

# Ai GROUP SUBMISSION

Response to the Taxation  
Discussion Paper

JUNE 2015



## Contents

|     |  |    |
|-----|--|----|
| 1.  | Executive Summary .....  | 4  |
| 2.  | The Need for Tax Reform .....  | 6  |
| 3.  | Addressing Particular Areas of Inefficiency.....                       | 10 |
| 4.  | Moving towards a Cash Basis of Taxation for Small Businesses .....     | 16 |
| 5.  | Rationalising the GST and State and Territory Payroll Taxes .....      | 17 |
| 6.  | Taxation of Individuals' Investment Income .....                       | 20 |
| 7.  | Taxation of Superannuation .....                                       | 21 |
| 8.  | Using the Tax System to Lift Research and Development.....             | 22 |
| 9.  | Patent Box or Similar Approach to the Taxation of Income from IP ..... | 24 |
| 10. | The Taxation of Renewable Resources.....                               | 25 |
| 11. | State and Territory Taxation .....                                     | 26 |
| 12. | Better Addressing Tax Evasion through the Cash Economy .....           | 27 |

## **About Australian Industry Group**

The Australian Industry Group (Ai Group) is a peak industry association in Australia which along with its affiliates represents the interests of more than 60,000 businesses in an expanding range of sectors including: manufacturing; engineering; construction; automotive; food; transport; information technology; telecommunications; call centres; labour hire; printing; defence; mining equipment and supplies; airlines; and other industries. The businesses which we represent employ more than one million people. Ai Group members operate small, medium and large businesses across a range of industries. Ai Group is closely affiliated with more than 50 other employer groups in Australia alone and directly manages a number of those organisations.

## **Australian Industry Group contact for this submission**

Dr Peter Burn, Head of Influence & Policy

Ph: 02 9466 5503

Email: [peter.burn@aigroup.com.au](mailto:peter.burn@aigroup.com.au)

## 1. Executive Summary

The Federal Government's Taxation Review is an important step in the vital task of modernising Australia's tax system. It is clear that Australia's economic performance is lagging in many respects and is set to face further challenges in the face of continuing globalisation, technological change and demographic forces.

Addressing these challenges requires that the tax system be made more resilient and efficient, and that the administration of and compliance with taxation become less costly and onerous. Further, a better tax system is essential in ensuring that it continues to play a central role in meeting Australia's broader social objectives, both through the financing of a wide range of public sector activities including in the provision of health, education, income support and infrastructure, and through the substantial role it plays in the overall redistribution of income.

Ai Group supports the national conversation on tax reform that the Government has initiated. We agree that the discussion should be a broad one with nothing excluded from consideration. Taxation reform is inevitably complex and it is vital that some time is taken to improve understanding across the board. Ai Group members understand that the path to successful reform requires lengthy discussion to build understanding of the challenges and proposed solutions. Our membership has begun to engage in this national conversation and we are looking forward to further engagement with our members as this national conversation gathers pace.

For these reasons the measures aired in this Submission should be taken as directional rather than definitive. They reflect many positions Ai Group has developed over a considerable period, including through our participation in the *Australia's Future Tax System Review*; the results of recent member surveys; and the direct consultations we have had with members since the release of the Discussion Paper.

These directions will be developed further over the coming months as the Government continues the conversation it has initiated; as it calls for input on more specific proposals; and as we continue to consult with our members.

### 1.1 Major Reform Directions

The major directions of reform put forward in this Submission for consideration and further discussion are:

- Addressing areas of particular inefficiency:
  - Reducing the relatively high levels of tax levied on incorporated entities;
  - Increasing the levels of personal income at which high marginal tax rates apply;
  - Reducing the high effective marginal tax rates that act as a barrier to higher workforce participation and saving;
  - Reducing our reliance on taxes on insurance premiums, conveyancing duties and stamp duties.
- Moving towards a cash basis of taxation for small businesses.

- Rationalising the GST and state and territory payroll taxes to improve the overall efficiency of taxation and to reduce compliance and administration costs.
- Adopting elements of a dual income tax approach to the taxation of individual investment income. This could extend the idea of the capital gains tax discount to other forms of investment income or, alternatively impose a single flat rate of tax on individual investment income.
- Improving the taxation of superannuation so that it is better aligned with retirement income policy objectives and is more aligned with capacity to pay and equity principles.
- Restoring the role the tax system has played in providing a stable and effective R&D Tax Incentive as a means of correcting for the systematic under-investment in spillover-generating, private sector research and development.
- Exploring the capacity of adopting a patent box or similar approach to the taxation of income from intellectual property or its commercial application.
- Exploring the potential to improve the efficiency of taxation and to better manage the macroeconomic impacts of high commodity prices by replacing state-based royalties on the extraction or sale of non-renewable resources with a rent tax.
- Improving state and territory taxation and intergovernmental finances.
- Becoming smarter and more effective in addressing the evasion of taxation through the cash economy.

This submission first explores the need for tax reform, raising the points of concern of Ai Group members. We then outline in greater detail the policy directions listed above and illustrate them with quotes from member companies.

## 2. The Need for Tax Reform

### International Comparisons

The World Economic Forum's (WEF) Global Competitiveness Index and other data sources indicate that Australia's global competitiveness has slipped in recent years, falling to 22<sup>nd</sup> in 2014-15, from an all-time national best ranking of 15<sup>th</sup> place in 2009-10.

**Table 1: WEF Global Competitiveness Indexes: Australia's ranking, selected indicators**

| Year           | Overall competitiveness | Total Tax Rate | Burden of Gov. regulation | Wastefulness of Govt Spending | Transparency of govt decision making |
|----------------|-------------------------|----------------|---------------------------|-------------------------------|--------------------------------------|
| 2008-09        | 18                      | 88             | 66                        | 16                            | 9                                    |
| 2009-10        | 15                      | 89             | 85                        | 22                            | 15                                   |
| 2010-11        | 16                      | 94             | 60                        | 21                            | 19                                   |
| 2011-12        | 20                      | 99             | 75                        | 31                            | 24                                   |
| 2012-13        | 20                      | 106            | 96                        | 48                            | 29                                   |
| 2013-14        | 21                      | 109            | 128                       | 56                            | 51                                   |
| <b>2014-15</b> | <b>22</b>               | <b>104</b>     | <b>124</b>                | <b>51</b>                     | <b>51</b>                            |

Source: WEF Global Competitiveness Reports

Taxation is a factor that contributes to Australia's poor ranking. In the 2014-15 WEF survey Australia's total tax rate, which includes personal and business tax, was ranked 104<sup>th</sup> place, down from 88<sup>th</sup> place in 2008-09. This measure is calculated by the World Economic Forum based on tax rates, and is not a survey response. It is calculated as the taxes and mandatory contributions payable by a business in the second year of operation, expressed as a share of commercial profits.<sup>1</sup>

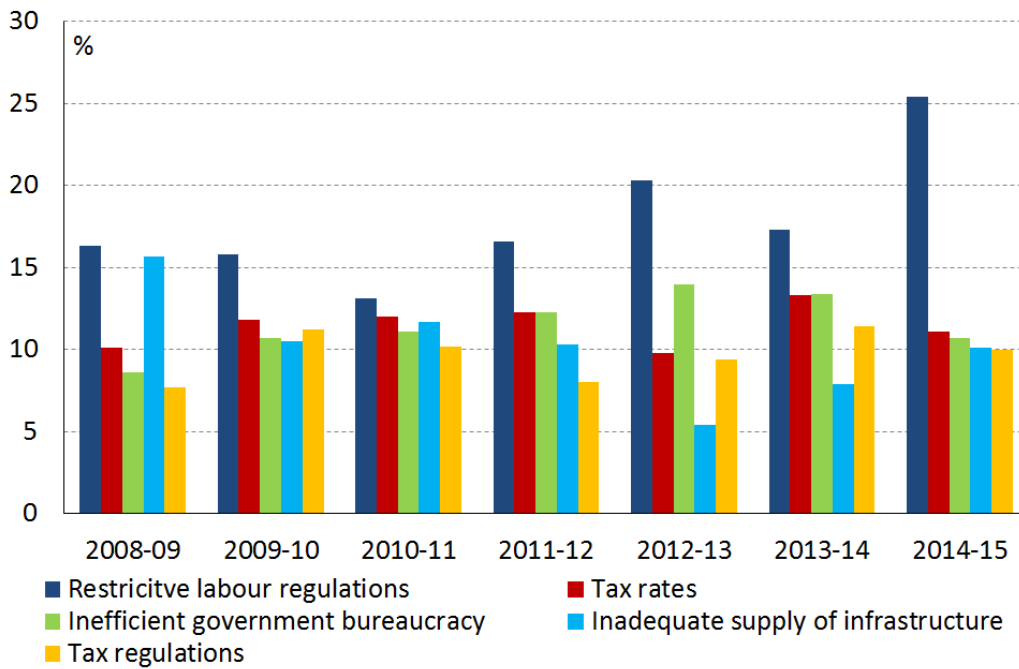
Australia ranks 74<sup>th</sup> place for the "effect of taxation on incentives to invest" in 2014-15 (and 80<sup>th</sup> place in 2013-14, the first time the question was asked).

Australia also performs poorly on the "effect of taxation on the incentive to work" questions, ranking 80<sup>th</sup> in 2014-15, deteriorating from 59<sup>th</sup> place in 2013-14.

The survey also asked respondents their five most problematic areas for doing business in Australia (Chart 1). A restrictive labour market has topped the list of key business impediments in Australia in each of the WEF's *Global Competitiveness Reports* since 2008-09, but business leaders also named tax rates (11.1%) and tax regulations (10.0%) among the five most problematic areas for doing business in Australia in 2014-15. Almost 11% of businesses highlighted concerns about Australia's "inefficient government bureaucracy".

<sup>1</sup> The World Economic Forum takes the sum of five different types of taxes and contributions payable after accounting for deductions and exemptions: profit or corporate income tax, social contributions and labour taxes paid by the employer, property taxes, turnover taxes, and other small taxes. These taxes are then expressed as a percentage of commercial profits and form part of the Global Competitiveness Index.

**Chart 1: Top Five Impediments to doing business in Australia**



Source: WEF Global Competitiveness Reports. \* Respondents were asked to select the five most problematic factors for doing business in their country, from a list of 15 possible factors.

### Businesses' Budget Priorities

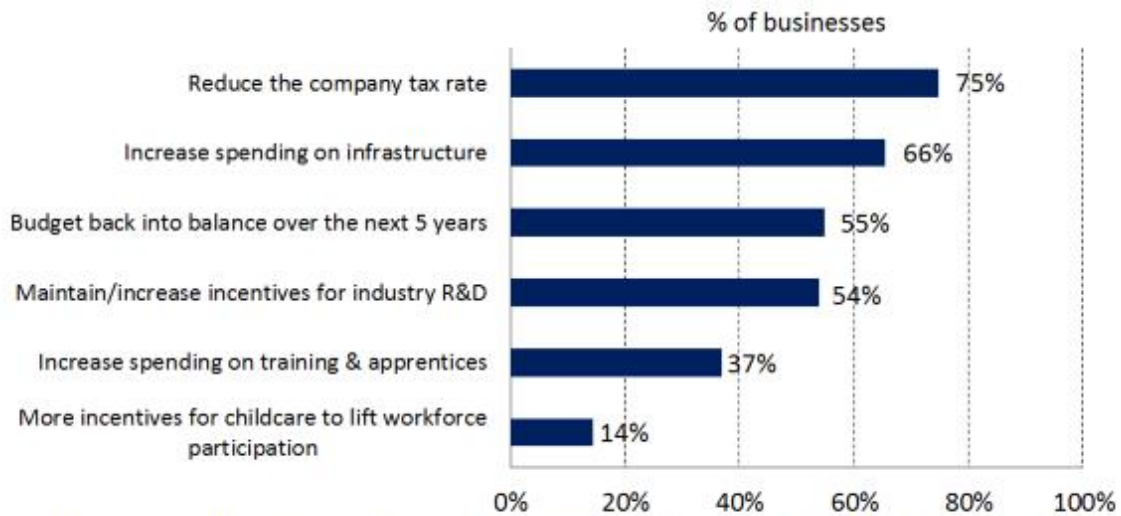
Ai Group surveys businesses each year to inform our Pre-Budget submissions to the Federal Government and State Budgets. Our *Business priorities for the 2015-16 Federal Budget* survey had 200 respondents spread across manufacturing, construction and services industries throughout the country. Ai Group has been undertaking this survey for several years and reducing the company tax rate has consistently polled as the highest priority for business ahead of other Budget measures such as investing in infrastructure and training.

In the most recent survey, the main priority for business ahead of the 2015-16 Budget was a cut in the company tax rate with 75% of businesses nominating this as one of their top three priorities and 32% nominating this as their the number one priority (Chart 2).

Over half (54%) of businesses listed stronger financial incentives for industry investment in R&D and innovation as one of their top three priorities for the upcoming Budget, placing this issue only slightly behind 'bringing the budget back into balance over five years'.

The results seen in 2015-16 Pre-Budget survey were similar to those seen in prior years. In 2014-15, 70% of businesses rated lifting the company tax cut as one of their top three priorities, and 32% rated it as their highest priority. In 2013-14, 32% of businesses rated it as their highest priority.

**Chart 2: Business Priorities for the 2015-16 Budget**



\* Businesses that ranked each budget measure among their top three priorities for the Federal Budget 2015-16.

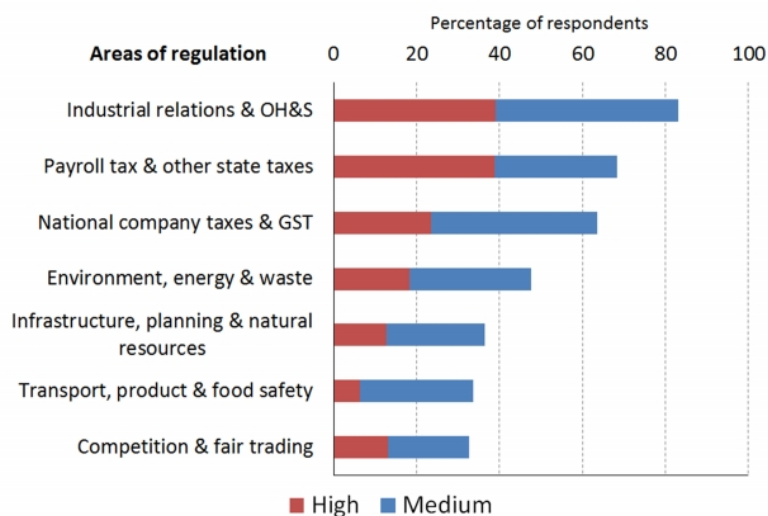
Source: Ai Group *Business priorities for the 2015-16 Federal Budget*

### The Compliance Cost Burden

In 2014, we used our National Survey of CEOs to assess the impact of regulation on Australian business. The *Australian Industry Group National CEO Survey: Burden of Government Regulation* released in March 2014 highlighted that many CEOs view **national and state tax compliance** as a large share of their overall regulatory burdens (Charts 3 and 4).

Regulatory burdens associated with taxation are ranked as medium-to-high by large proportions of businesses: 68% rank the compliance costs associated with state-based taxes and charges such as payroll tax as imposing a medium-to-high regulatory burden and 64% say they face a medium to high regulatory burden in relation to national taxes, including company tax and the GST.

**Chart 3: Expected degree of Regulatory Burden in 2014**



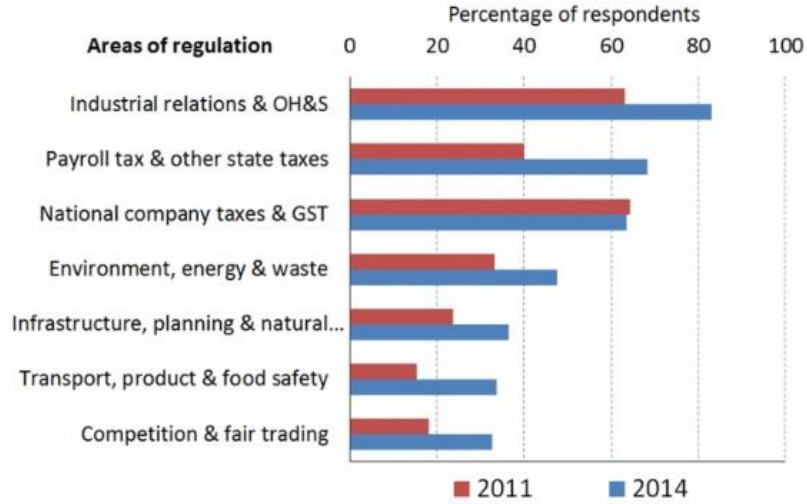
Source: Ai Group *National CEO Survey: Burden of Government Regulation*, March 2014

The regulatory burden of taxation high but has increased in recent years. Comparison between Ai Group’s CEO survey results for 2014 and our detailed study of regulatory burden in 2011 shows a



significant rise in CEOs' perceptions of the regulatory burdens associated with payroll tax and other state taxes.

**Chart 4: Degree of Regulatory Burden, 2014 and 2011\***



\* Include businesses who reported medium and high level of regulatory burden or red tape.

Source: Ai Group *National CEO Survey: Burden of Government Regulation*, March 2014

### 3. Addressing particular areas of inefficiency

Substantial improvements to the effectiveness of the economy can be achieved by decreasing the reliance our tax system has on relatively inefficient taxes and addressing other areas of particular inefficiency. Measures in these areas can improve domestic resource allocation, lift national productivity and increase the rate at which we can improve our material well-being and broader quality of life. Improving the efficiency of taxation is also the key to ensuring that tax reform is not merely a zero-sum game but is able to generate an efficiency dividend that could be used to ease the path of reform.

The major directions we identify in this section are:

- Reducing the relatively high levels of tax levied on incorporated entities;
- Increasing the levels of personal income at which high marginal tax rates apply;
- Reducing the high effective marginal tax rates that act as a barrier to higher workforce participation and saving; and
- Reducing our reliance on taxes on insurance premiums, conveyancing duties and stamp duties.

#### 3.1 Company Tax

Australia relies heavily on company tax as a source of revenue with Australia ranking very high among OECD countries both in terms of the amount of company tax collected as a share of GDP and in terms of the share of company tax in total tax paid. At a statutory rate of 30%, Australia has one of the highest company tax rates among small and medium-sized OECD countries and our corporate tax base is relatively broad.

To some extent, although only for domestic shareholders, Australia's full imputation system ameliorates the high rate and broad base of the company tax system by crediting (and refunding) tax paid at the company level when profits are distributed to shareholders. That said, different countries without a full imputation system offer a variety of other forms of relief against the double taxation of dividends.

Clearly the relief provided by the imputation system does not apply to retained profits (unless and until distributed to domestic shareholders); to income earned in other countries (on which foreign tax has been paid and credited against an Australian tax liability); or to profits paid as dividends to foreign shareholders.

Somewhat ironically, these exclusions from the imputation system align closely with where the adverse impacts of the company tax system weigh most acutely - namely on internationally mobile investment and particularly on the investment decisions made by local or foreign-based companies with investment options in other countries.

Reducing Australia's company tax rate, or narrowing its base, would have a favorable impact on inbound investment and on the retention of outbound investment. It would also impact favourably on

companies that retain profits. Incentives to invest in Australia would be improved. This in turn would deepen the capital intensity of production; hasten the renewal of the capital stock and lift productivity. It would raise output, employment and wages.

In general, the optimal allocation of increased investment will be more likely to be achieved by lowering the rate rather than narrowing the tax base. There are exceptions to this general rule in cases where narrowing the tax base can promote the efficient allocation of resources – for instance in providing research and development incentives.

Ai Group members frequently note that Australia's company tax system makes the country less competitive. Multinational companies raise the issue as a determining factor when making the decision to invest here or overseas. They argue that a reduction in the company tax rate would have an immediate and favourable impact on the decision to invest in Australia. This would be an especially positive reform given the current challenges facing the economy to lift productivity and to pick up the slack left by declining resource sector investment.

Ai Group members generally have a measured view when it comes to the required reduction in the company tax rate. Larger companies argue that Australia moving toward a 25% company tax rate would place Australia towards the average of OECD countries and would immediately increase our competitiveness, although other factors such as the increasing cost of energy, Australia's inflexible industrial relations system and high levels of regulation would remain as factors harming the country's competitiveness.

Small to medium-sized incorporated businesses are equally in favour of a reduction in the company tax rate, although less prescriptive around a specific rate viewing "lower as better". Across our discussions with smaller members, businesses were consistent in answering that a lower company tax rate would lead them to invest more in their business and expand.

*"We have had tough times over the past ten years and I would like to think we will be paying tax again soon. But the rate needs to be lower so earnings can be put back into the business."*

**Small NSW manufacturer**

*"The Australian statutory company tax rate of 30% is quite high compared to many of our competitors (New Zealand – 28%; UK – 21% and Singapore – 17%), the OECD average is 25%. High company taxes make Australia less competitive, discourage investment and reduce employment."*

**Large listed Australian company**

### **3.1.1 Tax Losses**

Ai Group has wide coverage in the manufacturing sector, which has experienced challenging conditions in recent years owing to the higher dollar, comparatively high unit labour costs and increasing energy prices. In several of our conversations with members in the manufacturing sector, they noted that they had not paid company tax for several years and would be unlikely to pay tax for several more years given the accumulation of tax losses (the nominal value of which are carried forward and offset against future taxable income).

These members see value in a less punitive and asymmetrical treatment of current year losses. Ideally a refund could be paid in the year a loss is declared. Alternatively a carryback arrangement that enabled access to relief for current tax losses against tax paid in previous years could be adopted. Like the immediate refund option, such an arrangement would have the benefit of allowing them the ability to get relief during the challenging (loss-making) period rather than when their businesses returned to profitability.

*“Our organizational structure is such that a R&D claim is being corralled in a tax loss situation which has no benefit. Loss carry back arrangements would be very useful. The tax system should be recognizing and incentivizing business to innovate to new products when the company is under pressure.”*

***Brisbane-based manufacturer***

### **3.1.2 Accelerated Depreciation**

In our discussions with members many raised the importance of more rapid write-off of capital expenditure than is currently the case. Further, a number of businesses thought that the periods of write off allowed by the Australian Tax Office were unrealistically long. While these are issues of the timing of deductions, they clearly can have a material impact on the assessment of the net present value of investments.

Ai Group recognises that a decade and a half ago a trade-off through which a reduction in the company tax rate was partly financed by the removal of accelerated depreciation. We also recognise the importance of avoiding tax-related biases in favour of more or less intensive capital intensive industries or production technologies.

Nevertheless, particularly with a view to the current situation facing the economy, we also recognise that having the flexibility to provide for periods of more generous write-off of capital expenditure can be a valuable way to boost business investment at a time when it is lagging.

### **3.1.3 Dividend Imputation**

Many of our Australian-based members view Australia’s system of dividend imputation as important to their local shareholders and are in favour of retaining the current system. However, it is also clear that dividend imputation provides no incentive to foreign-owned businesses operating in Australia and, insofar as it plays a role in elevating the amount of taxation paid at the company level, indirectly it may be a deterrent to inbound investment.

Imputation may also act as a barrier to offshore expansion from an Australian base. Domestic profits paid as dividends to domestic shareholders can be relieved of one level of taxation whereas foreign profits from an equivalent investment in a foreign jurisdiction would not attract imputation credits.

Ai Group recognises the role that imputation can play in encouraging the payment of tax by companies with Australian shareholders. We are, however, mindful that this argument does not apply to foreign-owned companies operating in Australia and for Australian-based companies with foreign shareholders and/or foreign income, it applies somewhat less. In these cases incentives to pay tax in

Australia (or disincentives against paying tax in Australia) are more likely to be a function of the direct company tax liability rather than the imputation system.

The dynamics of globalisation will tend to see more foreign-owned companies operating here, greater shares of foreign-source income among Australian-based companies and will also see more foreign ownership of Australian companies. In these circumstances, the relative importance of imputation as a defence against disincentives to pay company tax can be expected to fall relative to the defence of having a lower corporate tax rate.

### **3.1.4 International Taxation Arrangements**

The issue of base erosion and profit shifting has been central to the agenda of the G20 in recent years. Several Ai Group members have raised concerns around the strength of Federal Government's statements on international taxation. In particular, there is concern that political posturing together with low-quality analysis by groups such as the Tax Justice Network has created a local perception that there is widespread tax avoidance undertaken by multinational companies operating in Australia. Our members are concerned the position has created an international perception that Australia will target multinational companies specifically and this has created concerns around doing business here.

We are also wary of the potential for the abuse and misuse of information being made available about particular businesses which are complying fully with their Australian tax obligations.

The fact is that Australia has a robust company tax system with tough anti-avoidance laws and a series of double-tax arrangements with other countries. More importantly, Treasury notes that Australia has a high level of compliance, with 95% of company tax revenues raised through companies lodging on time.

So while it is important to modernise Australia's taxation system to improve its integrity and minimise base erosion, such reforms should be carefully implemented to ensure they do not unnecessarily harm Australia's attractiveness as a place to do business. Members would prefer that Australia takes a measured approach to adopting the agenda of the G20.

This includes the reforms around the new disclosure protocols announced for company reporting. If poorly designed or implemented, these could require companies to reveal details around the company's operations to competitors and provide information that is open to abuse and misuse. Australia already has a rigorous company reporting regime administered by ASIC. It provides investors and stakeholders with the necessary information for them to make decisions. With harmonised accounting rules, overseas-based multinational corporations operating in Australia, face similar requirements.

## 3.2 The Personal Income Tax System

The personal income tax system occupies a major role in total tax collections and in the redistribution of income in Australia. The personal income tax system is also the final tax for domestic profits attributable to domestic shareholders (with company tax operating as a withholding tax).

High rates of tax act as a disincentive to working, saving and investment. They can be a barrier to attracting internationally mobile personnel and they can make it more costly and difficult to retain these people. As such they act as a drag on the efficiency of the economy.

While our top marginal tax rates are relatively high, the relatively low rates of income from which they apply also stand out in international comparisons.

A leading objective of tax reform should be to reduce the relative importance of personal income tax with a priority on reducing the impact of high marginal tax rates by raising the thresholds from which they apply.

Ai Group members also note the complexity of the fringe benefits tax system which backs up the personal income tax system. Many would like to see the system reincorporated into the personal income tax system.

*“When we recruit from overseas, employees do get a shock at the cost of living here, and personal tax rates may come into that.”*

### **Large Australian-based multinational manufacturer**

*“We do have to deal a bit with the salary sacrificing people. A simplified personal income tax system would be good for the business. People have to be strategic about work and their salary. If this system was easier, it would remove burdens on my business.”*

### **An Illawarra-based labour hire company**

*“FBT is an awkward time-consuming measure to comply with, but we understand it is integrity measure. It is maybe time to put the onus on the individual.”*

### **A large multinational**

## 3.3 High Effective Marginal Tax Rates

While not raised by members in our consultations, high effective marginal tax rates at the intersection of the income tax and income support systems can have important impacts on businesses – particularly in relation to their efforts in attracting and retaining staff and in managing labour turnover.

These barriers can be expected to lower the returns to businesses of investing in the training of new staff. In turn, businesses will tend to invest less in upskilling new employees.

More broadly, high effective marginal tax rates are a barrier to workforce participation and a drag on the overall economy. High marginal tax rates can also be a disincentive to saving – particularly when

saving is made out of after-tax dollars and then is taken into account in the assets and incomes tests applying to the age pension.

Ai Group recognises that high effective marginal tax rates are linked closely to the targeting of our income support system to those most in need or, from another point of view, a way of containing “middle class welfare”. A balance is clearly required and tax reform should have an emphasis on selectively reducing high effective marginal tax rates where it makes most sense to do so.

### **3.4 Reducing Reliance on Inefficient State Taxes**

The continued recourse to a selective tax on insurance is an anomaly in Australia. With under-insurance a major economic and social concern, these taxes should be at or very near the top of the list of taxes to be removed.

Stamp duties on property and other transactions are a major impediment to undertaking commercially sensible transactions. As such they impede the efficient allocation of resources and the best working of the general economy.

A number of Ai Group members have indicated their support for using the revenue from increased use of a broader land tax to finance the removal of transaction taxes on property purchases.

Removing these taxes would require a reconfiguration of state, territory and federal taxation. This is explored in Section 11 below.

#### 4. Moving towards a cash basis of taxation of small business

The 2015-16 Budget measure allowing for a period in which small businesses can deduct the full value of certain capital expenditure in the year of purchase highlights the attractiveness of a cash basis of taxation of small businesses. For the next couple of years a business with annual turnover of less than \$2 million will not have to carry forward the value of partially-deducted capital assets purchased for \$20,000 or less.

The *Australia's Future Tax System* review explored the very significant compliance cost advantages of using a cash-flow basis of taxation for small businesses.

Ai Group recognises that this proposal would require careful development in close consultation with industry and tax professionals but believes that it is a direction that should be explored further by the current tax review.



## 5. Rationalising the GST and State and Territory Payroll Taxes

Major gains to the efficiency of taxation in Australia could be secured and major reductions in compliance costs achieved if the removal of state and territory payroll taxes were financed by broadening the base of the GST and increasing its rate.

From the perspective of many businesses payroll tax is a tax on employment which adds to the costs of labour and discourages businesses from expanding and creating new jobs. While economic theory might suggest that a well-designed payroll tax need not be a particular source of inefficiency, this is not the view from the coal face of operating businesses.

Even from the theoretical standpoint, there are important shortcomings with the Australian payroll taxes both from the efficiency and compliance cost points of view.

In relation to efficiency, there are significant problems due to the exclusion of companies with payrolls below the different thresholds that apply in each state and territory. This leads to an unevenness of taxation in the considerable areas of activity where businesses of different sizes (or organised differently) operate in similar markets. This in turn distorts business decisions about growth and organisational form. Further, for a given level of revenue, the existence of the thresholds means that marginal rates of the payroll taxes need to be higher thus imposing larger losses of efficiency than would otherwise be the case.

Businesses often raise a compliance-cost counterpoint in favour of the thresholds which operate to exclude businesses for which the additional resources associated with the extra compliance and administrative work are greater than the additional revenue collected. Similarly, the incremental compliance costs experienced when businesses' payrolls grow across the thresholds are also frequently put forward as an argument against payroll tax in general or in favour of further lifting the threshold despite the increase in economy-wide inefficiency that would be associated with this.

Further on compliance costs, while there has been some progress in harmonising the different payroll taxes, businesses operating in more than one state or territory still experience additional compliance cost associated with different bases and multiple filing obligations.

One way of addressing the problems associated with payroll taxes would be to completely harmonise the bases, reduce the thresholds and the marginal rates and organise collections so that employers could file a single return to a central collection agency which then dispersed the collections to the relevant state and territory revenue offices.

An alternative would be to fund the complete removal of payroll taxes by using the GST to raise the required revenue. This would clearly reduce compliance costs relative both to the existing arrangements and to option of reforming the payroll taxes. It would also be a more stable option immune from localised pressures to make *ad hoc* changes to individual state or territory payroll taxes.

Admittedly, however, there are two important difficulties that would be associated with using the GST option that would require addressing. The first is that the significant exemptions in the existing GST base are also a source of inefficiency and unless removed or substantially reduced, would yield fewer efficacy gains and would necessitate a higher compensating rate increase to finance the

removal of the payroll taxes than would otherwise be the case. There is a very strong case to say that broadening the GST base is a direction that should occur in any case.

Secondly, if the states and territories gave up their payroll taxes in return for a compensating increase in the GST, new arrangements would need to be developed to determine the quantity of revenue returned to the states and territories. There is no reason these additional intergovernmental flows should follow the existing GST allocation arrangements. They could, for instance, be linked to total wages paid in each jurisdiction.

Regardless of the formula that was developed, the substitution of additional GST collections for the state and territory payroll taxes would, in the absence of other changes, decrease the range of discretionary sources of state and territory revenue. This issue is discussed further in section 11 below.

This direction for reform need not exclude the use of the GST to finance the removal of other states and territory taxes – for example the removal of the insurance taxes could also be financed with a further increase in the GST.

The removal of taxes like insurance duties and the payroll taxes would of itself exert downward pressure on prices and the costs of living. As such, the overall impacts on consumer prices and costs of living if these reforms were financed by lifting the GST would be muted as would the need for compensating changes to income taxes and income support payments.

*“Unlike company taxes, payroll tax takes no account of capacity of the employer to pay regardless of its profitability. Payroll tax is a significant expense for us and anything that reduces a major cost would help the company be more competitive, which in turn, means we would be more likely to expand and employ more people and maintain the existing workforce.”*

*Payroll tax is one of the peculiarities of the Australian tax system that doesn’t exist in many other countries. For example, in New Zealand and in many other countries in which we manufacture, there is no payroll tax. Payroll tax is a deadweight burden on companies and a jobs killer.”*

**Large Listed Australian Company**

*“We are 60% based in NSW and 40% Victoria, and we also have to contend with the South Australia and Queensland system because we have an employee in each of those states. There are small differences between each payroll tax system, and we are devoting time to something that shouldn’t be material in this business.”*

**A small Riverina food manufacturer**

*“We don’t do a lot of R&D in Australia. Payroll tax is a factor that affects the level of R&D we do here. If we have 25 people in R&D here, payroll tax will be a significant cost and so that obviously impacts the decision to undertake R&D here, or take those activities to the US where there are more supportive incentives.”*

**US-based multinational**

**Ai Group Response to the Taxation Discussion Paper**

*“GST compliance is a pain. As a business that is in the food industry, GST can be complex for us. Frankly, we would prefer it if everything was GST-able at the same rate.”*

**Riverina Food manufacturer**

*“Businesses are already set up to pay GST, so if the Government increased GST and removed payroll taxes, then that removes a regulatory requirement which is good.”*

**Participants at a Wollongong discussion of Ai Group members**

## 6. Taxation of Individuals' Investment Income

Ai Group recognises the pressures that have given rise to the calls to address the problem of “negative gearing” of investments in residential accommodation.

However we very strongly caution against the selective quarantining to residential rental income interest deductions relating to funds borrowed to purchase assets of this class. Such a measure would distort investment decisions away from investments in residential real estate and would reduce the supply of residential rental properties.

That is not to deny the anomalies associated with the taxation and deductibility of nominal interest income and expenses. But these anomalies are not confined to interest on borrowings for residential rental properties and they are not confined to the expense side of the equation. The taxation of nominal interest earnings on accrual at full marginal tax rates is equally distorting against investments in interest-bearing instruments.

These issues were discussed at length in the *Australia's Future Tax System Review* where an approach was proposed that would considerably and more systematically address the distortions associated with the negative gearing of investments in residential rental properties than the selective approach frequently put forward.

The approach contemplated was to discount by 40% most components of individuals' investment income and expenses (including interest). An alternative approach would be to adopt the Nordic Model of having a dual income tax that applied a low, flat rate of tax to investment income and expenses.

Ai Group supports further examination of this approach.

## 7. Taxation of Superannuation

Ai Group recognises the important role played by the current tax arrangements for superannuation in Australia's overall approach to retirement incomes. We also recognise that the benchmark against which the tax expenditures associated with these arrangements are assessed is one which would systematically distort against the self-provision of retirement income (or indeed against saving for any purpose). In this respect we view the current approach to the measurement of superannuation tax expenditures to be inappropriate and in part responsible for the poorly informed nature of the debate about the purpose and cost of the current tax arrangements.

That said we are mindful of the potential misuse of superannuation tax arrangements, including the tax-free status of withdrawals from superannuation savings, for general tax planning purposes rather than as part of a targeted retirement incomes policy.

We support a thorough and expert examination of the taxation of superannuation tax arrangements in the context of a clear statement of the objectives of Australia's retirement incomes policy. A link to clearly stated objectives would assist in settling the tax arrangements for superannuation - something that would facilitate the much-needed stability of policy in this area.

Our consultations with members reveal that businesses are mindful of the compliance cost impost associated with superannuation and in particular the move to more frequent remittance of employer superannuation contributions on behalf of employees. Businesses are also conscious the impacts that frequent changes to superannuation tax arrangements have on their employees and on their own productivity.

*"The Superannuation system is shifting to weekly remittance to the clearing house instead of monthly as we have now. This is just another burden, even more paperwork and we don't need that when we would rather be focusing on our business."*

**Small NSW manufacturer**

*"We have an older workforce, and whenever you get tinkering, or even talk of tinkering of the superannuation system, our employees become concerned about how they are going to manage their super and become focused on that. I understand it, but I would rather they are focused on the business instead."*

**Small NSW manufacturer**

## 8. Using the Tax System to Lift Research and Development

Ai Group believes the tax system is well suited to provide a stable and predictable means of correcting for the systematic under-investment in spillover-generating, private sector research and development

Members note that frequent changes to the R&D Tax Incentives undermine confidence in, and the effectiveness of the incentive.

Recently, there have been changes to cap the R&D spending eligible for the incentive at \$100 million. Members note also that this would flow through to universities and the smaller companies that are dependent on collaborating with large companies to undertake research and development. The measure is all the more perplexing because the biggest direct impacts will fall on applied and commercial R&D. In contrast, other current policy directions are focused on lifting commercially-related R&D. Businesses will spend less on their own R&D and they will make less of a contribution to Australia's research infrastructure and research networks.

The arbitrary nature of this measure is highlighted by the prospects facing one Australian-based multinational company, which is R&D intensive and an iconic innovator in a highly-specialised area of advanced manufacturing. This business is now approaching total domestic R&D spending of a sufficient proportion that their next large R&D project would be likely to drag them across the \$100 million threshold. This is placing at risk the decision to locate the new R&D project in Australia.

More recently, there has been a Bill taken to the Senate to reduce the R&D Tax Incentive by 1.5 percentage points, effective from 1 July 2014. This was originally intended to align with the previously-announced across-the-board cut to the company tax rate. If the tax rate had been cut, the changes to the rate of incentive would have preserved the nominal value of the tax incentive. However now that the tax cut is not occurring other than for businesses with annual turnovers of less than \$2 million, the value of the tax incentive will be eroded by the change in the rate of tax incentive.

Two other issues have been raised in our discussions with member:

- Generally, businesses that are in a tax loss position receive no benefit as the tax offset is non-refundable. Businesses are therefore not encouraged to invest in domestic R&D. One instance of this issue has been raised by a company that has evolved from being predominantly a domestic producer with a considerable R&D spend to being a global producer that leverages an even larger domestic R&D spend across its global operations. Its Australian tax liability is now not sufficient to realise the full benefits of the tax incentive so that its incremental R&D spend in Australia is no longer eligible for the tax incentive. Other countries in which it operates also offer tax or other incentives and Australia is at risk of losing its R&D expenditure. As far as Australia is concerned, the company is now essentially an R&D company and its growth in Australia is therefore at risk.
- A second concern raised is that some R&D expenditure undertaken overseas is not able to be claimed under the existing tax arrangements. Yet such expenditure is often necessary if companies seek to comply with international product standards on products developed in

Australia. Greater international R&D spending would also foster greater international collaboration.

*“We are not at the \$100 million mark yet on R&D but we will hope to be at some stage so that decision [to limit the tax incentive] will have an impact.”*

**Australian multinational**

*“R&D Tax Concession is good, we are happy with the settings. But what we need is stability and consistency in the concession.”*

**Melbourne-based manufacturer**

*“The basic arrangements on the R&D Tax Incentive are sound and we don’t want too much change. But we would like to see better rules on our R&D spend overseas. We may develop a product here, but we will need to do clinical trials in the US and Europe, and that should be considered.”*

**Large Australian multinational**

*“Our organizational structure is such that a R&D claim is being corralled in a tax loss situation which has no benefit. Loss carry back arrangements would be very useful. The tax system should be recognizing and incentivizing business to innovate to new products when the company is under pressure.”*

**Brisbane-based manufacturer**

## 9. Patent Box or Similar Approach to the Taxation of Income From IP

Ai Group encourages exploring the benefits of adopting a patent box or similar approach to the taxation of income from intellectual property. Several members have indicated support for the Patent Box idea, noting that significant tax competition exists around these sorts of measures in Europe. Patent boxes enable the application of a lower rate of company tax on profits earned on patented inventions. In the United Kingdom, for example, the lower rate of tax is 10% on these earnings, rather than the 20% company tax rate.

An alternative approach that has been put forward by Ai Group's "advanced manufacturers" builds on the patent box idea of a concessional company tax rate by proposing it apply to income from investments that commercialise intellectual property in Australia. The approach could be aligned with the sectors that the Government has identified as having particular promise in Australia including advanced manufacturing.



## 10. The Taxation of Renewable Resources

Ai Group supports exploring the potential to improve the efficiency of taxation and to better manage the macroeconomic impacts of high commodity prices by replacing state-based royalties on the exploitation of non-renewable resources with a rent tax.

The very large increase in the capacity of our mining and energy sectors raises a number of challenging issues:

- The large increase in mining and energy output raises the relative importance of the efficient taxation of that output and the associated income;
- The extra exposure of the economy and national taxation revenue to commodity price fluctuations raises challenges for macroeconomic management and for the timing of revenue collection.

While the proposal put forward for discussion in *Australia's Future Tax System Review* was extremely poorly handled and while there were clear deficiencies in the design of the approach that was eventually negotiated by the former government, these are not sufficient reasons to avoid the serious consideration that the original proposal was intended to inform.

## 11. State and Territory Taxation

The evolution of Australia's federal system has:

- narrowed the range of state and territory discretion over taxation;
- seen the states and territories oversee an erosion of the efficiency of the taxes over which they have discretion;
- seen increased reliance on particularly inefficient taxes including conveyancing duties.

Ai Group supports a better alignment of spending responsibilities and taxing powers with a particular emphasis on ensuring that, at the margin, the states and territories have greater discretion over decisions to change the level of taxes in line with changes in their expenditure.

In view of the past experience with Australia's federal system, there is considerable merit in circumscribing the variables over which the states and territories have discretion. In general, there is considerable merit in having nationally-defined tax bases on which the states and can set tax rates. This would also improve the transparency of comparisons of taxation between the states and territories.

One option that is worth serious reconsideration is for the federal government to withdraw in part from the taxation of personal income thereby creating room for the states and territories to levy a state-based income tax surcharge on a specified personal income tax base.

Similarly, particularly if a reformed land tax was used as a means of financing the removal of conveyancing duties, the states and territories could have discretion over the land tax rates applying to a nationally-defined land tax base.

We do not see how the GST could be configured in a way that gave states discretion over the rates of tax without substantially adding to the complexity of the GST. An alternative approach to consumption taxation may provide scope for the states and territories to have discretion over consumption tax rates.

In section 5 above, we proposed a consideration of financing the removal of payroll tax by increased exploitation of the GST (by both broadening and raising the rate). We recognise that if this was achieved, the states and territories would lose a current source of discretion over their tax revenue. However, given the broader base of the personal income tax relative to the payroll tax base, the effective level of discretion could be expected to be greater than currently exists if the personal income tax proposal was adopted.

If however payroll taxes were retained, an arrangement in line with the general approach suggested above could apply where the states and territories had discretion over the rates levied on a nationally-defined base.

## 12. Better Addressing Tax Evasion through the Cash Economy

Several Ai Group members have raised concerns around the prevalence of the underground economy in particular industries.

Most households are familiar with the existence of the cash economy with cash rates lower than invoiced rates often quoted for household services.

Our consultations with members have highlighted that, as in the transport industry for example, networks exist across industries where transactions are cash-based with particular operators avoiding tax. This places those businesses meeting their taxation requirements at a significant disadvantage.

Other Ai Group members raise concerns around the illicit cigarette market and the enforcement of excise duties given that all cigarettes in Australia are imported. A report prepared by KPMG in 2014 called *Illicit Tobacco in Australia* suggested that the illicit cigarette market has risen substantially in recent years to now account for 14.5% of total consumption in 2014. Cigarettes are subject to a specific excise duty which is levied per cigarette, and does not change with the retail price. KPMG estimate that if the tobacco had been consumed in the legitimate market, this would raise the Government an excise amount of \$1.35 billion per year.

Australia should have world-class defences against the cash economy and the general public should be included in a concerted effort to keep the cash economy to a minimum.