

Part II

Building a strong foundation

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APPROACHING THE TASK OF REFORM

Part I provides an account of business income taxation and the current processes for policy development, legislation and administration. This account illustrates the need for a strong foundation for the business tax system.

The Review proposes for consultation a strategy for building that foundation. This encompasses a framework for business taxation, made up of national objectives and supporting principles and reform of the policy development, legislation and administration processes.

The strategy will recognise the core revenue-raising function of the business taxation system, including the role of entity taxation in fulfilling that function.

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How should the task be approached?

Through a strategy for fundamental reform

The current system has severe limitations

5.1 Part I of this paper has highlighted a number of conclusions about the business tax system taken as a whole:

- the central interface of that system — the business tax legislation — is excessively complex, as illustrated in part by the exponential growth in its volume, and is far from user-friendly;
- a major component of the system, the taxation of business income, operates in such a way that business decisions about investments and entities are far from tax-neutral;
- major drivers in the business tax environment — for example globalisation, electronic commerce and financial innovation — will increasingly expose the weaknesses in the business tax system, with the resulting policy responses likely to cause still greater complexity;
- there are few mechanisms operating to resist the trend to greater complexity and virtually none to reverse it; and
- the business tax system is a major asset in our system of governance, which has evolved, and continues to operate, with largely implicit system specifications.

5.2 The lack of a sound foundation for the business tax system is therefore the key focus of the Review's initial reform strategy set out in this paper. That strategy addresses two principal problem areas: systemic limitations of business taxation in respect to both design framework and design process.

Reform to be systemic yet revenue neutral

5.3 A review of the performance of the business tax system, particularly with a view to its radical improvement, must be undertaken against a cohesive framework. *Ad hoc* approaches are likely to offer band-aid solutions for what is essentially a problem in dynamic system re-engineering. As a complex adaptive system, not only do many of the major building blocks of the business tax system need repair and replacement — as proposed in *A New Tax System* — but the core processes

delivering business tax outcomes need fundamental recasting. Accordingly, the Review's initial reform strategy begins to address that challenge of re-engineering the business tax system's operational infrastructure.

5.4 The Review's terms of reference impose a clear revenue constraint in terms of the reform strategies announced in *A New Tax System*. Hence consideration by the Review of reforms to the system will need to be conducted against that baseline in a revenue-neutral setting.

What is the strategy?

One that establishes a clearer framework and better processes

Facilitating improved performance

5.5 The Review's approach to reform is based upon the premise that fundamental reform of the business tax system requires, as an essential first step, definition of a sound framework, consisting of a set of national objectives and supporting principles, to guide its operation. Without this framework, there can be no agreed prescription for improved performance. The Review is confident that a process of national consultation will produce genuine progress towards consensus on the need for, and substance of, such a framework.

5.6 Accordingly, while recognising the overall revenue-raising *function* of the system, the Review's initial reform strategy for the business tax system is:

- to suggest a framework comprising national *objectives* to constrain the design and operation of the business tax system in meeting its revenue function and *principles* on policy, legislative and administrative levels essential to achieving those objectives; and
- to suggest concurrent reforms to the policy, legislative and administrative *processes* which apply the national objectives and principles in their day-to-day operation. The suggested reforms include a strategy for simplification.

5.7 Succeeding chapters of this paper will develop options for reform in accordance with this strategy in the following way:

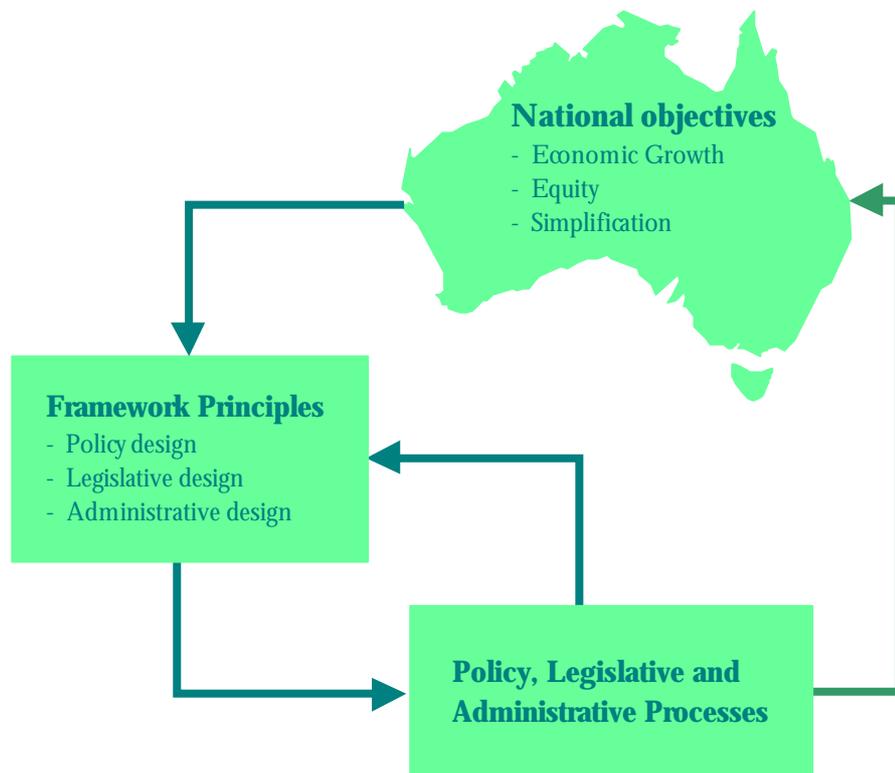
- Chapter 6 will outline suggestions for the substance of the proposed framework;

- Chapter 7 will outline options — as required by the Review’s terms of reference — for reforming the policy, legislative and administrative processes at the core of the business tax system, and include a strategy for its simplification; and
- Chapter 8 will address specific issues relating to tax administration.

Allowing for ongoing adjustment

5.8 Figure 5.1 shows how key components of the business tax system infrastructure are assumed to interact.

Figure 5.1: Interaction of objectives, principles and processes



5.9 The Review expects that the suggested national objectives, in providing high level guidance, will be particularly stable over time. Nevertheless, as the feedback to those objectives from the policy, legislative and administrative processes is meant to convey, their relative weighting is likely to change as the government of the day modifies its business taxation policies to reflect its wider priorities.

5.10 These modifications will necessarily impinge on the operation of the framework principles. These principles will also be affected by, as well as directly influence, the ongoing operation of, and the balance between, the policy, legislative and administrative processes of the business tax system.

Why shouldn't business entity taxation be abolished?

Abolition is neither feasible nor desirable

5.11 The primary function of business taxation, as with most taxation, is to provide a broadly accepted means by which the Commonwealth can cost effectively collect stable and sustainable revenue. Taken in a national interest perspective, the Review expects that this revenue-raising function is well understood and widely recognised. The Review therefore sees no need to question that core function but believes it should be expressly defined so that the fundamental purpose of the business tax system is clear.

5.12 From time to time the suggestion has been made that the function of raising revenue can be achieved by the abolition of business entity taxation, accompanied by a complete shifting of that tax burden to the level of personal taxation. It has been suggested that this would effect significant simplification. While the Review notes the potential simplification benefits, it considers such abolition of business entity tax to be neither feasible, in terms of the impact on revenue, nor desirable, given the adverse impact on the efficiency and equity of the tax system.

5.13 Entity taxation, by withholding tax payments at the income source that are then creditable to Australian taxpayers, backstops the integrity of personal tax collections. As well, delaying the payment of tax on business income earned through entities until distributions are made to individuals would impose substantial public debt interest costs on the Commonwealth budget and inequities between taxpayers. Entity taxation also ensures an Australian return on profitable inbound investments: abolition would lead to a much reduced return and may also transfer revenue to foreign treasuries for no impact on the incentive to invest in Australia.

5.14 In the light of these considerations, the Review's terms of reference, and the Government's announced strategies for business tax reform, the Review will not be examining further the case for abolition of business entity taxation.

