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1 February 2019

Dear Sir/Madam,

## 2019-20 PRE-BUDGET SUBMISSIONS

We refer to the invitation by the Assistant Minister for Treasury and Finance in a Media Release on 19 December 2018, to submit ideas and priorities for the 2019-20 Federal Budget. Informed by, amongst other things, the outcomes of the *2018 BDO Tax Reform Survey* (and surveys past), we make the recommendations summarised below under the following headings and elaborated upon in the Appendix, in respect of taxation priorities in the upcoming Budget period.

Our major recommendations are the reigniting of the tax reform process, not as one off but rather as an ongoing process that sees tax reform as a Government priority. To achieve this, we specifically recommend the establishment of an independent Tax Reform Commission to provide ongoing tax reform recommendations to Government. The remainder of our recommendations are issues that we recommend be considered as part of the holistic tax reform process.

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Tax reform	#1 - The Australian tax reform process needs to be reignited and there needs to be a holistic review of all the taxes in both the Federal and State tax systems. This needs to include an education process for the general public so they understand the good policy reasons for the tax reform changes.	4
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R&D	#21 - There should be reform of R&D to address the ATO's and AusIndustry's tightening of eligibility for R&D claims.	15
Investment	#22 - The Government should consider introducing tax discount for individuals that applies across the board to all savings income and capital gains which should be done in conjunction with a review of both the CGT discount, CGT small business concessions & imputation.	15

Employment Taxes	#23 - Consideration should be given to a repeal of the FBT, with fringe benefits, instead assessed to employees as salary and wages. This should be done in a way so as not to disadvantage not-for-profit entities that currently rely on FBT concessions to attract staff.	16
State Taxes	#24 - The Federal Government should seriously negotiate with the State Governments to reform their inefficient taxes, particularly payroll tax and stamp duties.	17
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	#27 - Section 99B of the ITAA 1936 should be revised so that it does not apply when accumulated foreign source income is paid to an Australian resident beneficiary who was a non-resident when the trustee derived the income. This provision should be redrafted so that it applies only to the mischief it was aimed at.	18
	#28 - The current uncertainty surrounding the interaction between Division 7A and UPEs should be resolved by either deeming UPEs to not be Division 7A loans and thus allowing Subdivisions EA and EB of Division 7A to apply in the manner in which they were originally intended to apply.	19

Should you have any questions, or wish to discuss any of the comments made in our submission, please do not hesitate to contact me on 02 9240 9736 or [lance.cunningham@bdo.com.au](mailto:lance.cunningham@bdo.com.au).

Yours sincerely

Lance Cunningham



BDO National Tax Director

## APPENDIX

### TAX REFORM

#### Issue #1 - Australian tax reform is getting urgent.

BDO and our clients have been calling for a holistic review of the Australian tax system. Over the last decade we have collated our client's thoughts on tax reform using our annual BDO Tax Reform Survey. Respondents to our surveys represent a broad range of sectors and business sizes and the sentiment from Australian taxpayers is clear the call for genuine tax reform is getting louder.

In our [2018 BDO Tax Reform Survey](#) we asked respondents whether the Government should recommence the broad tax reform process that covers all taxes and both the Federal and State taxes. In the first BDO Tax Reform Survey that was conducted in 2012 an impressive 77% of respondents responded with a resounding 'yes'. In the years since including last year this result has steadily risen to the point where there was an overwhelming 94% of respondents supporting a broad tax reform process. We suggest the Federal Government listen to our clients, who represent a good cross section of the Australian population and look to implement a genuine tax reform process.

In our opinion the major view that underpins the need for holistic tax reform is to produce an unambiguous tax system that also provides a fair and efficient means of revenue for the Australian Federal and State Governments. This means that where there are tax concessions provided, they need to translate into increased productivity and opportunity.

In terms of practical steps, at a high level there are two that need to be taken urgently. Firstly, there is a need to examine Australia's many different types of tax and rationalise them where possible. Secondly there is a public education campaign outlining the benefits of reform to the tax system. This education process should be done outside the electoral cycle and where possible obtain bipartisan support within the Federal Parliament and State Governments.

**Recommendation #1 - The Australian tax reform process needs to be reignited and there needs to be a holistic review of all the taxes in both the Federal and State tax systems. This needs to include an education process for the general public so they understand the good policy reasons for the tax reform changes.**

#### Issue #2 - Independent Tax Reform Commission.

In the BDO 2018/19 Pre-Budget Submission we stated that to achieve real tax reform, we need to focus on the journey, not the destination. If Australia starts on this journey of a long-term, holistic and strategic tax review process that involves the public, examines the challenges and opportunities it presented, and is not beholden to the election cycle, Australia will achieve fair and internationally competitive corporate tax reform.

In the last two BDO Tax Reform Surveys we asked respondents whether tax reform should be separated from the electoral cycle by the establishment of an Independent 'Tax Reform Commission'. In both the 2017 and 2018 BDO Tax Reform Surveys around 80% of respondents supported the creation of such a body. BDO believe that the tax reform process is continually ongoing and not one that should only be revisited every 10 or 20 years until tax reform becomes urgent. The establishment of an independent Tax Reform Commission would ensure that the journey of tax reform remains an ongoing process.

**Recommendation #2 - The Government should establish an independent Tax Reform Commission that has an ongoing role to develop tax reforms recommendation for the Government.**

**Issue #3- Changes to tax rates should not, on their own, be seen as tax reform.**

There have been too many instances in Australia as well as overseas, where reductions in tax rates have been sold as tax reform. Changes in tax rates, both increases and decreases, should be seen as an ongoing fiscal policy mechanism the Government uses to make adjustments to the economy to take account of inflation, recessions, international tax rate comparisons and government spending requirements.

Tax reform should instead be seen as a review and amendment of how all the various elements in the tax system interact e with each other and the economic and social aspects of the society. The tax reform process should consistently review these interactions to ensue as much as possible, that the tax system reflects the fundamental aim of all tax policy makers being to have a simple, efficient and fair tax system.

**Recommendation #3 - The Government should ensure they do not publicise tax rate reductions on their own as being tax reform. The term tax reform should rather be used for the more fundamental review of the interactions between the various taxes and the resto of the economic and social policies of the country.**

**Issue #4- The Australian Federal taxation laws are overly complex.**

Changes to the income tax laws which have been the subject of prolonged review and discussion should be implemented. In this regard, we particularly single out the controlled foreign company (CFC) rules, which have been the subject of a lengthy review undertaken by the Board of Taxation and then Federal Treasury. The most recent review of the CFC provisions commenced under the auspices of the Board of Taxation in 2006. It was subsequently the subject of a number of Discussion Papers released by the Board and by Treasury, culminating in the release of Exposure Draft Legislation in February 2011. The resulting reforms are now well overdue.

The Federal income tax laws are overly complex and need simplification. To this end the prolonged process of re-enacting the provisions of the ITAA 1936 into the ITAA 1997 should be expedited. The re-enactment of Australia's income tax legislation from the ITAA 1936 to the ITAA 1997 is a project that is still far from over. The responses to the BDO Tax Reform Surveys past provide strong indications of the complexity faced by taxpayers in addressing their taxation affairs. The mere simplification and updating of the language of the Australian income taxation laws that will come with such a redraft is desirable.

**Recommendation #4 - Certain income tax laws which have been the subject of prolonged review and discussion such as the Controlled Foreign Company rules should be implemented. The prolonged process of re-enacting the provisions of the Income Tax Assessment Act 1936 (ITAA 1936) into the Income Tax Assessment Act 1997 (ITAA 1997) should also be expedited.**

## COMPANY TAX

### Issue #5 - Implementation of proposed large business corporate tax rate cuts in Australia.

The 30% company tax rate for larger-sized companies is markedly higher than most other OECD countries including New Zealand, South Korea, US, UK and even Norway. Australia's corporate tax rate of 30% is 6% above the OECD average.

It is commendable that the Government lowered company tax rate for small to medium businesses (base rate entities) to 27.5% for the 2019-20 income year and a further 25% for 2021-22. These lower company rates are however likely to mostly benefit companies owned by Australian individuals and will not adequately deal with the competitive disadvantage the 30% company tax rate Australian has for the larger foreign owned companies investing in Australia. It is these larger foreign owned companies that will be affected most by Australia's uncompetitive corporate tax rates as they are more likely to have mobile capital that can be moved out of Australia and to countries with more competitive corporate tax rates.

Proposals to extend the 25% corporate tax rate to larger companies, contained in Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017, were stalled in the Senate [where they were introduced on 22 August 2018], despite the fact that this has become a matter of great urgency due to the United States' corporate tax cuts from 35% to 21%. If Australia is to remain an attractive place for foreign investment and trade, the Government must cut our large business corporate tax rate sooner rather than later. On effective tax rates, the results are dramatic. Australia's corporate tax collects in 2016 were equivalent to 4.5% of gross domestic product, which is around 50% higher than the OECD average.

With ongoing corporate tax rate cuts implemented by many developed countries, is this a game changer for Australia's tax competitiveness? In BDO's 2018 Tax Reform Survey, 73% of respondents thought so and were of the belief that the Australian corporate tax rate needs to be reduced for Australia to remain competitive in attracting international capital given other countries are reducing their corporate tax rates. This is up from 46% of respondents last year.

We suggest that the Government implements an education and media campaign pointing out why the reduction of the corporate tax rate from larger companies is important in keeping access to international capital, which Australia needs to develop our economy.

**Recommendation #5 - There should be a clearer plan on how the proposed large business corporate tax rate cuts will be beneficial to the Australian economy and in particular an education and media plan to identify the importance of a reduced corporate tax rate to ensure Australia is competitive in attracting international capital to develop our economy.**

## PERSONAL TAX

### #6 - Personal tax thresholds should be significantly simplified and reduced

Respondents of the 2018 BDO Tax Reform Survey voted personal taxes as the second most important area of tax in need of reform. As the Government's signature policy, corporate tax cuts have dominated the tax rate cut debate and the latest fiscal foray creates an opportunity to look at comprehensive reforms. Income tax rates should really be lowered and indexed to inflation, particularly given the stagnation of average wages, and increases in the cost of energy and housing.

The best solution to the problem of bracket creep is to index the marginal tax rates to average earnings. Indexing marginal tax rates to average earnings would enable marginal tax rates to increase at the pace of inflation. It would increase workforce participation incentives and correct for the overall economic and social costs caused by bracket creep. It would also make Australia more competitive on an international scale. Marginal tax rates can be indexed to things other than average earnings. Whatever the chosen index, it must not be subject at whim to adjustment or discretion, and must be published by an independent authority such as the Australian Bureau of Statistics.

**Recommendation #6 - Personal tax thresholds should be significantly simplified and reduced by indexing the marginal tax rates to average earnings.**

### #7 -The Medicare Levy is in need of review.

The durability of the Medicare levy (introduced in 1984) has withstood a number of suggestions to abolish it or absorbed into the income tax system which was one of the recommendations of the 2008 Australian's Future Tax System Review (Henry Review)<sup>1</sup>. However, the Henry Review did suggest an alternative of making the Medicare levy more progressive by applying it as a proportion of the income tax payable. Progressive taxation is the fairest and most efficient mechanism for raising this funding as people contribute at a level related to their capacity to pay.

**Recommendation #7 - The current Medicare levy system should be reviewed and consideration could be given to the Henry Review suggestion of replacing it with a new model whereby it is applied as a fixed proportion of income tax payable.**

## DIVIDEND IMPUTATION

### #8 - The dividend imputation system has not been thoroughly reviewed in decades.

The dividend imputation system has been very popular amongst Australian resident investors and this is evidenced by the results of the BDO Tax Reform Surveys. The abolishment or modification of dividend imputation to fund company tax rate cuts is an issue considered in the BDO Tax Reform Survey every year and was revisited again in 2018 when 79% of respondents felt it should not be changed as it provides an incentive for Australians to invest in local companies. This is consistent with the 80% of respondents who expressed this sentiment in 2017 and interestingly, an increase on the 69% of respondents in the 2016 BDO Tax Reform Survey. Therefore, any changes to the system need to be done carefully and with a good education program identifying the reasons and benefits of such a change. Below are some issues that could be considered in any review of the imputation system.

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<sup>1</sup> 2008, Australia's Future Tax System Review

<http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm>

There are arguments that the imputation system distorts the capital/debt markets and motivates companies to maintain high dividend payout ratios with a built-in disincentive for companies to invest their profits to expand their businesses, and puts a relative penalty on overseas investments by Australian companies.

Many other developed countries have disbanded their imputation systems and most have replaced it with a discount for investment income and capital gains. This could be considered as an alternative to the Australian Imputation system.

The dividend imputation system was introduced to stop double taxation of company profits on payment of dividends. However, this only applies in the case of resident taxpayers receiving distributions of Australian company profits. Foreign investors do not receive the benefit of imputation credits. Although the foreign investors do not have withholding tax deducted from franked dividends this is not much benefit to most of them as their home jurisdictions would generally give them foreign tax credits for the Australian withholding tax.

It has been argued that this causes an inequity between local investors and those from overseas and would discourage foreign investors from investing in Australia. However, these arguments are not supported by any technical analysis. While the imputation system does give an advantage to resident shareholders, it does not provide a disadvantage to foreign investors as they are not in any worse position (and in some cases better position) than they would be if the imputation system was abolished and withholding tax was therefore applicable to the Australian dividends they receive. BDO considers that removing dividend imputation will not increase foreign investment into Australia, but it may encourage Australian companies to use its profits to reinvest rather than being encouraged to payout profits as franked dividends.

The refundability of imputation credits should also be reviewed. It is generally accepted by many expert tax commentators that the refund of imputation credits is not good tax policy. However, because this policy has been in place for more than a decade, any change to this policy would need to be done carefully with transitional rules that allow investors who have made investments in good faith based on this policy to rearrange their investment portfolios to account for any new policy.

**Recommendation #8 - The imputation system should be reviewed to identify its effect on debt and capital markets and whether it affects company's decisions to either invest their profits or pay franked dividends. Any changes to the refundability of franking credits should only be done with appropriate transitional rules to allow time for existing investors to rearrange their investment portfolios.**

## **SUPERANNUATION**

**Issue #9 - The level at which contributions caps are currently set does not appropriately incentivise Australians to save for their own retirement.**

There have been two clear signals from the results of BDO's Tax Reform Surveys from the last several years in relation to superannuation. One is that taxpayers do not appreciate the continual 'tinkering' with the superannuation tax system. The other is that they perceive the level at which contributions caps are currently set does not appropriately incentivise them to save for their own retirement. In particular, they are concerned that the contributions cap restricts them from saving for their retirement during the years in which such saving is financially affordable for them.



Whilst many taxpayers save for their retirement progressively during the years that they are earning income, it is simply not affordable for the vast majority of the taxpaying community to do so. With the costs mortgages, raising and educating children taking almost all of most taxpayers funds during their early and middle income producing years most of them do not have the extra funds to put into retirement savings until towards the end of their working lives. Over the last 10 years the concessional superannuation contribution cap for older workers has reduced by three quarters from \$100,000 p.a. to \$25,000 p.a. (the same cap as for all other workers).

BDO submit that the level at which the concessional contributions cap is set should be reviewed in light of evidence (either to be collected or, if already collected, to be made public) on the adequacy of such savings for a range of scenarios having regard to the effect of capping.

As an alternative, the annual contribution cap process could be replaced with lifetime concessional contribution cap including appropriate transitional arrangements. The lifetime cap number should be meaningful to allow a person and their family to be self-sufficient in retirement.

**Recommendation #9 - Capping of superannuation contributions should be reviewed with the benefit of research into the effect of such capping on superannuation income stream adequacy and also consider the replacement of annual contribution caps with a lifetime contribution cap.**

## **SMALL TO MEDIUM BUSINESSES**

**Issue #10 - Small to medium businesses that apply s45B of the ITAA 1936 where they undertake a demerger under Division 125 of the ITAA 1997 are denied a 'demerger dividend'.**

Small to medium businesses should be given a 'safe harbour' in respect of the application of s45B of the ITAA 1936 where they undertake a demerger under Division 125 of the ITAA 1997. Where s45B applies in respect of a demerger, it, in conjunction with s45BA, operates to deny the recipient of a demerger dividend the concessional treatment accorded such amounts where they are received as part of a demerger under Division 125 of the ITAA 1997. It has been our experience that the ATO will rarely, if ever give a ruling that s45B will not be triggered where a small to medium businesses conducts a demerger under Division 125.

Demergers result in no economic change to the underlying ownership of assets. As such, concessions are available to make structures more efficient and allow for the splitting of incompatible business operations from one another. Existing general anti-avoidance provisions are sufficient to deal with the tax mischief of demergers undertaken for other reasons. Accordingly, there is an argument that more definite criteria should be specified for the application of s45B to demergers, at least where they are undertaken by small to medium businesses. A 'bright line' test, similar to the three year holding rule under the small business restructure rollover, should be introduced.

More definite criteria should also be specified for the application of s45B to demergers, at least where they are undertaken by small to medium businesses.

**Recommendation #10 - Small to medium businesses should be given a 'safe harbour' in respect of the application of s45B of the ITAA 1936 where they undertake a demerger under Division 125 of the ITAA 1997.**

## **Issue #11 - Small to medium business structures should be reviewed.**

Small businesses utilise various types of structures including sole traders, partnerships, trusts and companies. Most of these structures have complex tax and other legal rules that can cause real risks for many small businesses. Unfortunately, many of these small businesses and some of their advisers are not aware of all these risks. There are a number of alternatives that could be considered to help small businesses to comply with their tax requirements. Some of these are discussed below:

### **Small Business Company**

A new official definition of a ‘small or medium business entity’ should be introduced for the purpose of providing taxation safe harbours to small, entrepreneurial entities so that in their early stages they can concentrate on growing their businesses rather than complying with technical tax legislation. A common cause of frustration for small to medium business entities is that they are subject to the same technical requirements as their much larger competitors, without having access to the resources that their competitors have to manage compliance with these provisions.

A definition of ‘small to medium business entity’ could be introduced where they are provided with safe harbour treatment in relation to a number of technical tax matters, such as thin capitalisation, the CFC rules, transfer pricing, the debt/equity rules (the turnover threshold for ‘debt treatment’ of interest free shareholder loans was the provision upon which this suggestion is modelled) and application of various FBT exemptions i.e. the small business car parking exemption where there is an existing similar exemption. The nature of the safe harbours should also be the subject of consultation but should be designed to be easy to apply, ‘bright line’ tests to give taxpayers the required certainty.

The required definitions could be incorporated into the existing Division 328 and would therefore require aggregation of turnovers of connected entities and affiliates which would act as an integrity measure. We propose that the turnover threshold initially be set at \$20 million per year to align with the R&D refundable tax offset limit, but that this should be subject to 3 yearly reviews, in line with the recently enacted legislation regarding the review of the quantum of a penalty unit under the Crimes Act. Other similar thresholds (such as the small business entity threshold and the \$6 million maximum net asset value test threshold) should be similarly subject to periodic review.

### **Small companies taxed as partnerships**

As an alternative to a small business company, small companies could be allowed the right to choose to be taxed as a partnership. Many small companies are set up only to provide asset protection for the business operators and generally most or all or most profits are distributed to the company shareholders each year. If companies could elect to be treated as a partnership it would cut out a lot of complex tax integrity rules associated with companies and their shareholders. There would be a material saving in compliance costs for many small companies and their shareholders if they could elect into being taxed on a transparent basis in a manner similar to partnerships. A model for such an approach is provided by the tax treatment of ‘S-corporations’ in the United States.

### **Trusts taxed as companies**

Trust estates could be allowed a right to choose to be taxed as a company. One interesting outcome from the 2017 BDO Tax Reform Survey was that 42.2% of respondents agreed with the proposition that “the Government should consider taxing trusts as companies”. While we would be slow to advocate such a mandatory approach applying to trusts generally, there might be a case for allowing trusts to opt into such an approach.

Many small businesses in this country use a structure that is a combination of a trust and a company as it gives them flexibility and in many cases assets protection. However, that structure requires small business to deal with some of the most complex provisions in the tax system including the trust taxing provisions and Division 7A for private company loans, payments and debt forgiveness to shareholders and associates. Removing this burden from such taxpayers, by allowing elective corporate tax treatment to trusts, would alleviate this issue and is in line with the Board of Taxation's recommendation in its 2014 report into Division 7A.

**Recommendation #11 - The structures used by small to medium businesses should be reviewed and the establishment of a "small business company" concept introduced, allowing small business companies to choose to be taxed like partnerships; and/or allow trusts to choose to be to be taxed like companies.**

#### **Issue #12 - Small Business Tax Concessions are overly complex**

71% of respondents in BDO's 2018 Tax Reform Survey believed that the current tax concessions for small businesses are too complex and should be simplified, even if it means some of the concessions are reduced. This shows that small businesses recognise trade-offs may be needed to obtain simplification of the small business concessions. The small business CGT provisions are one of the most complex pieces of tax legislation we have and it is very difficult for small business and their advisers to understand and follow them correctly without specialist help. In addition, the small business company tax cut legislated in 2017 is an example of how a simple tax measure intended to assist small businesses can become grossly over complicated with unnecessary confusion and complexity. This sentiment is consistent with that expressed in 2017 when 70% of respondents of the 2017 BDO Tax Reform Survey believed the Government should simplify taxes for small businesses.

**Recommendation #12 - There should be simplification of small business concessions, even if it means losing some concessions.**

## **CAPITAL GAINS TAX**

#### **Issue #13 - A timing difference can result in a deferred tax asset that is subsequently reversed and this reversal can result in CGT event E4.**

CGT event E4 applies where a holder of an interest in a trust receives a distribution from the trust which is not otherwise assessable. In those circumstances, the cost base of the beneficiary is reduced to the extent of the distribution, except where the distribution exceeds such cost base, with the amount of any such excess being a capital gain. Differences between the distributable profit of the trust and its s95 net income can be either permanent differences or temporary timing differences. An example of a temporary timing difference is where the depreciation rate for tax is higher than that used for accounting, resulting in a deferred tax liability. This usually results in a CGT event E4 and the reduction of the CGT cost base of the interest in the trust and possibly a CGT gain. Currently, apart from AMITs, when a timing difference is subsequently reversed, there is no reversal of CGT cost base reduction or reversal of the CGT event E4 capital gain that previously applied.

There is also an issue where a timing difference results in a deferred tax asset that is subsequently reversed. There is no increase in the CGT cost base of the units on creation of the deferred tax asset but on the reversal of the deferred tax asset it results in a CGT event E4 and a reduction of the CGT cost base and a possible CGT gain. For example, the accounting depreciation rate exceeding the taxation depreciation rate will result in a deferred tax asset, that when reversed may result in CGT event E4. This could be addressed by adding to the cost base of an interest in a trust where the amount assessed under Division 6 of Part III ITAA 1936 exceeds the amount of the relevant distribution.

**Recommendation #13 - Where a beneficiary of a trust has CGT event E4 apply to it solely due to a tax timing difference, such CGT event should be reversed when the timing difference is reversed in a similar way to the rules for AMITs.**

**Issue #14 - Capital gains tax discount should be reviewed reconsidered in relation to the effect on investment decisions and whether it is consistent with international comparisons,**

The CGT discount is not a bad policy, however the level of the discount is generous and is open for abuse therefore there have been various calls for changes to Australia's perceived 'generous' CGT regime. Some of the options reportedly being considered by the Federal Government include decreasing the CGT discount to 25%, alternatively decreasing it to 40% (as recommended in the Henry Tax Review) only for property investments, or some other reduction in the CGT discount for property investments. Another option is completely removing the concession if the property is sold in the initial investment years and phasing the discount in after the investment has been held for some specified number of years.

There is also a good argument for abolishing the CGT discount and reintroducing the indexation of CGT cost bases. The indexation of CGT cost bases was replaced with the CGT Discount in 1999 at a time when inflation was relatively high and it was seen that the CGT discount would provide a reasonable offset for the loss of indexation. However, more recently there has been low inflation, therefore this approach could be reconsidered to see if it still appropriate. One of the other reasons for the replacement of the cost base indexation was because of the complex calculation required for each capital gain. However, with most capital gains being calculated electronically these days this should not now be seen as so much of a problem. However, any change will require revisiting and considering the previous system of capital gains tax calculation to understand relevant issues rather than leaping towards simplistic, arbitrary solutions.

**Recommendation #14 - There should be measured reform to the 50% CGT discount.**

## **CAPITAL ALLOWANCES**

**#15 - Small business needs an incentive to assist with business activities.**

A business investment allowance is a common tool used by governments for economic stimulus. It is an additional tax deduction available for the purchase of plant, equipment and vehicles and encourages business people to invest in income-producing business assets. The most recent version of an investment allowance in Australia was introduced as part of a temporary package to limit the impact of the global financial crisis. That investment allowance was set at 50% of the asset cost.

BDO recommends the investment allows rules be permanently placed in the ITAA 1997 with the ability for the Government to turn the investment allowance on and off as is appropriate for the economic conditions. This could be done by either having a particular end date or a regular review of the end date. If particular changes are needed to the investment allowance rules to account for special conditions, it would be just a matter of amending the particular conditions in the rules instead of recreating new rules every time

**Recommendation #15 - Investment allowance rules should be permanently included in the Income Tax law with the ability of the Government to turn these allowances on and off as required by the current economic conditions.**

## VALUE SHIFTING

### Issue #16 - The value shifting rules are too complicated.

The value shifting rules introduced in 2002 addressed arrangements that shift value out of assets, distorting the relationship between their market values and their values for tax purposes. Without a value shifting regime, these arrangements could encourage the creation of artificial losses and the deferring of gains. These rules are too complicated, as well as being mechanical and prescriptive, and can apply in situations where there is clearly no tax avoidance purpose.

**Recommendation #16 - The value shifting rules should be simplified and there should be a higher de-minimis thresholds. There are de minimis rules that have the effect that where the value of a value shift is less than a set value, the value shifting rules will have no application, however these de minimis levels are low and have not been revised since they were introduced in 2002.**

## LOSS INTEGRITY MEASURES

### Issue #17 - Capital losses made by companies are often unusable.

Where a company realises a capital gain, it is often assessed and taxed to the company in an identical manner to the taxation of an equivalent revenue gain. Notwithstanding this, companies continue to be prohibited from deducting net capital losses from their assessable income of current or future years. This can result in the unsatisfactory situation of a company being assessed and taxed on taxable income while simultaneously carrying forward a 'quarantined' net capital loss.

Consideration should be given to the removal of the quarantining of capital losses of companies where such companies are prepared to forgo any residual indexation of the cost base of their CGT assets. The income tax legislation should be amended so that companies that elect to forgo indexation can deduct net capital losses, in the same way that they can deduct revenue expenses or losses. Provided a company is prepared to forgo any residual access to indexation of cost bases in respect of capital gains there appears no good reason for the continued quarantining of such capital losses. Accordingly, the law should be amended so that such a company can immediately deduct such a capital loss, for all income tax purposes. Arguments that capital losses should continue to be quarantined because taxpayers can control the timing of such losses are not persuasive. The timing of an equivalent revenue loss on a similar revenue asset is similarly under the control of relevant taxpayers as are other deduction events such as the writing off of a bad debt. Contrived 'wash sales' can be adequately addressed by application of the general anti-avoidance rule in Part IVA.

**Recommendation #17 - Consideration should be given to the removal of the quarantining of capital losses of companies where such companies are prepared to forgo any residual indexation of the cost base of their CGT assets.**

### Issue #18 - The loss integrity measures in Subdivisions 165CC and 165CD ITAA 1997 are over complicated.

Australia has some of the most complicated loss integrity measures in the world, many of which were put in place prior to tax consolidation and deal with problems that have been largely resolved by recent tax reforms.

**Recommendation #18 - The complicated loss integrity measures in Subdivisions 165CC and 165CD ITAA 1997 need to be re-examined.**

### **#19 - Tax loss carry-back and carry-forward mechanisms are not generous enough, resulting in asymmetrical treatment between profits and losses**

Tax loss carry-back is a provision that allows an individual or a business to use a net operating loss in one year to offset a profit in one or more previous years. A tax loss carry-forward works the same as a tax loss carry back, carrying the tax loss over to a future year of profit.

The current mechanisms are limited to loss carry forward resulting in an asymmetry that means that a company that makes a profit in one year and a loss in the next year will pay a higher effective tax rate over those two years than another companies that either make the loss in the first year and a loss in the second year or have the same total profit more evenly over the two years. This can give rise to a bias against riskier investments, which diverts capital to investments that are of lower value for the economy.

A loss carry-back tax offset should also be re-introduced (it was repealed when the Mineral Resource Rent Tax was repealed in 2014). A loss carry-back will encourage companies to adapt to changing economic conditions and take advantage of new opportunities through investment. Companies will be able to utilise their tax losses sooner and reduce the extent to which they risk never being able to use those losses. A loss carry-back offset will also improve the cash flow of affected companies by allowing them to access their losses in a timelier manner. This promotes sensible risk taking by companies, helping them to adjust to changing economic conditions. It should also be available for companies that are eligible small business entities.

BDO suggests that Tax losses should be able to be carried back for two years by re-introducing a loss carry-back tax offset. The former offset was only available if the company had paid tax in the previous two years and this restriction should be retained to ensure that the offset rewards previous success and encourage continuation of such success and not reward careless risk taking by management, which should not be done at public expense.

To ensure that this measure is revenue neutral it could be accompanied by amendments to restrict the loss carried forward for a maximum of 10 years before they are forfeited.

**Recommendation #19 - Tax loss carry-back rules should be reintroduced**

## **FRANKING**

### **Issue #20 - The 45-day rule applies too broadly.**

The 45-day rule requires resident taxpayers to hold shares at risk for at least 45 days (90 days for preference shares, not including the day of acquisition or disposal) in order to be entitled to franking credits. This rule was brought in to counter some inappropriate schemes for the trading in franking credits but it is so wide that it affects many arrangements that do not relate to franking credit trading.

**Recommendation #20 - Revise the 45 day holding rule so that it only applies to the specific situations it was meant to stop and is re-written into the ITAA 1997. We also note that the 45-day rule relies on repealed legislation from the 1936 Act, which is difficult to find and its wording is ambiguous and difficult to read and that this should be addressed as part of any rewrite.**

## R&D

### Issue #21 - AusIndustry has tightened eligibility for R&D claims.

AusIndustry's feedback on R&D activities drastically differs from what is, based on previously decided cases, considered to be R&D activities within the legislative definition. AusIndustry often narrows the legislative definition of a core R&D activity through introducing additional criteria absent from s355-25 ITAA 1997. AusIndustry suggests an eligible core R&D activity cannot include a standard experimental procedure as the results can already be determined in advance. This is a flawed position as it fails to consider all the variables that could result in an unknown income such as the various experimental parameters and their interactions.

**Recommendation #21 - There should be reform of R&D to address the ATO's and AusIndustry's tightening of eligibility for R&D claims. The current definition of eligible activities and expenses under the law should be retained but there needs to be more AusIndustry and (where necessary) ATO guidance, including plain English summaries, case studies and public rulings, to give greater clarity to the scope of eligible activities and expenses.**

## INVESTMENT

### Issue #22 - There needs to be further incentive for Australians to work and invest.

Superannuation's tax-preferred status has enabled it to become the primary savings vehicle for most Australians. Whilst this has been very beneficial for retirement savings it does little to recognise the necessity for individuals to save income outside of superannuation to afford major capital purchases during their working life.

The Henry Review proposed that there should be a 40% savings income discount available to individuals for non-business related net interest income, net residential rental income (including related interest expenses), capital gains (and losses) and interest expenses related to listed shares held by individuals as non-business investments. Such a recommendation may make investments outside of residential property (that is not the family home) and superannuation more attractive. To provide further incentive for Australians to work and invest we support the introduction of a savings income discount.

**Recommendation #22 - The Government should consider introducing a tax discount for individuals that applies to all savings income and capital gains which should be done in conjunction with a review of both the CGT discount, CGT small business concessions & imputation. The Government could consider introducing a savings income and capital gains discount for individuals.**

## EMPLOYMENT TAXES

### Issue #23 - The FBT produces an onerous compliance burden on employers and inappropriate tax outcomes for employees who are on lower income tax marginal rates compared to the FBT rate.

The Fringe Benefits Tax (FBT) was introduced in 1986 in order to address a perceived shortcoming in the then existing income tax measures (s25(1) and s26(e) of the ITAA 1936) in appropriately taxing non-salary or wage benefits provided to employees by employers. An appropriate response would have been to amend the existing income tax legislation in order to ensure that such benefits were appropriately valued and assessed to the relevant employees. Instead, the (then) Government, introduced a whole new tax regime which assessed and taxed the benefits to the employer providing the same. Additionally, it imposed a whole new compliance regime with returns and a taxation year quite different and separate from relevant income tax compliance obligations.

The current design and rate of FBT is such that it is implicitly assumed that employees paying the maximum marginal rate of income taxation should be indifferent as between receiving salary or wages or receiving the equivalent value in fringe benefits. However, the corollary of this is that FBT applies regressively, as it implicitly taxes benefits provided to earners of income whose marginal rates of income tax are less than the maximum marginal rate, at the maximum marginal rate. In other words, in addition to taxing the wrong taxpayer (being the employer rather than the employee), the tax unfairly penalises the provision of fringe benefits to low income earners. In addition to the above, any alleged simplicity benefits which flow from assessing and taxing the benefits centrally to the employer rather than to the employee, have been substantially eroded by the requirement that the employer separately identify ‘reportable fringe benefits’ attributable to each employee and record the same on PAYG payment summaries provided to the employee and the ATO. This is further exacerbated by the absence of tax consolidation in respect of FBT.

The current paradigm for FBT is also at odds with most other tax jurisdictions. Most other jurisdictions, appropriately, assess and tax to employees, fringe benefits supplied to such employees in respect of their employment. Notwithstanding this mismatch, Australia has made little or no effort to address the international economic double taxation of fringe benefits where they are provided in a “cross-border context”. Thus, for example, an Australian employer would be assessed to FBT in respect of fringe benefits supplied to a resident employee carrying out services in a foreign jurisdiction. Such foreign jurisdiction would often assess and tax the employee in respect of the same benefits. Because FBT is not imposed under the Income Tax Assessment Acts and the persons upon whom the Australian and foreign taxes are imposed differ, Australia will provide no relief (under the Foreign Income Tax Offset measures in Division 770 of the ITAA 1997) from the effective double international taxation of the same benefit. The situation is no better under bi-lateral double tax agreements (DTAs) which Australia has entered, as FBT is not a “tax covered” by the majority of such DTAs and thus is not a tax in respect of which the majority of such DTAs can intervene to relieve double taxation.

We note that the Henry Review advocated a partial reduction in the scope of the FBT. While this could have some benefits, we would suggest a complete repeal of the FBT would result in greater material simplicity gains. A note of caution needs to be added in respect of this proposal as it applies to the not-for-profit sector. Participants in that sector currently rely on FBT concessions to compete with other prospective employers. Replacement concessions would need to be provided to maintain the status quo. If the FBT were not to be repealed, consideration should be given to measures aimed at reducing the tax’s compliance burden, such as allowing corporate groups to comply on a consolidated basis. If a repeal of the FBT was seen as not achievable, consideration should be given to measures aimed at reducing FBT compliance costs such as allowing consolidation of corporate groups for the discharge of FBT liabilities and compliance obligations.

**Recommendation #23 - Consideration should be given to a repeal of the FBT, with fringe benefits instead assessed to employees as salary and wages. This should be done in a way so as not to disadvantage not-for-profit entities that currently rely on FBT concessions to attract staff.**

## **INEFFICIENT STATE TAXES**

### **Issue #24 - Negotiate with the State Governments to remove their inefficient taxes**

85% of respondents in BDO’s 2018 Tax Reform Survey felt that the complexity of the current tax system is a significant barrier to operating an efficient business. Of the country’s taxes, State payroll taxes and stamp duties have been consistently criticised. 90% of participants in the 2018 BDO Tax Reform Survey said payroll tax placed a significant burden on businesses and 84% of respondents said stamp duties have a detrimental effect on the economy by discouraging the sale of real estate and business assets.



The Henry Review considered the potential to consolidate payroll taxes into a single tax on employee remuneration administered through the PAYG withholding system. It also recommended replacing payroll taxes with revenue from more efficient broad-based taxes that capture the value-add of labour. Each of these options would require careful consideration of implications associated with altering the current payroll tax base, as well as how to distribute revenue between States and Territories, but are worth examining for their potential to significantly improve the efficiency of our tax system (including by reducing tax administration). While BDO does not propose any specific reforms to specifically deal with the payroll tax administration challenge, it is conceivable that a reform program similar to the implementation of the GST could facilitate the removal of State based taxes such as payroll tax subject to their replacement with a suitable alternative. Critical to any reform efforts will be to adopt a national approach. The Commonwealth, States and Territories should work together (rather than individually) to identify reform opportunities that are the most fruitful.

Stamp duty is also viewed as unfair because it is usually only paid by those people that are acquiring assets. Imposing stamp duty at the point of acquisition puts a disincentive on acquisition of land and expansion of businesses. This means the State Governments are imposing more tax on the people who, for whatever reason, need or want to change their assets more often than other people. There is no good policy reason why these people should be contributing more to State Government revenues than people who don't need or want to change their assets often.

According to Infrastructure Australia's 'Making Reform Happen' Paper Australia<sup>2</sup> stands to gain \$24.3 billion every year in GDP from 2047 if State Governments phased out stamp duty replacing it with a broad-based land tax, a new report has found. Transitioning to this new tax system would also boost Government tax revenue to \$11.2 billion annually by 2047.

**Recommendation #24 - The Federal Government should seriously negotiate with the State Governments to reform their inefficient taxes, particularly payroll tax and stamp duties.**

## **GOODS & SERVICES (GST)**

**Issue #25 - GST has been conspicuously missing from the tax reform debate.**

The main rationale for bringing in the GST and giving the revenue to the States was that it would enable them to review their taxes, and get rid of their inefficient or inequitable ones. They have done that to some extent, but not to the extent that was expected when the GST was brought in. The GST is seen as a modern and, efficient tax that could actually replace some of these archaic taxes that the states are currently using, particularly stamp duty.

Having identified problems in respect of payroll taxes and stamp duties, the funding of the removal of such inefficient taxes could be provided by a broadening of the tax base of the GST and/or an increase in the rate of such tax.

BDO Recommends the GST rate should be increased to 15% across a broadened base with appropriate compensation to ensure that it is fair and equitable. Australia's 10 % rate is very low compared to the 15 to 20% in other countries that have GST/VAT.

**Recommendation #25 - The GST rate should be increased and the base broadened in line with other jurisdictions.**

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<sup>2</sup> 2018, Infrastructure Australia Paper 'Making Reform Happen: Using incentives to drive a new era of infrastructure reform' < <https://infrastructureaustralia.gov.au/policy-publications/publications/making-reform-happen.aspx>>.

## TRUSTS

### **Issue #26 - Review the rules for taxing trusts and their beneficiaries.**

In 2010, the Henry Review said "the current trust rules should be updated and rewritten to reduce complexity and uncertainty around their application". Trust reform is also something past Governments have looked at but some trust taxation changes in recent years have in fact complicated the tax system even more. Treasury recently reformed managed investment trusts but reform of other fixed trusts and discretionary trusts has not proceeded.

The current rules around taxing trusts and their beneficiaries are some of the most complicated rules in the tax Acts. This is mainly because of awkward interactions between trust law and tax law. These interactions need to be reviewed and the tax law changed to simplify the taxing of trusts and their beneficiaries.

**Recommendation #26 - The review and reform of the rules around taxing trustees and beneficiaries should be reviewed with urgency.**

### **Issue #27 - Section 99B of the ITAA 1936 sometimes applies when accumulated foreign source income is paid to an Australian resident beneficiary who was a non-resident when the trustee derived the income.**

Section 99B of the ITAA 1936 was drafted to tax resident taxpayers who receive non-taxable distributions from non-resident trusts where the taxpayer would have been assessed on the amount if it had been directly received by the taxpayer when it was derived by the trust. However, section 99B is very widely drafted so that it inappropriately catches many other situations, including where a taxpayer becomes a resident and receives a distribution from a non-resident trust that derived the relevant income while the taxpayer was not an Australian resident.

Section 99B should be redrafted so that it more narrowly applies only to the mischief it was aimed at. As acknowledged on pages 17 and 18 of the 2011 Treasury Consultation Paper 'Modernising the taxation of trust income' s99B, in its generality of language, goes well beyond the mischief it was intended to address, as identified in the EM to the ITAA 1979. The language used should be amended to make it clear that s99B only applies to the application of foreign sourced amounts accumulated in a non-resident trust for the benefit of residents.

**Recommendation #27 - Section 99B of the ITAA 1936 should be revised so that it does not apply when accumulated foreign source income is paid to an Australian resident beneficiary who was a non-resident when the trustee derived the income. This provision should be redrafted so that it applies only to the mischief it was aimed at.**

### **Issue #28 - There is uncertainty surrounding the interaction between Division 7A and UPEs.**

Subdivisions EA and EB of Division 7A were clearly inserted into the ITAA 1936 on the basis of an understanding that a UPE in respect of a company did not constitute a Division 7A loan from such company to the relevant trust. TR 2010/3 has asserted that a UPE of a private company can comprise a loan for Division 7A purposes has caused much anxiety and uncertainty for controllers of trusts and has hindered trusts in maintaining working capital. These problems would be addressed if UPEs were deemed not to be loans for Division 7A purposes - allowing Subdivisions EA and EB to apply as originally intended; or a 'safe harbour' was allowed such that trusts could retain UPEs in respect of companies where the amounts are used as working capital of the trust estate.

Alternatively, consideration could be given to applying an otherwise deductible rule so the trust would not have to pay interest where the UPE funds are being used by the trust for income producing purposes.

**Recommendation #28 - The current uncertainty surrounding the interaction between Division 7A and UPEs should be resolved by either deeming UPEs to not be Division 7A loans and thus allowing Subdivisions EA and EB of Division 7A to apply in the manner in which they were originally intended to apply.**

**Another solution would be allowing a 'safe harbour' such that trusts be allowed to retain UPEs of companies without minimum repayments to the extent that such UPEs were used to fund working capital of such trust estate.**