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Dr Ken Henry
Chairman
Australia's Future Tax System Review Panel
The Treasury
Langton Crescent
PARKES ACT 2600

6 May 2009

Dear Dr Henry

We enclose PricewaterhouseCoopers' second submission to Australia's Future Tax System Review of Australia's tax and transfer system.

Our submission is in response to the Consultation Paper issued in December 2008.

The PricewaterhouseCoopers' submission on the Retirement Income Consultation Paper was lodged on 27 February 2009.

Our approach in preparing the submission

PricewaterhouseCoopers' client base is comprised primarily of large to medium sized businesses (many of which have cross-border operations), emerging private groups, high wealth individuals and expatriate employees.

Our comments and perspectives in relation to tax reform and this submission therefore concentrate on those issues where we believe our experience allows us to provide practical insight and perspective. Accordingly we have not sought to address all aspects of the Panel's terms of reference. In particular we have provided limited comment on reforms in relation to the transfer system.

Our second submission is much more extensive than the first, reflecting the detailed nature of the many questions posed in the Consultation Paper. In some cases, we have reinforced the comments in our earlier submission.

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Main themes of our submission

It is against this background that our submission has been written with two central themes in mind:

- the overall tax burden on business should be reduced, and
- the tax system needs to be simplified.

We believe that the Australian economy and our society will benefit greatly if the Panel's recommendations reflect these goals. The task is by no means easy. As with any tax reform process, there will be trade-offs, and winners and losers.

PricewaterhouseCoopers and our contribution to the debate

This submission is accompanied by three PricewaterhouseCoopers' studies which are directly relevant to the work of the Panel:

- *What is your Company's Total Tax Contribution? 2008 Survey Results*

  This is the third survey conducted with the assistance of Australia's major companies, and examines the impact of Australia's tax system on business.

- *Review of Effective Tax Rates in Australia*, August 2008

  While the statutory income tax rate is a guide to the tax burden in Australia, the *effective* tax rate gives a greater insight into the tax base. This study looks at the movement in effective tax rates in Australia over the last decade, and compares Australia's effective tax rate against comparable countries.

- *Paying Taxes 2009 The Global Picture*

  A joint World Bank and PricewaterhouseCoopers review of the ease of paying taxes for small to medium domestic companies in 181 countries.

Publication of our submission

PricewaterhouseCoopers consents to making this submission available to the public on the Panel's website.

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6 May 2009

Key contact

The main PricewaterhouseCoopers contact for both this submission and future input to the Panel’s work is Tim Cox. Tim can be contacted on (03) 8603 6181 or via email, tim.cox@au.pwc.com.

Yours faithfully

Luke Sayers
Managing Partner – Tax and Legal

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PricewaterhouseCoopers

Submission

Australia's Future Tax System Review Consultation Paper

May 2009

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Executive summary

This is the second submission by PricewaterhouseCoopers to the Australia's Future Tax System (AFTS) Review Panel as part of its review of Australia's tax and transfer system.

Our first submission focused on the broad issues which PricewaterhouseCoopers believes are of most importance to the design of a world class system of taxation (including globally competitive rates of taxation).

Our second submission responds to questions raised in the Australia's Future Tax System Consultation Paper published in December 2008. Our comments and perspectives in this submission concentrate on those issues where PricewaterhouseCoopers believes our experience enables us to provide practical insight and perspective.

Accordingly we have not sought to address all questions posed in the Consultation Paper. In particular we provide limited comment on reforms to the transfer system.

Our key recommendations are as follows:

An internationally competitive tax system

In essence, we believe a world class tax system for Australia would have the following features.

- A system where tax policy, tax law and tax administration act in harmony to provide a consistently attractive system and environment for business to operate.
- A more balanced overall mix of taxes with less reliance on income taxes.
- A competitive overall taxation burden (particularly the company income tax rate) and an efficient system for imposing tax, such that it is relatively easy and competitive to do business in this country.
- In reducing the overall tax burden on business, we believe that the Review Panel should focus on ensuring the maximum reduction in the corporate tax rate rather than narrowing the base of taxation.
- There should be a significantly reduced number of taxes on business, both in terms of taxes imposed on business and taxes that business collects on behalf of government. Currently there are some 56 taxes that business has to comply with in Australia, and we would like to see this reduced to a significantly smaller number. Particular focus should be given to removing further State taxes as envisaged under the *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations*[1]. The main targets

[1] "The Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations" can be found in Schedule 2 of the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999* (Cth).

should be the poorly designed and distortionary taxes (including property conveyance duties and insurance taxes) and a range of nuisance type taxes. Harmonisation of the remaining State taxes should be a key priority.

- The remaining, more limited number of taxes would include income taxes (including fringe benefits, capital gains and resource rent taxes), consumption taxes (principally GST and excise duties), taxes on employment (principally payroll tax), a single new tax on property ownership, and other taxes that are appropriate from a policy perspective (including environmental taxes).

Taxing business

- Apart from a lower company tax rate, business needs a less complex tax system. Suggestions in this submission include greater reliance on accounting data, a reduction in specific anti-avoidance rules, and a renewed attempt to simplify the income tax law into one Assessment Act.
- In the absence of any tax policy changes relating to current tax related adjustments (eg non-assessable or non-deductible items), at this stage we do not see radically different bases for taxation of business income (eg a move to a cash flow basis for business taxation) as being appropriate.
- Caps on interest deductibility need to be the subject of further modelling and analysis before any decision is made. The allowance for corporate equity (ACE) has some attractions, particularly in terms of providing a more level playing field for debt and equity financing, and because it can fit with the dividend imputation regime.
- We acknowledge the arguments for and against retention of the dividend imputation regime in its current form. We believe removal of imputation should only be seriously considered if it is part of a package of measures to redesign company and shareholder taxation arrangements. These design issues would include the company tax rate and base, and the taxation of dividends in the hands of shareholders, including superannuation funds. We would encourage the Panel to attempt to design a regime which both preserves overall returns to Australian shareholders and make company taxation more attractive to foreign investment, irrespective of recommendations in relation to dividend imputation.

Personal tax and transfers

- Consideration should be given to a dual income tax system where capital income is taxed at a flat rate, possibly the same as a reduced corporate income tax rate, with other income continuing to be taxed at marginal tax rates.
- Individuals with relatively straightforward tax affairs should not need to lodge income tax returns. This would require expanded domestic withholding tax arrangements on dividends and interest at a flat rate, changes to PAYG withholding, and some practical concessions (eg a limited personal allowance and CGT concession).

- Consideration should be given to tax effective saving mechanisms beyond superannuation to encourage individuals to make better provision for life events (eg major illness, education, first home, children etc). The current range of ad hoc tax offsets and transfer payments should be reduced, as part of a move to greater self-reliance by those who can afford to do so.
- Fringe benefits should be taxed in the recipient's hands. Irrespective of this, there are a number of other improvements to the FBT system that should be considered.
- The use of the taxation system as the delivery mechanism for welfare payments needs to be re-considered.

Complexity – tax law and administration

- A robust compliance cost reporting mechanism should be a feature of new tax law – at the design, implementation and administration phases.
- State taxes should be collected by one national taxing agency, replacing the various Offices of State Revenue, to radically improve the efficiency of the current process.
- The senior management structure of the ATO should be reviewed, with a view to having a more diverse leadership team or advisory board with representatives from outside the ATO.

State and local taxes and transfers

- Transparent, easy to understand performance frameworks should be developed and implemented by the Commonwealth. States should remain responsible for delivering services to the agreed standards.
- The redesign of State taxation revenue should attempt to reduce the existing Verticle Fiscal Imbalance.
- The necessary Federal funding should be provided to the States in a manner that allows them to deliver services at the required standard, and we see potential in using such funding to provide incentives to the States to improve performance over time.
- In deciding the allocation of funding for service delivery between the states, we see an enhanced role for the Commonwealth Grants Commission (CGC).

Tax and transfer impacts on housing

- Where market failure exists, there is a strong argument for government to continue to intervene to ensure that long-term accommodation can be accessed by individuals on low-incomes.
- A range of approaches is necessary to meet the diversity of needs. As far as possible, any assistance provided should be structured to minimise the reliance of individuals on assistance in the long-term.

- To ensure the efficient use of housing stock and land, taxes and transfers should be applied to ensure that they do not distort the decision making process.

Fuel, roads and transport

- We see scope for greater use of road charges so that the revenue raised can be targeted to improve road transport routes.
- Efficient transport options include promoting the use of public transport and encouraging more rail freight. The tax system should be re-designed in a way to encourage these choices.
- Fuel taxes should raise revenue specifically for the transportation system only. Where improved technology can monitor the actual use of roads (including location of congestion) and fuel's impact on the environment, this should be applied to generate a system of taxes and charges which is more targeted to actual road use.
- The Panel should consider incentives linked to more fuel efficient forms of transport – for example, lower tariff rates and registration charges on hybrid vehicles.

Tax-transfer impacts on the environment

- The tax system should be used successfully in conjunction with the Carbon Pollution Reduction Scheme (CPRS) to provide incentives for business to assist with reducing demand for high emission inputs. Our preference would be for simple, incentives via increased or accelerated tax deductions for business for environmentally friendly initiatives.

For further detail please contact Tim Cox, Partner, on (03) 8603 6181 or via email, tim.cox@au.pwc.com.

Challenges and opportunities for reform

1.1 In considering the community's aspirations for the type of society that Australia should become over the next two decades and beyond, which key features should inform or drive the future design of the Australian tax-transfer system?

The submissions already received by the Panel indicate that there is little likelihood of consensus on this broad question.

We acknowledge the comments made in many submissions about the important redistributive role played by the tax system, and flow on impact to the type of society we enjoy. However, we see a future where enormous demands will be placed on government (for example, by an aging population), and Australia will need to compete harder for tax revenue against other jurisdictions seeking to attract talented labour and capital – both of which are likely to be even more mobile than they are now.

In our view, the key features that should drive the long term future design of the Australian tax-transfer system are as follows:

- a society which supports those who are less well off, and assists those who can do so to become productive members of the workforce,
- a tax transfer system which encourages responses to life cycle events, such as skill development, first home, children, illness and saving for future needs (this includes, but is not limited to, superannuation),
- a country which nurtures talent, retains skilled workers, and attracts talented labour from overseas,
- a country which encourages business to invest in research and development so that we become a country renowned more for its intellectual capital than for its natural resources,
- an internationally competitive business environment, which attracts businesses which are globally mobile, and by operating in Australia, provide the economic growth necessary to sustain our society in the long term,
- a tax framework where there is greater harmony between tax policy, tax law, and tax administration – all acting in concert to help achieve a favourable environment for businesses to operate and individuals to live and work,
- a tax collection and administration system which is efficient, and reflects the need to minimise compliance costs on taxpayers, and provides administrative savings and efficiencies for government, and
- a tax system that includes mechanisms which help achieve Australia's reduced carbon emission targets and other environmental objectives, and which encourage the development and early adoption of environmentally appropriate technology.

1.2 Assuming that the absolute size of government will not fall, should (and can) Australia nonetheless aim to reduce the burden of taxation over time by promoting faster economic growth than public spending growth? Can it be demonstrated that alternative tax policies could help deliver that outcome?

In our view, the burden of taxation should be reduced by focusing on economic growth.

In particular, we regard reduced business taxation as an important factor in stimulating economic growth. We acknowledge that the impact of tax cuts on economic growth has been the subject of recent debate as governments around the world grapple with the design of short-term stimulus packages to counter the global financial crisis[2]. The problem is best described in terms of flow-on effects: a tax reduction which does not have a positive impact on economic growth will result in declining government revenue, lower levels of national saving, and lower levels of economic growth in future years.

There is however empirical evidence to support lowering income taxes (and corporate taxes in particular), combined with a shift towards property and consumption taxes, as part of a growth strategy[3].

Our experience also indicates that large multi-national corporations operating in open economies are responding to high tax rate regimes by moving some or all of their operations to other jurisdictions[4]. In some cases, the intellectual property of such companies has been shifted to, or registered in, low tax jurisdictions. Such decisions have an obvious impact on economic growth, and perhaps more so in the Asia Pacific region where Australia faces strong tax competition from countries outside the OECD.

We think it is also reasonably clear that reform of the *structure* of the tax system can have a positive impact on economic growth[5]. For example, the economic literature supports the general proposition that income taxation is more detrimental to growth than broad based consumption taxes. We therefore reiterate our view that, even though the Panel's Terms of Reference excludes GST, the Panel should endeavour to reform the taxation system so that there is less reliance on income taxation and greater reliance on consumption-like indirect taxes[6].

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[2] Alexander Klemm, *Causes, Benefits, and Risks of Business Tax Incentives*, IMF Working Paper WP/09/21, International Monetary Fund, January 2009.
[3] Jens Arnold; Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries, OECD Working Paper No. 643, 2008.
[4] On 29 April 2008, the Chancellor of the Exchequer, Alistair Darling, announced the creation of a forum to discuss the long-term competitive challenges facing the UK Government and business: refer http://www.hm-treasury.gov.uk/press_4208.htm. The announcement followed decisions by a number of leading UK companies to relocate their headquarters to Ireland and other countries for tax reasons.
[5] Engin & Skinner (2000).
[6] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 4.

Finally, efficient tax administration and enforcement is also a factor contributing to economic growth. Although tax compliance costs are notoriously difficult to quantify with any accuracy[7], there is sufficient qualitative and economic analysis to indicate that measures to reduce such costs would have a beneficial effect on the economy[8].

* * * * * * * * * *

The PricewaterhouseCoopers submission to the Panel dated 17 October 2008 included a range of measures which we feel would promote economic growth, primarily through improving the international competitiveness of businesses located in Australia and reducing the compliance cost associated with the existing taxation environment.

More broadly, there are a range of economic growth outcomes associated with different taxes. Tax reforms considered as part of this Review should be evaluated in terms of the impact they have on economic growth. Those taxes that are determined to have a lower relative impact on growth should be preferred.

Some of the most inefficient taxes are those that are administered by the States. There is evidence to suggest that transaction-based taxes tend to be the most inefficient, these include stamp duties on non-residential conveyancing, stamp duties on insurance and fire service levies.[9]

Broadly speaking, taxes that fall on investment activity tend to have the greatest economic cost. Taxes can act as a deterrent to investment, which in turn impacts on the level of economic growth that can be achieved. Wherever possible these taxes should be reduced or eliminated.

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[7] John L Turner, Malcolm Smith and Bruce Gurd, *Recognising the Pitfalls in Tax Compliance Costs Research*, Revenue Law Journal, Volume 8, Issue 1, 1998.
[8] The Board of Taxation, Scoping study of small business tax compliance costs - A report to the Treasurer, December 2007; Tracy Oliver and Scott Bartley, Tax system complexity and compliance costs — some theoretical considerations, Economic Roundup, Winter 2005, Treasury (Australia).
[9] Access Economics, *Axing The Alcabala: A Program For A 21st Century State Tax System,* A Report for the Business Coalition for Tax Reform, November 2004, Canberra, p.i.

The revenue mix

3.1 What problems, if any, are generated by the overall mix of taxes in Australia on business and labour income, consumption, transactions and assets, and what changes, if any, should be made?

It would be desirable for the Panel to recommend the appropriate overall mix of taxes which would serve as a useful guide to governments for ongoing tax policy. This mix should reflect the Panel's view on the future direction of short, medium and long-term influences in the Australian economy, as well as international comparisons.

Building upon comments made in PricewaterhouseCoopers' first submission in October 2008, we make the following observations in relation to the tax mix.

Business taxation and the corporate tax rate

Our first submission put forward the view that the overall tax burden on business should be reduced, with a particular focus on reducing the corporate tax rate, rather than narrowing the base of taxation. This was in the context of having the right mix of taxes and improved tax policy settings.

The problems generated by Australia's complex mix of business taxes are described in detail in the PricewaterhouseCoopers Total Tax Contribution study[10], a copy of which accompanies this submission. These problems relate not just to the mix of taxes borne by business, but also the number of taxes collected by business and the associated compliance costs[11].

The Total Tax Contribution study also shows that Australian corporate income tax is high by international standards, and accounts for almost two-thirds of corporate tax revenue. As a result, and as we are currently seeing, the Federal Government's overall tax revenue is powerfully impacted by any changes in corporate profitability.

Our focus on addressing the corporate tax rate is prompted by:

- concerns over Australia's future ability to attract mobile capital, which is vitally important for maintaining high levels of employment,
- international competitiveness,
- the direction of industry policy – illustrated by the on-going shift in manufacturing activity to lower cost jurisdictions, and the current heavy reliance on the banking and mining sectors for government revenue, and

[10] PricewaterhouseCoopers (Australia), *What is your company's Total Tax Contribution? 2008 Survey Results.* Refer in particular to Chapters 2 and 11.
[11] Taxation Revenue, Australia, 2007-08, Australian Bureau of Statistics, Canberra; Architecture of Australia's Tax and Transfer System, Treasury, August 2008.

- recent economic events – that is, how can the corporate tax environment be improved to better position Australia to be one of the economies to emerge early and strongly from the financial crisis?

Consumption (goods and services) taxes

We support an increase in consumption taxes. However the restriction on changes to the rate or base of GST, leaves the Panel with little flexibility in this regard. Other consumption taxes include customs duty, excise, government charges and so-called “sin taxes”[12]. There are at least 25 such product taxes[13], far too many in terms of the small amount of revenue that some of these raise.

However, we do not support the introduction of new consumption taxes, unless they meet a specific policy objective. Indeed, this is an area where some rationalisation of the number of existing taxes is warranted. Compliance cost implications for business should be a high priority in any reshaping of consumption taxes.

Taxes on labour

In our first submission, we supported the Federal Government’s aspirational goals for personal income tax rate reductions[14]. Since then, the impact of the global financial crisis has caused the Government to remove this goal from Budget forecasts[15].

We would urge the Panel to focus on the long term direction of personal tax rates, with a view to ensuring that Australia treats its workforce in a way which is at least competitive with similar economies.

Factors relevant in this context include:

- the need for distributive fairness whilst maintaining incentives for individuals to work and take entrepreneurial risks,
- inter-generational factors, and
- the global mobility of highly skilled labour.

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[12] In the Federal sphere, fuel taxation has been the subject of recent reform, and there was a Treasury review of excise in 2005.
[13] PricewaterhouseCoopers (Australia), *What is your company’s Total Tax Contribution? 2008 Survey Results* – copy lodged with this submission. Page 25.
[14] The goal was to have three tax rates by 2013/14 – 40%, 30% and 15%. Australian Labor Party, *A Tax Plan for Australia’s Future*, 18 October 2007. Source: www.alp.org.au.
[15] Federal Treasurer, *Mid-Year Economic and Fiscal Outlook 2008-09* (MYEFO), 5 November 2008.

The authors of the Consultation Paper[16] indicate that it is unclear what impact inter-generational and international factors will have on the supply and demand of labour and capital. In our view, the trend is already apparent. Through the services our firm provides to entrepreneurs and employees of multi-national companies, we regularly see examples of the impact that personal tax rates can have on individual decision-making. Those with high level skills have long been attracted to the "old economies" (notably the United States) which have a better track record for nurturing and rewarding talent, and they have recently being drawn in increasing numbers to the new growth economies of the East, many of which have low personal tax rates.

Taxes on property

Property transfer taxation (eg transfer duty), as distinct from taxes on property ownership (eg land tax), result in a number of problems for both business and individual taxpayers. These problems include:

- inefficiency (such taxes create a barrier to property acquisitions and new investment),
- unreliable revenue streams,
- inequity, which has prompted the creation of a range of concessions, and
- differing rates and administrative regimes across Australia.

The elimination of stamp duty on property transfers should be a (long term) objective of the Review.

Inefficient taxes in the tax mix

The current tax mix also creates numerous inefficiencies. Two areas are of particular concern to business:

- Fringe Benefits Tax

  FBT is an example of a "drag net" tax with high administration costs which produces revenue mainly in respect of a small number of benefits. FBT is commonly cited by business clients as a tax which imposes an administrative burden totally disproportionate to the revenue collected. The most recent PricewaterhouseCoopers' Total Tax Contribution survey[17] indicates that FBT has by far the highest tax compliance cost to revenue ratio.

  Our preferred approach for the reform of FBT is set out in our response to Question 4.6.

[16] AFTS Consultation Paper, December 2008, pages 59-60.
[17] PricewaterhouseCoopers (Australia), *What is your company's Total Tax Contribution? 2008 Survey Results* – copy lodged with this submission.

- State taxes

  State purchaser transfer duties are particularly inefficient: they distort investment decisions and produce unreliable revenue streams[18]. Insurance duties and fire services funding arrangements also rank poorly on a number of criteria.

  Land tax and payroll tax, although opposed by a range of business and industry groups, appear to be the most efficient State taxes[19] and, assuming they are retained, consideration should be given to broadening the tax base and lowering the rate for these taxes.

3.2 Does Australia's tax system penalise (or favour) the returns to savings relative to other activities and should this lead to changes in the structure of taxes and means tests?

Interest income is currently taxed at the tax rate applicable to the relevant taxpayer, with the exception of a flat 10% withholding if paid to a non-resident[20]. As noted in the Consultation Paper[21], there are a range of efficiency and equity arguments which support a reduced tax rate on saving.

We have previously recommended that the taxation system should be changed to more effectively encourage savings and investment[22]. In particular, we supported consideration of a dual tax regime with low PAYG withholding on interest and unfranked dividend payments provided the withholding obligations on payers are kept simple.

As noted in the Consultation Paper[23], the two mechanisms typically used are to exempt the income, or impose a lower tax rate.

Such arrangements are found in a number of comparable jurisdictions. For example, residents of the United Kingdom can open Individual Savings Accounts (ISAs), save up to £7,200 each tax year, deposit and withdraw at will, and pay no tax on the earnings. The flat tax arrangements in The Netherlands are referred to in the Consultation Paper[24].

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[18] Independent Pricing and Regulatory Tribunal, *Review of State Taxation. Draft Report.* June 2008 Sydney.
[19] Independent Pricing and Regulatory Tribunal, *Review of State Taxation. Draft Report.* June 2008 Sydney.
[20] Note however that interest withholding tax exemption is, subject to various conditions, available for Australian businesses seeking access to global financial markets.
[21] Consultation Paper, page 64.
[22] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 6.
[23] Consultation Paper, page 65.
[24] Consultation Paper, page 67.

To date, Australia has only allowed such concessions for special purpose savings vehicles relating to superannuation and first home saving arrangements, with numerous conditions associated with the operation of such accounts[25].

Our proposal would be for a much broader incentive available to all resident individuals, but perhaps subject to an annual deposit cap so that high income earners could not exploit the incentive. A low final interest withholding tax rate[26] would apply, as part of a dual tax system for savings. This would also form part of a revamped administration system that would reduce opportunities for avoidance of tax on such income and remove the need for many individual taxpayers to lodge tax returns. Assuming dividend imputation is retained, unfranked dividends paid to resident taxpayers would similarly be subject to a final withholding tax at source.

3.3 Does Australia's tax-transfer system appropriately deal with property and wealth, or should new approaches be introduced? What, if any, implications would any changes have for the taxation (or means testing) of capital income flowing from property and wealth?

Property taxation

The most significant taxes on wealth are imposed in relation to property, either on acquisition (stamp duty), holding (land taxes, rates, income taxes on property income) or disposal (capital gains tax on non-residential properties).

Although features of the current property tax arrangements can be improved, we regard land tax as a relatively simple and efficient tax on immovable wealth held in the form of real property[27]. Council rates and the mechanism for setting such rates also operate reasonably effectively.

We would like to see stamp duties on property conveyances abolished. We acknowledge that land taxes may need to be reviewed, and their tax base possibly expanded, as a trade-off for any such abolition.

Wealth transfer taxes

We note comments in the Consultation Paper relating to wealth taxes[28] and statistics which indicate concentration of wealth in high income households[29].

From a practical perspective however, we do not support the introduction of wealth transfer taxes in addition to those currently found in the capital gains tax provisions in the income tax law.

[25] Retirement Savings Accounts and First Home Savings Accounts.
[26] The withholding rate should ideally equate to the lowest personal marginal tax rate, to reduce arbitrage opportunities.
[27] Independent Pricing and Regulatory Tribunal, *Review of State Taxation. Draft Report.* June 2008, Sydney.
[28] Consultation Paper, Box 3.1. Page 63.
[29] Australian Bureau of Statistics 2006, *Household income and income distribution.*

Drawing upon overseas experience, there are a range of problems associated with wealth transfer taxes. In many cases, they are the same reasons which previously led to the abolition of these taxes in Australia. The reasons include:

- the difficulty in setting appropriate thresholds, and the need for annual indexation or regular review of such thresholds,
- the substantial anti-avoidance safeguards associated with such taxes (eg to counter the use of associates to hold assets, and the need to track life time gifts designed to help taxpayers fall below the tax threshold),
- problems in valuing certain types of assets (eg interests in private companies), and resultant valuation disputes,
- the impact of such taxes on those who are asset rich, but cash poor. Farmers and small business owners are typically cited as examples,
- the need for a range of concessions to cater for the devolution of assets to family members, passing on businesses to children, and special circumstances relief,
- the delays such taxes cause in the administration and winding up of deceased estates,
- the compliance costs relating to legal, accounting, valuation and taxation services,
- the encouragement such taxes give to increased use of offshore jurisdictions and / or non-disclosure of wealth,
- for non-resident individuals, the disincentive to hold assets in Australia and the practical difficulties of enforcing such taxes where the taxpayer (or their legal representative) is offshore, and
- for revenue collection agencies, the comparatively high administration costs associated with such taxes, and the relatively low "net" yield from such taxes in those jurisdictions where they are imposed[30].

3.4 Assuming no increase in the rate or base of the GST, what principles should guide the future development of other consumption taxes in Australia, and is there a need to change the role and structure of such taxes?

The assumption underlying the question illustrates the way in which the Panel's Terms of Reference relating to GST hampers the Review. GST is a mechanism which could, with changes to the tax rate and re-design of the base, reduce the need to develop "secondary taxes" on consumption.

We support expansion of consumption taxes, but not through the introduction of new taxes, which would add to compliance costs on business. The most efficient and sensible way to increase consumption taxes is clearly to either expand the base or increase the rate of GST.

[30] Consultation Paper, Box 3.1, page 63.

However, if there is need for new sources of revenue, the main avenue for further investigation would appear to be in the area of user pay charges (see 3.5 below).

3.5 Could greater application of user charges, rather than general taxes, in the funding of government services or infrastructure bring social, environmental or economic benefits?

In principle, we support greater application of user charges where the efficiency and simplicity criteria referred to in the Consultation Paper can be met[31]. The difficulty is that such charges, where levied for commonly provided goods or services, have a regressive impact on low income earners. In order for lower (or zero) user charges to apply to persons on low incomes, links with a national agency would be necessary to establish their eligibility for the concession (ie pensioner, unemployed, or persons whose income is less than a particular threshold).

As indicated in the Consultation Paper, there are a range of areas where such charges could be considered. One emerging example is healthcare, where escalating costs and an aging population raise the issue of whether taxpayers should make a greater contribution throughout their working life.

On environmental issues, we believe that there is growing acceptance within the community of the need for action on a range of fronts, including user charges. Success in leveraging this community support will require a clear correlation between any "green" imposts and the particular environmental objective. To take a simple example, additional charges levied for waste collection should have a clear connection with the goal of achieving higher, measurable, recycling targets and / or reduced, measurable, demand for new landfill sites.

The problems associated with beneficiary taxation are well summarised in the Consultation Paper[32]. In view of the efficiency costs and lack of transparency commonly associated with such taxes, we do not generally support their extended use.

[31] Consultation Paper, page 72.
[32] Consultation Paper, page 73.

Personal tax and transfers

4.1 How might the personal tax system be changed to better achieve the goals of greater simplicity, transparency, equity and efficiency?

Our earlier submission[33] suggested a number of personal tax measures.

- An expanded domestic resident PAYG withholding tax regime, which reflects a dual tax regime with low withholding on interest and unfranked dividend payments.
- Taxation of "big ticket" fringe benefits at the employee's marginal tax rate through the PAYG withholding system.
- Individuals with less complex tax arrangements can opt not to lodge a tax return, thereby benefiting from a "personal allowance" reflecting the deductions forgone.
- For taxpayers who elect not to lodge a tax return, net capital gains below a certain amount would be tax free.
- Reduced use of the tax system for incentives, and greater use of direct payments. By making greater use of technology however, it may be possible to use the PAYG withholding system to deliver some payments (eg a baby bonus). But rather than using the tax system to determine eligibility, individuals would need to advise a central government agency of "life events" which trigger entitlement to a transfer payment (eg the birth of a child in order to receive a baby bonus payment).

We suggested that an election to be taxed on the basis of family income also be considered, although we acknowledge that this has the potential to add complexity to the system.

We also suggested a range of measures for individual non-resident taxpayers[34].

[33] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008.
[34] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 20.

A residency test for individuals based on days in Australia – Part year tax free threshold

Another suggestion is a residency test for individuals based on days, rather than the current test, which focuses predominantly on whether a person "resides" in Australia[35]. Time based tests for residency are common in other jurisdictions, are simple to apply, and give certainty to expatriates and Australians working abroad. In the United Kingdom for example, a person will be regarded as resident under UK tax law if he or she is:

- in the UK for 183 days or more in a tax year (resident for that year for tax purposes),
- living in the UK permanently or will remain for three years or more (resident from the date of arrival), and
- in the UK for an average of 91 days or more in a tax year - worked out over a maximum of four consecutive tax years.

The other suggested reform to simplify personal tax is to remove the part-year tax-free threshold rules[36]. These rules add complexity to tax calculations, and are often overlooked or incorrectly applied.

Deductions for those lodging income tax returns

For those whose tax affairs are sufficiently complex to require the lodgement of tax returns (or those who "opt-in" to lodgement), there is the issue of continued entitlement to the range of personal income tax deductions currently available.

A reduction in work-related income tax deductions as part of a trade-off for lower personal tax rates targeted at low to middle income earners would address a number of issues: taxpayer compliance costs, ATO administration costs, and the significant cost to revenue of such deductions[37]. Such an approach not only offers efficiency benefits, but also acknowledges equity concerns relating to the over-claiming of personal income tax deductions by some taxpayers under the current self assessment system[38].

[35] Refer definition of "resident" in s6(1), Income Tax Assessment Act 1936. The practical problems, and subjectivity, of the current definition are well demonstrated by the leading ATO ruling on the topic – TR 98/17. Although there is a 183 test in the Australian definition, the "resides" test is paramount, and the 183 test also requires consideration of another concept which is difficult to apply in practice (ie an individual's "usual place of abode"): refer TR 98/17.
[36] Section 18 and s20, Income Tax Rates Act 1986. Note that a similar rule applied to those joining the workforce for the first time, but this was repealed in 2006 due to the practical problems in applying the provision: refer s19 (repealed), Income Tax Rates Act 1986.
[37] Consultation Paper, page 80.
[38] The growth in tax refunds to individuals is one indicator of this problem. Refer Table 2.2.2 (ATO net cash collections, 1998-99 to 2007-08), Commissioner of Taxation, *Annual Report 2007-08*.

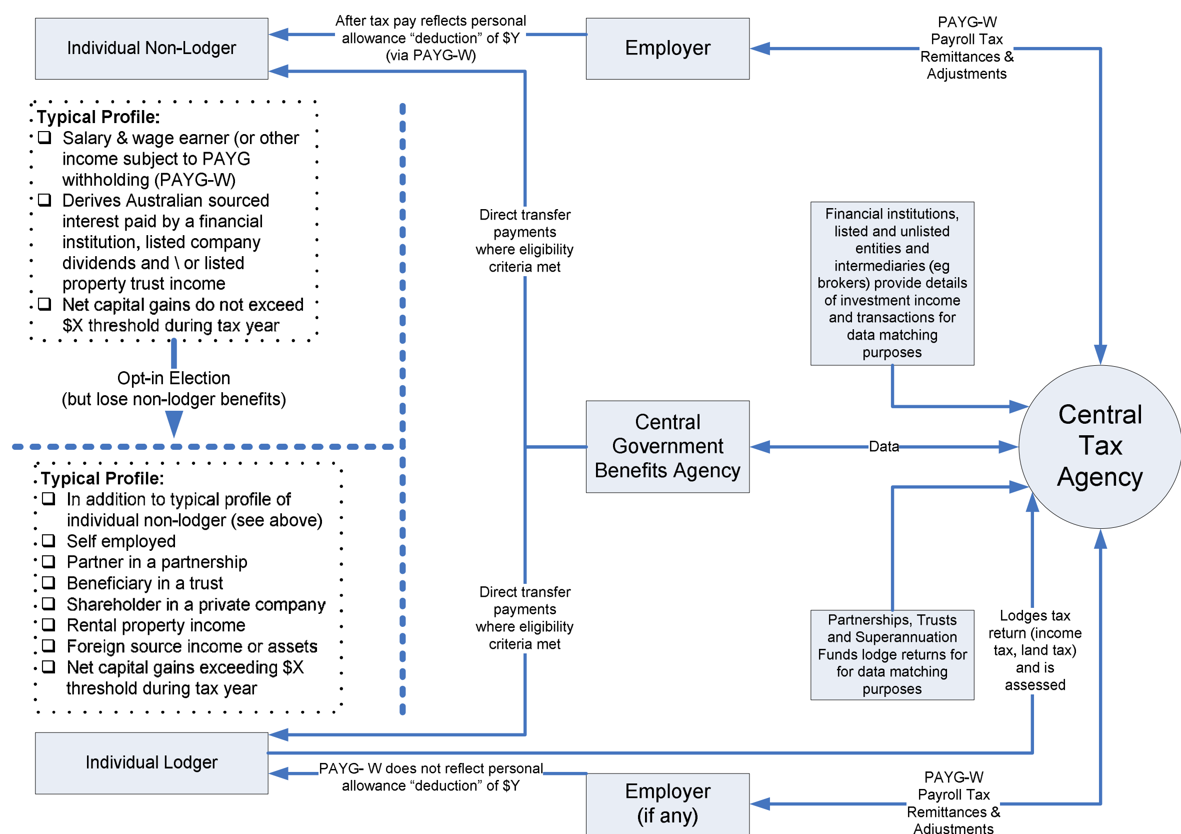
Non-lodger status

For those who do not lodge tax returns, our proposal would be to reflect the loss of work-related deductions and the ability to claim small CGT losses in:

- a "personal allowance" reflected in the PAYG withholding arrangements, and / or
- a reduction in personal tax rates, targeted in particular at low to middle income earners.

Diagram 1 below seeks to summarise the design of our model. Note that for the reasons given below, the model has a central government benefits agency, not the ATO, being responsible for transfer payments.

Diagram 1: Individual tax lodgement arrangements



The tax system is not the preferred option for delivery of transfer payments. We believe

- the sole purpose of the tax system should be to collect revenue, efficiently and simply. Combined tax-transfer systems run counter to this objective,
- the tax system provides inaccurate data for transfer payment purposes, due to the information "lag" that results from lodging an annual tax return. This lag has contributed to a number instances of "churn" (eg transfer payments paid based on information provided in the Year 1 tax return, then clawed back once updated Year 2 tax data becomes available),

- transfer payment eligibility often depends on means testing families. The personal tax system currently focuses on the individual taxpayer,
- the tax system does not gather all the information (both financial and personal) relevant to eligibility, in the same way that (for example) a case worker can, using ATO data as factor to make a fully informed decision, and
- the tax system is largely based on self assessment, and open to fraudulent claims for tax benefits.

4.2 What is the appropriate distribution of income tax across income levels and how should it differ from the current distribution? Should governments seek to maintain a similar distribution over time, or should they fix the value of current tax thresholds through indexation?

As noted in the Consultation Paper[39], the low income tax offset (LITO) effectively seeks to provide a concessionary tax rate scale for low income earners, and is less costly to the revenue compared to an increase in the tax free threshold which benefits all individual resident taxpayers. Nonetheless, this approach has added complexity to the system, and lacks transparency.

The other interesting feature of current tax policy has been to ensure that the 30% 'standard' rate applies to individual taxpayers whose income puts them close to average earnings. Whilst this reflects a pragmatic approach, it does little to address the distortions caused by the top marginal rate (46.5% including the Medicare levy).

Although some submissions have called for higher tax rates for high income earners, our view is that:

- Like global capital, labour is increasingly mobile. Income tax rates play an important role in deciding whether to work here, or abroad.
- The large discrepancy between the top marginal rate (46.5% including the Medicare levy) and the corporate tax rate distorts decision-making (eg entity selection, salary packaging), and encourages many high wealth individuals to set up private companies to shelter income, even though dividends which could be paid by such companies are capable of being franked. These outcomes give rise to obvious equity issues and efficiency costs, and in our earlier submission we recommended that the Panel consider narrowing the differential between the two rates[40]. We acknowledge the difficulty in pursuing this goal in the current economic environment, but urge the panel to retain this as a long-term objective.

[39] Consultation Paper, page 82.
[40] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 19.

- High personal tax rates may inhibit entrepreneurial behaviour.
- The trend in comparable countries has been to lower the top marginal rate[41]. The Australian top marginal rate (and / or the income threshold at which it applies) stands out as particularly high when compared to other countries.
- For many years, successive Australian Governments failed to adequately and regularly adjust the threshold at which the top marginal rate applies. The income level at which the top rate commences at $180,000 is now over three times average earnings, about twice the level of the early 1980s. In our view, a benchmark such as this should form part of the Panel's recommendations, so there is an ongoing yardstick against which to measure the appropriate level for imposing the top marginal rate.

* * * * * * * * * *

We support indexation of income tax rate thresholds so that the "real" value of such thresholds is maintained. Indeed, there is a case for the adoption of indexation (subject to rounding) throughout the various thresholds that apply for tax law purposes.

The arguments for and against indexation have been well summarised[42]. In addition to the matters set out in the Consultation Paper, we would add that:

- greater use of technology within business, accounting and government makes it relatively easy to adjust thresholds used in tax calculations, although some rounding of amounts would be desirable.
- a move towards resident withholding tax on interest and unfranked dividend income would negate the need for indexation on that part of the income taxed at a flat concessional rate, and
- indexation is a tax design feature that promotes fairness. Failure to index can mean that the value of a concession to the target taxpayer group may be eroded over time, or the impact of a specific tax measure broadened beyond its original intent.

[41] In New Zealand, the "headline" top personal income tax rate (ignoring levies) is 39%, and will fall to 38% in 2009/10 and 37% in 2010/11. The GST rate in New Zealand is 12.5%.
[42] Consultation Paper, page 86.

4.3 Is the personal income tax base appropriately defined? Should reforms such as changes to the scope of deductions or other measures be considered?

As noted above, our preferred personal income tax model would involve greater use of the PAYG withholding system for assessable receipts, big ticket fringe benefits, and in some cases direct payments from Government.

For the reasons stated in the Consultation Paper[43], we would fold the Medicare levy into the personal tax rate scales.

Refer our response to Question 4.1 for comments on personal income deductions.

4.4 Should the tax treatment of transfer payments be reconsidered? Should transfer payments be taxed at the same rate or a lower rate than earned income?

In principle, we support changes to the tax treatment of transfers to achieve greater consistency and equity between recipients of transfer payments.

In keeping with our model of keeping the majority of individual taxpayers outside the tax return lodgement system, we would recommend that entitlements be factored into the PAYG withholding rate calculations. For example, a couple would inform a central government benefits agency of the birth of a child in order to obtain a government payment (or to have the necessary adjustment to be made to PAYG withholding) reflecting any baby bonus or childcare entitlements[44].

4.5 Should people in different circumstances be taxed differently (for example, by age, occupation, location), and what might be the implications of such arrangements? Are tax offsets the best way to achieve differential taxation?

The goal of simplicity suggests that differential taxation according to personal circumstances be kept to a minimum, and preferably not used at all.

From an administration, taxpayer and tax agent perspective, there are enormous costs associated with such provisions under the current rules. These costs currently include:

- determining and quantifying entitlement to personal tax offsets, Family Tax Benefits etc,

[43] Consultation Paper, page 83.
[44] In the United Kingdom, a tax credit system applies with the amount of credit dependant on notification of changes in circumstances. See http://www.hmrc.gov.uk/taxcredits/index.htm.

- the use of the tax system to recognise or reward desirable behaviour (such as serving in the Australian defence combat forces overseas), when the class of eligible persons can be readily identified and payments made directly,
- the inter-relationship of tax offset entitlements on other calculations, which even extends in some cases to the use of “notional” amounts in arriving at the entitlement, and
- applying occupation based ATO public rulings (which in some minds are seen as entitling a taxpayer to a deduction, even if the relevant expenditure has not been incurred or cannot be verified).

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Tax offsets currently obtained through the tax return lodgment system are not in our view the best way to achieve differential taxation. In our experience, it can be difficult in practice for the ATO and tax agents to prove entitlement to offsets relating to personal circumstances (as distinct from an offset based on an easily ascertained benchmark, such as age). We believe it would be preferable for such benefits to be supervised and paid directly by a central government agency that has case workers with access to records relating to an individual’s background and personal circumstances, and who can come to a better informed decision on eligibility.

4.6 How can fringe benefits tax be simplified while maintaining tax integrity? Would it be better to adopt the general OECD practice of taxing fringe benefits in the hands of employees, rather than employers?

PricewaterhouseCoopers, along with many private sector organisations, have advocated taxing fringe benefits in the employee’s hands. The arguments in favour of such an approach are generally well known[45]. Now that the top individual marginal rate cuts in at $180,000, it is particularly inequitable that a flat FBT rate of 46.5% applies regardless of the employee’s taxable income.

We acknowledge that taxing employees on fringe benefits would not reduce employers’ compliance costs as the employer will still have the obligation to calculate the taxable value of each benefit.

[45] Consultation Paper, page 89.

Our preferred model would treat only specified “big ticket” fringe benefit items[46] as taxable, with their value calculated by employers and factored into PAYG withholding calculations. Living away from home allowances would be included in assessable income where they exceed threshold amounts determined by reference to a suitable benchmark[47].

Benefits not listed as taxable benefits would be tax free and deductible to the employer. The exception here would be entertainment[48] and the payment of fines, both of which would be non-deductible.

The calculation of the “taxable value” of taxable benefits should be reviewed and simplified where possible. Here, we refer particularly to company cars whose taxable value should be based on readily ascertainable factors such as published fuel emission levels or similar ratings[49].

The employer would report the value of taxable benefits on each employee’s PAYG Payment Summary, and remit PAYG withholding. This would make no difference to the employer’s costs where an employee currently salary sacrifices for a benefit as the PAYG withholding will be packaged to the employee as is the case nowadays. For non-salary packaged benefits the employer would remit PAYG withholding to the ATO at the employee’s marginal tax rate based on the grossed up taxable value rather than paying FBT at the maximum marginal tax rate of 46.5% on the grossed up taxable value as currently occurs, in may cases resulting in a saving to the employer.

To further alleviate employer compliance costs, employers could make a simple declaration as part of their annual tax return that no taxable benefits are provided[50]. The aim of this declaration would be to reduce the need for ATO audit activity on such employers in respect of benefits.

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[46] Examples are cars (not work-related vans, utes etc) available for private use, low-interest loans relating to the purchase of private use assets, childcare, free or discounted goods and services unrelated to duties of employment where the taxable value exceeds a specified annual amount. Private employee meal entertainment would revert to being treated as non-deductible. The current FBT treatment of car parking creates enormous compliance difficulties (eg measuring proximity to commercial car parks, monitoring rates charged by commercial car parks etc), and this benefit should be:

- treated as a non-taxable benefit for income tax purposes, and
- reflecting environmental concerns, subject to user pays taxation (which most employers would pass on to the employee through salary packaging arrangements).

[47] For example, the threshold could be set by reference to allowances paid under Commonwealth Public Service guidelines.

[48] The existing rules relating to non-deductible entertainment would broadly apply. However, the concept of meal entertainment fringe benefits would be removed, and such benefits would become non-deductible to the employer, and non-assessable to the employee.

[49] Refer for example to the submission to the Panel by McMillan Shakespeare Limited for a more environmentally friendly approach to company car taxation. We endorse this submission.

[50] In the United Kingdom, such declarations can be made in respect of cars.

If the Panel considers that FBT should be retained as a tax levied on employers, there are a range of improvements which should be made to the existing law and its administration. Apart from legislative amendments to counter the current "drag net" style of drafting (ie to focus only on "big ticket" fringe benefits, and reduce the need for exemptions and concessions), we would recommend the following simplifications to compliance arrangements.

Declarations and elections

Employers are currently required to collect various declarations and complete various elections in preparing their FBT return. We propose the following changes.

- Declarations: adopt a uniform "primarily for use in employment" requirement (as per s.58X in the Fringe Benefits Tax Assessment Act 1986), which relies on the employer's intent in providing the benefit, rather than the employee's use. Flowing on from this, removal of the otherwise deductible rule in respect of employment related payments or reimbursements such as interest on investment loans.
- Elections: rather than require an election, simply accept the employer's method as evidenced in their FBT work papers.
- Imposition of penalties on employees where incorrect information provided by employees has resulted in an underpayment of FBT.

Improved FBT return lodgement arrangements

Employers and tax agents are currently provided with the following lodgement extensions for annual FBT returns:

- Employers: 21 May
- Tax Agents: 28 May

These extensions are too short and place significant pressures on those seeking to achieve a high level of compliance. Most employers struggle to have their information collated until early May, due to reliance being placed on external providers (eg. leasing companies or packaging bureaus) and tedious administrative requirements (eg. employee declaration requirements).

We propose an extension to 31 May for employers and 30 June for tax agents each year. Historically, the ATO has been reluctant to provide additional extensions due to its revenue collection targets.

We also suggest a number of simplifications to the law relating to benefits.

Cars

Statutory formula method: we recommend that the statutory formula be replaced with a formula based on the carbon-emission rating of the vehicle. The more environmentally efficient, the lower the taxable value.

Car parking

Car parking facilities provided for airline travellers and employers located within one kilometre of parking provided primarily for airline travelers should be excluded from the definition of a commercial car park. The rates are artificially inflated and not reflective of the market value of car parking within a one kilometre radius.

Etags

The inclusion of Etags as an additional and separate benefit has created a considerable record keeping burden: Etags should be built into the car fringe benefit calculations, or treated as a minor benefit where no company car is provided (see below).

Minor benefits

The FBT treatment of minor benefits is becoming increasingly complex. ATO rulings on the topic have further complicated employer decision-making processes. Consideration could be given to:

- legislating the number of permitted benefits per FBT year, thus removing the irregular and infrequent analysis, or
- providing an FBT exempt threshold for certain benefits provided to employees. For example, an exemption for the first $2,000 (indexed) of benefits with a maximum value of $300 each benefit (indexed) that are not part of an employee's remuneration package, such as meal entertainment and recognition awards. This could be done by an employer creating a pool to which the cost of benefits such as meal entertainment available to all employees (eg Christmas parties) could be allocated. This pool could then be treated as non-deductible / non FBT. The exempt amount per employee would be based on the number of employees entitled to attend the event, not those that actually attended. This would eliminate detailed record keeping for many employers and reduce the complexity of the current income tax/FBT interaction. All benefits provided in excess of this pool should then be taxed in full. Any employer found to providing benefits to any employee or group of employees disproportionately to be subject to penalties.

Living away from home benefits

The existing FBT legislation relating to living away from home allowance benefits should be retained. However, some amendments could be considered to eliminate perceived abuses of the current provisions. For example, further documentation of reasonable thresholds could be required (this requirement is currently limited to expatriate employees for food) and/or time limits set during which an employee will be considered as living away from home.

Part-day travel and meal expenses

Currently, meal expenses associated with part-day travel are subject to FBT, whilst meal expenses associated with travel involving an overnight stay are otherwise deductible. This distinction should be removed. If necessary, a distance threshold should be inserted to qualify for travelling classification (eg. 50 km radius from the usual place of employment / residence).

Fly-in-fly-out travel arrangements

Due to resource shortages, employers are increasingly required to fly-in labour to the work location and these arrangements are given concessional FBT treatment. However, FBT can apply to travel and accommodation costs where employees commute from an interstate location regularly. We recommend that the FBT exemption for fly-in-fly-out arrangements be extended to cover such situations.

Public transport

To encourage greater use of public transport and help achieve reduced greenhouse emission targets, an FBT exemption or concession could be introduced for employer assistance with public transport costs for travel to and from work.

Non-meal entertainment expenses

Whilst still being taxable they should become not reportable to relieve the employer of the burden of tracking the employees who attended entertainment type events.

4.14 Does the tax-transfer system create disincentives for individuals seeking to acquire new skills or upgrade existing skills? If so, what sort of tax or transfer changes would provide better incentives?

The current tax system impacts skills acquisition in a number of ways:

Business

- Aside from the on the job learning that typically occurs in the workplace, businesses which qualify for the research and development (R&D) concession can obtain incentive deductions for costs, which include labour and associated costs, relating to R&D projects.
- An employer can generally deduct the cost of supporting an employee's education. No FBT applies if the costs would have been "otherwise deductible" to the employee, had they been incurred by the employee.
- Business can deduct gifts to educational institutions, although the level of business support in Australia is not as high as it is in other jurisdictions (notably the United States).

Individuals

- A scholarship, bursary or educational allowance can be treated as tax exempt if it meets various legislative requirements[51]. Note here that certain types of Commonwealth education or training payments are not exempt. A tax offset may be available where an individual's assessable income includes, inter alia, a Commonwealth education or training payment[52].
- At an individual taxpayer level, an income tax deduction is available for self education costs after the individual has obtained initial qualifications, and then only if there is a nexus between the course of study and current or prospective income earning activities. Only the excess over $250 is deductible[53]. There have been many disputes with the ATO on the deductibility of personal self education costs[54].
- Individuals can invest in so-called "education bonds", which provide tax paid proceeds after 10 years to meet a child's education expenses (or for any other purpose). The tax policy which gives rise to these products is not motivated by a desire to support education, but the financial intermediaries who promote the products typically target parents with children.
- The current Government introduced an education tax offset from 1 July 2008 to cover "key education expenses" such as laptops, educational software, textbooks etc[55].
- Debts arising under the Higher Education Loan Programme (HELP) are repaid through the tax system once the student's income exceeds a repayment threshold. Employers who pay this debt for an employee obtain a deduction for the outlay, but pay FBT.

For individuals in particular, the current review provides an opportunity to streamline the treatment of educational support mechanism in a way that encourages the development of human capital, a key factor in determining whether Australia succeeds in a global economy.

We note that the Panel has commissioned a background paper to examine the link between effective tax rates and human capital investment decisions, and PricewaterhouseCoopers may have further comments to make when the paper is published. As an interim comment, our model would include:

- if further incentives are needed, greater reliance should be placed on direct payments to individuals (or educational institutions) where eligibility criteria has been met,
- uniform tax exempt treatment for government bursaries, scholarships etc,

[51] Refer s51-10 item 2.1A and s51-35, Income Tax Assessment Act 1997.
[52] s160AAA(3) Income Tax Assessment Act 1936.
[53] Section 82A Income Tax Assessment Act 1936.
[54] Refer ATO Tax Ruling TR 98/9 for a summary of the relevant case law.
[55] Subdivision 61-M Income Tax Assessment Act 1997.

- to encourage private sector support for study, consideration should be given to exempting employer payments up to a specified threshold[56]. Employer financial assistance with HELP debts would attract PAYG withholding, rather than FBT.
- the introduction of a general tax concession for savings accounts would enable individuals to save for a range of "life events", including further education, and
- an option (refer 4.15 below) for couples to elect family unit taxation, so that the decision by one person in the relationship to pursue further study (eg retraining, post-graduate study) is not unduly hindered by tax considerations.

4.15 Given the competing demands of targeting assistance to people when they need it and minimising unnecessary transactions, what changes could be made to existing tax and transfer policies?

We reiterate our view that there be greater reliance on direct transfer payments, and less use made of the tax system as the mechanism to determine entitlement and delivery of entitlements. In terms of the submissions made to the Panel, our preference is for greater separation of the tax and transfer systems[57].

Other suggestions to minimise unnecessary transactions include:

- greater use of technology for notifying employers of PAYG withholding variations to reflect entitlements (if any) still delivered through the tax system, and
- greater centralisation of data and better use of technology for sharing State and Government information on "life events" and asset holdings etc (eg births, deaths, marriages, divorce, land title data etc) for determining and cross checking entitlements to transfer payments. We acknowledge privacy concerns, but Australia has lagged behind many other jurisdictions where a central identifier is used for a wide range of purposes.

[56] In the United States of America for example, the first $5,250 of employer support payments are tax free in the hands of the recipient. Amounts above this figure are also concessionally treated if it is a "working condition fringe benefit" (a similar concept to the "otherwise deductible" in Australia's FBT regime).
[57] Consultation Paper, page 114.

4.16 Should the different bases of assessment for tax and transfers be reconsidered (including the unit of assessment, income definitions, period of assessment and assets treatment)?

We have previously put forward the view that, as part of the move to a streamlined personal income tax regime, consideration should be given to allowing taxpayers to elect to be taxed on the basis of family income[58]. An elective approach caters for some of the differing viewpoints referred to in the Consultation Paper[59], and provides a degree of flexibility for families.

From a policy perspective, family unit taxation enables all eligible couples to obtain tax outcomes which are currently available only to those who are able to structure their affairs to achieve income splitting. It would also reflect in a tax sense what has for many years been the case under most transfer payment eligibility regimes, where levels of support are typically determined on the basis of household income.

We acknowledge that family unit taxation does however add complexity, particularly in an environment where we are trying to reduce the number of personal tax returns that need to be lodged. Family unit taxation also has other complications: for example, the relevant law would need to cater for divorce or separation, and joint liability issues.

[58] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 19.
[59] Consultation Paper, page 115.

The retirement income system

We note the Minister for Superannuation and Corporate Law and a coalition of peak superannuation industry bodies released a Communiqué of Principles for Superannuation on 28 April 2009.

The press release states that this will lead to a review of "the current operational features of our superannuation system…across the system as a whole and complement the work underway by the Australian Future Tax System review".

5.1 In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?

The objectives we would emphasise are those already reflected in the retirement incomes policies of recent Federal governments:

- compulsory life cycle saving arrangements (reflected in the Superannuation Guarantee arrangements for employees),
- public awareness that, although the government should provide safety net age pension arrangements, the onus is on the individual to plan ahead for the costs associated with retirement,
- incentives for self employed persons to put money into superannuation, or to use the proceeds from the sale of business for superannuation, and
- co-contributions from the Federal government to encourage after tax contributions from low to middle income earners.

There is growing awareness within the community that the government cannot fully cover the escalating cost of providing health and aged care services without substantially increasing taxes. A tax effective savings vehicle to allow individuals to put aside funds for such costs is both desirable and necessary. There are however a range of design issues to consider, including:

- should the savings made to this type of account be "ear-marked"[60], or made available for other types of life events (eg to help during periods of unemployment, or to assist with education costs)? Our preference would be for a general purpose account,
- capping the amount that can be contributed to such accounts, presumably through use of an identifying tax file number and sharing of data provided by financial institutions, and
- the limitations (if any) placed on financial institutions as to the use to which the deposited funds can be put.

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[60] First Home Saver Accounts are an example of a savings incentive ear-marked for a particular purpose. Refer *First Home Saver Accounts Act 2008*.

It is also important for any recommendations from the Panel to be accompanied by broader policy pronouncements from relevant Federal and State Governments on how the government sector will achieve greater efficiencies in the delivery of health and aged care services.

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The beneficial impact of the Superannuation Guarantee system has yet to fully emerge[61]. Whilst there are legitimate questions concerning the adequacy of the current 9% contribution rate, any change to the rate needs to be carefully considered. Clearly, the current economic environment is not conducive to an increase in the Superannuation Guarantee, and business owners need adequate lead times to factor into projected labour costs any increase that may be recommended by the Panel.

Of particular concern is the adequacy of current arrangements for the self-employed and owners of small business entities. Those in this category have a tendency to “pay themselves last”, and it is difficult to devise a policy framework which encourages superannuation-type saving in a commercial environment where incomes are unreliable and fluctuating. The “lock-away” (preservation) aspect of current superannuation arrangements is also a discouraging factor. Assuming that current preservation arrangements remain, one possible model for consideration by the Panel is extending the farm management deposit scheme currently available to primary producers[62] to the self-employed and small business owners.

5.2 As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?

Refer to our response to Question 5.1 for self-employed persons.

The existing superannuation concessions already figure prominently in Treasury’s list of tax expenditures[63], and the affordability of further concessions is questionable. Nonetheless, other measures which could be considered to assist persons referred to in the question include:

- Allowing employers to make “salary sacrifice” deductible superannuation contributions to a complying fund in respect of an employee’s spouse or partner, without attracting FBT.

[61] Consultation Paper, page 100.
[62] Division 393, Schedule 2G, Income Tax Assessment Act 1936. As at 30 September 2008, 39,570 account holders held $2,567,082,000 in farm management deposits, and the overall balance has remained relatively constant despite the drought affecting large parts of rural Australia (source: Department of Agriculture, Fisheries and Forestry website).
[63] *Tax Expenditures Statement 2008*, Treasury (Canberra). Refer Table 2.3, page 12.

- Removing the 10% test[64] for tax deductible personal superannuation contributions completely. As tax concessions on deductible contributions are effectively limited by caps, the 10% rule is obsolete, as "double dipping" can no longer occur. Indeed, the rule is potentially discriminating, eg the impact on a woman commencing or ceasing work part way through a year due to maternity leave.
- Increasing the current government co-contribution[65] and / or easing eligibility requirements.
- Encouraging migrants to transfer their retirement benefits into the Australian superannuation system. From 10 May 2006, tax barriers arose to discourage the transfer of retirement benefits above a threshold, which is set too low for those whose working life has mostly been outside Australia. Subject to appropriate anti-avoidance mechanisms, overseas transfers should be allowed into Australia, without tax penalties[66].

5.9 In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?

The simplification of the taxation of superannuation, effective 1 July 2007, has greatly reduced complexity and the cost of advice for retirees and workers. In particular, the removal of any limits of taxes on benefits, for those over age 60, has been a major factor in the simplification. Two further areas of complexity requiring simplification are:

- The imposition of tax on death benefits on lump sums paid to non-dependants, following the death of the member. Apart from the complexity of the calculation, this is in contrast to payments being tax free if paid directly to members over age 60 or to their dependants following death. This distinction creates confusion and results in unnecessary benefit withdrawals. The complexity could be reduced by exempting from tax all lump sum death benefits paid.
- Employer SG contributions are currently 9% of an employee's Ordinary Time Earnings (OTE). OTE is not well defined by legislation and is subject to interpretation by employers, employees and the regulator (the ATO). With all employers bound to use OTE for the calculation since 1 July 2008, there is uncertainty over what elements of pay are to be included. This is already resulting in industrial disharmony and additional costs for employers who, whilst anxious to meet their superannuation obligations, are unclear as to what those are. A clearly articulated legislative definition of OTE would solve this.

[64] Section 290-160 Income Tax Assessment Act 1997.
[65] Refer *Superannuation (Government Co-contribution for Low Income Earners) Act 2003*.
[66] Recommendation by Senate Standing Committee on Economics, *Tax Laws Amendment (Simplify Superannuation) Bill 2006 and Related Bills*, February 2007, Canberra, paragraphs 3.14 to 3.25.

5.13 The cost of providing health and aged care to older Australians is currently met by government through the health sector. Should retirement income policy take into account projected increases in health costs for older Australians? If so, what would be the most effective mechanism and how might the transition to such a system be achieved?

Refer our response to Question 5.1.

Taxing business and investment

6.1 Can the tax system be structured to better attract investment to Australia in a way that increases national income, and if so how? For any given revenue outcome, what are the relative merits of broader base/lower rate (comprehensive income tax) or narrower base/higher rate (a narrow income tax or an expenditure tax) approaches?

Attracting investment to Australia

PricewaterhouseCoopers has a very strong view that the tax system is an important component in the attractiveness or otherwise of a country for business investment, although we acknowledge that tax is only one of a number of regulatory[67] and commercial factors. The more difficult questions to address are:

- how important a factor is tax in attracting business investment?, and
- what aspects of the tax system are most important in that regard?

In relation to the relative importance of the tax system as a factor in business decision making, in our experience, business will often seek to optimise tax outcomes when making investments. It should be recognised that taxation considerations include transaction taxes, property taxes, taxes on employees, as well as corporate income tax.

It is important to note, however, that these tax considerations are nearly always part of wider commercial objectives and it is very unusual for taxation to outweigh commercial objectives.

Nevertheless, many business activities are now globally mobile. Foreign governments and economic commentators are increasingly recognising this, although sometimes making rather superficial comparisons between industries which are mobile (eg financial services) and industries which are less mobile (eg extractive industries). We believe the situation is more complex. Certainly some industries are more mobile than others, but even industries which might be regarded as less mobile have enormous flexibility as to where certain functions might be geographically located. For example, while the mining industry has to explore and mine where the resources are located, many other activities (including processing, marketing, research and development, treasury, head office functions, etc), can be and often are located elsewhere. Moreover, even less mobile industries make investment decisions between projects in different countries and tax is one factor in determining the relative return on these investment options.

[67] World Bank Doing Business 2009, Comparing regulation in 181 economies which investigates the regulations that enhance business activity and those that can restrain it.

We acknowledge that some of these general propositions are hard to support. It is worth mentioning that the Australian Taxation Office's 2009 compliance program recognises this issue and states "we are concerned about global corporate restructures that shift assets, functions and risks offshore, …". The ATO goes on to say these arrangements are of concern to revenue agencies around the world[68].

Not only do tax administrators around the world believe this is an issue, but increasingly governments are recognising and responding to the impact that tax has on business decisions. For example, over the last few years a significant number of UK resident groups have shifted residence from the United Kingdom to more attractive tax regimes. In many of these cases, these companies have publically stated that the UK tax regime was a significant motivator for those decisions. In response, the UK government has recently announced proposals to unwind some of the features of UK tax law that have influenced these corporate emigrations. The point is not how Australia's tax system compares to that in the UK, but rather that tax can and does influence location decisions.

The Canadian government has also recognised the significance of globalisation and mobility of capital. *Advantage Canada*, a long term economic plan for Canada, included a plan to establish the lowest tax rate on new business investment in the Group of Seven (G7)[69].

This trend for countries to take action and ensure their tax regimes are internationally competitive is well summarised in the World Bank PricewaterhouseCoopers *Paying Taxes 2009* publication, which outlines global tax reforms, both to systems and rates in the previous 12 months (refer pages 9–15). We enclose a copy of this report.

In summary, with increasing globalisation and mobility of capital, we think it is critical that Australia's tax regime is internationally competitive.

While there are many factors that could be seen as relevant to making Australia's tax regime attractive to do business here, we believe two factors are central to achieving this objective; namely

- the tax burden (both company income tax and other business taxes) should be reduced to a competitive level, and
- the system(s) imposing tax should be refined to world's best practice, with a particular focus on minimising their compliance burden.

[68] Australian Taxation Office, 2008-09 Compliance Program (http://www.ato.gov.au/corporate/content.asp?doc=/content/00155156.htm&page=53&H53).

[69] *Advantage Canada – Building a strong economy for Canadians.* Department of Finance Canada, 2006. Refer page 73 et seq. Refer: http://www.fin.gc.ca/ec2006/plan/pltoc-eng.asp.

In relation to the overall tax burden, PricewaterhouseCoopers does not believe an objective of having a competitive tax rate necessitates the lowest overall rate of tax, but the objective should be to very much have a competitive tax burden. We make a number of observations in relation to this:

- Any consideration of the tax burden must involve not just corporate income tax, but also the impact of all other business taxes. PricewaterhouseCoopers has done significant work, both in Australia and other countries, examining the impact of all business taxes on business. While the mix of income tax to other business taxes varies considerably between countries, unquestionably Australia has a particularly high reliance on corporate income tax (refer section 10 of the Total Tax Contribution study)[70].
- The Architecture Paper acknowledges that Australia's nominal rate was above the OECD average of 26.6% in 2008[71]. This OECD comparison is already out of date, and the position is worsening with proposed rate reductions in other countries including New Zealand and Canada. In fact, Australia has already slipped to the equal 6th highest tax rate within the OECD.
- A comparison of rates against OECD countries ignores the increasingly important developing countries, including within our own geographic region. Generally the rates in these countries are much lower than the OECD. Any analysis of Australia's competitive position should include an analysis of relevant non-OECD member countries, particularly those in Asia.
- In any event, any comparison of income tax itself needs to extend far beyond the statutory rate of income tax. Far more important than the statutory income tax rate is the effective rate of tax[72] by business. The effective rate of tax takes into account the tax base to which that rate is applied. We enclose a study, undertaken by PricewaterhouseCoopers for the Business Council of Australia and the Corporate Tax Association last year, of effective rates of tax of public companies in Australia and selected other countries[73].

  Our comparison of effective tax rates in Australia, Canada, Germany, Singapore, the United States and the United Kingdom demonstrates, the differential between statutory and effective tax rates is very low in Australia compared to these other countries[74].

[70] *What is your company's Total Tax Contribution? 2008 Survey Results.* PricewaterhouseCoopers (Australia), August 2008.
[71] *Architecture of Australia's tax and transfer system*, Treasury, August 2008, page 210.
[72] Effective rate of tax refers to tax expense as a proportion of accounting profit.
[73] *Review of Effective Tax Rates in Australia*, August 2008.
[74] *Review of Effective Tax Rates in Australia*, August 2008, pages 12 and 13.

In summary, the tax burden imposed on business in Australia is high by global standards. Not only is Australia's statutory company income tax rate increasingly uncompetitive internationally, our analysis shows that our effective company tax rate is of even more concern. There is a very strong case to argue the overall income tax impost on business needs to be reduced to retain and attract globally mobile investment.

The second important factor influencing the attractiveness of our tax system, is the structure of the system itself. We would like to see an output of the Panel's review being the design of the most efficient business tax system among developed countries, one which, over time, other countries see as a model for their tax systems. We acknowledge that there are many challenges to address if this objective is to be achieved, not least of which is our Federal system of government.

In section 8 of our submission we consider the issues related to complexity in more detail, but addressing system complexity would go a considerable way to making our tax system more internationally competitive.

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As noted above we believe the income tax burden is too high and, to the extent affordable, it should be reduced. We also made the point that, by global standards, we have a broad tax base to which our tax rate is applied. Nevertheless we believe the reduction in the tax burden should largely be achieved through a reduction in the rate rather than base.

We have adopted this view partly because a tax rate reduction benefits the broadest spectrum of Australian business, compared to base narrowing measures which would create winners and losers. For example, an incentive such as the investment allowance (a base narrowing measure) is of particular benefit to businesses with high levels of capital investment, but provides little benefit for businesses which operate in the financial services sector for example. Although the Panel will receive many business submissions which seek both lower tax rates and base narrowing concessions, there is obviously a finite ability to cater for both.

Nevertheless, we recognise that there are situations where the taxation system might be used to provide appropriate incentives to business. In our view, the most important examples of this are:

- A competitive capital allowance regime. Capital investment, particularly in the extraction industries, infrastructure and manufacturing sectors, is important to the long term strength of our economy. Remaining anomalies relating to tax "black hole" expenditures need to be identified and brought within the scope of current provisions.

- Incentives for research and development. Although the R&D incentive is a base narrowing measure, the available literature indicates that the current R&D concession provides valuable spill-over effects which enhance national income[75]. We therefore support continuation of this feature of the tax law and await the Government's response to the Cutler Review[76].

Base and rate

The Consultation Paper has flagged for discussion a number of more radical measures which could potentially improve international competitiveness. These included both some base broadening options (eg limiting interest deductions) and base narrowing measures which have been adopted in other countries. Our comments on these are set out in Appendix A.

As a general proposition, we think it is useful to debate these alternative arrangements, although we have particular reservations about a cash-flow tax. Of the various ideas discussed in the Consultation Paper, we think the ACE merits most consideration.

As a general proposition we would not support radical changes (including those proposed in the Consultation Paper) to the base for income tax, unless these changes involved a reduction in complexity and hence compliance costs. Given the inevitable transitional costs, this ongoing reduction in complexity would need to be significant to justify radical change to the existing system.

6.2 What changes, if any, to the tax system would improve the ability of Australian companies to operate internationally orientated businesses? How should the tax treatment of companies and shareholders be integrated in an open economy?

Much has already been done to improve the way in which the Australian tax system applies to inbound and outbound investors. In broad terms, the current regime acknowledges that tax deferral is appropriate where an Australian company invests in a foreign company with an active business. The policy of capital export neutrality is reflected in the tax treatment of outbound passive investment however, where attribution of the foreign income applies. We broadly support the current international tax framework.

[75] Department of Industry, Tourism and Resources, *How R&D Assistance Influences Company Behaviour,* Canberra, July 2007.
[76] The Review of the National Innovation System - V*enturous Australia - building strength in innovation* **-** has been completed. The Government is now considering the Review's recommendations in preparing a 10 year White Paper on Innovation.

In terms of Australia as a base for regional operations, the conduit foreign income rules[77] provide some incentive to the establishment of holding companies in Australia. However, Australia remains at a competitive disadvantage with countries in our region such as Singapore[78].

We also note also that the Board of Taxation is currently examining the following areas as part of its review of the anti-tax-deferral regimes[79]:

- "modernisation" of the controlled foreign company (CFC) and foreign investment fund (FIF) rules - including a new definition of passive income for the purposes of the accruals taxation regime to ensure that there is no accruals taxation of what is active business income, new exemptions, and more ways to calculate attributable income, and
- consistent treatment of superannuation entity investment offshore whether it is through a controlled entity, flow-through entity, or direct investment.

We urge the Panel to give favourable consideration to the Board's recommendations.

Managed funds and the financial services sector

The Consultation Paper makes specific reference to the "Competitiveness of Australian-based managed funds and other financial service providers"[80], and in particular the input taxing of financial services providers.

The policy basis for input tax treatment of financial supplies is that there is no readily agreed identifiable value for supplies consumed by customers of financial services. Most jurisdictions with a GST (or Value Added Tax) therefore exempt financial supplies[81].

This policy was overturned in New Zealand, which amended its GST Act in 2003[82] to allow supplies of financial services by a GST-registered person to another GST-registered person to be "zero-rated". The changes were made to integrate the supply of financial services more fully into the GST system by taxing such supplies at the rate of 0% and allowing financial services providers to deduct input tax in respect of those supplies. The New Zealand Government described the policy in the following terms[83]:

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[77] Division 802 ITAA 1997.
[78] Approved regional headquarters in Singapore are taxed at a concessionary rate of tax of 15% on qualifying overseas income, and approved international headquarters can negotiate for various tax incentives including tax exemption or concessionary tax rates on qualifying income.
[79] The Hon Peter Costello MP, Press Release No 109, 10 October 2006.
[80] Consultation Paper, page 141.
[81] Explanatory Memorandum to *A New Tax System (Goods and Services Tax) Act 1999*, paragraph 5.140.
[82] Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003 (NZ).
[83] Explanatory note, *Taxation (Annual Rates, GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003*, page 9.

The changes are a response to the problem that the current exempt treatment of financial services is distortionary relative to the supply of other goods and services. The distortion arises because GST is not charged on the supply of financial services and, therefore, financial service providers are unable to claim a credit or "input tax" for GST paid on purchases used to supply the services. This leads to the potential for GST to cause over-taxation or "cascade" from the financial services sector to business customers. The cascade may result in higher than optimal prices or restructuring in a less than efficient manner by some financial service providers to lower their GST burden.

We see obvious parallels in an Australian context and a policy change of this nature would radically simplify the operation of the GST law.

However, the two significant hurdles to overcome are the:

- cost to revenue, and
- ability of the benefits to be passed onto consumers, given the myriad of dealings and fee structures in the financial sector.

To progress the discussion further, Treasury should attempt to quantify the revenue implications. We also understand that relevant industry bodies are making representations on this matter, and they are best placed to identify the benefits that could flow to consumers.

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The second question raises the important issue of the impact of the current imputation rules on Australian companies with offshore activities, and the shareholders of those companies.

At the outset, it is important to emphasise the inter-relationship of the imputation regime with other aspects of the tax system. Any consideration to remove imputation would need to be packaged with other changes including a significantly lower corporate tax rate, reduced taxation of dividends to shareholders including superannuation funds.

As recently noted by Dr Henry[84], an imputation system in a small open economy such as Australia's has a number of advantages and disadvantages, and combined with recent reforms to the taxation of foreign source income, imputation creates a bias towards inbound debt funding (countered to some extent by the thin capitalisation rules).

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[84] Refer speech by Dr Ken Henry, Australian Business Tax Reform in Retrospect and Prospect colloquium, 23 February 2009.

At the moment we remain broadly supportive of the current imputation regime. Its beneficial effects include:

- Removal of the "over-taxation" problems associated with the classical system of shareholder – company taxation.
- The encouragement given to equity investment and employee share ownership in particular.
- The encouragement given to Australian companies to pay Australian income tax.
- The benefits it provides to the superannuation savings of Australian workers (the excess franking tax offset reduces tax on non-dividend income). Indeed, the removal of the franking tax offset would be seen by the superannuation sector as an effective tax increase on member accounts.

Arranged against these benefits are a number of disadvantages:

- In a small, open economy like Australia, dividend imputation creates some significant biases against inbound and outbound investment.
- Assuming that Australia cannot afford to align the company tax rate with the top marginal rate, imputation creates a bias in favour of profit retention in companies. In the past, such tax planning was countered by a "tax" on un-distributed passive income[85]. A dual rate system with a low flat tax rate applying to income from capital perhaps at the company tax rate, but continues to tax labour income at marginal tax rates, is one potential way of addressing the problem[86].
- The non-recognition of foreign tax payments under the imputation rules is often cited as a short-coming. In addition to the points made in the Consultation Paper[87] however, it is important not to view the imputation system in isolation from other aspects of the current tax system. In keeping with the trend in other countries, Australia:
    - exempts foreign source non-portfolio dividends derived by Australian companies,
    - does not apply accruals taxation to active offshore income derived by offshore companies controlled by Australian companies, and
    - reduces the CGT on gains from the sale of shares in foreign subsidiaries, by reference to the "active" nature of the offshore company's activities.

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[85] This was the so-called "Division 7 tax" under the Income Tax Assessment Act 1936. These provisions were abolished upon introduction of the dividend imputation system.
[86] Dual rate tax systems have been adopted by some Nordic countries.
[87] Consultation Paper, page 140.

> In effect, Australia "waits" to collect income tax from the abovementioned Australian companies *if and when* they distribute their tax protected profits to shareholders. The inability of companies with substantial offshore operations to adequately frank dividends is also compensated for to some extent by the CGT discount available to individual and superannuation fund investors, if and when they sell their shares.
>
> Earlier in this submission, we suggested a dual tax regime with low flat PAYG withholding on interest and unfranked dividend payments. Assuming the company tax rate is not reduced to parity with the relevant withholding rate, we would envisage that business taxpayers would also be subject to withholding at source as part of a move to streamline tax payments relating to corporate and institutional investors.

Streaming of franked dividends

We note submissions seeking dividend streaming to address some of the shortcomings of the imputation system[88]. The current anti-avoidance safeguards against streaming add much complexity to the law, and part of the policy thinking behind imputation in 1986 was that there should be some "wastage" of credits. To allow streaming therefore would be a marked policy turnaround. Nonetheless, the Panel should consider commissioning a study of the outcomes a streaming policy might achieve.

6.3 Can the tax system be restructured to improve resource allocation within the economy and minimise operating costs, and if so, how? What changes would reduce distortions to risk taking and encourage entrepreneurial activity?

This question in the Consultation Paper is preceded[89] by a discussion of two broad approaches to tax reform:

(i) Improvements to the current tax arrangements, or

(ii) Moving to a business level expenditure tax.

In our first submission, we focused on the first of these two approaches, and we submitted that the Panel's primary focus should be on ensuring the maximum reduction in the corporate tax rate rather than narrowing the base of taxation. However, we did support change in two specific areas relevant to investment and risk-taking behaviour:

[88] Consultation Paper, page 140-141.
[89] Consultation Paper, page 142 et seq.

- the introduction of flow-through loss shares for companies engaged in certain sectors, such as mining, oil and gas, renewable energy, and high tech development companies[90], and
- a review of capital allowances[91].

We also submitted that loss carry back rules should be considered as part of the Panel's review[92].

6.4 What principal goals should inform the taxation of capital gains in Australia, and what, if any, changes should be made to capital gains tax as a result?

We support the main design features of the current CGT regime, and in particular the imposition of tax only upon realisation.

Our main observations are as follows:

- the current provisions would benefit from a re-write, to both simplify the law and make a number of "small p" policy changes,
- consideration should be given to removing a number of "value shifting" adjustments to cost base in favour of a general anti-avoidance provision, and
- less sophisticated investors have particular difficulty with CGT (eg keeping track of "cost base erosion" information relating to non-assessable distributions from companies and unit trusts). Possible approaches here include exempting individuals from paying CGT on gains below an annual threshold, which also fits with our proposal to exclude most individuals from the tax return lodgement requirements.

6.5 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 approaches to entity taxation?

See comments under Question 6.1 and Appendix A relating to business expenditure taxes.

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We reiterate comments in our previous submission[93] for improvements to the treatment of company losses, and a more streamlined approach to the taxation of partnerships and trusts.

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[90] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 14.
[91] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 17.
[92] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 15.

6.6 Should the tax system be structured to cater for the specific circumstances of small business, and if so, how?

We agree that small business has particular circumstances, which it would be desirable for the Review to address. In our earlier submission, we supported consideration of a flow through tax regime[94].

Apart from the observations made in the Consultation Paper[95], it is important to note that tax law design already has rules that differentiate between "big" and "small" business (sometimes there is even a "medium" category). For example, Division 230 in the Income Tax Assessment Act 1997, dealing with the taxation of financial arrangements, effectively confines elective tax timing methods to large, audited enterprises.

On balance therefore, we support tax rules which cater for the circumstances of small business. In our view:

- small business concessions should be rationalised, following a review of which concessions are "under-utilised" in practice
- the complexity associated with current eligibility criteria should be reduced, and
- if small business entity concessions are retained across a variety of tax topics, consideration should be given to drafting a separate small business tax regime so that the relevant body of rules can be found in one place, and more easily understood and applied.

It is worth mentioning that any separate regime (as opposed to specific rules) for small business will need to address a range of practical issues, including the definition of "small", and the transition from "small" to "large" (and back).

In view of the complications which can arise when a "small" entity becomes "large", we recommend:

- clearer tax close off rules when eligibility for the small business regime ends, and
- that a growing business that ceases to be eligible for small business concessions cannot later revert to small business status.

Just as importantly, we believe that there is an enormous dividend to small business if the complexity of the business tax system can be addressed. In reality, the tax system is designed for very large business, and the PricewaterhouseCoopers Total Tax Contribution survey indicates that there is clearly an inverse correlation between the size of a business and the relative

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[93] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 14-16.
[94] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 17.
[95] Consultation Paper, page 154.

cost of the compliance. The cost of compliance is clearly relatively more onerous on smaller organisations[96] and small business would be the major beneficiary of a less complex tax system.

6.7 Should the tax system be restructured to deliver a more neutral tax treatment for the different forms of return on household savings and investments, and if so, how?

See comments under Question 3.2.

[96] PricewaterhouseCoopers (Australia), *What is your company's Total Tax Contribution? 2008 Survey Results*. Page 45 and Figure 8.2.

Not-for-profit organisations

7.1 What is the appropriate tax treatment for NFP organisations, including compliance obligations?

We regard the current tax policy settings for the Not-for-profit (NFP) sector as basically sound.

Our dealings with the ATO on behalf of NFP organisations indicate that matters relating to deductible gift recipient (DGR) and charitable status are generally dealt with in a timely and professional manner. When it comes to dealing with the relevant State Government bodies however, there is scope for improving current arrangements through greater harmonization of relevant legal requirements and streamlining applications through a central regulator.

Indeed, we see merit in having a “one stop shop” national agency for registering and regulating NFPs. We would envisage that this agency operate separately from the ATO, allowing the latter to focus on its revenue collection role.

There are a number of other areas where we would suggest reforms:

FBT

The Consultation Paper summarises the current issues relating to the FBT concessions for some parts of the NFP sector[97]. The paper notes that the $30,000 or $17,000 capped exemption per employee, and “rebateable employer” status, offend the neutrality principle. In practice, these tax concessions are now used as a disguised taxpayer subsidy enabling NFP employers to attract staff who can be paid in a tax effective manner not available to other employers and their employees.

Removing FBT and including the value of big ticket benefits in assessable income (as recommended elsewhere in this submission) would remove the inequity created under the current rules. It would then be left to employers to determine how to compensate affected employees, applying commercial (rather than tax based) factors.

We acknowledge that this may lead to requests for greater Government support for NFP organisations, but that direct support will be more transparent than the current disguised tax subsidy.

Quantifying the cost to Government is difficult because it would appear that not all employees in the public benevolent institution and not-for-profit health sector take advantage of the current concession[98]. The relevant employers will need to consider the impact of any FBT changes on all employees, not just those who currently salary sacrifice to obtain the FBT concession.

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[97] Consultation Paper, page164.

[98] *The case for PBI and public / not-for-profit health employer retaining and indexing concessional FBT to assist the retention and attraction of employees,* McMillan Shakespeare Limited.

Income tax – mutual receipts

Although we are loathe to recommend anything that adds to the volume of tax law, it is time that the so-called mutuality principle was given some statutory foundation, rather than continuing as a “grey area” of the tax system, understood only by a relatively small group familiar with relevant judicial authorities and ATO administrative practice.

Although this might add to complexity, a legislative approach affords Parliament an opportunity to consider and, if necessary, address long-standing taxation and commercial issues affecting clubs (eg the adequacy of income tax arrangements for determining member and non-member income, the impact of State based poker machine taxes, the differentiation between a club’s core community activities and its profit-making commercial operations).

Gift deductibility

PricewaterhouseCoopers has recently participated in a study which indicates that more can be done to encourage “payroll giving” arrangements[99]. The study found that changes made in 2002[100] have had a beneficial impact on payroll giving, and the main barriers to overcome were:

- limited time and resources,
- low program visibility within the firm,
- staff preference to use other forms of charitable giving, and
- whether such programs were a low business priority.

Embedding workplace giving programs into typical salary arrangements, combined with electronic payment technology, has a number of advantages for both DGRs and employees. It also provides greater assurance that deductions are not being over-claimed.

In the tax environment envisaged in this submission - where less individual taxpayers lodge tax returns - workplace donations would need to be linked to the PAYG withholding rules so that the gift is reflected in the withholding rate, rather than being claimed back through the tax return lodgement process. Recent Government moves to reduce the salary sacrifice - FBT problems associated with such arrangements are a step in this direction, and most welcome[101].

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[99] *The Giving Business. Creating successful payroll giving programs*. PricewaterhouseCoopers, The Australian Charities Fund, Charities Aid Foundation, The Centre for Social Impact, United Way Sydney. Sydney, March 2009.

[100] *Special Gazette 251*, 2 July 2002 (in which the ATO issued a PAYG variation for workplace giving programs under s15-15 of Schedule 1 to the *Taxation Administration Act 1953);* ATO Practice Statement PS 2002/15 (in which the ATO set out guidelines for evidencing the making of a gift by a taxpayer who participates in a workplace giving program).

[101] The Assistant Treasurer announced on 24 February 2009 that the Government will amend the FBT law from the beginning of the 2008-09 FBT year to ensure that donations made under salary sacrificing arrangements do not result in an employer incurring a FBT liability.

Businesses and individuals who are still required to lodge a tax return (or who opt to do so) would continue to claim tax deductions for charitable gifts through tax returns. Given advances in technology (in both the DGR sector and the methods used to solicit and obtain donations), consideration should be given to the collection of tax file information for donations exceeding a specified amount. This will enable greater accuracy in claiming deductions, and data matching by the ATO. For those PAYG earners who donate on an ad hoc basis (eg to the Red Cross door knock appeal), the personal allowance arrangements referred to earlier in this submission would reflect an assumed amount of charitable giving.

We note the reference in the Consultation Paper to the Gift Aid arrangements in the United Kingdom[102], but the associated compliance costs appear burdensome. As noted elsewhere in this submission, we prefer to see the ATO's functions confined to tax administration and revenue collection, as distinct from also being a payment agency for non-tax related purposes.

Productivity Commission enquiry

We note that the Productivity Commission has recently been asked to examine the extent to which tax deductibility influences both decisions to donate and the overall pool of philanthropic funds[103].

PricewaterhouseCoopers is currently preparing a submission to the Productivity Commission Review into the Contribution of the Not for Profit Sector.

Reviewing and, if necessary, revoking charitable status

There have been a number of recent instances where the tax exempt status of an organisation has been abused, typically because of the actions of a few individuals in senior management positions. The proliferation of charitable foundations has also raised concern that the founders need to maintain an arm's length distance from the organisations they helped to create.

Revoking an organisation's charitable status is a serious step that is generally only used in cases of serious non-compliance. This includes, but is not limited to, instances where an organisation such as the ATO audit identifies:

- significant non-charitable activity,
- private benefits directed towards directors and/or related persons,
- tax receipts issued in excess of actual gifts received or directed to specific persons,
- failure to spend sufficient amounts on charitable activities,
- inadequate or non-existent books and records, or
- lack of control or direction over expenditure of funds.

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[102] Consultation Paper, page 166.
[103] Joint press release (the Deputy Prime Minister, the Assistant Treasurer, the Parliamentary Secretary for Social Inclusion and the Voluntary Sector), 17 March 2009.

One of the practical difficulties we encounter is that the regulation of Australian charities is a responsibility shared primarily by the Federal and State governments. For example, tax deductible status is determined at Federal level, whilst authorisation for fund-raising activities is done at State level.

We therefore see merit in:

- creating clear, published and uniform (ie Federal and State) Government "best practice" guidelines for the establishment and day to day operation of charitable organisations, and
- a more regular review process by a single national regulator (eg the ATO or other Government approved agency), which involves the publication of findings and recommendations for improving the way in which the organisation is operated.

7.2 Given the impact of the tax concessions for NFP organisations on competition, compliance costs and equity, would alternative arrangements (such as the provision of direct funding) be a more efficient way of assisting these organisations to further their philanthropic and community-based activities?

In relation to competitive neutrality arising from the tax exempt status of organisations engaged in commercial ventures, we note that that the matter has been previously considered[104], and the existing arrangements were left undisturbed.

However, it has recently been announced that the impact of tax exemptions on "the commercial neutrality of the market" will again be the subject of a further review by the Productivity Commission[105].

[104] *Report of the Inquiry into the Definition of Charities and Related Organisations*, Treasury, Canberra, 2001; *Charitable Organisations in Australia*, Industry Commission, Canberra, 1995.
[105] Joint press release (the Deputy Prime Minister, the Assistant Treasurer, the Parliamentary Secretary for Social Inclusion and the Voluntary Sector), 17 March 2009.

Complexity — cost, risk and transparency

8.1 Which taxes or transfers are the most complex and impose the greatest costs? How should these costs be reduced (by abolishing the taxes or transfers or by making the rules applying to them simpler)?

PricewaterhouseCoopers has been concerned about the complexity of Australia's tax system for some time. This was indeed one driver for our Total Tax Contribution initiative. Section 8 of the study analyses the impact of compliance on business. Complexity is clearly the hidden cost of our tax system, and is far greater than often recognised. It is clear that business, through its own tax obligations and obligations to collect tax on behalf of Government, bears the cost of this complexity.

In the latest study we analysed the cost of complying with the Australian tax system as a percentage of taxes actually paid or collected as the case may be. The average and median "compliance surtaxes" are set out below. The overall compliance cost is high by comparison with both the United States and the United Kingdom[106] and it is very clear that the most inefficient taxes are FBT and stamp duty.

Borne	Median	Average
Income Tax	0.87%	1.58%
Payroll Tax	0.24%	0.65%
FBT	4.78%	7.60%
GST	3.28%	2.64%
Customs	0.94%	7.88%
Gaming and Wagering	0.01%	0.10%
Stamp Duty	13.13%	9.89%
Land Tax	0.37%	1.13%
Excise	0.02%	0.26%

Collected	Median	Average
PAYG – Employees	0.05%	0.11%
GST	0.14%	0.83%
Excise Duty	0.01%	0.01%
Insurance	0.04%	0.04%

The table in Appendix B summarises our response to the question relating to complex taxes. Of particular concern at the moment, are announcements by the ATO over the past 18 months reflecting new "preliminary draft views" on the operation of Australia's thin capitalisation, transfer pricing and debt/equity rules. These rules are at the foundation of our company tax system and, in essence, it is currently not possible to adopt a capital structure that is without risk of ATO challenge. Put simply, it is unclear what mix of debt and equity funding is acceptable to the ATO. PricewaterhouseCoopers has recently made representations on these issues to the Assistant Treasurer and Treasury.

[106] PricewaterhouseCoopers (Australia), *What is your company's Total Tax Contribution? 2008 Survey Results*. Refer page 61.

To examine how the costs associated with these complex areas of the tax law can be reduced, it is first necessary to understand the many causes of complexity in our tax system. These include:

- Tax system complexity, by which we mean the interaction of an unnecessarily large number of taxes in different jurisdictions, administered by different tax authorities.
- Tax law design complexity, which reflects:
    - a "drag net" approach to tax collection (ie tax every transaction contemplated by the policy, then provide exemptions and concessions),
    - a concern that specific types of tax planning needs to be countered with specific anti-avoidance provisions, rather than rely on a general anti-avoidance approach,
    - on some occasions, undue haste in accepting advice provided to Government by Treasury and ATO officials, without input from outside the public sector,
    - a desire to cater for increasingly complex business models and transactions (often reflected in making choices or elections available to taxpayers),
    - the failure to complete the Tax Law Improvement Project (TLIP), and an unwillingness to permit anything other than "small p" policy changes during the TLIP re-write process, and
    - a lack of any regular legislative "house-keeping" to address defective or anomalous tax law.
- The self assessment system where taxpayers have the primary onus of complying with the tax law, both in terms of interpretation and collection. In our view, self assessment has contributed to a tax design and implementation mind-set which assumes taxpayers and their advisers will manage to correctly apply the new law, and gather the data relevant to correctly record the revenue impact of the new measures. The foreign exchange provisions[107] are a recent example of new law where that assumption has proved incorrect.
- Tax compliance complexity, with the most common complaint here being the need to provide data necessary to populate annual[108], quarterly or monthly tax forms with information required by the relevant tax collection authority for its own use and for the use of others (eg for statistical purposes)[109].

[107] Division 775, Income Tax Assessment Act 1997.

[108] For the annual Form C company tax return for example, 27 pages of information is required from companies obliged to complete all relevant schedules.

[109] In addition to a 6 page annual company income tax return, another 21 pages of tax based financial information are potentially necessary, to be provided as part of the compliance process.

In particular, there is an unwillingness to base tax calculations and data reporting on accounting information, with the result that the preparation of a business income tax return requires a large number of adjustments to be made to accounting profit (or loss), to arrive at taxable income (or loss).

Some of these issues were addressed in the Tax Design Review Panel's report *Better Tax Design and Implementation*[110], and we endorse the recommendations of that Panel.

As for other issues listed above, this submission recommends a mix of measures which include the abolition of certain taxes, and the simplification of others.

8.2 In what ways might the administration of Australia's tax-transfer system be changed to better meet the needs of individuals and businesses? How might the process of personal income tax returns be simplified, including by removing the requirement for some taxpayers to lodge returns? Should the administration of the system be more integrated (across taxes and transfers and between jurisdictions)? How might advances in technology assist?

Good tax administration lies at the heart of a good tax system, and the current review provides a useful opportunity to put consider ideas for reforming tax administration in Australia.

A national tax collection agency

Our first submission suggested consideration of a national tax collection agency[111] for all State and Federal taxes. We believe that such an option should be pursued if it can be demonstrated that the benefits from reduced compliance and administration costs exceed the cost of eliminating State offices of revenue collection and centralising their functions. We note that this is a focus of the reform process in Canada. The Advantage Canada strategy states "Provincial governments have an important role to play in improving our national tax competitiveness. Already, nine provinces and the three territories have entered into tax collection agreements with the federal government. These agreements make the tax system more effective by streamlining the tax process and generating compliance savings for taxpayers. Tax harmonization not only results in administrative efficiencies for governments but, more importantly, makes tax payments simpler by allowing businesses to file only one return, which reduces their costs"[112].

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[110] Tax Design Review Panel, *Better Tax Design and Implementation. A Report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs*, 30 April 2008 (released on 22 August 2008). Treasury website, Canberra.

[111] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 9.

[112] *Advantage Canada – Building a strong economy for Canadians.* Department of Finance Canada, 2006. Refer page 75 et seq. Refer: http://www.fin.gc.ca/ec2006/plan/pltoc-eng.asp.

A management board for the ATO?

The current tax law allocates to the Commissioner of Taxation “the general administration” of various Commonwealth tax laws, with the support of three Second Commissioners. Special rules govern the appointment, remuneration, resignation, suspension and removal of those who fill these senior positions[113]. Very broad powers are vested in the Commissioner and his senior officials, some of which are coercive in nature. These arrangements reflect the importance attached to the role, and the need for the role to be free of external interference.

The ATO consults regularly with many stakeholders in the community, and is for the most part an “open” organisation which communicates on a regular basis its strategic goals, compliance plans, current activities and outcomes achieved.

Notwithstanding all this, the need for a different leadership model for the ATO is a topic regularly discussed within business and professional groups. We summarise the main concerns with ATO administration as follows:

- a hierarchical culture which impacts organisational agility,
- a “home grown” approach to grooming future leaders, which means that few in senior positions have experience outside the organisation,
- an apparent reluctance to engage in advocating changes to tax policy, even where ATO consultative processes indicate that change is needed,
- compliance processes which are often slow, unnecessarily disruptive, labour intensive and costly, and
- a lack of deep technical talent to reflect the complex laws it administers (although we acknowledge that higher salaries in the private sector and an increased demand for tax advisers since 1985 have adversely impacted staff retention in the ATO).

Changing the current arrangements by having a more diverse leadership team is seen by many large corporate clients as a positive step which can help address these concerns.

The Board of HM Revenue and Customs in the UK is often cited as a potential model, with its mix of Executive and Non-executive Directors[114].

The Canadian Revenue Agency (CRA) is another model which is of particular interest if Australia moves to a single national tax collection agency: 11 members of the 15 person CRA Board of Management are appointed by the various Canadian provinces[115]. State representation would be relevant in an

[113] Refer Taxation Administration Act 1953, s 3A and Part II.
[114] For further details, see www.hmrc.gov.uk/board/index.htm.
[115] For further details, see www.cra-arc.gc.ca/gncy/brd/menu-eng.html. The CRA Board has no authority in the administration and enforcement of tax legislation. In this respect, the CRA remains fully accountable to the Minister of National Revenue.

Australian context if a central tax agency became responsible for collecting both Federal and State taxes.

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Our response to Question 4.1 outlines our views on simplifying personal taxation compliance.

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Our first submission supported the creation of a central tax agency to administer tax at both Federal and State level.

Apart from operational efficiencies that could be achieved, the administration of the various tax laws could be further integrated, reducing compliance costs for business taxpayers in particular.

Assuming one tax identification number and integrated systems, for example, a taxpayer who purchases an investment property would deal with the one tax collection agency during ownership in relation to various tax obligations, principally:

- conveyance duty on the purchase of land (assuming this category of stamp duty is not abolished) – the taxpayer would be identified on the system as a holder of commercial property,
- land tax – notification triggered by purchase data,
- GST registration – notification of requirement to register triggered by purchase data,
- income tax (declaring income and claiming deductions),
- development charges (if any),
- council rates, and
- CGT on disposal of the investment – notification triggered by transfer data.

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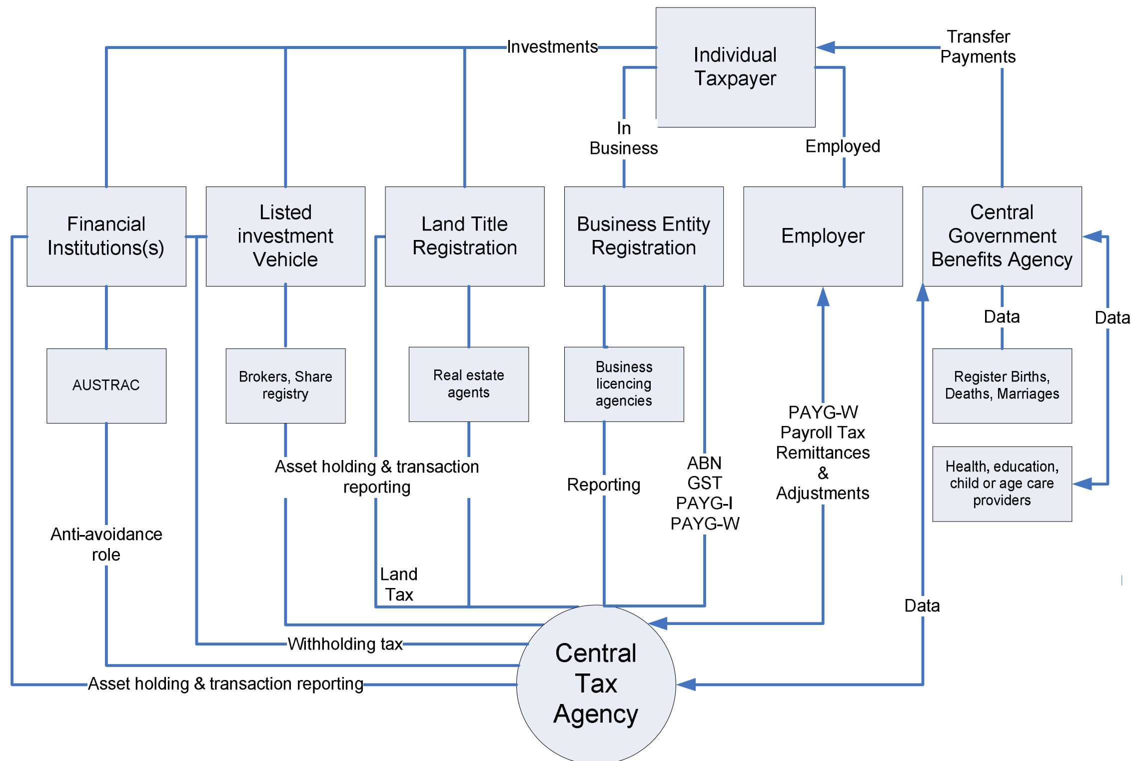
Greater use of technology, and in particular a central taxpayer identifier, is an essential element in a streamlined tax administration system.

In such an environment, it is not difficult to imagine the ATO (as the central taxation agency for all taxes) obtaining and providing the data necessary for a streamlined tax and transfer payment system, as Diagram 2 seeks to illustrate.

Diagram 2: Streamlined tax and transfer payment system



8.3 To what extent might policy objectives be traded off to achieve a simpler system? In what areas should efficiency, equity or choice be traded off for simplicity?

There are a number of areas where trade-offs are suggested in this submission.

These include:

- Fringe benefits tax – where the current “drag net” style of drafting indicates a policy objective of taxing all fringe benefits, with a large number of exemptions and concessions. The complexity associated with this approach is one of the reasons behind calls to remove the tax and focus on assessing to the individual the taxable value of “big ticket” fringe benefits.
- Personal tax collections – where the current requirement for most adult individual taxpayers to lodge returns reflects in part a policy to enable each person to accurately quantify taxable income, based on personal circumstances. The resultant compliance costs and high level of personal tax deductions claimed are the primary reasons behind calls to change the current arrangements to a system where individuals with straight-forward affairs need not lodge a return.

- Greater reliance on financial reports – where there has been reluctance on policy grounds to have tax outcomes determined on the basis of accounting principles. Apart from the recent Division 230 reforms[116], we see scope for extending the use of audited financial reports for other purposes of the tax law to reduce the extent of tax related adjustments in arriving at taxable income, or in tax calculations relating to thin capitalisation for example. Consideration should also be given to the use of internal accounting data for calculating PAYG installment income, in place of the "ordinary" and "statutory" income distinction currently used[117]. We acknowledge however that there are limits on the extent that accounting data can be used for tax purposes (ie accounting standards in some cases would narrow the corporate tax base).

8.4 How could the governance of the tax-transfer system be reformed to reduce complexity, uncertainty and cost, and to improve transparency, understanding and support for the system?

We take governance in this context to mean both policy making and administration.

Tax policy making

The design of tax law needs to be improved in various respects, including:

- ensuring policy considerations are better reflected in the drafting process,
- an end to the "drag net" mind-set in designing tax law (reflected in the current FBT law for example), and
- a reduction in specific anti-avoidance measures, many of which are considered unnecessary in view of the general anti-avoidance provisions.

In terms of on-going improvements to the design and implementation of new tax laws, we endorse the recommendations contained in the Tax Design Review Panel's report *Better Tax Design and Implementation*[118].

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[116] Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008.
[117] s45-120 Taxation Administration Act 1953. It is becoming increasingly difficult for businesses to calculate ordinary income, particularly where the tax law calculations are required to identify items within the "ordinary" category (eg gains on financial arrangements and forex gains - refer Division 775 and Division 230 Income Tax Assessment Act 1997).
[118] Tax Design Review Panel, *Better Tax Design and Implementation. A Report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs*, 30 April 2008 (released on 22 August 2008). Treasury website, Canberra.

Tax administration

Apart from endorsing the above-mentioned Tax Design Review Panel recommendations relating to the implementation of tax measures, and our response to Question 8.2, we would add the following:

- enhanced use of technology to improve tax compliance processes, and
- an improved framework for ATO and Treasury relations, to reduce the "blame game" that sometimes occurs between the two organisations during the settling-in period for new tax legislation.

State and local taxes and transfers in the Australian federation

9.1 Noting the overall structure of Australia's federal financial arrangements, what changes, if any, should be made to the assignment of revenue raising powers and intergovernmental transfers in Australia?

Ideally, each level of government should be financially self-sufficient. However, given the current revenue raising powers of the different levels of government this is not possible.

Achieving greater vertical fiscal balance should be a goal for any reforms to Australia's federal taxation system. Clearly own source revenue for the States is desirable, but we would be supportive of tax base sharing (as in Canada) or further revenue sharing (as is the case with GST).

Accepting the current revenue raising powers of the Commonwealth and State governments however, the allocation of funding from the Commonwealth to States should focus on outputs and outcomes to be achieved. Transparent, easy to understand performance frameworks should be developed and implemented by the Commonwealth. States should remain responsible for delivering services to the agreed standards.

Funding should be provided to the States in a manner that allows them to deliver services at the required standard. There is the potential for the Commonwealth to use funding to provide incentives to the States to improve performance over time. However, this should not compromise service delivery and the manner in which this is done is likely to be different depending on the desired outcome and the service that is being funded.

In deciding the allocation of funding for service delivery between the states there could be an enhanced role for the Commonwealth Grants Commission (CGC). Rather than the States directly negotiating with the Commonwealth in order to secure funding, the CGC could provide an independent assessment of each State's requirement, which the Commonwealth could consider in making its allocation along with State government submissions. This could provide a greater level of transparency and accountability to the allocation process.

We support the retention of the existing funding model whereby the Commonwealth collects revenue and provides it to the States to deliver services. However, there may be some merit in examining the service delivery roles of the Commonwealth and those of the States. Much of the existing discussion revolves around whether the revenue raising powers should be changed. Alternatively, it may be worth reassessing service delivery roles to determine whether the Commonwealth should have greater responsibility for service provision.

Refer also to our response to Question 8.2 for comments on tax collection matters.

9.2 Given the widely held view in submissions that the current state tax arrangements need to be reformed, what changes should be made to state and local government own source revenue instruments? What scope is there for greater use of user charging to bring social, environmental or economic benefits?

Particular focus should be given to removing further State taxes as envisaged under the *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations*[119]. The main targets should be the poorly designed and distortionary taxes (including property conveyance duties and insurance taxes) and a range of nuisance type taxes.

As has been discussed in other parts of this submission, we support the abolition of a number of inefficient State taxes. Three of the most inefficient state taxes are:

- stamp duty on property transfers,
- stamp duty on insurance, and
- fire service levies.[120]

We also support greater harmonisation of State tax bases, rates and design. This has the potential to greatly improve the ease of doing business in multiple Australian jurisdictions.

As noted in our response to Question 8.2, there is also a case for the establishment of a central tax collection agency that would collect taxes on behalf of all state governments.

There is also scope for greater application of user charges by State and local governments. Greater user charging:

- would provide State and local governments with alternative revenue sources within their control, and
- has the potential to provide for a better allocation of resources as they provide a price signal to users.

User charging is also a way to address negative externalities and can be used to achieve improved social, environmental and economic outcomes. By placing a price on these externalities users are forced to incur the cost, or consider the full impact, of the activity they are undertaking. User charging can be used as a policy tool to achieve desired outcomes and / or address local issues.

[119] "The Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations" can be found in Schedule 2 of the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999* (Cth).

[120] Access Economics, *Axing The Alcabala: A Program For A 21st Century State Tax System,* A Report for the Business Coalition for Tax Reform, November 2004, Canberra, p.ii.

The introduction of greater user charging would allow for a greater mix between user payments and direct government funding to pay for government service delivery. User charges could be collected and retained by agencies responsible for providing the service. By providing services more efficiently agencies would be able to maximise their revenue. There is also the potential for user charging to reduce the call on consolidated revenue.

If State and local governments did move towards a greater application of user charging there may be some benefits in ensuring that a consistent approach is used across jurisdictions. As with taxes, user charges have the potential to distort business and consumption decisions and a consistent approach across jurisdictions could act to minimise these distortions.

A common argument against user charging is that it is regressive. With those who earn the least paying a proportionally greater amount of their income. To the extent that this can be reduced in the structure of the charge, without adding too much complexity, such options should be pursued.

9.3 What is the appropriate allocation of the roles of the Australian and State governments in income redistribution?

We support the retention of a model whereby the Commonwealth remains the main revenue collection body, at least in the short-to-medium term. The role of redistribution therefore remains largely with the Commonwealth. The question remains as to how the Commonwealth should redistribute income.

The CGC model, which aims to achieve horizontal fiscal equity, generally works well. It provides a degree of rigor and transparency to the distribution of funding between the states. As mentioned earlier, the CGC could have a greater role in allocating funding to the States, providing a more robust and transparent approach.

We understand that the model for redistribution is currently under review and is therefore considered to fall outside the scope of this review. We consider that there is room for improvement in the CGC's approach. In particular the five year averaging period that is currently used should be shortened.

9.4 What opportunities could be pursued to deliver more seamless administrative arrangements of the tax-transfer system across the federation?

We have previously submitted that a central tax collection agency should be considered for Australia[121].

[121] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 9.

Combined with a rationalisation of inefficient taxes, tax collection by one national taxing agency, replacing the various State OSRs, would radically improve the efficiency of the current process for both business and

Governments. The collection of GST by the ATO on behalf of the States provides a useful model which should be considered in the context of other taxes. Harmonisation of the State tax base would further enhance the compliance cost savings, and in reality would be a prerequisite for the benefits of centralised administration to be achieved.

Centralisation would also deliver scale benefits, such as:

- lower tax collection costs,
- greater use of electronic reporting of tax data, and of electronic payments,
- refund arrangements,
- streamlined tax reporting, and
- streamlined statistical collection.

We also believe that the payment and administration of transfer payments should be the role of a body other than the ATO, with the payments made outside the tax system. For obvious reasons, there would be a high level of data sharing between the two agencies responsible for the tax-transfer system.

Tax and transfer impacts on housing

10.1 What should be the objective of the tax-transfer system in respect of housing? Should there be assistance for housing over other assets or services? Should assistance be based on housing tenures? Should assistance be focused on people on low incomes? Should assistance differ between public and private tenants?

As with government intervention in any market, intervention in the housing market should be aimed at addressing an identified market failure.

In the case of low-income earners and the provision of social housing it could be argued that a market simply does not exit. That at the price that these individuals are able to purchase accommodation there is simply very limited or no supply. As a result there is a strong argument for government to intervene to ensure that long-term accommodation can be accessed by these individuals.

Assistance should be structured to ensure that individuals who are in need of accommodation are able to access accommodation that meets their needs. The nature of assistance may vary depending on housing tenure and whether the individual is accessing public or private housing. There needs to be a range of approaches to meet the diversity of needs.

As far as possible, any assistance that is provided should be structured to minimise the reliance of individuals on assistance in the long-term.

10.2 What role, if any, should the tax-transfer system play in respect of housing affordability? Should the tax-transfer system be used to influence housing supply and/or demand to improve housing affordability? What changes, if any, should be made to housing-related transfers that assist disadvantaged households to find housing?

In terms of using the tax-transfer system to influence the demand and / or supply of housing or to improve affordability, such measures should only be pursued where it can be shown that such an approach is the best way to achieve these objectives. Again, such interventions should only be pursued where there is a clearly demonstrated market failure.

10.3 Recognising the influence that some taxes and transfers have on the use of housing and residential land, what changes, if any, should be made to ensure the housing stock and residential land are used efficiently?

To ensure the efficient use of housing stock and land, taxes and transfers should be applied to ensure that they do not distort the decision making process. Efficient use of housing stock and residential land is more likely to occur in an environment where the market is able to operate with minimal interference.

Taxes on specific goods and services

11.5 Are taxes on specific 'luxury' goods an effective way of making the tax system more progressive? If so, what principles should apply to the design and coverage of these taxes?

Although efficient, indirect taxation is a blunt, imprecise instrument when it comes to making the tax system more progressive.

We generally see little point in higher taxes on luxury items due to the classification and compliance problems that arise[122]. Such goods are by definition, highly priced, and the dollar amount of GST embedded in the final price paid by the consumer is therefore greater.

Taxes on luxury goods are also usually easily avoided. Those who aspire to own such goods can, in many cases, afford to travel to jurisdictions where they can be purchased “tax free”, and tax enforcement at the customs barrier on re-entry to Australia is difficult. Luxury cars are an obvious exception here, and we note that the Panel has been asked to consider the future of the Luxury Car Tax (LCT). As stated elsewhere in this submission, we favour a tax regime which encourages fuel efficient vehicles and lower emissions.

Finally, there are services which some would regard as luxury items, but these rarely figure in the design of luxury taxes. This distinction between goods and services raises competitive concerns between different providers.

11.6 Should the tax system have a role in influencing the relative prices of different types of cars, including luxury cars and higher polluting cars, and if so, on what basis? What does this mean for taxes on the purchase price of motor vehicles?

There is a growing community concern about environmental issues generally, and the need for fuel efficient, low emission vehicles. We have noted at Question 13.2 some ideas for how the tax system can play a part in encouraging desirable behaviours in this area.

[122] Under the Sales Tax (Exemptions and Classifications) Act 1992 (Repealed) for example, a schedular design was used to identify “luxury” goods for which a higher tax rate applied. As technological advancements were made, goods which were once “luxury items” (eg cameras) became more readily available and pressure was exerted on the Government to remove those goods from the higher rate classification.

Fuel, roads and transport

12.1 How can motor vehicle related taxes and road funding arrangements be designed to improve the efficiency of transport of people and goods in Australia? Is there potential to design taxes for specific transport issues?

The efficiency of transporting people and goods on Australian roads is predicated on a number of factors including:

- the ability of roads to cope with the volume of traffic,
- the availability of suitable alternative transport options,
- a co-coordinated approach between Federal and State authorities,
- centralised infrastructure planning and construction, supported by adequate funding, and
- a system of taxes and charges that promotes outcomes consistent with policy objectives (for example, lower tolls for motor cycles relative to cars based on the number of passengers/road wear-and-tear and congestion charges to encourage a switch towards public transport, assuming it is available).

There is a major disconnect between motor vehicle taxes and road funding arrangements. Fuel taxes are more than five times higher than tax on other goods and services. The revenue raised is not hypothecated to the construction and maintenance of roads, and goes to general revenue.

Revenue-raising and political considerations currently top the agenda for considerations around spending rather than directing the fuel tax revenue back into specific road infrastructure. Inconsistent road charging policies exist which further exacerbate the perceived inequity - for example; congestion tolls imposed on motorists using the Sydney Harbour Bridge, but not motorists using major Western Sydney freeways.

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Road charges could be targeted to improve certain hot-spots. Despite being one of the heaviest freight corridors in Australia, much of the Pacific Highway between Sydney and Brisbane remains single lane in each direction. Contrast the Pacific Highway with the relatively free-flowing Hume Highway between Sydney and Melbourne. Targeted road charges could be introduced to tackle this issue.

Efficient transport options include promoting the use of public transport and encouraging more rail freight. The tax system should be designed in a way to encourage these choices.

12.2 What should be the role, if any, of fuel taxes? What does this mean for how fuels and their uses are taxed and the rates of tax applied?

Fuels should be taxed in a manner consistent with policy objectives and funding requirements necessary to create and maintain an efficient road transport network. With a growing awareness of environmental objectives, these taxes are increasingly being associated with objectives such as climate change. Indeed, the question now is whether the government wishes to advance its environmental policies through fuel taxation or encourage specific economic outcomes.

We agree with the system "based on targeted taxes and charges" outlined in the Consultation Paper[123] – in that fuel taxes and charges should be targeted to address congestion and road usage. However, we question whether fuel tax as a general revenue raiser is appropriate. Why raise general revenue from fuel tax when the costs of the road transport system are so high? Fuel taxes should raise revenue specifically for the transportation system only.

Where improved technology can monitor the actual use of roads (including location of congestion) and fuel's impact on the environment, this should be applied to generate a system of taxes and charges which is more targeted to actual road use.

We question whether cent-for-cent fuel tax cuts should be introduced alongside the Carbon Pollution Reduction Scheme (CPRS) to smooth the impact of CPRS on fuel. The effect of these cuts is that the CPRS will not alter behaviour to reflect the environmental impact of using fuel.

12.3 Do the existing tax arrangements lead people to make economically inefficient transport choices, and if so, how might they be improved?

The question here is how we measure "economic efficiency".

Some existing tax arrangements encourage people to make bad environment choices with respect to transport including:

- fringe benefits tax concessions on motor vehicles encourage high levels of vehicle use to attract lower fringe benefits tax liability, and
- customs duty of 5% on four-wheel drive vehicles versus 10% duty on passenger vehicles encourages the import (and impacts the price) of four-wheel drives.

However, these choices may not be economically inefficient for the individual consumer or even for the wider economy in the short-term.

[123] Consultation Paper, Chart 12.1, page 235.

We question whether businesses should be able to recover fuel tax credits for fuel used in heavy industry. Whilst this measure reflects the strong representations of important heavy industries (such as mining, fishing, forestry etc), it does nothing to encourage businesses to decrease fuel use via the taxation system. Perhaps, the fuel tax credit regime should be removed altogether so that there is no difference in excise suffered by businesses compared to private consumers from fuel use (this would be “fairer” from an environmental impact perspective).

An example of fuel taxation potentially encouraging people to make both economically and environmentally inefficient transport choices is the proposal to tax “cleaner” fuels, such as LPG, from 2011. When LPG becomes subject to excise (with resulting higher prices), there is a view that people will stop converting their vehicles to LPG, the car industry will stop producing LPG-powered vehicles and people will be encouraged to continue purchasing traditional diesel/petrol vehicles, which over the long-term, lead to poor economic and environmental choices.

We believe the review should consider further incentives linked to more fuel efficient forms of transport – for example, lower tariff rates and registration charges on hybrid vehicles.

Tax-transfer impacts on the environment

13.1 Bearing in mind that tax is one of several possible instruments that can address environmental externalities, what opportunities exist to use specific environmental taxes to address Australia's environmental challenges?

Australia has committed to significant greenhouse gas emissions reduction targets between 2012 and 2060. The Government is currently in the process of implementing the Carbon Pollution Reduction Scheme (CPRS). The CPRS will be a mechanism whereby the Government can reduce demand of high emission inputs (eg fuel, electricity) by in essence imposing a cost to use them.

The tax system can be used successfully in conjunction with the CPRS to incentivise business to assist with reducing demand for high emission inputs. Incentives can encourage the development of new technologies, products and jobs. It would be our preference that the any change to the tax system be incentive based, rather than penalty/cost based, as this is one of the key roles of the CPRS.

Incentives can be delivered in a number of ways. Our preference would be for simple, incentives via increased or accelerated tax deductions for business for environmentally friendly initiatives. Some of the potential initiatives have been discussed further below. .

We are also cognisant that in order for effective tax changes to be implemented to assist in driving environmental outcomes that these must be undertaken in conjunction with industry and government initiatives and that these may take a number of years in order to effect a successful implementation. For example, if increased deductions are allowed for low emission cars or use of public transport, the relevant industries and governments need to work together to ensure the associated infrastructure to allow taxpayers to move to such products is in place.

13.2 Noting that many submissions raise concerns over unintended environmental consequences of taxes and transfers, such as the fringe benefits tax concession for cars, are there features of the tax-transfer system which encourage poor environmental outcomes and how might such outcomes be addressed?

We agree that the current FBT and income tax treatment of cars results in a poor environmental outcome as the more the car is driven, the higher the level of tax incentive.

Apart from the suggested change to the way in which the tax value of cars is determined (refer Question 4.6), we would urge consideration of relatively low cost incentives for renewable heat and power technologies such as wind power, solar air and hot water heating, as well as energy saving retrofitting strategies[124].

We would urge consideration of relatively low cost incentives for renewable heat and power technologies such as wind power, solar air and hot water heating, as well as energy saving retrofitting strategies and reduction in fuel usage.

The Government's focus on housing insulation in the recent economic stimulus package is an example of an incentive delivered via direct payment / subsidy. The tax system can also be a delivery mechanism through:

- accelerated capital allowances for businesses for investment in environmentally friendly depreciating assets (which could include 100% write-offs for certain categories of expenditure, or expenditure below a specified dollar threshold),
- changing the personal income tax deduction rules so that access to certain methods (eg the log book method) is available only for cars which meet certain emission standards,
- incentives for business that encourage employees to use public transport or telecommuting,
- easier access to the premium rate R&D concession for companies developing more efficient environmentally friendly sources of power,
- a review of Division 250 in the Income Tax Assessment Act 1997 to assess whether it is operating in a way which does not unduly discourage public private partnership relating to power generation using low emission technologies, water conservation etc, and
- attaching environment-related eligibility conditions for the capital works deduction in Division 43 Income Tax Assessment Act 1997 (eg by reference to energy star ratings for income producing buildings).

For reasons previously given, we discourage use of the tax system to deliver incentives via tax offsets to individuals. Direct subsidies, such as the insulation incentive, are an additional way to incentivise individuals.

13.3 Given the environmental challenges confronting Australian society, are there opportunities to shape tax-transfer policies which do not currently affect the environment in ways which could deliver better environmental outcomes?

See response to Question 13.2.

[124] In respect of energy retrofitting, we note that businesses may be prompted to invest in such strategies anyway (eg in response to the ramifications of the carbon reduction scheme on energy prices).

Natural resource charging

14.2 What is the most appropriate method of charging for Australia's non-renewable resources, given they are immobile but that Australia needs to compete globally for mining investment?

We generally concur with the observations in the Consultation Paper[125] relating to host country taxation on location-specific rents, and the impact on decisions to invest. To date, State Governments have primarily been the instigators of royalty type taxes on location-specific rents, with the Federal Government levying a Petroleum Resource Rent Tax. As noted by the Minerals Council of Australia (MCA), there are a range of important mining royalty reform issues which should be considered by the Panel, but it is important that any changes do not adversely impact existing projects. PricewaterhouseCoopers concurs with this aspect of the MCA submission[126].

As discussed in 6.1 above, there are a range of activities associated with extractive industries that are mobile, and which provide substantial benefits if located in Australia. These activities include processing, marketing, research and development, treasury, head office functions, etc. Companies have choices where activities such as these should be located globally, and care should be exercised in designing any specific regime for non-renewable resources.

We believe that a stimulatory effect could be achieved from the introduction of flow-through loss shares for companies engaged in certain sectors, such as mining, oil and gas, renewable energy (reflecting the Government's climate change policies), and high tech development companies. The main supporting considerations are as follows[127]:

- international competitiveness, particularly with resource rich nations such as Canada,
- attracting equity investment in such companies,
- Australia's national interest in continuing to encourage investment in these sectors, and
- utilisation of tax incentives available at the corporate level by investors at risk, rather than having the losses which result from those incentives jeopardised by company loss carry forward tests.

Given the potential cost to revenue of this measure, there would need to be an array of safeguards and limitations placed on the availability of the needs to be carefully.

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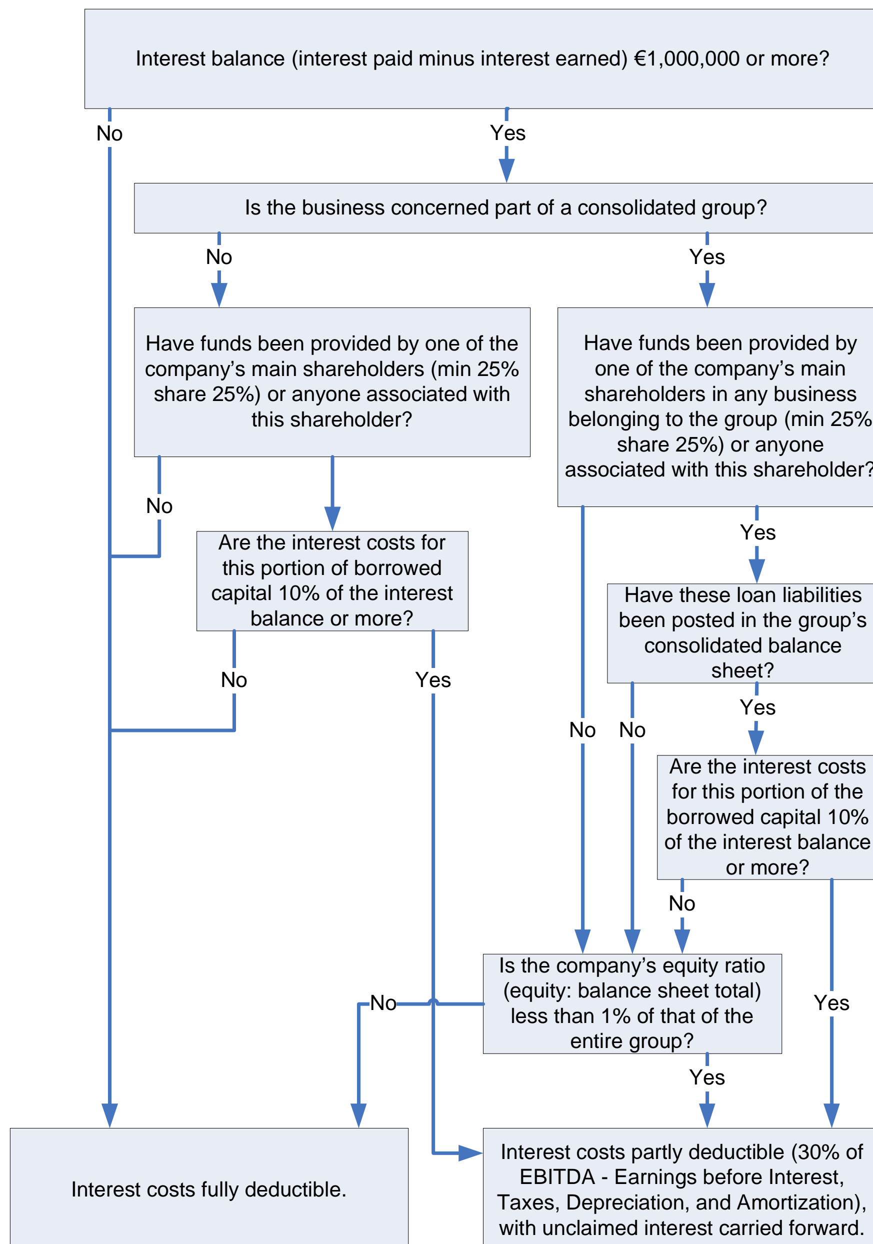
[125] Consultation Paper, page 131.
[126] Minerals Council of Australia, *Henry Tax Review*, November 2008. Refer Part 7 Mining Royalties, page 7 et seq.
[127] Minerals Exploration Action Agenda, *The Road to Discovery,* 2 July 2004 (http://www.ret.gov.au/resources/industry_consultation/minerals_exploration_action_agenda/Pages/MineralsExplorationActionAgenda.aspx); *Minerals Council of Australia, 2007-08 Pre-Budget Submission*, http://www.minerals.org.au/economics/publications.

Appendix A
Alternative tax bases

The German experience with the interest barrier – Zinsschranke

We note the reference in the Consultation Paper[128] to the limitation of interest deductions in Germany. This measure – which replaced thin capitalisation rules with a different form of restriction – denies interest deductions once a so-called interest barrier has been reached (see Flowchart summary below[129]). It was introduced as part of a rate reduction, base broadening policy, and reflected a need to reduce the tax rate on companies from around 39% tax on average to below 30% to improve Germany's international competitiveness[130]. The circumstances in Australia differ markedly in this respect.



[128] Consultation Paper, page 134.
[129] Source: http://www.steuerliches-info-center.de/en/003_menu_links/002_ISt/003_BestKoerp/035_Zinsaufwendungen/index.php.
[130] The exact rate depends on applicable municipal trade tax.

Other comments on the German experience include:

- The interest barrier only applies from the 2008 tax assessment year. It is too early to assess the impact on the economy and the business sector, and such analysis is needed before a conclusion can be formed on the suitability of this measure in Australia.
- Businesses can be exposed to the interest barrier where major (25%+) shareholder financing exceeds specified thresholds. This would be a radical change in an Australian context, effectively mandating a debt to equity ratio which may be out of kilter with the commercial realities faced by medium sized, closely held enterprises.
- Businesses with a "positive" interest balance (or a negative balance below €1,000,000) remain entitled to full interest deductions. The measure is particularly detrimental to those sectors with high start up debt funding costs, and long term pay-off periods. In the Australian economy, mining, infrastructure and property are three sectors in this category. Conversely, the financial services sector seems to be favoured due to high levels of interest income.
- The €1,000,000 threshold targets the measure mainly at large corporates. But the impact of the interest barrier to collective investment vehicles (eg geared property trusts) would need to be carefully considered in the design stage.
- Several companies within a fiscal unity (*Organschaft*) are deemed to be one business. The de minimis rule (€1,000,000) applies regardless of the number of companies within the fiscal unity. Setting an appropriate threshold for Australian consolidated and connected groups would be contentious.
- Undeducted interest expense can be carried forward to a future year when (subject to the operation of the barrier in that year) it can be deducted. German tax law adjusts the carry forward amount which can be claimed where ownership changes. In an Australian context, it would be important to determine whether the carry forward amount would be subject to similar rules (eg the continuity of ownership test), the impact of capital restructuring on carry forward entitlements, and whether the deduction can be inherited under the consolidation rules.
- Considerations relevant in the current Australian thin capitalisation rules would still be relevant: ie the debt and equity rules, measuring debt, adjusting for related party debt etc. Complexity would remain an issue unless current law is amended.
- In an international context, a barrier to one type of tax deductible profit repatriation (interest) focuses attention on other strategies (eg optimise transfer prices to the extent permissible).

The CBIT proposals in the United States[131]

A comprehensive business income tax (CBIT) system seeks to create neutrality in the debt-equity choice by taxing the return to capital of corporates only once. Under CBIT, no tax deduction is available for either interest payments, or the return on equity from taxable corporate earnings. Except for the CBIT rate, no additional taxes are imposed on distributions to equity holders or on payments of interest.

Although more severe in its treatment of interest deductions than the interest barrier described above, CBIT offers the prospect of tax free treatment at shareholder level for interest, dividends and capital gains. Dividend imputation is therefore not required under a CBIT model, but it is noted that superannuation funds and resident individuals on low tax brackets would be losers in terms of the current franking tax offset and refundable tax offset arrangements. Thin capitalisation rules would also be unnecessary.

As with the interest barrier, a CBIT is particularly detrimental to those sectors with high start up debt funding costs, and long term pay-off periods.

Our other comments would be that:

- CBIT would be a significant base broadening reform. The accompanying corporate tax rate reduction should reflect this.
- The eradication of taxes at shareholder level would be costly from a revenue perspective. Careful modelling would be required to gauge the revenue impact. We also note that, if adopted in Australia, a CBIT with full tax exemption at shareholder level would:
    - overturn the current policy of taxing non-residents on the indirect disposal of taxable Australian property (which mainly comprises land), and
    - be a unilateral decision benefiting all inbound investors, without a corresponding concession for Australian outbound investors being provided by other countries. Nor would other countries necessarily wish to reciprocate in Tax Treaty negotiations.
- The transition to CBIT would be difficult, with sufficient time needed for businesses to adjust current funding arrangements.
- It is assumed that there would be a "carve-out" for small business, otherwise a CBIT would:
    - penalise those small businesses where a substantial proportion of the return is due to the labour of the business owners, and
    - Be highly detrimental to those SMEs reliant on debt financing from shareholder \ owners in a tight credit market or during the business start-up phase.

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[131] CBIT was considered in *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, Department of Treasury, USA, January 1992. Refer http://www.ustreas.gov/offices/tax-policy/library/integration-paper/.

- The treatment of tax preferences obtained at entity level (eg foreign source income treated as non-assessable, non exempt income, and the R&D incentive deduction) would need to be clarified. Would shareholders in companies which obtain such concessions still qualify for the tax exemption where the distribution relates to an untaxed or concessionally taxed profit pool? If not, identification of the source of distributions creates compliance difficulties.
- On the positive side, CBIT would remove the current incentive to warehouse profits in a company, due to the tax rate differential between the corporate tax rate and the top personal marginal rate faced applicable to resident individuals.

Allowance for corporate equity (ACE) - Belgium[132]

The deduction for notional interest under the ACE is based on the financial theory that it is relatively easy to isolate a risk free interest rate component embedded in a return on risk capital.

This theory suggests that the cost of equity can be estimated by analysing the return investors require when purchasing a share. Typically, the greater the risk taken on by an investor, the higher the rate of return expected. The notional deduction in the ACE model seeks to recognise the risk-free interest component by treating it as a deductible item. The resultant greater equality between equity financing and debt financing creates a more level playing field for corporates when they choose between the two alternative forms of financing.

In our view, the ACE model is worth further consideration in an Australian context, although more research is needed to enable a well-informed decision to be made on whether it should be implemented[133].

As part of PricewaterhouseCoopers' contribution to this debate, we have set out our initial observations in Table 1 below.

[132] Helpful commentary on the ACE is contained in *How notional interest deduction can add value to the Treasury function in Belgium*, Kurt De Haen and Sarah Vanhoutte, PricewaterhouseCoopers, July 2007. (Source: www.gtnews.com/article/6817.cfm).
[133] For example, more data on the economic impact of the measure in Belgium would be useful.

Table 1: The Pros and Cons of an ACE, and practical ramifications

Pros	Cons	Practical ramifications
ACE narrows the tax base of a company and reduces the effective tax rate, thus providing an attractive tax saving.	To what extent would: 1. a corporate tax rates be adjusted if an ACE were introduced[134]? 2. current tax concessions and the imputation system be removed to compensate for the cost of introducing ACE? A conclusion on the beneficial impact of ACE can only be made once all associated corporate tax changes are revealed.	ACE is of particular benefit to highly capitalised, capital intensive companies (eg the banking sector due to prudential capital requirements). Companies operating in high risk sectors, who may find it difficult to raise equity finance, obtain less benefit. Indeed, ACE reflects a policy incentive for such companies to finance their investments through equity and therefore strengthen their capital structure. The transition to an ACE regime would inevitably prompt companies to maximise the starting value of equity.
It should be possible to carry forward any unused amount of the notional interest deduction under an ACE model. In Belgium the carry forward period is 7 years. The impact of changes of ownership on this carry forward entitlement needs to be clarified.	In Belgium, ACE was viewed as a solution to the withdrawal of the Belgian Coordination Centre Regime, caused by European Union tax rules. In other words, Belgium had an existing advantage that it was seeking to protect in a way that would comply with EU requirements. The starting base in Australia is much different. There are other aspects of the Australian tax system which would also need to be addressed in order to encourage such activity in Australia.	The calculation of equity capital under the ACE model is complicated not just by the tax concessional treatment in Australia of foreign income[135], but also by value of assets in foreign branches attracting s23AH treatment. Other adjustments would be required – eg for part-year periods, tax free subsidies or tax incentives obtained by the company – and there would need to be anti-avoidance arrangements (eg to prevent “stuffing” schemes). In other words, ACE provides another example of the need for a “tax balance sheet”.

[134] The Consultation Paper (Box 6.4, page 136) indicates that a higher tax rate is required because of the narrower tax base.
[135] Consultation Paper, page 278.

Pros	Cons	Practical ramifications
The potential for changes to the thin capitalisation rules under an ACE model would be welcomed by the business sector. However, the nature and extent of such changes need to be clarified before the full benefits of ACE can be assessed.	In Belgium, ACE was accompanied by the abolition of dividend withholding tax for dividends paid to treaty partner countries, subject to a 15% minimum shareholding being in place for at least one year (a measure also designed to increase the attractiveness of Belgium as a holding company location)[136]. There was also a further expansion of Belgium's already impressive tax treaty network (including the first treaty by an OECD country with Hong Kong). It is difficult to gauge the full impact of ACE unless such issues are also addressed in an Australian context.	As noted in the Consultation Paper, ACE can accommodate the existing tax framework[137]. This would include the dividend imputation regime. We note however that ACE could (dramatically in some cases) reduce a company's potential to generate franking credits in its franking account, leading to reduced franking capability when dividends are declared. Research would be required to determine whether, from the perspective of *Australia's* tax treaty partners, ACE: o undermines foreign tax credit entitlements, o is seen as a feature which attracts problems under CFC or FIF type legislation.
	ACE necessarily requires a company to provide details of share capital, retained earnings etc. Those companies which currently have the ability not to prepare annual accounts would presumably need to do so for tax purposes. In a tax consolidated group, the operation of the single entity rule on ACE calculations would need to be clarified.	For private companies: o Belgium provides a slight increase in the reference rate used to calculate the notional deduction if the company is in the "small to medium" category, o an adjustment would presumably be made for personal use assets held in a company (eg the family home occupied by shareholder -directors), o deemed dividends arising from the disguised distribution of profits would presumably be subtracted in arriving at the closing value of equity.

[136] In the absence of treaty or conduit foreign income relief, Australia imposes withholding tax on unfranked dividends.
[137] Consultation Paper, page 136.

Business expenditure tax based on cash flows

The discussion of business expenditure taxes based on cash flows in the Consultation Paper[138] will no doubt attract much debate, in the same way as the tax value method (TVM) did when it was recommended by the Review of Business Taxation (Ralph Committee) in 1999[139]. The TVM proposal was eventually discarded after Government consideration of a Board of Taxation recommendation not to proceed with the measure[140]. The method was recently described as a "silver bullet" solution[141].

In light of the TVM experience, we have particular reservations about the adoption of a cash-flow tax model.

In particular, the Consultation Paper gives no indication of the tax-related adjustments (if any) which would still apply under the various models described[142]. That is:

- would all receipts not currently assessable (and in some cases also not exempt) continue to be excluded from the income side of the cash flow tax calculation?
- would all expenditures not currently deductible be excluded from the outlays side?
- how would current tax incentives (eg for R&D) fit into the cash flow tax model?
- how would current tax timing rules be reflected (if at all) in the cashflow tax methodology?

In other words, it is difficult to discuss a cash-flow tax methodology without a complete understanding of the tax policy modifications that might accompany the introduction of such a tax.

Cash-flow taxes would also appear to further stratify the tax system. For example, businesses in the financial services sector would need distinct treatment under the 'R' (real) base cash-flow tax[143]. The 'R+F' (real plus financial) and 'S' (share) base cash-flow tax models presumably need to be underpinned by accounting methodology, but businesses operate in a commercial environment where only large corporates are typically required to comply with accounting standards.

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[138] Consultation Paper, page 136, and Appendix E, page 277. Cash flow taxes were also mentioned by Dr Ken Henry in his speech to the National Press Club on 12 November 2008.
[139] Review of Business Taxation, *A Tax System Redesigned*, July 1999 ("Ralph Report"), page 155-213.
[140] Refer Board of Taxation website (www.taxboard.gov.au), under heading "Tax Value Method".
[141] Prof Graeme Cooper, *Business Tax Reform in Retrospect*, paper presented at Australian Business Tax Reform in Retrospect and Prospect, 23-25 February 2009.
[142] Consultation Paper, page 278.
[143] As indicated in the Consultation Paper, page 278.

At this stage of the consultative process therefore, our initial observations would be that a cash-flow tax:

- is novel and untested,
- does not appear to produce a reliable revenue stream, and has high up front costs for the revenue base during the start-up phase of a typical business, and
- suggests that the current tax rules are unworkable, and need to be replaced with an entirely new model, whereas our staring point would be to consider how the current provisions could be improved and simplified.

General comments on the design phase of business expenditure taxes

As part of the consultation process, it would be useful to develop draft legislation and worked examples to illustrate how a business expenditure tax would apply to a typical business taxpayer, and compare the outcomes to the current method of calculating tax payable[144].

Consideration would also need to be given to the coverage of business expenditure taxes. For example, would it apply to businesses generally, regardless of the type of operating structure used?

[144] This approach was adopted in testing the outcomes of the tax value method, with PricewaterhouseCoopers involved in drafting prototype legislation for the Board of Taxation. Refer www.taxboard.gov.au (select “Tax Value Method”).

Appendix B
Addressing complexity — cost, risk and transparency
Question 8.1

Complex Taxes

Complex taxes	Suggestions

Payroll tax (States) – assuming it is retained	• Further work should be done on full alignment of tax base (eg with PAYG withholding rules).
	• Ideally, payroll tax should be abolished with the only collection obligations (compliance costs) on employers in terms of salary or wages being:
	    • PAYG withholding, and
	    • Superannuation Guarantee.

Stamp duty (States) – assuming it is retained	• Uniform approach to corporate reconstruction relief.
Income tax • CFC and FIF rules	• Await Board of Taxation recommendations resulting from its review of the anti-tax-deferral regimes[145].
Income tax • Thin capitalisation[146]	• Consider adoption of ACE model (refer our response to Question 6.3). • Consider greater alignment with relevant accounting concepts in applying tests.
Income tax • Application of various anti-avoidance provisions relevant to capital restructuring (eg streaming, value shifting)	• Review and rationalise existing provisions, and preferably move to a general anti-avoidance approach. • Introduce "fast-track" private ruling procedure in ATO for large transactions.

[145] The Hon Peter Costello MP, Press Release No 109, 10 October 2006.

[146] Particular uncertainty in this area has been caused recently by:

1. ATO Draft Tax Determination TD 2007/D20 (Income tax: where there is no excess debt under Division 820 of the Income Tax Assessment Act 1997 can the transfer pricing provisions apply to adjust the pricing of costs that may become debt deductions, for example, interest and guarantee fees?), 28 November 2007; and
2. ATO draft paper 'Intra-group finance guarantees and loans – Application of Australia's transfer pricing and thin capitalisation rules', 3 June 2008.

Complex taxes	Suggestions
Income tax • Trusts	• Await Board of Taxation recommendations resulting from its review of the tax arrangements applying to managed investment trusts[147]. It is envisaged that the Board's report will contain options for introducing a specific tax regime for managed investment trusts. Although there are no specific details, a move to a specific regime has broad in-principle support. • The general income tax rules relating to trusts in Division 6 ITAA 1936 have not yet been reviewed as part of the tax law simplification project. We have previously suggested that a working party be established to re-draft the provisions applicable to "general" trusts"[148]. • For nominee arrangements, bare trusts and trusts where there is an absolutely entitled beneficiary, the income tax law should adopt a consistent approach and treat the asset or interest as that of the beneficiary.

Income tax
• Debt equity rules
	• Review the existing debt test, and in particular the:
	  • concept of an "effectively non-contingent obligation" and
	  • on-lending of amounts to connected entities (s974-80 ITAA 1997).
	The scope of the current measures is unclear, and for some types of commercial funding arrangements, clients typically seek an ATO private ruling in order to proceed with transactons.

Income tax • Small business concessions	• Review extent of usage. • If retained, streamline eligibility criteria.

[147] Hon Chris Bowen MP, Media Release No 10, 22 February 2008.
[148] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 15.

Complex taxes	Suggestions
Income tax • Personal income tax deductions relating to derivation of personal services income	• Limit ability to claim personal deductions in return for personal income tax cuts and / or lower tax on investment income. • A personal allowance "deduction" could be reflected in PAYG withholding arrangements as part of the design of a regime where most individuals need not lodge tax returns.
FBT	• Remove tax and include taxable value of big ticket items in employee's assessable income (where it would be subject to PAYG withholding and, if retained, payroll tax). • If FBT is retained, impose tax only on big ticket items and simplify taxable value calculations[149].

[149] PricewaterhouseCoopers' submission to Australia's Future Tax System Review, 17 October 2008, page 18-19.