EXPLORING THE PROBLEM OF COMPLEXITY

Complexity is one consequence of the continual building of the business tax system upon a deficient foundation. It has become a recurring complaint — and the attendant call for simplification a recurring theme — in commentary on Australia's business tax system.

Complexity has a technical dimension, of ascertaining the effect of tax provisions, but is more than a matter of statutory volume or opaque language. Its structural dimension is reflected in unintended or inconsistent statutory interactions, as well as excessively specialised provisions lacking general application and adaptability. Complexity also has a compliance dimension for taxpayers, tax administrators, the judiciary, policymakers and other stakeholders.

Complexity causes economic costs on a large scale. However, simplification will also involve some resource costs and require trade-offs in relation to both equity and economic efficiency concerns. The Review will focus initially on options which can produce benefits at little cost.

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What is complexity?

More than a matter of volume or language

3.1 Complexity and simplicity, like various systemic properties such as efficiency or equity, are concepts lacking simple definitions. It may be anecdotally convenient, and not unduly misleading, to equate complexity to some index of the growth in volume of tax legislation — as, for example, the Review has done at Figure 2.1. Nevertheless, it is clear that short provisions of legislation may not be simple and long provisions may not be complex. Nor is the issue of complexity solely one of legal language: no application of plain English may be able to render intelligible a poorly defined policy.

3.2 Amongst the senses of complexity relevant to the tax debate are:

- technical complexity;
- structural complexity; and
- compliance complexity.

3.3 *Technical* complexity arises wherever ascertaining the meaning of tax legislation is less than straightforward. It is thus more a static property of the tax legislation — although the operation of case law may produce dynamic evolution in the accepted interpretation and application of particular provisions.

3.4 *Structural* complexity refers to the poor structuring of provisions and to the unintended or inconsistent interaction of different provisions of the tax legislation — on the one hand, producing uncertainty about tax outcomes and, on the other hand, opening up opportunities for abuse. As a systemic property of the business tax system, structural complexity fuels a dynamic process of exploitation and anti-avoidance response that generates escalating complexity.

3.5 *Compliance* complexity arises wherever taxpayers and tax administrators bear an excessive burden of record-keeping, tax form completion or other compliance activity. Compliance complexity includes the information demands imposed on business taxpayers, advisers and administrators, not only by the volume of that part of the business tax law with which they have to deal, but also by the associated structural complexity.

How can complexity be illustrated?

3.6 The examples below illustrate the complexity that has been created in the Australian business tax system from the process of accelerating and unstructured accretion discussed in Chapter 2.

3.7 Projects like the rewrites of the income tax and sales tax legislation have identified how the existing law has been corrupted by complex policy and legislation. There are numerous examples in the taxation system of very different treatments being afforded to arrangements that are substantially similar in nature. Indeed, when now reviewing some of the structures previously enacted, it is sometimes difficult to understand the policy rationale for the difference in treatment.

3.8 However, at this time it is not necessary to attempt to understand, or establish the precise reason for, various past treatments being decided upon. What is apparent is that the different treatments would not have arisen to the extent they have if policymakers had been guided by a framework of principles at policy, legislative and administrative levels. Such a framework would have ensured that policy developments minimised the boundaries to be described in the legislation, and that standard rules were used wherever possible. The resultant legislation would be simpler and shorter, and thus more certain, than that experienced over recent years.

Example 1: Withholding systems

3.9 Tax on both salary or wages and non-salary or wages income is collected in a number of ways. For this case study eight different systems under which tax is withheld by a payer are considered. The study tracks the respective payments through the stages of remittance to the Commissioner of Taxation, variations to the rate of deduction or exemption from deduction, and refunds of deductions. Figure 3.1 lists the multitude of treatments required by the existing legislation.

Figure 3.1: Existing withholding systems

Question	Pay as You Earn	Prescribed Payment System	Reportable Payments System	Dividend Interest Royalty	Mining (a)	Natural Resources Payments (b)	No Tax File Number on Investments	Withdrawal of Farm Management Deposits
When must the withholder pay amounts to the Commissioner?	Large remitters - within 6-9 days of withholding Medium remitters - within 7 days after month of withholding Small remitters - within 7 days after quarter of withholding			Within 21 days after month of withholding		Within 14 days after month income paid	Within 21 days after month income paid	Within 21 days after the month of withholding
When can instalments be varied?	If special circumstances or, if employed successively by 2 or more employers	If standard per cent differs from expected tax, and obligations met for last 12 months	Never	If special circumstances	Never		If a partly franked dividend from a public company	Never
When are instalments exempt?	If exempt certificate	Payee has met obligations for 3 years or unreasonable not to exempt	If tax file number quoted	If special circumstances		Never	7 specific exemptions (eg; interest <$120pa)	If withdrawal not assessable or certificate that payee is having serious financial difficulty
When are incorrect instalments refundable?	No entitlement at law, though it is administrative practice to follow the 'fair and reasonable' test under prescribed payment system provisions	If fair and reasonable	If special circumstances and fair and reasonable	Never			Payee applies to payer by 15 July. Afterwards payee applies to Commissioner subject to conditions	Administrative Appeals Tribunal decides that certificate of serious financial difficulty should have been issued

3.10 If a single set of rules had been uniformly applied, rather than each of these systems of withholding having a separate set of rules designed for them, the resultant system would be far simpler. Subject to the form of the rules that might be agreed in development of the Pay As You Go proposals in *A New Tax System*, a uniform withholding system perhaps could be along the lines of Figure 3.2.

Figure 3.2: How withholding systems could be standardised

Q When must the withholder pay amounts to the Commissioner?	**Large remitters - within 6-9 days of withholding** **Medium remitters - within 21 days after month of withholding** **Small remitters - within 21 days after quarter of withholding**
Q When are instalments exempt or able to be varied?	**If it is probable that there will be a significant over- or under-deduction of instalments;** **or** **If there are special circumstances**
Q When are incorrect instalments refundable?	**If payee applies to payer during the financial year or by 21 July after the end of the financial year** **or to the Commissioner afterwards**

3.11 A standardised withholding system could leave in place different withholding bases. If they serve separate policy needs, they will still do so once collection, variation, exemption and refund are simplified to a single system.

Example 2: Capital allowances

3.12 A general rule of the taxation system is that capital expenditure is not deductible when paid, but is recognised over the life of the benefit. There are, however, circumstances where capital expenditure may be deductible immediately, others where it is deductible over a timeframe other than the life of the benefit, others where the expenditure is deductible upon disposal of the benefit acquired, and still others that are not deductible. The existing legislation contains detailed sets of provisions to deal with the treatment of over thirty-seven types of capital expenditure, illustrated in Figure 3.3.

Figure 3.3: Deductibility of capital expenditure

Equipment and Machinery	accelerated write-off quicker than life of equipment
Cars and Motorcycles	accelerated write-off quicker than life of equipment but less accelerated than machinery and equipment
Hotels and Motels	25 years
Industrial Buildings	25 years
Rental Buildings	40 years
Timber Mill Buildings	shorter of life of building and 25 years
Mining Buildings	shorter of 10 years and life
Quarry Buildings	shorter of 20 years and life
Office Buildings	40 years
Lease Document Expenses	immediate deduction
Establishing Longer-Term Loan	shorter of life of loan and 5 years
Creating Intellectual Property	effective life of asset
Registering Intellectual Property	immediate deduction
Australian Films	immediate deduction
Prepaid Contracts	shorter of life of contract and 10 years
Horticultural Plants Establishment	accelerated write-off quicker than life of plant
Grapevines	4 years
Electricity Connection	10 years
Telephone Connections	10 years
Mining Exploration	immediate deduction
Quarry Exploration	immediate deduction
Mining Operations	shorter of 10 years and life
Quarry Operations	shorter of 20 years and life
Mining Transport	shorter of 10 years and life
Petroleum Pipelines	10 years
Quarry Transport	20 years
Forestry Roads	shorter of life and 25 years
Research and Development	immediate deduction
R&D Pilot Equipment	accelerated write-off quicker than life
Election Expenses	immediate deduction
Environmental Impact Statements	shorter of 10 years and life of project
Pollution Control and Waste Mgmt	immediate deduction
Farm Water Conservation & Conveyance	3 years
Landcare (Fences, Levees)	immediate deduction
Computer Software	2 ½ years (proposed)
Spectrum Licences	effective life (proposed)
Wasting Assets Not in Other Boxes	capital loss on expiry of the asset

Notes:

1. In addition to rules for when capital expenses can be recognised, there are concessional subsidies for some types of capital expenditures that allow taxpayers to recognise part of the cost twice — once through the normal cost recognition rules and an immediate deduction for part of the cost in addition to the full recognition under the normal rules. The concessional additional deductions include:
   - large development projects: additional immediate deduction of 10 per cent of cost under the development allowance rules;
   - research and development: additional immediate deduction of 25 per cent of cost; and
   - research and development equipment: additional deduction over an accelerated depreciation period.
2. Capital expenditures for non-wasting assets may be recognised when the assets are sold.
3. Capital expenditures for wasting benefits that are not separate assets and which do not fall into any of the amortisation regimes are never recognised for tax purposes and are known as ‘black hole’ expenses.
4. Within the depreciation provisions there are several regimes including an option to ‘pool’ assets which has rarely (if ever) been used, and special rules regarding assets acquired under hire purchase or situated on Crown leases.
5. Several provisions severely restrict or eliminate capital expenditure deductions otherwise available depending on the tax status of the ultimate asset user, the type of finance involved, and the degree of control the owner enjoys over the asset.

3.13 From a high level principle approach there are three basic questions to be addressed in determining the taxation treatment of capital allowances. Those questions are:

- Who deducts?
- Over how long? and
- What is the effect of disposal?

3.14 When these questions are answered in accordance with the terms of the existing policy, as reflected in the current law, a wide number of treatments emerge. This is because many different regimes have been constructed to deal with the capital allowance question. These regimes do not reflect the consistent application of a common principle and differences between them are not always explained by explicit policy decisions. If, for example, a uniform policy position in respect of deductible capital expenditure had been adopted, the complex, *ad hoc* and inconsistent approach reflected in the legislation today would have been avoided. The Review will be returning to such questions in its second discussion paper.

Example 3: Non-arm’s length transactions

3.15 The income tax legislation contains more than one hundred provisions dealing with non-arm’s length transfers of property for more or less than its market value. Different terminology is used throughout the legislation to describe non-arm’s length relationships (for example, ‘parties not at arm’s length’, ‘associates’, ‘relatives’, etc.) and each of these is defined many times, often in an inconsistent manner. Almost all of the provisions were inserted in the legislation as *ad hoc* responses to particular cases or schemes and almost all address only those particular situations, failing to support general principles.

3.16 A survey of only a few of the provisions applying to two types of assets, trading stock and depreciable property, illustrates some of the anomalies and inconsistencies in the legislation dealing with non-arm's length transactions.

Table 3.1: Trading stock acquired for less than true market value

Situation	Value used
General rule	Actual amount paid
Acquired from vendor selling outside existing course of business	Market value
Acquiring interest (shared ownership)	Market value, but joint election by all parties to use book value of the previous owner if lower
Acquiring upon death of the previous owner	Market value, but election by personal representative to use book value of the previous owner

Table 3.2: Property subject to capital allowances

Situation	Value used by transferor	Value used by transferee
General rule	Market value	Market value
Intellectual property sold for less than market value	Market value	No rule
Intellectual property gifted (nothing received)	The greater of: the item's written down value; and its market value at the time of the balancing adjustment event	Transferor's unrecouped expenditure (may be adjusted if the property is a licence)
Mining building sold for less than market value or gifted	Market value	Market value
Timber mill building sold for less than market value or gifted	Market value	Market value
Other buildings or structures	No rule	No rule

What are the sources of complexity?

3.17 A range of factors interact to produce tax law complexity.

Black letter law

3.18 A drafting philosophy predicated, in part, on enumeration of specifics rather than enunciation of principles and, in part also, on fine-tuned policy responses to the depredations of tax avoiders, minimisers and evaders has contributed directly to the volume and complexity of the tax legislation. Reinforcing such responses have been judicial interpretations of tax legislation that — in the absence of clear objectives and principles, either express or implied — have tended to resolve individual cases without systematically balancing wider national interests in an effectively and sensibly functioning tax system. This is not a problem confined to the tax arena but appears in any legislation dealing with complex commercial arrangements.

Grafting of legal meaning

3.19 The business tax system uses many terms that have legal meanings developed for different purposes. For example, the income tax legislation contains no definition distinguishing between an employee (subject to Pay As You Earn (PAYE) withholding of tax) and an independent contractor (exempt from PAYE withholding). Tax law has adopted a distinction developed in the context of the tort law issue of when employers will be 'vicariously liable' for the acts of their employees. The basis of the tort law distinction bears no necessary relevance to the need for the distinction in modern tax law.

3.20 Similarly, the tax legislation distinguishes between capital gains and other gains, but contains no definition of the distinction. Again, tax law has drawn upon a distinction, originally developed for trust and property law purposes, to classify some types of employment, business and investment income as 'capital gains' for income tax purposes. The distinction in trust and property law has no obvious relevance to taxation.

Policy instability

3.21 Instability in key areas of the tax law (for example, depreciation provisions; other investment incentives such as R&D or the development allowance; and superannuation) has promoted further complexity via transitional arrangements, eligibility criteria and grandfathering provisions. In large part, such policy instability reflects multiple objectives served by the tax system —revenue-raising, business cycle management, industry policy, distributional, social policy and market failure objectives — and changing priorities amongst those objectives over time.

Tax preferences

3.22 New tax preferences require ring-fencing, which adds to complexity. Potential tax arbitrage — occasioned by progressivity of tax rates, differentiated tax treatment of entities and investments and the interaction of new with old preferences — typically underpins the need for such ring-fencing. In turn, that complexity interacts with existing complexity in the business tax system to alter taxpayer behaviour in unexpected ways, leading to anti-avoidance responses and still further potential changes.

Tax reform

3.23 Unpalatable or counter-intuitive as the conclusion may be, the legacy of tax reform in the past two decades has been increased complexity of the tax law. Reform has tended to add new features to the tax system, rather than reconstructing the whole system so that it integrates solutions to new problems into a new framework. While in part that is no more than the above factors writ large, along with the expansion of taxing arrangements (for example, capital gains tax (CGT), fringe benefits tax or imputation), in part also it reflects the myriad trade-offs that have been required to achieve the necessary support for reform packages.

Differentiated taxation of entities and investments

3.24 The differentiated tax treatment of entities or of investments is also a significant contributor to tax law complexity. A significant rationale for the Government's strategies announced in *A New Tax System* is to address those sources of complexity.

Policy framework

3.25 Related to, but separate from, policy instability as a source of complexity is the role of the business tax policy framework — taken here to connote the set of typically implicit policy principles reflected in the fine detail as much as in the broad structure of the tax legislation. More a patchwork quilt than a unified set of tax principles, that framework, as previously discussed, is flawed, inconsistent, excessively differentiated and insufficiently adaptable — characteristics each making their own continuing contribution to tax law complexity. The earlier examples illustrate this factor amongst others.

Progressivity of personal tax system

3.26 Fundamental to the overall tax system — both as a social policy objective and as a key driver of complexity — is the progressive rate structure of the personal tax system. Collectively, taxpayer behaviour tends to ameliorate the degree of formal progressivity legislated into the personal income tax system. For example, taxpayers are able to exploit the difference between the top marginal personal tax rate and the company tax rate to defer payment of tax. Complex interactions amongst differentially taxed entities, tax preferences, debt and equity, domestic and foreign source income, ordinary and capital income all combine to produce effective personal tax rates that may be not only unintended but often unforeseeable by policymakers. Incentives for income conversion, income splitting and deferred taxation are all compounded by the progressive rate structure. Complex legislative amendments seeking to defend the legislated degree of progressivity are regularly made to respond to this collective behaviour of taxpayers, inducing still further behavioural responses by taxpayers.

Equity

3.27 Equity concerns other than progressivity also contribute to complexity. Transitional arrangements and grandfathering provisions are frequently necessary to facilitate equitable reforms that do not unfairly affect existing arrangements, accrued entitlements and long term planning. The complexity of current superannuation arrangements is a topical illustration. On the other hand without these arrangements, uncertainty would increase and this has its own costs.

Taxpayer coverage

3.28 The past two decades have seen a clear trend for more and more entities, especially individuals, to become subject to a larger tax law 'footprint'. While complex features of the system once affected few taxpayers, now complex features affect many. CGT is an obvious example, but there are many others (such as the various reporting systems), which are often driven by legitimate concerns about avoidance or evasion. Complexity here refers not only to the number of taxpayers interacting with the tax system but also to the qualitative nature of the average interaction. The 124-page TaxPack, with its 60-page supplement, is but the most obvious manifestation of the increased complexity associated with this trend.

What are the costs of complexity?

The cost of complexity

3.29 Like the business tax system, simplification is itself a complex process and requires more than superficial analysis. It is not something identifiable that has been grafted onto the tax system and can likewise be excised. As a result, neither diagnosis nor cure is straightforward.

3.30 In practice, taxpayers interact selectively with the business tax system. Small businesses may have very little exposure to international dimensions of that system; information-based businesses are likely to have much more limited exposure to depreciation write-offs than manufacturing businesses; multi-national businesses potentially face the widest exposure to the tax legislation and so on. The nature of those exposures is likely to affect differentially the benefits and costs of particular simplification strategies.

3.31 From a national perspective, however large or small are the economic costs of complexity borne by taxpayers, their sum is clearly an economic cost on a much larger scale. These costs have not been adequately recognised in the policy development, legislative and administrative processes. Moreover, business tax simplification is an economic activity with a public good characteristic: while the costs of individual efforts to achieve simplification (such as lobbying, educating, and representation) are privately shouldered by some, any benefits from such efforts may accrue to all.

The cost of simplification

3.32 Simplification does not come without a cost. It would require the devotion of considerable resources by both the public sector and the private sector. It is well recognised that reduced complexity may be at some cost in terms of equity or economic efficiency. Simplification would inevitably affect the impact of business taxation, with the possibility of both advantages and disadvantages to taxpayers in terms of the tax liability they face.

3.33 While accepting that there needs to be a balance struck in pursuing greater simplicity, the Review believes that current arrangements fall a long way short of giving appropriate weight to simplicity. In response to that recognition, the Review therefore proposes to focus its attention initially on options which seem fairly likely to produce benefits at little cost.