

## ESTABLISHING FRAMEWORK OBJECTIVES AND PRINCIPLES

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In meeting the Commonwealth's revenue targets, the business tax system should be designed to meet three national objectives: optimising economic growth, ensuring equity and facilitating simplification.

While government must determine how to balance those objectives in accordance with its broader policy objectives, the national objectives should be given operational effect through principles supporting the policy, legislative and administrative processes characterising the business tax system. Articulation of these supporting principles potentially enables greater clarity in evaluating and improving performance of the business tax system.

Three categories of supporting principle are required: policy design principles to specify key criteria for policy development, legislative design principles to guide tax legislation development, and administrative principles to govern taxpayer interaction with the tax administration. The policy design principles are directed primarily to achieving the growth objective; various principles specifically address fairness concerns; and consistent application of the collective design principles would facilitate simplification.

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## *What role do objectives and principles play?*

They provide a design framework for the business tax system as a whole

6.1 National objectives have the role of providing high level guidance for the design and operation of the business tax system. The prime function of the business tax system is to raise revenue but the national objectives recognise that this has to be achieved subject to important constraints. The focus should be on a tax system that delivers socially optimal outcomes — particularly job growth and productivity performance — over the long term.

6.2 The supporting principles proposed by the Review in this chapter offer useful guidance, without being definitive, about the best way to achieve the national objectives. Typically, most principles will retain a range of possible application, so that judgments will inevitably remain necessary. The supporting principles are thus more open to debate than the objectives themselves. Nevertheless, articulation of supporting principles can be expected to foster rational debate and to make tax design judgments both more transparent and easier to debate constructively.

6.3 The Review proposes three categories of supporting principles relating to:

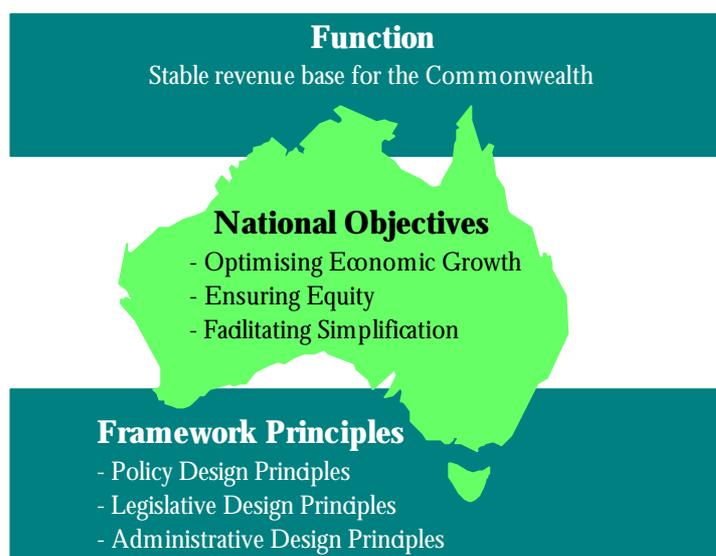
- policy design;
- legislative design; and
- administrative design.

Naturally there are linkages across these three groupings and interactions between them.

6.4 As the national objectives and supporting principles are intended to constitute a coherent framework for the development and maintenance of the business tax system, the Review is looking for response to their substance. Following refinement, the framework will be applied to consideration of the detailed entities and investments issues raised under the Review's terms of reference.

6.5 Figure 6.1 shows how the objectives and principles are related and how together they impact on the other elements of the business tax system.

**Figure 6.1: Summary of proposed framework for business tax design**



## *What should be the objectives of business taxation?*

6.6 To facilitate consensus, the Review believes that the objectives must avoid being too prescriptive. They must also be clear, understandable and free of unnecessary jargon.

6.7 Box 6.1 defines three national taxation objectives being suggested by the Review as a basis on which to structure debate towards formation of a national consensus.

### **BOX 6.1: NATIONAL OBJECTIVES**

#### **Objective**

- |                                       |  |
|---------------------------------------|--|
| <b>1. Optimising economic growth</b>  | Imposition of the smallest possible impediment to economic growth, including jobs growth, thereby reducing the resource allocation and risk-taking distortions necessarily associated with revenue raising from business taxation. |
| <b>2. Ensuring equity</b>             | Application of equitable tax arrangements to all investments and other business activities.  |
| <b>3. Facilitating simplification</b> | Optimum design of the business tax system — from policy to legislation to administration — to ensure maximum simplicity, certainty, stability and voluntary compliance as well as lowest system operating costs.                   |

## 1 Optimising economic growth

6.8 In raising revenue for the Commonwealth the business tax system should interfere to the least extent possible with the best use of existing national resources, with the efficient allocation of risk and with national economic growth in the longer term.

6.9 The rationale for this objective springs from broader social goals. Irrespective of taxation arrangements, Australia's economy — its market structures as well as its complementary institutional arrangements — needs to be marshalled with the objective of ensuring that investment funds are allocated in such a way as to optimise economic growth. Our business tax arrangements should not be allowed to affect this allocation any more than is necessary.

6.10 Of course, there are examples where existing market forces and institutional structures do not produce an optimum outcome and in those cases the tax system may sometimes be the best instrument to correct that deficiency.

## 2 Ensuring equity

6.11 Equity, like simplicity, is one of the more complex properties of a tax system, and is difficult to define with precision. It may refer variously to:

- taxpayers in similar circumstances being treated in a similar way (*horizontal equity*);
- those who earn more paying higher rates of tax (*vertical equity*);
- administrative procedures that do not inappropriately advantage some and disadvantage others (*administrative equity*); or
- the fairness of transitional arrangements associated with changes to tax legislation (*transitional equity*).

6.12 Multifaceted though it is, no acceptable system of taxation can proceed without due weight being given to equity considerations — the history of democracy has many object lessons in that regard.

6.13 The personal tax and welfare systems are the main instruments for handling community preferences about vertical equity. To the extent that the business tax system ensures business income is ultimately taxed in the hands of the individual beneficiaries then the personal income tax system will address questions of vertical equity in relation to business income. The taxation of business income contributes to horizontal equity by seeking to ensure consistent treatment of income in whatever form and from whatever source.

6.14 Concerns about transitional and administrative equity also must be taken into account, the more so where a major reform plan of the kind announced in *A New Tax System* is proposed for implementation.

### 3 Facilitating simplification

6.15 On any of a number of criteria the tax legislation supporting the business tax system, and representing its principal user interface, is complex. It is excessively long, technically intricate, quite inconsistent in its application, plagued by unnecessary policy differentiation, too susceptible to the adoption of form over substance, generally fails to disclose its policy intention, is costly to administer and comply with, and is too prone to frequent remedial and anti-avoidance repair.

6.16 While the law is the manifestation of the problem, in the opinion of the Review, the complexity problem is a deeper one:

- of not building the tax system on the basis of widely applicable objectives and consistently applied principles; and
- of not taking sufficient account of administrative and compliance mechanisms in designing rules to give effect to policy.

6.17 Simplification can only be pursued through optimal design of the business tax system — so that achievement of this national objective is intrinsically a multi-dimensional task of ensuring the tax legislation has:

- much needed clarity via structured application of expressed principles;
- far greater simplicity, certainty, uniformity and consistency of application;
- improved adaptability in the face of continuing change; and
- significantly increased ease of compliance and administration.

6.18 Simplification relates not only to the tax legislation, but also to tax administration where the success of simplification should lead to improved levels of voluntary compliance with the tax system. Unless the business tax system can achieve substantial voluntary compliance by the large majority of taxpayers, it will also fail to achieve the other national objectives and will probably not satisfy its revenue targets.

6.19 As opposed to the framework objectives and principles, the *process* or operational mechanics of tax design has also been criticised as a source of unnecessary complexity. The principles of tax system design and the process of carrying them out are closely related, with the Review's terms of reference also requiring it to address matters of process. The Review's process reform strategy will be set out in Chapter 7.

## *How can these national objectives be reconciled?*

### By making judgments about trade-offs and weighting

6.20 The Review would expect that the intent of each of these three national objectives is likely to receive widespread support (leaving aside the issue of their precise formulation to best capture that intent).

6.21 But immediately posed by these suggested national objectives are three important questions:

- What are the sources and extent of mutual interactions amongst those objectives (*trade-offs*)?
- What is the relative importance of each objective in designing the business tax system (*weighting*)?
- How are those objectives to be given operational content (*implementation*)?

### **Making trade-offs amongst the national objectives**

6.22 Any practical business tax system will be subject to trade-offs amongst these national objectives.

6.23 Equity and complexity, the latter representing system design outcomes, certainly interact. Complexity in the tax legislation is created, for example, by the capture of individual taxpayer circumstances or by the provision of transitional provisions in meeting equity objectives. Conversely, increased complexity diminishes equity where the relative accessibility of the business tax law is differentiated by taxpayer training, experience or income, or where taxpayer capacity to exploit the opportunities created by an increasingly complex code is similarly differentiated.

6.24 Tax incentives directed at repairing market deficiencies and thereby promoting productivity growth may likewise increase complexity. This may result, for example, from the need to 'ring fence' incentives to ensure they are well targeted. Simultaneously, existing tax law complexity may alter or impair the intended effect or overall efficacy of incentives. Tax incentives may diminish equity because of restricted eligibility or unintended effects; equity concerns may mitigate the efficacy of tax incentives (for example, where savings incentives run foul of equity objectives).

6.25 In any review of the business tax system, debate is accordingly to be expected about the nature and extent of these trade-offs.

## Adjusting the weighting of national objectives

6.26 Debate must also focus on the weighting to be given to these objectives. As a general principle, the Review considers that determination of those weights is a matter for the government of the day, so that any modification of the system should not impinge on the prerogative of government to determine policy in any field, not only in respect of taxation. Different governments will apply different weights to efficiency and equity, for example, with differing consequences for tax system design and complexity.

6.27 It seems reasonably clear that the manifest complexity of the business tax system is a residual consequence of pursuing other objectives for the business tax system with a relatively low weighting for tax legislation simplification. In many instances the Review believes that tax system design could have been given greater weight at no cost, and indeed some benefit, to the achievement of other objectives.

6.28 If this preliminary assessment is supported by its consultative processes, the Review would recommend that substantially increased weighting be accorded the national objective of simplification. To give practical effect to that imperative, following consultation the Review will be making a number of specific recommendations about the policy, legislative and administrative processes characterising the business tax system.

## *How are the national objectives to be achieved?*

### With the support of clearly articulated design principles

6.29 In relation to the implementation of the national objectives in a practical manner, the Review is suggesting specific supporting principles as a basis for consultation and subsequent adoption during the Review's further processes.

6.30 To aid debate, public understanding and effectiveness, the supporting principles should be jargon-free, clearly expressed and operationally focused. To that end, the Review has opted for the most understandable, rather than the most elegant or compact set of principles.

6.31 Some such supporting principles as these, whether articulated or not, must necessarily be used by those involved in designing business tax policy to make choices between implementation options. They sketch a broad, rather than a precise, road map for moving more efficiently towards desired outcomes on the national objectives. As such, they are necessarily

more open to debate than the higher level national objectives to which they give expression. For that reason, it is all the more important that they be articulated as transparently as possible — and not, as may happen now, be left undefined, implicit or disagreed.

6.32 Policy design principles are primarily directed to the achievement of the economic growth objective, but will also have consequences for the equity objective. Thus measuring income comprehensively ensures resources are utilised efficiently, but also has equity benefits in taxing all forms of income comparably. A number of the principles directly address the equity objective, referring to horizontal, transitional or administrative equity. The application of the principles collectively and consistently can be expected to facilitate simplification. In certain cases, the pursuit of one objective (such as equity) may have offsetting impacts on another objective (such as simplification).

6.33 Accordingly, there is no simple (or indisputable) correspondence, particularly of the policy design principles, to each of the national objectives or to subsets of those objectives. Business tax policy design is inherently an exercise in determining an optimal design for the business tax system subject to the government's revenue targets and to the constraints on performance of that system represented by the national taxation objectives.

6.34 Despite those necessary practical qualifications, the process of design can be expected to be facilitated and improved where a more systematic attempt is made to define objectives and a configuration of principles that will deliver outcomes compatible with these objectives. Design principles provide a consistent structure against which design issues can be considered. They make explicit a range of tax design considerations left implicit in their absence, and identify trade-offs in a more concrete fashion.

6.35 In the end, tax design in a complex environment is as much art as science, and one in which judgment is often as important as fact and analysis. The Review proposes these principles be used as guides to tax analysis and design, without insisting on rigid adherence to them but imposing the discipline of identifying and explaining departures from them wherever they occur.

### **Policy design principles to guide design judgments and design transparency**

6.36 Policy design principles constitute the highest level of supporting principle, providing important operational design rules that affect the degree of achievement of each of the national taxation objectives. In many cases the policy design principles to be discussed individually below would be very difficult, or impossible, to fully implement in a practical tax system.

The policy design principles thus offer conceptual anchors, each within its own continuum of possible operational settings. In practice, actual settings will depart from perfect implementation, with each such setting representing a different degree of departure from the relevant principle.

6.37 For example, the principle discussed below for a comprehensive income base is a conceptual anchor for defining the tax base traditionally underlying Australia's business tax system. It serves as a benchmark against which proposed policies can be assessed, the trade-offs involved can be made explicit, and judgments as to their appropriateness can be made. Without the benchmark concept, such judgments have nothing on which to anchor.

6.38 Different configurations of settings across the policy design principles will reflect varying community preferences and entail different overall performance of the business tax system. Thus the policy principles proposed by the Review are likely to stimulate more debate than the national objectives themselves.

### **Legislative design principles to make design outcomes simpler**

6.39 Legislative design principles have the purpose of ensuring that tax policy intentions are converted into legislation in as simple, transparent and user friendly manner as possible. The focus of these principles is mainly on the user end of the system — producing a tax system that works better for taxpayers and administrators as well as achieving the desired objectives.

### **Administrative design principles to guide day-to-day administration**

6.40 Tax administration is the final link in the tax system chain. The full implementation of the preceding policy and legislative design principles would not guarantee that the system works successfully on a daily basis. Further principles are necessary that apply to the tax system in operation.

## ***What policy design principles does the Review suggest?***

6.41 Suggested policy design principles are listed in Box 6.2.

## BOX 6.2: POLICY DESIGN PRINCIPLES

Principle		See page
<i>Defining tax base</i>		
1. <b>Income tax base</b>	Business tax arrangements reflect an income tax base.	71
2. <b>Taxation of comprehensive income</b>	Comprehensive income is defined as the sum, over an annual period, of the taxpayer's current revenue less current costs, plus the net change in the value of the taxpayer's assets and liabilities.	72
3. <b>Real or nominal taxation</b>	Comprehensive income is conceptually measured as real income (i.e., income comprehensively adjusted for uniform inflation) but for practical reasons comprehensive nominal income (i.e., income not comprehensively adjusted for inflation) may be an unavoidable compromise.	73
<i>Determining tax liability</i>		
4. <b>Integration of ownership interests</b>	For business tax — as distinguished from commercial or legal — purposes, entities should be considered as extensions of their ultimate owners.	74
5. <b>Single layer of domestic taxation</b>	Business income should not bear more than a single layer of Australian taxation.	74
<i>Promoting equity</i>		
6. <b>Horizontal and transitional equity</b>	<p>Under the integration principle, ability to bear tax ultimately refers only to natural persons, not entities, so that for tax purposes all income — e.g. entity profits, interest, royalties, rental and wage income — should be taxed comparably.</p> <p>Changes affecting existing taxpayer arrangements should also be designed and implemented fairly.</p>	75
<i>Affecting economic growth</i>		
7. <b>Investment neutrality</b>	<p>In order not to distort the cost of capital used to evaluate alternative investments, business tax arrangements should avoid differentially taxing:</p> <ul style="list-style-type: none"><li>▪ the type of investment;</li><li>▪ the type of entity (companies, trusts, partnerships, direct investment etc);</li><li>▪ entity financing alternatives (retentions, capital issues, debt issue, dividend reinvestment, reductions in share buy-backs);</li></ul>	75

	<ul style="list-style-type: none"> <li>▪ the type of income distribution (dividends and the income component of share buy-backs or liquidations); or</li> <li>▪ distributions relative to retentions.</li> </ul> <p>To achieve neutrality, the tax base adopted should be as close as possible to comprehensive income.</p>	
<b>8. Risk neutrality</b>	Since capital markets must compensate investors for bearing undiversifiable risk, business tax arrangements should seek to minimise distortions to the pattern of such risk bearing by adopting a tax base as close as possible to comprehensive income.	76
<b>9. Balanced taxation of international investment</b>	Taxation of inbound and outbound investment and other cross-border business activities should be consistent with Australia’s national interests, including its competitiveness, while respecting Australia’s international obligations.	77
<b>10. Tax incentive provision</b>	Business tax incentives should be provided only following a formal assessment of their net impact on the national taxation objectives, and only where assessed to be an essential or superior form of government intervention.	77
<b><i>Reflecting incidence and substance</i></b>		
<b>11. Effective tax incidence</b>	Business taxation measures should be designed on the basis of an assessment of their actual behavioural impacts — not simply their formal or legal impacts.	78
<b>12. Economic substance over form</b>	Economic transactions having the same economic substance should be taxed similarly, irrespective of their form.	78

6.42 Five groupings of policy design principles are identified in Box 6.2, referring to principles that define the tax base, determine tax liability, promote equity, affect tax neutrality and reflect incidence and substance. Any such grouping is of broad assistance only, and should not be stretched too far.

6.43 For example:

- the principle of comprehensive income taxation not only defines what is included in the income tax base but implies integration of ownership interests for that reason;
- where more than a single layer of domestic taxation applies to income (for example, some transactions related to capital gains taxation), investment neutrality is necessarily violated; and

- where effective tax incidence is overlooked, design of tax incentives may have quite different effects from those intended.

6.44 In general, each of these policy design principles will impact on each of the national taxation objectives, with each such effect not only differing but also depending on how rigorously the other principles are being applied.

6.45 To illustrate, comprehensive income taxation contributes strongly to both the economic growth and equity objectives, fostering neutral tax outcomes and even-handed treatment of taxpayers. It would, however, require continual asset valuations in order to tax the change in asset values, thereby imposing compliance complexity. Yet to the extent that changes in asset values are not taxed consistently across taxpayers, both the economic growth and equity objectives will be compromised — as has been recognised in the Government’s entities and investments reform plan contained in *A New Tax System*.

6.46 In the current discussion paper, the Review does not attempt to explore these interactions amongst the suggested policy design principles in any detail, reserving illustration of them to the subsequent discussion paper on specific reforms to the income taxation of entities and investments.

## Principles defining the tax base

6.47 Under this grouping three principles define the tax base (income) and taxing concept (comprehensive income, either on a real or nominal basis) variably applied in current business tax arrangements.

### 1 Income tax base

6.48 There are three principal competing visions for the tax base to be used in the business tax system:

- comprehensive income taxation;
- cash flow taxation which, for example, allows immediate write off of capital expenditure; and
- schedular income taxation incorporating differential tax rates on investment income compared with wage and salary or other income.

6.49 Each utilises or defines a different tax base: taxation of comprehensive income, taxation of profits in excess of a normal rate of return and separate taxation of capital and labour income.

6.50 Comprehensive income taxation has long been the dominant practice, but support for the alternative tax bases has grown in the past

couple of decades. Proponents for either cash flow or schedular taxation have usually been motivated by pro-savings benefits relative to the taxation of comprehensive income, by the relative mobility of labour and capital and, in respect of cash flow taxation, by the greater simplicity.

6.51 Historically, the Australian business tax system has been based on income. The Government's tax reform strategies announced in *A New Tax System* are likewise predicated on an income tax base. Conversion to either of the alternative bases would entail resolution of a number of substantive design issues. As part of the overall design of a new tax base, the treatment of depreciable assets now in place, the taxation of financial arrangements, transitional provisions and international taxation implications would all need consideration. With these considerations and its reporting timeframe in mind, the Review has interpreted its terms of reference as confining its attention to an income tax base as the relevant operating principle.

6.52 Related to this, the Review will also be examining the scope for revenue-neutral changes to the taxation of capital gains in the hands of individuals, as required by its terms of reference. For that purpose, the Review will regard such capital gains measures as requiring a departure from the income tax base but not as a fundamental rejection of that tax base as a policy principle.

## 2 Taxation of comprehensive income

6.53 If able to be fully implemented, a comprehensive income tax would be equivalent to a tax on the taxpayer's current revenue less current costs plus the net change in the value of the taxpayer's assets and liabilities. Where either component is negative, a deduction at the appropriate tax rate would be allowed; where their sum is negative, a refund at that tax rate would be made to the taxpayer.

6.54 Accordingly, a comprehensive income tax would:

- treat economic gains and losses symmetrically;
- avoid complex timing rules for derivation of income/incurrence of expenditure;
- collapse the ordinary versus capital income character distinction; but
- rely on continual market valuations of assets coupled with accruals taxation of real economic gains/losses at marginal tax rates.

6.55 In practice, the business income tax system entails a number of important departures from comprehensive income taxation — some

necessary on practical grounds, others reflecting policy considerations — and this would be expected to continue. Existing arrangements:

- are applied jointly at the entity and individual levels, adding complexity relative to a purely individual comprehensive income tax but ensuring income derived by onshore investors through domestic entities is taxed;
- avoid the need for impractical continual asset valuations by adoption of an annual income period, as a result also adopting, for practical or policy reasons, a mix of realisations, mark-to-market and accruals timing rules;
- apply the ordinary versus capital income character distinction;
- treat economic gains and losses asymmetrically in the sense that the tax value of currently unusable losses is either not refunded to the taxpayer or not carried forward at an appropriate rate of return; and
- systematically depart from a comprehensive real income base.

6.56 Of these substantive departures from comprehensive income taxation, the first and last will be examined separately below (Principles 3 and 4). The asymmetry in tax treatment of economic losses — represented by non-interest bearing carry-forward losses combined with the quarantining of capital from revenue losses — is a major non-neutrality. Yet the ability of taxpayers to control the timing of tax recognition of economic gains and losses under a realisations basis means that allowing a more generous treatment of losses would pose a significant threat to revenue.

6.57 The other two departures — going to timing and character considerable scope for base reforms, of the kind required to be examined by the Review's terms of reference. In its forthcoming issues paper, the Review will therefore be defining a variety of options for base reforms which address the timing and character distinctions.

### 3 Real or nominal taxation

6.58 Use of real income would require full indexation of the entire income tax base. Many practical issues would need to be addressed in that context, as canvassed for example in the 1985 government paper *Reform of the Australian Tax System*. Amongst the issues to be considered would be depreciation adjustments, treatment of financial arrangements, international tax arrangements and transitional regimes. In this regard, the Review notes that comprehensive indexation of the tax system poses a range of questions extending well beyond the business tax system scope of the Review's terms

of reference and of the Government's announced strategies in *A New Tax System*.

6.59 A compromise position is full nominal, rather than real, income taxation. Going down this path would require two primary adjustments to current arrangements. In the first place, the indexation component currently not taxed under capital gains tax arrangements would need to be included in the tax base. In the second place, depreciation arrangements would need to be adjusted. Such nominal taxation treatment would nevertheless remain a significant compromise in relation to a comprehensive real taxation base.

6.60 The Review recognises that simplification benefits may follow from adoption of a comprehensive nominal base, and does not exclude consideration of proposals along those lines.

## Principles determining tax liability

6.61 While the tax base principles also determine liability, the two principles grouped here directly determine tax liability either by looking through entities to the underlying beneficial ownership interests or by limiting tax liability to prevent excessive taxation. Both principles have strong equity as well as efficiency implications.

### 4 Integration of ownership interests

6.62 Where individuals invest indirectly through entities of various types, comprehensive income taxation would look through the entity veil in order to attribute to each individual investor a share of the entity's net cash flows and of the change in its net worth proportionate to that individual's ownership interests. In practice, both valuation requirements and complicated capital structures place significant obstacles in the path of this full integration approach.

6.63 The Review notes that the full imputation system — particularly, as proposed in the Government's reform strategy, when applied with full refundability and extended to other entities such as trusts — would go a long way towards achieving distribution-related integration.

6.64 The treatment of profits retained in entities (whether or not subject to entity taxation) remains the key departure from the integration principle.

### 5 Single layer of domestic taxation

6.65 Full integration of ownership interests would impose, at most, a single layer of taxation on all income comprehensively defined. The

proposed entity imputation regime with full refundability of excess credits would achieve that result for all distributions from entities.

6.66 Two qualifications attend this principle. The reference to ‘at most’ one layer of tax refers to whether ‘tax-preferred income’ retains tax relief on pass-through. The reference to ‘domestic’ taxation leaves the appropriate treatment of foreign source income — which may bear a layer of foreign as well as domestic tax — for a separate principle.

## A principle promoting equity

### 6 Horizontal and transitional equity

6.67 Equity concerns related to administrative and transitional fairness figure prominently in the business tax code. Since transitional provisions are often a source of tax code complexity, the more frequent their use the more often will a balance need to be struck between equity and simplification as competing national objectives. Under the income tax base principle, a concern for horizontal equity — for treating individuals in similar circumstances similarly — finds reflection in the treatment of all income, including from wages, rents, royalties or capital gains, as being equally liable to tax.

## Principles affecting economic growth

6.68 Grouped here are four principles — related to investment neutrality, risk neutrality, international neutrality and tax incentives — all of which bear centrally on the efficiency effects of the business tax system and thus on achievement of the economic growth objective. Equity and efficiency conceptually go hand in hand under a comprehensive income taxation principle. But, in practice, their simultaneous achievement would require trade-offs with the simplification objective since compliance complexity increases substantially, because of asset valuation requirements, where comprehensive taxation is closely approximated.

### 7 Investment neutrality

6.69 Income taxation drives a wedge between the before-tax return earned by an entity and the after-tax return obtained by the individual investor. Where that proportional wedge is the same across all types of investments, whether held directly by the investor or indirectly through different types of entity, the pattern of investment and hence the allocation of scarce economic resources will be unaffected by income taxation.

6.70 Where that proportional wedge varies with the type of investment, the type of entity, the choice of financing adopted by an entity or an entity's distribution policy, investment neutrality will be absent. In general, the more skewed and uneven the pattern of tax wedges is, the larger are the likely costs of resource misallocation: with tax-favoured sectors or investments over-expanded relative to other sectors or investments.

6.71 The more even this pattern of tax wedges, the greater the degree of investment neutrality in the business tax system, and the more likely is it that business taxation minimises impediments to productivity growth. The Review notes that a number of the Government's proposed initiatives — its entities regime, refundability of excess imputation credits, liquidation and buy-back measures and its strategy of examining the scope for further base reforms — are directed towards the goal of a much more neutral treatment of business investments.

6.72 In terms of this policy principle, perhaps the major distortion that would remain after implementation of these reforms stems from the misalignment of the entity tax rate with marginal rates of personal taxation. The resulting differential taxation of entity earnings, as between retentions and distributions, affects both entity financing and entity distribution policies, particularly in respect of privately-owned entities. Moreover, a reduced rate of entity tax, which is raised in the Review's terms of reference and has attractions particularly from the perspective of international tax competitiveness, would exacerbate this distortion. With the top marginal rate of personal taxation fixed by *A New Tax System*, reducing the company tax rate and imposing deferred company tax would increase the tax preference favouring retentions by opening a still larger gap between the two tax rates.

## 8 Risk neutrality

6.73 Under a comprehensive income tax base, where risk affects investments undertaken by individuals either directly or through entities, income would continue to be measured comprehensively whatever risks eventuated. The business tax system would have the generally desirable property of risk neutrality. It would not distort the pattern of risk either assumed or transferred by investors, thereby facilitating the efficient reallocation of undiversifiable risk amongst investors.

6.74 Given the range of practical or policy related departures from a comprehensive income tax, the central question is what can be effectively done to mitigate the resulting distortions of risk bearing behaviour created by those departures.

6.75 One important category of risk distortion — the non-neutral treatment of carry forward losses (in the absence of loss refunds, neutrality

would be best served by allowing the value of carry forward losses to earn notional interest) and the quarantining of capital and revenue losses — stems directly from the need to protect the revenue-raising function of the business tax system. The realisations based taxation of capital gains and losses, which allows tax-driven timing of recognition of gains and losses, is important in this context and logically the two issues need to be considered together.

6.76 A second, but quite different, aspect of the non-neutral taxation of risk arises from the fact that (undiversifiable) risk is a property of asset portfolios and not merely of individual assets and liabilities. For that reason, the instrument by instrument approach typifying the tax legislation is unlikely to be a sufficient response to ensuring risk-neutral taxation. Proposed reforms to financial assets and liabilities are important here. Financial innovation and globalisation are increasingly producing hybrid and synthetic instruments (representing portfolios of assets) that not only promote more efficient risk management but also exploit systemic weaknesses in the tax system, not least the debt-equity borderline. The Review intends to consult widely on the taxation of financial arrangements, with a view to bringing the ongoing examination of those arrangements to finality.

## 9 Balanced taxation of international investment

6.77 Both inbound investment (by foreigners in Australia) and outbound investment (by Australians overseas) have grown dramatically. Other forms of cross-border activity, such as trade, have also increased. Globalisation, financial innovation and growth performance in Asian markets are factors that will continue to affect those trends.

6.78 As both a capital importer and exporter, and a net capital importer for the foreseeable future, Australia must approach the international dimensions of its business tax arrangements as a dynamic balancing act. In this regard, a relevant issue to be considered by the Review will be the appropriate recognition of foreign tax paid in relation to the incentives for maintaining domestic domicile for Australian entities investing offshore. Australia must ensure that its international tax arrangements attract desirable inbound investment, do not detract from the incentives Australian entities have to remain domiciled here, recover an appropriate return from both inbound and outbound investment, and further the competitiveness of the economy generally.

## 10 Tax incentive provision

6.79 The provision of tax incentives designed to encourage particular activities typically influences the ability of the tax system to meet its various

objectives. There can be little doubt that some major tax incentives — such as R&D and infrastructure borrowings — initially proved to be inadequately designed to achieve their intended effect. To a significant degree, those design deficiencies stemmed from an inadequate process of review and consultation preceding their introduction, as well as from inadequate integration of the policy, legislative and administrative processes used to implement the policy.

6.80 The Review believes that improved, more rigorous, processes for proposing, implementing and evaluating the efficacy of tax preferences are required and will be seeking submissions on such processes.

## Principles reflecting incidence and substance

### 11 Effective tax incidence

6.81 Taxation regimes must necessarily be designed on the basis not of formal incidence (that is who nominally pays the tax) but of effective incidence (that is which economic agents actually bear the burden of the tax). Where effective incidence differs from formal incidence, as it typically will, the impact of taxation on economic behaviour can only be assessed with an analysis of the likely effective incidence of the tax.

6.82 In the case of corporate tax, for example, it reduces the after-tax return to capital proportionally to the tax rate. The effect of taxing the return to capital is likely to fall, perhaps predominantly, on suppliers of that capital, but may also be shifted in part to users of the entity's goods or services or to the entity's employees. In this case, reducing the corporate tax rate would have real effects on the supply of capital and on the demand for the entity's output and labour use.

6.83 Making judgments in this way about effective incidence is no easy task, but is unlikely to be anywhere as misleading as relying on formal incidence.

### 12 Economic substance over form

6.84 Economic transactions should be taxed on the basis of their economic substance — not of their legal form. Sometimes this principle is no more than a straightforward re-statement of investment neutrality. Taxing trusts in the same way as companies is an illustration of this. If there are tax advantages in deriving income through one type of entity rather than the other, that outcome puts form (the type of entity) before substance (economic income).

6.85 Sometimes the distinction may be more subtle. Thus hire purchase arrangements are, in substance, equivalent to a compound transaction of a sale of property together with a loan by the seller. Hire purchase and vendor-financed sales transactions should therefore receive equivalent taxation treatments. Still more subtle examples can be found with modern financial arrangements that transform risk in various ways.

## *What legislative design principles does the Review suggest?*

6.86 Box 6.3 sets out the legislative design principles being suggested by the Review. Those principles are grouped under four headings:

- principles ensuring consistency in legislative design;
- principles integrating user needs into legislative design;
- principles imposing drafting standards for tax legislation; and
- principles ensuring the dynamic robustness of the business tax system.

6.87 These principles contribute to the simplification objective for the tax system, and their implementation is unlikely to impair achievement of the other national objectives.

### BOX 6.3: LEGISLATIVE DESIGN PRINCIPLES

Principle		See page
<i>Ensuring consistency</i>		
<b>1. Limited policy differentiation</b>	Tax legislation should ensure minimal and consistent differentiation in the policy treatment of similar or related economic transactions, by permitting such differentiation only where there is an expressly stated intention.	81
<b>2. Integration across policy areas</b>	Tax design should seek to ensure that the tax system is as consistent as possible with wider government policy.	81
<i>Integrating user needs</i>		
<b>3. Integrated compliance</b>	To the maximum possible extent, the same activity should fulfil or support a range of compliance obligations.	82
<b>4. User-based design</b>	Tax legislation should be designed from the perspective of those who must comply with it.	83
<i>Imposing drafting standards</i>		
<b>5. Policy transparency</b>	Tax legislation should disclose the policy intention and design purpose underlying the rules and be consistent with the national objectives and policy design principles.	84
<b>6. Standardisation</b>	Tax legislation should use standard rules, concepts and terminology.	84
<b>7. Clarity of rules</b>	Tax rules should be clear, certain and consistent.	85
<i>Ensuring dynamic robustness</i>		
<b>8. Durability/sustainability</b>	The tax system should accommodate successive programs of change over a long period without disturbance to its basic design and operation.	86
<b>9. Timeliness</b>	The tax system should keep pace with economic and social change.	86
<b>10. Anti-avoidance provisions</b>	Tax legislation could retain general anti-avoidance provisions but should be sufficiently robust to do without specific anti-avoidance provisions.	87

## Principles ensuring consistency

6.88 Grouped under the consistency heading are two legislative design principles — limited policy differentiation within the tax area and integration with broader government policy.

### 1 Limited policy differentiation

6.89 The case studies discussed in Chapter 3 demonstrate widespread reliance on differentiated (if implicit) policy objectives in circumstances where the case for such differentiation is neither disclosed nor obvious by inference. Simplification benefits would follow from limiting such policy differentiation to cases where it is genuinely required and where the grounds for such differentiation are made clearly evident.

6.90 This principle has a close relation to the policy design principles affecting economic growth and reflecting economic substance. Collectively these principles indicate that the basic concept of income should be applied comprehensively and consistently so as not to produce economic distortions across transactions. As an initial design measure it means that common issues should be dealt with under common, generally applicable regimes. As a design principle for change after the initial system is established, the limitation of policy differentiation means that any particular ‘new’ measure should be able to fit within established principles. Indeed in most cases new measures should be able to find an appropriate place in the existing law, rather than be by way of *ad hoc* addition.

6.91 The capital allowance example given in Chapter 3 illustrates the twin sides of the principle. The original rules for capital allowances were for depreciation of plant and equipment. Because this regime was conceived in the relatively narrow confines of physical assets used up in production processes, the general design was not sufficiently generic to accommodate other capital allowances. Accordingly, other capital allowances came to be established in separate regimes. Once this pattern of particularisation was established, capital allowance regimes proliferated, each with its own special rules, with little consideration of whether it was possible to use rules from other regimes. The Tax Law Improvement Project (TLIP) tried to identify common rules and enact them as such but was precluded by its terms of reference from reconsidering the original policy design.

### 2 Integration across policy areas

6.92 Governments implement a set of economic and social objectives across a broad range of policy areas. The business tax system should be designed to fit with such other policies to the extent consistent with fundamental tax policy principles. This principle has application both

within taxation more generally and across policy areas. For example, the design of the goods and services tax (GST) and the business income tax should complement each other to the extent consistent with the underlying principles of each. A concern of this kind outside business tax in recent times has been the interaction of tax and social security arrangements as they affect individuals.

6.93 The general design principle has a potentially broad range of application and affects a number of areas of business taxation. For example, in recent times all governments have pursued policies that pay greater regard to environmental concerns. Yet, until recently, the business income tax system positively discriminated against firms incurring expenditure to prevent or clean up pollution.

## Principles integrating user needs

6.94 Tax legislation to date has paid little attention to user needs, whether of taxpayers or the Australian Taxation Office (ATO). Simplification will be significantly advanced if user needs are integral to the development of tax legislation. Integrated compliance and a user-based design are intended to achieve this outcome.

### 3 Integrated compliance

6.95 Integrated compliance involves ‘killing as many birds with one stone’ as possible. Where possible, the same activity should be designed to fulfil or support a range of compliance obligations or be compatible with existing commercial practices.

6.96 This principle applies both across different taxes, and across tax and other policy areas. The alignment of payment dates for various taxes is an obvious application of this principle (see the example of withholding taxes in Chapter 3). Where there are record keeping requirements for other purposes, such as corporate law, the same rules (or at least rules that do not conflict with rules for other areas) should be adopted for taxation purposes where possible. The principle has wider application. If it is common for a particular record to be kept or calculation to be made by a particular group of the taxpayer population, the tax legislation should try to accommodate itself to this practice. For example, although some businesses are required by law to keep accounting records in certain ways, other businesses are not. Nevertheless, most businesses keep some basic records which can properly be assumed in tax design.

## 4 User-based design

6.97 The tax law (and related administrative systems) should be designed from the perspective of those who must comply with it, to ensure that they can understand their rights and obligations and can comply with them in a convenient and cost effective manner.

6.98 It must be recognised that there are different categories of taxpayers and that consistency of principle does not preclude greater or lesser elaboration of rules for particular groups. Rules for individuals should generally be as few and as simple as possible. On the other hand, rules for dealing, for example, with double taxation and deferral of tax on foreign source income in the case of multinational corporations are likely to be necessarily complex.

6.99 As well as trying to match rules appropriately with types of taxpayers, the tax system should apply the same design principle to compliance systems. In particular, compliance burdens should be allocated where the overall system cost of administration and compliance is the least. As between the tax administration and taxpayers this means that costs should only be shifted to the private sector if significant overall cost saving occurs. Cost savings in administration should always be measured in conjunction with any increase in costs imposed on the private sector.

6.100 As among taxpayers, necessary compliance burdens should generally be placed upon those best able to deal with them. The usual outcome is that considerable compliance costs will be borne by businesses. In order to keep such costs within bounds, care needs to be taken to ensure that unnecessary costs are not imposed on businesses.

6.101 Within the business sector it is generally recognised that compliance costs fall proportionately most heavily on small businesses. In designing tax measures the differential impact of compliance costs on businesses should receive consideration and, where possible, rules should be adapted to reduce the differences.

6.102 If compliance costs are to be reduced generally, the system should be designed so that the tax administration has appropriate scope to deal with taxpayers rather than intermediaries. Closer alignment of tax and financial accounting and adoption of clear and generally applicable tax principles may reduce the need for large scale professional checking of business tax returns as currently occurs.

6.103 To put this principle another way, the tax legislation should be the servant of the business tax system — of its functions, national objectives and supporting principles — not the reverse. It should be built according to the policy and administrative needs of that system, taking into account the policy requirements of the government of the day as well as what is

possible or reasonable for the individuals who have to comply with, or administer, that system. It clearly matters, for example, whether taxpayers must conform to arbitrary system requirements imposed by the tax law (such as signed paper lodgment where validated electronic lodgment is possible) or whether the tax law is designed consistently to support best practice and cost effective administrative and compliance systems.

## Principles imposing drafting standards

6.104 In recent times considerable attention has been focused on drafting standards for legislation generally and tax law in particular through the TLIP. The Review considers that this focus needs to be intensified but in a context where an inability to address policy does not hinder the achievement of greater simplification. Standards relating to policy transparency, standardisation and clarity of rules need to be used for the drafting of all tax legislation.

### 5 Policy transparency

6.105 The case studies discussed in Chapter 3 illustrate a lack of policy transparency in the tax legislation. Such examples can be multiplied many times over. Rarely is the user of the existing tax legislation able to read individual provisions and find a clear statement of the underlying policy purpose or the basic principle that is being applied. Where purpose is stated, it is usually in isolation from more basic or fundamental policies or principles from which the particular purpose derives. The organisation of the tax legislation likewise has little relation to its basic building principles.

6.106 The Review considers that the tax legislation should be redrafted and reorganised to clarify and disclose the policy purpose and the basic principles. The statements of principle may in appropriate cases be an operative part of the Act, and not just a statement of purpose to assist in interpretation of other provisions.

6.107 How this is best to be accomplished must be a matter for consultation, including with legislative drafters, and actual users of legislation.

### 6 Standardisation

6.108 Viewed as a set, the legislation covering business taxation should use standard rules, terminology and concepts across all relevant acts. In appropriate cases the rules, terms or concepts can come from outside the tax area where they are used for other purposes. The tax legislation — and the law generally — should be as seamless as possible.

6.109 Standardisation is more than a surface characteristic of the law. In deciding the appropriate level of detail in which to express the law, where the rules are to be located in organisational terms and whether the detail is to be found in the tax legislation itself or elsewhere, consistent principles should be applied. For average individuals the tax law should be as brief and broadly applicable as possible (while conveying its meaning with sufficient certainty), whereas for large and complex businesses more elaborate rules will generally be necessary. It is not inconsistent at the same time to seek to apply the same principles or rules effectively to all taxpayers, while achieving compliance simplifications for particular groups of taxpayers.

6.110 The tax law at the moment demonstrably fails to achieve standardisation in any sense. Multiple definitions of the same or similar terms and concepts abound, while the detail in which the law is expressed is usually a function of its age, not its topic or target group of taxpayers. Inevitably, the more recent in origin a set of rules is, the more detailed and complex it will be.

## 7 Clarity of rules

6.111 The rules in the tax law obviously need to be clear, certain in their application, and consistent across applications. Certainty does not require inordinate detail. No matter how much detail is provided in the law, there will be ambiguity. Indeed the more detailed tax law is, the greater the likelihood of ambiguity or mistakes (from a principles perspective) as detail has a tendency to bury principle. Likewise, clarity is often more likely to be achieved by the statement of a principle rather than the elaboration of detail.

6.112 Certainty is not only a function of the tax legislation. Administrative mechanisms (such as rulings) are available to clarify the application of principles in particular cases. A balance needs to be struck in drafting the tax law on the level of detail necessary to produce the desired level of certainty. Once again this balance will need to be struck after consultation with stakeholders.

## Principles ensuring dynamic robustness

6.113 The sounder the national objectives, supporting principles and the policy, legislative and administrative processes supporting them, the more likely is it that the tax legislation will be able to accommodate successive programs of policy change as well as changes in taxpayer behaviour over time. To be robust over time the tax legislation has to be organised and written in a way that is durable and sustainable in times of change. It has to be capable of change in a timely fashion. A general anti-avoidance

provision may be necessary to cope with unanticipated taxpayer behaviour but measures generally must be able to be expressed without relying on a plethora of specific anti-avoidance rules.

## 8 Durability/sustainability

6.114 Durability and sustainability have two aspects. On the one hand, the system has to be sufficiently robust to accommodate changes in government policy. Obviously there are limits on how far current design can accommodate major policy changes (such as changing from a comprehensive income tax base to a cash flow business tax base). The system should be able to accommodate government decisions to provide assistance or to respond to inadequately functioning markets in a particular sector by tax provisions directed to that sector.

6.115 On the other hand, the tax design system should place some constraints on policy development so that apparently minor changes in policy do not produce major system instability. Proposed changes should be tested for consistency with existing policy principles (or policy principles should be clearly established if they do not exist) and possible destabilising elements identified.

6.116 As the world economy changes at an ever increasing pace, a more specific aspect of durability may be to separate out the basic principles of the tax system in legislation and allow for development of the details of some of the principles elsewhere. In this way the tax system should be better able to cope by applying consistent principles to changing circumstances.

## 9 Timeliness

6.117 In an era of rapid change it is important that tax legislative design keep pace with current events. Up to now, there have been considerable time lags in identifying issues of current concern and finalising decisions. These lags have led in part to the phenomenon of legislation by press release as well as to increasing revenue costs for government and transitional costs for taxpayers.

6.118 Timeliness in tax legislation has become a much higher priority. A system based on clearly articulated and consistent principles should assist in making responses on a timely basis. Issues of process may also affect timeliness. Process is canvassed in Chapter 7.

## 10 Anti-avoidance provisions

6.119 The current plethora of specific anti-avoidance rules in the legislation result largely from reactive policy decision making in response to particular problems. They can be thought of as patches on the system rather than improvements to its structure. One test of whether the kind of principled and consistent approach espoused by the policy and legislative design principles above has been achieved will be whether the tax legislation can be drafted without resort to specific anti-avoidance provisions.

6.120 It is likely that tax avoidance opportunities may be created either through problems in drafting or through the evolving interpretation of the tax legislation. In other countries, the problem of tax avoidance has been left to a greater degree to the judiciary. In the context of tax legislation drafted on the basis of fundamental and transparent principles, Australia may wish to consider such a possibility. Australian courts at the moment do not generally undertake this role because the anti-avoidance rules are specifically legislated and because no underlying principles are discernible from the current legislation.

6.121 If general anti-avoidance rules are maintained, consideration may be given to whether the current legislative approach in this area is appropriate or not. Rather, general anti-avoidance rules could be designed, in parallel with the overall design of the tax system, to deal more generically with avoidance behaviour.

### *What administrative design principles does the Review suggest?*

6.122 Administrative design principles being suggested by the Review are set out in Box 6.4. They are in groups dealing with:

- engendering taxpayer trust;
- facilitating taxpayer compliance;
- enforcing taxpayer compliance; and
- ensuring responsive administration.

6.123 These principles are directed to maximising voluntary compliance with the tax system thereby contributing to the simplification objective.

## BOX 6.4: ADMINISTRATIVE DESIGN PRINCIPLES

Principle		See page
<i>Engendering taxpayer trust</i>		
<b>1. Independence</b>	The operation of day to day tax administration should be free of external influence in relation to particular taxpayers.	89
<b>2. Privacy/confidentiality</b>	An effective administrator must ensure that taxpayer information is collected, used and kept in accordance with privacy and confidentiality laws and guidelines.	89
<b>3. Fairness</b>	Taxpayers should receive fair and consistent treatment in their dealings with the ATO.	89
<b>4. Review mechanisms</b>	Internal and external review mechanisms should promote taxpayer confidence in the equity and accountability of the system's administrators.	90
<i>Facilitating taxpayer compliance</i>		
<b>5. User friendly relationship</b>	The tax administration should facilitate its dealings with taxpayers by service-oriented and simple-to-use approaches.	90
<b>6. Certainty/reliability</b>	Consistent decision making and coordinated administration should help ensure that taxpayers have certainty with regard to their income tax liability.	90
<b>7. Cost effective administration and compliance</b>	Compliance costs should be minimised to assist taxpayers to comply voluntarily with their tax obligations. Collection costs should be minimised to enable administrators to allocate limited resources to best effect.	91
<i>Enforcing taxpayer compliance</i>		
<b>8. Enforceability</b>	To enable evasion to be detected and deterred, administrators must have a range of enforcement powers.	92
<b>9. Proportionality</b>	Administrators must exercise enforcement powers proportionally to the circumstances of the case.	92
<i>Ensuring responsive administration</i>		
<b>10. Flexibility and responsiveness</b>	Administrative practices should be reviewed, monitored and modified regularly so as to maintain relevance. These changes should be communicated effectively to taxpayers so as not to compromise certainty.	93

## Principles engendering taxpayer trust

### 1 Independence

6.124 To achieve the maximum level of voluntary compliance, the tax administration must be seen to be impartial and fair to taxpayers. Independence is generally viewed as one important pillar in achieving this goal. The tax system, like the law and justice system, is central to a civilised society, yet requires a degree of independence to retain the confidence of society. The day to day tax administration in specific cases needs to be seen to be free from influence whether of particular taxpayers or groups or government. But such independence need not necessarily extend to matters like general administrative policy and accountability.

6.125 Independence is usually achieved by separating the tax administration from Ministerial direction in relation to individual taxpayers through the mechanism of a statutory office or board. Potential influence from outsiders is then effectively restricted by imposing strict secrecy obligations on the tax administration with respect to taxpayer information. Only the minimum exceptions are necessary to provide the necessary liaison with government and other arms of the public service.

### 2 Privacy/confidentiality

6.126 As well as bolstering the independence of the tax administration, tax secrecy and associated privacy principles serve an independent function of assuring taxpayers that the information demands of the tax system do not breach their privacy or confidentiality. Unless taxpayers have sufficient confidence in the ability of their administrators to keep the information they provide confidential, they are not likely to comply with their obligations.

6.127 The tax administration must ensure that taxpayer information is collected, used and kept in accordance with privacy and confidentiality laws and guidelines.

### 3 Fairness

6.128 Voluntary compliance will be encouraged if taxpayers have confidence that they will be treated fairly and consistently. This concept of equity extends to the expectation that taxpayers are entitled to natural justice and due process in their dealings with the administration.

6.129 Various aspects of administrative due process are relevant to the tax system. First, taxpayers must be regarded as honest unless there is clear evidence to the contrary. Secondly, taxpayers should be treated openly and with respect by the tax administration. Thirdly, administrative discretion

must be applied in a fair and reasonable way. Finally, resource allocations and general conduct of the tax administration should not give rise to any perception that certain groups of taxpayers are treated more or less favourably than others. Many of these ideas and the administrative principles are reflected in the Taxpayers' Charter.

#### **4 Review mechanisms**

6.130 Apart from confidence in internal processes, taxpayers should have internal and external dispute resolution mechanisms that are not unduly expensive and are readily available to them in the event of disagreement with the tax administration. The availability of review mechanisms bolsters taxpayer confidence in the fairness of the tax administration. Consistent with this principle, a number of internal and external avenues of review are currently available for taxpayers.

### **Principles facilitating taxpayer compliance**

#### **5 User friendly relationship**

6.131 If voluntary compliance is the overriding objective then the tax administration needs to emphasise carrots rather than sticks in dealing with taxpayers. The emphasis on taxpayer service, which has received more attention around the world in recent years (including in Australia), reflects this objective. Increasing professionalism of the tax administration is a necessary part of increasing taxpayer service.

6.132 A generic approach to improving taxpayer compliance, particularly in the business tax area, may be to focus more on overall relationships with taxpayers rather than specific issues. As applies in other common law countries like Canada and the US, tax policy administration is very much based in Australia around particular issues or transactions in taxpayers' affairs rather than the totality of their tax position. By contrast many European and Asian systems are more directed to total relationships. Changes of this kind are harder to implement by administrative fiat. They require changes in attitudes and the gradual building of greater trust between tax administrator and taxpayer. They can be facilitated, for example, by having one contact point for major business taxpayers in the ATO (something that has recently been used, though more in the nature of a service contact point rather than an active manager of the relationship).

#### **6 Certainty/reliability**

6.133 It is administratively desirable that taxpayers have certainty with regard to their income tax liability and how the law operates. As noted

above, certainty can be achieved through other means apart from ever more complex legislation (which often can produce the opposite result). As is now done, the tax administration can provide mechanisms like rulings to clarify the operation of the law in particular cases. Reliability also requires consistency in decision making and is assisted by a more cohesive administration that has increased coordination across its functions and over time.

6.134 There are, however, some tensions in trying to achieve certainty or reliability in tax administration. Certainty and reliability are enhanced by a stable system that is not subject to constant change, leading to a recurring need to re-educate taxpayers. Yet it is also important that an administration be flexible and responsive where necessary. Additionally, while it is desirable that taxpayers receive consistent treatment, decision makers must still have sufficient discretion to be able to respond to taxpayers' individual circumstances within the general policy principles of the tax system.

## **7 Cost effective administration and compliance**

6.135 Efficiency costs of the tax system are something to be dealt with through the policy and legislation design principles described above. For the tax administration and taxpayers, however, the most important and visible costs generally are those of administration and compliance. A study by the Australian Taxation Studies Program at the University of New South Wales, commissioned by the ATO, estimated compliance costs for business at \$8.9 billion in 1994-95 — or around 2 per cent of GDP and 18 per cent of the associated tax revenue. After allowing for the tax deductibility of such costs and cash flow benefits, the cost was estimated at \$4.6 billion, or 9.4 per cent of the associated tax revenue.

6.136 High compliance costs are negative from every perspective and every effort should be made to diminish them. Nevertheless, compliance costs are initially the result of policy and legislation design. The tax administration, in its systems and processes, can add to compliance costs inherent in tax design. Hence compliance cost issues need to be addressed at all levels.

6.137 A less complex system of administration, while promoting greater certainty for taxpayers also contributes to minimising the costs of compliance by reducing the need for assistance from the ATO in the form of calls, letters and ruling requests. One of the initiatives to promote simplification that has emerged from the recent restructure of the US equivalent to the ATO is the production of a yearly analysis on sources of complexity in administration of the US tax system.

6.138 The Government's recent tax reform paper, *A New Tax System*, also identifies the need to reduce administrative costs. Reductions in such costs enable administrations to allocate limited resources to best effect.

## Principles enforcing taxpayer compliance

### 8 Enforceability

6.139 Taxpayers have important obligations under the tax law including being truthful with the ATO, taking reasonable care in dealings with the ATO, keeping and producing required records, and meeting payment and return obligations. As taxpayers have the information relevant to their tax affairs and the ATO often does not, it is necessary that the ATO have sufficient powers to enforce taxpayer obligations. In the case of businesses conducted through legal entities, it is also necessary that the ATO can deal with deliberate misuse of limited liability to avoid tax liabilities.

6.140 Enforceability not only ensures that taxpayers can ultimately be made to meet their obligations if they fail to voluntarily comply. It is also integral to taxpayers' confidence in the system that tax administrators be able to detect and deter tax avoidance and evasion. The perception that there are cheats, who are not paying tax that is properly due, or well advised taxpayers who find loopholes in the tax system, erodes this confidence and is detrimental to compliance. It is critical that tax administrators are able to detect tax avoidance and evasion, impose penalties where applicable, secure payment and call on a range of enforcement powers to these ends.

6.141 Such powers constitute the sticks in the tax administration armoury. While deterrence is important in the tax system, as in other areas it cannot be the sole — nor indeed the primary — method of inducing tax compliance.

### 9 Proportionality

6.142 The fact that friction exists in the tax system is not a sign that voluntary compliance has broken down. Tax administration necessarily generates friction with taxpayers as there will always be disagreements over the amount of tax correctly payable. Some taxpayers will deliberately not comply or will pursue tax minimisation aggressively. All these cases need to be dealt with appropriately if the compliance of the rest of the community is to be maintained.

6.143 The key principle that is emphasised under this head is the appropriateness of the response to the gravity of the taxpayer's conduct. Over or under reaction by the tax administration is likely to be

counterproductive to the overall relationship with the taxpayer concerned, and more generally destructive of compliance by other taxpayers where publicised. While attempts have been made during this decade to be more precise in the design of rules on matters of proportionality, ultimately issues of tax administration discretion and judgment are inevitably involved, which is why this principle has been included under tax administration principles.

## A principle ensuring responsive administration

### 10 Flexibility and responsiveness

6.144 A tax administration needs to be able to adapt to changes in the domestic and international environment. If it is not able to review and monitor its own administrative practices in the light of these changes, its practices have the potential to become outdated and irrelevant. In the current era of very rapid change, it is not enough to be reactively responsive. Tax administration must be proactive in anticipating and dealing with change before current systems and practices are overtaken by events.

6.145 Whilst it is imperative that a tax administration has the capacity to be flexible and responsive, these principles have the potential to reduce certainty for taxpayers. One way of resolving or minimising this conflict is to ensure that the administration systematically communicates changes to taxpayers. Another way is to design administration systems so that they have inbuilt flexibilities which, so far as possible, do not require major adaptation by taxpayers. For example, in designing a pay as you go system based on one and three month payments periods, future development would be assisted by having system flexibility to deal with other (shorter or longer) periods for particular groups of taxpayers, should it be decided in future that such a change represents a logical development of the current alignment of payment obligations.



