AUSTRALIAN INDUSTRY

GROUP

Tax Reform Priorities

A Position Statement for the Tax Forum

October 2011

Overview

The Tax Forum is an opportunity to put the case for tax reform and to advocate changes that better gear Australia's tax arrangements to contribute to our ability to meet current and emerging challenges and our preparedness to capitalise on current and emerging opportunities.

In short, Australia should put in place a tax system that facilitates greater workforce participation; reduces distortions against saving; that boosts business competitiveness by attracting investment, including early-stage investment; that keeps barriers to innovation and business restructuring to a minimum and that is conducive to the ongoing development of high value-adding industries. In addition, the taxation system has important roles to play in ensuring that Australia maintains and improves its character as a fair and socially inclusive society.

The following priorities are developed further in the Attachment and have been informed by discussion and feedback by Ai Group members.

Personal Income Tax Priorities

- While short-term opportunities may be constrained, effective rates of income tax should be lowered to improve investment, saving and workforce participation incentives.
- Support changes that reduce compliance costs associated with the valuation and reporting of fringe benefits and support the transfer of fringe benefits tax to employees.
- Support the further investigation of the broader savings income discount proposal.
- Support a reconsideration of the Henry Review superannuation proposal ahead of the Government's proposal to raise the level of compulsory contributions.

State Tax Reform Priorities

- Support in principle the removal of the inefficient state taxes.
- Support using a higher rate and/or broader base GST to finance the removal of as many existing taxes as possible.
- In the absence of its removal, support the harmonisation of the payroll tax base.
- Support the further investigation and development of the conveyance duty/land tax proposal and the Business Cash Flow Tax Proposal.

Business Tax Reform Priorities

- Support reduction in the company tax rate to 25% as soon as possible;
- Improve and extend tax measures designed to facilitate the development of a strong early-stage capital market in Australia;
- Support changes to deduction rules to remove barriers to setting up and reorganising businesses;

- Support the full implementation of the small business measures proposed by the Henry Review (raise the small business threshold and increase the immediate write off facility);
- Support more symmetrical treatment of business losses;
- Support simplifications across business taxation;
- Support measures to address the multispeed economy; and
- Support further investigation and development of proposals for longer-term structural reform of company taxation.

Road Transport Taxation Priorities

- Support further investigation and development of changes to road transport taxation.

Governance Priorities

- Support changes that improve transparency and accountability of the taxation system and that improve standards of governance and management of the Australian Taxation office.

AI GROUP TAX REFORM PRIORITIES

The starting point for the Tax Forum is the Australia's Future Tax System (AFTS) (Henry) Review which put forward the following high-level points:

- Revenue raising should be concentrated on four robust and efficient and broad tax bases:
    - Personal income;
    - Business income;
    - Rents, including rents from natural resources; and
    - Consumption.
- Narrowly based taxes should only be used where they improve social outcomes or market efficiency through better price signals.
- The transfer system should remain structurally separate from the tax system and remain highly targeted.
- Administration of the tax system needs to be more transparent and responsive to problems experienced by taxpayers.

A Key to Successful Tax Reform

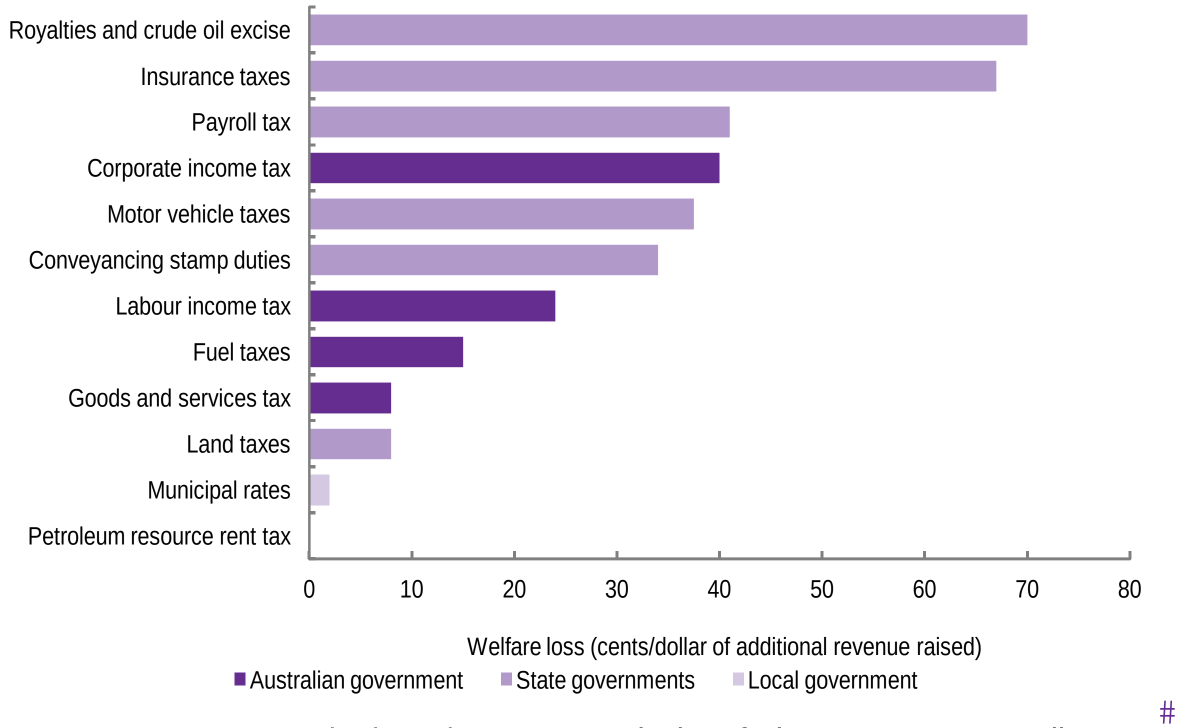
A hurdle in building support for tax reform is the often-cited constraint of revenue neutrality. In its narrowest form, this would imply that any proposal to reduce a tax burden needs to be offset by an increase in revenue raised by some other means or by a reduction in public expenditure.

While expenditure reductions should be explored, this is something that should occur in its own right and tax revenue will still need to be raised to meet whatever level of expenditure remains. Some relief from this grim constraint can be achieved by ensuring reform proposals involve a reallocation of tax collections away from taxes that do relatively more harm to growth prospects and towards taxes whose impacts on growth are less damaging. Such a reallocation would boost GDP and expand the tax base. This is sometimes referred to as the fiscal dividend.

A key element in successful tax reform is to decreases reliance on relatively inefficient taxes or redesigns taxes to improve their efficiency. This can produce a magic pudding of sorts by allowing the same amount of revenue to be raised by levying lower rates of less inefficient taxes on the larger tax base.

The Chart below ranks the inefficiency of some of the more important taxes used in Australia.

Marginal welfare loss from a small increase in selected Australian taxes



Source: KPMG Econtech (2009), *CGE Analysis of the Current Australian Tax System*. Reproduced from AFTS.

Bearing in mind that Australian governments collect the equivalent of around 30% of GDP in tax revenue, the magnitude of some of these welfare losses gives an indication of the important role that tax reform can play in improving national productivity.

Personal Income Tax/Transfer System Design

Personal income tax arrangements impact on incentives for business investment because a large proportion of business income is taxed under personal income tax arrangements.

- The incomes of sole traders, partners and family businesses operating through a trust are all taxed directly under the personal income tax system; and

- Company income distributed to resident owners/shareholders is also taxed under personal income tax arrangements (with a credit for company tax paid under the imputation system).

Other, less direct but still important, impacts on business from personal income tax and transfer arrangements relate to:

- Incentives for workforce participation and therefore the supply of labour and labour turnover, and

- Incentives to save and their impacts on the availability of domestic funds.

Savings

The Henry Review floated a new approach to the taxation of saving that would extend the capital gains discount approach across a full range of saving alternatives. This would ameliorate top some extent the “double taxation of savings” and create a more level playing field for alternative savings vehicles.

The Henry Review proposed a 40% discount on income from savings – other than dividend income. This would:

- Reduce the capital gains discount available to individuals (from 50% to 40%);

- Reduce tax paid on regular savings and rental income by 40%;

- Reduce the value of tax deductions (including interest income) related to earning this income by 40%.

Dividend income and direct business income was excluded from this proposal because it did not fit well with the operation of the imputation system. The Henry Review proposed however, that all interest expenses related to individual saving, including those related to loans used to purchase shares, would be caught by the 40% discount. Inevitable complications and boundary issues would arise over business loans (the interest on which would continue to attract the benefit of full deductibility) and loans related to personal saving.

In view of entrenched recourse to negative gearing in the residential investment property market, the reduction in tax deductibility of interest, together with the increase in the effective rates of capital gains tax could be expected to impact adversely on the supply of rental properties. Changes along the lines proposed would therefore need to be balanced with supply-inducing changes such as improvements in planning laws, development arrangements and the removal of state stamp duties to offset negative impacts on housing supply.

Taxation of Fringe Benefits

The Henry Review suggested reducing scope of the Fringe Benefits Tax regime by substantially returning the obligation to pay tax on remuneration to employees.

- Employers would still face complexities related to valuation and reporting but would not have to pay the tax itself (other than via PAYG deductions at employee’s marginal tax rates.) There would still be considerable potential advantages from a thorough simplification of valuation rules.

- Switching the incidence to the employee would raise the after-tax value of benefits to employees and provide scope for employers to enjoy a share of the tax reduction.

Superannuation

The Henry Review recommended a new approach to the taxation of superannuation that would tax employee superannuation contributions as normal income in the hands of employees; provide a rebate to at least partly offset the loss of disposable income and remove the tax paid by super funds on contributions. The Review also proposed a reduction in the rate of tax on super fund income.

- The proposal would raise the after-tax level of contributions in super accounts and therefore help address adequacy concerns without raising the level of compulsory contributions;

- The proposal would make super more attractive to lower income earners but, depending on the design and durability of the rebate, could reduce disposable income for middle and higher income earners.

Personal Income Tax Priorities

- While short-term opportunities may be constrained, effective rates of income tax should be lowered to improve investment, saving and workforce participation incentives.

- Support changes that reduce compliance costs associated with the valuation and reporting of fringe benefits and support the transfer of fringe benefits tax to employees.

- Support the further investigation of the broader savings income discount proposal.

- Support a reconsideration of the Henry Review superannuation proposal ahead of the Government's proposal to raise the level of compulsory contributions.

State Taxes

The taxes imposed by the states and territories are among the most inefficient and poorly designed of all Australia's taxes.

In an ideal world:

- Insurance taxes and conveyance duties should be removed together with a range of lesser taxes and payroll tax should either be remodeled or removed;

- Land tax could be improved substantially and synergies between land taxation and local government rates could be exploited to reduce compliance costs and improve overall efficiency of land taxation;

- Compliance costs could be reduced by harmonising remaining state and territory tax bases; and

- Economies of scale could be exploited and compliance costs reduced by outsourcing state revenue collection to the Australian Taxation Office.

While the potential gains are large, there are considerable difficulties involved in getting a reform program off the ground.

- The states currently raise only a relatively small proportion of their total revenue requirements with the remainder supplied by the allocation of GST revenue and other grants from the Commonwealth. They are therefore very reluctant to give up revenue sources in the absence of security and discretion over alternative revenue sources.

- Getting agreement across the states and territories is also inherently difficult and requires Commonwealth leadership (and incentives).

- The progress made in the GST reform in state taxation (which saw the removal of financial services duties and many of the “rats and mice” stamp duties) should not be underestimated and to some extent points the way to the resolution of these difficulties. At the same time the ongoing fiscal difficulties faced by the States and the subsequent increases in their recourse to inefficient taxes to meet these difficulties points to the limitations of an approach that did not provide adequate scope and incentives for the States to utilise more efficient tax bases. This points to the desirability for a whole-of-system approach.

Options to Replace State Taxes

Various business groups have advocated raising the rate and/or extending the base of the GST to finance the removal of at least some of these taxes.

The terms of reference of the Henry Review excluded the possibility of it proposing changes to the GST to finance reform of state government taxes and instead it discussed three proposals:

- Introducing a state Business Cash Flow Tax that would be imposed on value added without the tax and credit mechanism employed in the GST. At a rate of around 3% a BCFT could finance the removal of payroll tax, insurance duties some other state imposts;[1]

[1] Broadly the tax would be levied on cash inflows less cash outflows (other than financial flows including interest and employee remuneration outlays). Cash flows would be defined to exclude imposts on exports and to capture the value of imports. The value of domestic consumption of financial services could be taxes under a separate financial services tax.

- Phasing out conveyance duties over a number of years and replacing the revenue with a remodeled (flatter and broader) land tax; and

- Sharing the personal income tax system base between the states and the Commonwealth.

While the welfare losses associated with the personal income tax base are not generally assessed to be as large as those of the major state taxes, they are still significantly larger than efficient consumption or land taxes. The sharing of the personal income tax base could, however, be a way to reduce the financial dependence of the states on the Commonwealth and reducing the pressures for them to retain their inefficient taxes.

The Henry Review put forward the Business Cash Flow Tax (BCFT) as a means to finance the removal of payroll tax and other taxes including duties on insurance premiums. A logical extension of the arguments it put forward, but one which it was precluded from making, is to replace the GST itself with the BCFT. Due to it having a broader base than the GST, a rate of around 10% could finance both the explicit and implicit Henry Review recommendations.

The BCFT would have the following impacts:

- Remove payroll tax, GST, insurance taxes and a handful of other state taxes;

- Considerably broaden the consumption tax base both by including consumption excluded under the GST (food and health) and effectively broadening the payroll tax base (by effectively rolling the payroll tax into a flat-rate BCFT);

- Replace the tax-refund paperwork element of the GST with the cash flow basis of the replacement tax;

- Introduce a source of potential complication arising from the deduction of an allowance of a return on capital employed.

The Henry Review proposal on land taxation is worth consideration on efficiency grounds although it would be politically difficult. The existing conveyance duties, as concentrated imposts at the time of purchase, are very inefficient as they hinder relocation and restructuring options.

Replacing conveyance duties would require phasing and/or refund arrangements so that relatively recent purchasers were not penalized by a double tax burden.

Suggested State Tax Reform Priorities

- Support in principle the removal of the inefficient state taxes.

- Support using a higher rate and/or broader base GST to finance the removal of as many existing taxes as possible.

- In the absence of its removal, support the harmonisation of the payroll tax base.

- Support the further investigation and development of the conveyance duty/land tax proposal and the Business Cash Flow Tax Proposal.

Business Taxation

The major business tax proposals of the Henry Review were:

- To reduce the company tax rate to 25% and maintain it at a level towards the lower end of the range of small and medium sized-OECD countries;

- Allow a one-year carry-back of company losses (so a tax refund would be available if a loss was made providing the company paid tax on profits in the previous year);

- Provide a more generous low-value asset write off provisions for all businesses (and a higher $10,000 threshold for a broader range of smaller business under a $5m turnover);

- Extend the effective life principle to a wider range of business assets;

- Streamline small business capital gains tax arrangements; and

- Change exploration concessions to a refundable tax credit at the company tax level.

Possible longer-term reform directions put forward included the adoption of a business level expenditure tax, flow-though taxation of closely held companies and fixed trusts, and reconsideration of the imputation system.

The Government has announced some changes that head towards the Henry Review recommendations – shaving a percentage point off the company tax rate and, for small business putting in place a $5,000 asset threshold for immediate write off, and an extension of the low-value write off pool. The threshold for small businesses is unchanged at $2 million turnover. With the carbon pricing announcement the Government has proposed lifting the asset write-off threshold to $6,500.

There remains a significant uncompleted reform agenda and in particular the reduction in the company tax rate and further progress on the small business changes should be pursued.

The exploration of a cash-flow basis of company taxation and trading off the imputation system for a lower company tax rate, are both worth keeping on watch if they can prove themselves to be a major way to reduce distortions against investment and compliance costs. These proposals have a time horizon stretching out a decade or two.

Multi-Speed Economy Measures

The reduction in the company tax rate along with the proposed minerals resources rent tax was the major structural response proposed by the Henry Review to the multispeed economy associated with the minerals boom. The lower company tax rate would bring Australia more into line with other small to medium OECD countries and it would help attract investment to sectors on the wrong side of the minerals boom.

The lower company tax rate is still worth pursuing, although without the same revenue in play as would have been in play with a minerals rent tax proposal closer to the Henry Review option, the immediate prospects are not as strong.

Additional options include:

- Reducing the biases in the tax system against losses (including in relation to the continuity of ownership test);

- Allow immediate expensing of costs relating to setting up and reorganizing businesses;

- Accelerated write-off provisions for investment by industries in particular industries (e manufacturing and tourism);

- Heightened deductibility (say 150%) of particular classes of expenditure by such industries;

- An allowance for corporate capital that concentrated company tax liabilities on rates of return above a certain threshold; and

- A selective refundable tax offset/rebate equivalent to a reduction in the company tax rate for particular industries.

Early-Stage Capital Markets

Many countries have in place well targeted and effective measures to promote the development and ongoing success of an early-stage capital market. In Australia this market remains too thin and we are not exploiting the opportunities that we could develop in this area. Ai Group supports a range of measures to facilitate much more depth in the venture capital market. Internationally competitive tax measures are an important element in this program.

Minerals Resource Taxation

There are a number of concerns with the proposed minerals rent tax proposals and in particular the failure to remove the states' royalties. Further there is an apparent hole in the design of the proposed arrangement which has the Commonwealth underwriting further royalty increases by allowing them as a deduction against rent tax liabilities. The Commonwealth may address this problem by adjusting other grants to the states.

Suggested Business Tax Reform Priorities

- Support a reduction in the company tax rate to 25% as soon as possible;
- Improve and extend tax measures designed to facilitate the development of a strong early-stage capital market in Australia;
- Support changes to deduction rules to remove barriers to setting up and reorganising businesses;
- Support the full implementation of the small business measures proposed by the Henry Review (raise the threshold and increase the immediate write off facility);
- Support more symmetrical treatment of business losses;
- Support simplifications across business taxation;
- Support measures to address the multispeed economy; and
- Support further investigation and development of proposals for longer-term structural reform of company taxation.

Road and Transport Taxation

The Henry Review recommended a number of changes in the area of taxation and road transport. These included:

- Consideration of phasing in comprehensive congesting charging;
- Removal of the luxury car tax;
- Accelerate development in COAG of mass-distance-location pricing for heavy vehicles;
- Improve compulsory third party insurance to reflect individual risks;
- Impose an additional heavy vehicle charge where road and rail compete directly for freight;
- Replace fuel taxes over time with more efficient taxes. If maintained, link more closely to efficient financing of the road network; and
- Taxes on vehicle ownership should be made more transparent; taxi quantity restrictions should be removed.

A completed reform program in this area could see the removal of, or at least much lower fuel taxes, a greater reliance on congestion charging and no revenue-raising element to motor vehicle registration and transfer taxes and the removal of the luxury car tax.

While the detail would need to be further investigated and developed, the broad direction of reform appears sensible and capable of delivering improved and more cost-effective road use and more appropriate allocation of road funding between Commonwealth, state and local governments.

Suggested Road Transport Taxation Priorities

- Support further investigation and development of changes to road transport taxation.

Tax System Governance

The Henry Review recommended a number of changes to the Governance of the tax system. The most important of these included:

- Changes to the role of the Board of Taxation, giving it the right to initiate its own inquiries and improve its independence;
- Creating an advisory board on ATO governance and management; and
- Clarifying that the role of the Inspector General of Taxation relates to systemic administration of issues that affect business

Suggested Governance Priorities

- Support changes that improve transparence and accountability of taxation system and that improve the standards of governance and management.