the information was not specified.

69 This assumes an income tax treatment of savings consistent with the current Tax Expenditures Statement. That is, using a comprehensive income tax benchmark for measuring the extent of the tax concessions. Under this benchmark, all income is taxed at marginal rates. The alternative would be an expenditure tax benchmark, where income from capital is exempt from tax. Using either benchmark, superannuation is in aggregate taxed concessionally. For more information see the 2013 Tax Expenditures Statement. The choice of benchmark should not be interpreted as indicating a view on how an activity or class of taxpayer ought to be taxed.

The second argument for the lower taxation of superannuation contributions is that unlike other savings, superannuation cannot be accessed on demand, but is 'locked up' for retirement. The preservation age for superannuation is currently 55, gradually increasing to 60 with effect from 1 July 2024.

Superannuation is designed to improve individuals' retirement incomes. In doing so, it also reduces pressure on Age Pension expenditures.

At 31 December 2014, total Australian superannuation assets amounted to $1.93 trillion. This constitutes around 121 per cent of GDP.[70] Superannuation assets are expected to continue to grow as the system matures and wages grow.

Compulsory superannuation savings appear to have made a significant contribution to national savings (around 1.5 per cent of GDP in 2011 and rising to close to 3 per cent over the next few decades). This is despite some reduction in other forms of savings.[71]

Voluntary savings can also be made to superannuation funds. Individuals, including the self-employed and those who do not work, can choose to save in a superannuation fund to have a higher income in retirement.

The majority of superannuation savings in Australia is in accumulation funds (where the final retirement benefit depends on contributions made, the earnings accrued and fees paid over the period invested). Pre-tax contributions, whether compulsory or voluntary, are generally taxed at the rate of 15 per cent. Income generated in the fund is generally taxed at 15 per cent during the accumulation phase, and tax exempt in the retirement phase where assets are supporting a retirement income stream. Benefits withdrawn in retirement are then generally exempt from tax (Box 4.3). Australia's system is unique in that other countries do not tax contributions and earnings, but rather tax retirement savings when benefits are paid.

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70 Australian Prudential Regulation Authority (APRA) 2015, *Quarterly Superannuation Performance (interim edition), December 2014*, APRA, Sydney; and ABS 2015, *Australian National Accounts: National Income, Expenditure and Product*, cat. no. 5206.0, ABS, Canberra.

71 Gruen, D, Soding, L 2011, 'Compulsory Superannuation and National Saving', Address by Gruen, D, to the Melbourne Institute/the Australian 2011 Economic and Social Outlook Conference, 1 July 2011.

Box 4.3: Tax treatment of superannuation savings: accumulation funds

Contributions	Earnings	Benefits
Pre-tax contributions: taxed at 15%; for high-income earners 30% up to an annual cap (currently $30,000 for people aged under 50 and $35,000 for people aged 50 and over). The government effectively refunds the 15% tax for people with income under $37,000 up to an amount of $500 (until 2017). Post-tax contributions: no additional tax if below an annual cap (currently $180,000).	Taxed at 15%. Earnings on assets supporting income streams (i.e. pensions) are tax-free. CGT: if asset is sold during accumulation phase, effectively taxed at 10%; if sold while supporting an income stream, tax-free.	60 and over: tax-free Between preservation age and age 60: • Lump sums are tax-free up to $185,000 and taxed at a maximum of 15% thereafter. • Income streams are taxed at marginal rates less a 15% offset. Below preservation age: • Lump sums are taxed at a maximum of 20%. • Income streams are taxed at marginal rates.

Note: Pre-tax contributions include personal deductable contributions. Tax rates on benefits exclude the Medicare levy.

While there are policy grounds for superannuation being taxed at a lower rate than labour income, there are issues around the distribution of the impacts and their effectiveness in supporting higher retirement incomes, as well as their complexity. The Financial System Inquiry made observations relating to the differential earnings tax rate across the accumulation and retirement phases, as well as the targeting of superannuation tax concessions.[72] The Government has indicated these will be considered as part of the Tax White Paper process.

Issues associated with differential treatment of superannuation earnings

The different rates of tax on earnings in the pre- and post-retirement phases add costs to the operation of the superannuation system. They also give rise to tax planning opportunities that are usually more accessible to high income earners. For example, it may be possible to delay realisation of a capital gain until the post-retirement phase so that no CGT is payable. Furthermore, it may also complicate the development of retirement income products.

With Australia's ageing population, more individuals will enter the retirement phase where no tax is paid on earnings in superannuation funds. This will put pressure on the long-term sustainability of the superannuation tax arrangements, particularly given other long-term budgetary pressures as the population ages, such as calls for higher spending on health and aged care, and relatively lower revenue from personal income taxes.

72 Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

Issues with the distributional effects of superannuation

The flat rate of tax on superannuation contributions means that most high income people receive a larger tax concession, relative to their marginal tax rate, than low income people. The same is true during the accumulation phase and even more so during the retirement phase when there is no tax on earnings.

Overall government assistance for retirement

Superannuation is only one pillar of Australia's retirement income system. The Government also provides assistance for retirement through the means tested Age Pension which ensures that all Australians receive a minimum level of income through their retirement.

As at 30 June 2013, there were 1.39 million people receiving the full-rate Age Pension 960,000 receiving a part-rate Age Pension (partly self-funded), and almost 250,000 individuals aged 65 years and over on some other pension payment, such as the Service Pension, Disability Support Pension or Carer Payment. Around another 760,000 individuals aged 65 years and over were self-funded and/or still employed, of which almost 290,000 were in receipt of the Commonwealth Seniors Health Card.[73]

Age Pensioners receive income support through the base rate of the Age Pension and through supplements and other non-cash concessions. For example, a single full rate Age Pensioner may currently receive a total payment of $860.20 per fortnight, which comprises a base rate pension of $782.20 per fortnight, as well as a Pension Supplement of $63.90 per fortnight and an Energy Supplement of $14.10 per fortnight. In addition to these cash payments, Age Pensioners may also be eligible for in-kind benefits, including the Pensioner Concession Card which entitles the holder to a range of concessions including cheaper medicines and discounts on utilities, council rates and public transport. The Government also provides generous subsidies for residential aged care, targeted at low-income earners.

Most middle-income individuals will also receive a tax discount relative to their marginal tax rate on their superannuation savings. Over time, the proportion of pensioners receiving a full-rate of Age Pension is expected to decline, and superannuation balances for low- and middle-income earners will make up a larger part of their retirement incomes.

Individuals on high incomes will generally receive minimal or no Age Pension, given it is subject to income and asset tests.

Discussion questions:

22. How appropriate are the tax arrangements for superannuation in terms of their fairness and complexity? How could they be improved?

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73 Australian Government 2015, *Income support customers, a statistical overview 2013*, statistical paper no. 12, Department of Social Services, Canberra; and ABS 2014, *Demographic Statistics, June 2014*, cat. no. 3101.0, ABS, Canberra.

4.3: Alternative approaches to taxing income from savings

In the past, suggestions have been made for broad-based, lower rates of tax on income from savings (with separate arrangements for owner-occupied housing and superannuation). The objective of these arrangements is to achieve a more neutral treatment of savings vehicles leading to a better allocation of domestic saving.

As an example, the Australia's Future Tax System report recommended providing a 40 per cent savings income discount to individuals for non-business related interest income; residential rental income (including related interest expenses); capital gains (and losses); and interest expenses related to listed shares.[74]

In contrast, some countries adopt a schedular system under which various types of income from savings are taxed separately to other income, and are taxed at relatively low, flat rates. One type of schedular system is the dual income tax (DIT) system (Box 4.4). Because a DIT system separates the labour and capital income tax bases, allowable deductions relating to capital income can only be deducted against other capital income. Variants of the DIT system have been operating in Norway, Finland, Sweden and Denmark for the last 20 years.

Box 4.4: Norway's Dual Income Tax System

In the late 1980s Norway's savings levels were low, the return to investment was low, and the investment allocation was seriously distorted. There was a strong concern that the tax settings induced excessive borrowing for socially unprofitable investment. The introduction of the dual income reform in 1992 was to achieve a moderate taxation of capital income that is also neutral in a broad sense, while maintaining the distributional role of the progressive tax on labour income.[75]

These days the two pillars of Norway's income tax system consist of a progressive labour income tax schedule, with a base rate of 32.1 per cent and top marginal rate of 47.2 per cent, and a 27 per cent flat capital income tax rate for interest, rental income, royalties and capital gains.[76]

Australia has a similar approach in relation to the taxation of superannuation and the treatment of capital gains and losses. Generally, however, such an approach makes the tax system more complex.

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74 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra.

75 Christiansen, V 2004, *Norwegian Income Tax Reforms*, CESifo DICE Report 3/2004.

76 Nordisk e-tax 2014, *Norway — Tax rates and limits*, viewed 08 December 2014: www.nordisketax.net/main.asp?url=files/nor/eng/i07.asp.

4.4: Estate taxes

Estate taxes are not currently levied in Australia. They were levied by both the Commonwealth and States in the past but were progressively scrapped in all jurisdictions. Internationally, estate taxes usually take the form of estate and gift taxes on accumulated gifts and inheritances, although some countries (for example, France and Switzerland) also levy annual wealth taxes. These taxes generate relatively little revenue. For example, Belgium, with the highest reliance on estate, inheritance and gift taxes in the OECD, raised only 1.4 per cent of total tax revenue from these taxes in 2012.[77] Furthermore, such taxes can be difficult to administer effectively.

Estate taxes may influence the savings decisions to leave an inheritance, but would not be expected to affect the savings decisions to fund an adequate retirement.[78]

Discussion questions:

23. What other ways to improve the taxation of domestic savings should be considered? How could they be applied in the Australian context?

77 OECD 2014, *Revenue Statistics 2014*, OECD, Paris.

78 Australian Government 2010, *Australia's Future Tax System Review* (Henry Tax Review), Australian Government, Canberra.

5: General business tax issues

Overview

This chapter provides an overview of the business tax system in an increasingly digitised and globalised world.

Key points

- Tax is becoming increasingly important as competition for foreign investment intensifies and businesses become more mobile. Australia's corporate tax rate is high compared to many countries we compete with for investment, especially those in the Asia-Pacific region.
- While company tax is paid by companies, the burden is passed on to shareholders, consumers and employees. A more competitive business tax environment would encourage higher levels of investment in Australia and benefit all Australians through increased employment and wages in the long run.
- Dividend imputation ensures there is no double taxation on income from Australian shares owned by Australian resident shareholders and supports the integrity of the business tax system. However, it makes little contribution to attracting foreign investment to Australia other than eliminating dividend withholding tax for franked dividends paid to foreign shareholders. It also involves a significant cost to revenue and may impose more compliance costs to achieve similar outcomes to other jurisdictions.
- Australia's corporate tax system is also extremely complex. Artificial distinctions embedded in the system often create unintended biases towards particular forms of investment, distort business decisions and increase incentives to engage in complex tax planning.
- Business innovation encompasses improvements to goods and services, processes and marketing. Benefits can include productivity enhancements, firm growth, job creation and higher living standards. The research and development tax incentive and concessional taxation of employee share schemes are two ways the tax system supports business innovation.

5.1: Overview of the business tax system

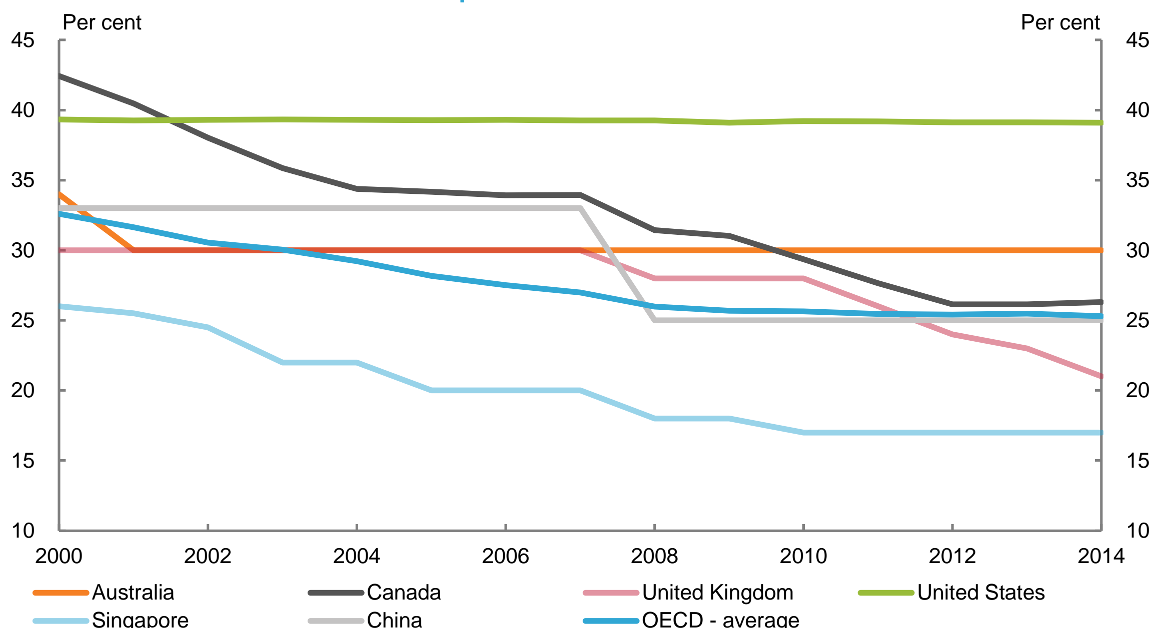
Businesses can be taxed differently depending on their structure, such as whether they operate through a company, partnership, trust or as a sole trader, and whether they are closely held by a small number of private shareholders or widely held, like a publicly-listed company. There are also special tax arrangements for small businesses. These are considered in Chapter 6, with this chapter addressing tax issues that apply to businesses more generally.

Most business income in Australia is derived through corporations, rather than partnerships or trusts. Accordingly, this chapter focuses primarily on the taxation of corporations, particularly widely-held corporations. Where relevant, some specific considerations for closely-held corporations or businesses conducted through partnerships or trusts are highlighted.

Corporate income tax is currently levied at a rate of 30 per cent on all taxable income earned by companies. This means Australia's corporate tax rate is higher than many countries we compete with for investment (Chart 5.1 and Chart 5.2).

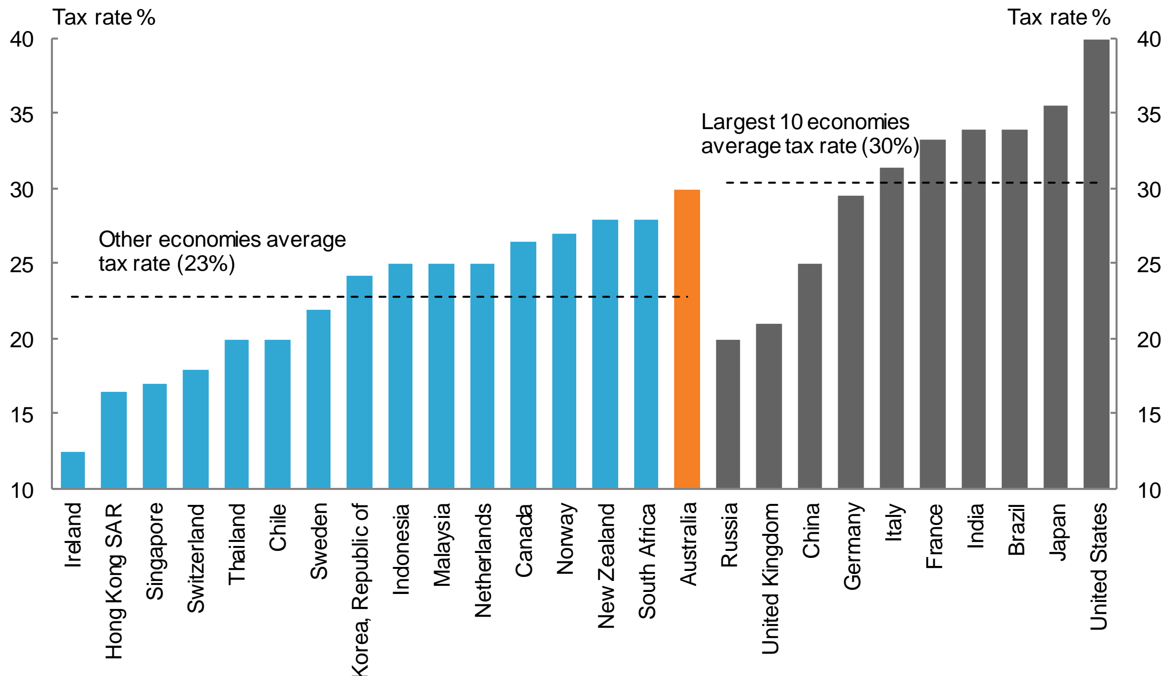
As economies become more open, barriers to investment can have a greater impact on economic growth and real wages growth. In response, corporate income tax rates have fallen worldwide in recent years. For example, since 2008, the United Kingdom, Canada and Singapore have all reduced their main corporate tax rate.

Chart 5.1 Trend in corporate tax rates in selected economies



Source: Organisation for Economic Co-operation and Development (OECD) 2014, *Tax Database — Taxation of Corporate and Capital Income*, OECD, Paris, viewed 5 December 2014: www.oecd.org/ctp/tax-policy/Table%20II.1-May-2014.xlsx ; KPMG 2014, *Corporate tax rates table*, viewed 5 December 2014: www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx; and KPMG 2007, *Hong Kong Tax Competiveness Series: Corporate Tax Rates*, viewed 5 December 2014: www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/corp-tax-rate-0707.pdf; KPMG 2006, *KPMG's Corporate Tax Rate Survey, An international analysis of corporate tax rates from 1993 to 2006*, viewed on 21 January 2015: www.lib.uwo.ca/files/business/KPMGCorporateTaxRateSurvey.pdf.

Chart 5.2 Corporate tax rates, selected trading partners, 2014

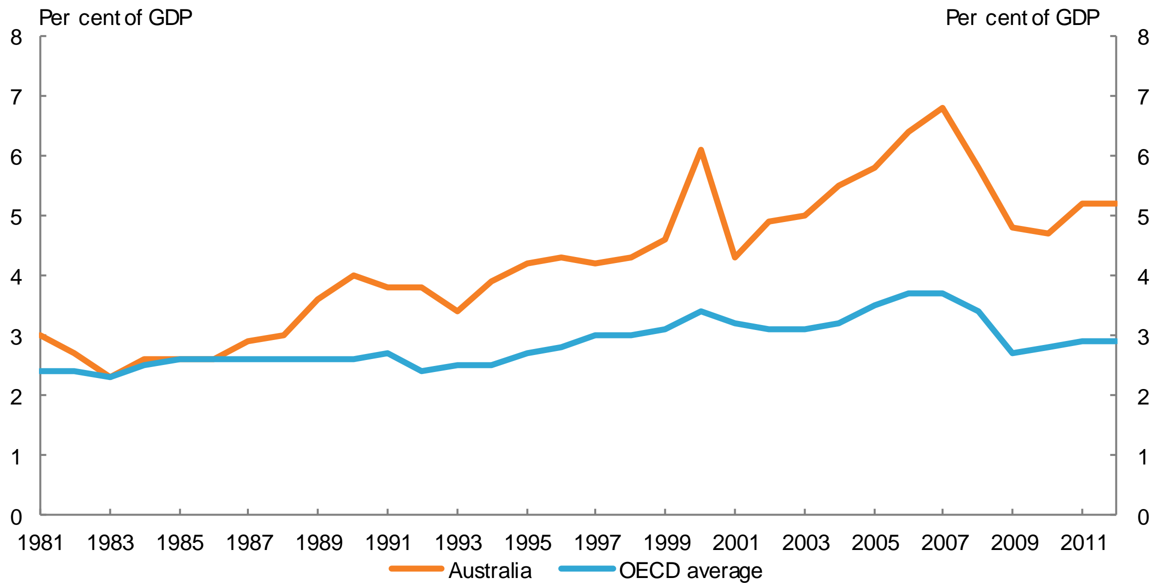


Note: Corporate tax rates in this chart are estimates as the effective tax rate can vary depending on the specific tax rules applied in each jurisdiction. Chart 5.2 uses a different data source to Chart 5.1 which may result in slight differences in the estimates. For example, the United States' corporate income tax rate is approximately 40 per cent. The estimate of this rate can vary depending on how corporate income taxes applied at the sub-central level (by state and local governments) are measured.
Note: The Indian Government announced in their 2015-16 budget that they would introduce a company tax cut from a base rate of 30 to 25 percent over four years, coupled with some reductions in tax concessions. The rate of 33.99% shown above includes various surcharges over the base rate.
Source: KPMG 2014, *Corporate tax rates table*, viewed 10 December 2014:
www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx.

How important is corporate tax to Australia?

Australia relies more heavily on corporate income tax than most other countries. In 2012, Australia's corporate taxation was 5.2 per cent of GDP, while the OECD average was 2.9 per cent. A relatively heavy reliance on corporate tax has been a consistent feature of our tax system over several decades (Chart 5.3).

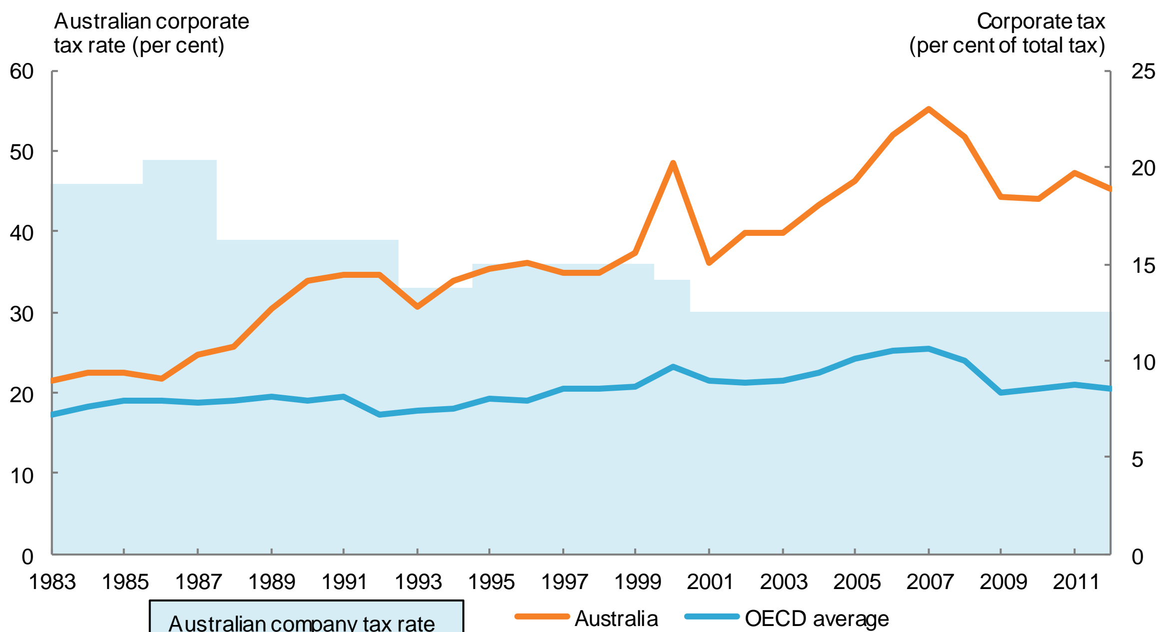
Chart 5.3 Corporate tax revenue



Source: OECD 2014, *Revenue Statistics 2014*, OECD, Paris.

Corporate tax as a share of total tax for all Australian Governments has increased in recent decades, from around 9 per cent of total tax in 1983 to around 19 per cent in 2012 (Chart 5.4). The main reasons for this increase include increased corporate profitability and efforts to broaden the corporate tax base (while lowering the rate). By contrast, the OECD average corporate tax revenue (as a percentage of total tax revenue) has remained relatively stable at around 8.5 per cent over the same period.

Chart 5.4 Corporate tax revenue as a percentage of total tax revenue



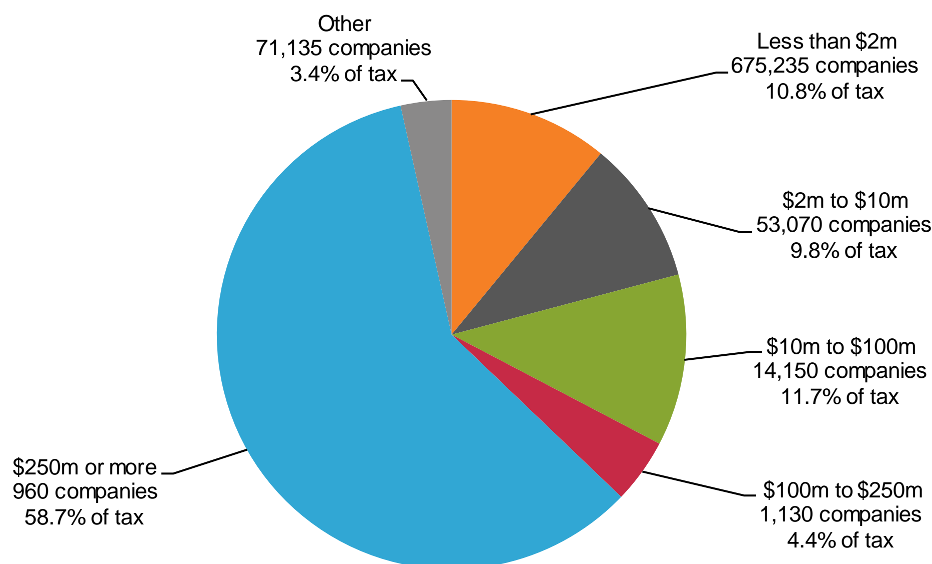
Source: OECD 2014, *Revenue Statistics 2014*, OECD, Paris.

Who ultimately pays corporate tax?

Every resident company that derives taxable income (including capital gains) sourced from Australia or internationally is required to pay Australian corporate tax. Every non-resident company that derives taxable income from Australian sources is also required to pay tax in Australia.

While there are over 800,000 companies in Australia, most corporate income tax is paid by a relatively small group of large companies. Around 2,000 companies paid approximately two-thirds of company tax in 2011-12 (Chart 5.5).[79] The mining and financial services sectors are the largest contributors to corporate tax collections in Australia.

Chart 5.5 Resident company income tax by company size, 2011-12



Note: Total income is used as a measure of company size. 'Other' includes companies classified as a cooperative, registered organisation, non-profit, strata title, pooled development fund, limited partnership, corporate unit trust or a public trading unit trust.
Source: ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

For resident shareholders, corporate income tax is a withholding tax, or a pre-payment of individuals' income tax. Resident shareholders declare the dividends they receive from the company in their taxable income, and receive a credit for tax paid by the company for that dividend. Shareholders can use the credit to offset their income tax liability. If the dividend credit exceeds their income tax liability, the excess corporate tax paid may be refundable to the shareholder. However, for companies that choose to retain earnings, corporate tax reduces the funds available for reinvestment.

For non-resident shareholders, corporate income tax may be the final taxing point in Australia. Imputation credits for tax paid by the company for the dividend are not available for use by non-residents. Other jurisdictions may offer a full or partial credit for tax paid in Australia, or an exemption from further tax if tax is paid in Australia.

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79 Australian Taxation Office (ATO) 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

While the legal incidence of corporate tax falls on companies, the economic burden of company tax is ultimately shared among its shareholders, consumers and employees. Empirical studies show that, in the long run, over half of the economic burden of corporate tax is likely to be shifted away from shareholders through lower wages for employees and higher prices for consumers.[80] Individuals who rely on labour income could be expected to be affected more significantly from lower wages growth associated with company tax.

This analysis does not take into account the behavioural responses to company tax that may be more relevant for closely-held companies with more control over when and how profits are distributed. For individual resident shareholders, the effectiveness of company tax as a withholding tax is reduced if dividend distributions are delayed until a period where the shareholders are subject to a relatively low marginal tax rate in the individuals income tax system (for example, in retirement).

The impact of corporate tax on economic growth and living standards

Australia relies on domestic and foreign savings to finance additional investment in the Australian economy. This includes new capital assets like machinery, as well as training and research and development activities. Tax is only one of many factors that affect Australia's appeal as a destination for foreign investment. Nevertheless, tax can have a significant impact on investment decisions.

Corporate tax applies to the profits of companies, reducing the return from their investments. This reduces the level of investment in small, open, capital importing economies, such as Australia. This is because the marginal investor in Australia is likely to be a non-resident, who will invest in business opportunities in Australia only if they achieve an after-tax return that matches their target rate of return (see Box 5.1).

Tax on investments can influence decisions about where to invest, what to invest in, and how much to invest. Higher taxes on investment generally mean that fewer investments will be viable. This effect is more pronounced where the rate of corporate tax is higher than in other countries offering comparable investment opportunities. The types of investments that are made can also be distorted. Key features of the corporate tax system that affect investment decisions include the tax rate and the tax treatment of capital assets, losses and financing costs.

Reducing Australia's corporate tax rate would increase Australia's appeal as a place to do business. It would encourage higher levels of investment in Australia and lead to capital deepening, which promotes growth in productivity, innovation, employment and wages. In the near term, lower taxes would provide an increased incentive for non-residents to invest in Australia. In the long run, increased investment would benefit all Australians.

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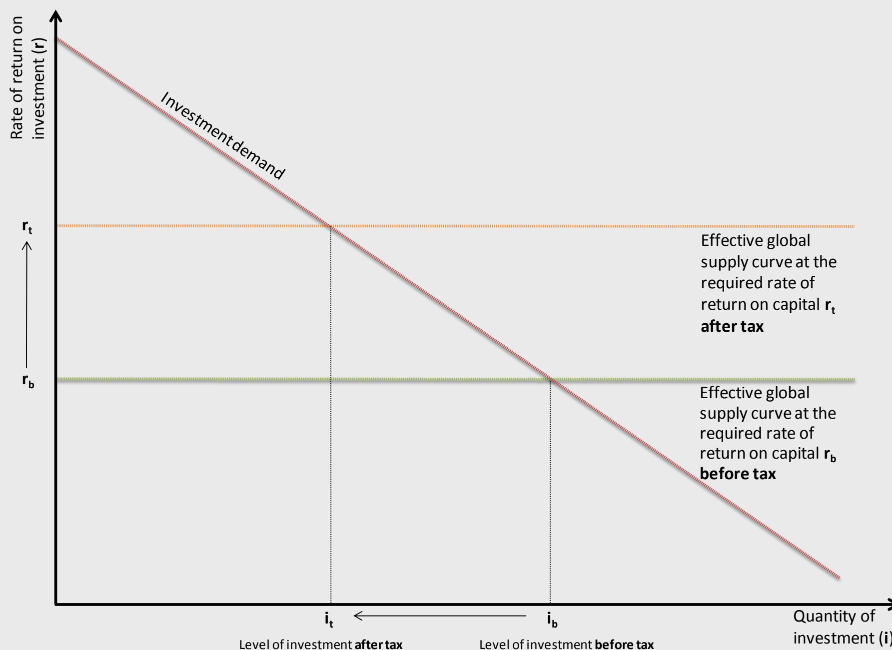
80 Hassett, K A, and Mathur A 2006, *Taxes and Wages*, American Enterprise Institute for Public Policy Research working paper no. 128, American Enterprise Institute, Washington; Felix, R A 2007, *Passing the Burden: Corporate Tax Incidence in Open Economies*, regional research working paper no. 07-01, Federal Reserve Bank of Kansas City, Kansas; and Arulampalam W, Devereux M P, and Maffini G 2011, *The Direct Incidence of Corporate Income Tax on Wages*, working paper no. WP09/17, Oxford University Centre for Business Taxation, Oxford.

Box 5.1: The impact of company tax on investment

All else being equal, an investment project will go ahead only if it delivers an adequate return, that is, if the internal rate of return[81] from the investment project is enough to compensate the investor for the capital they provided, taking into account the price of capital[82] and time value of money.[83] A more internationally competitive company tax rate should encourage higher levels of investment in Australia.

Investors often consider comparative returns for projects across countries when making investment decisions. Decisions will be based on the expected returns after tax as tax reduces the return from the investment. Therefore, the higher the company tax rate in a country, the higher the before-tax rate of return required to make an investment competitive.



The diagram illustrates the overall effect of company tax on investment in a small open economy like Australia, which has minimal effect on the global price of capital. As the price is set in the international market, the before-tax global required rate of return faced by firms is fixed (shown by the green line, $\mathbf{r_b}$).

As the amount of investment undertaken increases, the rate of return realised from investment will decline as less profitable investments are brought to market (shown by the demand for investment along the red line).

81 Internal rate of return is the interest rate at which the net present value of all the cash flows (both positive and negative) from a project or investment equal zero.

82 The price of capital is primarily determined by the demand and supply of capital, which is affected by various factors, including investors' risk appetite, investment barriers etc.

83 Money available at the present time is worth more than the same amount in the future due to the potential of money today to generate future income.

Box 5.1 con't

The level of investment undertaken will be $\mathbf{i_b}$ in the diagram, that is, where the investment opportunities line equals the global before-tax rate of return.

Company income tax drives a wedge between the before-tax rate of return and after-tax rate of return.

Firms would have to offer a higher rate of return in order to attract their investment. This reduces the demand for investment, because there are fewer investment opportunities available that generate the required higher rate of return (shown by the orange line, $\mathbf{r_t}$). Hence, the total amount of investment in the economy is less (shown by the move from $\mathbf{i_b}$ to $\mathbf{i_t}$) than would be in the absence of a company tax.

A lower level of investment—for example, in new machinery and more efficient technology—makes existing workers less productive[84] and, in doing so, reduces company profits, returns for shareholders, jobs and wages.

In considering changes to the company tax rate, there are a number of additional factors that need to be taken into account. For multinational companies, a lower corporate tax rate would reduce the incentive for tax planning and profit shifting from Australia. This would potentially reduce the revenue that is lost to tax planning and allow the resources devoted to tax planning and compliance activities to be used more productively in the economy.

On the other hand, a reduction in the corporate tax rate (in isolation) would exacerbate the existing disparity between the corporate rate and the highest marginal tax rate in the individuals income tax system. For closely-held companies, this would increase incentives to engage in tax planning (for example, portraying personal income as corporate income, or changing the timing of dividends to minimise additional individuals tax liability and maximise refunds of corporate tax for individuals with a marginal tax rate below the company tax rate).

A reduction in the corporate tax rate would also have a significant impact on tax revenues in the short term. This effect would be partially offset in the medium to long term, as increased economic activity from new investment generates additional tax revenue. For example, modelling undertaken by the UK Treasury Department indicates that, for the UK, between 45 and 60 per cent of the cost of a corporate rate cut will be reduced in this way.[85] While Australian estimates may differ, the UK study suggests the possible order of magnitude involved.

While new investors would benefit from a lower corporate tax rate, some of the benefit would accrue to existing investments. This would mostly benefit non-resident investors as Australian company tax is often the final tax for these investors. Australian investors would still pay tax at their marginal tax rate on company dividends through the imputation system and so would not benefit from a company tax cut to the same extent.

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84 There is less capital for each worker.

85 HM Revenue and Customs, and HM Treasury 2013, *Analysis of the dynamic effects of Corporation Tax reductions*, United Kingdom Government, London.

There may be alternative policy options that would effectively target new investment only, such as changing depreciation allowances for new assets. However, these approaches provide a continuing incentive to represent 'old' investments as 'new' investments and, unless carefully designed, would distort economic outcomes and increase tax system complexity.

Similarly, reducing the corporate tax rate would also decrease the tax paid by investments that would have taken place under the old tax rate. This may be seen as a particular concern, as it limits the ability of the general corporate tax system to tax excess returns when barriers to competition exist, such as a monopoly or ownership of valuable intellectual property. In practice, it can be difficult to identify excess returns, the degree of their mobility and what has created them. Consequently, the significance of this concern is not clear. There are other mechanisms to provide governments with a share of the value of some excess returns, most prominently royalties on minerals and royalty withholding tax on intangible assets.[86]

Discussion questions:

24. How important is Australia's corporate tax rate in attracting foreign investment? How should Australia respond to the global trend of reduced corporate tax rates?

Digitisation and globalisation

Digitisation and globalisation of the economy are positive developments that are reshaping the world. Digitisation has enabled businesses to innovate and increase productivity, while new businesses and new ways of doing business have flourished. Meanwhile, technological advances have enabled multinational companies to develop sophisticated value chains across multiple countries.

A globalised economy means that companies have greater choice about where to locate their activities and assets, including intangible assets. This has increased the opportunities for multinational companies to use legal means to minimise their tax liabilities, through multinational tax avoidance, also known as Base Erosion and Profit Shifting (BEPS). BEPS refers chiefly to situations where the interaction of different tax rules allows profits to be shifted away from the countries where the activities creating those profits take place, leading to low taxation or even no taxation.

The extent to which tax avoidance is currently affecting Australia's corporate tax base is unclear. The imputation system provides strong incentives for Australian-owned companies to pay tax in Australia. However, it is clear that the risks to the corporate tax base are increasing.

86 The trend towards reduced withholding taxes on royalties may mean that the effectiveness of royalty withholding tax in taxing excess returns is declining.

To maintain the integrity and fairness of our tax system, it is important to ensure that companies that conduct business in Australia pay tax in Australia.

The issue of multinational tax avoidance is a key focus for governments around the world. As G20 president in 2014, Australia led the global response to tax avoidance.

The two-year G20/OECD BEPS Action Plan is designed to address deficiencies in the international tax system that create opportunities for tax avoidance. Its recommendations will be finalised by December 2015.

Furthermore, Australia already has some robust and sophisticated laws that deal with tax avoidance by multinational companies. These include comprehensive thin capitalisation rules, tough transfer pricing and controlled foreign company rules and an extensive general anti-avoidance rule.[87]

Recent reforms have tightened Australia's thin capitalisation rules to stop multinationals claiming excessive debt deductions and closed other loopholes in the tax system. The ATO also has several compliance programs specifically addressing global tax structuring arrangements by multinational companies. The Commissioner of Taxation is now also required to publish certain tax details of corporate taxpayers with total income of $100 million or more for an income year.

Lowering our corporate tax rate would also reduce the underlying incentive for companies to engage in profit shifting, debt loading and tax avoidance.

5.2: Key features of Australia's business tax system

This section outlines some important features of Australia's business tax system and highlights some of their benefits and drawbacks. It is not intended to be an exhaustive list, or to narrow the scope of submissions on possible reform areas of business tax. The section focuses on the operation of the business tax system for large widely-held companies, with some additional perspectives noted where relevant.

The dividend imputation system

Historically, Australia had a 'classical' system of dividend taxation that resulted in the double taxation of company profits when they were distributed to non-corporate shareholders as dividends. Dividend imputation was introduced in 1987 to relieve double taxation. The current imputation system was reformed in the early 2000s to make imputation credits refundable for some taxpayers.

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87 A comprehensive thin capitalisation regime aims to prevent excessive debt deductions by companies; tough transfer pricing legislation ensures cross-border related party payments are priced appropriately; controlled foreign company rules aim to prevent Australian companies shifting income offshore; and an extensive general anti-avoidance rule aims to capture arrangements designed to avoid paying Australian tax.

The objective of Australia's imputation system is to integrate the Australian corporate tax system with the taxation of resident shareholders. This is achieved by ensuring that distributed company profits face only one layer of tax, equal to the marginal tax rate of the resident shareholder that receives a share of the profits through dividends.

Under imputation, company tax acts as a withholding tax on Australian shareholders by collecting some of the tax that would be paid by the shareholder when they receive a dividend. Australian shareholders then receive a credit against their tax liability for the tax paid by the company. Individuals, superannuation funds and some tax-exempt entities, including charities, are entitled to a refund of any excess tax paid at the company level. As a result, the final tax on company profits reflects each shareholder's tax rate.

In recent years, the value of imputation credits claimed by individuals, superannuation funds and charities has been around $19 billion per year. The value of imputation credits claimed by other Australian companies has been around $10 billion per year. The remainder of the difference between company tax paid (which has been around $65 billion) and imputation credits claimed is largely related to earnings retained by companies (rather than paying dividends) and imputation credits paid to non-resident shareholders who cannot utilise them to offset Australian company tax paid. An estimated $12 billion (30 per cent) of the imputation credits distributed each year are received by non-resident shareholders.[88]

Features of dividend imputation

The imputation system was introduced to reduce a number of existing biases in the tax system, particularly for widely-held companies with a significant domestic shareholding. It provides a more neutral tax treatment of incorporated and unincorporated businesses and reduces the bias towards debt (rather than equity) in company financing choices.

While the imputation system addresses some biases in the tax system, it leaves some issues unaddressed. As shown earlier in Box 5.1, company tax means that investments need to deliver a higher rate of return for all investors to attract non-resident investors. However, unlike non-resident investors, Australian investors do not face a higher tax burden from company tax, because of imputation. As a result, imputation effectively increases the rate of return for Australian investors.

Australian investors therefore have an incentive to invest more of their savings in Australian shares rather than other investments (such as foreign companies). Further, because imputation does not offer relief from underlying foreign corporate taxes, it creates a bias against Australian-owned companies investing in foreign companies or engaging in foreign business activities.

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88 ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra. The residual amount of around $24 billion represents the tax paid on company retained earnings and differences between accounting profit and taxable income.

For many companies, imputation reduces the bias that exists in some classical tax systems towards companies retaining their profits, rather than distributing them to shareholders as dividends.[89] In addition, by encouraging greater use of equity financing, the imputation system may also improve the stability of the economy. This may have contributed to the strength of the Australian corporate sector through the recent financial crisis.[90]

The imputation system also has integrity benefits. Tax avoidance by Australian companies reduces their ability to pay franked dividends, so any Australian tax avoided by the company is recaptured at the shareholder level when the company pays unfranked dividends to Australian shareholders. This reduces incentives for Australian companies with Australian shareholders to avoid Australian tax.

To the extent that dividends are distributed, the imputation system also reduces the effectiveness of tax concessions, such as the research and development (R&D) tax incentive for Australian resident shareholders. An Australian resident shareholder who receives a dividend paid out of corporate profits that were partially exempt from tax (for example, due to the company receiving the R&D concession) may receive a lower tax credit on that dividend. This may make them subject to an offsetting increase in personal tax.

On the other hand, a non-resident shareholder may benefit from a lower corporate tax liability (due to the R&D incentive) as unfranked dividends are only subject to dividend withholding tax, typically at a rate much lower than the corporate tax rate (under Australia's tax treaties). As such, there remains an incentive for foreign equity to flow to companies with more tax concessions.

These biases may be undesirable in an increasingly open and globalised world economy. The final report of the Australia's Future Tax System Review in 2010 stated

> … the benefits of dividend imputation have declined as the Australian economy has become more integrated into the global economy. In particular, benefits in relation to financing neutrality between debt and equity financing have fallen, while the bias for households to over-invest in certain domestic shares has increased.[91]

The imputation system has also increased the complexity of the tax system. Complex rules have been introduced to address integrity concerns arising from the imputation system. For example, specific rules address practices like franking credit trading, which involves franking credits being transferred to other entities that have not borne the economic risk associated with those credits, and dividend streaming, which involves franking credits being distributed to only the shareholders that value them.

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89 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra.

90 Davis, K 2011, *The Australian Financial System in the 2000s, Dodging the Bullet*, viewed 16 October 2014: www.rba.gov.au/publications/confs/2011/pdf/davis.pdf, page 341.

91 Australian Government 2010, *Australia's Future Tax System Review* (*Henry Tax Review*), Australian Government, Canberra, page 198.

International comparison

Other countries currently use a number of alternative approaches to relieve the impact of double taxation of corporate dividends (Table 5.1). Many European countries (including the UK, Germany, Finland and Norway) discontinued their imputation systems during the 2000s to comply with EU free trade laws. There is now only a small group of OECD countries that operate a full dividend imputation system (including Australia). However, many OECD countries provide other forms of shareholder relief that seek a similar outcome. Many of these systems provide partial relief from double taxation of dividend income, regardless of whether the income stems from domestic or foreign sources or how much tax was paid at the company level on that income.

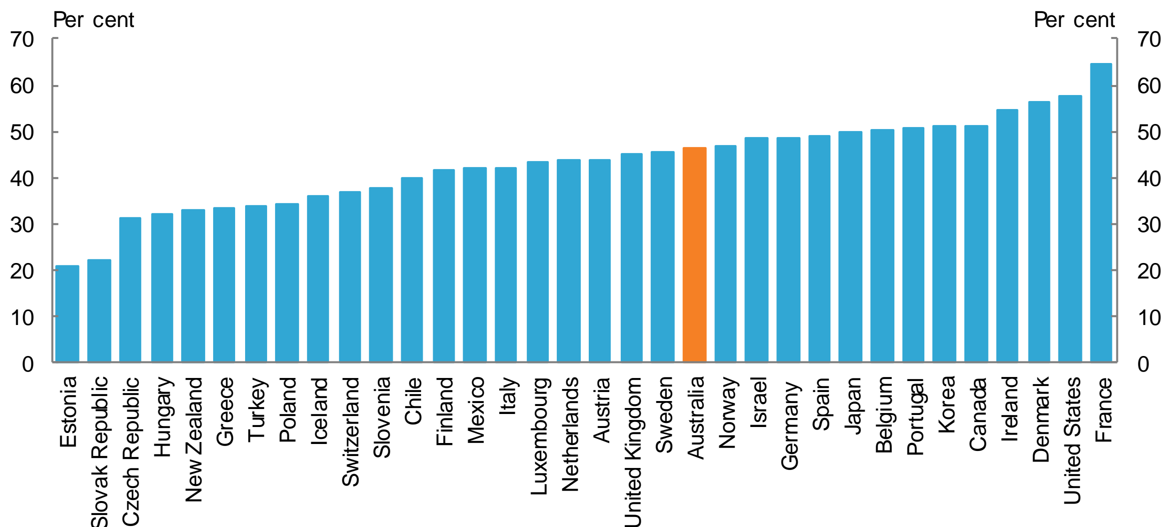
Table 5.1 Treatment of domestic dividends received by resident individuals in selected OECD countries, 2014

System	Description of treatment	Countries
Double taxation (classical system)	Dividend income is taxed at the shareholder's personal tax rate in the same way as other types of capital income (such as interest income). For some of these countries, the tax rate for capital income is lower than the tax rate for labour income. There is no relief for underlying company tax paid, so company profits are taxed again.	Germany, Austria, Belgium, Czech Republic, Greece, Iceland, Ireland, Israel, Netherlands, Slovenia, Sweden
Partial double taxation (some shareholder relief)	Dividend income is taxed again at preferential rates (for example, compared to interest income) at the shareholder level.	United States, Denmark, Japan, Poland, Portugal, Spain, Switzerland
	Dividend tax credit provided at shareholder level at a lower rate than the corporate rate.	United Kingdom, South Korea
	A portion of the dividend is taxed again at the shareholder level.	France, Finland, Italy, Luxembourg, Turkey
No double taxation	Imputation — dividend tax credit at shareholder level for underlying domestic corporate profits tax. No credit is available for underlying foreign tax paid.	Australia, New Zealand, Chile, Mexico
	Dividend tax credit at shareholder level for notional domestic corporate profits tax (whether or not domestic corporate tax has been paid).	Canada
Exemption	No shareholder taxation of dividends.	Estonia, Slovak Republic
	No shareholder taxation of the risk-free return.	Norway

Source: OECD 2014, *Tax Database, Corporate and capital income taxes*, OECD, Paris, viewed 9 December 2014: www.oecd.org/ctp/tax-policy/tax-database.htm#C_CorporateCapital

Despite the diversity of dividend taxation practices, the overall taxation of a dividend received from an Australian company, by a resident individual shareholder on the top personal tax rate is comparable with many other OECD countries (refer to Chart 5.6). A key question is whether Australia's imputation system imposes more compliance costs to achieve similar outcomes to other jurisdictions.

Chart 5.6 Overall taxation (percentage) of resident individuals who receive dividends from domestic corporations in OECD countries, 2014



Note: Overall taxation comprises corporate and personal taxation of dividends. Assumes that the dividend is paid by a domestic company to a resident individual on the highest marginal rate. These rates do not include the Temporary Budget Repair Levy of 2 per cent or the 0.5 percentage point increase in the Medicare Levy Surcharge which took effect on 1 July 2014.
Source: OECD 2014, *Tax Database, Corporate and capital income taxes*, OECD, Paris, viewed 9 December 2014: www.oecd.org/ctp/tax-policy/tax-database.htm#C_CorporateCapital.

Refundability of imputation credits

As noted above, imputation credits are refundable for resident individuals, superannuation funds and some tax exempt entities, including charities. ATO data shows that around $4.6 billion in imputation credits were refunded to taxpayers for the 2012-13 income year.[92]

Refundability ensures that the final tax on company profits reflects each shareholder's tax rate at the time that the profits are distributed. Arguably, this provides for greater neutrality between different types of investments and removes a penalty that would otherwise apply to shareholders who have a lower tax rate (for example, retiree shareholders on relatively low incomes). However, as noted above, domestic shareholders may receive higher returns on domestic shares compared to global rates of returns on equities, because of imputation.

There are some revenue concerns with the refundability of imputation credits. As mentioned earlier in this chapter, it provides a greater incentive for shareholders of closely-held companies to delay distributions until a time when individual owners are subject to a relatively low tax rate, to receive a refund of tax paid by the company. A similar incentive also exists under classical systems.

Effect of imputation on foreign investment in Australia

The imputation system reduces the cost of investing in Australian companies for Australian residents. However, it provides little benefit for non-resident shareholders in Australian companies, other than exempting the dividend from dividend withholding tax, because

92 2012-13 ATO data.

Australian imputation credits do not reduce their tax liability in their home country. A franked dividend paid to a foreign investor is exempt from dividend withholding tax which currently varies between 30 per cent to 0 per cent, subject to the terms of a tax treaty.

Most countries exempt dividends from overseas companies or apply a classical system where dividends are taxed again in the home country of the investor (some credit for foreign tax paid may be available, up to the local tax rate). In either case, Australian company tax generally affects the final return to foreign investors.[93] It reduces the dividend received by foreign shareholders and there is no imputation credit allowed for Australian company tax paid. This suggests that the imputation system does not help attract new investment into Australia.

The merit of Australia and New Zealand recognising each other's imputation credits has been considered in a number of previous reviews.[94] Mutual recognition would involve Australian shareholders being eligible to receive a credit (against their Australian taxable income) for New Zealand company income tax paid. A similar arrangement would apply for New Zealand shareholders.

Mutual recognition might improve the allocation of investments between the two countries.[95] However, it would likely impose higher revenue costs on Australia than on New Zealand and result in an overall cost to Australian GDP,[96] due to the higher levels of investment by Australian companies in New Zealand. Mutual recognition would also create additional complexity and increase administration and compliance costs.

Discussion questions:

25. Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?
26. To what extent would Australia benefit from the mutual recognition of imputation credits between Australia and New Zealand?

93 The exception to this is countries where the dividend is taxed and the domestic rate is higher than Australia's (which is the case for non-portfolio investors from the United States).

94 Productivity Commissions of Australia and New Zealand 2012, *Strengthening Economic Relations between Australia and New Zealand: Supplementary Paper F: Mutual Recognition of Imputation Credits*, pages 133-141 viewed 16 October 2014: www.pc.gov.au/__data/assets/pdf_file/0020/136802/15-trans-tasman-supplementaryf.pdf; Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra; New Zealand institute of Economics Research and the Centre for International Economics 2012, *The costs and benefits of mutual recognition of imputation and franking credits*.

95 Productivity Commissions of Australia and New Zealand 2012, *Strengthening Economic Relations between Australia and New Zealand: Supplementary Paper F: Mutual Recognition of Imputation Credits*, viewed 16 October 2014: www.pc.gov.au/__data/assets/pdf_file/0020/136802/15-trans-tasman-supplementaryf.pdf

96 Productivity Commissions of Australia and New Zealand 2012, *Strengthening Economic Relations between Australia and New Zealand: Supplementary Paper F: Mutual Recognition of Imputation Credits*, viewed 16 October 2014: www.pc.gov.au/__data/assets/pdf_file/0020/136802/15-trans-tasman-supplementaryf.pdf, page 20.

Depreciation of capital assets

Effective life depreciation, introduced as part of the 1999 Review of Business Taxation (Ralph Review) reforms, aimed to align tax depreciation more closely with economic depreciation. More recently, the diminishing value[97] rate for depreciation deductions was increased from 150 per cent to 200 per cent, to better reflect the pattern of economic depreciation for most assets. This was intended to address concerns that the depreciation system could distort investment decisions by taxing some assets more heavily than others.

The life of some assets for tax purposes is deemed to be lower than their true economic life, including assets involved in transport, oil and gas production and distribution and primary production. This is referred to as a ‘statutory cap’ and it reduces the effective rate of tax on those assets as depreciation deductions can be claimed earlier.

In addition, the requirements for tax and accounting depreciation differ. For example, different depreciation methods and periods may need to be used. As a result, most taxpayers need to keep separate records of their depreciating assets for tax and accounting purposes and this can increase compliance costs.

Discussion questions:

27. To what extent does the tax treatment of capital assets affect the level or composition of investment? Would alternative approaches be preferable and, if so, why?
28. How complex is the tax treatment of capital assets and are the costs of compliance significant?

Losses

The tax treatment of losses was explored extensively by the Business Tax Working Group in 2012.

Most governments, including Australia’s, do not pay the value of losses for income tax purposes to taxpayers on an accruals basis. Rather, the Government in certain circumstances allows tax losses to be carried forward and deducted against assessable income in future years. The real value of tax losses that are carried forward decreases over time, as they are not indexed. The longer a loss is carried forward, the greater the reduction in its real value. However, losses generated by one member of a tax consolidated group can generally be used against profits earned by other members of the same group.

A neutral tax system would have a similar impact on projects that incur expenses up-front and income later, and projects that incur expenses and income at the same time. It would also treat low-risk and high-risk economic activity neutrally. Perfect alignment would involve making losses refundable at the same rate and at the same time that profits are taxed. This

97 The diminishing value method of depreciation provides most of the depreciation deductions in the earlier years of an asset’s life.

would reduce the complexity of the tax system and improve its ability to stabilise the economy during a downturn. However, refundability would reduce the amount and increase the volatility of tax revenue and may encourage tax avoidance.

Losses carried forward are subject to integrity rules that restrict the use of those losses where there is a substantial change in company ownership (the continuity of ownership test) and the type of activity undertaken by the business (the same business test). These rules seek to prevent 'loss trading', whereby a company that is stripped of all of its assets, except its tax losses, is sold to another company. The rules also prevent inter-entity 'loss multiplication' that occurs where a group of companies benefit from a single economic loss more than once, by artificially duplicating the loss through a chain of interposed entities.

These rules can lead to losses being 'trapped' or never able to be used. This may disadvantage small businesses and businesses that undertake higher-risk investments. Aspects of these integrity rules may also hinder the legitimate restructuring of some businesses. For example, the current rules do not determine whether a change to a company's ownership was motivated by a tax avoidance purpose rather than commercial considerations. The same business test may be difficult to determine in advance and may too narrowly prescribe the range of activities that a company can engage in without risking forfeiture of its losses.

These concerns with the tax treatment of losses may be less relevant today because of the tax consolidation regime and the dividend imputation system. The Business Tax Working Group recommended a review of loss integrity rules (particularly the same business test) to ensure the right balance between supporting appropriate risk taking and innovation, and maintaining appropriate integrity.

Discussion questions:

29. To what extent does the tax treatment of losses discourage risk-taking and innovation and hinder businesses restructuring? Would alternative approaches be preferable and, if so, why?

Intangible assets

Changes in the economy, including globalisation and digitisation, have elevated the importance of intangible assets. Investment in intangibles has been growing at around 1.3 times the rate of tangibles since 1974-75.[98]

Investment in creating goodwill and other intangibles is taxed more concessionally than investment in most tangible assets, such as plant and equipment. Expenditures incurred to create 'new' goodwill or intangible assets, such as marketing expenses incurred to develop a brand, are immediately deductible for tax purposes, while the economic benefits persist over

98 Productivity Commission Staff Working Paper 2009, *Investments in Intangible Assets and Australia's Productivity Growth,* Productivity Commission, Canberra.

time. Conversely, acquired goodwill and other intangibles cannot be depreciated for tax purposes. Gains or losses on these acquired intangible assets are taxed only when the asset is sold.

These taxation arrangements may distort investment in these assets in Australia by encouraging intangible assets to be developed in-house but discouraging the subsequent sale of those assets to other parties. Furthermore, intangible assets are very difficult to value because many intangibles are unique, proprietary and rarely traded. This can create significant challenges for tax administrators who seek to ensure that intangible assets are valued appropriately, particularly when they are transferred between international related parties.

Discussion questions:

30. How could the current tax treatment of intangible assets be improved?

Inbound investments

There is a range of different tax treatments of inbound investment depending on the precise nature of income derived. One driver of these differences is the distinction between active and passive investment, which is an inherent feature of the international tax framework. This distinction is intended to share taxing rights between jurisdictions and avoid double taxation on international investment, while balancing the competing policy objectives of capital export and capital import neutrality.

Capital export neutrality aims for neutrality in international investment decisions and is achieved where an investor from a particular country faces the same effective tax rate on an investment regardless of the country of investment. Capital import neutrality is achieved when an investment has the same effective tax rate (and therefore after-tax return) for both domestic and foreign investors. Generally, it is not possible to achieve capital import neutrality and export neutrality at the same time as it is unrealistic for every jurisdiction to have the same tax base and the same rate.[99]

Active income is typically taxed in the source country (that is, where the business activity takes place), whereas passive income is primarily taxed in the investor's country of residence (with a lower amount of tax payable in the source country, for example, through withholding taxes). A possible rationale for this is that passive investment is more mobile and therefore a closer alignment with the benchmark of capital export neutrality is appropriate. Bilateral tax treaties add further complexity to this allocation of taxing rights by imposing different rates of tax on different types of income between countries.

99 Australian Treasury 2013, *Base Erosion and Profit Shifting scoping paper*, Australian Treasury, Canberra, pages 5-6.

The distinction between active and passive investments also forms the basis of targeted concessions designed to increase Australia's international tax competitiveness (for example, the reduced withholding rate on certain passive income derived by non-resident investors through a managed investment trust). The distinction also seeks to protect Australia's corporate tax base and to ensure that Australian active businesses are not at a competitive disadvantage.

A contemporary policy issue in this area relates to the international expansion of Australia's financial services sector. A 2009 report by the Australian Financial Centre Forum found that while Australia's managed funds sector is highly sophisticated, the export of financial services is low by international standards.[100] The removal of tax obstacles and greater clarity on the tax treatment of foreign investors could strengthen Australia's international competitiveness in this area.

The Government considers that there is a case for extending the range of collective investment vehicles that can be offered by Australian funds managers. This is an issue that has been raised in the context of the report by the Australian Financial Centre Forum,[101] the final report of the financial system inquiry[102] and by the Board of Taxation. A broader range of collective investment vehicles will assist the export of financial services, by allowing Australian funds managers to offer products that are familiar to overseas investors. While a lot of work has already been done in this area, there are still a number of difficult taxation and regulatory issues that need to be worked through. The Treasury will consult with industry stakeholders in coming months with a view to developing proposals for inclusion in the Options Paper.

The different tax treatment of various forms of income (see Table 5.2 below) could result in an inefficient allocation of investment because similar economic activities can be subject to very different tax outcomes. This may affect the activities that non-residents choose to invest in and the vehicles that they use to invest through. It may also create difficulties for tax administrations and add complexity to the tax system.

These issues raise questions about the extent to which it is desirable to provide more attractive tax settings for investments perceived as being more likely to be internationally mobile.

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100 Australian Financial Centre Forum 2009, *Australia as a Financial Centre: building our strengths (Johnson Report)*, Australian Financial Centre Forum, Canberra, page 7.

101 Australian Financial Centre Forum 2009, *Australia as a Financial Centre: building our strengths (Johnson Report)*, Australian Financial Centre Forum, Canberra.

102 Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

Table 5.2 Summary of tax rates applying to the Australian-source income of foreign residents

Type of income	Foreign resident
Business income from corporate tax entities[103]	Assessable at 30 per cent of taxable income
Dividends	Franked dividends: 30 per cent (effectively) as they have been subject to Australian company tax Unfranked dividends: • No treaty — 30 per cent; or • Treaty — generally 15 per cent but can vary between 0 and 25 per cent
Royalties	30 per cent for non-treaty countries For treaty countries, generally 5 to 15 per cent, but in some cases up to 25 per cent
Interest income	10 per cent; or 0 to 10 per cent depending on treaty rates Exempt if debt satisfies the public offer test
Capital gain from land or land rich assets, or permanent establishment (PE) business assets	30 per cent[104]
Other capital gains	Exempt
Rental income received through a managed investment trust (MIT)	15 per cent (or 10 per cent for newly constructed energy efficient commercial buildings, known as clean MITs)
Gains from disposal received through a MIT	15 per cent or 10 per cent (if a clean MIT)
Foreign source income received through a MIT	Exempt
Gains from disposal received through a foreign fund under the Investment Manager Regime (IMR)[105]	Exempt

Discussion questions:

31. To what extent should the tax system be designed to attract particular forms of inbound investment (for example, by distinguishing between active and passive or portfolio and non-portfolio)? If so, what principles should inform this?

103 Business income of foreign residents derived from corporate tax entities. MITs can only invest in passive activities.

104 A 30 per cent rate applies to entities; the rate is at least 32.5 per cent for non-resident individuals.

105 In respect of IMR income only.

Outbound investments

As noted above, imputation may act to discourage Australian taxpayers from investing in foreign companies. The taxation of foreign income may further distort decisions.

Australian resident companies are taxed on their worldwide income. Foreign income may be taxed in both Australia and the country from which it is received. To avoid double taxation, some foreign income is exempt from tax in Australia. The treatment of different types of income is outlined in Table 5.3. Where foreign income is subject to tax in Australia, foreign tax credits may be available for foreign tax paid.

Another avenue used by tax authorities to avoid double taxation is tax treaties. Australia has tax treaties with over 40 countries. These treaties set out which country has the right to tax various forms of income as well as allowing the exchange of information between the parties to the treaty. Tax treaties limit the tax rate that one country can impose on some forms of income (particularly dividends, interest and royalties) derived by residents of the other country. The actual treaty rate limit is determined by bilateral negotiation, having regard to the domestic laws and tax treaty policies of the two countries. Consequently, the operation of the tax treaties could result in the same form of investment being taxed differently depending on where it is located.

Table 5.3 Summary of tax treatment of foreign income earned by Australian resident companies

Type of income	Tax treatment
Passive income including interest, royalties, rent and portfolio dividends (interest of less than 10%)	Assessable
Non-portfolio dividends (interests of more than 10%)	Exempt (subject to certain conditions)
Attributed income from foreign entities	Assessable
Dividends paid from previously attributed income	Exempt (subject to certain conditions)
Foreign branch profits	Exempt (subject to certain conditions)
Foreign income from the sale of goods and services that is not branch profits	Assessable
Most capital gains	Assessable
Foreign branch gains of an Australian company	Exempt (subject to certain conditions)
Capital gains on the sale of shares in foreign companies with underlying active assets	Exempt (subject to certain conditions)

Discussion questions:

32. To what extent does the tax treatment of foreign income distort investment decisions?
33. To what extent should the tax system be designed to encourage particular forms of outbound investment (for example, by distinguishing between active and passive or portfolio and non-portfolio)? If so, what principles should inform this?

Transfer pricing

Differences in corporate tax rates around the world provide incentives for companies with operations in several countries to shift their profits into low tax jurisdictions. One way of achieving this is by manipulating the prices that multinational companies pay to offshore related parties for goods and services. For example, a foreign entity charging a high price to an Australian entity means less profit will be earned in Australia and more in the foreign company where the tax rate may be lower.

Australia's transfer pricing rules counter the underpayment of Australian tax by requiring entities to price their international related party transactions at a price that independent parties dealing at arm's length would consider reasonable.

Australia has recently strengthened its transfer pricing rules to counter corporate tax evasion and to bring them into closer alignment with international best practice, as represented by the *OECD Transfer Pricing Guidelines.* The new rules also encourage taxpayers to keep detailed records of their international related party transactions to avoid higher penalties in cases of non-compliance.

The OECD is currently reviewing its guidelines as part of its two year Action Plan to counter Base Erosion and Profit Shifting (BEPS). The new guidelines are expected to be finalised at the end of 2015.

Discussion question:

34. How can tax avoidance practices such as transfer pricing be addressed without imposing an excessive regulatory burden and discouraging investment?

Business financing arrangements (debt/equity)

Firms can raise capital to finance investment by issuing equity or debt, or by using retained earnings.[106] Similar to most foreign jurisdictions, under Australia's tax system, interest payments are tax deductible while returns on equity are not. This means that the primary location of the tax liability for foreign debt investors is overseas, while foreign equity investors are primarily taxed in Australia. Australia's relatively high corporate tax rate contributes to the bias for foreign investment to occur through debt funding.

The economic costs of a tax-induced bias toward debt finance could potentially be significant. The allocation of taxing rights means that a bias towards debt can have the effect of eroding Australia's corporate tax base, particularly in the international context where interest deductions are being claimed in Australia while interest income is being taxed overseas. Thin capitalisation rules seek to limit the extent of the potential erosion. In addition,

106 In practice, the distinction between debt and equity can be blurred for hybrid instruments that combine debt and equity features, such as non-cumulative preference capital.

overreliance on debt makes companies more vulnerable to insolvency and to economic shocks, which may impact on macroeconomic stability.[107]

Financing decisions may also be distorted by other tax treatments in the system. For example, investments financed by retained earnings can be favoured over new equity due to the concessional treatment of capital gains. The tax system may therefore provide a tax advantage to more mature firms and discourage the entry of new firms (which rarely make profits in early years). In addition, providing a deduction for debt and not equity introduces biases against small businesses and knowledge-based industries, which often face difficulties in accessing debt finance.

The imputation system partially offsets the debt bias in Australia by creating an incentive for domestic investors to fund local companies through equity.

Interest withholding tax may also help reduce the tax bias, in respect of international capital, in favour of debt over equity. On the other hand, interest withholding tax can increase the cost of funding from overseas, which may lead to lower investment in Australia. The impact of interest withholding tax is discussed in more detail in the final report of the Financial System Inquiry.[108]

Different tax treatment of these financing arrangements leads to complexities in the tax system and creates incentives for tax planning. This has been compounded over recent decades with the increased innovation in complex financial products that exhibit features of both debt and equity. Because of this innovation, the traditional distinction between debt and equity has become even less clear, and its interaction with other regulatory requirements, such as prudential requirements and accounting standards, has further complicated firms' financing decisions.

Increased globalisation has also expanded opportunities for tax arbitrage, particularly where countries have different views as to whether a particular instrument qualifies as debt or equity.[109] These inconsistencies between countries are a focus of the BEPS project that the OECD is currently undertaking.

The Board of Taxation is currently undertaking a Post-Implementation Review of the Debt-Equity regime, which is due to report in March 2015.[110]

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107 International Monetary Fund (IMF) staff discussion note 2011, *Tax Biases to Debt Finance, Assessing the problem, Finding Solutions*, IMF, Washington, p. 4.

108 Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

109 By way of example, unlike Australia's substance approach to characterise debt and equity, New Zealand, the UK and Canada follow a legal form approach.

110 Board of Taxation 2014, *Post-Implementation Review of the Debt-Equity rules: discussion paper*, Australian Government, Canberra, viewed 8 December 2014: www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/debt_and_equity/default.htm&pageid=007.

Discussion questions:

35. Should the tax system provide a more neutral treatment of different financing arrangements (debt, equity and retained earnings), and if so, how? What principles should inform the approaches?

Revenue/capital distinction

The distinction between revenue and capital in the income tax law arises from a distinction in trust law between income beneficiaries and capital beneficiaries. Under Australia's business taxation system, taxpayers may generate income that is classified as revenue (held on revenue account) or capital (held on capital account). Income generated from realising a capital gain is potentially given concessional tax treatment for non-resident investors.

Expenses incurred in carrying on a business will generally qualify for an immediate deduction. However, an expense that is of a capital nature will not be immediately deductible but will be recognised at a later point in time. For example, the cost of acquiring a depreciating asset will generally be recognised over the effective life of the asset. The cost of acquiring some other assets, such as shares, will generally be recognised at the time the asset is sold.

The distinction between revenue and capital is often unclear, even in simple business transactions.[111] In more complex cases, the characterisation of revenue and capital income for tax purposes depends on fine distinctions in the circumstances of a transaction and the taxpayer's investment activities. The resulting reliance on case law and ATO determinations can create uncertainty and complexity, and may encourage taxpayers to adopt complicated tax structures in order to receive concessional treatment.

In the large business context, the boundary between capital income and revenue income is particularly significant for non-resident investors. Non-resident investors are taxed on revenue income from all Australian sources, while they are taxed on capital income only if it arises from a narrow list of Australian sources (for example, real property).

Australian resident companies cannot access the capital gains tax (CGT) discount, which means that capital income is taxed at the corporate level in much the same way as revenue income (other than the quarantining of capital losses against capital gains).

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111 For example, expenditure on salary or wages to construct and upgrade depreciating assets has been found to be capital expenditure and is not deductible. See ATO ID 2011/42.

Discussion questions:

36. Should the tax system provide a more neutral treatment of income earned on revenue account and capital account? Does the distinction create significant compliance costs for business and, if so, how could it be simplified?

Tax consolidation and Taxation of Financial Arrangements (TOFA)

Australia has developed complex rules for the taxation of consolidated groups and for the taxation of certain financial arrangements. These regimes were designed, in part, to reduce compliance costs for businesses by better aligning the tax system with how large businesses operate in practice (that is, as groups of companies). The regimes also aimed to ensure that tax outcomes reflect the commercial substance of the financial arrangements that they undertake. However, the consolidation and TOFA rules are contained within a very large and complex set of legislation, rulings and ATO guidance material which create their own uncertainties and complexities.

The simplification of these regimes requires detailed consideration. This is being undertaken through separate review processes which the Government has already announced,[112] rather than through the Tax White Paper process. These reviews are a high priority for the Government, reflecting its election commitment to reduce unnecessary or inefficient regulation imposed on individuals, business and community organisations.

The Treasury has started the TOFA review process and is consulting with major industry groups and representatives about possible reform directions in this area, following advice from the Board of Taxation on the scope of the review. The Consolidation review will commence in the second half of 2015 and will focus on implementing key recommendations made by the Board of Taxation in its recent reviews of the consolidation regime.

Discussion question:

37. Are there other important issues in the business tax system, not covered in this section, which should be considered as part of the Tax White Paper process?

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112 Assistant Treasurer Senator the Hon Arthur Sinodinos AO, Media Release, 14 December 2013, *Integrity restored to Australia's taxation system*, viewed 8 December 2014: http://axs.ministers.treasury.gov.au/media-release/008-2013/.

Specialised industries

Due to the specialised or unique nature of certain businesses, special tax provisions may apply.

Agriculture or 'primary producers', due to the variability of their earnings, are able to use tax averaging to ensure they do not pay more tax over a number of years than taxpayers on comparable but steady incomes. There are also rules that apply to calculate the value of livestock. Specific provisions for small businesses are considered in Chapter 6.

Life insurance companies are also subject to special rules to take into account the different characteristics of their underlying business. For example, special rules ensure that, while taxable income relating to ordinary business is taxed at the corporate tax rate (currently 30 per cent), taxable income relating to superannuation business is taxed at the superannuation fund rate (currently 15 per cent) and income relating to annuity business is exempt from tax.

Discussion questions:

38. In what circumstances is it appropriate for certain types of businesses to be subject to special provisions? How can special treatment be balanced with the goal of a fair and simple tax system?

Tax and accounting definitions of income

Taxpayers in Australia must calculate their profit for tax purposes using rules that are, in some cases, significantly different from those that apply to the calculation of profit for accounting purposes. For more than a decade, policy consideration has been given to greater alignment of the calculation of 'profit' between tax and accounting systems. For example, the Ralph Review recommended the adoption of the Tax Value Method, which is a principle-based framework that works out the taxable income (or tax loss) of a taxpayer with a focus on the changing value of assets and liabilities. This approach is consistent with current accounting concepts.

The convergence of accounting and tax calculations of profit would potentially reduce complexity and compliance costs. This is because businesses may not need to maintain separate records of financial information for accounting and tax purposes.

One challenge that would require consideration is the inherent conservatism and use of judgement in accounting, with a requirement to recognise losses and outgoings as soon as possible, but to recognise gains only when they are nearly certain.

A shift to greater reliance on accounting standards may further encourage companies to under-report their earnings to gain a tax advantage, which may have broader implications for corporate governance. However, there is a 'natural hedge' against this behaviour in that the management of large widely-held companies is often keen to demonstrate strong financial

performance to shareholders. It is also arguable that many of the incentives to under-report income already exist in our current tax laws.

Some European countries (such as France, Germany and Sweden) have closer links between accounting and tax principles than Australia. However, there has been a shift towards more independence between accounting and taxation as the adoption of international accounting standards has reduced the ability of countries to tailor their accounting standards to accommodate their domestic tax systems.[113]

The tax system is also used by governments as a delivery mechanism for some policy objectives (for example, R&D tax incentives). If these objectives continue to be delivered through the tax system, calculations based on accounting standards would require adjustment, which may reduce the benefits of closer alignment with accounting standards. Alternatively, some other delivery mechanisms for these policies could be considered.

5.3: Entrepreneurship and innovation

Innovation is commonly defined as the implementation of a new or significantly improved product, service or work method.[114] The economic benefits of innovation are well recognised, including productivity enhancements, job creation[115] and ultimately, improvements in living standards. The benefits from innovation are not constrained to one firm. Performance improvements in one firm following successful innovation impose competitive pressures that force other firms to improve their own performance. Innovative firms introducing new-to-the-world products or processes bring further benefits through the dissemination of new knowledge, technologies and processes that may spread throughout the economy.

Encouraging more business innovation is one of the four ambitions of the Government's Industry Innovation and Competitiveness Agenda. The Agenda includes grant programs to assist businesses to collaborate with researchers, build their management skills and undertake early stage commercialisation activities.

While these programs involve spending, a number of elements of the tax system seek to encourage entrepreneurship and innovating businesses. The R&D tax incentive is a particular element of the tax system that supports innovation in the Australian economy.

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113 Hoogendoorn, M N 1996, 'Accounting and taxation in Europe — A comparative overview' *The European Accounting Review*, vol. 5, supplement 1, page 786, viewed 10 December 2014: www.tandfonline.com/doi/abs/10.1080/09638189600000050.

114 OECD 2005, *Guidelines for Collecting and Interpreting Innovation Data*, Third edition, (Oslo Manual) OECD and European Commission, Paris.

115 Canberra data suggest that firms engaged in innovative activities are more than twice as likely to report increases in the total number of positions compared to the previous year, as shown in Australian Bureau of Statistics (ABS) 2014, *Innovation in Australian Business 2012-13*, cat. no. 8158.0, ABS, Canberra.

Research and development

R&D is often a critical step in innovation. The incentives for businesses to invest in R&D and exploit or commercialise their innovations can be affected by commercial risks such as public spillovers from R&D. They can also be distorted by the tax system; for example through the treatment of losses (losses are inherent in risky activity such as R&D).

Knowledge or technology produced by R&D activities can have spillover benefits that freely accrue to other businesses or to the public generally. The existence of these spillovers may reduce the incentives for businesses to bear the private costs of R&D. Non-tax policies relating to intellectual property seek to balance private and public interest in the creation and dissemination of knowledge.

Distortions introduced by the tax system exacerbate the impact of commercial risks on investment in R&D. Expenditure on R&D activities can contribute to a business' tax losses which can only be claimed once the business is making a profit. This may affect the incentives of businesses to pay the upfront costs of R&D, particularly where there is a lengthy time-lag in the benefits of R&D being realised. While profits are subject to corporate tax at the time that the profits are realised, tax losses must be carried forward and therefore lose value over time. Large businesses may be able to utilise their tax losses sooner, as they may already be profitable.

The existence of these commercial risks and tax distortions means that the amount of R&D that a business chooses to undertake may be less than optimal in the absence of corrective Government intervention. Policy intervention through the tax system is often used to address these perceived distortions, encourage R&D activities that would not otherwise occur and generate positive spillover benefits for the public.

R&D tax incentive

The R&D tax incentive is the primary mechanism by which the Government seeks to encourage companies to undertake R&D activities in Australia. The R&D tax incentive is intended to encourage R&D activity that would not otherwise occur, and to improve the incentives for smaller companies to engage in R&D. It may also attract new investment in R&D activities, including from foreign investors.

The R&D tax incentive currently provides:

- a 45 per cent refundable tax offset for eligible entities with an annual aggregated turnover of less than $20 million, and which are not controlled by income-tax exempt entities, for expenditure on eligible R&D activities in Australia; and
- a 40 per cent non-refundable tax offset for all other eligible entities for eligible R&D expenditure.

In the 2014-15 Budget, the Government announced that the refundable and non-refundable tax offset rates would be reduced by 1.5 percentage points, from 45 per cent to 43.5 per cent and from 40 per cent to 38.5 per cent, respectively. The proposed changes would take effect for income years commencing on or after 1 July 2014.

On 12 February 2015, the Parliament enacted the *Tax Laws Amendment (Research and Development) Act 2015*, which introduces a limit of $100 million on the amount of R&D expenditure that companies can claim at the standard offset rate. For amounts above $100 million, companies will be able to claim a tax offset at the company tax rate. The changes take effect for income years beginning on or after 1 July 2014.

Many countries, including the majority of OECD countries, provide incentives for R&D through their tax systems, in addition to grants and other forms of direct assistance. However, the nature and degree of tax support for R&D varies significantly by country. Tax support for R&D activities can take the form of volume-based or incremental tax credits (generally equivalent to an offset in Australia), enhanced tax deductions and accelerated depreciation for R&D capital expenditure.

As reported by the OECD,[116] volume-based R&D tax credits (offered by countries including Australia, Japan, Korea and Norway) can be claimed for all eligible or qualifying R&D expenditure, while incremental R&D tax credits (offered by countries including Japan and Korea) can only be claimed for any additional R&D expenditure beyond a certain baseline amount. Some countries allow R&D tax credits to be carried forward or refunded, while other countries impose caps on the amount of R&D expenditure that can be claimed under the tax incentive.

Review of the R&D tax incentive

The Government intends to review the operation of the R&D tax incentive through the Tax White Paper, within the broader context of reviewing the effectiveness of existing tax incentives for innovation, industry-funded research and collaboration with public research institutions.[117]

The R&D tax incentive was introduced in 2011 to replace the former R&D tax concession. The R&D tax incentive is a simpler and more generous programme, offering eligible companies a refundable or non-refundable tax offset for expenditure on R&D activities.

Given the R&D tax incentive is the primary policy mechanism by which the Government encourages innovation, it is appropriate that the Government periodically review the operation of the incentive, evaluate its effectiveness and assess the extent to which it is meeting the intended policy objectives.

As the R&D tax incentive has now been in operation for more than three years, stakeholders are expected to be well-placed to provide informed perspectives on the R&D tax incentive, in relation to its policy design, administration and effectiveness.

The R&D tax incentive does not target particular sectors of the economy. Instead, it is a market-based programme which is open to companies in all sectors of the economy. Some of the many sectors that benefit from the R&D tax incentive include information technology,

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116 OECD 2014, *Summary description of research and development tax incentive schemes for OECD countries and selected economies, 2013*, OECD, Paris.

117 Department of Education and Department of Industry 2014, *Boosting the Commercial Returns from Research,* Australian Government, Canberra.

communications, biotechnology, energy and food processing. Companies, however, are generally required to have R&D expenditure of at least $20,000 to be eligible for the R&D tax incentive, which reflects the fact that a certain amount of investment in R&D is necessary to generate significant innovation outcomes.

The R&D tax incentive aims to support specifically-defined R&D activities that are conducted for the purpose of acquiring new knowledge (including knowledge or information concerning the creation of new or improved materials, products, devices, processes or services).

The R&D tax incentive is claimed by an increasing number of companies each year. As at 30 June 2014, 11,936 companies had registered to claim the R&D tax incentive for the 2012-13 income period. As at 29 August 2014, the R&D tax incentive had a reported cost to the Budget of around $2.5 billion for the 2012-13 income period.[118]

Discussion questions:

39. Does the R&D tax incentive encourage companies to conduct R&D activities that would otherwise not be conducted in the absence of government support? Would alternative approaches better achieve this objective and, if so, how?

Employee Share Schemes

Employee share schemes allow employers to provide shares (an ownership stake in the company) or options (the right to acquire shares in the company at a later date) to their employees at a discount to the market price.

This helps to align the interests of employers and their employees, and can be beneficial for both parties. Employees can realise a benefit if the firm performs well, as they have a financial share in the potential upside of the company. For employers, employee share schemes are often an attractive way of remunerating employees, particularly in the early stages of development where cash flow may not always be available. Employee share schemes can have many benefits, including encouraging positive working relationships, boosting productivity and reducing staff turnover, as employees have a direct interest in the performance of the firm.

Changes in 2009 to the way that employee share schemes are taxed mean that the discount component of shares or options issued under an employee share scheme is currently taxed when the employee receives those shares or options. This often means that employees have to pay tax on their options before they can take any action to realise a financial benefit from those options (for example, by converting them to shares and selling the underlying shares).

118 Department of Industry 2014, *2014-15 Science, Research and Innovation Budget Tables*, Australian Government, Canberra, viewed 10 December 2014: www.industry.gov.au/innovation/reportsandstudies/Pages/SRIBudget; and Department of Industry 2014, *Information Bulletin July 2014*, Australian Government, Canberra, viewed 10 December 2014: www.industry.gov.au/innovation/reportsandstudies/Pages/SRIBudget.

Consultations with a range of industry and government stakeholders suggested that firms, particularly small start-up firms, have been reluctant to issue options under employee share schemes since 2009, as employees would be taxed on something that is difficult to value and that may never result in any financial benefit. Businesses have claimed that this reduces the number of people they can employ and sometimes drives firms offshore, where more favourable tax conditions exist.

Consultations also revealed that it can be very difficult to set up and maintain an employee share scheme, imposing unnecessary red tape on businesses, especially small businesses.

In response to these concerns, as part of the Industry Innovation and Competitiveness Agenda, the Government announced that it will reform the tax treatment of employee share schemes. These changes are designed to boost entrepreneurship in Australia and support innovative start-up companies.[119]

The Government will change the taxing point for options, so that employees (of all companies) will generally not be taxed on their options until they have converted them into shares.

Employees of eligible start-ups will be given an additional concession, which will mean that tax will not generally be payable up-front on shares or options that are provided by eligible employers to their employees at a small discount, as long as they are held by the employee for at least three years. Options, under certain conditions, will have taxation deferred until sale. Shares (issued at a small discount) will have that discount exempt from tax.

Criteria to define eligibility for this concessional tax treatment will include the company having aggregate turnover of not more than $50 million per year, it being unlisted and being incorporated for less than 10 years. Furthermore, to give start-ups more time to be competitive and succeed, the maximum time for tax deferral will be extended from seven to 15 years.

The announced changes are designed to make Australia's taxation of employee share schemes more competitive by international standards. These changes will seek to make Australia a more attractive investment destination, particularly for innovative start-up firms, by making employee share schemes easier to access and administer for employers and their workers. These changes will bring Australia's taxing point into line with other nations such as the UK, USA, Singapore, India, China and Hong Kong.

In addition, the ATO will work with industry to develop standardised documentation and a 'safe harbour' valuation method for unlisted shares, which will streamline the process of establishing and maintaining an employee share scheme.

The Government has been consulting on the implementation of these changes to bring them into effect for new shares and options issued from 1 July 2015.

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119 Minister for Industry the Hon Ian Macfarlane MP, Media Release, 14 October 2014, *Encouraging employee share ownership and entrepreneurship*, viewed 10 December 2014: http://minister.industry.gov.au/node/497.

Discussion questions:

40. What other taxation incentives, including changes to existing measures, are appropriate to encourage investment in innovation and entrepreneurship?

6: Small business

Overview

This chapter identifies characteristics of the tax system that impact on small businesses and their owners.

Key points

- Australian small businesses are numerous, diverse, and make an important contribution to the Australian economy. These businesses adopt different legal and management structures, and may be driven by different preferences and profit motives than larger businesses.
- Navigating a complex tax system can be disproportionately burdensome for small businesses, especially where certain features of the system encourage them to adopt particular legal structures that are costly to establish and maintain.
- Tax law provides a number of concessions intended to benefit small businesses, but these may add to the complexity and compliance burden.

6.1: Key features of Australian small businesses

Australian small businesses[120] are numerous, diverse, and make an important contribution to the Australian economy. They account for about 43 per cent of private non-financial employment and 33 per cent of private non-financial sector production,[121] spanning almost the entire range of business activities, particularly construction, professional services, and retail (Chart 6.1).

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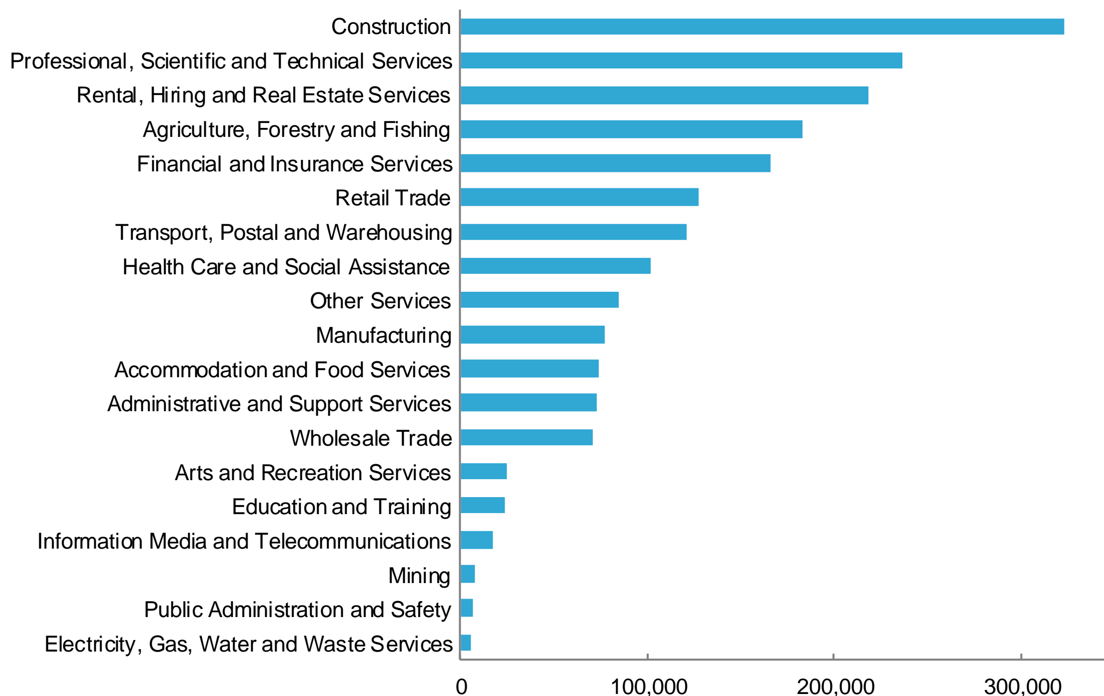
120 There is no single definition of 'small business', reflecting the diverse nature of small businesses and how they are currently regulated and taxed. For example, the Australian Bureau of Statistics defines a small business as employing fewer than 20 staff; much of the tax law defines a small business entity as a business with less than $2 million of aggregated turnover; and Fair Work Australia defines a small business as one with fewer than 15 employees. This chapter does not adopt a strict definition of small business because the issues affecting small business often affect most businesses, although the proportionate effect is generally greater the smaller the business. Where external data is used, the paper adopts the definition used by the data source.

121 ABS 2014, *Australian Industry, 2012-13*, cat. no. 8155.0, ABS, Canberra. Data is not available to incorporate the financial and public sectors. As such, the contribution of small business to output and employment may be overstated.

Small businesses can differ significantly from large businesses. Larger businesses are more likely to be widely-held companies that seek to maximise profits for the benefit of owners (shareholders). As such, the owners of a large business are often different from the people involved in day-to-day management. In contrast, small businesses are often family businesses and a person can be simultaneously owner, manager, employer and employee. Further, generating profits is not the only motivating factor for some small business operators. This means that specialised tax treatments will only be effective to the extent that they align with the objectives of the small business owner. For example, tax incentives for growing businesses may not be relevant to small businesses that have no intention to grow.

Chart 6.1 Number of small businesses by industry, 2013



Note: Small businesses are based on the ABS definition of less than 20 employees.
There are approximately 83,000 small businesses which are classified as ‘Unknown’ by the Australian Bureau of Statistics (ABS). These businesses include unclassified or other industries that do not belong to the other classified industries.
Source: ABS 2014, *Counts of Australian Businesses, including Entries and Exits*, June 2009 to June 2013, cat. no. 8165.0, ABS, Canberra.

Current policy context

Businesses operate in an often complex regulatory environment. Compliance costs associated with regulation are felt most by small businesses (see the compliance cost discussion at section 6.4). The Government is committed to reducing the regulatory burden facing all Australian businesses, including small businesses.[122] Tax is just one element of the broader regulatory environment small businesses must navigate.

122 Chapter 10 provides further discussion on the Government’s deregulation agenda, and the impact of complexity more generally.

Recognising the impact of the tax system on small businesses, on 28 March 2014, the Government announced that the Board of Taxation (the Board) would conduct a fast-track review to identify features in the tax system that are hindering or preventing small businesses from reaching their commercial goals. The Government asked the Board to identify short- and medium-term priorities for small business tax reform, with a particular focus on high-priority options for simplification and deregulation. The Government released the Board's report *Tax Impediments Facing Small Business* on 20 January 2015. In releasing the report, the Government noted that the ATO had already begun implementing most of the administrative recommendations identified in the report.

6.2: Legal structure of Australian small businesses

All Australian businesses should choose the structure that best suits their business objectives and needs. While large businesses tend to operate as companies, small businesses operate as a sole trader, partnership, trust, corporation or a combination of these. The choice between structures depends on a number of factors, including different tax treatment, nature of ownership (such as a family business), limited liability for companies, easier access to equity capital for companies and differences in compliance costs.

Trends in business structures

There are three key business structure trends in recent years: the increasing use of companies and trusts; the rise of superannuation funds; and the decreasing use of partnerships (Chart 6.2). The increased use of companies may reflect the legal protection provided by companies to owners, as well as the lower tax rate imposed on companies relative to personal income tax. The reduction in the number of partnerships may reflect the relative decline in the number of entities in the farm sector due to consolidation.[123]

Using trusts as a business structure has grown strongly since the early 2000s. There are a range of different types of trusts, such as testamentary trusts, unit trusts and investment trusts. These trusts all serve different purposes and are used in different circumstances, depending on the objectives of those using the trust. In the small business context there has been an increase in the number of businesses utilising a discretionary trust as their preferred business structure.

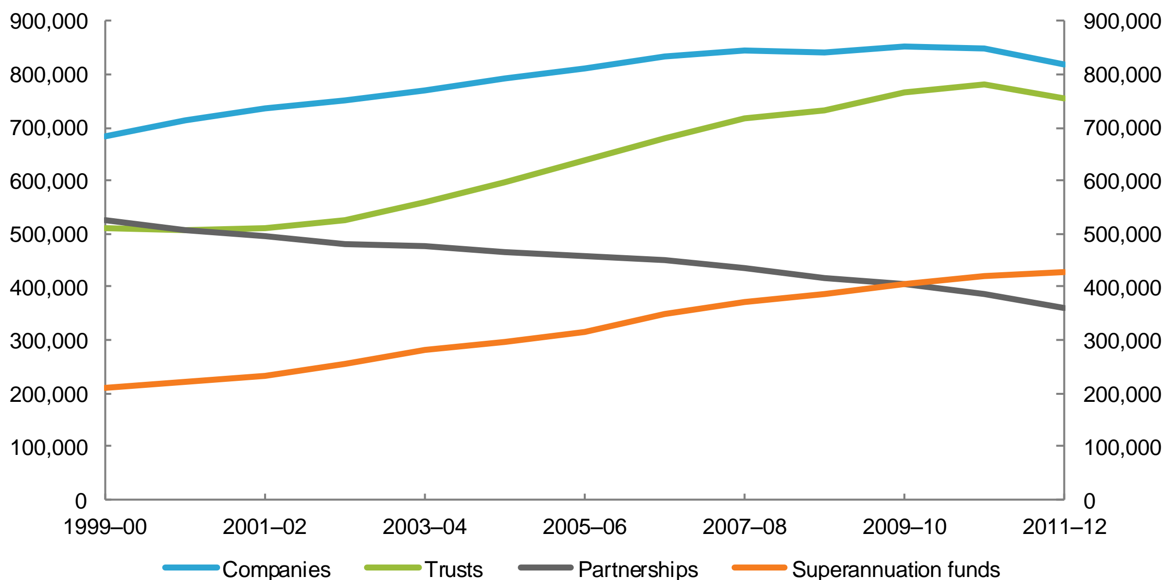
A discretionary trust can offer more legal protection to business owners than a partnership or sole trader. Further, a trust with a corporate trustee offers business owners similar legal protection to a company but offers tax advantages, such as greater flexibility in distributions and access to the 50 per cent capital gains tax concession when an asset appreciates and is

123 Connolly, E, Norman, D, and West, T 2012, *Small Business: An Economic Overview*, Small Business Finance Roundtable, Sydney; and Bishop J, and Cassidy N 2012, 'Trends in National Saving and Investment', *Reserve Bank of Australia Bulletin March Quarter 2012*, Reserve Bank of Australia, Sydney.

then sold. A company must distribute dividends in proportion to the size of shareholdings,[124] whereas a trustee of a discretionary trust has complete discretion about the size of distributions to beneficiaries of a trust. This allows the tax position of beneficiaries to be taken into account in making distributions to beneficiaries of trusts. In addition, the growth in the number of companies and trusts may reflect the increasing sophistication of business structures, where individual businesses involve a number of companies and/or trusts. One example is where a trust will have a corporate beneficiary that acts as a 'bucket company'. In this instance, income is either distributed and held, or made presently entitled. If income is made presently entitled, there must be a reciprocal Division 7A-compliant loan arrangement, which enables the trust to avoid distributions to individuals in high marginal tax brackets. The Board of Tax has reviewed the operation of the tax law as it relates to some business structures often involving trusts, in particular the extraction and retention of profits from private companies and provided advice to Government.[125]

The different treatment of different legal entities, and the ability of a small business owner to navigate this complexity, can have a significant effect on a business' tax liability, and can lead to different tax outcomes for economically similar activities.

Chart 6.2 Number of entities lodging tax returns



Source: Australian Taxation Office 2014, *Taxation Statistics 2011-12*, Australian Taxation Office, Canberra.

124 Within each class of share.

125 Board of Taxation 2012, *Post Implementation Review of Division 7A of Part III of the* Income Tax Assessment Act 1936 — *Discussion Paper*, Board of Taxation, Canberra; and Board of Taxation 2014, *Post Implementation Review of Division 7A of Part III of the* Income Tax Assessment Act 1936 — *Second Discussion Paper*, Board of Taxation, Canberra.

Tax implications of different legal structures

Each business structure is treated differently under the tax law, both in terms of the applicable tax rate and in terms of the concessions that apply. While the choice of business structure should be driven by the objectives of the business, it is likely that the tax treatment of different structures is now a key factor in choosing a business' legal structure.

For some small businesses, the cost of identifying the optimal structure (from a tax perspective) may be higher than the benefits they would obtain, particularly given that expert tax advisors are likely to be required to advise and assist with establishing complex structures. Even for those businesses, however, the complexity of the system can drive owners to seek advice, adding to costs. Further, the potential need for complex business structures can act as a disincentive for some small businesses to pursue growth activities.

As a business grows, it would be increasingly rational for it to adopt the legal structure that would minimise its tax liability. This may involve incorporating, or utilising a trust, but more likely it would involve a combination of structures. The primary objective of these structures is often to minimise tax liability by dispersing income to attract either the lowest marginal tax rate or the corporate tax rate.

The tax treatment of different structures means that economically similar activities can be taxed in different ways and at different rates depending on the legal structure employed by the business. From a first principles perspective, similar economic activities should be taxed similarly. Also, a perception arises that those with additional resources are able to 'play' the system, which challenges the perception of equity within the tax system.

Box 6.1: Flow-through tax treatment for 'S-Corporations' in the US

Given the evolution of complex structures, it has been suggested that a new, single structure which contains the benefits of these structures without the complexity may be useful in Australia. One option that has been proposed is the adoption of the 'S-Corporation' as it is applied in the US. An S-Corporation is a corporation which has elected to have a set of special tax rules applied to them (Subchapter S of Chapter 1 of the US Internal Revenue Code). S-Corporations can pass corporate income, losses, deductions and credit through to shareholders for federal tax purposes — the corporation itself is not taxed, as all taxation is done at the individual income level. Shareholders report the flow-through of income and losses on their personal tax returns and are assessed for tax purposes at their individual income tax rates.

S-Corporations offer the benefits of reduced establishment cost and complexity, limited liability (which follows from a corporate structure), and tax treatment similar to a partnership, including for losses. However, the tax treatment is not as favourable as a discretionary trust, as there is only limited ability to choose which taxpayer is liable for tax on the profits of an S-Corporation.

S-Corporation shareholders may claim deductions for losses incurred by the corporation but there are a number of overlapping limitations to the use of S-Corporation losses. Shareholders must satisfy a series of requirements, such as:

Box 6.1 con’t

- basis rules — which limit the use of losses to each shareholder’s level of investment in the corporation and loans the shareholder has made to the business;[126]
- at-risk limitation — which limits the use of losses to the amount the shareholder stands to lose from their investments or loans to the company;[127]
- passive activity loss limitation — provides that shareholders who do not have a regular, continual and substantial engagement with the company may only deduct losses from the S-Corporation against income from other passive investments; and
- hobby-loss rules which quarantine deductions where a business is not carried on for profit.

S-Corporations provide business owners with limited liability, without the tax treatment that would ordinarily apply to an entity that is legally separate from its owners (that is, separate taxation applicable to the profits of a company). In the US context, S-Corporations also provide for the avoidance of double taxation of corporate profits, as profits are only taxed once in the hands of the shareholders. This benefit is not as relevant in the Australian context, where dividend imputation eliminates the double taxation of corporate profits that occurs in a classical tax system (see discussion of imputation in Chapter 5).

Reporting, accounting and administrative requirements of S-Corporations can be burdensome and complex compared to those placed on other organisations. The most burdensome requirements involve providing shareholders with the necessary information regarding what has been passed through to them. Other requirements are related to an S-Corporation’s corporate status, such as the need for separate accounts and scheduled director and shareholder meetings.

While, in isolation, an S-Corporation style entity may be an attractive option for some small businesses, introducing such an entity in Australia without otherwise reducing the complexity of the tax system may have mixed impacts on the overall compliance burden for small businesses. This is because businesses will need additional time and possibly professional advice to determine whether such an entity would be better overall than the existing suite of complex structures.

Discussion questions:

41. What effect is the tax system having on choice of business structure for small businesses?
42. What other options, such as a flow-through entity (like an S-Corporation), would decrease the overall complexity and costs for small business involved with choosing a business structure? How would such an entity provide a net benefit to small businesses?

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126 The losses a shareholder can utilise are limited to the shareholder’s basis, which equates to their cost basis plus their loan basis. Cost basis equals initial contribution for membership interest; additional capital contributions; and allocated income; less allocated deductions and actual distributions. Loan basis is the indebtedness of the S-corporation to the shareholder.

127 A shareholder’s amount at risk equals the sum of the cash and the adjusted basis of non-cash property contributed to the business, as well as amounts borrowed for use in the S-corporation for which the shareholder is personally liable, or for which the shareholder has pledged property they own. A loss in excess of either basis or the amount at risk is non-deductible in the year it is incurred, but carries over into future years and may be utilised when basis is restored or the amount at risk is increased.

6.3: Personal-business tax interaction

As already stated, the Australian tax system applies different tax rates to different types of entities. In particular, income derived by individuals is taxed at progressive rates of up to 49 per cent, depending on the level of income. In contrast, companies currently pay a 30 per cent rate on all income. The imputation system seeks to provide an interface between the flat rate of company tax and the progressive individual tax system (see Chapter 5).

This interaction between personal and business tax systems influences the choices that small businesses make about business structures. If all company profits were immediately paid out as dividends, dividend imputation would ensure that corporate profits are ultimately taxed at the individual tax rates applicable to the owners of a company. The tax system would achieve neutrality across these business structures because business owners would pay the same tax on profits earned as a sole trader or partnership, or on dividends received from a company. The same would apply to passive investors using holding companies (see Chapter 5).

However, there is no legal obligation for companies to pay out profits as dividends to shareholders. If shareholders pay additional tax on dividends, as they would if they pay the highest marginal tax rate of 49 per cent, there is an incentive to avoid paying dividends to delay tax payments. For example, if a company makes a profit of $100,000 and its sole shareholder has a marginal tax rate of 49 per cent, the shareholder will face an additional $19,000 of tax when a dividend of $70,000 (for example, $100,000 profit minus $30,000 corporate tax) is received. If $70,000 is reinvested in the company and a dividend is paid 10 years later, the present value of $19,000 of tax would be reduced to approximately $13,700.[128]

The incentive to retain profits in a company is further enhanced by the treatment of capital gains. Following from the earlier example, if, instead of paying a dividend of $70,000, profits are retained and the company is sold for a capital gain that is $70,000 higher than otherwise, an individual can halve the capital gain to pay tax of $17,150 ($35,000 x 49 per cent). Again, assuming this tax payment has been delayed by 10 years, its present value would be approximately $12,400 instead of $19,000 that would be payable on a dividend paid immediately. Furthermore, if the individual's marginal tax rate is 30 per cent in 10 years' time, the present value of tax payable would be further reduced to approximately $7,600. Alternative structuring arrangements, such as using a superannuation fund, could achieve lower tax outcomes than in this worked example.

These incentives may provide a strong reason for privately-held companies to retain earnings as much as possible — for example, where the owner does not require the funds for their personal expenses. This can provide a cheap form of finance for future activities. Conversely, they generate the need for rules around private access to company funds and resources, such as those found in Division 7A of the tax law.

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128 Assuming a 10-year government bond rate of 3.29 per cent and the taxpayer continuing to face a marginal tax rate of 49 per cent.

The interaction between individual and business tax is one area where the tax system implicitly encourages the adoption of complex structures and makes the total compliance costs experienced by Australian businesses unnecessarily high. Significantly different tax outcomes from adopting different structures provide incentives for businesses to engage in tax planning and, in some cases, structures are adopted that involve significant compliance costs (for example, trusts with associated corporate beneficiaries).

Further issues arise in the context of trusts, where the default treatment is that tax is imposed on beneficiaries rather than in the trust. These issues are compounded by longstanding problems with the legal framework for the taxation of trusts, highlighted in recent court decisions (such as *Commissioner of Taxation v Bamford* (2010) 240 CLR 481). For instance, one problem is that income received by trusts may not retain its character for tax purposes when passed on to beneficiaries. Another is the mismatch between the amounts on which a beneficiary is taxed and the amounts that they are entitled to under trust law. Following the decision in *Bamford*, a discussion paper was released canvassing wider changes to address these systemic problems. However, while changes have been made to address some specific issues, wider reform has not occurred and the underlying problems remain.

Discussion questions:

43. Is the interaction of the personal and business tax systems a problem? What can be done to manage the personal-business tax interactions?

6.4: Tax compliance costs for small businesses

Compliance with tax laws is the most significant compliance cost faced by small businesses, accounting for between one-half and two-thirds of the total compliance burden on small business.[129] The ATO estimates that compliance costs associated with the tax system (for all taxpayers, including individuals) are likely to be in the order of $40 billion per year.[130] Further, recent research has estimated that in aggregate, tax compliance costs for the small and medium enterprise (SME) sector are in the order of $18 billion, which is approximately 1.2 per cent of GDP, or 14 per cent of tax revenue.[131] Tax compliance costs are higher per dollar of turnover for smaller businesses than they are for larger business (see Table 6.1). These compliance costs can act as a disincentive to establishing a small business, and can impact the ability of a small business to grow.

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129 Hasseldine J, Evans C, Hansford A, Lignier P, Smulders S and Vaillancourt F 2012, *A comparative analysis of tax compliance costs and the role of special concessions and regimes for small business in Australia, Canada, South Africa and the United Kingdom*, National Tax Association Conference, Providence.

130 ATO analysis of commissioned Newspoll survey data relating to the 2011-12 tax year, to be presented at a forthcoming conference in 2015.

131 UNSW and Chartered Accountants of Australia and New Zealand 2014, *Tax Complexity Research Project*, Sydney.

Table 6.1 Tax compliance costs (including state and territory taxes)[132]

Business turnover	Annual cost	Cost per $1000 turnover
<$75,000	$3,400	$90
$75,000 — $2 million	$12,000	$12
$2 million — $50 million	$55,000	$2

While compliance costs are significant, some (but not all) of the costs are costs that would be incurred by a small business for operational reasons (such as to record sales and expenses). Many of the costs of complying with tax laws are either fixed, or do not vary in proportion to the size of the business. Small business owners can therefore choose either to spend limited resources seeking expert tax advice, or completing compliance activities themselves, instead of engaging in activities to support their business.

Discussion questions:

44. What are the most significant drivers of tax law compliance activities and costs for small business?

6.5: Small business tax concessions

Successive governments have recognised that small businesses make an important contribution to the Australian economy and provide opportunities for continued employment growth. Multiple policy rationales are often used to support proposals for differential tax treatment of small businesses, including:

- to address compliance costs falling disproportionately on small business;
- to correct a bias towards risk aversion — this can occur because:
  - individual small business owners may be risk averse because they have a limited ability to recover from a failure and a limited ability to diversify; and
  - there is asymmetry in the tax system whereby gains are taxed and losses are ignored or claimable only against future profits which may penalise risk-taking and exacerbate risk aversion;
- to improve equity as earnings from capital are treated more generously than labour income, while small business income is typically a mixture of return on capital and labour;

132 UNSW and Chartered Accountants of Australia and New Zealand 2014, *Tax Complexity Research Project*, Sydney.

  - having adequate access to capital and resources on hand is essential for small businesses to thrive and thereby retain and create more jobs;[133]
- to correct disadvantages of being small that do not stem from the tax system; and
- to support job creation.

While all of these rationales are used at different times, some concessions may overlay additional complexity and drive behaviour in ways that cancel out or exceed any benefits.

The tax system contains a number of provisions which are either unique to small business, or are more commonly accessed by small business. The most significant include:

- measures to reduce the regulatory burden, such as:
  - businesses with turnover of less than $75,000 can generally choose not to register for GST;[134]
  - businesses with turnover of less than $20 million can report and pay GST quarterly instead of monthly;
  - businesses with turnover of less than $2 million can account on a cash basis;
  - simplified trading stock rules do not require a stocktake in certain circumstances;
  - simplified depreciation rules allow businesses with turnover of less than $2 million to pool most depreciating assets and write them off at a 30 per cent depreciation rate (15 per cent in first year) irrespective of their expected life; and
  - availability of the Superannuation Clearing House;[135]
- capital gains tax concessions (see below); and
- industry specific concessions, such as primary producer concessions including farm management deposits, and income tax averaging.

These types of provisions are intended to provide a benefit to small businesses in their engagement with the tax system. However, the introduction of concessions can lead to additional compliance burdens as businesses must learn about the concessions and, potentially, adjust their affairs to qualify. In addition, rules that determine eligibility for the concessions, such as hard cut-offs or connected entity tests, can be complex for small businesses to navigate. Tax concessions with hard cut-offs can also discourage growth, as passing a cut-off can remove entitlement to a concession.

Concessions which are intended to provide a benefit to small business may also introduce other difficulties, such as to cash flow. Concessions such as those to reduce the regularity of GST payments and pay as you go withholding instalments to once per year, are intended to reduce the amount of paperwork that a small business must comply with and improve small

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133 Department of Industry, Innovation, Science, Research and Tertiary Education 2012, *Australian Small Business: Key Statistics and Analysis*, Australian Government, Canberra, p. 42; and Dilger R J 2013, *Small Business: Access to Capital and Job Creation*, United States Congressional Research Service, Washington.

134 While businesses can choose not to register for GST, many do in response to pressure from their customers.

135 Currently, small business employers with fewer than 20 employees can register to use the ATO's free online Small Business Superannuation Clearing House to pay their superannuation contributions in one transaction to a single location. The contributions are then distributed by the clearing house to employees' relevant superannuation funds on the employer's behalf.

business cash flow in the short term. However, they may cause difficulties where a business owner does not anticipate the size of the payment and does not have the cash flow to pay when it eventually falls due. This could be alleviated by small businesses making more regular payments, improved technology development, and other strategies to improve tax liability and payment predictability.

The introduction of concessions (as with all different specialised tax treatments) can introduce new elements of complexity as the boundaries between different taxes are shifted. This expanding complexity further creates incentives for more sophisticated taxpayers to organise their affairs to benefit from interactions within the tax system, and small businesses can have limited capacity to comply with complex laws.

In addition to the creation of new concessions, regular changes to the tax law require small businesses to continuously monitor the tax law and adapt to any changes. This adds to the compliance costs for all businesses. However, this has a disproportionate impact on small businesses as they often do not have the expertise or funds to use advisors, such as tax experts, to maintain up-to-date knowledge of tax law.

Capital gains tax concessions

The most significant, quantifiable tax concessions for small businesses are the capital gains tax (CGT) concessions. The CGT concessions are primarily intended to provide small business owners with access to funds for their retirement. There are four CGT concessions:

- the 15 year exemption — capital gains tax is not payable on the sale of business assets if they are owned for more than 15 years and the owner is over 55 and retiring or permanently incapacitated;
- the small business retirement exemption — capital gains tax is not payable if the owner is under 55 years old and amounts are paid into a superannuation fund or retirement savings account (subject to $500,000 lifetime limit);
- the 50 per cent active asset reduction — sale of assets attracts a 50 per cent capital gains tax discount; and
- the small business roll-over — capital gains tax is deferred if the funds are used to replace small business assets or make a capital improvement to an existing asset.

A business can generally qualify for the concessions if they have less than $2 million turnover or have net CGT assets of $6 million or less. The turnover or the value of the assets of connected entities also counts towards these tests.

Capital gains tax concessions can add to the complexity of the system and the compliance burden for a small business. The concessions can also dampen the incentive for businesses to grow because larger businesses are not able to access them.

The value of these concessions to certain businesses is estimated at approximately $1.4 billion (in 2013-14). This benefit is made of up of $390 million for the small business retirement exemption, $160 million for the 15 year exemption, $220 million for small business

roll-over relief for replacement small business entity active assets and $600 million for the 50 per cent active asset reduction.[136]

There may be scope to simplify and streamline the small business capital gains tax concessions while ensuring that they satisfy the stated objectives.

Specific small business tax treatments

Some tax concessions are available only for businesses in a certain industry, or are most commonly accessed by small businesses. Industry-specific concessions are intended to either support activity in a particular industry sector, or recognise an objective to provide differential treatment for that sector.

A particular example of this is in agriculture. Small businesses make a significant contribution in the agriculture sector, making up 82 per cent of output and 83 per cent of employment.[137] While many sectors have some concessions available, the network of concessions available to primary producers is illustrative of some of the broader range of concessions also available in other sectors.

Primary producer concessions

Primary producers are able to access a number of special concessions to compensate for the impact of natural events that are difficult to predict such as drought, fire, flood or disease that contribute to the volatility of income received by primary producers. These concessions can be broadly grouped into the following categories: special deductions; treatment of abnormal receipts;[138] income averaging; and farm management deposits. Special deductions can be claimed for capital expenditure that relates to telephone lines, horticultural plants and grapevines, water facilities, land care operations and timber depletion. Primary producers can elect to apply abnormal receipt rules to profits relating to double wool clips, insurance recoveries for livestock and timber and the forced disposal or death of livestock. In addition, primary producers who are also small business taxpayers may also be entitled to small business tax concessions. Extensive primary producer concessions may, in some circumstances, operate to prevent or discourage rational exit from the industry.

Income tax averaging

Incomes of primary producers and specific professionals may fluctuate from year to year, for reasons such as adverse weather conditions or demand. The income averaging rules ensure that taxpayers with fluctuating incomes pay no more tax over a number of years than is paid by taxpayers with comparable but steady incomes.

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136 Australian Government 2015, *Tax Expenditure Statement 2014*, Australian Government, Canberra.

137 ABS 2014, *Australian Industry 2012-13*, cat. no. 8155.0, ABS, Canberra. This calculation uses the ABS definition of small business — 19 employees or less.

138 Abnormal receipts is an accounting term applied to income earned outside of its normal earnings period. Double wool clips, where a second shearing of sheep in the year, brought forward by a natural disaster is one example of abnormal receipts.

Primary producers as individuals, partners or beneficiaries of trusts are eligible to smooth their income tax liability by averaging their primary production income over a period of at least two years. Primary producers may receive tax offsets if their average income is less than their basic taxable income.[139] Conversely, a primary producer may be required to pay extra income tax if their average income is higher than their basic taxable income. The averaging adjustment can include up to $5,000 in non-primary production income. A 'shading out' system applies to non-primary production income between $5,000 and $10,000, meaning as non-primary production income increases up to $10,000 only a proportion of this income can be included in income averaging. Any non-primary production income above $10,000 is excluded from income averaging.

Basic taxable income follows the calculation of assessable income but excludes certain death benefits received by dependents and non-dependents and also any net capital gain. It also excludes above average special professional income included in the income year. Income averaging is optional. However, if the individual chooses not to do so, the decision once made cannot be reversed.

Farm management deposits

Farm Management Deposits (FMDs) are a risk management tool to help primary producers deal with unpredictable income, which can be due to challenging production circumstances or market variability. FMDs are designed to help primary producers become more self-reliant and better manage income fluctuations associated with price variability and seasonal variations. The scheme provides a tax incentive to save money to draw upon in times of hardship. It is available to individuals, a partner in a partnership and the beneficiaries of trusts.

The scheme allows primary producers whose off-farm income is less than $100,000 to claim a tax deduction for any FMDs that they have made that income year. The total value of deposits is capped at $400,000. When an FMD is withdrawn, the amount of the deduction is included in the assessable income of the income year in which it is withdrawn. The advantage of this system is that it allows primary producers to smooth their income against the natural fluctuations of business in primary production. Primary producers are able to pay a lower average tax rate over an extended period, as they can pay tax on income earned in a good year in later years, when their marginal rate is lower. There was around $3.6 billion held in FMDs in June 2014.[140]

'Non-commercial' losses

The 'non-commercial' loss rules prevent individuals from claiming losses from business activities that are more in the nature of hobbies or lifestyle choices against their other income (for example their salary) in the year it is incurred.

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139 Basic taxable income is an accounting term applied to taxable income less: certain superannuation benefits; net capital gains; amounts above average special professional income; and deductions excluded under the non-commercial loss provisions.

140 Department of Agriculture 2014, *Farm Management Deposit Statistics*, Department of Agriculture, Canberra, viewed 5 December 2014: www.agriculture.gov.au/agriculture-food/drought/assistance/fmd/statistics.

The rules prevent losses from business activities (as opposed to passive activities like negatively geared residential property or shares) being offset against other income until one of four objective tests is passed. These four tests are based on the income, profits and assets of the business activity and determine whether an activity may be treated as commercial in nature for the tax laws. However, if an individual's adjusted taxable income is $250,000 or more then the objective tests are not available and the loss cannot be offset against other income. Instead it can only be carried forward to offset future income from that business. The Commissioner of Taxation can exercise an extremely limited discretion only if a taxpayer does not pass one of the tests (including the $250,000 test) and in limited circumstances such as drought, flood or bushfire or where there is a lead time before the activity becomes profitable.

The tax system should not operate in a way that discourages economic activity, however, it should not support or subsidise unproductive businesses or the private activities of taxpayers. The way tax losses are treated by a tax system is relevant to this outcome. Box 6.2 below compares the tax treatment of non-commercial losses to the tax treatment of company losses and of losses from non-business activities.

Box 6.2: Tax treatment of losses

Scenario 1 — Non-commercial losses

John's salary is $300,000. John also owns and operates an established vineyard which has been profitable in previous years. The vineyard makes a loss of $20,000.

The non-commercial loss rules prevent John from offsetting the loss against his salary, as his income (excluding the vineyard's loss) is greater than $250,000. John could ask the Commissioner to exercise his discretion to offset the loss, however, the Commissioner can only exercise this in limited circumstances. If the Commissioner does not exercise his discretion, the quarantined or deferred loss can still be offset against any future profit of the vineyard.

Alternatively, in future years, if the vineyard business passes one of the four objective tests and John's income (excluding the vineyard's loss) falls below $250,000, the quarantined or deferred loss can be offset against his salary.

Scenario 2 — Company losses

Sarah's salary is $300,000. Sarah is also the sole shareholder of a company that operates an established vineyard which has been profitable in previous years. The vineyard makes a loss of $20,000.

As the loss is incurred by the company and a company is a separate legal entity, Sarah cannot offset the loss against her salary. The loss can only ever be offset against other income of the company. If the company has no income to offset this year, the loss is carried forward and can be offset against its future income subject to the loss integrity rules. That is, the loss is quarantined in the company.

The non-commercial loss rules do not apply as the rules only apply to losses incurred by individuals, not by companies.

Company losses are considered in more detail in Chapter 5.

Box 6.2 con't

Scenario 3 — Passive investment losses

Matthew's salary is $300,000. Matthew also has a loan for his portfolio of shares which are not from a share trading business.

His interest repayments on the loan exceed the income earned from this portfolio and he makes a loss of $20,000.

Matthew can offset this loss against his salary. The non-commercial loss rules do not apply as the rules only apply to losses from business activities.

Non-business losses are considered in more detail in Chapter 4.

Alternatives to multiple, specific concessions

Instead of multiple concessions across the tax system, an alternative option that could be considered is to apply a lower or zero tax rate for small businesses. A lower rate that replaced multiple specific concessions could encourage small businesses to spend their resources expanding their business, rather than managing their tax affairs.

There are examples where other countries have used reduced tax rates as part of their small business tax policies, such as Canada, China, Belgium, Japan, South Korea, the US, the UK and Singapore, where tax rates on small business can be as low as zero.

In the Australian context, it may be possible to introduce a lower or zero tax rate on small companies to compensate for higher compliance costs and the removal of specific, small business concessions. Reduced tax rates on small corporations may also provide an easy source of finance to businesses by allowing them to retain more of their earnings and expand business activity.

The UK experimented with a low corporate tax rate for small companies. The aim of this lower rate was to encourage start-up businesses and investment. The UK established a special low corporate tax rate for small companies during financial years 2000 to 2005. It provided a low corporate tax starting rate to companies with profits not exceeding £10,000, and a progressively reduced benefit to companies with profits between £10,000 and £50,000. For financial years 2000 and 2001 the corporate tax starting rate was 10 per cent. From 2002 to 2005 it was reduced to zero.

This tax concession was a compelling reason for many existing UK small businesses to incorporate. While a large number of companies accessed the concessions, UK policymakers found that in the specific circumstances where it was introduced in the UK, it did not drive significant growth in small businesses or the economy. Instead, it introduced disincentives for companies below the threshold to grow and the disadvantages faced by small companies were not offset. The UK small companies starting rate 'experiment' ended in 2006. The Mirrlees Review (2011) concluded that this policy was ineffective and costly.

Another option is to allow an immediate refund for tax losses. Many start-up small businesses make taxable losses in their first years of operation. Refunding these losses would provide a cash-flow benefit to the business to help it grow and reduce the tax system's bias against risk aversion.

Discussion questions:

45. How effective is the current range of tax concessions (such as CGT and industry specific concessions) at supporting small business engagement with the tax system? To what extent do the benefits they provide outweigh the compliance, complexity and revenue costs they introduce?
46. What other mechanisms (such as a single lower tax rate, improved technology deployment or other non-tax mechanisms) could assist small businesses to engage with the tax system while decreasing compliance and complexity costs?

7: Not-for-profit sector

Overview

This chapter provides an overview of the not-for-profit (NFP) sector in Australia and the tax concessions available to different types of NFP organisations.

Key points

- The NFP sector is large and diverse and provides important benefits for the Australian community.
- Governments provide a number of tax concessions to support the NFP sector. While these tax concessions help increase the level of activity in the NFP sector, the value of revenue forgone from the concessions is significant and growing steadily.
- Tax concessions for the sector can also increase complexity, in part because they vary according to the type and purpose of NFP organisations. In some cases, NFP tax concessions may provide NFPs with a competitive advantage over their commercial competitors.

7.1: Not-for-profit sector

Not-for-profit (NFP) organisations play an important and intrinsic role in Australian society. NFPs are diverse, providing their members, clients and the general community with a range of services, including welfare, education, religion, health, sport and culture.

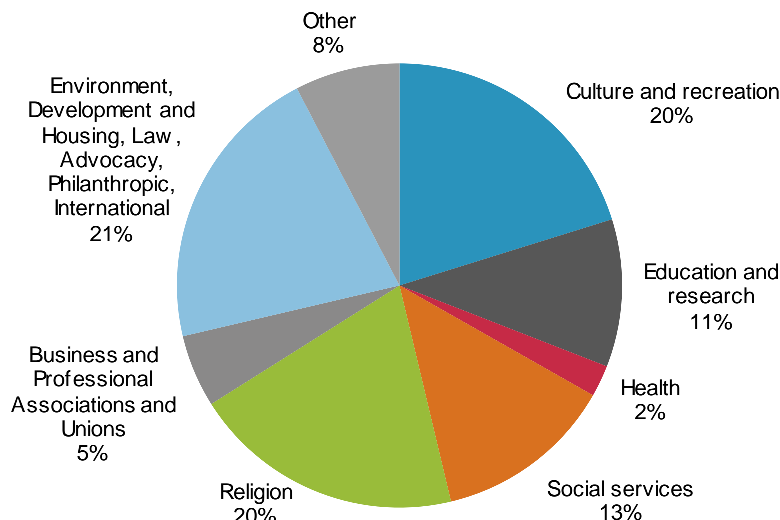
There are around 600,000 NFPs in Australia, the majority of which are small, unincorporated or non-employing organisations that undertake activities to meet local needs and rely on the volunteer contributions of community members. Of these NFPs, around 60,000 are registered charities.[141]

141 Australian Charities and Not-For-Profits Commission 2014, *Homepage*, viewed 1 December 2014: http://acnc.gov.au/.

According to the Australian Bureau of Statistics (ABS), there are almost 57,000 NFPs that are economically significant.[142] As a proportion of the economy, in 2012-13, these NFPs accounted for around 3.8 per cent of GDP (up from 3.2 per cent of GDP in 2006-07). They generated revenue of about $107 billion, had total assets worth about $176 billion and net worth of about $123 billion at the end of June 2013.[143]

Economically significant NFPs operate in both market and non-market sectors (such as religion) (Chart 7.1). Government funding (including tied funding) accounts for just over 38 per cent of the revenue of these NFPs, donations account for a further 5 per cent, while income from donated goods and services accounts for close to half of their revenue.[144]

Chart 7.1 Share of NFP organisations by activity, 2012-13



Source: ABS 2014, *Australian National Accounts: Non-Profit Institutions Satellite Account, 2012-13,* cat. no. 5256.0, ABS, Canberra.

Almost 1.1 million people are employed by economically significant NFPs, with around 70 per cent employed in three sectors — social services, education and research and health.[145] These three sectors also dominate contributions to gross value added (Chart 7.2).[146]

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142 Economically significant NFPs are defined as organisations registered with the ATO with an ABN and classified to either the non-financial corporations sector or the non-profit institutions serving households sector in the national accounts.

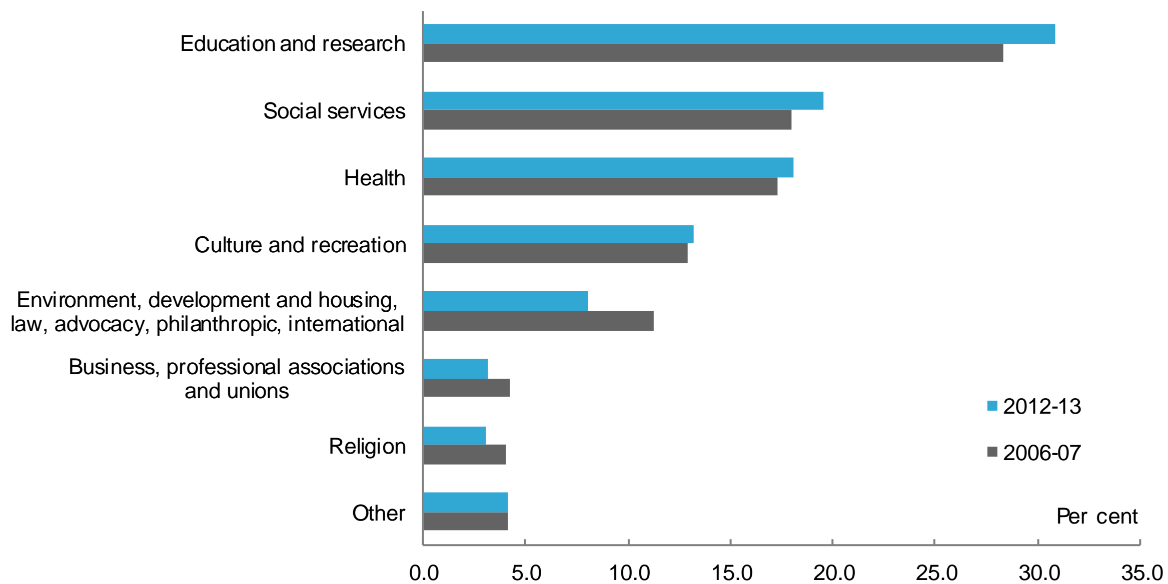
143 ABS 2014, *Australian National Accounts: Non-Profit Institutions Satellite Account, 2012-13*, cat. no. 5256.0, ABS, Canberra.

144 ABS 2014, *Australian National Accounts: Non-Profit Institutions Satellite Account, 2012-13*, cat. no. 5256.0, ABS, Canberra.

145 ABS 2014, *Australian National Accounts: Non-Profit Institutions Satellite Account, 2012-13*, cat. no. 5256.0, ABS, Canberra.

146 As defined by the ABS, 'gross value added' represents the total market value of goods and services produced in Australia within a given period after deducting the cost of goods and services used in the process of production.

Chart 7.2 Shares of total gross value added by activity



Source: ABS 2014, *Australian National Accounts: Non-Profit Institutions Satellite Account, 2012-13*, cat. no. 5256.0, ABS, Canberra.

7.2: The role of tax concessions

In recognition of the NFP sector's contribution to the Australian community, it has been a longstanding policy of successive governments to provide support to the sector in the form of tax concessions.

At the state and local government level, many charitable institutions are exempt from state and local government taxes.[147] Exemptions differ across jurisdictions, but may be available for taxes, including municipal rates, payroll tax, stamp duty, motor vehicle registration and land tax. At the Commonwealth level, these tax concessions vary according to the type of entity as well as the activities that the NFP undertakes (Table 7.1). These tax concessions include income tax exemption; a higher GST registration threshold; the ability to make supplies GST-free in certain circumstances; capped exemptions from (or rebates of) fringe benefits tax (FBT); and the ability to receive tax deductible gifts.

147 State and territory taxes are discussed in Chapter 8.

Table 7.1 Main tax concessions for main types of NFP entity

	Charities[1]	Public Benevolent Institutions (PBIs) and health promotion charities	NFP public hospitals and NFP public ambulance services	Deductible gift recipients[2]	Tax exempt clubs and other NFP entities
Income tax exemption	Yes	Yes	Yes	No	Yes
Refundable franking credits	Yes	Yes	Yes	Yes	No
FBT exemption ($17,000 cap)[3]	No	No	Yes	No	No
FBT exemption ($30,000 cap)[3]	No	Yes	No	No	No
FBT rebate	Charitable institutions only	No	No	No	Some non-clubs only
Other FBT concessions	Yes	Yes	Yes	No	No
GST concessions	Yes	Yes	Charities only	Yes	No
Deductible gifts	No	Yes	No	Yes	No

(a) Charities endorsed as deductible gift recipients or specifically listed in the *Income Tax Assessment Act 1997* can receive deductible gifts.
(b) Deductible gift recipients are generally charities that also have income tax exemptions, but income tax and FBT concessions do not automatically flow from an entity having DGR status.
(c) These caps were temporarily increased (to $17,667 and $31,177) as part of the 2014-15 Budget measure to introduce a Temporary Budget Repair levy.

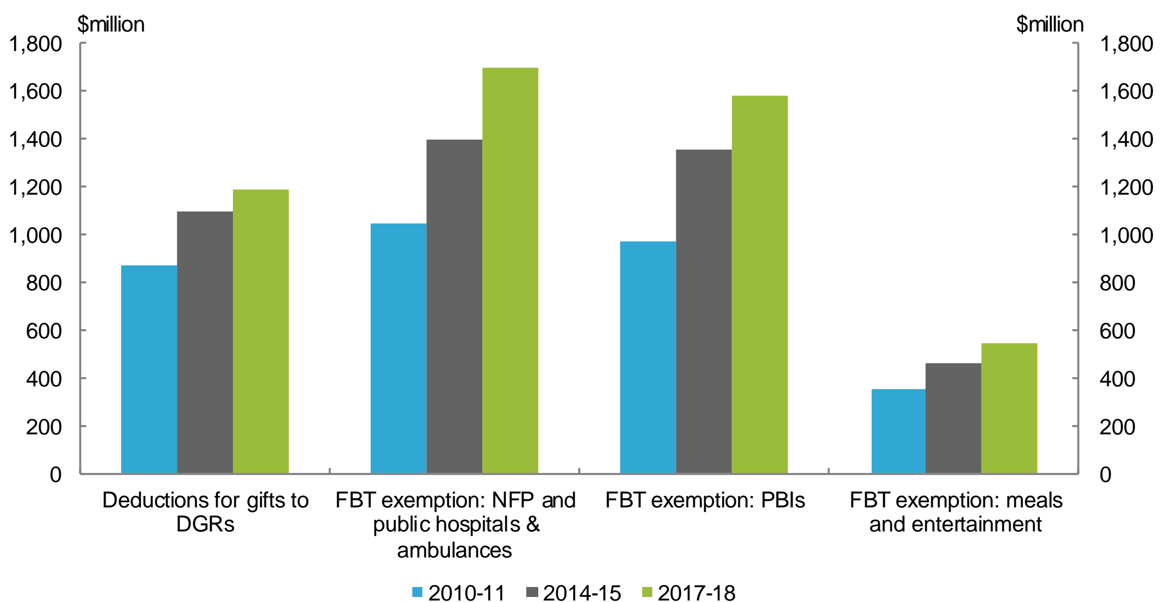
Recognising the wider benefits of NFP activity (particularly where an NFP provides services that for-profit private sector organisations do not), these tax concessions arguably help to both improve societal outcomes and ensure that the overall level of activity in the NFP sector is closer to optimal. Notwithstanding this, it is important to assess their effectiveness to ensure that the concessions continue to meet their intended policy objectives, do not result in unintended consequences (such as high compliance costs or an uncompetitive advantage) and deliver the greatest possible community benefit. This is particularly important considering the revenue forgone as a result of these tax concessions.

NFP tax concessions result in significant revenue forgone. The two largest groups of tax concessions involve exemptions from paying fringe benefits tax (FBT) for public benevolent institutions (PBIs), health promotion charities (HPCs), public hospitals, non-profit hospitals, and public ambulance services; and income tax deductions for making gifts to DGRs. The amount of revenue forgone from these concessions has been increasing, particularly the FBT exemptions.

By 2017-18, the PBI concession is estimated to result in revenue forgone of nearly $1.6 billion, from almost $1 billion in 2010-11 (Chart 7.3). In comparison, the deduction for gifts to DGRs has remained relatively stable, increasing from nearly $900 million in 2010-11 to almost $1.2 billion in 2017-18. However, the actual revenue forgone from NFP concessions cannot be quantified because many organisations are not required to submit tax returns. This means that the actual revenue forgone is likely to be higher than is currently reported.

Given the size and reach of the NFP sector, some tax concessions may result in distortions that affect the broader allocation of resources in the economy, particularly where they operate in competition with for-profit providers. These distortions arise when the prices that NFPs pay for their inputs (such as labour) are altered by the presence of concessions in the tax legislation.

Chart 7.3 Estimated revenue forgone for selected Commonwealth tax concessions



Source: Australian Government 2015, *Tax Expenditures Statement 2014*, Australian Government, Canberra.

Fringe benefits tax concessions

A range of NFP entities are exempt from paying tax on fringe benefits provided to employees up to a monetary limit per employee (either $17,000 or $30,000 for certain NFPs, excluding the temporary increase associated with the Temporary Budget Repair Levy) or are entitled to a rebate. By utilising salary sacrificing arrangements, the cost of labour to these NFPs is reduced. This lower cost could be used by the NFP to offer employees a higher salary, providing them with an advantage in hiring and retaining staff. This concession effectively provides a wage subsidy to those employed by eligible NFP organisations, which must be paid for by all other taxpayers. This concessional treatment is particularly problematic where the NFP competes with for-profit providers, in particular in the hospital sector. These concessions allow employees of eligible entities to spend from pre-tax income, thereby

reducing income tax payable. There is evidence that some employers and employees have tax-sharing arrangements to share this benefit.[148]

While there are capping thresholds on the fringe benefits tax concession, meal entertainment and entertainment facility leasing benefits are excluded from the caps and are unlimited. Benefits received by eligible NFP employees exempt from tax and not limited by a cap include payments for holidays, weddings and family celebrations. Expenditure on this concession in terms of revenue forgone was estimated to be around $430 million in 2013-14, and is estimated to rise to around $545 million in 2017-18.[149]

Another issue results from FBT being levied on individual employers with caps assessed per employee. This allows employees with more than one employer to receive benefits with multiple caps.

Income tax exemption and mutuality

A range of NFP organisations are eligible for income tax exempt status, such as employee or employer associations and clubs established to encourage animal racing, sport, art, literature or music. Although an income tax exemption does not pose as many concerns regarding competitive advantage and any retained earnings must ultimately be used to further their purposes, there appears to be no clear rationale underlying this exemption.

Membership organisations not prescribed as income tax exempt may utilise the mutuality principle. Under the mutuality principle, where a group of individuals join together to contribute to a common fund, created and controlled by all of them for a common purpose, any surplus created in the fund from the individual contributions or dealings between the members of the fund is not considered to be income for tax purposes. For a mutual organisation, income received from transactions with their members is tax exempt. A range of licensed clubs and societies, co-operatives, strata title bodies corporate and other associations utilise the mutuality principle.

Deductible gift recipients

Some NFP organisations, including around half of all registered charities, are eligible for deductible gift recipient (DGR) status. This entitles donors to claim a tax deduction for any eligible gifts they make to such organisations.

Organisations that seek DGR status generally apply to the ATO for endorsement as a DGR. However, in the areas of foreign aid, environment, culture and harm prevention, organisations must apply to the relevant department and seek the approval of the Minister as well as the Treasurer. In exceptional cases, organisations are specifically listed in the tax legislation.

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148 For example, the NSW Department of Health specifies in its Salary Packaging Policy and Procedure Manual that benefits made available for salary packaging will be shared on a 50-50 basis.

149 Australian Government 2014, *Tax Expenditures Statement 2013*, Australian Government, Canberra.

While DGR status is highly valued, the process for applying for it can be time consuming. In addition, organisations that operate across a range of DGR categories may not be eligible to be endorsed under a single category. This may require them to restructure, seek specific listing by name in the *Income Tax Assessment Act 1997*, or forgo DGR status altogether. There are also different requirements for DGR status across the different general categories, which creates further complexity.

Discussion questions:

47. Are the current tax arrangements for the NFP sector appropriate? Why or why not?
48. To what extent do the tax arrangements for the NFP sector raise particular concerns about competitive advantage compared to the tax arrangements for for-profit organisations?
49. What, if any, administrative arrangements could be simplified that would result in similar outcomes, but with reduced compliance costs?
50. What, if any, changes could be made to the current tax arrangements for the NFP sector that would enable the sector to deliver benefits to the Australian community more efficiently or effectively?

8: The Goods and Services Tax and state taxes

Overview

This chapter provides an overview of taxes that generate revenue for state and territory governments (including local councils). This includes payroll tax, stamp duties, land tax and the Goods and Services Tax (GST).

Key points

- As with most other federations around the world, in Australia, state and territory governments (including local governments) spend more than they raise in revenue, with the difference made up by grants from the Australian Government.
- The states and territories receive all of the revenue raised by the GST. About 23 per cent of total state revenue comes from the GST, with state-levied taxes generating about 31 per cent of total state revenue. The GST is relatively efficient compared to some other taxes because it has a much broader base than many other taxes. However, exemptions reduce its efficiency and introduce significant complexity. In total, around 47 per cent of Australia's national consumption is subject to GST.
- Legislation requires that changes to the GST base or rate require unanimous agreement by all state and territory governments, as well as both Houses of the Australian Parliament. The Australian Government will not support changes to the GST without a broad political consensus for change, including agreement by all state and territory governments.
- The major sources of state tax revenue are payroll taxes and stamp duties. State governments also impose taxes on land, gambling and motor vehicles. Municipal rates are the sole source of local government tax revenue.
- Some studies have suggested there are significant economic gains associated with state tax reform, particularly reducing stamp duties and making greater use of potentially efficient payroll and land taxes.

8.1: Context

The size and distribution of taxes in Australia today is distinctly different from the early days of Australia's Federation.

Before 1901 the Australian colonies collected most of their tax revenue through customs duties and excises. The colonies also imposed income tax, stamp duties, land taxes and estate taxes. At Federation, the Constitution granted the Australian Government exclusive rights to levy customs duties and excises, reflecting the importance of free interstate trade.

Today, about 23 per cent of total state revenue comes from the GST, with state-levied taxes generating about 31 per cent of total state revenue.[150] Royalties also play an important role in supporting many state and territory budgets.[151] The states and territories no longer levy estate taxes or income taxes.

The Australian Government has committed to produce a white paper on the reform of the Federation (Federation White Paper) to clarify roles and responsibilities and to ensure that, as far as possible, the states and territories are sovereign in their own sphere. In doing so, its objectives include reducing waste, duplication and second-guessing between different levels of government and achieving a more efficient and effective Federation that supports Australia's economic growth and international competitiveness.

There are significant points of overlap between the Tax and Federation White Papers, including how the structure of our Federation influences which taxes are raised by which level of government, and how those taxes are used. This chapter discusses some of the broader issues relating to the Federation that are also being discussed in the Federation White Paper. Issues relating to the distribution of tax revenue from the Australian Government to state and territory governments are being considered by the Federation White Paper.

This chapter begins with an examination of the GST and the major taxes raised by state, territory and local governments.

150 Australian Bureau of Statistics (ABS) 2014, *Government Finance Statistics, Australia, 2012-13*, cat. no. 5512.0, ABS, Canberra; and Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

151 Under the Australian system of *Government Finance Statistics*, royalty income is not a form of taxation and is included in the property income category, along with interest income and dividends.

8.2: The Goods and Services Tax (GST)

What is the GST?

The GST is Australia's primary tax on consumption. It applies at a rate of 10 per cent to a broad range of goods and services. In total, around 47 per cent of Australia's national consumption is subject to GST,[152] however, there are also other forms of consumption taxation in Australia (as outlined in more detail in Chart 2.5 and Chapter 9).

The GST was introduced in 2000 to replace a number of narrow-based taxes. It primarily replaced the Australian Government's system of wholesale sales taxes which, by that time, had become very complex and distortive with a multitude of tax rates. It also replaced a number of narrow-based taxes at the state level, including financial institutions duties and various kinds of stamp duties.[153] At the same time as the introduction of the GST, the Australian Government also made reforms to individuals income tax and family payments, in part to compensate for the effect of an expected small net increase in indirect taxes.[154]

The GST is levied by the Australian Government on behalf of the states and territories. All of the money raised by the GST is provided to the states and territories (except for non-general interest charge penalties), and the states and territories compensate the Australian Government for the costs incurred by the Australian Taxation Office (ATO) in administering the GST.

Any change to the GST rate or base would require the unanimous support of the state and territory governments, the endorsement of the Australian Government and the passage of relevant legislation by both Houses of the Australian Parliament. These requirements are codified in the 2008 *Intergovernmental Agreement on Federal Financial Relations* and the *A New Tax System (Managing the GST Rate and Base) Act 1999*.

As part of the Tax White Paper process, interested parties are welcome to put forward proposals to change the GST. However, the Australian Government will only consider progressing any such proposals if there is a broad political consensus for change, including agreement by all state and territory governments.

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152 OECD 2014, *Consumption Tax Trends 2014*, OECD, Paris.

153 The 1999 *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (the agreement) provided for all GST revenue to be distributed to the states and territories. In return, the states and territories agreed to the abolition of several inefficient state taxes, including accommodation tax, financial institutions duty, quoted marketable securities duty and debits tax.

The 2008 *Intergovernmental Agreement on Federal Financial Relations* reaffirmed the commitment to abolish and not reintroduce the taxes listed in the 1999 Agreement. States and territories also agreed that any taxes not yet abolished but listed for abolition, would be abolished before 1 July 2013. Some states have deferred their obligations on certain taxes (including non-real property conveyance duty) agreed for abolition under the 2008 Intergovernmental Agreement mentioned above.

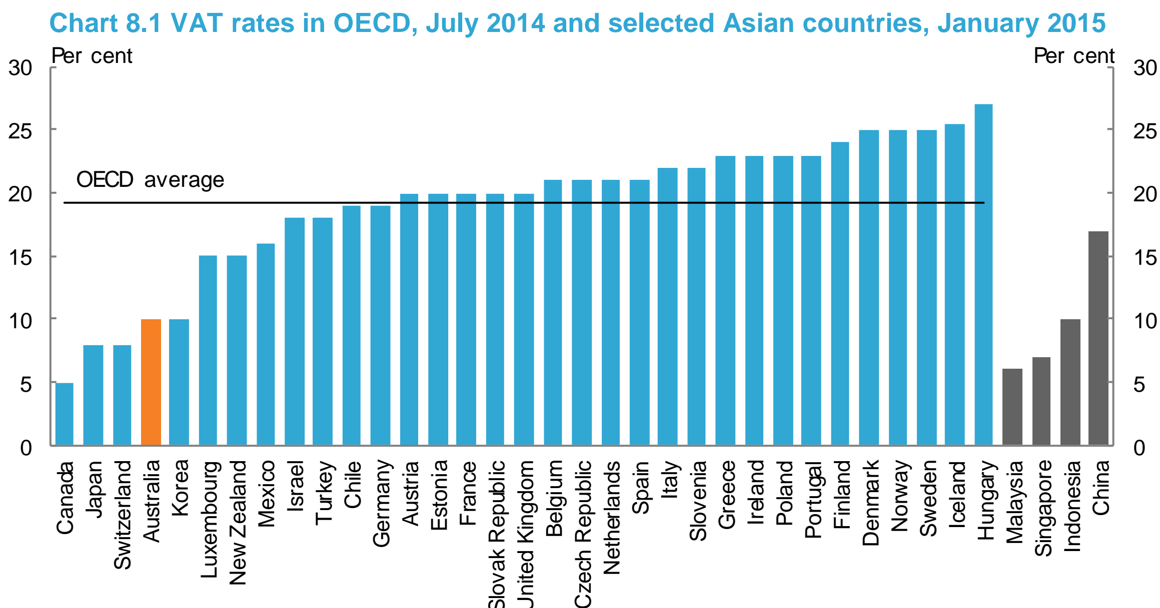
154 Australian Government 1998, *Tax Reform: Not a New Tax, A New Tax System — The Howard Government's Plan for a New Tax System,* Australian Government, Canberra.

The GST rate

Australia's GST rate is one of the lowest among developed countries and is roughly half of the average rate among OECD countries (see Chart 8.1). Of the 33 countries in the OECD that operate taxes like the GST (known more generally as value added taxes or VATs), only Canada, Japan and Switzerland have lower rates.

However, some Canadian provinces have higher tax rates than Australia when sub-central government VATs and sales taxes (another type of consumption tax) are taken into account. The United States is the only OECD country that does not impose a VAT. Nonetheless, many of its states, counties and cities impose sales taxes, the rates of which range from zero to around 10 per cent. These sales taxes are not included in Chart 8.1.

Chart 8.1 VAT rates in OECD, July 2014 and selected Asian countries, January 2015

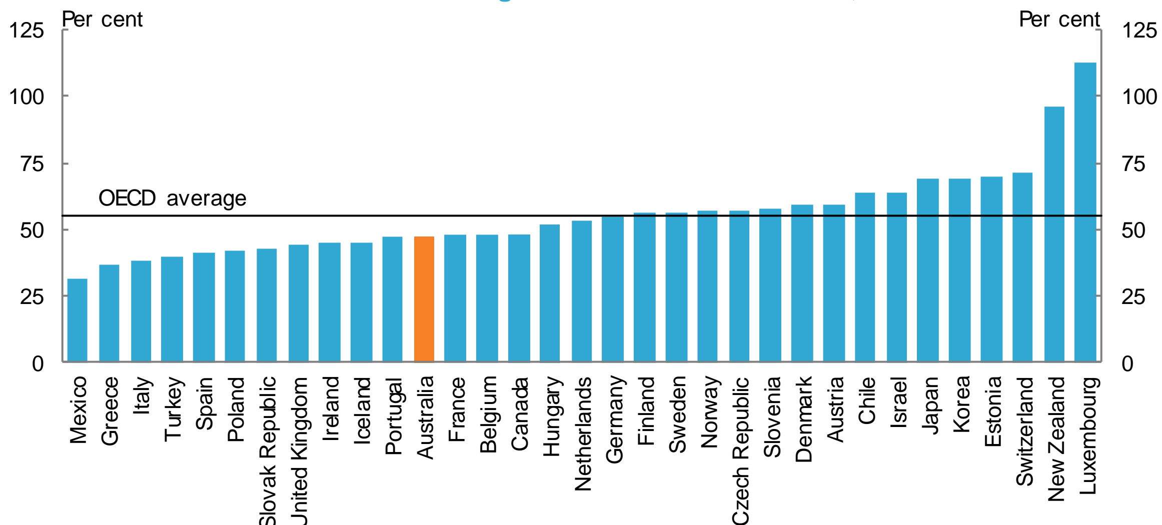


Note: The VAT rate for Japan has been adjusted to account for the increase in the rate from 1 April 2014. The rate for Malaysia reflects the GST scheduled to replace separate sales and service taxes in April 2015. The US and Hong Kong are not included in the list of countries in this chart as they do not have a VAT. India is not included in the chart due to extensive variation in consumption tax rates.
Source: OECD 2014, *Consumption Tax Trends 2014*, OECD, Paris; Deloitte 2015, *Global Indirect Tax Rates*, viewed 22 January 2015: www2.deloitte.com/global/en/pages/tax/solutions/global-indirect-tax-rates.html.

The GST base

The GST applies to most types of goods and services. However, a significant portion of consumption is excluded. Australia is not unique in this regard, as most developed countries also have a range of exemptions to their VATs. The exemptions to Australia's GST mean that it was paid on only 47 per cent (see Chart 8.2) of the consumption of all goods and services in 2012. This was slightly less than the OECD average of 55 per cent and much lower than New Zealand (96 per cent), where almost all goods and services are subject to a consumption tax. Furthermore, the coverage of Australia's GST has decreased from its peak in 2005-06 when Australia's 'VAT coverage ratio' was 56 per cent.

Chart 8.2 VAT coverage ratios in OECD countries, 2012



Note: Luxembourg's VAT coverage ratio of greater than 100 per cent is likely a consequence of its role as an international financial centre and an international centre for e-commerce which can result in Luxembourg collecting VAT revenue even though the final consumption of these services occurs in other countries.
Source: OECD 2014, *Consumption Tax Trends 2014*, OECD, Paris.

Most of the categories of consumption not subject to GST are 'GST-free'. This means that not only are these goods and services not subject to GST when sold, but their suppliers can also claim a refund on any GST levied on the inputs they used to produce them.

The main categories of consumption that are GST-free are fresh food, health, education, childcare, as well as water, sewerage and drainage services.

When the GST was introduced, health and education, for example, were made GST-free because of the significant public sector provision of these goods and services and concerns that applying the GST to them would put private providers at a competitive disadvantage.[155]

Fresh food was made GST-free as part of negotiations with the Australian Democrats to secure passage of the GST legislation through the Senate.[156]

Some stakeholders support the retention of many of these exemptions on the basis that these goods and services are 'basic necessities' and argue that the burden of applying GST to them would fall disproportionally on lower-income households.

Imported goods (but not imported services) are generally subject to GST, unless the value is $1,000 or less.[157] On the other hand, most imported services and intangibles purchased by consumers (primarily those purchased online, such as multimedia downloads) are not subject to GST. Issues regarding the low value threshold on imported goods, and imported services and intangibles, are discussed in more detail in the section Pressures on the GST base: GST and the digital economy.

155 Australian Government 1998, *Tax Reform, not a new tax, a new tax system — The Howard Government's Plan for a New Tax System*, Australian Government, Canberra.

156 Smith, J 2004, *Taxing Popularity: the Story of Taxation in Australia*, Australian Tax Research Foundation, Sydney.

157 Tobacco and alcohol are an exception, being subject to GST even when their value is $1000 or less.

There are other categories of consumption that are neither subject to GST nor GST-free. Instead, these goods and services are 'input-taxed'. This means that, while they are not subject to GST when sold, their suppliers cannot claim a credit or refund on the GST levied on the inputs used for producing them. In this way, input-taxed goods and services will include some GST embedded in their prices, but not the full 10 per cent. The main categories of consumption that are input-taxed are residential rent and financial supplies.

When the GST was introduced, residential rent was input-taxed so that it would not distort household decisions about whether to rent or live in owner-occupied properties. Applying GST to residential rent would also result in many more taxpayers being required to register for GST resulting in significant additional administration and compliance costs.

Financial supplies, that is, the lending and borrowing of money, were input-taxed due to the difficulty of identifying and measuring their value, which is often not explicit. While applying GST to financial supplies would introduce significant complexity, the current approach brings its own complexities and also means these services are taxed more lightly than others. The current treatment of financial supplies is estimated to be worth over $4 billion in forgone revenue in 2014-15.[158]

One of the key advantages of the GST is that it applies at a uniform rate to a broad range of goods and services. By taxing most goods and services in the same way and at the same rate, the GST reduces the complexity and distortions that arise when things are taxed differently.

However, exemptions to the GST detract from this. Exemptions significantly increase the complexity of the GST and introduce distortions by changing the relative prices of goods and services. This complexity is discussed in more detail later in this chapter.

How important is the GST?

The GST is Australia's third-largest tax source. In 2013-14, it raised $56 billion, or 16 per cent of total Australian Government taxation revenue. All the money raised by the GST is distributed to the states and territories (except for non-general interest charge penalties).

Who pays GST?

Businesses are generally legally liable to collect GST on the sale of taxable goods and services and remit this GST to the ATO. While businesses have a legal requirement and incur the compliance burden of collecting and paying the GST, these costs are ultimately passed on to consumers. As such, all Australians pay the GST when they purchase taxable goods and services.

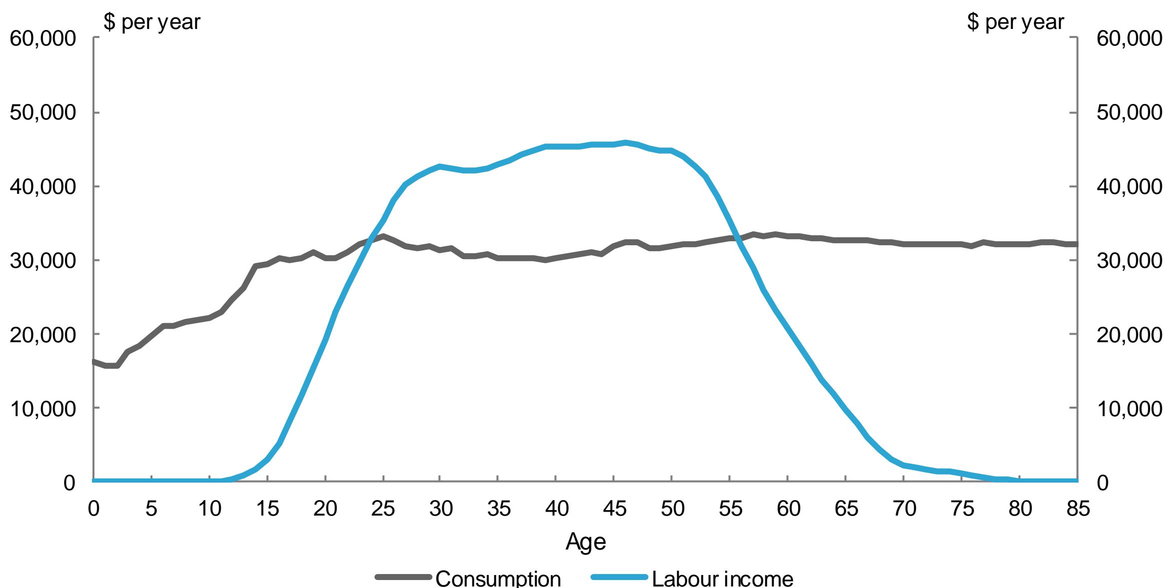
Households that save a greater proportion of their income in any given year will typically incur less GST as a proportion of their income on an annual basis. Because higher-income households tend to save more than lower-income households, this means higher-income households will typically incur less GST as a proportion of their income on an annual basis.

158 Australian Government 2014, *2014 Tax Expenditures Statement*, Australian Government, Canberra.

However, when viewed over an entire lifecycle, many individuals will ultimately incur a similar amount of tax from a broad-based consumption tax as a proportion of their lifetime income. While households that save a greater proportion of their income in any year will incur less tax as a proportion of that year's income, if and when these households eventually run down their savings they will incur more tax as a proportion of their income in those years compared to other households.[159]

Chart 8.3 shows how this can occur. It shows that when young, individuals' labour income is lower than their spending. This then becomes higher than their spending in middle age (when they have the highest incomes and are saving) and then falls, becoming lower than their spending, when they are older and are running down their savings.

Chart 8.3 Estimated per capita consumption and labour income by age in 2003-04



Note: Consumption includes both public and private consumption, such as on housing, education, child care, aged care and health. Labour income comprises labour earnings, including fringe benefits and self-employed labour income.
Source: The National Transfer Accounts Project 2014, *National Transfer Accounts*, viewed 26 November 2014: www.ntaccounts.org.[160]

Therefore, except for the effect of bequests and exemptions for certain categories of spending, it is likely that most individuals would ultimately pay a similar amount of tax from a broad-based consumption tax as a proportion of their lifetime income.[161]

Broad-based consumption taxes increase the price that consumers pay for goods and services, which therefore reduces the real value of the stock of existing household savings. In this way, broad-based consumption taxes have an impact on wealth, even if households do not consume all their income over their lifetimes.

159 Warren, N 2008, *A Review of Studies on the Distributional Impact of Consumption Taxes in OECD Countries*, OECD social, employment, and migration working paper no. 64, Paris.

160 See also Rice, J, Temple, J, and McDonald, P 2014, *National Transfer Accounts for Australia: 2003-04 and 2009-10 detailed results,* Crawford School of Public Policy, Canberra, viewed 5 December 2014: https://crawford.anu.edu.au/sites/default/files/news/files/2014-07/nta_report_2014_r.pdf.

161 Thomas, A 2014, *The Distributional Effects of the VAT in OECD Countries*, OECD, Paris.

While it is useful to understand the distributional effects of individual taxes, it is not the progressivity of any particular tax base that ultimately matters but, rather, that the tax and transfer system as a whole delivers fair outcomes.

Distributional effects of GST exemptions

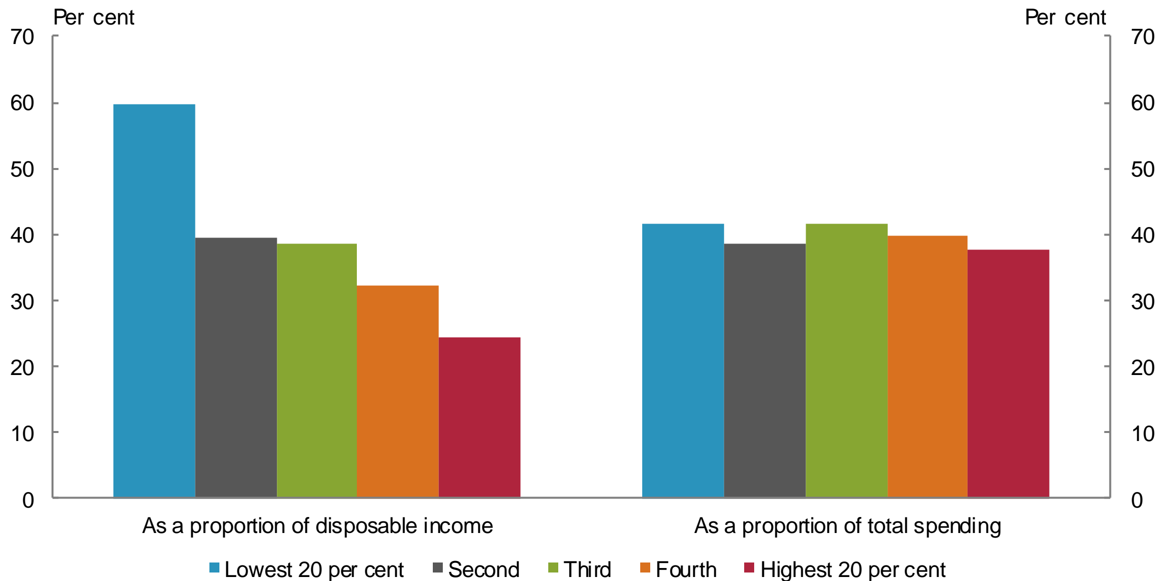
Unlike transfer payments (which are generally means-tested and highly targeted to lower-income households), GST-exemptions cannot be means-tested. The main exemptions to GST include: fresh food, health, education, child care, water sewerage and drainage, residential rent and financial services. They are available to all households, regardless of their income level. This potentially makes GST exemptions less effective and more costly than other means of targeting assistance to lower-income households.

As a proportion of their income, lower-income households spend more on GST-exempt goods and services than higher-income households. This is largely due to higher-income households saving a greater proportion of their income, meaning that their total spending represents a smaller proportion of their income.

On the other hand, as a proportion of total spending, lower-income and higher-income households spend a similar proportion on GST-exempt goods and services in aggregate. This indicates that the distributional effects resulting from having exempted these goods and services could be somewhat similar to the distributional effects of instead having taxed all goods and services, but at a lower GST rate.

While households may spend a similar proportion of their total spending on GST-exempt goods and services in aggregate, this is not necessarily true for the individual exempted categories of spending. For example, lower-income households may be more likely to spend comparatively more of their total spending on GST-exempt food, medical products and health services, or residential rent. Conversely, higher-income households may be more likely to spend comparatively more of their total spending on GST-exempt education or childcare services.

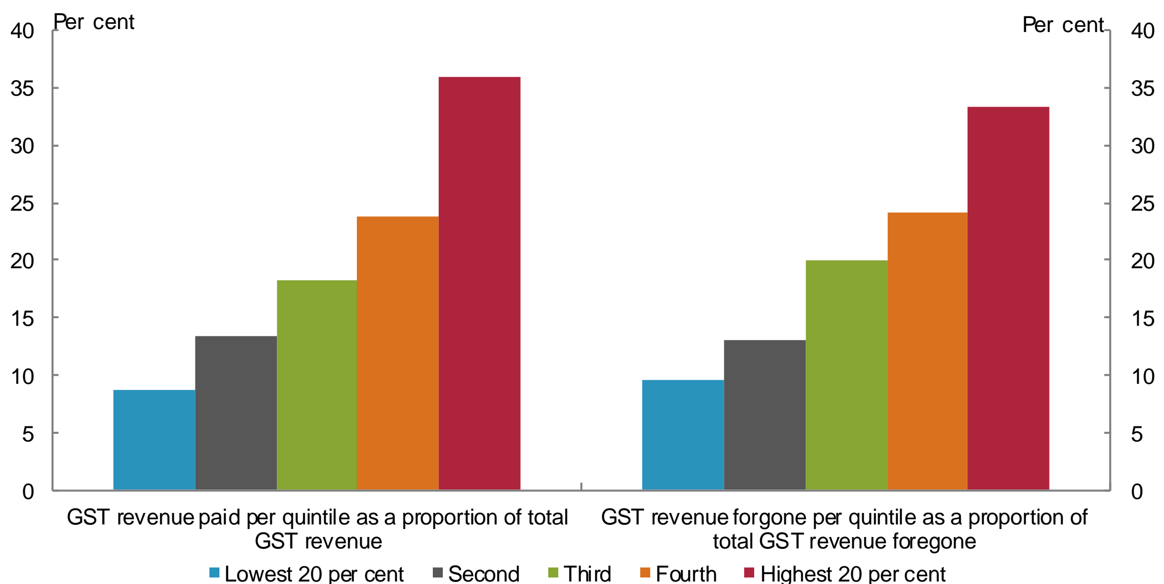
Chart 8.4 GST-exempt spending by gross household income quintile, 2009-10



Note: The main categories of GST exempt spending are fresh food, health, education, rent, and financial supplies.
Source: Treasury estimates using ABS 2011, *Household Expenditure Survey 2009-10*, cat. no. 6530.0, ABS, Canberra.

Despite lower-income households spending a greater proportion of their income on exempt goods and services (Chart 8.4), most of the benefits from these exemptions are received by the highest-income households, because these households spend more in absolute dollar terms (similarly, the highest-income households also spend more in absolute dollar terms on goods and services which attract GST). In 2009-10, the top 20 per cent of highest-income households benefited from GST exemptions estimated to be, on average, 3.5 times more in absolute terms than those received by the lowest 20 per cent (Chart 8.5).

Chart 8.5 GST revenue paid and GST revenue forgone (as a result of exemptions to the GST) by gross household income quintile, 2009–10



Note: The main categories of GST-exempt spending are fresh food, health, education, rent, and financial supplies.
Source: Treasury estimates using ABS 2011, *Household Expenditure Survey 2009-10*, cat. no. 6530.0, ABS, Canberra.

What impact does the GST have on economic growth and living standards?

A broad-based consumption tax like the GST is considered a relatively efficient tax. This means it has relatively lower adverse impacts on economic growth and living standards than other, less efficient taxes.

The GST can, however, reduce the reward for effort and incentives to work in a similar way to a labour income tax. Both taxes reduce the incentive to work by reducing the real purchasing power of additional pay earned from working an extra hour. The GST does this by increasing the price of goods and services an individual can buy with their pay, while a labour income tax reduces the take-home pay by the amount of the tax.

Exemptions to the GST base reduce the efficiency of the tax. Taxing some goods and services but not others changes the relative prices of taxed and non-taxed goods, which distorts consumer decisions about which goods and services they buy.

Complexity

Exemptions to the GST significantly add to its complexity and increase the compliance costs incurred by businesses (see Box 8.1). For example, businesses can incur significant costs in attempting to work through exemptions, concessions and having to classify whether goods and services are taxable, GST-free or input taxed. In Australia, these costs fall disproportionately on small businesses.

Box 8.1: GST and pizza rolls

Under the GST law, food is generally GST-free unless it is a type of food specifically listed as being subject to GST. This appears to be reasonably straightforward but is not.

Pizzas, pizza subs, pizza pockets and similar foods are subject to GST. In contrast, pizza rolls are generally GST-free but can be subject to GST when they are similar to 'pizzas, pizza subs or pizza pockets'.

Defining whether something is a pizza or a similar food has proved complex in the context of various baked goods. The ATO has advised that determining whether a pizza roll is taxable requires consideration of the depth of any filling or topping, the recipe for the dough and whether the roll can be cut, have additional filling added or is expected to be served as is.

This analysis is complex and undertaking it places a considerable burden on businesses. The rationale for having different tax treatments apply to pizza rolls with thicker topping is not clear.

Further, the administrative costs for businesses associated with paying, collecting, claiming credits and remitting GST on sales and purchases can be significant. These costs are currently felt particularly by small businesses, despite many of these businesses paying very little GST.

Pressures on the GST base

GST and the digital economy

While most imported goods are subject to GST, goods valued at or below the $1,000 low value threshold and most imported services and intangibles provided to consumers (primarily those purchased online, such as multimedia downloads) are not subject to GST.

A low value threshold on imported goods has been in operation since the implementation of the GST. The current $1,000 low value threshold was set in 2005. Prior to this, import thresholds for postal items were still set at $1,000, however, import thresholds for non-postal goods (those arriving by air and sea cargo) had a threshold of $250. The thresholds were aligned at $1000 to ensure all modes of transport were treated in the same manner.[162]

There is growing concern both internationally and domestically that the strong growth in online retail spending by consumers will continue to increase imports of low value goods, services and intangibles directly over the internet. Without reform, this would increase foregone GST revenue and affect the competitiveness of domestic businesses over time.

A 2011 Productivity Commission inquiry into the retail industry found there were strong in-principle grounds for the low value threshold to be lowered significantly. On the basis of tax neutrality, goods sourced from overseas should face the same tax regime as goods sourced domestically. The Productivity Commission estimated in its final report that in the absence of radically redesigned and highly efficient revenue collection systems, the collection costs would outweigh the revenue gains. By its estimates, removing the threshold completely would generate revenue of around $600 million per annum but at a cost of well over $2 billion borne by businesses, consumers and governments.[163] Accordingly, the Productivity Commission recommended the low value threshold should not be lowered until it is cost effective to do so.

Some subsequent studies undertaken by stakeholders suggest that there are alternative arrangements for collecting GST on low value goods that would not be as prohibitively expensive as current arrangements.[164] Other developed countries have relatively low thresholds compared to Australia,[165] suggesting that a cost-effective reduction in the low value threshold could be feasible.

The Australian Government agreed to a request from the states and territories to explore options around lowering the threshold, however, at the 19 September 2014 meeting of the Council on Federal Financial Relations, the states and territories indicated they had not agreed on a preferred workable approach to this issue.

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162 Commonwealth Competitive Neutrality Complaints Office 2000, *Customs Treatment of Australia Post*, Investigation No. 5, AusInfo, Canberra.

163 Productivity Commission 2011, *Economic Structure and Performance of the Australian Retail Industry*, report no. 56, Productivity Commission, Canberra.

164 See, for example, National Retail Association Ltd 2012, *The threshold question: Economic impact of the low value threshold on the retail industry*, prepared by Ernst and Young.

165 Thresholds in other developed countries include €22 for most European Union countries, £15 for the United Kingdom, C$20 for Canada and NZ$400 for New Zealand. OECD 2014, *Consumption Tax Trends 2014*, OECD, Paris.

The exclusion from the GST base for imported services reflects how difficult it is to identify the supplier and recipient in a transaction because it has not occurred physically and, unlike imported goods, cannot be stopped at a border.

Both the OECD and the broader OECD Global Forum on VAT are investigating the taxation of imported services and intangibles.[166] Working Party No.9 of the OECD's Committee on Fiscal Affairs is also considering the cross-border taxation of low value goods.[167]

The impact of changing consumption patterns

Since 2002-03, GST revenue has declined relative to the size of the economy. In 2002-03, GST revenue was 3.9 per cent of gross domestic product (GDP) but, by 2013-14, this had fallen to 3.5 per cent of GDP — in dollar terms, this is equivalent to reduced GST revenue in 2013-14 of more than $6 billion (Chart 8.6). This decline is the result of two main factors.

Firstly, the decline in GST revenue as a share of GDP has resulted from a decline in household consumption as a share of GDP. Since 2002-03, total household consumption has fallen from 59 per cent of GDP to 56 per cent in 2013-14,[168] given the unprecedented growth in mining investment which was driven by record high commodity prices throughout the 2000s.

Secondly, the decline in GST revenue as a share of GDP has resulted from a decrease in the proportion of household spending spent on taxable goods and services, and a corresponding increase in the proportion spent on GST-exempt goods and services. In particular, the proportion of total household spending on health, education, rent and financial services has been increasing. Spending on these categories in 2013-14 made up 40 per cent of total household spending compared to just 33 per cent when the GST was introduced in 2000-01.[169] In large part, this has been the result of increases in the relative prices of these goods and services, rather than an increase in the volume of these goods and services consumed. If this trend persists, it will tend to reduce the amount of GST revenue as a proportion of GDP.

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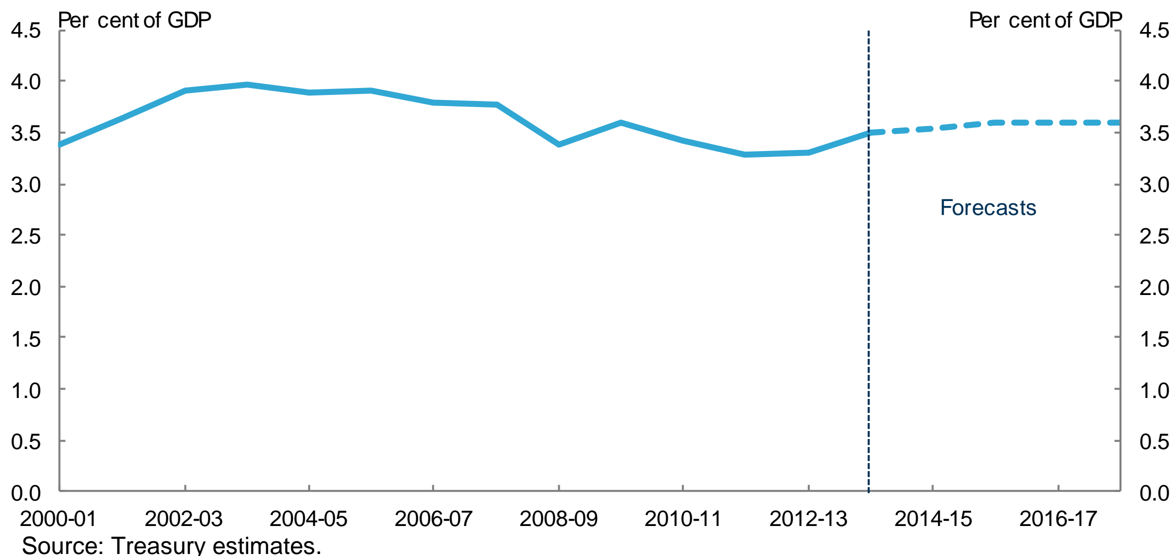
166 See, for example, OECD 2014, *Statement of Outcomes on the OECD International VAT/GST Guidelines*, OECD Global VAT Forum on VAT, Tokyo, 17-18 April 2014, viewed 11 February 2015: www.oecd.org/ctp/consumption/statement-of-outcomes-on-vat-gst-guidelines.pdf.

167 OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.

168 Australian Bureau of Statistics 2014, *Australian National Accounts: National Income, Expenditure and Product*, cat. no. 5206.0, viewed 8 December 2014: www.abs.gov.au/AUSSTATS/abs@.nsf/ViewContent?readform&view=ProductsbyCatalogue&Action=Expand&Num=6.1

169 Australian Bureau of Statistics 2014, *Australian National Accounts: National Income, Expenditure and Product*, cat. no. 5206.0, viewed 8 December 2014: www.abs.gov.au/AUSSTATS/abs@.nsf/ViewContent?readform&view=ProductsbyCatalogue&Action=Expand&Num=6.1

Chart 8.6 GST revenue over time



Source: Treasury estimates.

The GST is distributed to the states and territories under the principle of horizontal fiscal equalisation (HFE). HFE seeks to reduce fiscal disparities between states and territories, ensuring they all have the fiscal capacity to provide an equivalent level of public services. Issues around the distribution of the GST and HFE have been considered in more detail in an issues paper on the Council of Australian Governments (COAG) and Federal Financial Relations, released as part of the Federation White Paper process. The issues paper is available at www.federation.dpmc.gov.au.

Discussion questions:

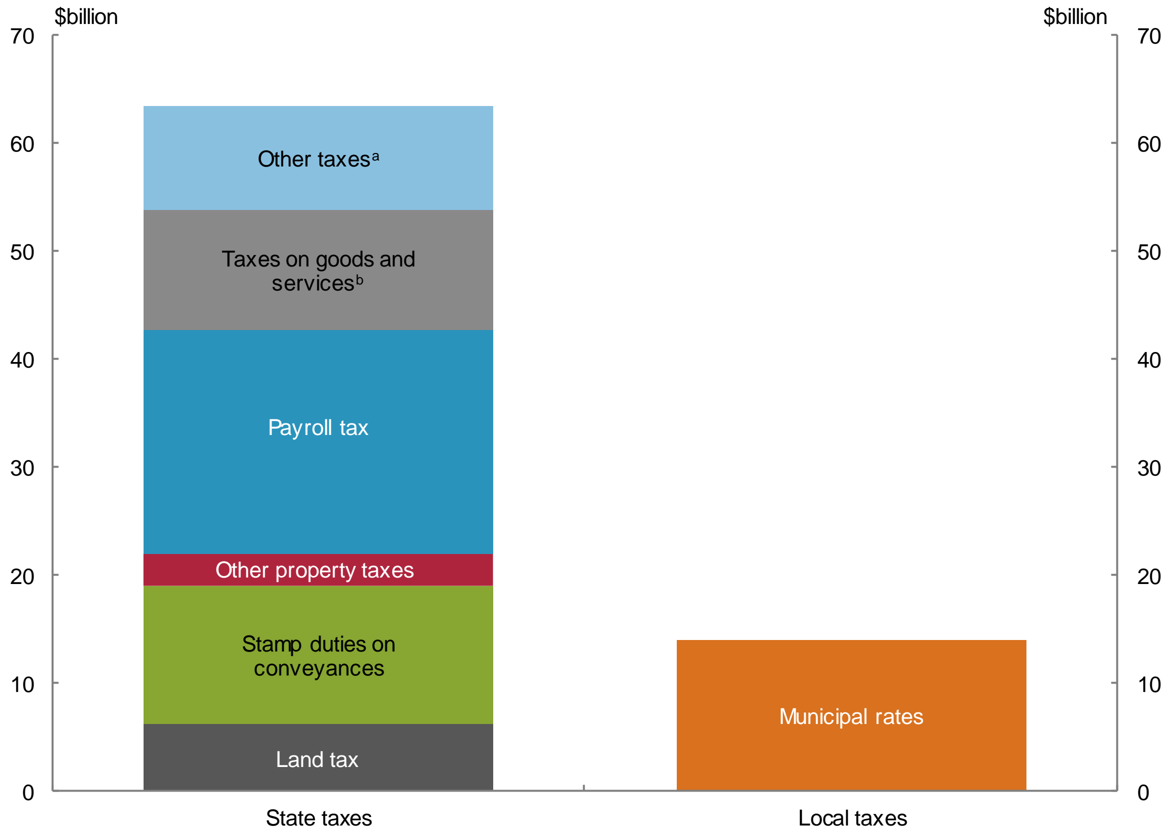
51. To what extent are the tax settings (that is, the rate, base and administration) for the GST appropriate? What changes, if any, could be made to these settings to make a better tax system to deliver taxes that are lower, simpler, fairer?

8.3: Features of state (including local government) taxes

All states and territories raise tax revenue from broadly the same range of taxes (noting the Northern Territory does not have a land tax), although each sets its own rates and thresholds. As such, each has differing reliance on particular taxes.

In aggregate, states and territories generate about 31 per cent of their revenue through state taxes.[170] Chart 8.7 shows the major sources of state and local government tax revenue. The chart shows the majority of state tax revenue comes from payroll taxes and stamp duties on conveyances. Municipal rates are the sole source of local government tax revenue.

Chart 8.7 Sources of state, territory and local government tax revenue, 2012-13

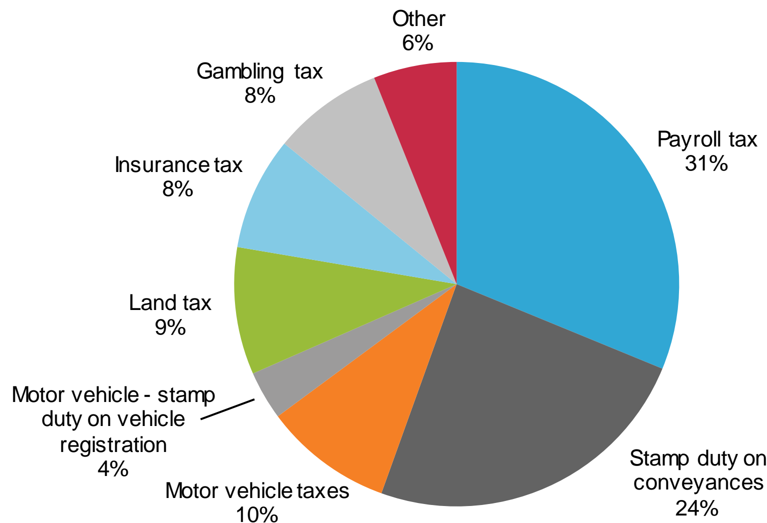


(a) Primarily motor vehicle taxes.
(b) Primarily gambling and insurance taxes. This does not include GST revenue.
Note: Figures are for 2012-13, as this is the most recent year local government data is available.
Source: ABS 2014, *Taxation Revenue, Australia, 2012-13*, cat. no. 5506.0, ABS, Canberra.

Looking more closely at state taxes, Chart 8.8 shows about two-thirds of state tax revenue is generated from payroll tax and stamp duties on conveyances, vehicle registration, and insurance taxes, with taxes on land, gambling, motor vehicles and other taxes making up around one third of state tax revenue.

170 ABS 2014, *Government Finance Statistics, Australia, 2012-13*, cat. no. 5512.0, ABS, Canberra.

Chart 8.8 Sources of state and territory tax revenue, 2013-14



Source: Treasury calculations using state and territory 2013-14 final budget outcomes (or equivalents) and 2014-15 state and territory budgets.[171]
Note: 'Motor vehicle taxes' excludes stamp duty on vehicle registration.

Some studies have suggested there are significant economic gains associated with state tax reform. For example, Independent Economics and the 2011 NSW Financial Audit both estimated that replacing stamp duties on conveyancing with broad-based land tax could generate long-run gains to economic activity of about 1.3 per cent.[172]

Payroll tax

Payroll tax is levied on employers and is based on components of employee remuneration. Payroll taxes are legally imposed on businesses. In the short run (around 12 months), business are unlikely to be able to change existing wages and prices. As such, business owners will bear any costs associated with increased payroll taxes. In the long run, the cost of the tax is likely to be passed onto employees (through lower wages) and consumers (through higher prices).

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171 New South Wales Government 2014, *Report on State Finances 2013-14*, New South Wales Government, Sydney; New South Wales Government 2014, *NSW 2014-15 Budget, Budget Paper 2 — Budget Statement*, New South Wales Government, Sydney. Victorian Government 2014, *2013-14 Financial Report (incorporating Quarterly Report No.4)*, Victorian Government, Melbourne. Queensland Government 2014, *2013-14 Report on State Finances of the Queensland Government — 30 June 2014*, Queensland Government, Brisbane. Government of Western Australia 2014, *2013-14 Annual Report on State Finances*, Government of Western Australia, Perth. Government of South Australia 2014, *2014-15 Budget Paper 3: Budget Statement*, Government of South Australia, Adelaide. Government of Tasmania 2014, *Treasurer's Annual Financial Report 2013-14*, Government of Tasmania, Hobart. Australian Capital Territory Government 2014, *Consolidated Annual Financial Statements — 2013-14*; Australian Capital Territory Government, Canberra; Australian Capital Territory Government 2014, *September Quarter 2014 Consolidated Financial Report,* Australian Capital Territory Government, Canberra. Northern Territory Government 2014, *Treasurer's Annual Financial Report*, Northern Territory Government, Darwin; Northern Territory Government 2014, *Budget Paper No.2: Budget Strategy and Outlook 2014-15*, Northern Territory Government, Darwin.

172 Independent Economics 2014, *Economic impacts of negative gearing of residential property — report for the Housing Industry Association*, Independent Economics, Canberra; and NSW Treasury 2012, *NSW Financial Audit 2011 (*'Lambert review'), NSW Treasury, Sydney.

Broad-based payroll taxes have similar economic consequences to a broad-based consumption tax, making them a relatively efficient way of raising revenue.[173] For 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.

In practice, payroll tax in Australia is less efficient and more complex than it could be because of tax-free thresholds and other exemptions, often introduced to reduce tax paid by groups such as small businesses. These include exemptions related to size of payroll, business type and wage type (for example, maternity pay).

As a result of current exemptions and thresholds, a significant proportion of the payroll base is not subject to tax. Estimates by the states of their tax expenditure on payroll tax give some indication of the size of the payroll tax base not subject to tax. These estimates can underestimate revenue foregone because they do not measure the impact of the threshold itself. For example, NSW reports that tax expenditure on payroll tax amounted to $1.3 billion in 2013-14 or about 18 per cent of payroll tax revenue.[174] The Business Council of Australia has estimated that closer to half of the potential payroll tax base is exempt.[175] Current payroll tax arrangements may also impact on business decisions to expand. For these reasons, some reviews have suggested broadening existing payroll taxes by lowering the threshold, removing exemptions and cutting rates.[176]

However, there is significant criticism of payroll tax, including of its short-run impact on business costs. While the states and territories have substantially harmonised legislation and the administration of payroll tax in recent years, some business groups, particularly those operating across state borders, remain concerned about the complexity associated with differing thresholds and rates across states.[177] A zero threshold would also likely impose significant administrative costs and compliance burdens on very small businesses.

Stamp duties

State governments levy stamp duties on a range of transactions, including conveyances, insurance and motor vehicles. Australia is relatively more reliant on these taxes (largely stamp duties on conveyances) than other countries, as Chart 8.9 shows.

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173 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 on consumption.

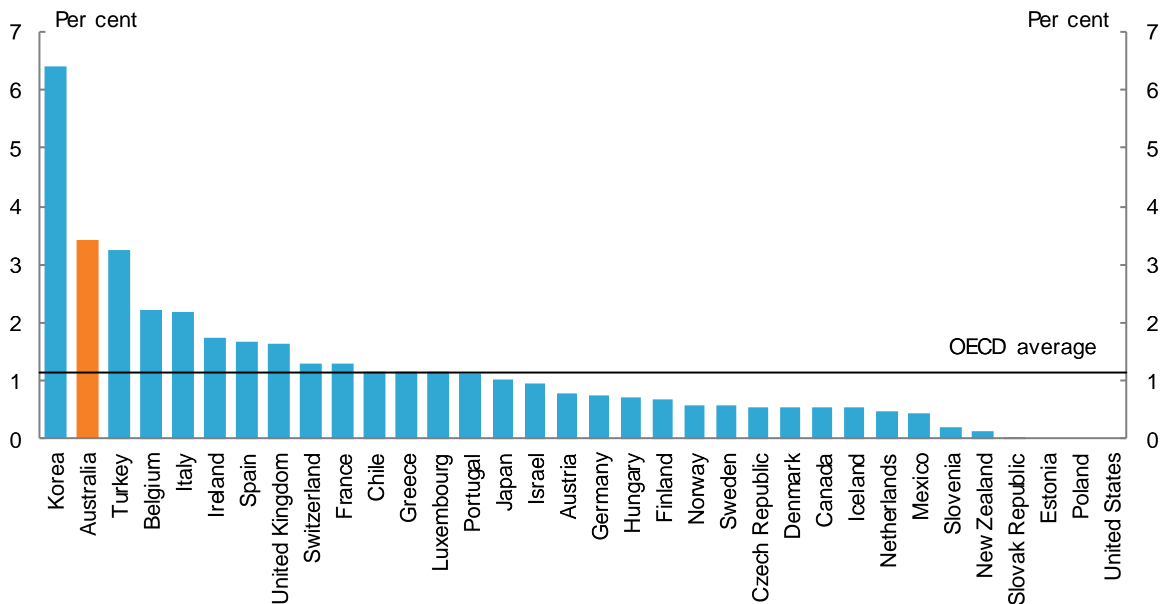
174 NSW Treasury, 2014, *Budget Statement 2014-15 — Budget Paper 2*, NSW Government, Sydney, p. 6-31.

175 Business Council of Australia 2014, *The Future of Tax Australia's current tax system,* viewed 9 December 2014: www.bca.com.au/publications/the-future-of-tax-australias-current-tax-system.

176 NSW Treasury 2012, *NSW Financial Audit 2011 (*'Lambert review'), NSW Treasury, Sydney; and Victorian Competition and Efficiency Commission 2011, *Securing Victoria's Future Prosperity: A Reform Agenda*, Victorian Government, Melbourne.

177 For example, *ACCI Pre-Budget Submission*, provided to the Treasury, 2014, viewed 9 December 2014: www.acci.asn.au/getattachment/be749436-f50c-46b7-b876-60664cce3aa7/ACCI-Pre-Budget-Submission-2013-14.aspx.

Chart 8.9 Taxes on financial and capital transactions as a percentage of total taxation, OECD countries, 2012



Note: Taxes on financial and capital transactions include taxes on the issue, transfer, purchase and sale of securities, taxes on cheques, and taxes levied on specific legal transactions such as validation of contracts and the sale of immovable property.
Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris.

Stamp duties are some of the most inefficient taxes levied in Australia. Unlike broad-based taxes on consumption or payrolls, they are levied selectively on activities or products and are taxed on the total transaction value, rather than the 'value added' component. Such transaction taxes are more likely to discourage turnover of taxed goods, as taxpayers attempt to reduce or avoid paying the tax.

Stamp duties on conveyances

Stamp duties on the transfer of residential and commercial property ('stamp duties on conveyances') are the second-largest source of state tax revenue (generating 24 per cent of state tax revenue).[178] All states and territories have progressive rate scales, although the rates, thresholds and exemptions (for example for first home buyers) differ in different states.

Because revenue growth is driven by property prices and numbers of transactions, stamp duties on conveyances are a highly volatile tax, with revenue collected from stamp duties on conveyances fluctuating by over 50 per cent in previous years.[179] Stamp duties on conveyances add to the costs of buying and selling property and can discourage businesses from undertaking productivity enhancing purchases of existing land and capital. The outcome can be retention of land for relatively unproductive purposes.

178 Treasury calculations based on state and territory 2013-14 final budget outcomes (or equivalent) and state and territory 2014-15 budgets.

179 ABS 2014, *Taxation Revenue, Australia, 2012-13*, cat. no. 5506.0, ABS, Canberra.

Stamp duties also impact on consumers by increasing the cost of buying and selling houses. As house prices increase over time, unadjusted progressive tax rates also increase the tax burden associated with stamp duty. For example, the burden of stamp duty on a median-priced house in Melbourne has almost doubled over the past 20 years — from 2.67 per cent of the sale price in 1988 to 5.16 per cent in 2011.[180]

This clearly adds to transaction costs and contributes to Australia's high (by international standards) costs of moving.[181] These costs can discourage householders from moving to housing that best suits their needs and can be an important barrier to labour mobility.[182] A number of reviews have found that, by dampening the number of house sales, stamp duties can also add to commuting times.[183] Stamp duty can also be inequitable — those who move more frequently face higher costs than those who move less frequently, even if their circumstances are otherwise similar.

Stamp duties on insurance

The states and territories levy stamp duties on insurance products, including life insurance and general insurance. Some states also levy taxes on insurance products to partially fund fire and emergency services, although there has been a trend since the late 1990s to fund these services from additional taxes on property, rather than insurance.

In general, states provide a number of exemptions from tax on general insurance, including workers compensation, public liability insurance for not-for-profit organisations and insurance on the transport of goods.

As with stamp duties more broadly, insurance taxes are among the most inefficient taxes in Australia. Insurance taxes increase the cost of insurance to consumers and place a large burden on home insurance. They may lead to under-insurance or to people not insuring at all, particularly if householders are sensitive to price increases. In this regard, Tooth and Barker found that rates of non-insurance can be higher for particular demographic groups, including retirees with mortgages and single parents, leaving them more financially vulnerable in the event of loss.[184]

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180 Real Estate Institute of Victoria 2011, *Submission to the Victorian Competition and Efficiency Commission Inquiry into a State-based Reform Agenda*, viewed 9 December 2014: www.vcec.vic.gov.au/Inquiries/Completed-inquiries/State-based-reform/Submissions.

181 Andrews, D, Caldera Sánchez A and Johansson Å 2011, *Housing Markets and Structural Policies in OECD Countries*, OECD economics department working paper no. 836, OECD, Paris.

182 Van Ommeren, J and M. Van Leuvensteijn 2005, 'New evidence of the effect of transaction costs on residential mobility', *Journal of Regional Science*, vol. 45, issue 4, pages 681-702.

183 Independent Economics 2014, *Economic Impacts of Negative Gearing of Residential Property — report prepared for the Housing Industry Association*, Independent Economics, Canberra; and Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra, page 255.

184 Tooth, R and Barker, G 2007, *The Non-Insured: Who, Why and Trends — prepared for the Insurance Council of Australia*, viewed 9 December 2014: www.insurancecouncil.com.au/issues-submissions/reports/non-insurance.

Motor vehicle stamp duties

States and territories raise taxes from road users by way of annual motor vehicle registration charges, stamp duties on the sale of new and used vehicles, weight taxes, surcharges and levies on compulsory third party insurance, car parking space levies and a range of minor taxes.[185]

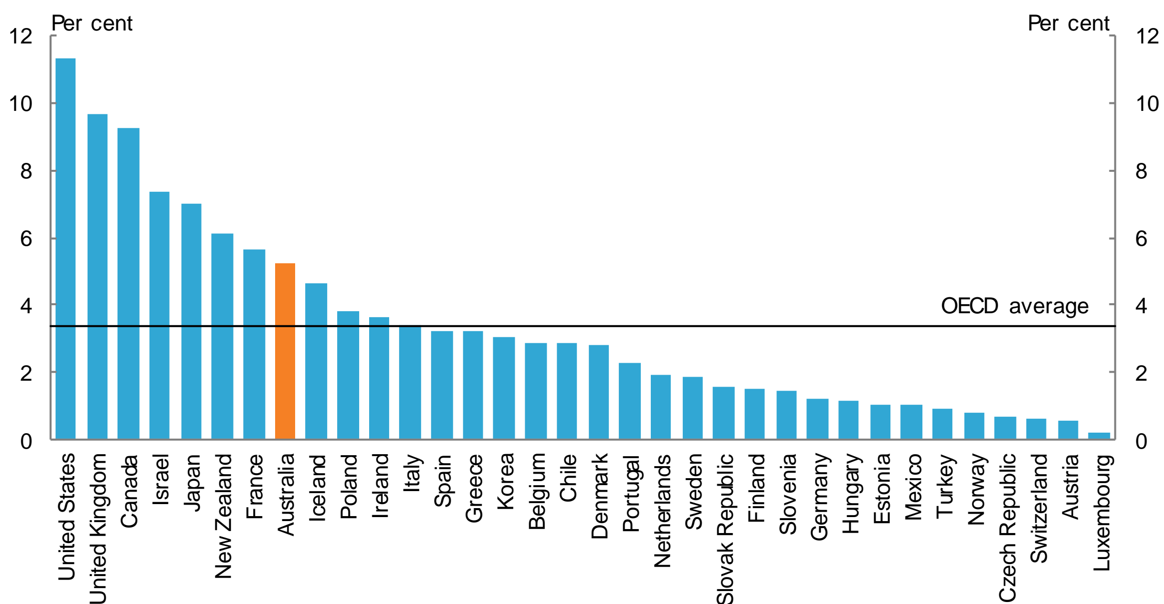
Stamp duties on the registration of new and used vehicles raised about $2.4 billion (or 4 per cent) of state tax revenue in 2013-14.[186] These taxes add to the costs of transferring new and used vehicles.

Taxes on land

In Australia, taxes on land are levied by state governments in the form of land tax and by local governments in the form of municipal rates. Currently, the ACT levies both land tax and municipal rates (see Box 8.2 for more detail on ACT land tax reforms).

Chart 8.10 compares tax revenue raised from land in Australia to other developed countries. It shows Australia's reliance on taxes on land, as a percentage of total taxation is higher than the OECD average, but around half the proportion raised in the US, UK and Canada.

Chart 8.10 Recurrent taxes on immovable property as a percentage of total taxation, OECD countries, 2012



Note: Recurrent taxes on immovable property cover taxes levied regularly in respect of the use or ownership of immovable property.
Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris.

185 Some of these taxes, for example, annual motor vehicle registration and operation fees, have some features of user charges, which are discussed in Chapter 9 *Indirect taxes.*

186 State 2013-14 final budget outcomes and 2014-15 budgets.

Land tax

All states and territories, apart from the Northern Territory, levy annual land taxes on property, with some states using unimproved land value and other states using market value to determine land value. State land tax regimes commonly feature a tax-free threshold and progressive rate scales.

The land tax base in Australia is narrow due to tax-free thresholds and many exemptions, some of which are motivated by equity concerns. Exemptions apply primarily to owner-occupied housing and primary production land. In fact, more than half of the potential land tax base, by value, is exempted from state land taxes.[187]

This results in forgone revenue and distorts land-use. For example, levying land tax at progressive rates on total landholdings leads to higher taxes on large landholdings, compared to smaller landholdings. The OECD argues this introduces a bias against large investments in residential property and discourages institutional investors from investing in private rental housing.[188]

Unlike capital and labour, land is an immobile and fixed factor in productive activity. An ideally designed land tax would result in a once-off reduction in the value of the land. Even with this reduction in land value, land supply remains fixed and cannot fall. Without a decline in the supply of land, renters would be unwilling to pay higher rents. As such, in an ideal land tax, land owners would bear the full cost of the tax and would not pass any onto renters.

In practice, no land tax fits the theoretical ideal. Land tax as currently implemented in Australia is far from such a model because of exclusions and because different types of land attract different rates of tax (for example, commercial versus residential). Because of this, the burden of land tax is likely to be shared by landowners and downstream users.

Box 8.2: Australian Capital Territory tax reforms

In its 2012-13 Budget, the ACT Government committed to a 20 year tax reform process to replace insurance duties and stamp duties on conveyances with a broad-based land tax regime that includes owner-occupied housing.

The reform involved significant transitional costs, including to governments (with short-term falls in revenue as stamp duties decline), new home buyers (with equity concerns about people who have recently purchased a house facing double taxation) and low-income home owners (who might have financial difficulty making regular land tax payments).

The ACT government’s response to these concerns included a range of concessional schemes and a long and phased implementation programme (with insurance duties abolished over five years and conveyance duties over 20 years).

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187 Australian Government 2010, *Australia’s Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra p. 260; and Business Council of Australia 2014, *The Future of Tax Australia’s current tax system,* viewed 9 December 2014: www.bca.com.au/publications/the-future-of-tax-australias-current-tax-system.

188 OECD 2010, *OECD Economic Surveys: Australia 2010*, OECD, Paris; and OECD 2012, *Activating Jobseekers: How Australia Does It,* OECD, Paris.

Municipal rates

Local councils levy municipal (or council) rates under powers provided by state governments. They are applied broadly across all residential land based on land valuations with few exemptions and are used to fund a broad range of local activities.

As with broad-based land taxes, municipal rates are an efficient way to raise revenue. In the theoretical scenario, land is a fixed factor of production and therefore the tax burden of broadly-applied municipal rates is paid by landowners, rather than passed onto final land users. Low rates and few concessions or exemptions also reduce the incentives and ability to avoid the tax.

While municipal rates are widely agreed to be one of the most efficient taxes in Australia, there are some concerns about how land values are determined and rates are set. For example, some councils determine land value on the basis of improved value, rather than unimproved value, which can discourage capital improvement.[189]

Differences between councils may also generate some complexity for people with landholdings in different regions. Councils collect substantially different amounts of revenue through rates. In 2010-11, the proportion of revenue raised from rates varied between a high of 57 per cent for South Australia and a low of 20 per cent for the Northern Territory.[190]

Part of the explanation for this variation is due to institutional differences. While most local councils have the authority to set municipal rates in their area, in New South Wales the Independent Pricing and Regulatory Tribunal determines the maximum percentage rate rise each year. In addition, there is substantial variation across Australia in population density, average incomes and land values, which has an impact on the ability of some councils to raise additional revenue through rates.

Both the ACT and South Australia have rate deferral schemes, which allow eligible homeowners to defer rates using a mechanism akin to a reverse mortgage.[191] These schemes help taxpayers, particularly with low incomes, meet the costs of municipal rates.

Gambling taxes

Gambling taxes are a tax on gambling activity and take many forms, including a turnover tax, a tax on net profits and a tax on player loss and licencing fees. Rates differ on the basis of both the form of gambling and the type of venue. In general, lotteries are taxed more heavily than other forms of gambling.

The gambling sector is highly regulated, with restrictions on the numbers of machines and venues. State tax reviews in the ACT and NSW have argued that government restrictions on competition to deal with problem gambling generate 'excess profits' for the owners of

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189 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra, page 692.

190 Department of Infrastructure and Regional Development 2013, *2010-11 Local Government National Report*, Australian Government, Canberra.

191 Brownfield, C 2014, *The Fourth Pillar — the role of home equity release in retirement funding*, presented to the Actuaries Institute Financial Services Forum, 5-6 May 2014, Sydney.

gambling venues and that taxing these profits is an efficient way to raise revenue.[192] Both of these reviews recommended increasing gambling taxes.

In a similar vein, the Productivity Commission recommended that governments eliminate tax concessions for particular types of gambling providers. The Productivity Commission argued that support for these businesses would be better provided by way of transparent and direct government funding.[193]

While gambling taxes have historically been a stable source of revenue for governments, competition between states and growing trends in online gambling, particularly with providers outside Australia, may threaten gambling revenues.

Royalties

A mineral royalty is the price charged by government for the transfer of the right to extract a mineral resource. The prices (royalty rates) for different minerals are prescribed in mining legislation and associated regulations. Royalties are generally based on a percentage of the value of production (ad valorem) or a fee per unit produced (volumetric).

Royalties are not classified as taxes, but do make up a significant proportion of revenue in resource-rich states. For example, royalties generated 22 per cent of Western Australia's revenue in 2013-14, up from 6 per cent of revenue in 2004-05.[194]

The efficiency of volumetric royalties depends on the prevailing price for mineral products. When prices are high, the impact of volumetric royalties on economic activity is relatively low but revenue does not reflect the full value of the resources. When prices are low, they have a larger impact on a project's viability and can affect the viability of some mines. Ad valorem royalties, being price-based, will reflect rising prices, but as they are levied on the price of a unit of production rather than profit, ad valorem royalties may still compromise marginal projects. For example, the unit sale price and hence royalty payments may be increasing but if costs of production are increasing at a rate faster than unit price growth, profitability will be decreasing as royalty payments are increasing. Some states have adopted a progressive scale of royalties to give themselves more flexibility.

Royalty revenue depends on commodity prices, the exchange rate and production volumes. The inherent volatility of the resources sector and the size of royalties in some state budgets can make budget planning more challenging. There is a trade-off between price-based and volumetric royalties. Profit-based royalties respond better to changes in profitability and are less likely to compromise a project's viability, but are more volatile. Volumetric royalties are simple, have low compliance costs for industry, are easily enforced, and are more stable in terms of revenue generated, but by not responding to changes in profitability, may negatively

192 NSW Treasury 2012, *NSW Financial Audit 2011 (*'Lambert review'), NSW Treasury, Sydney; ACT Government 2012, *ACT Taxation Review*, ACT Government, Canberra.

193 Productivity Commission 2010*, Gambling*, no. 50, Productivity Commission, Canberra.

194 Government of Western Australia 2014, *2013-14 Annual Report on State Finances*, Government of Western Australia, Perth; and Government of Western Australia 2005, *2004-05 Government Financial Results Report,* Government of Western Australia, Perth.

impact a marginal project's viability. Of the two forms of royalties, royalties based on the volume of resources extracted are more stable than royalties based on prices but may be less economically efficient.

Discussion questions:

52. What are the relative priorities for state and local tax reform and why? In considering reform opportunities for particular state taxes, what are the broader considerations that need to be taken into account to balance equity, efficiency and transitional costs?

8.4: Principles for assigning taxes in a Federation

A full consideration of taxation in Australia needs to take into account state government revenue raising as people bear the cost of poorly performing and inefficient taxes, no matter which level of government levies them. However, there are broader issues relating to how the Federation works that help explain why and how governments levy the taxes they do.

On this topic, much academic literature has focussed on the principles of effective federations.[195] Discussion has centred on principles, including that:

1. each level of government should have access to tax revenue it can use to finance new spending decisions;
2. the central government should levy taxes for macroeconomic stabilisation, redistribution purposes and taxes on mobile bases; and
3. the assignment of tax responsibility should take account of how different arrangements affect the complexity of the tax system.[196]

Another principle that falls more squarely within the scope of the Federation White Paper, but is clearly relevant to this discussion, is that intergovernmental grants should be transparent. This is to ensure all levels of government are accountable for their taxing and spending decisions.

195 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra, pages 669-675.

196 This list is not exhaustive. Other principles include adequacy (taxes meet local need and expand over time to meet growing expenditure) and revenue stability at the sub-national level. See Bird, R 2010, 'Taxation and Decentralization', *The Economic Premise*, no. 38, Poverty Reduction and Economic Management (PREM) Network Vice-Presidency of the World Bank.

8.5: Issues in the Federation

How individual federations measure against the principles listed above is a matter of judgement, but it is clear that no federation meets all these principles. In fact, principles may well need to be balanced against each other, rather than achieved entirely.

The remainder of this chapter discusses how the Australian Federation meets these principles and highlights points where particular principles might be at odds.

Does each level of government have access to tax revenue bases sufficient to finance new spending decisions?

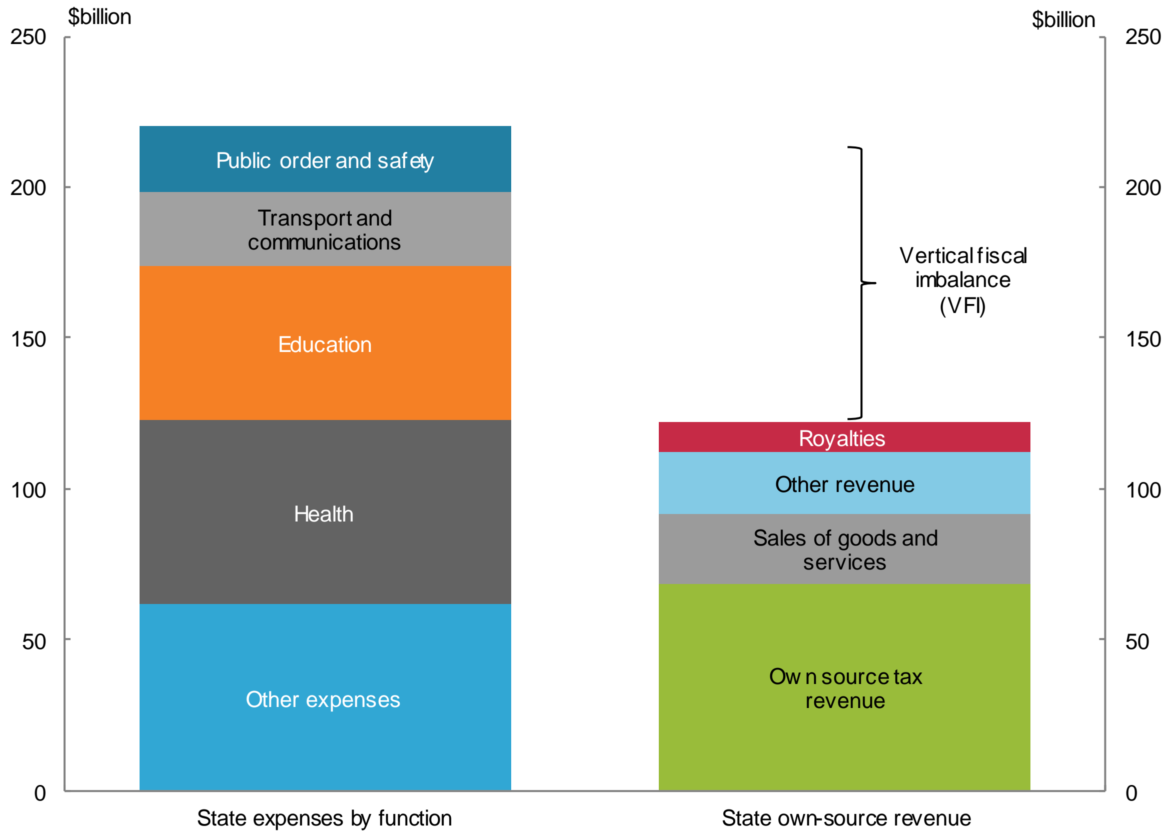
Accountability in federations is achieved with the principle that each level of government should have access to tax revenue bases in order to finance marginal expenditure decisions. It ensures that all governments face the full (electoral and financial) costs associated with new spending decisions.

As with most other federations around the world, in Australia, the Australian Government raises more tax revenue than it spends on its own programmes. The states (including local governments) spend more than they raise in revenue, with the difference made up by Australian Government grants. In fact, about 45 per cent of state government revenue comes from the Australian Government.[197]

Chart 8.11 shows the difference between state and territory expenses and own-source revenue, with the difference made up from grants from the Australian Government (around $100 billion in 2013-14 including the transfer of GST receipts).[198]

197 State and territory 2013-14 final budget outcomes (or equivalent) and 2014-15 budgets.
198 Federal, state and territory 2013-14 final budget outcomes (or equivalent) and 2014-15 budgets.

Chart 8.11 State and territory government expenses and own source revenue, 2013-14



Note: 'Sales of goods and services' includes user charging on state provided services. For the purpose of this chart the distribution of GST revenue is not considered state own-source revenue. 'Own source tax revenue' includes stamp duties on conveyances, land tax, other property taxes, and payroll tax, among other state taxes.
Source: Treasury calculations based on state and territory 2013-14 final budget outcomes (or equivalent) and state and territory 2014-15 budgets.[199]

While fiscal imbalance exists in all federations, vertical fiscal imbalance (with central governments collecting more tax revenue than they spend, and sub-central governments spending more than they directly finance) is higher in Australia than in other federations.

How vertical fiscal imbalance impacts on the principle that each level of government has access to sufficient tax revenue to finance marginal expenditure decisions has been the source of much debate.

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199 New South Wales Government 2014, *Report on State Finances 2013-14*, New South Wales Government, Sydney; Victorian Government 2014, *2013-14 Financial Report (incorporating Quarterly Report No.4),* Victorian Government, Melbourne. Queensland Government 2014, *2013-14 Report on State Finances of the Queensland Government — 30 June 2014*, Queensland Government, Brisbane. Government of Western Australia 2014, *2013-14 Annual Report on State Finances*, Government of Western Australia, Perth. Government of South Australia 2014, *2014-15 Budget Paper 3: Budget Statement*, Government of South Australia, Adelaide. Government of Tasmania 2014, *Treasurer's Annual Financial Report 2013-14*, Government of Tasmania, Hobart. Australian Capital Territory Government 2014, *Consolidated Annual Financial Statements — 2013-14*, Australian Capital Territory Government, Canberra. Northern Territory Government 2014*, Treasurer's Annual Financial Report*, Northern Territory Government, Darwin.

On the one hand, some have argued that the growth of grants tied to particular activities has added to complexity in service delivery and reduced state government autonomy. State governments have also argued that Australian Government decisions to change the size, growth rate and form of payments to the states reduce their ability to effectively manage their own budgets.

At the same time, there is an opportunity for states to make better use of their existing efficient tax bases. Importantly, the principle that each level of government should have access to tax revenue bases does not require that governments raise all the revenue they spend. Instead, this principle is about imposing a 'hard budget constraint' to ensure that governments that want to increase spending should finance new spending themselves. Governments need not fund all of their own activities to meet this principle — just those on the margin. A more detailed discussion of the advantages and disadvantages of vertical fiscal imbalance is included in an issues paper on COAG and Federal Financial Relations, released as part of the Federation White Paper. The issues paper is available at www.federation.dpmc.gov.au.

Should the states and territories only levy taxes on immobile bases?

Much of the discussion on whether the states and territories should only levy taxes on immobile bases is centred on the argument that states in a federation will compete against each other to attract business and particular groups of people, including by reducing tax rates and introducing greater exemptions and concessions. The result is lower taxes overall, particularly on mobile tax bases.

In Australia, examples of competitive forces include decisions by states to increase their statutory payroll tax thresholds. A second example is the abolition of estate duties, starting with Queensland in 1977 and quickly followed by the Australian Government (1979), South Australia and Western Australia (1980), Victoria and New South Wales (1981) and Tasmania (1982). Narrowing the land tax base by introducing exemptions for primary production land and principal place of residence from the 1970s onwards might be a further example.[200]

There has been a mixed assessment of these competitive forces, with some academics arguing that devolved and competitive federal structures give citizens more control over government decisions.[201] The outcome is argued to be an optimal mix of taxes and services that meets the needs of the population. Alternatively, competition between states may result in a 'race to the bottom', with states competing against each other to lower their taxes and, as a consequence, deliver fewer services.

200 Smith, J 2004, *Taxing Popularity The story of taxation in Australia*, Australian Tax Research Foundation Research Study no. 43.

201 Kasper, W 1996, *Federations: competing jurisdictions*, presented at Australian Treasury seminar series.

How important is complexity across the Federation?

Because states and territories set the rates, base and exemptions of the taxes they levy, it is likely that there will always be some difference between them, which adds to complexity.

Further efforts to support the principles outlined above may come at the cost of greater complexity. For example, proposals that the states levy personal income tax alongside the Australian Government, and be permitted to vary the rate, could help ensure that they have access to revenue to fund their activities. At the same time, this option could add complexity for governments and taxpayers alike, particularly in determining the location of income where rates differ across states. In assessing this and other reform options, it will be important to weigh potential costs from complexity alongside other benefits.

Discussion questions:

53. Does each level of government have access to tax revenue bases to finance new spending decisions? If not, should arrangements change to achieve this? How should they change? How important is it that the national government levies taxes on mobile bases? Could some taxes be shared?

9: Indirect taxes

Overview

This chapter provides an overview of indirect taxes levied on specific goods and services, including fuel taxes, alcohol taxes, tobacco tax, the Luxury Car Tax, agricultural levies and tariffs. This chapter also discusses financial transaction taxes, corrective taxes and user charging.

Key points

- Indirect taxes on specific goods and services can be an efficient way to raise revenue. However, an ad hoc approach has contributed to a range of complexities and inconsistencies.
- Fuel taxes are the largest source of revenue on a specific good or service.
- The taxation of alcohol has two separate regimes, applying a value based tax for wine products and a volume based excise tax for other alcoholic beverages, with 16 different excise categories.
- The Luxury Car Tax has a narrow tax base, is complex and is the Australian Government's only luxury tax on a specific good or service.

9.1: Indirect taxes

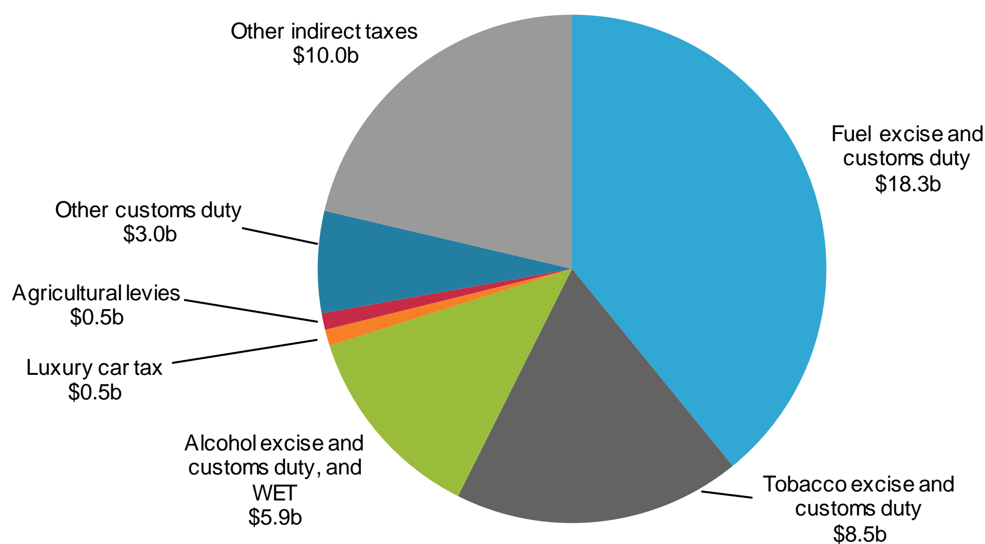
In addition to the GST, which the Australian Government collects on behalf of state and territory governments, the Australian Government collects a range of other indirect taxes. While the GST operates as a broad-based tax, these other indirect taxes are levied on specific goods and services. This chapter considers the main Australian Government specific indirect taxes including fuel taxes, alcohol taxes, tobacco tax, the Luxury Car Tax, agricultural levies and tariffs.

The rate and method of tax imposed on these specific goods and services varies, which reflects a diverse range of policy rationales underpinning the different indirect taxes. Traditionally, some indirect taxes have had a dual purpose of revenue generation and achieving desired behavioural changes.

Indirect taxes can be an efficient way to raise revenue. If taxes are imposed on goods or services where demand is less responsive to price changes, then they have a relatively small distortionary impact on behaviour. In this regard, modelling undertaken for Australia's Future Tax System Review found fuel taxes have a relatively low marginal welfare loss compared to other taxes.[202]

Indirect taxes, other than the GST, raised $47 billion in 2013-14, or 13 per cent of total Australian Government taxation revenue. Of this $47 billion, $33 billion came from fuel taxes, alcohol taxes and tobacco tax. The $47 billion includes $7 billion from the carbon tax that the government has since abolished.[203]

Chart 9.1 Australian indirect tax revenue, 2013-14



Note: Excludes the GST. Other indirect taxes include the passenger movement charge, broadcasting license fees, the carbon pricing mechanism and a range of other levies, penalties and charges.
Source: Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

9.2: Fuel taxes

Fuel taxes (that is, excise and excise-equivalent customs duty) apply to fuels used in Australia. Fuel taxes raise the most revenue of the taxes levied on goods and services by the Australian Government with the exception of GST (Chart 9.1). Fuel taxes raised $18.3 billion in tax revenue in 2013-14.[204]

Products subject to fuel taxes include petrol, diesel, certain oils and lubricants, and stabilised crude petroleum oil.

202 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra, page 13.

203 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, page 9.

204 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government.

From February 2015, the rate of fuel tax that applies to petrol and diesel is 38.9 cents per litre. In contrast, alternative fuels (liquefied petroleum gas, compressed natural gas, liquefied natural gas, and domestically produced ethanol and biodiesel) are, or will be, taxed at a rate based on the energy content of these fuels in comparison to petrol and diesel, and then discounted by 50 per cent.[205] This discount reflects the potential supplementary benefits provided by these fuels.

Fuel tax credits (FTCs) are provided to businesses that use fuel in their business for off-road activities (and partially for on-road activities where the vehicle exceeds 4.5 tonnes) to remove the incidence of fuel tax. FTCs give effect to the policy objective of ensuring that fuel tax on business inputs is minimised. This approach avoids distorting business investment decisions and behaviour that would occur by taxing business inputs. FTCs were worth $5.7 billion in 2013-14.[206] While the mining industry is the largest recipient of FTCs, other industries combined receive more than 60 per cent of the total value of FTCs. These other industries include transport, postal and warehousing; agriculture forestry and fishing; professional, scientific and technical services; construction; and manufacturing.[207]

9.3: Alcohol taxes

The taxation of alcohol is complex, with rates of taxation varying considerably for different types of alcoholic beverages. This reflects policy changes over time to meet multiple objectives — raising revenue, reducing the social costs of excessive alcohol consumption, and supporting wine producers and independent beer producers. Evidence suggests consumers are likely to change the amount of different types of alcohol they consume based on relative price changes of different alcoholic products.[208] Chart 9.2 shows the difference in the amount of taxation of different alcoholic products.

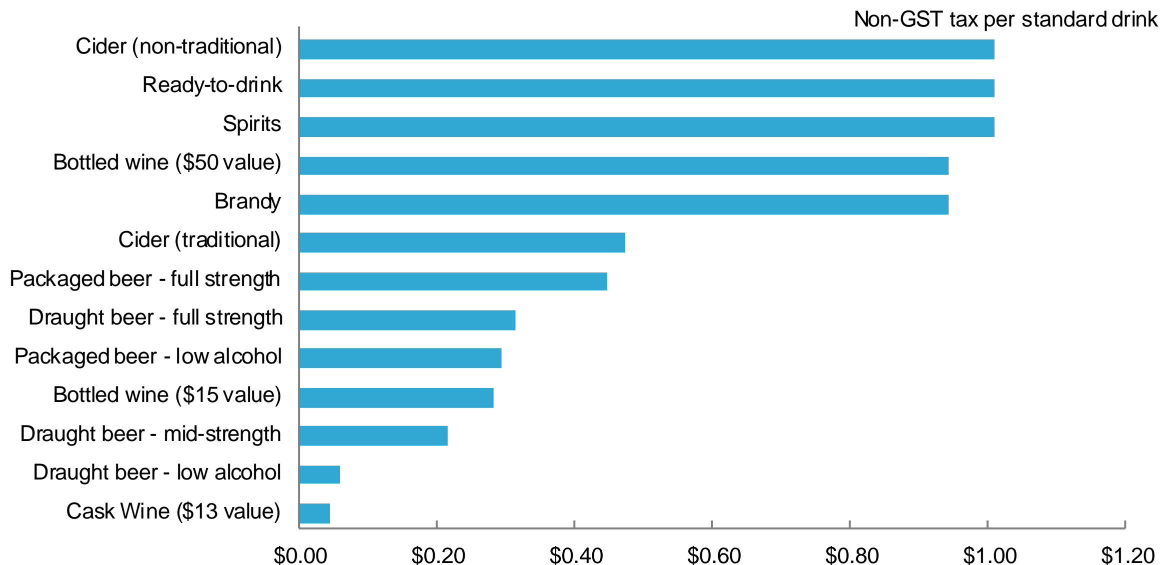
205 Imported ethanol and biodiesel will be taxed at 38.6 cents per litre, as noted in Australian Government 2014, *2014-15 Budget*, Australian Government, Canberra.

206 Australian Taxation Office (ATO) 2014, *Commissioner of Taxation Annual Report 2013-14*, ATO, Canberra.

207 Australian Taxation Office (ATO) 2014, *Excise and Fuel schemes: Fuel tax credits scheme — claims paid, by fine industry, 2006-07 to 2012-13 financial years*, Taxation Statistics 2011-12, ATO, Canberra.

208 Clark, J and Hollis, A 2013, ‘Tax-to-GDP: Past and Prospective Developments’, *Economic Roundup*, Issue 2, 2013, pages 29-30.

Chart 9.2 Alcohol tax paid per standard drink, August 2014



Source: Treasury estimates.

Most alcoholic beverages are subject to excise or excise-equivalent customs duty at one of 16 different excise categories depending on alcohol type, concentration, commercial use, and container size. Wine and some other alcohol products, such as traditional cider, are treated separately and subject to the Wine Equalisation Tax (WET). The WET was introduced as part of the GST tax reform package with the intent of equalising the amount of tax on wine, in particular cask wine, with that which existed under the wholesale sales tax system.[209] While alcohol excise is based on the alcohol content, WET is generally based on the wholesale price of the wine. WET applies at 29 per cent of the value of the wine at the last wholesale transaction, before adding GST. In some cases, it can be difficult to determine if a product is subject to excise or WET (see box 9.1 'Tax Treatment of Ginger Beer'). Differences in the rate of tax can also create incentives to engineer products to receive the more favourable tax treatment.

In 2013-14, excise and excise-equivalent customs duty on beer, spirits and other excisable beverages raised $5.1 billion in tax revenue. WET revenue amounted to $826 million in 2013-14, net of producer rebates, which are typically around 25 per cent of total WET.[210]

There are two tax concession schemes for producers of alcoholic beverages. The brewery refund scheme provides eligible independent breweries with a refund up to a maximum of $30,000 per financial year, while the WET producer rebate provides eligible wine producers with a rebate up to a maximum of $500,000 per financial year, regardless of whether they are independent or not. The significant variations in concessions, in conjunction with the favourable tax treatment afforded to specific types of alcohol, particularly low-value wine, can influence production and consumption decisions.

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209 Australian Government 1998, *Tax reform: Not a new tax, a new tax system*, Australian Government, Canberra.

210 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra; and ATO 2013, *Taxation Statistics 2011-12*, ATO, Canberra.

Box 9.1 Tax treatment of ginger beer

The tax treatment of ginger beer demonstrates the inconsistencies in the current tax arrangements for alcohol, with the tax treatment dependent on alcohol content.

For example, a ginger beer with 4.5 per cent alcohol by volume is taxed as a 'ready to drink' (RTD) at a rate of $1.01 per standard drink. The tax payable on a case of twelve 500ml bottles is $21.54 under the excise regime.

However, a ginger beer that is nearly identical except that it has 8 per cent or more alcohol by volume is, instead, taxed on its wholesale selling price because it is characterised as a fruit or vegetable wine and subject to the WET regime. At a wholesale price of $30, the tax payable on a case of twelve 500ml bottles is $8.70 under the WET regime. The producer may also be able to claim the wine producer rebate.

This shows the significantly lower rate of taxation that can apply to beverages subject to taxation under the WET regime, despite the beverage containing more alcohol.

Internationally, beer, wine and spirits are typically taxed at different rates. There is a range of approaches to alcohol taxation across the OECD countries. Within the European Union, countries tax wine on a per litre of product basis, and beer and spirits based on the percentage of alcohol. In the United States, wine and beer are taxed on a per litre of product basis, and spirits are taxed based on the proportion of absolute alcohol. In both Chile and Mexico, there is a consistent taxation approach of charging a percentage of the value of alcohol on all alcohol products.[211]

9.4: Tobacco tax

Taxes on tobacco are the second largest, in terms of revenue raised, of the indirect taxes (excluding GST) raised by the Australian Government. Tobacco taxes raised $8.5 billion in 2013-14.[212] Should rates of smoking continue to decline, this could result in tobacco taxes making up a smaller share of taxes over the long term.

Tobacco is subject to excise and excise-equivalent customs duty. Cigarettes and cigars with up to 0.8 grams of tobacco per stick are taxed on a per stick basis. As at March 2015, the per stick excise and excise-equivalent duty is $0.47008 or $11.75 on a pack of 25 cigarettes. All other tobacco products, such as snuff and rolling tobacco, are subject to an excise and excise-equivalent custom duty rate of $587.62 per kilogram. Rates are indexed twice a year in line with average weekly ordinary time earnings.

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211 OECD 2012, *Consumption Tax Trends 2012L VAT/GST and Excise Rates, Trends and Administration Issues*, OECD, Paris.

212 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra, page 5.

9.5: Luxury Car Tax

Like the WET, the Luxury Car Tax (LCT) was introduced as a part of the GST tax reform package. The LCT has a narrow tax base, is complex and is the Australian Government's only luxury tax on a specific good or service.

Before the introduction of the GST, items such as expensive cars, furs, jewellery and electronics were all subject to a higher rate of wholesale sales tax. Since 1979, luxury cars had been subject to a wholesale sales tax of 45 per cent. Following the introduction of the GST and the abolition of the wholesale sales tax regime, the LCT was introduced at a rate of 25 per cent of the GST-exclusive value of the car to maintain the higher rate of taxation. The aim of this tax was to ensure that the price of luxury cars did not fall dramatically.[213] The LCT applies to a range of vehicles including passenger cars, station wagons, four-wheel drives and limousines.

Currently, the LCT applies to cars sold in or imported into Australia, with some limited exemptions, where the value of a car exceeds a GST-inclusive threshold. The LCT is currently applied at a rate of 33 per cent to the GST-exclusive value of the car (including accessories) when it exceeds the LCT threshold. For the 2014-15 financial year, the threshold is $61,884 for regular cars and $75,375 for fuel efficient vehicles. The LCT raised $476 million in 2013-14.[214]

In the past, it has been noted that the LCT's thresholds may not be an accurate representation of luxury in the car market — for example, a seven-seater family vehicle and a small sports car may both attract similar amounts of LCT.

Changes to the LCT have increased the tax's complexity over time. For instance, the two thresholds are now indexed to different price indices; the thresholds are no longer aligned with the 'car (depreciation) limit'; some industries and vehicle types are eligible for exemptions; and the LCT's interaction with the GST has become more complex.

Some stakeholders have raised concerns that the LCT falls mainly on imported cars originating from a limited number of jurisdictions and is therefore a barrier to trade. However, the LCT applies to all cars purchased in Australia, regardless of where the car is manufactured and therefore does not discriminate against imports.

Whilst the LCT does not discriminate between domestic and foreign manufactured vehicles, the majority of LCT revenue is derived from imported vehicles. Industry estimates indicate that in 2014 around 94 per cent of vehicles subject to LCT were imported. This has increased from around 89 per cent in 2005.[215]

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213 Australian Government 1998, *Tax Reform: Not a New Tax, A New Tax System — the Howard Government's Plan for a New Tax System*, Australian Government, Canberra.

214 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

215 Federal Chamber of Automotive Industries 2014, *VFACTS Data*, Federal Chamber of Automotive Industries, Canberra.

9.6: Agricultural levies

The Australian Government collects agricultural levies under its taxation powers at the request of primary producer associations. The purpose of the levies is to provide a significant, reliable and ongoing source of pooled funds for research, development and marketing of particular agricultural commodities. Levies are considered minor taxes due to the narrow base on which they are applied (usually per unit of commodity), and the relatively small amount of revenue generated by each individual levy. According to the Department of Agriculture, there are 97 primary industry levies imposed on 73 agricultural commodities with 18 recipient bodies.[216]

Levies are imposed on individual producers of agricultural products. The Department of Agriculture collects the levy funds and passes them to the relevant Rural Research and Development Corporations and marketing bodies, as well as to Animal Health Australia, Plant Health Australia and the National Residue Survey, to fund activities that benefit levy-paying industries. The introduction of a new levy or a change in a levy requires support from a majority of the levy payers. Bodies that receive levies to conduct research, product development and marketing are accountable to levy payers and to the Government. Agricultural research and development corporations receive levy funds supplemented by Government matching up to a cap of 0.5 per cent of the industry's gross value of production.[217]

Primary industry levies may be justified in theory where they address an identified potential market failure. When used effectively, they can assist producers to pool their efforts and resources, enabling greater levels of investment in activities that may otherwise be undersupplied as, due to the free-rider problem,[218] producers do not have the same incentive to invest when acting individually as they do when acting collectively.

Government support in the form of matching funds for research and development is provided on the expectation that the combination of the anticipated benefits for an industry and any positive spillovers outweigh the total costs. Levies are not the complete solution to address under-investment in rural research and development as they are unlikely to facilitate investment in research where the benefits are spread thinly across a wide range of industries or mainly accrue to the wider community.

216 Information provided by the Department of Agriculture.

217 Productivity Commission 2011, *Rural Research and Development Corporations*, final inquiry report no. 52, Productivity Commission, Canberra.

218 In this context, the free-rider problem refers to a situation where some producers would be able to receive the benefits of investment by other producers without having to make any investment themselves.

9.7: Tariffs

Tariffs are taxes applied to goods imported into Australia. In 2013-14, revenue from 'other customs duty' was $3.0 billion.[219] Tariffs are usually imposed in order to protect domestic industries, rather than to raise revenue. In general, zero tariffs are expected to lead to higher living standards, regardless of tariffs imposed on Australian goods exported to other countries.

All import tariffs, except for those applying to textiles and motor vehicles and components, were progressively reduced from up to 19 per cent in 1988 to five per cent in 1996. Tariffs on motor vehicles and components were reduced from 45 per cent to five per cent between 1988 and 2010. For textiles, clothing and footwear, tariffs are being reduced from up to 89 per cent in 1988 to five per cent in 2015.[220]

As tariff revenue declines, the cost of collecting tariffs is increasing as a proportion of revenue raised. Tariffs raise costs for all businesses. The Productivity Commission estimates that, in 2012-13, Australia's tariff system imposed an aggregate cost on Australian businesses of $7.1 billion by increasing the price of imported inputs and allowing domestic businesses to charge higher prices than they otherwise could.[221] This cost is ultimately passed on to domestic consumers.

The general tariff rate in Australia is five per cent and, prior to the commencement of the Korea Free Trade Agreement and the Japan Economic Partnership Agreement, applied to around 53 per cent of imports by value.[222] A Tariff Concession Scheme provides exemptions on application for imports for which no locally made substitute exists. Other tariff concessions also exist. Most goods imported from countries with which Australia has a free trade agreement attract no tariff, with the exception of certain automotive, steel and textile goods where the agreements provide for phased elimination.

Determining the tariff payable on imported goods, establishing whether any exemptions apply or proving that the goods meet the requirements for being eligible under free trade agreements can impose a significant compliance burden on some importers, a cost that is also passed on to consumers. However, some level of compliance is necessary for government data collection and law enforcement purposes.

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219 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra, Table 4, page 9. Note: this figure does not include tariffs applied to imported fuel, tobacco or alcohol as Table 4 aggregates excise and tariff revenue for these items.

220 Centre for International Economics 2009, *Benefits of trade and trade liberalisation*, Centre for International Economics, Canberra. Note: historical tariff rates for textiles, clothing and footwear include the effect of import quotas; *Customs Tariff Act 1995*.

221 Productivity Commission 2014, *Trade & Assistance Review 2012-13, Annual Report Series*, Productivity Commission, Canberra.

222 Information supplied by the Department of Foreign Affairs and Trade.

9.8: Financial transaction taxes

As the name suggests, transaction taxes are imposed on prescribed transactions, and are generally determined as a proportion of the value of the transaction. Examples of transaction taxes in Australia include stamp duties on property and insurance taxes levied by state and territory governments (see chapter 8).

Financial transaction taxes (FTTs) impose a tax on transactions levied on a broad range of financial trading instruments, such as stocks, fixed income securities, derivatives and foreign exchange — the latter more popularly known as a Tobin tax.

The arguments against FTTs are similar to those against other stamp duties — taxes on FTTs add to the costs of buying and selling financial products and, as a result, can distort decisions about mutually beneficial transactions. Rather than being based on economic grounds, the revenue intake is a function of how often transactions take place, and those that frequently engage in transactions will be taxed more heavily even if they are in a similar position to other taxpayers. In addition, the Australia's Future Tax System Review (Henry Tax Review) concluded that FTTs can increase, rather than decrease, financial instability.[223] This is because hedging activity (that is, transactions to disperse risk) could be impeded, or market liquidity could be reduced, resulting in prices becoming more volatile.

9.9: 'Corrective' taxes

Some taxes are introduced not as a means to collect revenue, but as a way to change behaviour. These are called corrective taxes. They are sometimes used instead of, or in addition to, information provision, regulation or fiscal measures, as a way of encouraging behaviour deemed socially desirable.

Using economic terms, corrective taxes might be imposed when a particular activity by an individual generates negative externalities for other people. Corrective taxes add to the costs of the activity borne by the individual — they aim to 'internalise' the costs of the wider harm caused by their activity.

Corrective taxes are usually advocated as a response to environmental or social concerns. In Australia, tobacco, alcohol and some motor vehicle taxes (such as annual vehicle registration fees) have some features of corrective taxes. Other corrective taxes used around the world include taxes on sugary drinks (to reduce obesity) and taxes on driving in specific areas or times (to reduce congestion).

223 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra.

9.10: User charges

User charges can also be used instead of taxes to fund the provision of services. A user charge is not a tax. Instead, it is a fee for a good or service provided by government where the user receives a distinct benefit. To the extent that such charges are appropriate, they can lower the cost to society of providing services, give the community greater say over whether they wish to consume (and pay for) the services and more directly influence the standard of service provided. In this way, user charges can be a useful way to help balance supply and demand for publicly-provided services.

Cost-reflective road pricing (or user charging) has been supported as a means to promote efficient investment in road transport, improve congestion and reduce vehicle costs.[224] The Productivity Commission in its inquiry into Public Infrastructure recommended that the Australian Government actively encourage state and territory governments to undertake pilot studies of user charging for light vehicles.[225] The Government supported this recommendation in principle as a long-term reform option. However, it also noted that user charging for roads was a complex issue and that matters like equity, as well as technological and privacy implications, would also need to be considered.

Most recently, the Competition Policy Review Draft Report recommended governments introduce cost-reflective road pricing and work across jurisdictions to reduce indirect charges and taxes on road users, as direct pricing is introduced (Draft Recommendation 3).

Discussion questions:

54. To what extent does Australia have the appropriate mix of taxes on specific goods and services? What changes, if any, could improve this mix?
55. To what extent are the tax settings (i.e. the rates and bases and the administration) for each of these indirect taxes appropriate? What changes, if any, could be made to these indirect tax settings to make a better tax system to deliver taxes that are lower, simpler, fairer?

224 For example, see Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra, page 374

225 Productivity Commission, 2014, *Public Infrastructure*, Report no. 71, Canberra.

10: Complexity and administration

Overview

This chapter considers the sources of tax system complexity, the costs it creates and different methods through which it can be alleviated.

Key points

- The complexity of the Australian tax system reduces integrity and transparency, and imposes unnecessary compliance costs on taxpayers, as well as other costs on the Australian economy.
- The complexity largely reflects the historical foundations of the tax system and the way changes to the system have been implemented in the past. This makes it difficult to address without broad community support.
- Tax administration will play an increasingly important role in minimising the impact of tax system complexity by making it easier for members of the community to comply with their obligations.
- Establishing a metric to measure tax complexity could assist in managing the complexity of the tax system.

Australia's tax system has become increasingly complex over time. Previous government reviews, tax professionals and other stakeholders have expressed frustration and concern about its sustainability. Complexity also creates costs for the community as a whole. When excessive, these costs detract from the wellbeing of Australians. These costs include compliance costs for taxpayers, revenue impacts from forgone revenue and other unintended outcomes, distortion of commercial decisions, increased administration costs, and decreased confidence in the fairness of the tax system.

Tax systems, at their core, are a series of rules and procedures designed to produce revenue to fund government programmes. The Australian tax law has grown incrementally over time, delivering new policies and responding to integrity problems and other unintended outcomes.

Each addition to the law has involved trade-offs, such as those between the benefits sought and the competing interests of different groups of taxpayers. It is not clear, however, that the costs imposed by complexity have been given appropriate weight in balancing those trade-offs.

Growing tax system complexity is a problem facing most modern economies. While there appears to be a broad consensus that the Australian tax system is overly complex, addressing the problem requires common ground to be found on what strategies will be most effective in simplifying the system. There is compelling evidence that simplifying the system would provide significant benefits to both the economy and the taxpayer experience.

The Government's deregulation agenda seeks to directly address costs of compliance by reducing the volume of regulation with which individuals and entities must comply. This process can also include simplifying particularly complicated areas of law, including tax law. The Government's deregulation agenda takes a three-pronged approach to addressing the regulatory burden:

- using an enhanced regulation impact statement process to provide quality assurance for the flow of new regulation;
- systematically reviewing the stock of existing regulations in the context of a net annual red tape reduction target of $1 billion per annum; and
- establishing a new framework for assessing regulator performance to ensure that regulators minimise the burden they create when administering legislation.

10.1: What is meant by complexity?

Taxpayers are likely to have differing perceptions of complexity depending on the impact it has on their compliance costs, other regulatory impacts, or tax outcomes. Perhaps unsurprisingly, people are more likely to tolerate the burden of complexity if it delivers a more beneficial outcome for them.

A useful way of discussing tax system complexity is by way of 'complexity indicators', such as:

- the number of treatments, choices and exceptions a particular taxpayer needs to navigate to work out their tax liability;
- the length and comprehensibility of the tax law and supporting material;
- the number of changes to the law or interpretation products;[226]
- the amount of information a taxpayer needs, or the difficulty of the processes required, to comply with the law or a request from the Australian Taxation Office (ATO); and
- the prevalence, or perceived likelihood, of tax disputes.

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226 There has been an average of 77 tax measures introduced into Parliament each financial year since 2002-03.

The aspects of complexity reflected in these indicators cannot be considered in isolation. Each aspect interacts with and increases complexity in the others. For example, the number of treatments, choices or exceptions in the law will impact on the amount of administrative guidance the ATO needs to provide, the amount of information a taxpayer needs to inform their choices and meet their reporting obligations, and the prevalence of tax disputes.

In addition, frequent changes to the tax system contribute significantly to its complexity. In particular, taxpayers experience considerable uncertainty when announcements of proposed changes to the law are made but remain unenacted. When the Government came to office in September 2013, there were 96 outstanding announcements of an intention to change the law. These were addressed in the Government's announcement 'Restoring integrity in the Australian tax system' (November 2013).[227]

While these indicators are useful, they provide little guidance on the causes and drivers of complexity. Some of these causes and drivers are discussed later in this chapter.

10.2: Impact of complexity

While a certain degree of complexity is inevitable in a dynamic, sophisticated and inter-connected economy, an overly complex tax system can have adverse consequences for the Australian economy.

Complexity can divert resources away from more welfare-enhancing activities. It makes it more difficult for taxpayers to identify their tax obligations, and to incorporate tax consequences into their decision-making, without significant professional advice. While some professional advice is likely to be necessary to manage the innate complexity of the tax system (especially for business taxpayers), the extent of tax advice currently relied upon suggests the system is overly complex. Time and resources spent by taxpayers or their agents on their tax affairs is time not spent innovating, creating products, delivering services, generating wealth or enjoying leisure.[228]

The time and resources spent on managing tax affairs rose significantly from 1998-99 to 2009-10. This could reflect the increasing complexity associated with the accumulation of changes that have been made to the tax system over time (Chart 10.1). The cost of managing tax affairs for individual tax filers appears to have levelled off since 2009-10. This could reflect the impact that technology is having on the taxpayer experience. While the underlying complexity of the system may have continued to build in this time, ATO use of electronic tools (such as pre-filled tax returns) has improved the taxpayer experience.

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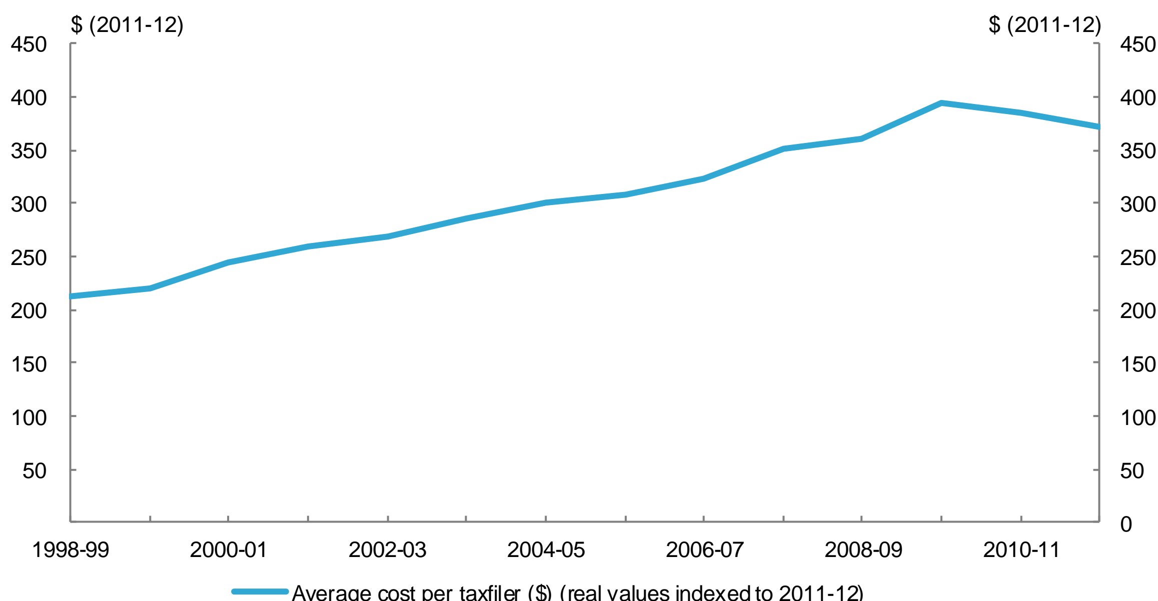
227 Treasurer the Hon Joe Hockey MP, Media Release, 6 November 2013, *Restoring integrity in the Australian tax system*, viewed 9 December 2014: http://jbh.ministers.treasury.gov.au/media-release/017-2013/.

228 In 2011-12, companies with turnover of less than $1 million spent 224,849 hours on preparing income tax returns. Micro, small and medium businesses also spent 87,741 hours preparing fringe benefits tax forms and 5,464,245 hours preparing Business Activity Statements as shown in Australian Taxation Office 2014, *Taxation Statistics 2011-12*, Australian Taxation Office, Canberra.

Chart 10.1 Average real cost of managing tax affairs for Australian tax filers (individuals)



Source: Australian Taxation Office 2014, *Taxation Statistics 2011-12*, Australian Taxation Office, Canberra.
Note: This data is sourced from taxpayers claiming a deduction for managing their tax affairs. The average cost for all taxpayers may be different.

By its nature, the tax system creates economic incentives for taxpayers to engage in particular behaviours or refrain from others. Where this is a deliberate policy choice, the resulting change in behaviour can be consistent with the policy objective. However, behavioural changes sought through the tax system often involve fine distinctions to ensure proper targeting. These distinctions often interact with other parts of the tax law and can lead to unintended consequences where the policy objective is not delivered. This, in turn, means integrity rules have to be introduced to safeguard the resulting boundaries.

As the system becomes more complex, interactions between different parts of the tax law can create unintended incentives or disincentives that may be inconsistent with good policy outcomes. Confronted with this complexity and the opportunities it creates, taxpayers who can afford it are more likely to seek expert assistance to manage their tax affairs.

The complexity of the tax system also makes it less transparent. It can conceal special treatments that result in taxpayers in similar circumstances receiving very different tax outcomes, and can mask effective tax rates. This can adversely affect voluntary compliance. Researchers have consistently found that perceived unfairness in the tax system reduces taxpayers' willingness to comply.[229]

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229 Ayres, I and Braithwaite, J 1992, *Responsive Regulation: Transcending the Deregulation Debate*, Oxford; Braithwaite, J 2011, 'The Essence of Responsive Regulation', *University of British Columbia Law Review*, vol. 44 issue 3; Braithwaite, J 2005, *Markets in Vice, Markets in Virtue*, Oxford; Braithwaite, V 2003, *Taxing Democracy: Understanding Tax Avoidance and Evasion*, Ashgate Publishing Ltd, Aldershot: http://vab.anu.edu.au/pubs/1/taxingdemocracy.pdf; Ashgate; and Freedman, J, 'Responsive regulation, risks and rules — applying the theory to tax practice', *University of British Columbia Law Review*, vol. 44 issue 3.

Finally, a more complex tax system is more expensive to administer, and thereby increases the resources required by the ATO. For example, complexity in the tax law is more likely to give rise to protracted disputes. This reflects the difficulty taxpayers, tax professionals, the ATO and the courts face in working out how the law is meant to apply in particular situations.

Discussion questions:

56. What parts of Australia's tax system, and which groups of taxpayers, are most affected by complexity? What are the main causes of complexity?

Measuring complexity

While there is general agreement that complexity can have significant impacts on the Australian economy, there is not agreement on an approach to measure it. One common measure is the compliance burden — that is, the time spent engaging with the tax system (including completing a tax return, maintaining records or substantiating eligibility for tax treatments).

Compliance burden

The Commonwealth Government is committed to reducing the regulatory compliance burden for Australian businesses and individuals. Australia's tax system is a major contributor to the regulatory burden faced by businesses and the wider economy, with the ATO estimating that compliance with the tax system costs Australian taxpayers in the vicinity of $40 billion annually.[230] For individuals, the cost of managing tax affairs can be significant (see Chart 10.1 above), and 72.4 per cent of Australian tax filers lodged their tax return through a tax agent in 2011-12.[231] However, the compliance burden is only one measure of complexity of the tax system.

Developing a metric to measure complexity

Developing a broader metric for measuring the complexity of Australia's tax law could help identify the areas of the tax law most in need of simplification, and the areas where reform could have the greatest impact. While quantifying the compliance burden would be an important element of such a metric, other aspects or indicators could be incorporated into an index to provide a more holistic assessment of the complexity of the system.

Such a metric would provide a measurable way to compare different areas of the tax law. It may also provide an opportunity to measure relative complexity over time, which would show whether areas of the tax law, or the tax law as a whole, are becoming more complex. This would provide a way to assess regularly how the degree of complexity in the tax system is

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230 ATO analysis of commissioned Newspoll survey data relating to the 2011-12 tax year, to be presented at an upcoming conference in 2015.

231 Australian Taxation Office 2014, *Taxation Statistics 2011-12*, Australian Taxation Office, Canberra. Table 1: Individuals Tax, as at 30 September 2014.

changing. The idea of developing a tax complexity metric is receiving increased attention from governments and academics. For example, the United Kingdom Office of Tax Simplification is currently developing a 'Tax Complexity Index', and Australian academics have published papers and research on the measurement of complexity. Possible examples of approaches to develop a metric are considered in Attachment A.

There is no single, easily measurable factor that directly correlates with the overall complexity of the tax law. Factors are most useful if they are easily measured while still providing a meaningful indicator of complexity. Further, a metric would need to be intuitive and easy to use.

It is important to recognise that developing a metric will not, of itself, be enough to tackle complexity. Best practice strategies would be needed to properly manage complexity in the tax system, while a metric would inform where those strategies are best engaged.

Discussion questions:

57. Would there be benefit in developing an Australian metric for tax complexity? What factors should be included? How should they be combined into a metric?

Drivers of complexity

Complexity is rarely introduced intentionally and there are a number of factors that contribute to its continuing growth. Tax reviews, academics and other key stakeholders in the tax system have been examining and attempting to articulate the underlying causes for many decades.[232] What is clear is that there are many drivers of increasing complexity that do not operate in isolation. Rather, each tends to feed into and exacerbate the others.

At a general level, complexity may be sourced or found in the setting of tax policy and amendment to the tax law to reflect those policy settings, and compliance with and administration of the tax law.[233] Complexity is particularly intractable when it is a result of underlying policy settings or of how these settings are translated into law. This complexity may also be found in law that is difficult to understand or navigate, and in elaborate compliance and administrative requirements. On the other hand, complexity that results from administrative practices may be relatively straightforward to address, where the ATO is able

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232 Parsons, R 1991, 'Income Taxation: An Institution in Decay', *Sydney Law Review*, vol. 13, page 435; Krever, R 2003, 'Taming Complexity in Australian Income Tax', *Sydney Law Review*, vol. 25, no. 4; Review of Business Taxation 1998, *Review of Business Taxation — A Strong Foundation: Discussion Paper Establishing objective, principles and processes*, Canberra, viewed 10 December 2014: www.rbt.treasury.gov.au/publications/paper1/html/Prelim.htm; and; High Court Chief Justice French 2013, *Law — Complexity and Moral Clarity*, speech delivered to North West Law Association and Murray Mallee Community Legal Service viewed on 10 December 2014: www.hcourt.gov.au/assets/publications/speeches/current-justices/frenchcj/frenchcj19may13.pdf.

233 See further Ralph Review of Business Taxation 1998, *Review of Business Taxation — A Strong Foundation: Discussion Paper Establishing objective, principles and processes*, Review of Business Taxation, Canberra, viewed 10 December 2014: www.rbt.treasury.gov.au/publications/paper1/html/Prelim.htm.

to adjust its administrative requirements without any need for the Government to change policy settings or the law.

More specifically, historical and continuing causes of these kinds of complexity include:

- artificial boundaries and distinctions that do not reflect commercial or economic differences;
- 'patching' the law to fix particular outcomes (especially by adding specific integrity measures);
- attempts to provide certainty for particular groups of taxpayers or transactions;
- attempts to minimise compliance costs or adverse outcomes of reform for existing situations; and
- complex drafting styles.

Artificial boundaries and distinctions

Australia's tax system, particularly its income tax system, is based on an architecture that reflects the economy and environment prevailing at the time the system was introduced, including the transactions common at that time. Changes to the system have been built on these historical foundations and have tried to make this architecture fit new and innovative ways of doing business. For example, rather than a general income tax that captures all realised gains and then carves out intended exceptions and concessions, Australia's income tax law is based on a narrower concept of income. This was construed by the courts as embracing the Court of Chancery trust law understanding of 'income of a trust', to which income beneficiaries are entitled, and distinguished from the 'capital of a trust', to which any 'remainderman' is entitled. The persistence of distinctions like this, as well as the additional complexity it generates, illustrates the difficulty of a system designed for previous generations but operating in a modern context.

This narrow historical foundation has also seen a significant number of extensions made to the law over the years to ensure the overall integrity of the income tax base. These extensions are often accompanied by concessions and exceptions that seek to ensure that these extensions do not inappropriately apply to particular taxpayers or circumstances. This framework of constantly introducing integrity measures to protect the base creates an ever increasing number of artificial boundaries within the tax system. These boundaries and the way they interact with each other and other areas of the tax law can create unforeseen or unintended outcomes that may be exploited by taxpayers. If these outcomes are inconsistent with broader tax policy and the objectives of the system, it can create a need for further integrity measures that further exacerbate the problem. The ultimate outcome viewed over time is a cycle of changes in a perpetual attempt to achieve the appropriate policy scope for the particular extension in question.

There is also a link between the frequency of rule changes and taxpayer attitudes. The more taxpayers want certainty about particular provisions, and especially the more taxpayers seek to exploit weaknesses in the law to minimise tax, the more pressure there is for legislative change. Accordingly, the broader 'compliance culture' is an important factor in the design and administration of the system.

Box 10.1: General anti-avoidance rules

The spread of integrity rules and specific anti-avoidance provisions at different points of the system's evolution (for example, during the 1970s and 1980s in the income tax system) prompted the development or refinement of general anti-avoidance rules (GAARs). GAARs are intended to provide an ongoing solution to arrangements that have the dominant purpose of avoiding tax, particularly where these arrangements are entered into in an artificial or contrived manner. Nevertheless, GAARs present their own complexity trade-offs.

More specifically, GAARs are an example of the challenge of seeking to find an appropriate balance between maintaining a robust system and providing certainty in tax treatment. As they are designed to operate, GAARs can apply to any transaction or structure where there is a predominant purpose of avoiding tax. In doing so, they can eliminate or reduce the need to legislate against specific schemes.

However, these provisions can also reduce certainty, particularly when they are first developed or modified, as taxpayers may be uncertain whether the provisions will apply to their specific circumstances. To obtain certainty a taxpayer may need to seek advice and apply for a ruling from the ATO that may delay a business transaction and increase costs, and may ultimately have the scope of GAARs tested through the courts.

Once the operation of all of these additions is considered across the entire system, a range of different regimes and rules can be identified, which are often essentially trying to do the same or a similar thing, or are dealing with the same or a similar transaction. Such an overgrown myriad of regimes and rules produces overlaps that are difficult to reconcile or resolve, as well as gaps that create uncertain or unfair outcomes.

'Patching' the law to fix particular outcomes

The common systemic response to fixing particular outcomes has been to 'patch' gaps or problems in the law. Such amendments are introduced frequently in response to particular unwanted or anomalous outcomes, for example, to close a loophole or to ensure a concession applies as intended. These types of amendments tend to be driven by a need to 'fix' the outcomes for particular situations identified by ATO audits or by taxpayers seeking the benefit of a concession that applies to others in similar circumstances. However, these amendments only address symptoms. The underlying systemic cause of the problem remains, meaning that further adjustments may be required for situations not covered by the amendments. 'Patching' responses are also a major cause of backlogs of announced but un-enacted legislative measures, such as the one the Government addressed in its announcement 'Restoring integrity in the Australian tax system' November 2013.[234]

Without a change in approach, amendments to patch the law to fix particular outcomes will continue to generate extra complexity while masking the need for structural repairs.

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234 Treasurer the Hon Joe Hockey MP, Media Release, 6 November 2013, *Restoring integrity in the Australian tax system*, viewed 9 December 2014: http://jbh.ministers.treasury.gov.au/media-release/017-2013/.

Attempting to provide certainty for particular groups of taxpayers or transactions

Complexity in the tax law can also be exacerbated by pursuit of certainty at the margin of a particular tax obligation or the intended operation of a particular tax benefit. While the core operation of tax rules is generally clear, there can never be certainty for every possible taxpayer circumstance. Attempts are often made in the law to specifically articulate that particular taxpayers or transactions are included or excluded from the operation of a regime. These attempts to seek a guaranteed outcome for particular transactions historically reflect risk aversion on the part of policy advisers, administrators and other stakeholders in the system.

Certainty makes tax outcomes easier to anticipate, plan for and administer, while also reducing the disputes arising from differing interpretations. 'Black letter' rules are often proposed to achieve regulatory certainty by providing specific rules that apply clearly to particular situations. However, while black letter rules can make the law certain for regulating simple and stable situations, they are not suitable as the basis for regulating complex, dynamic systems and can obscure any underlying policy principles in the law.[235] Uncertainty will inevitably arise when a new situation is not covered by specific rules. Parliament can never foresee all possible ways a commercial outcome might be achieved, particularly in the contemporary global economy, where business structures, investments and financial products are constantly evolving.

Rules providing certainty for some taxpayers may also generate uncertainty for others not specifically covered.

Tax reviews and academics have recommended principles-based design as best practice. This means developing laws in a way that clearly articulates the intended policy outcome in operating principles.[236] Nevertheless, there are trade-offs between broadly applying principles that are more likely to be robust over time and the desire for certainty in known situations. When broad principles are used, certainty in specific circumstances is delivered through the administration or interpretation of the law, rather than in explicit rules or amendments to tax legislation.

Use of concessions

The use of concessions, or specific treatments for particular groups of taxpayers, is another driver of complexity in the Australian tax system. Although tax reform can benefit Australia as a whole, there are often adverse impacts for individual taxpayers, such as losing a

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235 Braithwaite. J 2003, 'Making tax law more certain: A theory', *Australian Business Law Journal*, vol. 31, pages 2-80; and Freedman, J 2010, 'Improving (Not Perfecting) Tax Legislation: Rules and Principles Revisited' *British Tax Review*, vol. 717.

236 See for example: Review of Business Taxation 1999 *Review of Business Taxation — a Tax System Redesigned*, Canberra, viewed 12 December 2014: www.rbt.treasury.gov.au/publications/paper4/index.htm; Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra; Avery-Jones, J, 1997 'Tax Law: Rules or Principles?' (1997) *Fiscal Studies*, Vol 17, page 63; Braithwaite J 2003, 'Making tax law more certain: a theory' *Australian Business Law Journal*, vol 31, page 2; Krever R 2003 'Taming Complexity in Australian Income Tax', *Sydney Law Review* vol 25, no 4; and Freedman J 2010, 'Improving (Not Perfecting) Tax Legislation: Rules and Principles Revisited' *British Tax Review,* vol 717.

concession or incurring additional compliance costs. Parliaments often try to minimise these costs to groups of taxpayers by including concessions and exemptions from all or part of the reform. These concessions are often provided in response to lobbying by particular industry groups. While the benefits of such concessions could be seen as promoting equity or fairness in the tax law, they also need to be balanced with the cost of complexity to the tax system as a whole. In addition, significant compliance costs may be incurred by taxpayers devoting resources to understanding how the rules apply to them.

One common example of this is concessional 'grandfathering', which is a way of sheltering the tax treatment of particular segments of taxpayers when a new regime is introduced by creating an artificial boundary in time. 'Grandfathering' can support investment activities because it provides certainty for arrangements that had already been entered into at the time the new regime was introduced. However, grandfathering also means that there is an enduring need to recognise and administer regimes that would otherwise have been replaced by new, potentially more efficient approaches. Grandfathering also creates new boundaries in the system, because transactions are taxed based on when an event occurred, rather than because they are economically different.

Sometimes Parliament tries to reduce compliance costs or impacts for taxpayers of changes to the tax law by offering choices of tax treatment. For example, taxpayers may be offered a choice of two or more methodologies in calculating an income or deduction amount. The choice does not necessarily alleviate compliance costs for taxpayers and may actually increase them if taxpayers closely assess the relative merits of each of the options.

Preparation of legislation and complex drafting style

As with all regulatory systems, legislation generally follows the Government's announcement to implement a particular policy. The period between the announcement of a policy and the introduction of legislation can be significant, and can cause uncertainty for affected taxpayers. Circumstances where a policy is ultimately not enacted can create even more uncertainty and complexity.

The way policy is translated into law can be another cause of complexity. The Tax Law Improvement Project is one example of an attempt to rewrite the tax law with a better structure and make it easier to understand.[237] For a number of reasons, this process has not been completed, so the income tax law is now spread over two income tax assessment acts — one dated 1936, the other 1997. The aim of the project was not to review the policy behind the law but to concentrate on improving the expression and structure of the existing law.

While useful in addressing a particular aspect of complexity, the overall value of simplifying the drafting of legislation without any change in underlying outcomes is questionable. Simplifying language can only do so much if the underlying policy remains highly complex. In many cases, it will simply make the complexity of the policy more apparent and, in practice, only benefits the very small section of society using the tax legislation itself or related guidance material.

237 Tax Law Improvement Project 1995, *Building the New Tax Law*, information paper number 2 April 1995, Australian Government, Canberra.

Discussion questions:

58. What system-wide approaches could have the greatest impact on reducing complexity in the tax system? Why have previous attempts to address complexity in the Australian tax system not succeeded? How might it be done in a way that is more successful?

10.3: The Australian Taxation Office's role in administering a complex system

Almost all Australians interact with the tax system at some point in their lives, with most individuals having at least an annual obligation to lodge an income tax return. Businesses generally have more frequent and expensive interactions with the tax system. Complexity makes it more difficult for the ATO to design administrative systems, communicate obligations and resolve disputes which in turn increases administration costs.

The ATO has an important role in minimising complexity for taxpayers and in improving the efficiency of tax system administration. While a clear and simple articulation of the policy objective in formulating policy can make it easier for the ATO to communicate the tax system to taxpayers, there are other options to improve the administrative experience for taxpayers that would also help. The ATO can assist in this respect by designing administrative solutions that make it easy for taxpayers to fulfil their obligations, harnessing information to reduce and simplify interactions with taxpayers and working together to understand compliance obligations and devise solutions. While tax administration cannot eliminate the impact of complexity, it can certainly help reduce it.

The ATO has embarked on a long-term *Reinventing the ATO* programme, which is aimed at making it easier for taxpayers to understand their tax entitlements and obligations and comply with the law, and harder for taxpayers not to meet their obligations. The programme combines contemporary technology and digital information to simplify tax compliance and reduce complexity by way of services that are tailored to the taxpayer's circumstances. The focus will shift toward early intervention to help taxpayers get the right outcomes, as well as more effective and timely engagement with taxpayers, supported by changes in the ATO's internal culture and operations.

Advances in information technology, and the storage of digital information and digital interfaces, provide many opportunities for streamlined digital or online tax system administration that could mitigate the impact of tax system complexity. Since 1990, the ATO has offered its Electronic Lodgement Service to tax agents, and e-tax has been available to individual taxpayers since 1999. Pre-filling electronic tax returns has been occurring since 2004-05, with most taxpayers who lodge electronically using the prefilling service either

through etax, myTax or through tax agents. Last year, over 10.5 million taxpayers used pre-filled information.[238]

In 2014, myTax was offered for individual taxpayers with relatively simple tax affairs. MyTax offers a simple online interface through which taxpayers can access and lodge tax returns already pre-filled by the ATO. This is expected to save approximately $156 million in compliance costs each year.[239]

Similarly, the ATO has embraced digital information solutions for small businesses through its Small Business Assist initiative. Standard Business Reporting (SBR) also offers further potential benefits in terms of reducing compliance and administration costs.

The ATO continues to seek opportunities for technology to improve the experience of taxpayers when interacting with the tax system. There may be specific opportunities to leverage off the experience of other 'natural systems', whereby businesses or individuals are engaging in and recording transactions for purposes unrelated to taxation. If separate tax reporting obligations can be dispensed with as part of those natural business processes, compliance costs for taxpayers could be significantly reduced. Further benefits, in terms of faster, more convenient and more reliable service for taxpayers, alongside lower long-term compliance and administration costs, could be realised for taxpayers by embracing digital and online engagement where possible.

The impact of complexity in the tax system, as well as in other areas of government administration, could also be minimised for the community by better integrating administration across government. Better integration, in turn, could reduce reporting obligations and the number of interactions members of the community need to have with government. In recent years, there has been an expanded, whole-of-government approach to administration with measures such as myGov, which provides a single digital entry point for interaction with the government. Ensuring privacy of information continues to be an important consideration of such measures.

This type of integration could also be considered in the context of the administration of taxes across the federation. Most Australian taxes are administered by the jurisdiction that receives the taxation revenue, with the key exception of the GST. This may lead to a duplication of some administrative arrangements and greater complexity and compliance costs for taxpayers who engage with multiple revenue agencies. Tax administration and compliance costs could potentially be reduced by centralising the administration of some taxes or through a single government entry point. However, any changes in this area would need to be carefully examined to ensure state and territory governments have appropriate flexibility and control. There may also be some taxes that are best administered by state and local agencies (the GST and state taxes are discussed in chapter 8).

238 ATO internal data.

239 Australian Government 2014, *Spring Repeal Day October 2014*, Australian Government, Canberra, viewed 10 December 2014: www.cuttingredtape.gov.au/sites/default/files/documents/2014_spring_repeal_day_overview.pdf.

Discussion questions:

59. In what ways can reforms of tax administration best assist in reducing the impact of complexity on taxpayers? Are there examples from other countries of tax administration reform to reduce the impact of complexity that Australia should adopt?
60. What processes or systems currently being used by businesses and individuals could the ATO better utilise to lower the compliance costs of the tax system?
61. Could administrative responses — such as embracing technology, harnessing data and taking the whole-of-government approach to administration — help address the issue of tax system complexity?
62. Would there be benefits in integrating the administration of taxes across the Federation? If so, what would be required to realise these benefits?

11: Tax system governance

Overview

This chapter considers the governance arrangements Australia has in place to support the sound design, maintenance and administration of the tax system.

Key points

- Governance institutions and arrangements apply across the tax system, including at the policy design, legislative, administrative and appeals stages.
- In Australia, decisions on tax policy are made by the Government and the Parliament, with formal policy advice provided by the Treasury, in consultation with the ATO. Further advice is provided by many different groups, including tax practitioners, industry groups, think tanks, members of the public and the media.
- A range of possible reforms to tax system governance could be considered to increase certainty, improve consultation processes and enhance public understanding of tax policy and administration.

11.1: Why is tax system governance important?

Governance is important because it promotes sound decisions regarding the design, maintenance and administration of the tax system. Examining governance arrangements will clarify how decisions are currently made and how they could be made better.

Tax system governance encompasses the institutions that design, implement and govern the administration of the system, including parliamentary and executive bodies. It has important implications for the way the tax system evolves and how changes are announced and implemented. This chapter examines tax system governance at the federal level of government in Australia.

11.2: How is tax policy made in Australia?

Given the coercive nature of the taxation power of governments, making tax policy in Australia is closely tied to democratic processes. Unlike monetary policy, there is no entity independent of the Government and the Parliament that makes key decisions on tax policy. Instead, decisions are made by the Government and the Parliament.

While tax policy in Australia is proposed by government ministers and is enacted by the Parliament of the day in the form of Australia's tax and superannuation laws, and the ATO administers those laws, tax policy ideas are increasingly advocated and debated by the broader community. Policy positions are advanced by, among others, tax practitioners, industry groups, electoral parties, parliamentary inquiries, academics, think tanks, lobby groups, tax representatives, the OECD, the IMF and the media. Reviews of the tax system (for example, the reviews led by Asprey, Ralph and Henry)[240] also play an important role in advancing policy ideas.

It is the Treasury's role to formulate and provide advice to the Treasurer and other portfolio ministers on tax policy. This includes the production of regulation impact statements (RIS) and official costings, which together with the overall revenue forecasts, underpin government budgets. All of these activities are undertaken in close conjunction with the ATO, the statutory authority responsible for the administration of Australia's tax and superannuation laws and the Australian Government's principal revenue collection agency.

Following government endorsement, tax policy changes require parliamentary approval to become law.

Is uncertainty in tax policy a problem?

A range of business groups have expressed concern about uncertainty in tax policy and the negative impact this has on business sentiment.[241] They draw attention to the rapid pace of change in tax policy and argue there are too many retrospective tax laws and too many announced tax policy decisions, not yet enacted by Parliament.[242]

Uncertainty may also partly stem from efforts by taxpayers to test the full extent of the tax law. In these circumstances, the courts have the role of interpreting the law to determine disputes between the Commissioner of Taxation and taxpayers, and the outcomes may not accord with the expectations of the parties.

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240 Asprey, K (Chairman), Lloyd, J, Parsons, R and Wood, K 1975, *Taxation Review Committee — Full Report (The Asprey Review),* AGPS, Canberra; Australian Government 1999, *Review of Business Taxation, A Tax System Redesigned (The Ralph Review),* Australian Government, Canberra; and Australian Government 2010, *Australia's Future Taxation System Review, (Henry Tax review),* Australian Government, Canberra.

241 Nasser, J (Chairman BHP Billiton) 2012, '*Australia — The Global Context'* Address to Australian Institute of Company Directors, 16 May 2012, Sydney.

242 Chartered Accountants Australia and New Zealand 2012, Retrospective tax legislation, viewed 9 December 2014: www.charteredaccountants.com.au/News-Media/Charter/Charter-articles/Reporting/2012-03-Retrospective-Tax-Legislation.aspx.

Is a lack of transparency and consultation a problem?

A related argument posits that limited transparency and consultation in the development of Australian tax policy results in poorer quality policy.

Concerns about uncertainty and insufficient transparency and consultation are neither entirely new nor confined to Australia (see Decision making processes in New Zealand and the United Kingdom in section 11.3).

In Australia, successive governments have sought to improve consultation arrangements. Since the early 2000s, there has been a significant increase in stakeholder consultation on tax issues. The vast bulk of this consultation occurs on specific policies after announcement, although regular general consultations are also undertaken. In addition, while tax policy decisions are classified until the Government makes a formal announcement, for example on Budget night, targeted and confidential consultations with stakeholders are undertaken on more complex proposals before a final decision is made so that the proposed policy meets its objectives. These consultation processes remain confidential following the budget process.[243]

Australian Government departments are also required to provide information in public RIS on how recommended regulatory changes, including taxation changes, will be implemented, monitored and reviewed. In addition, post-implementation reviews, initiated within one to two years of implementation, are required for all regulations that have a major economic impact or that initially proceeded without a compliant RIS. In addition, tax review bodies (for example, the Board of Taxation) add to the transparency of decision making by conducting specific post-implementation reviews as well as reviewing the activities of the ATO.

Discussion questions:

63. What changes could be made to provide greater certainty, transparency and accountability to tax policy development in Australia?

What are the tax review bodies in Australia?

Successive governments have introduced tax review institutions and practices aimed at improving the quality of tax policy. For example, the Board of Taxation was established in 2000 following the Ralph review to facilitate greater involvement of the private sector and the broader community in tax policy development. Table 11.1 lists the tax review bodies in Australia.

243 Heferen, R, Mitchell, N and Amalo, I 2013, 'Tax Policy Formulation in Australia', *Canadian Tax Journal*, vol. 61, issue 4, pages 1011-29.

Table 11.1 Federal tax review bodies in Australia

	Type	Purpose
Board of Taxation www.taxboard.gov.au Established in 2000.	Non-statutory advisory body	The Board advises the Treasurer on improving the general integrity and function of the taxation system. It provides business and broader community perspectives.
Inspector-General of Taxation www.igt.gov.au/ Established in 2003.	Independent statutory agency	Identifies systemic issues in tax administration and reports to the Government with recommendations for improving tax administration. Will also handle tax complaints. Does not review tax policy.
Australian National Audit Office www.anao.gov.au Office of the Auditor-General established in 1901. The ANAO's audit independence and mandate were strengthened in 1997.	Independent statutory agency	Undertakes financial statement audits and performance audits examining the efficiency and administrative effectiveness of the ATO's administration of the tax system.
Parliamentary		
Parliamentary Budget Office www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Budget_Office Established in 2011.	Parliamentary department	Informs the Parliament by providing independent and non-partisan analysis of the budget cycle, fiscal policy and the financial implications of proposals.
Senate Standing Committee on Economics www.aph.gov.au/senate_economics	Committee of the Parliament of Australia	Investigate specific matters of policy, government administration and performance.
House of Representatives Tax and Revenue Committee www.aph.gov.au/Parliamentary_Business/Committees/House/Tax_and_Revenue Established in 2013.	Standing Committee of the Parliament of Australia	May enquire into and report on any matter referred to it by either the House or a Minister. The Committee regularly hears public evidence from the Tax Commissioner on issues in the tax system and the ATO's performance.

Are current tax review arrangements effective?

In Australia, there are some concerns that tax review arrangements are not as effective as they could be. In particular, concerns have been raised about overlapping governance arrangements and scrutiny of administrative decisions.

Both the Australia's Future Tax System (Henry) review and the Commission of Audit[244] identified overlaps between tax review bodies. In particular, both reviews highlighted overlap between the functions of the Taxation Ombudsman and the Inspector-General of Taxation. In the 2014-15 Budget, the Government announced that the tax complaint handling function of the Taxation Ombudsman will be transferred to the Inspector-General of Taxation.

A different type of concern relates to the degree of scrutiny of ATO decisions and the separation between the ATO's administrative and review/appeals functions. The ATO has introduced arrangements for the independent review of disputes between the ATO and large taxpayers in response to these concerns.

Discussion questions:

64. Are current tax review arrangements appropriate? How could they be improved?

11.3: Improving decision making

In addition to possible changes to existing governance institutions, there are a number of different reform options that might further improve decision making. These include reforms that have been adopted overseas to provide greater certainty and transparency for taxpayers, and reforms to introduce greater contestability by releasing more tax data and information about revenue costings.

Decision making processes in New Zealand and the United Kingdom

Both New Zealand and the United Kingdom have processes for developing tax policy in a staged and transparent way. In New Zealand, these processes are long-standing, widely supported by stakeholders and embedded. Reforms in the United Kingdom are less established, having been introduced in 2010.

In broad terms, governments in both countries commit to: setting out their revenue strategy before announcing any particular reforms; formal consultation with interested parties at each key stage of policy development; and to limiting any additional tax policy announcements

244 National Commission of Audit 2014, *Towards Responsible Government*, Australian Government, Canberra.

outside this process.[245] In the United Kingdom, the government's performance against its consultation framework is monitored by the Tax Professionals Forum. In addition, the Office of Tax Simplification (see Box 11.1) supports the implementation of this relatively new approach to tax policy making by providing advice on ways to reduce complexity in the tax system (see Chapter 10 for further discussion of complexity in the Australian tax system).

Box 11.1: Office of Tax Simplification[246]

The Office of Tax Simplification, established in the United Kingdom in 2010, is an independent office of HM Treasury that provides advice to the Chancellor about addressing complexity in the tax system. The Office is led by a board of four members, including an independent Chair and Tax Director, supported by public and private sector secondees.

The Office publishes individual reports on its inquiries, which are presented to Parliament. Board members may be required to give evidence before Parliamentary committees on these reports.

Increased access to tax data and costings

Several academics, including Wales and Wales,[247] point to confusion and debate around statistics commissioned and released by non-government bodies, particularly the selective release and publication of data. They argue this confusion could be avoided by publicly releasing more tax data. Others highlight the example of Denmark, which makes available de-identified data on individuals, families and companies, dating back decades, and the rich policy-relevant research that flows from this data.[248]

Releasing more information around revenue costings might also increase transparency and improve the quality of debate about tax issues. In this regard, since 2010, the United Kingdom has published one to two page costings for all new tax, tax credit and welfare policy decisions. These documents include: a description of the measure; the methodology and data sources used; a 'no change' (or static) costing; a post-behavioural change costing (which includes any behavioural changes resulting from the tax change); and an indication of the level of uncertainty surrounding the costing.[249]

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245 Inland Revenue Department of New Zealand, *How we develop tax policy*, viewed 14 November 2014: http://taxpolicy.ird.govt.nz/how-we-develop-tax-policy; and HM Treasury, and HM Revenue and Customs 2010, *Tax policy making: a new approach*, United Kingdom Government, London.

246 Office of Tax Simplification, *Homepage*, viewed 9 December 2014, www.gov.uk/government/organisations/office-of-tax-simplification.

247 Wales, C J and Wales, C P 2012, *Structures, processes and governance in tax policy-making: an initial report*, Oxford University Centre for Business Taxation, Oxford.

248 Card, D, Chetty, R, Feldstein, M, and Saez, E 2011, 'Expanding access to administrative data for research in the United States', in Schultze, C and Newlon, D eds, *Ten Years and Beyond: Economists Answer NSF's Call for Long-Term Research Agendas,* American Economic Association, Pittsburgh.

249 HM Government 2014, *Budget 2014: policy costings,* United Kingdom Government, London, viewed 9 December 2014: www.gov.uk/government/uploads/system/uploads/attachment_data/file/295067/PU1638_policy_costings_bud_2014_with_correction_slip.pdf.

In Australia, recent reforms have generated greater transparency around tax data and costings. These include the release since 2009 of a ‘reliability score’, based on the reliability of data and underlying assumptions, for tax expenditures in the annual Tax Expenditure Statement. In addition, since 2009, the ATO has produced and released a confidentialised 1 per cent sample file containing individual tax return information. This has recently been broadened to a 2 per cent sample file containing a wider range of information.

The main downside of these reforms is their additional resourcing costs, which are ultimately borne by taxpayers. In addition, privacy concerns have inhibited the release of further data on the tax system.

Discussion questions:

65. Could the arrangements for developing tax policy in Australia be improved? If so, how?
66. Would the benefits of releasing more tax data and detail around costings outweigh the costs?

Tax complexity metric

Measuring complexity in Australia

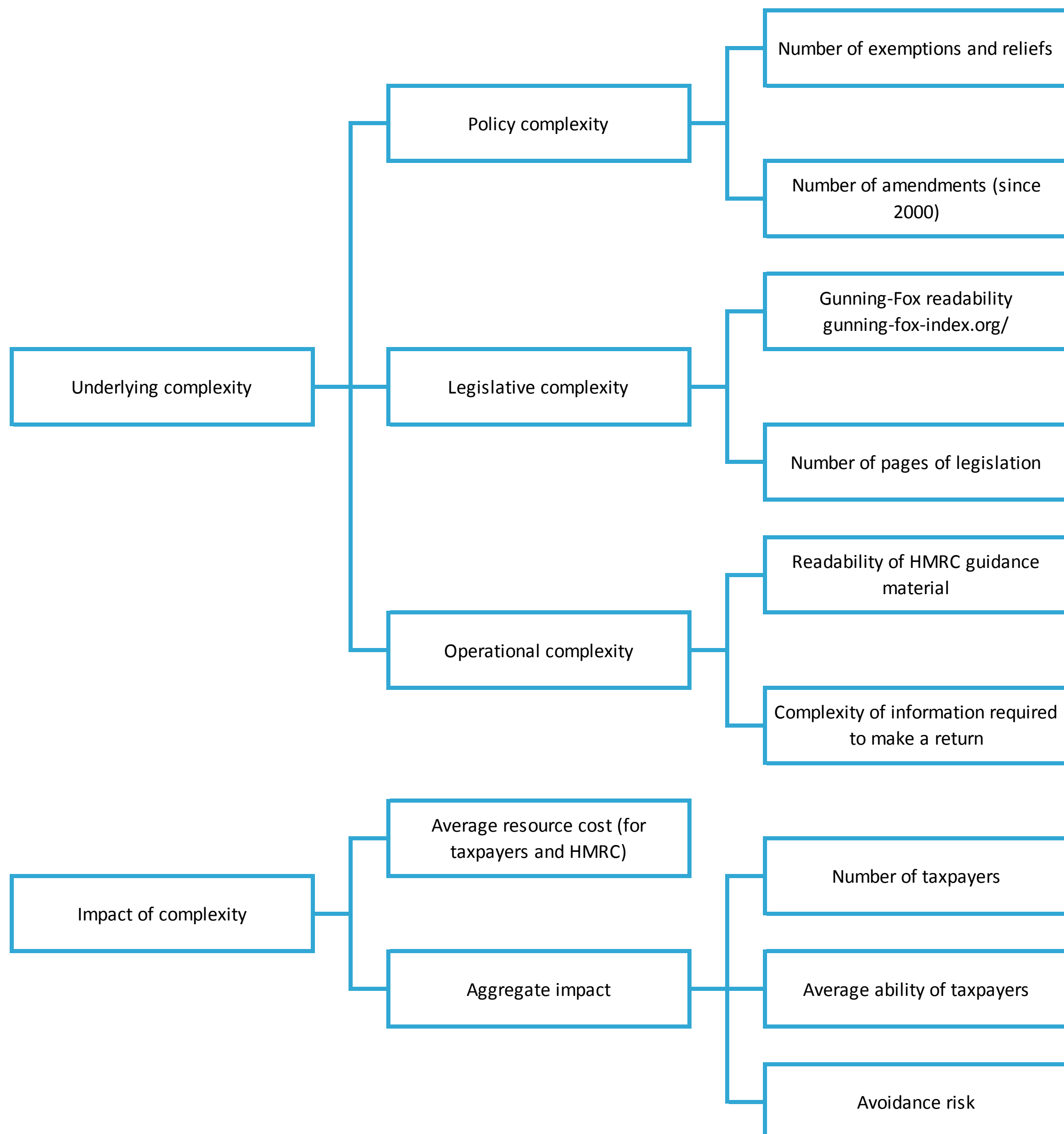
Developing a metric to measure the complexity of Australia's tax law could assist in future assessment of the areas of the tax law most in need of simplification, and the areas where reform could have the greatest impact. A metric may also provide an opportunity to measure relative complexity over time. The idea of developing a tax complexity metric has received increasing attention from government and academics around the world.

There is no single, easily measurable factor that directly correlates with the overall complexity of an area of tax law (unlike, for example, price changes, which are measured in the Consumer Price Index). The closest practical approach seems to be to use a range of factors as proxies, combined into an index. Factors are most useful if they are easily measured, while still providing an accurate proxy for complexity. To be useful, a metric would need to be intuitive and easy to use, while still providing a meaningful measure of tax complexity.

An example of the sort of metric that could be adapted to the Australian context is the tax complexity index being developed by the United Kingdom Office of Tax Simplification (OTS). In its paper on the proposed index, the OTS suggests that factors of complexity could be separated to create two separate measures of complexity: a measure of underlying complexity and a measure of the impact of complexity.[250] Factors would be weighted and then added together to determine a numeric measure. The factors making up each proposed measure are shown in Figure A.1.

250 Office of Tax Simplification and HM Treasury, *Developing a tax complexity index for the UK*, Office of Tax Simplification and HM Treasury, London, viewed 9 December 2014: www.gov.uk/government/uploads/system/uploads/attachment_data/file/285944/OTS_Developing_a_Tax_Complexity_Index_for_the_UK.pdf.

Figure A.1 Schematic diagram of the UK Tax Complexity Index



Source: Office of Tax Simplification and HM Treasury, *Developing a tax complexity index for the UK*, Office of Tax Simplification and HM Treasury, London, viewed 9 December 2014: www.gov.uk/government/uploads/system/uploads/attachment_data/file/285944/OTS_Developing_a_Tax_Complexity_Index_for_the_UK.pdf.

Some of the factors the OTS includes in its ongoing work may also be appropriate for an Australian metric. For example:

- **Number of exemptions:** exemptions and special cases cause a significant amount of the complexity in the tax law as taxpayers try to figure out how to apply the law to their circumstances. Alternative but similar measures include the number of exceptions to basic rules, or the number of possible paths to reach each outcome. These measures may provide a useful assessment of the maze that taxpayers must navigate, although there is some subjectivity in their application (for example, different people may classify a rule as either a single exception or a collection of similar exceptions).

- **Number of amendments:** frequent changes to the tax law are often identified as an important factor of complexity. Finding out how new rules apply to them imposes costs and uncertainty on taxpayers. Very frequent changes may also indicate that an area of the tax law is not working well in practice, although that is not always the case. The number of amendments over a certain period of time is objective and relatively easy to measure, but does not necessarily provide an indication of the relative significance of the changes.
- **Number of pages of legislation:** this measure of complexity is often used as an indicator of complexity. It is objective, easy to measure and simple to understand. However, a high number of pages does not always correspond to more complex law. In some cases, more pages may be used to make the legislation less dense and easier to read, or to add aids to interpretation such as diagrams, examples and signposts to related rules.

An alternative metric for Australia has been proposed by Tran-Nam and Evans.[251] Instead of differentiating between underlying complexity and the impact of complexity, they created separate measures for business and personal taxation. They also used different factors to the UK OTS, such as:

- the number of federal, state and local taxes;
- the number of requests for private rulings from the Australian Taxation Office;
- the number of external disputes;
- the use of tax agents by personal taxpayers; and
- the frequency of reporting and payments for business taxpayers.

251 Tran-Nam, B and Evans, C 2014, 'Towards the Development of a Tax Complexity Index', *The Journal of Applied Public Economics*, vol. 35, issue 3, pages 341-370.

Summary of Discussion Questions

1. Can we address the challenges that our tax system faces by refining our current tax system? Alternatively, is more fundamental change required, and what might this look like?
2. How well does Australia's utilisation of its available taxes align with the evolving structure of Australia's economy and changes in the international economy?
3. How important is it to reform taxes to boost economic growth? What trade-offs need to be considered?
4. To what extent should reducing complexity be a priority for tax reform?
5. What parts of the tax system are most important for maintaining fairness in the tax system? Are there areas where fairness in the tax system could be improved?
6. What should our individuals income tax system look like and why?
7. What should our fringe benefits tax system look like and why?
8. At what levels of income is it most important to deliver tax cuts and why?
9. To what extent does taxation affect people's workforce participation decisions?
10. To what extent are the interactions between the tax and transfer system straightforward for the people who deal with both systems?
11. How important is tax as a factor influencing people's decisions to work in other countries?
12. To what extent is tax planning a problem in the individuals income tax system? Are existing integrity measures appropriate?
13. What creates incentives for tax planning in the individuals income tax system? What could be done about these things?
14. Under what circumstances is it appropriate for assistance to be delivered through tax offsets?
15. To what extent do our arrangements for work-related expense deductions strike the right balance between simplicity and fairness? What could be done to improve this?
16. To what extent does our fringe benefits tax system strike the right balance between simplicity and fairness? What could be done to improve this?
17. To what extent are the concessions and exemptions in the fringe benefits tax system appropriate?
18. What tax arrangements should apply to bank accounts and debt instruments held by individuals?
19. To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?

20. To what extent does the dividend imputation system impact savings decisions?
21. Do the CGT and negative gearing influence savings and investment decisions, and if so, how?
22. How appropriate are the tax arrangements for superannuation in terms of their fairness and complexity? How could they be improved?
23. What other ways to improve the taxation of domestic savings should be considered? How could they be applied in the Australian context?
24. How important is Australia's corporate tax rate in attracting foreign investment? How should Australia respond to the global trend of reduced corporate tax rates?
25. Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?
26. To what extent would Australia benefit from the mutual recognition of imputation credits between Australia and New Zealand?
27. To what extent does the tax treatment of capital assets affect the level or composition of investment? Would alternative approaches be preferable and, if so, why?
28. How complex is the tax treatment of capital assets and are the costs of compliance significant?
29. To what extent does the tax treatment of losses discourage risk-taking and innovation and hinder businesses restructuring? Would alternative approaches be preferable and, if so, why?
30. How could the current tax treatment of intangible assets be improved?
31. To what extent should the tax system be designed to attract particular forms of inbound investment (for example, by distinguishing between active and passive or portfolio and non-portfolio)? If so, what principles should inform this?
32. To what extent does the tax treatment of foreign income distort investment decisions?
33. To what extent should the tax system be designed to encourage particular forms of outbound investment (for example, by distinguishing between active and passive or portfolio and non-portfolio)? If so, what principles should inform this?
34. How can tax avoidance practices such as transfer pricing be addressed without imposing an excessive regulatory burden and discouraging investment?
35. Should the tax system provide a more neutral treatment of different financing arrangements (debt, equity and retained earnings), and if so, how? What principles should inform the approaches?
36. Should the tax system provide a more neutral treatment of income earned on revenue account and capital account? Does the distinction create significant compliance costs for business and, if so, how could it be simplified?
37. Are there other important issues in the business tax system, not covered in this section, which should be considered as part of the Tax White Paper process?
38. In what circumstances is it appropriate for certain types of businesses to be subject to special provisions? How can special treatment be balanced with the goal of a fair and simple tax system?

39. Does the R&D tax incentive encourage companies to conduct R&D activities that would otherwise not be conducted in the absence of government support? Would alternative approaches better achieve this objective and, if so, how?
40. What other taxation incentives, including changes to existing measures, are appropriate to encourage investment in innovation and entrepreneurship?
41. What effect is the tax system having on choice of business structure for small businesses?
42. What other options, such as a flow-through entity (like an S-Corporation), would decrease the overall complexity and costs for small business involved with choosing a business structure? How would such an entity provide a net benefit to small businesses?
43. Is the interaction of the personal and business tax systems a problem? What can be done to manage the personal-business tax interactions?
44. What are the most significant drivers of tax law compliance activities and costs for small business?
45. How effective is the current range of tax concessions (such as CGT and industry specific concessions) at supporting small business engagement with the tax system? To what extent do the benefits they provide outweigh the compliance, complexity and revenue costs they introduce?
46. What other mechanisms (such as a single lower tax rate, improved technology deployment or other non-tax mechanisms) could assist small businesses to engage with the tax system while decreasing compliance and complexity costs?
47. Are the current tax arrangements for the NFP sector appropriate? Why or why not?
48. To what extent do the tax arrangements for the NFP sector raise particular concerns about competitive advantage compared to the tax arrangements for for-profit organisations?
49. What, if any, administrative arrangements could be simplified that would result in similar outcomes, but with reduced compliance costs?
50. What, if any, changes could be made to the current tax arrangements for the NFP sector that would enable the sector to deliver benefits to the Australian community more efficiently or effectively?
51. To what extent are the tax settings (that is, the rate, base and administration) for the GST appropriate? What changes, if any, could be made to these settings to make a better tax system to deliver taxes that are lower, simpler, fairer?
52. What are the relative priorities for state and local tax reform and why? In considering reform opportunities for particular state taxes, what are the broader considerations that need to be taken into account to balance equity, efficiency and transitional costs?
53. Does each level of government have access to tax revenue bases to finance new spending decisions? If not, should arrangements change to achieve this? How should they change? How important is it that the national government levies taxes on mobile bases? Could some taxes be shared?
54. To what extent does Australia have the appropriate mix of taxes on specific goods and services? What changes, if any, could improve this mix?

55. To what extent are the tax settings (i.e. the rates and bases and the administration) for each of these indirect taxes appropriate? What changes, if any, could be made to these indirect tax settings to make a better tax system to deliver taxes that are lower, simpler, fairer?
56. What parts of Australia's tax system, and which groups of taxpayers, are most affected by complexity? What are the main causes of complexity?
57. Would there be benefit in developing an Australian metric for tax complexity? What factors should be included? How should they be combined into a metric?
58. What system-wide approaches could have the greatest impact on reducing complexity in the tax system? Why have previous attempts to address complexity in the Australian tax system not succeeded? How might it be done in a way that is more successful?
59. In what ways can reforms of tax administration best assist in reducing the impact of complexity on taxpayers? Are there examples from other countries of tax administration reform to reduce the impact of complexity that Australia should adopt?
60. What processes or systems currently being used by businesses and individuals could the ATO better utilise to lower the compliance costs of the tax system?
61. Could administrative responses — such as embracing technology, harnessing data and taking the whole-of-government approach to administration — help address the issue of tax system complexity?
62. Would there be benefits in integrating the administration of taxes across the Federation? If so, what would be required to realise these benefits?
63. What changes could be made to provide greater certainty, transparency and accountability to tax policy development in Australia?
64. Are current tax review arrangements appropriate? How could they be improved?
65. Could the arrangements for developing tax policy in Australia be improved? If so, how?
66. Would the benefits of releasing more tax data and detail around costings outweigh the costs?