PART I

THE NEED FOR REFORM

Chapter 2

ILLUSTRATING A DEFICIENT FOUNDATION

The business tax system — an important part of Australia's taxation system and its broader economy — has been built upon a deficient foundation.

Taxation of business income is beset by a lack of consistency arising from decades of piecemeal and reactive change. That inconsistency distorts business decision-making and reduces Australia's international competitiveness. The ensuing complexity of the tax law adds significantly to the costs of compliance and administration, fuelling an ongoing cycle in which anomalies and loopholes are exploited and then closed.

Factors evident in the changing business environment, such as increasing globalisation and the growth of electronic commerce, will further expose the weaknesses in the current foundation for the business tax system. The Review believes a strong foundation for the business tax system is essential to support Australia's long-term growth performance as well as the Government's specific reforms announced in *A New Tax System.*

How has the current approach evolved?

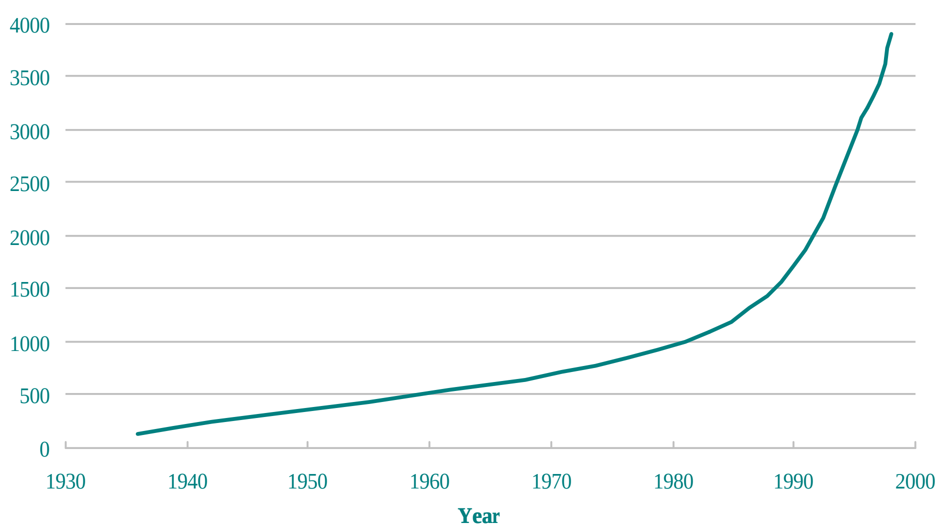
Through an accelerating process of unstructured accretion

Policy development

2.1 The rules governing business taxation are the result of an accelerating accretion of policy changes over several decades. This process of unstructured accretion has increased the complexity of changes and limited their effectiveness. While each policy change, or program of changes, has been designed to address particular problems, those policy changes are now revealed to have been additions to a system lacking a sound foundation.

2.2 Figure 2.1 fits a trend to the growth in pages in the *Income Tax Assessment Act* since 1936. While this is a very rough measure of the growth in complexity of the business tax system, the accelerating growth in the number of pages is remarkable and is indicative of a compounding problem.

Figure 2.1: Pages in the *Income Tax Assessment Act 1936*



Source: Review Secretariat analysis

Response to changes in commerce and the economy

2.3 Individual policy changes have been made in response to demands on the tax system from a changing business environment and from changing commercial practices. For example, the acceleration of legislative changes in the 1980s and 1990s occurred during a period of rapid deregulation and globalisation of the Australian economy.

- A prime example of changing commercial practice is the development of financial markets, with an increasing variety of financial instruments being used.
- In the same vein, the growth of leasing, as opposed to ownership of capital assets, has raised issues for business taxation.

Response to tax minimisation strategies

2.4 Many of the changes to the tax law were prompted by taxpayer responses to distinctions which were essentially arbitrary from a tax policy perspective and gave rise to opportunities to minimise tax. Prior to 1985, the absence of a general capital gains tax meant that there were much more significant incentives to convert 'revenue' income into 'capital' income artificially. That revenue/capital distinction also meant that there was an incentive to invest in assets where a high proportion of the return was in the form of capital gains at the expense of comparably yielding investments producing ordinary income.

Response to anomalies and inequities

2.5 The introduction of dividend imputation responded to the then effective higher rate of tax on income earned through a company and distributed to individual shareholders as dividends. Prior to 1987, the total tax rate on company income that was distributed as a taxable dividend to an individual shareholder on the top marginal tax rate could be as high as 78.4 per cent. Subsequent policy design responses to dividend streaming, franking credit trading and company tax rate alterations, amongst other factors, have transformed the initial imputation regime beyond recognition.

Development of case law

2.6 The impact of the courts on tax law has been profound. In recent years, when the volume and complexity of business income tax legislation have been increasing exponentially, court decisions have caused a re-evaluation of basic concepts of tax law: What is on revenue account and what is on capital account? At what point is an expense deductible? What is tax avoidance?

What are the chief consequences of unstructured accretion?

No uniformity of treatment

2.7 The rules that govern business taxation are lengthy and undoubtedly complex. They are contained in almost 4,000 pages of legislation, and in numerous judicial and administrative decisions and rulings handed down over many years. An important element of the business tax system is the taxation of business income about which key data are provided in Appendix C. The amount of tax collected from business income is a function of both the tax base and the statutory tax rate applied to that base. However, neither the definition of the tax base nor the statutory tax rate applicable is uniform across the full range of circumstances in which business income arises. A very broad description of some key differences in treatment is provided below.

Differential treatment of business entities

2.8 The tax system recognises a large number of entity types, and taxes them in different ways. Different tax treatment affects both the measurement of the tax base in different types of entity and the rate applied to that base. Five main types of business taxpayers are:

- companies;
- individuals;
- partnerships;
- trusts; and
- superannuation funds.

2.9 Most business taxpayers come within one of these broad categories. A variety of modifications, exceptions and special rules apply to adapt those basic rules for different entity types. For example, limited partnerships, public trading trusts and corporate unit trusts are treated as companies for tax purposes, rather than as partnerships or trusts. There are also differences between the taxation of ‘public’ and ‘private’ companies.

2.10 Some commercial activities are being conducted through tax exempt bodies. This results in similar businesses facing totally different tax regimes.

2.11 Significant differences apply in the treatment of business income earned through the different types of entities. Both the tax base (including timing) and the tax rate are affected. For example:

- Companies are taxed at 36 per cent on all taxable income, with imputation credits for this tax paid being attached to dividends, so that the ultimate tax burden on distributed income is generally equal to the marginal tax rate of the shareholder. Similarly, where discretionary trusts distribute taxable income, beneficiaries will pay tax at their full marginal rate, and no tax will be payable directly by the trust. Differences arise, however, where taxable income is retained as it is taxed at 36 per cent for companies and 47 per cent for discretionary trusts.
- Losses incurred by a company cannot be distributed to shareholders to be offset against their other income. Losses incurred by a partnership are, however, distributed among the individual partners.
- Income that is not taxable in the hands of a company because of tax preferences, prior year losses, or other reasons is taxable in the hands of shareholders when distributed as dividends. Similar income distributed by discretionary trusts to beneficiaries is not taxable in their hands.

2.12 These and other examples mean that the tax treatment of income depends on the entity through which it is earned.

The same 'economic' transaction taxed differently according to form

2.13 The same economic transaction should be taxed in the same way regardless of its particular form. Often it is not. This may well reflect the use for tax purposes of legal distinctions that are not appropriate to the taxation context. For example:

- Leasing and purchasing plant can be structured in such a way that the economic form of the two transactions is identical. However, the tax implications may differ between the two transactions.
- The choice between hiring individuals as employees or as individual contractors will lead to different tax consequences, even if the economic substance of the alternatives is the same. The distinction between employee and contractor for taxation purposes presently depends on an application of legal distinctions developed for the quite different purpose of allocating vicarious liability appropriately. Yet, for taxation purposes, the choice ought to be based on the appropriateness of

the pay as you earn mechanism and rates to the particular individual, whether that person is an employee or a contractor for other purposes. Differences in the economic substance of the two choices do not necessarily underlie the difference in the current tax treatments.

- Differences in the economic substance of purchasing all of a company's assets, and simply buying all of its shares, do not justify the differences in the current tax treatment of the two transactions.

Systemic double taxation, multiple loss creation and 'black holes'

2.14 Systemic double taxation and multiple loss creation occur not because of any intent of the law but because of deficiencies in the current drafting arising, at least in part, from the complexities of the current system.

- There are examples where existing rules are not always effective in removing double taxation. An example is the current treatment of buy-backs and liquidations.
- Similarly, the scope remaining for multiple tax loss creation from a single economic loss, through shifting assets between related entities, also reflects the interaction of piecemeal drafting and structural complexity.

2.15 A different form of 'double taxation' occurs where gains are taxed, while related losses or outgoings are either deferred or ignored by the tax system. This produces cases where genuine business expenses are not deductible under current tax law — the so called 'black hole' expenditures. There are some business expenditures where the expense:

- is neither deductible outright, deductible over time, nor eligible for eventual deduction on sale as part of an asset's capital gains tax (CGT) cost base, even though the gains produced by the expense are brought to account by the business income tax system; and
- gives rise to a long term mis-match, where income relating to the expenditure is taxed as it occurs, but the expense itself gives rise only to a long term capital loss.

2.16 Any distinction between expenses which are never recognised by the business income tax system and expenses which are substantially deferred can be more theoretical than real. The present value for tax purposes of an expense that is never recognised is zero; and of an expense that will be recognised only after a long, and perhaps indefinite deferral, is close to zero.

2.17 Black holes can occur in everyday situations, such as when a business incurs architect's fees to extend its business premises, but then decides not to proceed with the renovation. In this case, the fees are 'capital' in nature and so not immediately deductible, they do not form part of a depreciable asset, and cannot be taken into account for CGT purposes because the renovation 'asset' never eventuated.

Inefficiencies in the application of tax rates

2.18 Individual taxpayers are taxed under a progressive income tax scale whereas companies are taxed at a single rate of 36 per cent.

- The imputation system allows individual taxpayers a credit for the tax paid at the company level on dividend income. For taxpayers on marginal rates below 36 per cent this credit will more than offset their tax liability on the dividend income, allowing an offset against tax on other forms of income. The effective tax rate on their dividend income will therefore reflect their marginal tax rate. Where taxpayers have insufficient non-dividend income to fully utilise their imputation credits, the credits will be lost. The effective tax rate on their dividend income will then be higher than their marginal tax rate.
- On the other hand, effective tax rates on taxed or untaxed income retained in companies, prior to its distribution, may be lower than the shareholders' marginal rate of personal taxation. Just as the deferral of tax deductions will lower their value, the deferral of tax liability in this case will reduce its impact.

Anomalies relating to timing and mis-matching

2.19 Timing and matching anomalies abound in Australia's business income tax system. Both can lead to the mis-measurement of the business income tax base and to the over or under collection of tax. It is possible under the current tax system for income to be recognised in one taxation period and associated expenses in another. This can lead to taxpayers incurring a tax loss in one year, yet it may be some time before profits are earned against which that loss can be utilised for tax purposes. In rare cases it may never be utilised. If it were not for the misalignment of income and expenses, the loss would never have occurred and the taxpayer would have reported a lower taxable income in the year the income was earned.

Other business tax anomalies

2.20 Fringe Benefits Tax (FBT) is payable by companies on many expenses they incur which provide a personal benefit to their employees. The rationale for the FBT is that these expenses are equivalent to personal income to the employees, in the same way as wages and salaries, and so should be subject to tax at the marginal tax rate of the employee. Under existing tax arrangements, the FBT is levied on companies at the top personal marginal tax rate, although employees receiving the benefit may be on lower marginal tax rates. If the value of the fringe benefits received were to be taxed in the hands of the employee, then the employee's appropriate marginal tax rate would be used.

2.21 Not all fringe benefits provided by employers can be allocated to individual employees and there are administrative and compliance advantages flowing from the current arrangements. Other possible treatments may be able to achieve a similar result, while being simpler to comply with and administer.

2.22 Employers could potentially pay fringe benefits to employees as cash salaries. Yet, it is not always practically or legally possible to do so and much depends on award arrangements, enterprise agreements and the nature of the benefit itself.

Increased complexity

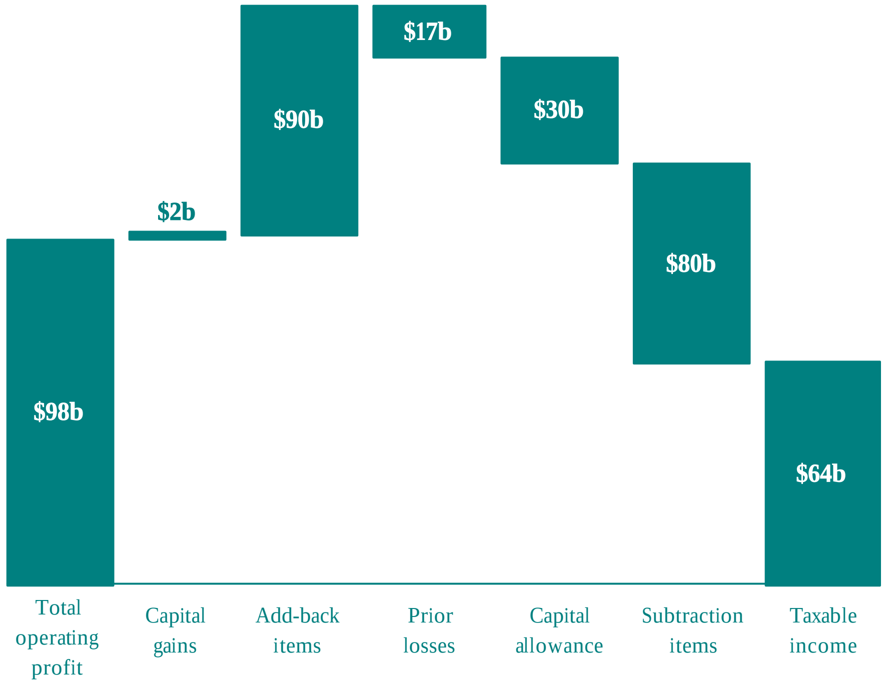
2.23 The long period of building upon a deficient foundation has produced high, and now accelerating, levels of complexity in the business tax system. The sources of this complexity and its costs are further explored in the next chapter, but two illustrations serve here.

Divergence of financial and tax accounting

2.24 A significant divergence exists between the measure of 'profit' used for accounting purposes and the measure of 'taxable income' used for tax purposes. This has often led to discussions about the rate of tax paid by businesses on their *accounting* income — as compared to their *taxable* income. Simplistic conclusions on this topic are often drawn, primarily because of a misunderstanding of the treatment of dividends. Dividends received by companies form part of their profits, but are excluded from taxable income. This ensures that tax is paid only once in a chain of corporate holdings. This gives rise to an apparent low effective tax rate in the financial accounts of the company receiving the dividends.

2.25 The scale of the adjustments that must be made to derive taxable income from a company's accounting profits does, however, indicate a level of complexity in the interaction of the business tax system with financial accounting requirements. Figure 2.2 compares, in aggregate, the accounting profits (as calculated from tax return data) with the taxable income of all companies, and the broad reasons shown on the returns for those differences.

Figure 2.2: Taxable income and accounting profits, 1995-96[(a)]



(a) Income year data. Data for 'add-back items' and taxable income are extracted from unpublished tax return data. Numbers do not add due to rounding.
Source: Australian Taxation Office.

2.26 Significant adjustments between accounting and taxable income are contained within 'add-back items' and 'subtraction items'. Detailed data of the various components making up these columns are not available, but the amounts are known to comprise a great variety of tax and accounting adjustments, both positive and negative. For example, many companies would make adjustments for:

- accounting depreciation and profits on the sale of assets;
- non-deductible entertainment and other expenses;
- movements in employee leave provisions and bad debt provisions;
- adjustments for inter-corporate dividends;

- timing differences between tax and accounting income and expenses; and
- amounts which have been capitalised for accounting purposes.

2.27 The magnitude of these adjustments — individually and in aggregate — relative to the size of profits and taxable income graphically highlights the large number of items businesses account for differently between their financial and tax accounting. It is not uncommon for larger companies to have hundreds of adjustments to make to their accounting profits in order to calculate their taxable incomes.

2.28 As required by its terms of reference, the Review will be consulting on the potential use of accounting principles for tax purposes as one of the issues to be raised in its second discussion paper.

Use of tax expenditures as policy tools

2.29 'Tax expenditures' or 'tax concessions' are variations in the tax system used to effect other policy objectives or to correct perceived market failures. Tax concessions are usually delivered by way of exemptions, deductions, rebates, alterations to the time when income must be recognised or deductions allowed, or reduced tax rates. They reduce or delay the collection of tax revenue, generally with the intention of providing some net benefit to target groups or activities. However, 'second round' impacts may redirect benefits away from their intended recipient. For instance, the benefit of accelerated depreciation may be capitalised into higher prices charged by the suppliers of depreciable assets. The cost of tax expenditures to the revenue neither definitively measures the extent of their economic benefit nor identifies their ultimate recipient.

2.30 Without clear guiding principles, this use of the business tax system to achieve other policy objectives can be a source of complexity. Complex rules are often required to ensure that a tax concession is correctly applied, and in fact, influences the behaviour at which the policy was targeted. Tax concessions may also create anomalies in the business tax system by directing economic resources away from, or towards, particular sectors of the economy, in a way unintended by the original policy maker.

2.31 The estimated cost to the revenue of selected tax concessions provided in 1996-97 is summarised in Table 2.1. The Review has been asked to consider the goal of moving towards a 30 per cent tax rate in the context of a revenue neutrality constraint. Clearly the Review will have to consider the projected contribution of some of these tax expenditures to increased economic growth and jobs compared with the expected contribution from a lower tax rate.

Table 2.1: Revenue costing of selected tax concessions relating to business, 1996-97

Tax concession	Amount ($m)
FBT exemptions	325
FBT allowance on motor vehicles	740
Primary producer averaging	180
Mining capital allowances (a)	370
Development allowances	525
R&D allowances	710
Accelerated depreciation (plant, structures) (a)	1,800
Write-off of expenditure on buildings (a)	510
Interest withholding tax exemption for foreign debentures	730

(a) This estimate is calculated as the difference between deductions available under effective life treatment and the accelerated write-off. In calculating the yearly cost of the concession, allowance is made for any clawback of the tax concession applying to property purchased since the introduction of the measure.

Source: Tax Expenditures Statement 1996-97 (The Treasury). The estimate for accelerated depreciation is an updated estimate provided by the Australian Taxation Office.

What key threats now face the current system?

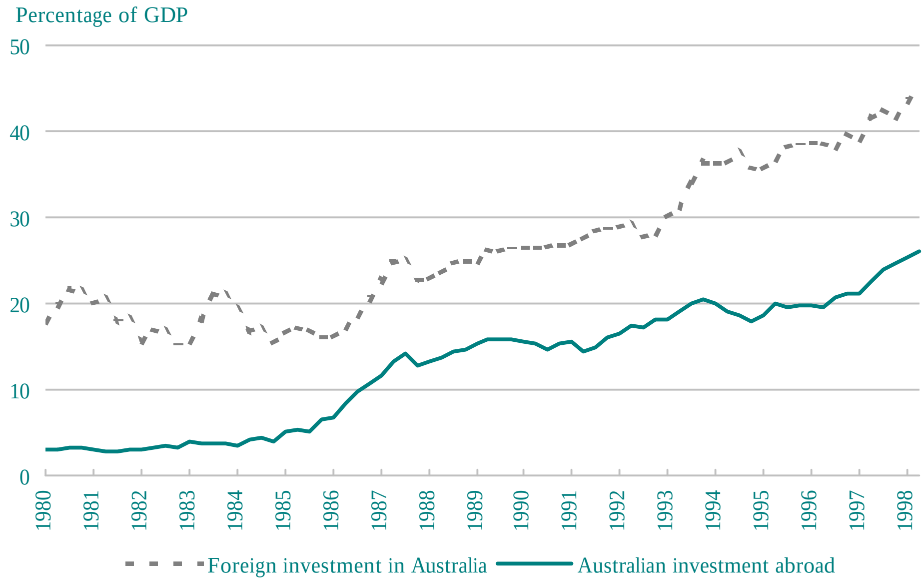
The changing business environment

2.32 Both business generally and the current business tax system face a changing environment creating threats and opportunities. Various threats posed by these changes highlight the inadequacy of Australia's current approach to business taxation in an increasingly complex business environment. Without a strong foundation upon which to build business tax policy, business and policy responses to these threats are likely to create further anomalies and complexity.

Globalisation

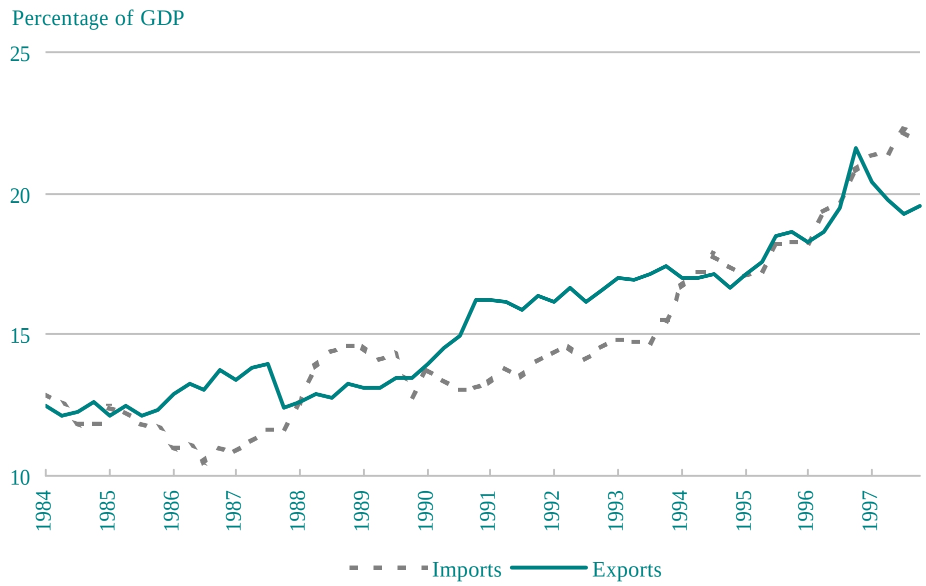
2.33 The continuing globalisation of the world economy means that international competition for resources, particularly capital, is intensifying. Over the past two decades, the integration of the Australian economy into the world economy has increased steadily, particularly in terms of capital (Figure 2.3) but also in goods (Figure 2.4) and services (Figure 2.5). Business taxation will need to be competitive in relation not only to tax base and rates, but also to transparency, certainty and compliance costs.

Figure 2.3: Foreign investment in Australia and Australian investment abroad, 1980-1998



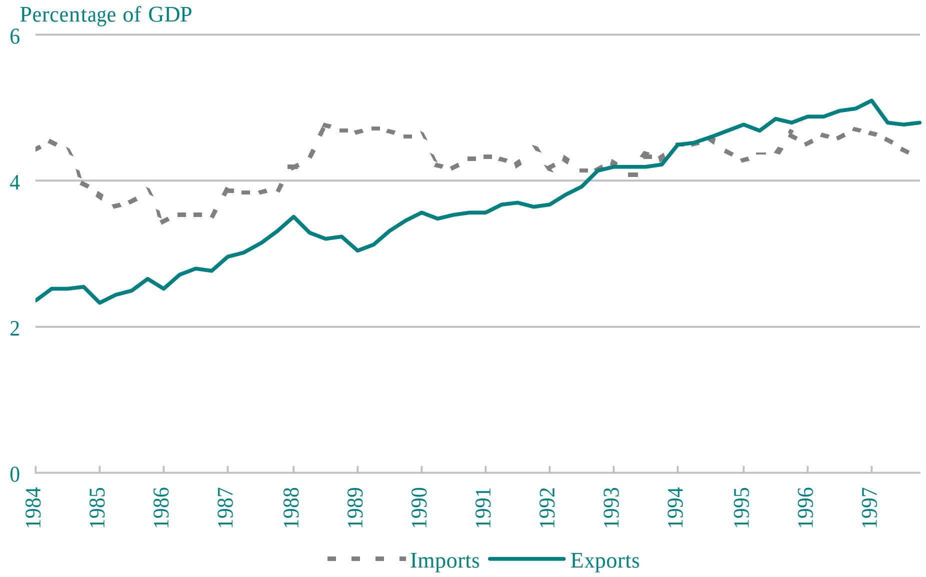
Source: Australian Bureau of Statistics

Figure 2.4: Australian exports and imports of goods, 1984-1998



Source: Australian Bureau of Statistics

Figure 2.5: Australian exports and imports of services, 1984-1998



Source: Australian Bureau of Statistics

Financial innovation

2.34 The financial markets are continually developing new financial products of increasing complexity. The line between debt and equity is becoming more and more blurred, posing challenges to the taxation of financial arrangements which affect Australia's income tax base.

Tax jurisdictions

2.35 Financing and production arrangements for particular goods and services are increasingly likely to spread across a number of tax jurisdictions. This raises questions about which nation's tax regime applies to which parts of the operation. The development of electronic commerce poses particular difficulties in terms of identifying transactions and the jurisdiction in which they take place. This leads to problems in attributing taxable income to particular individuals or entities in particular jurisdictions.

International tax competition

2.36 Competition among countries for taxation revenue poses a significant threat to national revenue bases and effective tax rates. The OECD has recognised the danger that such competition will simply see an erosion of tax revenues without any benefit to individual countries in terms of greater investment. The analogy with the destructive tariff competition of an earlier era is clear.

Taxpayer compliance

2.37 Taxpayer compliance is becoming an increasing problem. The complexity of the system means that even honest taxpayers have difficulty in complying. It also increases the opportunity for tax avoidance — tax engineering designed to circumvent the intent, without breaching the letter of the law. Finally, outright tax evasion continues to be a problem and countering it is more difficult in the increasingly complex and international business environment.

How does the Review respond to this deficient foundation?

With further analysis and suggested reforms

2.38 The fact that the existing business tax system represents an unstructured accretion of legislative changes over decades means that it lacks a consistent framework and an overall coherence. Each change was introduced in response to particular difficulties or policy objectives at the time, but given the starting point it was always difficult to integrate each new change into the existing system. This increased the scope for anomalies to emerge and for the system to become more complex.

2.39 The Review believes that this ongoing process of unstructured accretion and its resulting anomalies and complexity can only be overcome by the establishment of a strong foundation on which to build the business tax system in the future. The need for such a foundation is even more crucial given the changes to the business environment with which the system now needs to cope.

2.40 Chapters 3 and 4 of this paper will analyse further the problem of complexity and the processes that have been used to produce the current business tax system. In later chapters, the Review will make suggestions for consultation about the objectives, principles and processes that should be used to construct this new foundation.