

ABOUT THE REVIEW

The Review's terms of reference charge it to report on current arrangements in relation to business taxation and, in addition to addressing specific issues raised in *A New Tax System*, to make recommendations for fundamental redesign.

To facilitate widespread and effective consultation, the Review will publish two discussion papers. This first paper focuses on the need for a strong foundation to guide the design and administration of business taxation. A second discussion paper, for release early next year, will address the Government's announced reforms to the taxation of business entities and investments. In December 1998 an information paper will be released on how Australia's approach to business taxation compares with that of other countries.

The Review's final report will be presented to the Treasurer no later than 30 June 1999.

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What is the task of the Review?

One of fundamental redesign

1.1 The Review has been asked to conduct wide ranging consultations with a view to making recommendations about the fundamental redesign of business tax arrangements. The objective is a stable, simpler and more coherent business tax system –and one which reduces the costs of compliance and administration. Such a system will lead to more robust investment decisions, improved competitiveness, greater productivity, higher gross domestic product growth and more jobs. The scope of the Review is determined by its terms of reference which are reproduced in Appendix A. The Treasurer’s press releases of 14 August 1998 and 27 October 1998, concerning the Review, are reproduced in Appendix B.

1.2 While no aspect of the taxation of business entities and investments is precluded from the scope of the Review, the Review will particularly address the Government’s strategy for reforming business income taxation arrangements as identified in *A New Tax System*.

1.3 The Review is to make recommendations on the fundamental design of the business tax system, the processes of ongoing policy making, the drafting of legislation and the administration of business taxation.

1.4 Those recommendations are to be consistent with the following objectives:

- improving the competitiveness and efficiency of Australian business and thereby the competitiveness of the Australian economy;
- providing a secure source of revenue;
- enhancing the stability of taxation arrangements;
- improving simplicity and transparency; and
- reducing the costs of compliance.

1.5 The approach adopted by the Review is to be comprehensive, open and transparent. Reform is to be driven by clear, sound principles and involve a move towards greater commercial reality. The Review is able to call on the expertise of both the public and private sectors, academic tax experts and, through consultation, the wider community.

One matched by reform initiatives in other countries

1.6 Australia is not unique in its efforts to improve the structure of its taxation legislation and policy. Several countries are considering major reforms or have been involved in a process of continuous improvement of the tax system for some time.

- Major reforms are being considered in Germany, Canada, the Netherlands and Sweden.
- In Taiwan and Chile, the reform process has been completed only recently while significant changes in the business tax system have been announced in the United Kingdom.
- New Zealand has been one of the most active countries on tax reform in the world over the past decade and, although the pace of reform has slowed, considerable effort is devoted to determining if the tax system is well tuned to the needs of the New Zealand economy .

1.7 In many other countries where the reform process is not currently on the political agenda, there is serious concern about both the complexity and structure of the tax system.

1.8 The three major factors driving business tax reform in other countries appear to be:

- the need to bring business taxation into line with the global nature of world commerce;
- the desire to design the business tax system in a way that makes it more compatible with the goal of job creation and the reduction of unemployment; and
- the objective of removing the complexity of legislation resulting from old drafting styles and the continual overlay of new taxation policy on old.

What is the scope of the Review?

It encompasses both taxes and processes

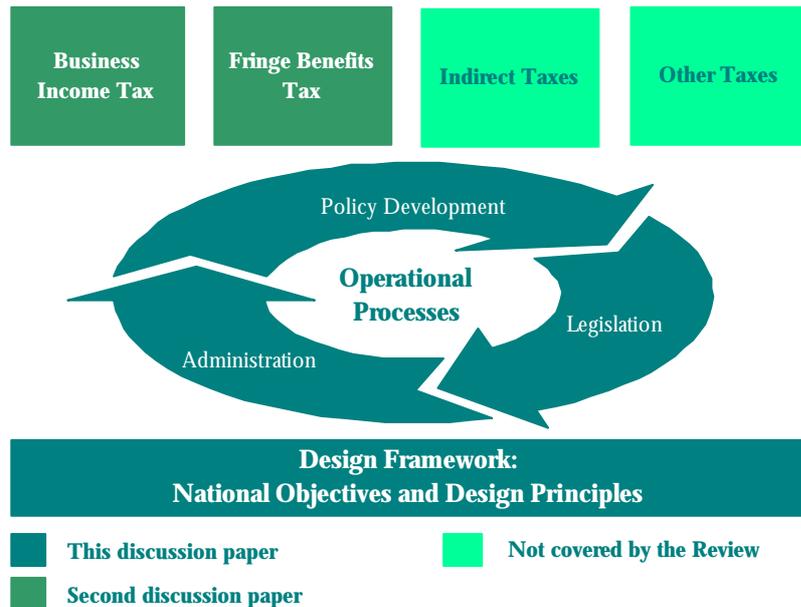
1.9 The business tax system consists of two basic elements:

- the *taxes*, including those which directly affect business (such as business income tax, fringe benefits tax (FBT), indirect taxes), and those which indirectly affect business (such as pay as you earn instalments); and

- the *processes* of policy development, legislation and administration which determine how well these taxes operate in practice.

1.10 The Review will consider and consult on appropriate objectives and principles for the business tax system as a whole as well as on its related policy development, legislative and administrative processes. The Review will then examine and consult on business income taxation, focusing on the Government’s business tax reforms announced in *A New Tax System*. In that context, the Review will also consider current FBT arrangements which continue to be a major issue for the business community. The terms of reference ask the Review to ‘include an assessment of the design and administration of the tax regimes affecting business to identify their main shortcomings and their impediments to productive activity and innovation’. Given the apparent level of dissatisfaction with the current FBT arrangements, the Review feels obliged to address this issue. Figure 1.1 illustrates the elements of the system and the scope of the Review.

Figure 1.1: Elements of the business tax system



1.11 The consideration of policy development, legislative and administrative processes will focus on the appropriate roles of both the public and private sectors in developing and maintaining an effective and low cost tax system. Mechanisms will be considered to achieve more effective consultation and better integration of, and feedback between, policy development, legislative drafting and administration. The objective will be to establish institutional arrangements to ensure that future development of the business tax system will be consistent with the national objectives and principles and will be implemented in the most cost-effective manner.

It encompasses both investments and entities

1.12 Business income taxation usually refers to the taxation of those carrying on a business, the assets they use to do it and the gains (or losses) that arise from it.

1.13 Business income taxation, as discussed in *A New Tax System* and defined in the terms of reference for this Review, is much broader. It is concerned with *all* investments –both active and passive –in assets that are held, used or managed with a view to gain of whatever kind. It would not, therefore, be confined to the annual cash flow returns on active business assets: it would conceptually include gains through changes in asset value, either during the time they are held or on realisation.

1.14 Assets producing business income in this expanded sense may be, for example, physical assets, intangible assets or financial assets. Since any of these assets may be held directly by investors or indirectly through various entities, business income taxation also includes the income taxation of arrangements through which investments in assets may be made or managed. These arrangements include various structures such as corporate entities, partnerships, trusts and other collective investment vehicles. Assets that produce gains without being actively used or managed –for instance, income-producing debentures –would also be included.

1.15 Used in this way, the scope of ‘business income taxation’ is necessarily broader than the taxation of those traditionally regarded as carrying on a business. For instance, individuals investing in shares or earning interest on savings deposits would be earning ‘business income’ but, in most instances, would not regard themselves as carrying on a business.

1.16 While the aim of the business tax system is to tax individuals who are the ultimate recipients of business income, the taxation of business entities is an essential part of the system. The taxation of business income in the hands of entities ensures that:

- business income attributable to foreign shareholders is subject to Australian taxation;
- the integrity of the personal tax collection system is reinforced by a withholding at the income source; and
- tax is collected at the time the income is realised. If it was not collected until distribution by the entity, entities would have an even greater incentive than they do now to defer taxation by retaining income.

How will the Review proceed?

Two stages

1.17 In responding to its terms of reference, the Review will proceed in two stages.

- In Stage 1, the Review will consult on and refine a suggested framework and proposed reforms to processes to govern the operation and evolution of the business tax system as a whole.
- In Stage 2, the Review will focus on the central taxation base of that system —business income taxation —consulting in order to recommend on the following matters:
 - the Government’s approach for reforming the taxation of business entities;
 - the scope for reforming the taxation of business investments, particularly in light of the current poor treatment of changing asset (and liability) values as well as the Government’s goal of lowering the company tax rate towards 30 per cent; and
 - the scope, within a revenue-neutral reform of the taxation of business investments, for some changes to capital gains taxation relief measures specified in the terms of reference.

Three papers

1.18 The Review intends to publish three papers before its final report:

- this discussion paper;
- an information paper presenting a comparison of Australia’s business tax system with the systems of various other countries; and

- a second discussion paper which focuses on business income taxation and, specifically, the Government's announced strategies.

1.19 The Review will be seeking submissions and undertaking consultations following the release of the first and third of these papers. The information paper is expected to be released in December 1998 and the second discussion paper in late January 1999.

This discussion paper

1.20 This discussion paper uses an analysis of existing features of business taxation to highlight the need for reform. It then proposes a stronger foundation of objectives, principles and processes for the development and administration of business taxation.

Information paper

1.21 The Review's terms of reference require it to report on the Australian business taxation system as a whole compared with international experience.

- 1.22 The purposes of the information paper will be to assist:
- both the Review and parties making submissions in the identification of issues for consideration by the Review; and
 - in framing recommendations by the Review that are consistent with the Government's objectives as stated at paragraph 1.4 above.

Second discussion paper

1.23 The second discussion paper will address Stage 2 of the Review's process by outlining specific issues and providing detailed guidance for consultation in relation to business income taxation and the matters identified at paragraph 1.17.

1.24 In doing so, the second discussion paper will seek to flesh out some of the detail around the skeletal structure of the Government's strategies for business tax reform announced in *A New Tax System*.

What will be the Review's consultative approach?

Facilitating widespread and effective debate

1.25 In releasing these papers, the Review will be seeking to facilitate, but not otherwise constrain the scope of, submissions made in accordance with its terms of reference.

1.26 Combined with the issues to be identified by the Review, the extent of the Government's proposed reforms of business income taxation have the potential to be among the most extensive set of reforms ever proposed for the Australian business tax system. For that reason it is important that there is widespread, sustained and effective consultation.

1.27 The Review is conscious also that the Government's extensive taxation reform agenda and the intended implementation timeframe impose a substantial challenge to business and investors in terms of participating in consultative processes.

1.28 In response, the Review will be ensuring that business and other groups have as much opportunity as possible to participate in the reform process:

- the timing of the release of the two discussion papers and the information paper has been compressed as far as is consistent with the integrity of the review processes;
- the Treasurer's agreement has been obtained to an extension of the final reporting date to no later than 30 June 1999, allowing longer periods of response by the business sector and others in the community to the discussion papers; and
- to offset the impact of that extension on implementation, as well as to maximise the scope for consultation, the Review will be arranging, with the assistance of the Office of Parliamentary Counsel and the Australian Taxation Office, for the concurrent drafting of exposure draft legislation.

1.29 Additionally, the Review will utilise its website, <http://www.rbt.treasury.gov.au>, to publish details of its consultative strategy and ongoing processes and to facilitate public access to Review material.

Sponsoring concurrent drafting of legislation

1.30 Normally, exposure draft legislation would be prepared only after the Government had determined its position on recommendations made by the Review.

1.31 In the context of the Government's extensive taxation reform agenda and of the anchoring of the Review to the Government's announced strategies, especially its entities taxation regime, the Treasurer has agreed that preparation of draft exposure legislation concurrently with the Review will help promote consultation and facilitate implementation.

1.32 The Treasurer's agreement to this consultative mechanism does not imply that the Government is necessarily bound, pending its own policy processes, by the specific policy reflected in the draft legislation.

1.33 The Review nevertheless notes that this innovative approach to concurrent drafting is fully consistent with its proposals in the current paper for substantial revision to the policy, legislative and administrative processes characterising the business tax system.

What is the purpose of this discussion paper?

To outline a strong foundation for reform

- 1.34 This discussion paper is structured in two parts:
- Part I examines various aspects of the current business tax system so as to highlight the need for fundamental reform; and
 - Part II suggests a strategy for reform that, if implemented, would establish a strong foundation for the business tax system and more effectively support the Government's reforms to business income taxation.
 - Firstly, it proposes suggested national objectives.
 - Secondly, to support those objectives and give them operational effect, it articulates for consultation principles addressing the policy, legislative and administrative processes of the business tax system.
 - Thirdly, it identifies possible reforms of those policy development, legislative and administrative processes.

To invite discussion on that foundation

1.35 The Review wishes to encourage community debate about each of the components of its proposed reforms.

1.36 Noting that this paper represents the first articulation of such a framework for the business tax system, the Review expects that its initial

statement of suggested objectives and principles is likely to be refined during its consultations. The Review then intends to use that refined framework as a basis against which to test not only proposals coming before it but also all Review recommendations. In doing that, the Review will be recognising that the balancing of competing objectives and principles must ultimately be the prerogative of government, now and in the future.

1.37 The Review is seeking detailed comment on the possible reforms of the policy development, legislative and administrative processes proposed in this paper as they will not be further addressed in the two subsequent papers. The Review's ultimate recommendations in this area will reflect consultation and submissions on these proposals.

1.38 Comments on the analysis and conclusions drawn in Part I will also be welcomed by the Review.