



# TAX FORUM

4-5 October 2011

## STATEMENT OF REFORM PRIORITIES

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### ORGANISATION

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### STATEMENT OF PRIORITIES

#### Priority Area 1: Removing the tax compliance burden on 8m Australians

Australia's income tax system has developed in such a way that it requires significant and highly technical compliance tasks from almost all adult citizens every year. While the Review of Australia's Future Tax System proposed some measures which would reduce the compliance burden for individuals, it was insufficiently bold in its recommendations.

The Government should pursue a package of measures affecting both tax administration and the base of the income tax which will eliminate the need for almost all:

- wage and salary earners,
- retirees, and
- pensioners (ie, pensions paid by both Government and onshore superannuation funds),

to have any compliance responsibilities under the income tax in most years.

#### Financing this proposal over the short and longer term

A package of measures designed to remove the need for individuals to file returns should be both revenue generating and revenue depleting. A balanced package with no net cost to revenue should be possible.

#### Priority Area 2: Reducing reliance on taxes that penalise work and saving

It is well understood that taxes discourage the activity being taxed. Australia relies heavily on taxing income and consumption. An income tax discourages things which society should value – work and



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saving. We pay almost no attention to the other principal tax base – taxes on wealth.

The recommendations of the Review of Australia's Future Tax System included few recommendations about wealth taxation. Indeed, it appears to have doubted the possibility of any serious shift away from income tax to more comprehensive taxes on wealth.

International experience has shown that net wealth taxes are possible and can generate not inconsequential amounts of revenue. A tax on net wealth may never be a dominant source of revenue, but increasing taxes on net wealth – and reducing commensurately taxes on income and thus the damage they do to our society – need not be regressive and can enhance the efficiency of Australia's tax system.

### **Financing this proposal over the short and longer term**

A package of measures designed to shift more of the tax burden away from income and profits in lieu to rely more heavily on taxing wealth should not involve a net cost to revenue.

### **Priority Area 3: Taking control of the misguided pursuit of comprehensiveness and precision in tax matters**

Compared to many countries, Australian citizens are very law-abiding. This is a precious value in our society and should not be undermined. Laws should ask people to do things that they can grasp and realistically perform. Expecting people to discover and then meet implausible and untoward obligations damages respect for the rule of law generally, and the tax system in particular because the tax system depends critically on voluntary compliance by employers, companies and citizens, and this will only survive where individuals have and retain respect for the system.

There may be many reasons for the problem of insisting on unrealistic obligations, but two likely causes are a misguided search by policy makers in Treasury and the ATO for:

- comprehensive solutions to particular issues, and
- precision and exactness in tax matters.

Our current systems for developing and executing tax policy appear incapable of reaching reasonable compromises and pragmatic solutions. Some kind of circuit-breaker is needed to inject a dose of reality into the expectations put upon taxpayers. The recommendations in Chapter G1 of the AFTS are perhaps capable of doing that, but they appear mostly directed to setting up new oversight bodies. What is needed is not a new oversight body *per se* but rather a new agenda – a determined focus on preventing and then removing implausible and untoward obligations.

### **Financing this proposal over the short and longer term**

A package of measures designed to constrain the efforts of policy-makers just to obligations that it is



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reasonable to expect should not involve a net cost to revenue.

## LIST OF ATTACHMENTS

1. Reducing the compliance burden on 8m Australians
2. Reducing the reliance on taxes that penalise work and saving
3. Taking control of the misguided pursuit of comprehensiveness and precision in tax matters



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## Priority Area #1: Reduce the compliance burden on 8m Australians

### *The problem*

Australia's income tax system has developed in such a way that it requires significant and highly technical compliance tasks from almost all adult citizens. Out of a population of almost 22m, about 12.3m individuals have to file tax returns with the ATO, which occupied at least some of the 21,000 people employed there. Around 75% of taxpayers feel unable to comply with the requirements imposed on them and so have to engage the services of a tax agent, at costs ranging from \$200 to \$700 per taxpayer (AFTS, *Final Report*, p. 53-61).

This situation is both unnecessary and inefficient. International experience shows it is possible to remove the bulk of citizens from the need to comply with a nation's income tax system.

### *The AFTS recommendations*

The Review of Australia's Future Tax System proposed three specific measures to reduce the compliance burden:

- an optional standard deduction which the Review did not quantify (Recommendation 11),
- restricting the number of work-related expenses available to be claimed as deductions (Recommendation 12),
- increasing the gift-deductibility threshold to \$25 (recommendation 13)

In addition, the recommendations to lift the tax free threshold to \$25,000 (Recommendation 2) and combine the LITO and other tax offsets into the tax rate scale would remove a number of citizens from having to pay income tax.

Some of these recommendations have been acted upon, but only half-heartedly:

- in the May 2010 Budget, the Government announced the option of replacing the itemisation of employee deductions with an optional \$500 standard deduction model: Treasury, *Budget Measures 2010-11, Budget Paper No 2*, p. 47, and
- in July 2011, as part of the carbon tax compensation package, the Government announced a proposal to increase the tax-free threshold to \$18,200 in 2012-2013 and \$19,400 in 2015-16: Australian Government, *Securing a Clean Energy Future* (July 2011) 40-41

### *A bolder vision*

But even if the government had acted fully on the AFTS recommendations, those recommendations were not sufficiently bold to begin with.



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The AFTS appears to have assumed that the end point of the process would still be a system under which most individuals would have to lodge tax returns (in order to verify their no-tax-liability status) albeit, there might be greater reliance on pre-filling of the fields in the return:

*To simplify people's interactions with the tax system and facilitate much greater levels of pre-filling of tax returns, an automatic standard deduction should be introduced.* AFTS, Final Report, vol 1. p. 5.

That vision of the end-point – a system in which most individuals file detailed, if partly pre-filled, returns – is not sufficiently ambitious. While the AFTS recommendations reduce the obligation for some to pay any tax, they do not do enough to remove the burden of having to prepare and file returns to prove that there is no obligation to pay tax – eg, it appears taxpayers would still have to file detailed returns to make the election to take the standard deduction, or to report charitable donations in excess of \$25.

The AFTS seems to have thought people want to know, and should be able to see easily, what is happening in the tax system:

*In time, citizens should be able to access, through a suitable choice of channels, comprehensive and timely information on their tax and transfer affairs, and be able to see and interpret how their tax and transfer outcomes have arisen.* AFTS, Final Report, Overview. p. xxiv.

This is one vision and it has some merits. But my suspicion is that most people would prefer to be freed from the tax system altogether – having satisfied themselves that the system is fair or fair enough, to let it run its course and live in considered ignorance of it and not to pursue 'timely information' about its impact in their lives thereafter.

What is needed is a system that removes the need to prepare and file returns – not a system in which taxpayers might find some of the entries on their returns pre-filled, or might find (were they to read the instructions carefully) that they were no longer eligible to enter amounts in some of the fields on the return.

## ***A more ambitious end-point***

A more ambitious outcome would be a system in which very few citizens would ever have to file returns.

Even if some personally signed form were considered indispensable, it should be possible to have a return as simple as, 'Did you earn income from working abroad? Yes / No. Did you sell any asset this year (ignoring your home and your car)? Yes / No' etc. Once a person ticked 'No' to every question, that would be all that was required.

**Wage and salary earners.** All wage and salary income should be taxable with a final tax either at source or in the hands of a trustee of an onshore superannuation fund. Clearly a number of changes would have to be made to the system for wage and salary earners:



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- PAYG withholding would have to function as a final tax. This would mean much more accurate withholding schedules that can accommodate fluctuating incomes over a year, holding multiple jobs, periods of unemployment, changing employers during a year, and so on,
- work-related expenses would have to be eliminated by the dual strategy outlined in the AFTS report: a standard deduction (of much more than \$500) and raising the threshold at which itemisation *can* occur to expenses totalling more than (say) 5% of gross income,
- [as a corollary, the range of taxable fringe benefits should be significantly reduced so that employers can more readily provide as benefits the kinds of work-related items that employees currently incur personally and deduct (especially travel, uniforms and self-education). If the 'otherwise deductible rules' were turned into exempt benefits there would be less nuisance to employers in providing directly the kinds of benefits that employees currently spend their income on], and
- turning the charitable donations deduction into a cash payment directly to the charity – for every \$7 donation made by a citizen, the charity receives (say) \$3 from the government.

**Retirees.** Additional changes would have to be made to the system to accommodate retirees:

- dividends and interest paid by local entities would be made subject to final withholding at source at a rate to be determined;
- the same treatment should apply to dividends and interest earned through managed funds, although withholding should occur at the level of the fund, rather than the borrower or company,
- rent and capital gains derived by owning units in a managed funds should also be subjected to a final withholding tax at the same rate as other investment income (which would create a disjunction between amounts earned directly and those earned via a fund, though one that retirees might well accept in order to be free of the compliance burden).

Superannuation pensions paid after 60 are exempt already.

**Pensioners.** For those in receipt of Government pensions, all pensions should be exempt from income tax (especially where they have been subjected to a means test!) If necessary, the amount of existing pensions should be adjusted in transition to reflect their tax-free status.

**Who is left?** There would still remain pockets of society where detailed reporting would have to happen:

- the self-employed,



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- those who have realised investment assets such as shares or second homes during the year. [I note that this group could even be reduced in size with a little thought. For example, some amounts that are currently taxed under the CGT rules could just as easily be taxed under the employment income tax rules – eg, a *Hepples*-type payment for a restrictive covenant could be taxed as ordinary employment income since it has no cost base and does not qualify for CGT discount],
- investors owning rental properties or other investments that are geared at the investor level,
- employees with (untaxed) offshore employment income, and
- investors holding foreign investments.

But this cohort of citizens is a small minority. For the rest, a return-free world ought to be possible.

Obviously a return-free world (i) would involve a loss of some of the precision that the current system is thought (mistakenly, in my view) to achieve (ii) would not be possible for everyone and (iii) would require not insignificant adjustments to the existing tax base. But it would be a worthy outcome for the Tax Forum, improving the lives of millions of citizens.

## **Financing this proposal**

A package of measures designed to remove the need for individuals to file returns should be both revenue generating (eliminating employee deductions, potentially higher effective rates on some investors, lower cost for subsidising charitable donations for high income earners, higher rates on some capital gains) and revenue depleting (higher threshold, proxy rate on some kinds of investment income, lower cost of funding exempt benefits). A balanced package should be possible.



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## Priority Area 2: Reducing the reliance on taxes that penalise work and saving

### *The problem*

Australia relies very heavily on taxes on income and to a lesser extent, consumption.

It is well understood that taxes discourage the activity being taxed, the amount of the discouragement depending on the elasticity of the thing being taxed. As the AFTS puts it,

Most taxes result in some loss of economic efficiency.

So it ought to concern us that an income tax falls on activities that ought to be encouraged and supported in a society – working and saving. Yet we choose to impose tax on the return from working (wages) and the return from saving for the future (dividends and interest). The tax on corporate profits similarly diminishes the return on the investment made by those who hold shares in the company and perhaps also the possibilities for, and the return to, employment by the individuals who work for local companies. (The incidence of the corporate is still debated in the literature, but in this context it does not really matter whether the burden of the corporate tax falls on local suppliers of capital or local suppliers of labour to resident companies.)

It seems clear that the heavy reliance on income tax to fund public goods and services and to fund transfer payments must diminish productive activity in the country and national income, making us poorer as a nation and as individuals.

### *The AFTS strategy*

While the AFTS report acknowledges that there are problems with heavy reliance on both of these tax bases, it proposes to continue this practice:

*Recommendation 1: Revenue raising should be concentrated on four robust and efficient broad-based taxes:*

- *personal income, assessed on a more comprehensive basis;*
- *business income, designed to support economic growth;*
- *rents on natural resources and land; and*
- *private consumption.*

The AFTS paid some attention to increasing the reliance on taxation of wealth but only in the form of local land. Instead, its recommendations continue the reliance on taxing income and consumption with a surtax on super-profits derived from sales of certain natural resources.

The Review was firm in its rejection of other taxes:

*Other existing taxes should have no place in the future tax system and over time should be abolished.*





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The discussion of taxes on wealth ownership and wealth transfers (chapters A3, C2, G2 and G3) is pessimistic or unambitious:

*Recommendation 25: While no recommendation is made on the possible introduction of a tax on bequests, the Government should promote further study and community discussion of the options.*

The main exception is chapter C2 which envisages an expanded role for land tax:

*Recommendation 52: Given the efficiency benefits of a broad land tax, it should be levied on as broad a base as possible. In order to tax more valuable land at higher rates, consideration should be given to levying land tax using an increasing marginal rate schedule, with the lowest rate being zero, with thresholds determined by the per-square-metre value.*

## **A different approach**

The AFTS strategy of having just 3 big tax bases is too limited.

There are certainly arguments for having few taxes that are highly revenue-productive. And there are certainly compelling arguments against having many nuisance taxes especially if they are unfair, costly and inefficient. But the arguments for the concentration on just 3 taxes are less compelling if those taxes are flawed, and the income tax is a flawed instrument in many ways.

There are other visions for a tax system which would include more tax bases than just income and consumption:

- Australia collects very little tax from the other major potential tax base – wealth. The main exceptions to this – stamp duty on transfers of wealth held in certain forms (principally, real estate), council rates imposed on wealth held as real estate and motor vehicle registration charges – collect modest amounts of revenue for government. While the report of the AFTS supported a broader reliance on land tax, it did not recommend taxing wealth (holdings or transfers) in other forms or other locations.
- There is some discussion of using taxes on ‘social bads’ such as environmental pollution, traffic congestion, tobacco consumption, excessive alcohol consumption or excessive gambling to produce revenue.
- Similarly while there is some discussion of reliance on user charges, it is not strongly advocated.

It is not suggested these tax bases are likely to be highly revenue productive but they should not be ruled out simply because they do not meet the ‘just 3 big tax bases’ strategy. They offer some modest options for decreasing the reliance on the income tax and moderating its damaging effects.

## **A few comments on this agenda**



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Australian policy-makers seem to take the position that taxes on wealth holding are simply not a viable policy option. This may be because they are seen as difficult to administer, will be evaded by holding undeclared wealth held offshore, will create liquidity problems, are inefficient (ie, too costly for the amount of revenue they generate), are too politically damaging to any party proposing this, or for some other reason.

But none of these arguments is overwhelming. It is important to observe that we already pay a price for having the income tax, and so arguing that wealth taxes are expensive is not an especially compelling position. Wealth taxes may be worth the administrative effort if their efficiency cost is low. Administrative concerns are real but not decisive, especially not for the kinds of assets which will generate the bulk of the revenue – land, listed securities, units in managed funds and other financial assets. A tax focussed on these assets does not suffer from serious valuation issues – values are available for other purposes and are reasonably reliable. Nor is there a serious problem of verification – the identity of the owner is already registered with authorities for other reasons. And liquidity problems may simply be evidence that wealth is being put to uses that are not especially productive, and may cause that to change.

It is important to challenge the prevailing orthodoxy that taxes on wealth are so difficult to administer and so easily avoided that they are not worth the effort of pursuing at all. International experience has shown that net wealth taxes are possible and can generate not inconsequential amounts of revenue. For example, The Netherlands imposes a net wealth tax of 1.2% on most non-private assets of tax residents (except for owner-occupied accommodation, although it taxes imputed rent instead). The tax is charged mostly on holdings of second homes, listed securities and other financial assets. According to my Dutch colleagues, the tax works well.

It may be argued that a progressive tax on income is fairer – or does more to enhance equity – than a consumption tax and so our decision to use income tax is preferable to greater reliance on forms of consumption tax. I do not seek to challenge that view. But I do challenge the view that a tax on income is so inherently desirable that it should also displace taxes on wealth, taxes intended to discourage undesired activities and user charges.

Increasing taxes on wealth – and reducing commensurately taxes on income – may thus be both neutral in terms of progressivity and efficiency enhancing. Indeed, the AFTS' own commissioned research showed that council rates and land tax had lower efficiency costs than taxes on labour income or corporate profits.



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## **Priority Area #3: Taking control of the misguided pursuit of comprehensiveness and precision in tax matters**

### ***The problem***

Compared to many countries, Australian citizens are remarkably law-abiding. It seems we have great respect for our laws and legal institutions. This is a precious value in our society and should not be undermined. Laws should ask people to do things that they can grasp and realistically perform. Expecting people to discover and then meet implausible and untoward obligations damages respect for the rule of law generally, and the tax system in particular because the tax system depends critically on voluntary compliance by employers, companies and citizens, and this will only survive where individuals have and retain respect for the system.

The tax system is beset with measures that are not understood, probably unnecessary and are (one suspects) simply not complied with. The tax system should not make offenders out of honest people. But this often happens in the tax system – taxpayers are expected to perform compliance tasks that it is unreasonable to expect them to meet. While the existence of a profession of tax advisers may moderate this concern – professionals can be expected to know and provide competent advice – this is not a complete answer.

### ***Some causes***

There may be many reasons for the problem of insisting on unrealistic obligations, but two likely causes are a misguided search by policy makers in Treasury and the ATO for:

- comprehensive solutions to particular issues, and
- precision and exactness in tax matters.

These efforts are too often misguided. Insisting on comprehensive solutions to particular issues ends up with regimes that are over-reaching. The search for precision is misguided in tax systems that are already fatally but inevitably affected by unavoidable inexactness and imprecision – it is not as though another inexactness will be fatal to an otherwise perfect system.

There are instances where comprehensive solutions are worthy and appropriate, and where difficult and time-consuming obligations have to be insisted upon to maintain the integrity of the system. However, our policy makers routinely conclude they have reached this point too soon.

### ***Examples***

The claims made in the preceding paragraphs will undoubtedly be challenged by those who design and devise our laws, so it is probably worth giving some examples to demonstrate the point.

Perhaps the most obvious example is the fringe benefits tax. This tax is routinely ignored by most businesses. Large business complies with the tax but it is evident that small business does not. The



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evidence is stark: about 800,000 businesses are registered for PAYG withholding – they appreciate that they have a responsibility to withhold payments from wages. But only around 50,000 entities are registered payers of FBT. This discrepancy cannot be explained on the basis that they do not provide fringe benefits to employees; the FBT net is cast absurdly wide – I doubt that any of the 750,000 missing employers could confidently say they provide no fringe benefits. Again, the evidence the special rule needed to ensure that providing toilets for employees is exempted, an exception that applies only to toilets on the employer's premises. I think it a fair bet that no employer has ever tried to report and pay FBT on toilets anywhere, and yet some of them will have had a liability for this as for much else.

Or take the pooling system for the depreciable assets of small businesses. The logic of a pooling regime is that the depreciable assets of a business, just like its inventory, are largely indistinguishable – that particular shelving unit may have been purchased last year, or 3 years ago, or 5 years ago or 8 years ago; no-one can say anymore. And yet one of the 2 pooling systems in the law requires taxpayers to track the use of assets for 4 years or sometimes up to 20 years. This is inherently illogical; the point of pooling is that the use of particular assets can't be tracked.

Or take the rules dealing with the substantiation of employee expenses. The tax legislation contains highly prescriptive rules about the documents that must be maintained to demonstrate certain expenses. There is a general rule for work-related expenses, but then there are further rules about small expenses, and then further rules where the small expense is really small, and then further rules about spending award money on meals, and then further rules about travel, and then further rules for depreciation, and so on. The ATO's rulings then prescribe even more stringent rules for documenting many expenses. Take for example, deducting the cost of laundering work clothes. According to the ATO, a nurse should keep records of power consumption 'calculated by reference to the average power consumption for household appliances guide that is available from a taxpayer's local electricity authority.' Receipts should be kept for laundry detergent and cleaning products unless each expense is \$10 or less in which case, provided that the total of all a taxpayer's small work expenses, not just laundry expenses, is \$200 or less for the year of income, the individual costs may be recorded in the diary that apparently one is meant to maintain at the cash register.

These rules are, on the one hand, counsels of perfection and, on the other, ludicrously complicated. They are requirements which, one suspects, few employees ever meet. Courts have already objected to the rigidity of the rules where honest taxpayers, whose evidence is accepted by the Courts, are nevertheless denied deductions by the strictness of the rules. And, what is worse, the provision of the law which Parliament enacted in order to moderate some of the strictness of these rules requires that employees claim a deduction for an expense is not deductible so that the Commissioner's discretion can be enlivened. The law in effect insists that taxpayers lie when they answer the question on their return about meeting the substantiation rules.

## ***Solutions – a new agenda***

Our current systems for developing and executing tax policy appear incapable of reaching reasonable compromises and pragmatic solutions. Some kind of circuit-breaker is needed to inject a dose of reality into the expectations put upon taxpayers. The recommendations in Chapter G1 of the AFTS are perhaps capable of doing that, but they appear mostly directed to setting up new



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oversight bodies. What is needed is not a new oversight body *per se* but rather a new agenda – a determined focus on preventing and then removing implausible and untoward obligations.