

Overview

My Background

This is an individual submission to the Tax Reform discussion which has been shaped by my personal experience over the past 25 years. I worked at the ATO for 24 years before finishing up last year. Most of that time I was in a risk and intelligence role and helped inform tax compliance business decision making in the the individuals and small business sectors. My experience and study during this period has led me to the conclusion that there are significant opportunities to improve decision making in this area.

I do not have a tax and accounting background and when I joined the Tax Office in 1990 it was clear that there was a significant gap between what ATO staff thought taxpayers knew and what they actually knew. While some small gains in recent years have been made in developing products for the individuals market which has addressed this 'knowledge' gap tax is still seen as a complex topic which is why over 70% of individual taxpayers and over 90% of businesses use tax agents to meet their tax obligations. This has led me to the conclusion that any future design for the tax system needs to be focussed on transparency and simplicity.

Later I do propose some specific changes to the tax system. My initial input however will be focussed upon a set of principles for guiding delivery of future tax outcomes.

Tax and Government

It is very difficult to have an informed discussion about tax in isolation. What tax is levied and who it is collected from needs to be shaped by a range of other factors determined by government. As an example it may be decided by government that affordable housing for Australian residents is important. This will then shape the policy response including tax policy. Unfortunately many of these underlying 'principles' are (i) not understood by the broader community and (ii) subject to rapid change due to a combative political system. This in turn leads to community uncertainty and perceptions of inequity. Research into the Australian tax system has shown this perception of uncertainty and inequity are also a feature of the tax system.

The process for developing tax policy has shortcomings in the decision making process that results in poor policy design and ultimately policy implementation challenges that contribute to the complexity of the tax system. These shortcomings include:

- I A political system that is based on conflict rather than collaboration that results in decisions at the political level that are not based on evidence but upon political strategy
- I The secretive nature of policy development which is driven in part by the adversarial nature of the political system
- I The perception among the community about the 'unfairness' of the tax system which is not necessarily informed by evidence. This can lead to compliance behaviour aimed at circumventing the policy intent where the tax design makes this possible.

- I A lack of understanding about how tax is used by government and how this benefits all Australians

Over the past decade the ATO has increased the level of community consultation in relation to the implementation of tax policy. This communication has resulted in positive outcomes but is still relatively limited in scope and focussed on traditional product delivery. This level of communication however is significantly greater than the level of input into tax policy design that, up until now, has been possible. Even tax reform conversations such as this are often dominated by professional associations and other interest groups that most times do not represent community consensus.

The digital revolution has now made it possible to leverage the power of the people in informing debates of this type. There are many examples around the globe where the social communication power of the internet has been used to facilitate communication, collaboration and idea development. The 'bettertax' site is useful in informing the parts of the community that already know about this tax discussion. It does not however provide any incentive that would promote broader discussion and idea development.

My *first suggestion* therefore is to effectively open this debate to the entire community. One way to do this is to establish a series of 'prize' competitions aimed at creating ideas for solving issues within specific parts of the tax system. This technique has been successfully used in the commercial arena to solve very difficult but achievable problems. I believe this type of incentive would encourage widespread community engagement from a variety of people and organisations. More importantly it would improve community awareness of the specific topic.

Tax Design Principles

There are no black and white answers to the question of what a tax system should look like. Tax can be applied in a multitude of ways which can be seen when you examine the ways in which tax has been applied historically. While there are no specific solutions there should however be a set of guiding principles that influence the design of taxation from inception of the idea through to implementation. These principles should be reflective of the broader community consensus.

I have included below some examples of possible design principles.

Transparency	A tax can be considered transparent when taxpayers do not need to know how it works. GST is transparent to most Australian consumers that purchase goods and services. No effort is required for consumers to comply. There are opportunities to develop transparent designs across a variety of taxes.
Simplicity	A simple tax is one that is very easy for taxpayers to understand and apply. Simplicity will also often lead to certainty for the taxpayer. A simple design also has few, if any, exceptions as this reduces

	complexity and reduces opportunities for tax minimisation.
Linked to social objectives	The linkage between the tax and the broader government / social objectives is understood. Community understanding of these linkages will improve acceptance and compliance.
Perception of fairness	The community may understand the linkage between social objectives and the tax but they also need to understand how the tax is applied. The design needs to describe why the tax is fair. This openness will improve community perceptions of fairness
Meets the majority need	Much tax law is focused on managing exceptions to the rule. Often this results in laws that negatively impact all taxpayers when it was only an extremely small proportion of taxpayers involved in that tax behaviour. This focus on exceptions then impacts the administrative design. The company tax return is a good example where there are many questions (over 60) that are only answered by less than 1,000 companies out of the 850,000 companies that complete company income tax returns each year.
Timeliness	The tax obligation should apply as close as possible to the event or transaction that triggers the obligation. Completion of tax returns can occur 18-24 months after actual the actual business events. This imposes costs and complexities for both taxpayers and the tax administration. A good example is a capital gains event that may occur at the beginning of one tax year and may not be reported in a tax return until the end of the following year. Often these are one-off events and could be dealt with at the time of the event if they were not part of the annual tax return reconciliation process.
Relative not absolute thresholds	Absolute thresholds such as the personal income tax ranges often cause unintended outcomes over longer time periods. Thresholds should be relative to some other measure. For example if the poverty line is determined as being at a particular income level then perhaps tax is not applied below that level. This would avoid unfortunate outcomes such as bracket creep.
Future focussed	Tax designs should be focussed on future behaviour and not retrospective. This will positively influence the perception of fairness and trust in the overall system of government. Where necessary implementation of tax policy will need to be staged to minimise any perceived negative consequences
Integration and dependency is minimised	There is a high level of integration in many parts of the tax system and other obligations / entitlements. The integration between the welfare and individual tax systems is particularly complex. Where possible this integration should be avoided as this leads to increased complexity and opportunities for avoidance.
Transitional arrangements are planned	Taxes are the dues we pay to enjoy the numerous vital benefits that government provides for our society. It is therefore important to ensure that existing revenue sources are protected until the new arrangements are in place

Specific Tax Reform Ideas

Reform of the tax system will require long term collaboration to achieve meaningful and worthwhile change. It will require changes in thinking, legislation and administrative design. A new tax system also needs to be informed by those 'principles' that the broader community believe is important.

Meaningful tax reform is not possible in our current political environment. Significant tax reform however is required and the government needs to find a way of promoting a non-partisan community discussion that will inform future discussions. A non-partisan body such as the Tax Ombudsman could be asked to facilitate this active community conversation.

Below are some specific ideas I have for tax reform that are focussed around the tax design principles that are outlined above. The changes are significant enough to need a non-partisan approach to their discussion and development.

Refining Concepts of Income - Individual taxpayers

There are opportunities to make personal income tax transparent or much simpler by taking a more focussed approach to income and the way in which it is taxed. The approach taken by Norway is a good starting point. In Australia for example we could distinguish between income from

*personal exertion (salary and wages and personal services income) and
income from capital (interest, dividends, rental income, capital gains and business)*

While splitting the income tax responsibilities in this way may appear to increase complexity it may provide opportunities to make income tax transparent to the majority of individual taxpayers. A good example is salary and wage earners where over 90% of these employees have one job and the tax is withheld by their employer. The number of taxpayers and the dollars involved where the personal exertion income comes from other sources is a small proportion.

Income from Personal Exertion

For taxpayers with a single job the tax on their personal exertion income could be transparent. Some changes however to the way deductions are treated would be required. The biggest stumbling block would be work related expenses where over the past couple of decades the presence of these expenses has distorted employment remuneration practices. The problems however are not insurmountable and given careful planning work related expenses and other deductions can be re-framed or removed.

For the small proportion of taxpayers that have multiple jobs or income from other personal exertion sources (eg personal services income, net income (but not a loss) from a sole trader business) the process of preparing the income tax return would be vastly simplified and in many circumstances could be pre-prepared by the ATO for the taxpayer.

Tax would be applied in the same progressive manner as the current system.

You might see that the above definitions of income does not include Commonwealth Welfare payments such as unemployment benefits and pensions. These income types could certainly be classified as related to personal exertion. One could however also ask why tax is applied to a government benefit.

Another area that would require resolution is offsets and rebates. Some of these offsets would disappear if commonwealth welfare payments were not taxed. Other rebates may need to be delivered in different ways.

These proposals meet the transparency and simplicity design principles.

The transition to this simplified approach would require a non-partisan approach in the short term. In the long term however this type of design would provide benefits to all the major players in the system by making personal exertion income tax transparent to taxpayers.

Income from Capital

The design objectives for individual taxpayer income from capital is transparency and simplicity. Tax would be applied at a flat rate (eg 30%) and aligned with company, partnership and Trusts to ensure income is not moved between entities to minimise tax outcomes. The Medicare levy would also be applied to this income. The individual taxpayer 'capital tax return' would include the following income sources:

Income Source	Commentary
Interest	Tax would be applied (at the flat rate) by financial organisations. Taxpayers with only interest to declare would not need to do anything to finalise their annual return. Amount disclosed at this item in 2012-13: \$15,045m
Dividends	For franked dividends no changes in approach would be required. As long as the company tax rate is the same as the individual taxpayer flat rate then the tax has been paid. Tax at the flat rate would have to be applied to unfranked dividends by the company. Amount disclosed at franked dividends in 2012-13: \$20,810m
Rental property	Could consider tax being applied by rental property managers as the majority of properties are managed by property agents. In short term however the income tax on rental property profit could be collected via current sources ie PAYGI and annual return. Losses can be offset against other capital income Amount disclosed at Net Rental Income in 2012-13: -\$5,394m
Capital Gains	In the short term this income will continue to be recognised via the tax return. In the long term however it should be possible to collaborate with State Land Title Offices to develop an interim tax collection

	mechanism for the sale of property. The sale of shares is another area that could be automated. Amount disclosed at Net Capital Gains in 2012-13: \$9,874m
Income not included	
Partnership & Trust distributions	In the future income tax should be applied to all income from partnerships and trusts <i>before</i> distribution. Tax would be applied at the same flat rate as that applied to the individual taxpayer capital income. Income from partnerships and trusts would then not need to be taxed at the individual taxpayer level. Amount disclosed at these items in 2012-13: \$47,993m

Further analysis of the impact of moving all this type of income into an individual taxpayer 'capital return' needs to be undertaken to understand the change in tax revenue that might result from the difference in the flat 'capital rate' of tax being applied as opposed to the progressive rate of tax applied to personal exertion income. It might also encourage some taxpayers to reclassify or re-direct their income sources if there was a perceived benefit.

Other Taxes (including GST)

The same design principles could be applied to other taxes and particularly to GST.

GST in particular is more complex than it needs to be because of exemptions. These exemptions primarily were put in place to minimise impacts on specific sectors of the population principally those with lower disposable income. These exemptions however apply to the entire population. A more targeted outcome could be achieved by increasing the appropriate welfare payments and removing these exemptions.

Similar issues apply to FBT where certain industries are afforded very generous fringe benefit tax conditions.

The aim with all these other taxes should be to achieve either transparency or simplicity but also to minimise integration and dependency between tax and other parts of the government system.

Summary

Meaningful reform of the tax system is both necessary and achievable. It will require however active collaboration and support of all the major contributors and the broader community. The conversation would need to be undertaken in a non-political way.

It may appear that this is not achievable. The digital revolution does however provide opportunities for very actively informing and engaging the community which will be required to achieve meaningful change.