Australian Government

A tax plan for our future
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TAX FORUM 4-5 October 2011

STATEMENT OF REFORM PRIORITIES

PARTICIPANT NAME AND POSITION

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ORGANISATION

Law Council of Australia

STATEMENT OF PRIORITIES

Around two or three pages, please. Please address both of these issues:

1. What are your priority reform directions for the tax and transfer system?
The priorities identified by the Law Council of Australia, Business Law Section, Tax Committee are (in no order of preference):

1.1. Adopt a high tax free threshold and constant marginal rate for most individuals. The low income tax offset could be abolished and there would be a reduced need for the senior Australians tax offset.

1.2. Companies:

(a) should be allowed to carry back revenue losses to offset them against prior years' taxable income. The loss carryback period should be a two year period, with refunds limited to the franking account balance.

(b) should have the real value of losses preserved rather than declining in economic value

(c) and the same business test for loss carryforward should be reviewed and modernised.

For widely held trusts, it is not feasible to have loss carryback rules. However:

(a) the operation of the loss trust rules should be improved and streamlined and

(b) the real value of losses should be preserved rather than declining in economic value.

1.3. Interest withholding tax should be reduced to zero:

(a) in future tax treaties in relation to interest paid to non-resident financial institutions; and

(b) in the domestic law in relation to interest paid:

(i) by resident financial institutions to offshore entities;

(ii) by non-resident financial institutions acting through Australian permanent establishments to offshore entities.

1.4. Inefficient State taxes (eg stamp duty, payroll tax, fire service levy etc) should be abolished.

1.5. Information or advice provided by Treasury and other materials used by the ATO to assist in determining the purpose and correct interpretation of the law should be made public. In addition, if the ATO changes its view on the purpose or interpretation of the law in a way that could affect the manner in which the law operates, it should make this change of view public in a timely manner.

1.6. A renewed focus on ensuring that legislation is drafted clearly and able to be consistently interpreted and understood to give effect to clearly articulated policy, will benefit the entire community. Close interaction between Treasury, the Office of Parliamentary Counsel, the ATO and the private sector in drafting clear and unambiguous legislation is critical to minimise unnecessary compliance costs in interpretation. Moreover, legislation should be capable of being interpreted and understood on the face of the statute.

2. How are your proposals financed over the short and longer term?

2.1 A cost analysis of proposal 1.1 should be undertaken, comparing the current tax collected at marginal rates, as impacted by the low income offset and other similar community transfer provisions, with the proposed smoothing of marginal rates. It is probably that an incremental cost (or benefit) to revenue may arise, as it would be unlikely that the revenue outcome would be identical. Costs of compliance would decrease, and greater levels of compliance would be expected.

2.2 There would be expected to be a revenue impact of proposal 1.2 from a timing perspective. Limiting the ability to carry back losses to a franking credit balance means that any losses applied back against former taxable income would be prevented from being used to attach to dividend distributions, and reduce the tax payable by a shareholder investor. While this may have a timing impact on the tax payable in any particular year, the measure would structurally be prevented from decreasing the overall tax payable as between the relevant company and its shareholders. The impact is further limited by restricting the carryback period to two years.

2.3 The revenue cost of proposal 1.3 should be determined in the context of current concessions and borrowing patterns. There are currently a number of exemptions from interest withholding tax in the domestic law and in Australia's tax treaties that mean that

the incidence of paying interest withholding tax is limited. Costs in complying with the exemption criteria are significant. In a Treasury costing of this proposal, it is likely that the proposal itself would give rise to a loss of revenue. However, the implementation of the proposal would enhance Australia's attractiveness as a financial services hub, which would be likely to increase investment activity in Australia, with positive flow-on impacts for revenue.

2.4 Eliminating inefficient State taxes would not have a direct impact on the Federal revenue. It would, however, have a significant impact on the revenue of the States and Territories, which would be expected to be recovered under the Grants Commission or some other mechanism. Proposals [x and y] should have no identifiable cost to revenue. Indeed, they should lead to easier, less costly and greater compliance by the taxpaying community with tax legislation. Incidental costs relating to resourcing of Treasury, ATO and OPC to facilitate those initiatives may arise

2.5 Proposals1.5 and 1.6 should have no identifiable cost to revenue. Indeed, they should lead to easier, less costly and greater compliance by the taxpaying community with tax legislation. Incidental costs relating to resourcing of Treasury, ATO and OPC to facilitate those initiatives may arise

LIST OF ATTACHMENTS

A short paper describing each of the priorities in more detailed is attached

1. High tax free threshold and constant marginal rate for most individuals

1.1 Committee recommendation

A high tax free threshold and constant marginal rate should be adopted for most individuals.

1.2 Recommendation 2 of the Henry Report[1]

The Henry Report stated[2]

> A much higher personal tax-free threshold, around $25,000, should replace the current complex array of thresholds and offsets.

Recommendation 2 states:[3]

> **Progressivity in the tax and transfer systems should be delivered through the personal income tax rates scale and transfer payments. A high tax-free threshold with a constant marginal rate for most people should be introduced to provide greater transparency and simplicity.**

1.3 Current position

Currently, Australian resident taxpayers pay tax based on a tax free threshold of $6,000, with a progressive rate scale with four levels of marginal rates, ranging from 15% to 45% (plus the Medicare levy).[4] A number of tax offsets are available to reduce the tax payable by some taxpayers, including the low income tax offset and the senior Australians tax offset.

The Government has recently announced, as part of its *Clean Energy Future* package, that it will increase the tax free threshold to $18,200 from 1 July 2012 and $19,400 from 1 July 2015.[5] The 30% marginal tax rate will increase to 32.5% and 33% from these dates (respectively); the 15% marginal tax rate will increase to 19% from 1 July 2012.[6] The withdrawal rate for the low income tax offset will also reduce.[7] These changes are intended to pass on tax cuts to many taxpayers to assist in meeting the additional costs that are likely to be incurred as a result of the introduction of a carbon price.[8] The Government has also stated that these measures are a reform to the tax system in response to the Henry Report intended to improve the simplicity and transparency of the tax system.[9]

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[1] Australia's Future Tax System, 2 May 2010 (**Henry Report**)

[2] Executive Summary, page xx

[3] Page 22.

[4] Schedule 7 of the *Income Tax Rates Act 1986* (Cth), *Medicare Levy Act1986* (Cth).

[5] Australian Government, *Securing a clean energy future – The Australian Government's climate change pla*n, Commonwealth of Australia, July 2011, chapter 4. See also Prime Minister, Deputy Prime Minister and Treasurer, "Combining tax cuts with significant tax reform", Press Release No 81, 10 July 2010 and Prime Minister, Deputy Prime Minister and Treasurer, Minister for Families, Housing Community Services and Indigenous Affairs, Minister for Climate Change and Energy Efficiency, "Assistance for nine out of ten Australian households", Press Release No 83, 10 July 201.

[6] Australian Government, *Securing a clean energy future – The Australian Government's climate change pla*n, Commonwealth of Australia, July 2011, page 42.

[7] Ibid.

[8] Australian Government, *Securing a clean energy future – The Australian Government's climate change pla*n, Commonwealth of Australia, July 2011, chapter 4.

[9] Australian Government, *Securing a clean energy future – The Australian Government's climate change pla*n, Commonwealth of Australia, July 2011, page 38. See also Prime Minister, Deputy Prime Minister and Treasurer, "Combining tax cuts with significant tax reform", Press Release No 81, 10 July 2010.

1.4 Analysis

Introducing a high tax free threshold and constant marginal rate for most individuals should provide greater transparency and simplicity in the tax system.[10]

The implementation of a high tax free threshold, such as $25,000 (as used as an indicative tax free threshold in the Henry Report)[11], would eliminate the requirement for approximately 1.2 million taxpayers to pay tax and, in most cases, to lodge a tax return.[12] It would also remove the need to provide the low income tax offset and reduce the need for the senior Australians tax offset,[13] making the preparation of tax returns and undertaking tax calculations simpler for many taxpayers. Although the recent Government announcement outlined above goes some way towards achieving this benefit (with up to one million taxpayers no longer to required to pay tax and a reduced use of the low income tax offset), greater simplicity would be achieved by moving to a higher tax free threshold with the removal of the low income tax offset entirely.

A higher tax free threshold would also reduce the likelihood that the combination of the imposition of tax and the withdrawal of welfare benefits will discourage individuals from taking up employment rather than remaining on benefits.[14]

The use of a constant marginal rate for most individuals improves the transparency of the tax system for taxpayers by making it easier to calculate their marginal rate of tax.[15] The Henry Report proposes an indicative rate of 35% for taxable income of $25,001 to $180,000, and 45% for taxable income over $180,000.[16] This constant rate for most taxpayers may also assist in encouraging individuals to earn additional income as it is easier to determine how much of the additional income will be paid in tax. There is also less scope for additional work to push the taxpayer into the next tax bracket, which reduces the after tax value of the additional income earned by the taxpayer. Encouraging taxpayers to earn more income will benefit the economy and society generally.[17]

The Henry Report states that the indicative tax free threshold of $25,000, combined with a constant marginal rate of 35% for most taxpayers, moving to 45% for those earning over $180,000, is broadly consistent with the aspirational tax cuts proposed by the Government for 2013-14.[18] These figures would need to be adjusted if the Government wishes to ensure that the additional tax cuts proposed in the *Clean Energy Future* package continue to benefit taxpayers in offsetting some of the additional costs likely to arise as a result of the introduction of a carbon price.

This simplification of the tax scale, with removal of relevant offsets, may reduce the reliance by taxpayers on tax agents to prepare their tax returns, allowing the requirement to lodge a tax return to be met more efficiently.

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[10] Henry Report page 22.

[11] Ibid Section 4.1, page 29,
[12] Ibid.
[13] Ibid.
[14] Henry Report page 23.
[15] Henry Report page 22.
[16] Ibid.
[17] Henry Report page 17.
[18] Page 23.

2. Carry back revenue losses, preserve their value and modernise tax loss rules

2.1 Committee recommendation

Companies:

a) should be allowed to carry back revenue losses to offset them against prior years' taxable income. The loss carryback period should be a two year period, with refunds limited to the franking account balance.

b) should have the real value of losses preserved rather than declining in economic value

c) and the same business test for loss carryforward should be reviewed and modernised.

For widely held trusts, it is not feasible to have loss carryback rules. However:

a) the operation of the loss trust rules should be improved and streamlined and

b) the real value of losses should be preserved rather than declining in economic value.

2.2 Recommendation of the Henry Report

Recommendation 31 of the Henry Report states:[19]

> **Companies should be allowed to carry back a revenue loss to offset it against the prior year's taxable income, with the amount of any refund limited to a company's franking account balance.**

2.3 Current position

For companies, revenue losses can be carried forward and offset against future gains subject to multiple tests. First, companies must meet either the continuity of ownership or same business tests.[20] These tests prevent the use of losses whenever the ownership of a company changes by 50% or more, unless the company satisfies the same business test. The same business test is a triple test: the company must carry on the same business, not generate income from a new business or a transaction of a type not previously carried on. As well, companies must satisfy multiple tiers of 'integrity' control rules[21] and rules against income injections for purposes of loss recoupment.[22]

For trusts including widely held trusts, the multiple trust loss carryforward rules are more severe.[23] Only widely-held listed trusts have a same business test.

While we accept the need for rules to prevent loss trafficking, the current law has perverse outcomes for real losses incurred by businesses and their complexity can lead to unjust outcomes. An example is the denial of losses to the ConnectEast toll road trust[24].

The government recognised in the 2011 Budget that the tax loss rules impede economic activity and announced reforms, narrowly targeted only to unspecified infrastructure projects, to allow them to carry forward losses with an uplift factor to maintain their value and to "exempt those losses from the continuity of ownership test and the same business test." This

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19 Henry Report page 176.

20 Section 165-10 of the *Income Tax Assessment Act 1997* (Cth).

21 Sub-division 165-CC of the *Income Tax Assessment Act 1997* (Cth) 'Change of ownership or control of a company that has unrealised losses', Sub-division 165-CD 'Reductions after alterations in ownership or control of loss companies', Sub-division 170-D 'Transactions by a company that is a member of a linked group and deferred losses'

22 • Division 175 of the *Income Tax Assessment Act 1997* (Cth) 'Use of a company's tax losses or deductions to avoid income tax'

23 Schedule 2F of Income Tax Assessment Act 1936

24 ConnectEast Management Ltd (as Trustee for the ConnectEast Investment Trust 2) v Commissioner of Taxation, [2009] FCAFC 22

welcome announcement was referenced to the Henry Report but did not deliver the recommendation of the Henry Report.

2.4 Analysis

The tax loss rules impede business growth and entrepreneurship in Australia. The Tax Forum discussion paper noted that the treatment of losses has adverse impacts:

> "...[Henry Report] also found that the tax system can discourage investment, particularly in projects with uncertain returns or long lead times (such as infrastructure projects). This occurs where businesses anticipate that they may not be able to get full tax benefit for their losses.[25]

The Henry Report noted, from an economic perspective, "tax arrangements that effectively impose an additional charge on the taxpayer, such as limitations on the use of losses...[26]:

The "additional charge" or deadweight cost of the tax loss rules arises because companies and trusts conducting businesses must estimate their income before the cash is received. However many deductions (e.g. capital allowances, depreciation and amortisation, and deferred expenditure such as remediation works) are deferred until incurred for tax purposes ("deferred deductions"). This asymmetry has the following outcomes.

a) a deferred deduction means that the company or trust will often have paid tax, expending cash, on income which does not represent its true economic gains

If the company or trust does not have sufficient income to absorb or utilise the deferred deductions when they arise, the deferred deductions create a loss which can only be carried forward. The company or trust (and beneficiaries) will from an economic perspective have paid tax on income which is not its true economic income.

This is a significant problem for any business which is faced by structural adjustment or financial or other crisis. For example manufacturing companies with major capital equipment will face challenges in a period of downturn, which lead to tax losses for which benefits are deferred and their value declines, which erode their economic viability.

One way to reduce the loss of tax value problem is to index the value of the losses. The Minerals Resource Rent Tax (**MRRT**) has, for "(c)apital invested in upstream operations ... an 'uplift' allowance to maintain the value of losses for activities upstream of the taxing point. The 'uplift' also includes a premium for the risk that losses may never be used."[27] Under the existing Petroleum Resources Rent Tax (**PRRT**), undeducted expenditure is carried forward and is compounded at a variety of set rates depending on the nature of the expenditure (exploration or general) and the year the expenditure was incurred.

The 2011 Budget proposal for designated infrastructure projects also included an uplift of project losses associated with at the government bond rate. No such uplift is provided for trusts or companies in relation to their business losses.

Another way to mitigate the timing problem would be a tax loss carryback for companies to allow cash tax reduction from the losses against prior year tax paid.

b) the deferred deduction is at risk of disallowance

Any tax loss generated is then subject to the complex tax loss rules for companies and for trusts. These can deny the company or trust the tax benefits for real losses.

[25] Tax Forum Discussion Paper, Session 3 Business Taxes, page 22
[26] Henry Report Page 169
[27] Minerals Resource Rent Tax Exposure Draft, Explanatory memorandum para 5.53

If a company suffers losses, has a significant ownership change and changes its business to recover and adapt, its losses cannot be carried forward if it fails both the continuity of ownership and of business tests. Nor might the losses of a trust be carried forward.

These constraints and complexities can cause real commercial damage. The *ConnectEast case of 2009*[28] concerned a widely held trust conducting a Victorian toll road. The trust was owned by one investor through two trusts but it could not pass the continuity of ownership tests in the trust loss measures. So, significant real losses could not be recognised.

Further, the same business test is quite severe and is interpreted severely by the Australian Taxation Office. As well, the tax consolidation regime has resulted in further difficulties for groups seeking to apply the same business test. As well, there are restrictions on the use of losses of acquired entities under the available fraction rules.

The 2011 Budget proposal for losses of certain infrastructure projects will also exempt those losses from the continuity of ownership test and the same business test. No such relief is provided for companies or trusts in relation to their ordinary losses.

c) Revenue and capital losses have further asymmetric treatment

For companies, the distinction between revenue and capital losses adds more problems:

i) where a company has capital gains and revenue losses, the capital gains are sheltered by revenue losses

ii) but where a company has revenue gains and capital losses, the revenue gains are **not** sheltered by capital losses.

Therefore any company losses that are classified as capital are deferred or unusable unless and until they generate capital gains.

Resident companies have no discounted tax applicable to their capital gains (unlike beneficiaries of trusts which enjoy discounted tax rates for capital gains). So there is little rationale for the asymmetric treatment for companies.

2.5 The recommended reforms

First, Australia should introduce loss carry back rules. The Henry Report recommended a one year carryback subject to the limit of a company's franking account balance.

In the view of the Committee a two year carryback is more appropriate and consistent with international experience. A one year carryback does not protect the position of a company which might have deteriorating fortunes. Limiting the carryback to a company's franking account balance would provide appropriate reduction in the cost to revenue.

Second, the reforms to preserve the real value of losses – as now introduced for MRRT purposes and for designated infrastructure projects, and operational for PRRT – should be adopted more broadly, certainly for businesses involving the expenditure of capital equipment on long-lived assets such as manufacturing or processing businesses.

Third, a comprehensive review is needed of the policy underpinning the carryforward of losses by companies and trusts in circumstances where there are real losses incurred in real business activities not involving loss trafficking.

In particular, the same business test needs to be improved: it should have a purpose test such as applies in Division 175, so that it applies only where a company or trust is acquired or have a major ownership change for a non-incidental purpose of using its losses. The interaction of the loss rules with tax consolidation should be reviewed also.

[28] ConnectEast Management Ltd (as Trustee for the ConnectEast Investment Trust 2) v Commissioner of Taxation, [2009] FCAFC 22

Fourth, companies should be permitted to offset capital losses against revenue gains. This could be limited to capital losses of resident companies referable to new undertakings which are not eligible for any concessional capital gains tax rules.

3. Interest withholding tax should be reduced to zero

3.1 Recommendation

Interest withholding tax should be reduced to zero:

(a) in future tax treaties in relation to interest paid to non-resident financial institutions; and

(b) in the domestic law in relation to interest paid:

(i) by resident financial institutions to offshore entities;

(ii) by non-resident financial institutions acting through Australian permanent establishments to offshore entities.

3.2 Current position

Interest paid by:

(a) an Australian resident; or

(b) a non-resident acting through a permanent establishment in Australia

to:

(c) a non-resident of Australia that is not deriving the interest though a permanent establishment in Australia; or

(d) an Australian resident where the interest is being derived through a permanent establishment outside of Australia

may be subject to interest withholding tax.[29] If interest withholding tax applies, the payer of the interest is required to remit 10% of the interest payment to the ATO on behalf of the payee.[30]

Several exemptions are available to prevent interest withholding tax from applying, including:

(e) if the public offer test is met in relation to the instrument underlying the requirement to pay interest;[31]

(f) the tax treaty exemption that applies in some treaties if the interest is paid to an independent offshore financial institution and certain anti-avoidance provisions are not breached;[32] and

(g) where an offshore branch pools borrowings and it is not possible to trace the end use of the borrowings.[33]

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[29] Division 11A of Part III of the *Income Tax Assessment Act 1936* (Cth).

[30] Division 11A of Part III of the *Income Tax Assessment Act 1936* (Cth) and subdivision 12F of Schedule 1 of the *Taxation Administration Act 1953* (Cth).

[31] Section 128F of the *Income Tax Assessment Act 1936* (Cth).

[32] See, for example, Article 11 of the Australian/United States of America Double Tax Convention.

[33] Taxation Ruling TR 2006/9 *Income Tax: interest withholding tax –cross border interbranch funds transfers within authorised deposit-taking institutions.*

The Government has announced that from 2013-14 it will phase down interest withholding tax by reducing the rate of withholding as follows:[34]

Type of payer	Current rate of withholding	Rate of withholding 2013-14	Rate of withholding 2014-15
Australian financial institution borrowing from an offshore financial institution (if not otherwise exempt)	10%	7.5%	5% (aspirational target of 0%)
Foreign bank branch borrowing from its offshore head office	5%	2.5%	0%
Australian financial institution borrowing from offshore retail deposits (proceeds used and traced to Australian operations)	10%	7.5%	5% (aspirational target of 0%)

3.3 Issues caused by the imposition of interest withholding tax

The imposition of interest withholding tax has a number of negative consequences, including the following.

(a) Interest withholding tax raises the cost of borrowing for Australian borrowers because offshore lenders generally either require an interest withholding tax gross up clause to be included in their arrangements, or increase the interest rate charged to offset the additional cost.[35] In addition to the increased costs passed on by the lender(s), the borrower incurs increased administrative costs because they are required to register for withholding (if they have not already done so), calculate and withhold the relevant amount from every payment to a lender and remit the amount to the ATO. Very often, they are also required to provide proof of payment to the lender.

(a) Where higher interest rates are paid by Australian banks (as outlined in (a)), domestic interest rates also increase for loans to businesses and individuals.[36]

(b) As there are a number of exemptions available, many offshore borrowings are not subject to interest withholding tax. This means that there is a competitive distortion where interest withholding tax does apply and this may prevent Australian banks from accessing the cheapest source of funding available.[37] For example, an Australian borrower might be more inclined to borrow from a bank located in the UK charging a higher interest rate for borrowings than a bank located in Germany that is charging a lower interest rate simply because the German bank is not entitled to an exemption from interest withholding tax under the Australian/German double tax agreement, but an exemption would apply under the Australia/UK double tax agreement. Equally, a competitive distortion arises when a smaller bank with a limited network of offshore retail depositors cannot avoid interest withholding tax while a larger bank with an extensive network may be able to avoid interest withholding tax because the funds

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[34] Table based on the table in Press Release No 35 Deputy Prime Minister and Treasurer, Minister for Financial Services, Superannuation and Corporate Law and Assistant Treasurer, "Phasing down interest withholding tax on financial institutions to support banking competition", 11 May 2010.

[35] Henry Report page 180, Australian Financial Centre Forum, *Australia as a financial centre: Building on our strengths*, November 2009, page 66.

[36] Australian Financial Centre Forum, *Australia as a financial centre: Building on our strengths*, November 2009, page 66.

[37] Australian Financial Centre Forum, *Australia as a financial centre: Building on our strengths*, November 2009, page 66.

are pooled.[38] Such competitive distortions may reduce the stability of the financial system and cause capital to be allocated to less productive investments that have greater access to debt.[39]

(c) There is a significant incentive for transactions to be structured to fall within the exemptions available to avoid the imposition of interest withholding tax and associated increased costs. This can lead to additional and unnecessary costs being incurred to structure the transaction and maintain the borrowing on an ongoing basis. For example, it is usually necessary to structure a loan as an issue of registered notes or debentures in order to meet the public offer test and avoid bearer debenture withholding tax. This requires additional documentation in setting up the transaction, and also requires that the register be maintained throughout the borrowing.

(d) It appears that the imposition of interest withholding tax reduces the use of offshore retail and wholesale deposits by Australian banks. This reduces the funds available to Australian banks.[40]

3.4 Need for reform

Australia imports capital and, accordingly, needs to access offshore funding in order to finance domestic investment.[41] The Johnson Report[42] confirms that the imposition of interest withholding tax is inconsistent with this need. It also indicates that many existing financial centres do not impose interest withholding tax,[43] which puts Australia at a competitive disadvantage to these financial centres in attracting offshore funds and investment.

Although the Henry Report states that interest withholding tax reduces tax avoidance schemes and supports the thin capitalisation and transfer pricing rules,[44] this is not a sufficiently strong reason to retain interest withholding tax in relation to interest paid to and by financial institutions. Further, the Government's announced changes do not go far enough to fully address the problems associated with the imposition of interest withholding tax.

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[38] Australian Financial Centre Forum, *Australia as a financial centre: Building on our strengths*, November 2009, page 67.

[39] Henry Report page 181.

[40] Australian Financial Centre Forum, *Australia as a financial centre: Building on our strengths*, November 2009, page 67.

[41] Australian Financial Centre Forum, *Australia as a financial centre: Building on our strengths*, November 2009, page 64.

[42] Australian Financial Centre Forum, *Australia as a financial centre: Building on our strengths*, November 2009, page 67.

[43] Australian Financial Centre Forum, *Australia as a financial centre: Building on our strengths*, November 2009, pages 65 and 68. For example, Hong Kong does not impose interest withholding tax and Singapore exempts interest payments from a Singapore bank to an offshore bank and certain other deposits.

[44] Henry Report page 181.

4. Abolish inefficient State taxes

4.1 Committee recommendation

Inefficient State taxes should be abolished, including:

(a) stamp duties;

(b) payroll taxes; and

(c) taxes on insurance products.

A review should be undertaken of other user charges and minor taxes in accordance with recommendation 81 of the Henry Report. A coordinated approach between the States and intergovernmental agreements are likely to be needed, as foreshadowed in recommendation 119 of the Henry Report.

4.2 Recommendation of the Henry Report

Recommendation 51 of the Henry Report states:[45]

> **Ideally, there would be no role for any stamp duties, including conveyancing stamp duties, in a modern Australian tax system. Recognising the revenue needs of the States, the removal of stamp duty should be achieved through a switch to more efficient taxes, such as those levied on broad consumption or land bases. Increasing land tax at the same time as reducing stamp duty has the additional benefit of some offsetting impacts on asset prices.**

Recommendation 57 of the Henry Report states:[46]

> **State payroll taxes should eventually be replaced with revenue from more efficient broad-based taxes that capture the value-add of labour.**

Recommendation 79 of the Henry Report states:[47]

> **All specific taxes on insurance products, including the fire services levy, should be abolished. Insurance products should be treated like most other services consumed within Australia and be subject to only one broad-based tax on consumption.**

Recommendation 81 of the Henry Report states:[48]

> **Governments should undertake a systematic review of existing and potential user charges and minor taxes against the principles set out in this report. This should be coordinated with the introduction of the system wide Tax and Transfer Analysis Statement proposed in Recommendation 132.**

Recommendation 119 of the Henry Report states:[49]

> **Reforms to State taxes should be coordinated through intergovernmental agreements between the Australian government and the States to provide the States with revenue stability and to facilitate good policy outcomes.**

4.3 Current position

Each State currently levies stamp duty on transfers of property and some other transactions at varying rates. Although efforts have been made in recent years to reduce the transactions

[45] Henry Report page 263.
[46] Henry Report page 301.
[47] Henry Report page 474.
[48] Henry Report page 479.
[49] Henry Report page 684.

on which stamp duty applies, calls for stamp duty on real property conveyances have been rejected.

Each State also levies payroll tax on businesses based on employee remuneration, subject to a number of exemptions including an exemption if a minimum threshold for total payroll is not met, exemptions for certain activities and exemptions for certain types of payments.[50] The thresholds are relatively high, such that most businesses are exempt from payroll tax.[51] Approximately half of those businesses to which payroll tax does apply have payroll tax obligations in more than one State.[52] Although there have been some recent efforts to harmonise payroll tax laws, States still have different thresholds and rates.[53]

States also impose a range of taxes and levies on insurance,[54] and a number of other minor taxes.[55]

4.4 Analysis

The Tax Forum Discussion Paper released by the Government confirms that the Tax Forum will include a session on State taxes.[56] Additionally, representatives from each of the States will attend the Tax Forum. This should provide a useful forum to have a productive discussion about the future of these inefficient State taxes.

If any recommendations impacting on State taxes are to be implemented, intergovernmental agreements will be necessary in order to coordinate the changes and assist the States to ensure stability of their revenues.[57]

Stamp duty

Stamp duty was originally introduced because it is a simple tax to collect. However, it is no longer an appropriate tax to be levied for a number of reasons, including the following.

(a) Revenues from stamp duty are volatile, particularly in relation to conveyance stamp duty, as it depends on the number of transfers that occur and the value of the property that is transferred.[58]

(b) Stamp duties on conveyances are inefficient as they discourage people from moving on when it would be appropriate to do so and may discourage capital improvements.[59] Discouraging people from moving may have a number of consequences, including increased road congestion (as people commute more), environmental impacts (as people live in houses that are bigger than needed), increased unemployment and lower productivity (as people are less likely to move to get a job or a better paying job) and inequity as some groups have less access to housing (due to the need to save to pay stamp duty).[60]

(c) Stamp duties are particularly bad for business.[61] This is because the cost of stamp duty means that businesses are less likely to move to cheaper premises, therefore increasing the cost of the products they produce or the services they provide.[62] Additionally, stamp duties are particularly complex where a transfer involves

[50] Henry Report pages 295 and 297-8.
[51] Henry Report page 299. In New South Wales the threshold exempts 91% of businesses.
[52] Henry Report page 299.
[53] Ibid.
[54] Henry Report pages 470-1.
[55] Henry Report pages 479-481.
[56] See pages 25-7.
[57] Henry Report page 684.
[58] Henry Report page 252.
[59] Henry Report page 254.
[60] Henry Report page 255.
[61] Henry Report pages 255-6.
[62] Henry Report page 256.

transferring properties in multiple jurisdictions as the rules and rates of duty differ, as do the circumstances in which exemptions can apply.[63]

(d) Stamp duties are not equitable since they tax people who need to move more often (eg due to changing jobs or changes in family circumstances) more heavily than those who do not need to move.[64] They also reduce the ability of people who are credit constrained to access housing.[65]

The abolition of stamp duty would be expected to severely impact on the revenue collections of the States and Territories.[66] This income will need to be replaced in some way.

Payroll tax

Payroll tax is an inefficient tax. Although it is imposed on businesses, it is generally employees that bear the burden of the tax through lower wages in the long run.[67] The tax is ultimately bourne by all employees, and not only those that are employed by businesses that are subject to the tax, with this reducing labour productivity and national income.[68]

Due to the number of businesses that are exempt from payroll tax, the payroll tax base is quite narrow, leading to distortions in the use of labour (as employees seek employment with businesses that are not subject to the tax) and requiring a higher rate of tax to raise the same amount of revenue, compared to the rate that would be required if it was applied to all employee remuneration.[69]

The imposition of payroll tax also gives rise to complexity and high compliance costs for businesses that are subject to the tax, particularly if operating in more than one jurisdiction, and also for those businesses that are close to the threshold over which payroll tax applies.[70] Compliance costs for each jurisdiction are also high since each State and Territory administers the tax separately.[71]

Due to its inefficiency and high compliance costs, payroll taxes should be abolished. The Henry Report states that payroll tax could be replaced by a broad based consumption tax that would apply to all businesses that sell goods and services.[72] This would be preferable to a tax on labour income administered through the PAYG withholding system.[73] Again, however, there is likely to be opposition to introducing any new taxes even though the abolition of payroll tax is likely to be viewed favourably by those affected.

Insurance taxes

Insurance taxes, although relatively simple to administer in many cases,[74] are one of the most inefficient taxes available to the States.[75] These taxes encourage under and non-insurance, giving rise to greater government expenditure in the case of major disasters such as the recent bushfires and floods in Queensland and Victoria.[76] Low income earners, who are more vulnerable in the event of an incident that could have been covered by insurance, are the most likely to abandon insurance due to higher premiums (including taxes).[77]

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63 Ibid.
64 Henry Report pages 256-7.
65 Henry Report page 257.
66 Henry Report page 253.
67 Henry Report page 294.
68 Henry Report page 295.
69 Henry Report page 298.
70 Henry Report page 299.
71 Henry Report page 300.
72 Henry Report page 301.
73 Henry Report page 302.
74 Henry Report page 473.
75 Henry Report page 472.
76 Henry Report page 474.
77 Ibid.

To the extent that insurance taxes are used to fund services such as the fire brigade and ambulance services, under and non-insurance means that not everyone is contributing to the funding of the services that are available to everyone, making them inequitable.[78]

Accordingly, taxes that are specific to insurance products should be removed. Insurance products should be treated in the same manner as most other services.[79]

Other minor taxes

To the extent that minor taxes imposed by the States are not efficient, equitable, simple, sustainable and consistent with policy, they should be abolished.[80] The States should undertake a review of their minor taxes to determine which, if any, should be abolished.[81]

Preferably, this should be done at the same time as other taxes are abolished so that the total revenue that needs to be replaced can be calculated and an appropriate course determined (eg introducing a new specific broad based tax or extending land tax).[82] This should prevent the need to introduce multiple new taxes in order to replace the lost revenue from taxes that are abolished at different times.

[78] Ibid.
[79] Ibid.
[80] Henry Report page 479.
[81] Ibid.
[82] Ibid.

5. Transparency of ATO views re interpretation of the law

5.1 Recommendation

Information or advice provided by Treasury and other materials used by the ATO to assist in determining the purpose and correct interpretation of the law (other than correspondence with or from government or correspondence the subject of client legal privilege specific to the affairs of a particular taxpayer) should be made public.

If the ATO changes its view on the purpose or interpretation of the law in a way that suggests a change in the way in which the law operates, it should make this change of view public in a timely manner.

5.2 Object

Adopting this recommendation should allow taxpayers to conduct their business and affairs with greater certainty as to the tax outcomes and reduce compliance costs.

5.3 Consistency with the Henry Report

Insofar as this recommendation relates to disclosure of information or advice, it incorporates, and is consistent with, one of the recommendations of the Henry Report.

Recommendation 114 of the Henry Report states: [83]

> **Information or advice provided by Treasury to assist the ATO in determining the purpose or object of the law, or materials used by the ATO to determine policy intent (other than correspondence with or from government) should be made public.**

5.4 Current position

Currently, Treasury advises the Government on tax policy, while the ATO administers the tax law.[84] The ATO can consult with Treasury on the interpretation of the law, although their views are not determinative.[85] Any such communications between Treasury and the ATO are treated as confidential and not made public.[86]

5.5 Analysis

Tax law in Australia is complex and gives rise to uncertainty in many instances. Certainty is essential for taxpayers as they are required to self assess their tax liability and need to be able to conduct their income earning activities with a full understanding of the income tax consequences of particular transactions. A lack of certainty in relation to the way in which the law operates can result in significant compliance costs relating to forming a view, obtaining expert advice and/or obtaining a ruling from the ATO. Correcting a previous mistake made by a taxpayer in interpreting the law can also be expensive if penalties and interest apply.

In 2008, the Government decided that tax measures should be developed by a tri-partite team comprising Treasury, the ATO and the private sector.[87] Transparency of communications between these parties in this process and in the interpretation of tax laws is consistent with such a decision.

The Inspector General observed in his report *Review into delayed or changed Australian Taxation Office views on significant issues* (“**the Inspector General's Review**”):[88]

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83 Henry Report page 654.
84 Henry Report page 652.
85 Henry Report page 653.
86 Ibid.
87 Henry Report page 653.
88 March 2010 paragraph 6.8, page 34

> *Discussion of technical issues with the taxpayer community — such as through a discussion paper — can better inform technical decisions through impartial discussions on issues. Developing an ATO technical view that involves open consultation with relevant parties ensures that the ATO correctly understands the arrangements and their context and that alternative views are robustly considered* before the ATO finalises its view.

Exposing to the taxpayer community information or advice provided by Treasury and other materials used by the ATO to assist in determining the purpose and correct interpretation of the law is:

(a) consistent with such open consultation; and

(b) likely to assist that community to provide informed responses and comments to the ATO.

As was observed in the Henry Report, taxpayers and practitioners have a legitimate expectation that the advice they receive from the ATO should be accurate and unbiased.[89] Disclosing information or advice provided by Treasury and other materials will assist in ensuring that the basis for such advice will be exposed and more readily understood.

Insofar as the ATO withholds scrutiny of the Treasury advice and other information it obtains, it allows for (potentially unfounded) suspicion to arise that its administration of the tax laws may have been influenced by political forces. That this should not be the case is important.[90] However, it is also important that this should be seen not to be the case. Disclosure would assist with this.

It would also assist in mitigating the recognised[91] imbalance of power between it and most taxpayers, especially individual and small business taxpayers by providing taxpayers with access to advice and information they might not otherwise have the resources to obtain.

It is not possible for the ATO to have considered and provided advice on every conceivable transaction that taxpayers may be considering entering into. While it is possible for taxpayers to apply for a ruling to obtain certainty in relation to a particular transaction, this can be expensive and time consuming.

Making public:

(a) advice provided by Treasury to the ATO; and

(b) other materials used by the ATO,

on the purpose and interpretation of the tax law would provide taxpayers with additional relevant information to assist them in interpreting the tax law. This:

(a) may reduce the need for taxpayers in conducting their affairs to apply for a ruling; and

(b) is likely to assist in ensuring that a ruling application can be prepared based on an interpretation of the law that is more likely to be consistent with the approach adopted by the ATO where a ruling is deemed to be necessary.

Adopting this recommendation should allow taxpayers to conduct their business and affairs with greater certainty as to the tax outcome and with reduced compliance costs.

Additionally, some taxpayers indicated during consultation undertaken for the Henry Review that the ATO creates further uncertainty by changing its view on the interpretation of particular aspects of the law (including those that have been settled for some time) and changing its

[89] Henry Report page 658.
[90] Henry Report page 660.
[91] Henry Report page 660.

administrative practices.[92] This view was considered in the Inspector General's Review and found to be justified in some circumstances.[93]

Requiring the ATO to make public any change of view on the purpose or interpretation of the law in a timely manner would assist in ensuring certainty in relation to the operation of the tax law.

[92] Henry Report page 652.
[93] March 2010 paragraph 2.11, page 7.

6. Approach to legislation

6.1 Recommendation

A renewed focus on ensuring that legislation is drafted clearly and able to be consistently interpreted and understood to give effect to clearly articulated policy, will benefit the entire community.

Close interaction between Treasury, the Office of Parliamentary Counsel, the ATO and the private sector in drafting clear and unambiguous legislation is critical to minimise unnecessary compliance costs in interpretation. Moreover, legislation should be capable of being interpreted and understood on the face of the statute.

6.2 Current situation

The costs of compliance with unnecessarily complex tax laws for commercial taxpayers, particularly small and medium enterprises, are increased by some aspects of themanner in which Australia's taxation legislation is currently drafted. Those costs increase further where there is a mismatch between the legislation and the commercial structures and transactions at which they are aimed. As a general rule, revenue legislation should be structured to exact tax from the commercial sector in accordance with the manner in which commerce is conducted in the market place. Far too often, taxation legislation, particularly recent legislation, fails in this respect.

In recent years, taxation legislation is being drafted by reference to what is called "principle based drafting" or "coherent principle based drafting". Often, the only way to discover the "principle" is to read the Explanatory Memorandum or the Second Reading Speech. While s.15AB of the *Acts Interpretation Act* permits the use of this material, this is only where the legislation is "ambiguous" or "manifestly absurd". It seems clear that it cannot be used to ascertain the "principle" underlying vague or loose language.

There is an increasing trend to seek to include concepts critical for the interpretation of legislation in explanatory material, rather than in legislation itself. In many cases, the explanatory material appears explain what its author thinks the legislation means, or worse, what its author hoped or intended it to mean. As the Chief Justice said in a recent, albeit non-tax, case[94]:

> *"According to the Explanatory Memorandum for the 2001 Excision Consequential Provisions Bill those words mean that a person is not in "'immigration detention' ... merely because the person is being dealt with under ... section 198A." They plainly do not and cannot bear that meaning.*

The traditional approach to construing tax legislation is articulated in the following observations of Gibbs CJ:[95]

> *``The established rule that no tax can be imposed on a subject by an Act of Parliament without words which clearly show an intention to lay the burden upon him does not mean that the court will strive to find loopholes where none are apparent; the words of the Act must be given a fair and reasonable*

[94] Plaintiff M70/2011 v Minister for Immigration and Citizenship; Plaintiff M106 of 2011 v Minister for Immigration and Citizenship [2011] HCA 32 (31 August 2011)

[95] *Western Australian Trustee Executor & Agency Co Ltd v C of ST (WA)* 80 ATC 4567, at p 4571:

> *construction, without leaning one way or the other. However, although, if the terms of the Act plainly impose the tax they should be given effect, equally if they do not reveal a clear intention to do so the liability should not be inferred from ambiguous words. If the words in question are words of exception or exemption the same rules of construction should be applied …"*

The use of so-called "principle based" drafting is a false economy. The "principle based" drafting style frequently results in insufficient precision or clarity being included in the legislation, with too much reliance on supplementary material. This supplementary material is generally written by people removed from the drafting of the legislation and is often expressed in broad generalities. This is most concerning when seeking to interpret legislation that, on its face, does not enable interpretation consistent with the underlying policy. The costs saved, if any, in drafting legislation in such a manner are passed on, many fold, to the community and often to those small or medium businesses or ordinary citizens who can least afford it.

For example, within the small to medium business sector, the complexity of the drafting of some taxation provisions regulating proprietary companies and trusts renders advice on those structures incomprehensible. The provisions themselves are at times also increasingly incomprehensible to many legal and accounting practitioners who are not tax specialists.

This impacts all sectors of the taxpaying community and leads to significantly increased costs for taxpayers.

6.3 Analysis

It is critical that tax legislation be drafted in the context of the commercial, business and family arrangements that exist. Drafting tax legislation in a theoretical vacuum does not lead to workable legislative solutions. A policy of "principle based" drafting, which seeks to confine all levels of precision and specificity to the explanatory material and, especially, examples within explanatory material, is unacceptable.

Unless the words of legislation are unclear, no recourse may be had to explanatory material. In the absence of an assumption that legislation may be drafted with an element of ambiguity, the use of explanatory material to clarify elements of imprecise legislation is ineffective and contrary to established principles of statutory interpretation.

A revised approach to drafting should be adopted in which greater detail and precision are employed. Those drafting and instructing on drafting need to have a better understanding of the taxation law and the principles of statutory interpretation. This would result in ease of interpretation by both the Australian Taxation Office and taxpayers alike and avoid potential occasions in which understanding the intention of the Parliament requires recourse to explanatory and extraneous material which itself suffers from the same broad generality and, as the High Court has noted, is simply unavailable. Such recourse does not preserve the integrity of the policy or legislative intent.