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Tax insights
Re: think – Implications of the Tax Discussion Paper

Snapshot

The Government has released a very broad reaching tax discussion paper that traverses many different areas of taxation, and seeks to start a conversation about a tax system for the future.

As an historical record of the current taxation mix and approach, the discussion paper achieves a level of education and summary that will be helpful in navigating a future path. The paper shows some propensity for action on certain areas and marks out some areas as no-go zones. But for the main part, it puts many issues firmly on the table for discussion, but does not offer any conclusion. It will be left to the submissions process and the ensuing dialogue to shape that future path as part of the Green Paper process, leading to the eventual White Paper.

The usual aspects of Australia's recent taxation discussions are addressed, including:

- GST
- Negative gearing
- CGT discount
- Corporate tax rate
- Imputation
- Superannuation, and
- International arrangements.

Many of the 66 questions in the discussion paper are very open, which could lead to a multitude of different responses. It will be a challenging exercise to work through submissions that vary significantly in approach or focus, while responding to the same question – and a difficult process to refine the submission process to a series of coherent and specific actions.

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While the discussion paper provides a level of observation of current issues, it also raises questions that examine equity in the tax system; for example, between:

- Alternative methods of savings
- Various ways in which business income is derived
- The distinction between capital and revenue, and
- The treatment of active and passive income.

Balancing competing social, political and economic priorities and managing transitional measures and compensation adjustments in any changes to the tax system will ultimately be the test of any tax reform exercise.

Federal/State relations are a critical element of the Australian tax discussion and receive some attention in the discussion paper. The effects of the aging population on the provision of services and infrastructure will particularly affect the State and Territory Governments, and an examination of the revenue base, roles, responsibilities and allocation of funds will be required to ensure that essential services can be provided efficiently and effectively.

In approaching the important task of tax reform, the discussion paper usefully extends the conversation beyond the GST rate and base. All elements in the mix of Australia's taxation system will need thorough examination and assessment to ensure a stable and sustainable taxation system of the future. This will require challenging conversations about many of the issues in the tax system that the discussion paper identifies.

Whether the issues raised in the discussion paper are able to be exposed sufficiently to make a case for a change in either significant tax policy, or in the tax mix, will remain to be seen and will be based on the strength of submissions and the resulting conversation.

Are we up to the challenge?

The following commentary seeks to highlight some of the key issues tabled in the discussion paper such as:

- A possible reduction of the company tax rate?
- The continued relevance of imputation
- Designing incentives for innovation
- A better way to tax fringe benefits?
- A debate about the Goods and Services Tax
- Structuring an efficient States taxes regime
- Rationalising the plethora of indirect taxes
- Dealing with the inconsistent taxation treatment of savings
- Saving for retirement
- Considerations for not-for-profits

A possible reduction of the company tax rate?

Australia's company tax rate is described as being high, relative to other countries in the Asia-Pacific and OECD, and the paper seems generally supportive of a reduction in the company tax rate. The Henry review previously advocated a reduction in the company tax rate to 25% (however no such target has been alluded to in this review).

The discussion paper sets out a number of expected positive impacts and expected negative impacts associated with a reduction in the company tax rate.

The discussion paper also seeks consultation on a number of broader business tax issues including:

- Suggestions as to how to simplify the corporate tax system
- To what extent specific incentives or tax regimes should be designed to further encourage inbound and outbound investment
- Transfer pricing
- The tax treatment of returns to debt and equity
- The distinction between revenue and capital
- Improving the regime for the taxation of financial arrangements, and
- The ability to better align tax and accounting definitions of income.

Deloitte perspective

Achieving any reduction of the company tax rate will be challenging in the context of the prevailing global and domestic economic conditions. In conjunction with political pressure, changes to the corporate tax rate present a complex challenge. However, this highlights the point that changes to the company tax rate cannot be viewed in isolation – rather, the White Paper process must address a comprehensive package of linked reform measures, and anticipate both short run and long run impacts.

The continued relevance of imputation

The discussion paper acknowledges that the Australian economy has changed dramatically since 1987 and that it is timely to review the dividend imputation regime.

There are many benefits of Australia's dividend imputation system; it provides a neutral treatment of incorporated and unincorporated domestic businesses, and can encourage Australian companies to pay Australian tax and distribute profits to shareholders. However, the discussion paper identifies concerns with dividend imputation because it may:

- Discourage foreign investment
- Create a bias against Australian companies investing offshore
- Increase the complexity, and
- Encourage the retention of company profits in closely-held companies to a time when the distribution may be subject to a comparatively lower tax rate in the hands of shareholders.

Most OECD countries have moved away from imputation in recent times, with only very few countries now operating a full dividend imputation system. A number of other methods provide relief from the taxation of dividends at the shareholder level, by exempting dividend income partially or completely from shareholders' taxable income, or taxing dividend income at a preferential rate. However, there is no clear trend or indicators of which alternative system for the taxation of dividends would best suit Australia.

Deloitte perspective

Although it is quite easy to see the advantages and disadvantages of the current dividend imputation system, determining an alternative system that might be better suited to the current Australian economy is not so simple.

Any alternative system should:

- *Encourage investment in domestic **and** global capital markets*
- *Be attractive to non-resident and resident investors alike*
- *Provide an even playing field for different types of investors (individuals, superannuation funds, mutuals etc.)*
- *Minimise the bias of debt as against equity,*

and

- *Manage a fair and effective transition away from imputation, whilst maintaining simplicity and the integrity of the taxation system.*

Designing incentives for innovation

The discussion paper proposes a review of the R&D tax incentive within the broader context of tax incentives for innovation. The paper does not address the impact of the current Senate Inquiry into Innovation which is due to report in July 2015. We assume that the findings of that inquiry will also feed into this process.

Deloitte perspective

The key considerations that the Government should consider include:

- *Whether the awarding of direct grants would better achieve the objective of incentivising innovation*
- *Whether the definition of eligible R&D entities should be widened to increase R&D in small unincorporated businesses*
- *Whether the refundable R&D tax incentive should be available to a wider range of companies*
- *Whether the quarterly refundable system proposal should be reinvigorated, as proposed by the Murray Inquiry into the Financial System*
- *Whether costing compliance simplifications could streamline the administration of the incentive, and*
- *Whether non-technological or business model R&D should be incentivised.*

A better way to tax fringe benefits?

The treatment of FBT in Australia differs from the approach taken by most other countries. The discussion paper notes that Australia and New Zealand are the only two countries which comprehensively tax fringe benefits in the hands of the employers and leaves open the option to consider taxing fringe benefits in the employee's hands.

The discussion paper also considers other reform options such as the simplification of valuation rules, concessions and exemptions.

The paper particularly questions the appropriateness of FBT exemptions for:

- Childcare provided on an employer's business premises
- Remote area housing, and
- Transporting fly-in, fly-out employees.

Deloitte perspective

A change in the design of the FBT system should aim to achieve the following goals:

- *Reduce complexity and compliance costs for employers*
- *Equity and fairness, so that employees of all income levels are treated similarly in that the tax rate they pay is a rate relative to their marginal tax rate*
- *FBT concessions and exemptions should reflect clear social and market objectives*
- *Any change in the taxation of fringe benefits, should maintain or improve the existing level of community compliance and calculation accuracy, and*
- *Any change in the tax base of a fringe benefit tax should be focused on those benefits which collect the least amount of revenue.*

The immediate priority should be to address complexity of the FBT system. If the FBT system is to be retained, consideration should be given to extended use of safe harbours, or a simplification of valuing benefits such as car parking, and decreasing compliance costs around exemptions, concessions and valuation of benefits.

A debate about the Goods and Services Tax

GST is Australia's third largest tax source, representing 16% of total Australian Government revenue (in 2013/14). The States and Territories (States) receive all of the GST revenue collected by the Federal Government.

In relation to the 10% GST rate, the discussion paper says little beyond observing that Australia's rate it is one of the lowest among developed countries and is about half of the average rate among OECD countries.

The discussion paper focuses more heavily on the scope to broaden the GST base. With GST being paid on only 47% of the consumption of all goods and services (in 2012), reform options canvassed in the discussion paper include applying GST to the main categories of consumption currently attracting GST-free treatment (i.e. fresh food, health, education, childcare, water, sewerage and drainage services) and input taxed treatment (i.e. residential rent and financial supplies). Apart from the implicit GST revenue boost to be derived from taxing these categories of consumption, the discussion paper also emphasises the reduction in complexity and distortions that would come from removing exemptions.

In terms of the distributional effects of the GST exemptions, the discussion paper points out that the exemptions are available to all households regardless of income level, potentially making them less effective as a means of targeting assistance to lower-income households.

The paper recognises the pressure being placed on the GST base by the digital economy – specifically, the growth in online retail spending by consumers and the resulting increase in importations of goods, services and intangibles, with most not subject to GST under current arrangements.

Deloitte perspective

Changes (if any) to the GST rate, base and administration should aim to achieve the following goals:

- *Provide a larger and more sustainable source of GST revenue – as part of an overall approach aimed at ensuring that the State and Territory Governments have sufficient funding to finance the services and functions for which they are responsible, and*
- *Reduce complexity and compliance costs for suppliers, particularly small businesses. A single rate of GST, applied to the broadest range of goods and services, with minimal exemptions, would contribute substantially to achieving this.*

Changes to the design of the GST would need to be accompanied by an adequate and appropriately structured compensation package for lower income households. Fair compensation could not be achieved through income tax cuts alone. Those on the lowest incomes, including pensioners and the unemployed, who pay little or no income tax, would need to be compensated via increases in relevant Government payments. Such compensation would provide better targeted assistance than the current GST exemptions.

Structuring an efficient State taxes regime

Broadly, the States each raise tax revenue from the same range of taxes - payroll tax, conveyance duties, motor vehicle registration fees and duties, insurance duty, land tax, municipal rates, gambling and other taxes – although each applies its own rates and thresholds.

In reviewing the main categories of State taxes, the discussion paper gives some general comments about the role some of these taxes might have in a reformed tax mix. For example:

- Payroll tax, if broadly based, could be a relatively efficient way of raising revenue. One reform option mentioned involves broadening the payroll tax base in each State by lowering current thresholds and removing exemptions, while also reducing the tax rate
- Land tax has scope for design improvements and base broadening, which could offer greater efficiency. The current land tax base is narrow due to tax-free thresholds and the exemptions for owner-occupied housing and land used for primary production
- Municipal rates are acknowledged as one of the most efficient of all Australian taxes.

In the case of some taxes however, it is less apparent that there are grounds for retaining them as part of a reformed State taxes mix. For example:

- In relation to stamp duties on conveyances, the discussion paper notes a range of negative impacts, including their volatility as a revenue source (due to property market fluctuations); and their cost deterring businesses from making productivity-enhancing purchases of land, etc.

- Insurance taxes are described being among the most inefficient of all Australian taxes. Their cost may lead to under-insurance or no insurance being purchased at all.

Deloitte perspective

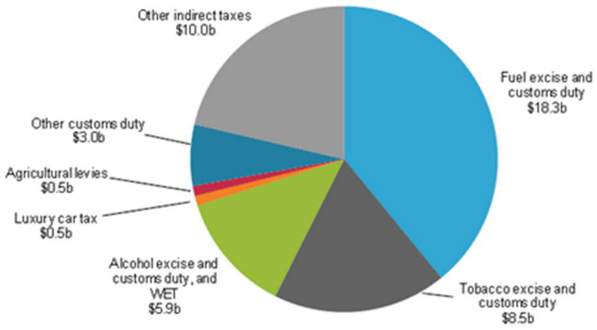
Changes to State taxes arrangements should aim to achieve the following goals:

- *Improved revenue raising capacity of each State – as part of an overall approach aimed at ensuring that the States have adequate funds to finance the services and functions for which they are responsible*
- *Greater efficiency and stability of revenue sources. For example, increased reliance on immobile bases (i.e. broadly applied land-based taxes such as land tax and municipal rates)*
- *Improved consistency across the States. The efficiency of payroll tax has been weakened by tax competition between the States, which results in increases in the tax free thresholds, variable rates and special exemptions. This could be addressed by harmonising threshold and exemption arrangements across States – reducing payroll tax complexity.*
- *Appropriate phasing-in arrangements to minimise any adverse or unanticipated impacts for particular groups such as low-income home owners*
- *Harmonising the treatment of contractors across payroll tax, FBT, Superannuation Guarantee, and WorkCover, and*
- *Taxes that were previously earmarked for abolition (typically undesirable on efficiency and equity grounds and which impede economic activity) should be abolished.*

Rationalising the plethora of other indirect taxes

A wide range of other indirect taxes are levied on specific goods and services for a diverse range of policy reasons, including behaviour modification. Their collective contribution to revenue is significant nonetheless, amounting to $47 billion, 13% of total Australian Government revenue in 2013-14 (inclusive of the carbon tax prior to its repeal), as shown in Chart 9.1 of the discussion paper.

Chart 9.1 Australian indirect tax revenue, 2013-14



Note: Excludes the GST. Other indirect taxes include the passenger movement charge, broadcasting license fees, the carbon pricing mechanism and a range of other levies, penalties and changes.
Source: Australian Government 2014, 2013-14 Final Budget Outcome, Australian Government Canberra.

The discussion paper provides a brief outline of each of these taxes, and in some cases outlines particular areas of inefficiency, complexity, anomalies, declining revenue generation potential and cessation of serving a particular policy purpose. Shortcomings have been highlighted in relation to the following taxes, providing some indication of potential reform options favoured by Treasury for consideration:

- Alcohol taxes - major problems with current arrangements are the complexity and variability of tax treatment, depending on which tax applies (wine equalisation tax, or excise/excise-equivalent customs duty) and other factors such as alcohol type, concentration, container size, etc. Tax concessions schemes for independent breweries and wine producers add to the complexity of alcohol taxation

- Luxury Car Tax (LCT) - is narrowly based, has become more complex since its introduction, and is the only luxury tax that is applied to a particular type of good or service, and

- Customs tariffs – revenues are declining as Australia seeks to reduce or remove barriers to trade. The cost to Government of collecting tariffs is increasing proportionally. Some importers are also facing a significant compliance burden determining whether and to what extent customs tariffs apply to the goods they import.

The discussion paper raises no shortcomings in relation to fuel taxes (i.e. excise and excise equivalent customs duty), and notes the significant contribution they make to taxation revenue. The fuel tax credit system is observed to give effect to the policy objective of minimising fuel tax business inputs, and as providing this benefit to the mining sector and a very wide range of other industries.

The discussion paper notes the potential relevance of certain imposts that are not taxes as such, but nonetheless could form part of a fair and efficient mix of charges on specific goods, services, activities etc. These include agricultural levies, new corrective taxes (i.e. taxes imposed to change behaviour), and user charging (e.g. fees for road use).

Deloitte perspective

Key considerations that the Government should consider include:

- *The need for an overhaul of alcohol taxation arrangements to streamline tax treatment, and reduce complexity for producers*
- *Determining whether the LCT has served its purpose and should be discontinued.*
- *Reconsidering recent decisions to apply or increase fuel taxes on certain alternative fuels.*

Inconsistent taxation treatment of saving

Australian households save primarily through home ownership, superannuation, investment properties, shares, bank accounts as well as trusts and company structures.

Income tax applies inconsistently to these different types of savings. As a result of this inconsistency, households have preferences to savings in the forms of superannuation and home ownership. Higher income householders will also structure their savings into trust or company vehicles for tax planning purposes.

The discussion paper considers some of the broader policy considerations that should be taken into account when designing a taxation system on savings such as:

- Whether income from savings should be taxed more concessionally than other forms of income such as labour income
- To what extent (if at all) different forms of income from savings should be taxed differently (as more favourable forms of tax treatment will lead households to invest in different risk-return profiles)
- Whether the tax treatment of savings has a distortionary effect on investment, particularly in Australia's real estate market.

In particular, the paper considers whether:

- A general discount on income from bank accounts and debt interests is desirable
- To what extent the rationale for the existence and size of CGT discount is still appropriate (particularly given Australia has different rates of CGT discount depending on the investment vehicle rather that the underlying asset), and
- To what extent dividend imputation impacts on saving decisions (particularly as Australian shareholders are more advantaged than non-resident investors in investing in Australian equities).

In terms of what is off the table, the discussion paper appears to preserve the current CGT-free status of the principal residence.

Also of interest is the airing of the negative gearing debate. The principal thrust of the paper is to debunk a number of the popular myths around negative gearing. The paper points out that the potential tax advantage will often be greater on the disposal side due to the discount CGT rate (this is particularly the case at present with good capital growth and a low interest rate environment).

Deloitte perspective

Consistency is an important feature of any taxation system. In principle, identical assets should be taxed in identical ways, irrespective of what vehicle they are held in, whether via a company, trust or in an individual's name. On this basis:

- *A review of the CGT discount should be considered*
- *In combination with that review negative*

gearing should be maintained unless there are compelling social or market outcomes for this to be changed.

In terms of providing a discount for savings as opposed to other classes of income, it is important to consider the fairness of such a proposition (given that taxpayers with higher incomes tend to have higher levels of income from savings). The practical aspects of taxing different types of income at different rates needs also to be considered with consideration of a tax offset as a simpler method of achieving this aim (if adopted).

Saving for retirement

The tax discussion paper notes that whilst there are policy grounds for superannuation being taxed at a lower rate than other income, there are issues around the distribution of the impacts and their effectiveness in supporting higher retirement incomes, as well as their complexity.

In essence this means that there is concern that:

- The bulk of superannuation concessions are benefiting those taxpayers at the high income levels
- Despite the considerable cost of the superannuation concessional treatment, the policy objectives of superannuation (to reduce dependence on the age pension and to provide incentives to save for retirement) are not being achieved. The Intergenerational Report predicts that the portion of retirees receiving a pension is not projected to decline over the period to 2055 (although the portion of part rate pensioners relative to full rate pensioners is expected to increase).

Deloitte perspective

There is general bi-partisan support for the suggestions in the Financial System Inquiry for a purpose statement to be established for superannuation that all policy will be based on. If it is considered that the purpose of superannuation should be to provide an adequate retirement for Australians, and to provide for the less well off in particular, policy decisions become clearer.

There does need to be some sort of concessional treatment of superannuation to compensate for the restrictions on access to these funds, and for the impact of income taxes on long term saving. This could be via concessions to contributions, earnings during the accumulation and retirement phase or for payments on retirement.

Equity is a key consideration, as is simplicity of design. Transitional provisions whilst often necessary for equity reasons are not optimal in terms of the complexity that they create, and could run for many years, if not decades.

An important consideration when reforming the superannuation system is how it will cope with the workforce of the future; where the population lives longer and moves in and out of the workforce several times due to changes in personal circumstances.

The superannuation system of the future will need to fund a longer retirement, and be flexible in allowing contributions where there are broken work patterns.

Any possible increase in the preservation age could place financial hardship on those in physical jobs (such as construction, mining, and agriculture), so reforms or opportunities in the labour market need to go hand in hand with superannuation policy.

Considerations for not-for-profits

The principal concerns highlighted in the paper for not-for-profits are around the equity and policy objectives; whether the concessions are effective in achieving their policy objectives; and whether the tax arrangements for the NFP sector result in the sector having a competitive advantage compared with arrangements for profit organisations.

Against this backdrop is an acknowledgement that in many cases, NFP organisations need these incentives to attract labour and provide services to the Australian community more efficiently and effectively.

Deloitte perspective

The rationale for providing tax concessions to the NFP sector as set out in the Treasury report

"Fairer, simpler and more effective tax concessions for the NFP sector" continues to be valid, that is;

- *Without incentives such as tax concessions, the overall level of activity in the NFP sector may be below what is optimal for society, and*
- *Tax concessions to the NFP sector are a form of payment or subsidy for the delivery of goods or services that are of public benefit. i.e. to fill the gap where Government does not have the resources or skills to provide similar services.*

However, the current tax exemptions are complicated and difficult to administer. To be effective, the concessions should be easy to understand and simple to apply, regardless of the type of not for profit entity.

A national conversation

The tax discussion paper is the first step along a long journey of tax reform. The purpose of the paper is to provide a platform for a wide ranging debate about tax design, in concert with principles of equity, efficiency and simplicity.

The clarity of the language used, together with the open-ended nature of the questions asked are intended to extend the debate to a wider audience. Community responses are sought by 1 June 2015.

These responses will inform the Government's tax options Green Paper which is expected to be released in the latter half of 2015. These options will also be subject to extensive consultation.

Final policy proposals will be contained within the Tax White Paper as a platform for the next election.

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