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Tax Policy Developments and Reform in Australia: Much Unfinished Business

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Abstract

Following an earlier paper written by the authors relating to Australian tax reform in the British Tax Review in 2001, this paper reviews the Australian tax reform and policy over the period 2000-01 to 2007-08 and discusses the successful implementation of Australia's Goods and Services Tax and associated reforms under A New Tax System as well as the overall characteristics of Australia's tax system. The paper also assesses reform in international tax, the significant superannuation and retirement policy changes from July 2007 and the review of income tax self assessment. Tax policy reform for small business and its failure to actually simplify as intended (at least until recently perhaps) is also examined, as is the forthcoming regulatory reform affecting tax agents and future reforms in two important policy areas, namely the efficiency of Australia's tax-transfer system and its proposed carbon pollution reduction scheme (both currently under government review). Recent UK tax policy is discussed from an overseas perspective and compared to Australian reform. Three overarching problems for Australian taxation policy are identified in the conclusions.

Introduction

Australian Commonwealth tax policy and reform were critically reviewed by the authors in the British Tax Review in 2001, and received favourable comment at the time[1] (Pope & Fernandez, 2001). Around eight years have passed since that paper was written, and it now seems timely to consider the major changes which have occurred in Australian tax policy and legislation since then, as well as the outcome of earlier reforms. Changes in the major Australian Commonwealth tax reforms since 2000 mainly include the International Tax Review, taxation of superannuation and retirement policy changes, the Review of Income Tax Self Assessment and small business tax reforms. This paper also summarises the benefits derived from the reforms following the Ralph Review and, looking ahead, discusses major reforms under consideration, namely the New Tax Agents Regime, Review of Australia's

Future Tax System (known as the Henry Review) and the Carbon Pollution Reduction Scheme (CPRS). The paper excludes state and local tax reforms.[2]

Since the introduction of the Goods and Services Tax (GST) in July 2000, major reform of business taxation flowing from the recommendation of the Ralph Review has been implemented in Australia (Costello, 1998; Dirkis & Ting, 2006[3]). These include: lowering the company tax rate to 30 percent; changes to the Capital Gains Tax (CGT) regime; the introduction of the simplified tax system for small business; the introduction of the uniform capital allowance system; new debt/equity measures and thin capitalisation arrangements; and the introduction of the Pay-As-You-Go Withholding System (PAYG) (Pope & Fernandez, 2001).

Although the reforms recommended through the Ralph Review were successfully implemented, the casualties were Small and Medium Enterprises (SMEs) which were subject to increased compliance costs (Dirkis & Bondfield, 2004). The SME sector had to deal with the new system to collect GST, and the Simplified Tax System (STS) introduced under the Ralph Review was too complex and very few businesses elected to adopt it. In October 2005 the Australian Government responded to small business concerns by commissioning a review into taxation complexity (Regulation Taskforce, 2006). Their recommendations will be discussed later in the paper.

There was much unfinished business identified in the 2000 reforms particularly in the areas of international taxation, superannuation taxation and its effect upon retirement policy. The Australian Government has made significant inroads in reforming these areas since 2000. This paper examines these reforms primarily from a policy perspective rather than a legalistic viewpoint. The reforms discussed in the paper are not in chronological order as they span a number of years and overlap each other.

Following this introduction, the second section of the paper discusses the degree of success of the earlier reforms followed by an analysis of international tax (section three), superannuation and retirement policy changes (section four) and the review of income tax self assessment (section five). Tax policy changes in the area of small business are then summarised in section six. Section seven reviews the forthcoming regulatory reform affecting tax agents and looks ahead to possible future reforms by considering two important policy areas, both currently under government review: the efficiency of Australia's tax-transfer system and the carbon reduction scheme. A succinct discussion of recent UK tax policy follows in section eight, and then the concluding section.

Success of Earlier Reforms

After three years of introducing GST, the Australian Government was able to satisfy its commitment to reversing the bracket creep in its paper 'Not a new tax, a new tax system'. Each year since the 2003 Budget, the Australian Government has managed to reduce income tax rates or increase the thresholds, especially for middle to

high income earners. However, the tax free threshold of $6000[4] has remained unaltered. A comparison of the income tax rates in 2000-01 and 2007-08 is shown in Table 1. The threshold at which the 30 percent marginal rate finishes has increased from $50,000 in 2000-01 to $75,000 in 2007-08. The most significant change is the threshold at which the highest marginal rate commences, which increased from $60,000 in 2000-01 to $150,000 in 2007-08. If the $60,000 threshold was indexed in line with inflation, the threshold would be $84,360.[5] Thus there has been a significant real increase in that threshold of $65,640 (77.8%) over the seven year period.

Table 1: Income Tax Rates on Individuals

2000-01		**2007-08**	
Income ($)	Rate	Income ($)	Rate
0-6,000	0	0-6000	0
6,001-20,000	17	6,001-30,000	15
20,001-50,000	30	30,001-75,000	30
50,001-60,000	42	75,001-150,000	40
60,001+	47	150,000+	45

Source: Australian Tax Office.

Despite the reduction in the income tax rates and the increase in thresholds, the taxation revenues from individuals increased from $90.1 billion in 2001-02 to $119.8 billion in 2006-07, which is a percentage increase of 33.02 percent. Table 2 shows that the income tax levied on enterprises also increased from $31.8 billion in 2001-02 to $67.7 billion in 2006-07 (an increase of 113%) and taxes on Goods and Services increased from $28.2 billion in 2001-02 to $42.3 billion in 2006-07 (an increase of 50%).[6]

Table 2: Taxation Revenues: All Levels of Government

Year	01-02	02-03	03-04	04-05	05-06	06-07
	$billion	$billion	$billion	$billion	$billion	$billion
Taxes on Income:						
Individuals	90.1	94.6	102.7	112.2	118.4	119.8
Enterprises	31.8	38.7	42.0	49.7	56.4	67.7
Employers Payroll	9.5	10.1	10.9	11.9	13.1	14.3
Taxes on Property	19.2	21.4	24.4	24.2	25.6	29.2
Sales Tax and GST	28.2	32.2	35.1	36.6	40.1	42.3
Excise and Levies	20.5	21.7	21.9	22.9	22.8	23.6
Other Taxes	18.4	19.6	20.3	21.1	21.3	22.9
Total	**217.7**	**238.3**	**257.3**	**278.6**	**297.7**	**319.8**
% increase from 2001-02	-	9.42%	18.47%	28.01%	36.82%	46.94%

Source: Australian Bureau of Statistics, 2008.

The Australian Government's reforms in 2000 played a significant part in encouraging and sustaining economic growth in Australia which is reflected in the increase in taxation revenues. In the 2008 Budget the Treasurer forecast the largest budget surplus as a share of GDP in nearly a decade, which was a surplus of $21.7 billion in 2008-09, or 1.8 percent of GDP (Fernandez, 2008). About 90 percent of the total revenues are derived from less than ten taxes. Table 3 shows that the three major taxes—taxation on individuals, taxation on enterprises and GST—accounted for 72 percent of total tax revenue in 2006-07 year. The same taxes in 2001-02 accounted for 69 percent of the total revenues. This shows that increase in revenue has been derived from all the taxes.

Table 3: Percentage of Taxation Revenues - All Levels of Government

Year	01-02	02-03	03-04	04-05	05-06	06-07
	%	%	%	%	%	%
Taxes on Income:						
Individuals	41.4	39.7	39.9	40.3	39.8	37.5
Enterprises	14.6	16.3	16.3	17.8	18.9	21.2
Employers Payroll	4.4	4.2	4.2	4.3	4.4	4.5
Taxes on Property	8.8	9.0	9.5	8.7	8.6	9.1
Sales Tax and GST	12.9	13.5	13.6	13.1	13.5	13.2
Excise and Levies	9.4	9.1	8.6	8.2	7.7	7.4
Other Taxes	8.5	8.2	7.9	7.6	7.2	7.1
Total	**100**	**100**	**100**	**100**	**100**	**100**

Source: Australian Bureau of Statistics, 2008.

The government is currently holding a review into the tax-transfer system, known as the Henry Review (Commonwealth Treasury, 2008a). This was announced prior to the global financial crisis that is likely to reduce Australia's annual economic growth rate. This, together with other proposed significant changes including a carbon reduction trading scheme, is later discussed.

International Tax Review

Flowing from the Ralph Review (1999), the Australian Government released the consultation paper 'Review of international taxation arrangements' (RITA) in August 2002. The government's three main objectives were to identify possible impediments to Australian companies expanding offshore, attracting domestic and foreign equity, and identifying issues related to holding companies and conduit holdings being located in Australia (Warburton, 2002).

The Australian Government recognised the need for policy reform in order to: promote international growth of Australian-based companies, encourage overseas companies to set up headquarters in Australia, and attract talented people into Australia.[7] In 2001, a White Paper[8] was commissioned by the Business Council of

Australia entitled 'Removing tax barriers to international growth' (Wachtel & Capito, 2001). The White Paper made 24 recommendations on policy changes which ranged from reviewing and modernising dividend imputation rules to renegotiating double tax treaties (Fernandez & Pope, 2002).

In 2002, the Australian Government requested that the Board of Taxation undertake public consultations on international tax issues and released a Treasury consultation paper. The consultation paper addressed a number of problems, one being the dividend imputation problem which stated the following reason for change (Board of Taxation, 2002):

> *The current dividend imputation system causes an overall tax bias against Australians investing in highly taxed and comparably taxed countries, whereas a tax bias is caused in favour of individuals investing in low taxed countries. An analysis of Australian direct investments offshore by destination shows 54.7% of investments in USA, 17.4% in the UK, 7.2% in New Zealand and most of the balance in Hong Kong, Singapore and Canada.*[9] *The paper seeks consultation on the extent of this bias and how much this bias costs Australian companies. According to the consultation paper, the imputation system may only be one factor affecting the foreign tax system. By correcting the imputation system only, the result would be a bias favouring offshore investments by individuals and funds. This would be difficult to justify.*

The Treasury consultation paper also addressed a number of other international tax arrangements to promote Australia as a location for internationally-focused companies and to promote Australia as a global financial service centre (Fernandez, 2003).[10] The Board of Taxation carried out an extensive consultation process and received 58 submissions from individuals and organizations. Based on the outcome of the consultations, the Board formulated recommendations to the Treasurer, two of which were to promote Australia's competitiveness (Board of Taxation, 2003a: 72):

> *Recommendation 2.1(1):*
>
> a) *that domestic shareholder tax relief should be provided for unfranked dividends paid out of foreign source income derived after the commencement date; and*
>
> b) *that the relief should be provided by way of a non-refundable tax credit of 20 per cent and without any requirement to trace foreign tax paid or incurred.*

Recommendation 2.1(2):

The Board recommends that the Government implement Option 2.1B to enable the streaming of foreign source income from an Australian parent company or through stapled stock arrangements from a foreign subsidiary, without adverse franking consequences (the Board does not recommend streaming between resident taxpayers).

According to the Board of Taxation's report, removing impediments to Australia's continuing integration into the global economy would bring significant benefits (Board of Taxation, 2003a). This reasoning is in line with the views of the Organisation for Economic Co-operation and Development (OECD): that attracting foreign direct investment lifts a country's economic performance and its living standards (OECD, 2001). The Board was of the opinion that these changes would increase the integration of Australian companies into world class businesses. This is essential as the Australian domestic market is small with a population of only about 22 million. This means that Australian businesses must continue to exploit expansion opportunities overseas if they are to attain economies of scale, establish presence so as to access new markets, compete in larger markets and access new technologies and business systems. By removing tax-induced distortions in investment decisions, the Board's recommendations would enable internationally-oriented Australian companies and investors in them to derive greater returns. Further, the Board considered that the bias in the imputation system of restricting franking credits to Australian source income increased the cost of capital for Australian companies wishing to expand offshore.

The Australian Government rejected the Board of Taxation's main proposal on the dividend imputation treatment of foreign source income, which was to provide a 20 percent tax credit to shareholders on unfranked dividends paid out of foreign source income and to allow the dividend streaming of foreign source income. The Treasurer, however, announced a number of reforms to reduce the costs of complying with the Controlled Foreign Companies (CFC) rules, reduce tax on foreign 'active' business income, and modernise Australia's tax treaties (Commonwealth Treasurer, 2003). The reforms adopted by the government include: simplifying the CFC rules; extending the company tax exemption for foreign non-portfolio dividends to all countries; exempting Australian companies and their CFCs from capital gains tax on sale of certain non-portfolio interests; increasing the Foreign Investment Fund (FIF) portfolio exemption from five to ten percent; and moving towards a more residence-based treaty policy. The reforms were implemented in three stages and the majority of the reforms commenced in July 2004.

The business community welcomed these Australian international tax reforms announced by the government in the 2003-4 Budget. The reason given by the Australian Government for rejecting the Board of Taxation's major recommendation to provide a 20 percent credit to shareholders on unfranked dividends paid out of foreign source income was that the imputation system enjoyed a wide support

amongst the business community and the shareholders. By not implementing the recommendation the problems with the current law remain, as highlighted by the following comments from the various submissions made to the Board of Taxation (2003b):

a) *The design of the current imputation system of wasting franking credits when distributed to non-resident shareholders creates a bias in Australian companies favouring domestic investment over offshore investment* (p. 15).

b) *The current dividend imputation rules create a disincentive for Australian multinational companies to expand their foreign operations and generate foreign profits* (p. 16).

c) *If Australian shareholders are dissuaded for tax reasons from investing in Australian companies expanding offshore, these companies will eventually have a preponderance of offshore investors and it will be inevitable that they will cease to be resident in Australia* (p. 16).

d) *The tax treatment of distributed profits should be the same, regardless of the source* (p. 16).

e) *Imputation works well in a closed economy, but alters the investment dynamics where firms operate globally* (p. 17).

f) *Australia needs to minimise tax on most mobile factors of production, as there is an international trend to reduce taxation of capital* (p. 17).

g) *The notion that offshore investment is treated differently to domestic investment is anachronistic* (p. 17).

h) *The bias was not a concern when imputation was first brought in but has evolved in recent years as a consequence of the evolution of the Australian economy* (p. 17).

i) *The bias may impair the international competitiveness of Australian businesses* (p. 17).

Although the Australian Government did not address the dividend imputation treatment of foreign source income, it did undertake substantial reforms to promote Australian subsidiaries of global groups by reforming harsh CFC rules, FIF rules and exempting from capital gains tax the profits from divestment of foreign subsidiaries which conduct active business operations.

In addition to the reforms arising through International Tax Arrangements, the Australian Government made substantial inroads into reforming superannuation. This is discussed in the next section.

Superannuation and Retirement Policy Changes

Since 2000, the Australian Government has brought about some major changes to Australia's superannuation policy. Changes were required as the existing regime was fraught with complexities arising from different taxation treatment of superannuation contributions and benefits. In addition to different treatment at the retirement stage, there was also a lack of uniformity in the treatment of superannuation contributions. A research paper prepared in 2001 by the Economics, Commerce and Industrial Relations Group for parliamentary debate highlighted the complexity in the taxation treatment of superannuation contributions in Australia (Kehl, 2001: 9):

> *The level of tax depends on a number of factors including who made the contribution, whether a tax deduction was claimed, the source of the contribution, and the timing of the contribution … A person's tax liability on retirement will depend on the proportions of their retirement benefits that fall into each of the 13* [possible] *components and decisions about how the benefits will be invested or spent on retirement.*

The general industry view was that superannuation was overtaxed as Australia was the only country to tax superannuation on entry, earnings and exit from funds. Moreover, high income earners were charged an additional Superannuation Surcharge Tax (SST) (Taxation Institute of Australia Media Release, 2001). Pressure was put upon the government to abolish SST (see, for example, Taxation Institute of Australia, 2001).

Superannuation Surcharge Tax

In the 2002 Budget the Australian Government re-affirmed its commitment to all the measures announced in their election campaign within its policy document 'A better superannuation system'. One of the commitments was the abolition of the SST.

While most countries provide tax incentives to individuals to encourage saving for retirement, Australia was one of the few countries in the world that imposed an entry tax on superannuation savings. The SST was introduced in Australia in August 1996 to reduce the tax advantages of superannuation tax concessions to high income tax earners. However, on the basis of Australian Taxation Office (ATO) statistics, SST also impacted upon middle income earners (Clare, 2002).

Research showed that those targeted by the surcharge were 'either significantly reducing their contributions or simply opting out [of superannuation] and looking for better places to invest their money' (CPA, 1997). In fact, 32 percent of accountants surveyed by the CPA Australia had clients already packaging out of superannuation. Fifty-nine percent of chartered accountants surveyed by the Institute of Chartered Accountants had indicated they would be advising clients to modify their superannuation arrangements (William Tuck ICA cited in Blizard, 1997). These results confirm the negative impact of the surcharge in discouraging rather than encouraging superannuation savings.

The Labor Senator's Minority Report for the Superannuation Contributions and Termination Payments Amendment Bill 1999 went so far as to comment that: 'Australia's reputation as a country with a world-leading retirement incomes policy has been damaged as a result of this inefficient and inequitable tax'. This was in addition to the damage to domestic public confidence in superannuation where a restoration of stability and faith in the system was at issue (CPA, 1997).

A research study conducted by the authors on the hidden costs of the SST concluded that SST was inefficient, inequitable, had high compliance costs on the superannuation industry, significantly increased some taxpayers' effective marginal income tax rates and lacked transparency within the overall tax system (Pope & Fernandez, 2003). Research findings were based on a qualitative and quantitative survey of 40 funds selected from the largest 300 superannuation funds, with respondent funds accounting for around four percent of total superannuation fund assets in Australia (Pope & Fernandez, 2003). The research found that around 80 percent of fund managers rated the abolition of SST as a high priority (Pope & Fernandez, 2003).

The fundamental disadvantage of the SST was that it was a hidden tax, with significant effects on marginal tax rates. For example, certain taxpayers' highest marginal rates increased from 48.5 percent up to between 64.2 and 67.6 percent for taxable incomes between $65,720 and $79,802 in 2000-01 when 24 percent of the taxable income was contributed towards superannuation. The hidden tax compliance costs of the SST on the superannuation industry were not only high—estimated around $76 million for 2000-01, or 11 percent of SST tax revenue of $699 million—but the costs were nearly always borne by all fund members and not just the members whose contributions attracted SST.

The government made an unexpected announcement in the 2002 Budget: that from 1 July 2002 the rate of surcharge was reduced from 15 percent to 13.5 percent. Further decreases followed to 12 percent (from 1 July 2003) and ultimately 10.5 percent (from 1 July 2004). In the 2004 Budget the government announced that the surcharge was to be cut to 7.5 percent. From 1 July 2005 the superannuation surcharge tax was finally abolished. This was followed by major reforms to the superannuation system, discussed below.

Introduction of 'A Better Superannuation System'

In 2006, the Australian Government announced a major $7.2 billion (Treasurer, 2006a) superannuation fund reform that has the potential to affect over 10 million individuals, 1.3 million employers and more than 310,000 superannuation funds (Treasurer, 2006b). The policy objectives were to simplify superannuation for retirees, make it easier to understand, improve incentives to work and save, and introduce greater flexibility on how superannuation savings can be withdrawn in retirement.

The reforms were set to satisfy the following three-pillar approach endorsed by the World Bank in order to alleviate poverty, re-distribute wealth, increase private savings, improve retirement income and promote workforce participation (CoA, 2006: 8.2):

1. *Provide a means tested age pension for Australians who cannot support themselves in retirement;*
2. *Ensure that employees have superannuation savings by making it compulsory for employers to make contributions for employees; and*
3. *Ensure that the superannuation laws promote voluntary private superannuation and savings.*

The superannuation rules that existed at that time were complex and prescriptive. The current reforms were announced by the Australian Government in the 2006-07 Budget. The government released a document called 'A plan to simplify and streamline superannuation' on 9 May 2006. After a three month open consultation period, the government announced its final policy decision on 5 September 2006. On 7 December 2006, the Australian Government introduced the Tax Laws Amendment (Simplified Superannuation) Bill 2006 together with other bills and draft regulations to support the simplification of the superannuation system. The Bill received royal assent on 15 March 2007 (Treasury, 2007).

The *Tax Laws Amendment (Simplified Superannuation) Act 2007* and supporting acts implemented the government's simplified superannuation reforms and rewrote other areas of superannuation taxation law into the *Income Tax Assessment Act 1997*. The new legislation came into effect on 1 July 2007. The centrepiece of the Act was that Australians aged 60 or over can access their superannuation benefits free from taxation from 1 July 2007 if they are paid from a taxed superannuation fund, essentially abolishing the exit tax on benefits for retirees over 60 years of age. Retirees aged over 60 will not have to declare any lump sum or pension payments in their tax return if the payments are made from a superannuation fund that has paid the contribution and earnings tax.[11] This will have a significant impact on retirees' income, and a retiree with no other income will not have to prepare a tax return. By not including the pension or the lump sum superannuation benefit in the taxable income of the retiree, the overall tax rate is reduced, thereby lowering the tax paid on other income of the retiree.[12]

Retirees will also benefit from the abolition of Reasonable Benefit Limit (RBL). Previously only superannuation contributions up to the RBL attracted concessional taxation treatment. The *Tax Laws Amendment (Simplified Superannuation) Act 2007* has abolished RBL. A concessional treatment of 15 percent entry tax now applies to contributions of up to $50,000 per person per annum.[13] Amounts in excess of $50,000 are taxed at the top marginal rate.[14] Payment to a superannuation fund from after taxed income of an individual is not taxed at the entry level in the superannuation fund. A cap of $150,000 per year is set on the amount of non-concessional

contributions to superannuation funds.[15] The abolition of RBL and the exit taxation for retirees over 60 is likely to create an incentive to maintain assets within the concessionally taxed superannuation system.

In summary, the biggest reform in this area is that superannuation benefit payments made to retirees aged 60 and over from a taxed super fund is tax free. Since members aged over 65 are no longer required to compulsorily withdraw their superannuation benefit, and with the abolition of RBL, the new rules give greater flexibility to members, giving them a choice of when they wish to draw on their superannuation. The rules governing contributions have also been simplified with the removal of the age based limit and substituting it with limits on concessional contributions and non-concessional contributions per person per year of $50,000 and $150,000 respectively. As a result of these reforms, superannuation may now be considered an attractive vehicle for investment of savings for retirement (Fernandez, 2007).

The total pool of superannuation funds under management is already very large and it is likely to grow even further with these changes to the legislation. Superannuation funds under management have already reached $945.6 billion, which is a holding equivalent to 95 percent of Australia's annual GDP and forecasted to reach $1.8 trillion by 2011, and $3.3 trillion by 2017 (Swan, 2007). The total estimated superannuation assets at June 2008 were $1.17 trillion (APRA, 2008). They have since fallen due to decline in share prices on world stock exchanges arising from the 2008 international financial crisis.

It can be concluded that the superannuation reforms provide a better and simpler framework for taxpayers and promote the principles conveyed through the Ralph Review. The Review of Income Tax Self Assessment discussed in the next part also promotes these principles.

Review of Income Tax Self Assessment

On 16 December 2004, the Australian Government released the Report on Aspects of Income Tax Self Assessment, following a review announced by the Treasurer on 24 November 2003 to determine whether the right balance had been struck between protecting the rights of individual taxpayers and protecting the revenue benefits of the Australian community as a whole (Treasury, 2004). The Australian Government adopted all of the 30 legislative recommendations made by the Review of Income Tax Self Assessment applying from the 2004-05 year.

The Review of Income Tax Self Assessment examined the self assessment system in Australia which has operated since 1986-7 where taxpayers' returns are accepted at face value, but the tax office can subsequently vary the assessments within a defined period after the initial assessment. The self assessment regime required a balance between uncertainty faced by the taxpayer and the risk of loss of revenue. Uncertainty faced by the taxpayer could be reduced by ensuring a sound system of tax rulings and

determinations to reduce the uncertainty of the law. Another way of achieving the same objective is to reduce the time within which the tax office can amend the assessments.

The key recommendations adopted by the government were:

a) *Improve certainty through providing a better framework for the provision of tax office advice by making public, private and oral tax office rulings binding on the commissioner.*

b) *Improve certainty by reducing periods where the tax office can amend assessments. The tax commissioner can only amend assessments for most individuals and simplified tax system (STS) taxpayers within two years; however, a four year period applies where tax avoidance is involved. Fraud and evasion cases continue to have an unlimited period of amendment.*

c) *Mitigate the interest and penalty consequences of taxpayer errors arising from uncertainties in the self-assessment system. In this respect, a penalty cannot be charged for failure by a taxpayer to follow a private ruling from the tax office.*

The implementation of these recommendations was aimed at improving the reliability, accessibility and timeliness of the ATO's advice and improving certainty for tax practitioners through increased levels of protection, better management of changes in published advice, expansion of matters to request private rulings and greater clarity of the application of general anti-avoidance provisions. The Review of Income Tax Self Assessment streamlined the process through which penalties are imposed upon taxpayers who have understated their tax liability. The ATO is required to make its rulings easier to understand and provide a clearer guidance in its rulings as to what attracts a penalty. The system of charging penalties for not following a private ruling is abolished (Vivian, 2005). The changes from this Review are to give taxpayers more certainty and, as a result, are likely to bring about some reduction in compliance costs.

Small Business Tax Reforms

In the 2006-07 Budget, the government announced a range of measures to reduce the complexity faced by small business. These included: changes to make the STS more attractive; aligning thresholds for small businesses to make it easier for them to understand the eligibility for various concessions; and simplifying and extending access to the small business CGT concession. The STS was introduced in 2001 as part of the recommendations from the Ralph Review. Under the STS, eligible small businesses with a turnover of less than $1 million were permitted to use a cash accounting regime, simplified depreciation rules and the simplified stock system. The purpose of the STS was to reduce the effective tax burden for eligible small businesses by simplifying their record keeping and reporting requirements. The uptake of the STS system has been very low due to its complexity and the costs of investigating whether or not it is beneficial to a particular business. In 2004 the government introduced the

Entrepreneurs' Tax Offset as an inducement to increase the uptake of STS. Since the introduction of the Entrepreneurs' Tax Offset, more than 600,000 taxpayers elected to use the STS (McKerchar, 2007).

The government responded to small business concerns by establishing a review, known as the Banks taskforce, in October 2005 to identify taxation complexity.[16] This recommended that the Australian Government introduce a uniform definition of a small business entity. As a result, the *Tax Laws Amendment (Small-Business) Act 2007* brought in a uniform definition of a small business entity that effectively overrode, but did not actually abolish, the STS. As from 1 July 2007, an entity could automatically be eligible for small business entity concessions without having to lodge an election with the ATO if it satisfied the following small business entity test:

- *entity carries on business*
- *aggregate turnover is less than $2 million.*

McCullough provides an interesting perspective from the Australian Government Treasury on the above changes and what has been termed 'small business alignment' (McCullough, 2008) by arguing that, taken individually, each of the five main eligibility tests for tax concessions[17] was 'clearly justified' yet the small business taxpayer was typically overwhelmed and not claiming their entitlements. The costs for small business, or their advisers, in identifying and complying with the concessions simply outweighed the benefits.[18]

Under the STS, taxpayers could use cash instead of accrual accounting. This was removed with effect from 1 July 2005. The common law position now applies and taxpayers may choose the most appropriate method. The remaining STS concessions will be available to entities that qualify as small business entities under the new definition, but without having to make an election. The entity must first determine whether it meets the definition of a small business entity and, if it does, there are no further conditions in order to access the remaining concession. If the entity fails to qualify as a small business entity, it may still be able to claim concessions under the old rules. The reason for this is that the government did not want any taxpayers to be disadvantaged by the new definition and as a result the small business entity criteria have been layered on top of the existing STS concession criteria. Thus the complexity of the system granting concessions to small business still remains, but will improve administration for taxpayers (Hodgson, 2007).

Small businesses may also benefit from the Board of Taxation's scoping study on small business tax compliance costs. The study provides valuable information about small businesses in Australia and guidance on identifying opportunities to further reduce compliance costs (Board of Taxation, 2008).

Prognosis

The New Tax Agent Regime

Australia has a large body of tax agents—around 26,000 registered tax agents in 2006-07 (Department of Parliamentary Services, 2008)—whose conduct is governed by general law and practice. Around 74 percent of personal income taxpayers use a tax agent, which is one of the highest figures in the world. Thus their further regulation and a much needed reform overall are probably long overdue. On 5 May 2007, the Minister for Revenue and Assistant Treasurer released the exposure draft of the Tax Laws Amendment (Tax Agent Services) Bill 2007 to introduce a Code of Professional Conduct for registered tax agents with sanctions to discipline them. In this respect, the Bill proposes to establish a national Board to register tax agents.[19] The function of the Board will be to administer the system of registration of tax agents, investigate breaches to the Code of Professional Conduct and impose sanctions where necessary, including imposition of civil penalties or an application to the Federal Court for an order for a pecuniary penalty.[20] These reforms introduce safe harbour provisions for taxpayers with the removal of liability for penalties for tax shortfalls arising from the practitioner or tax agent's fault and not the fault of the taxpayer.

The Bill introduces a specific written Code of Professional Conduct requiring tax agents to act honestly and lawfully, without conflict of interest, ensuring that the services are provided competently with the relevant knowledge, care and skill and to take all reasonable steps to advise and apply taxation laws correctly to the client's circumstances.[21]

The new tax agent reforms provide a professional status to tax practitioners with an ethical code of professional conduct and an educational requirement to ensure that the standards are upheld. Most tax professionals would commend the New Tax Agent regime for its establishment of an independent national Board with a broad range of powers to sanction impropriety by tax professionals which would increase community confidence to seek and rely on tax agent services without fear of tax penalties for errors or failures caused by tax agents.

A number of concerns, however, have been identified in the Code of Professional Conduct by members of the Taxation Institute of Australia.[22] The Code requires the tax professional to comply with the taxation laws in the conduct of their personal affairs.[23] The question is whether a tax practitioner could be penalised for taking a reasonably arguable position which later turns out to be incorrect. The current wordings in the Code could force tax professionals to take the most conservative position rather than the reasonably arguable position.

There are five main areas of concern:

1. *The Code requires a professional to not disclose any information relating to a client's affairs to a third party.*[24] *It is unclear as to how this provision will*

apply when information is transferred between associated entities or a family group.

2. *The Code requires a tax agent to provide their services competently.*[25] *It is not clear how competency will be determined subjectively or objectively based on an expert in a narrow field.*
3. *The Code requires the professional to ascertain the client's state of affairs.*[26] *It is not clear to what extent the professional would be held responsible for the veracity of tax information provided to them by their clients.*
4. *The Code requires the professional to advise their clients of their rights and obligations under the taxation laws.*[27] *It is not clear whether this is required for the particular advice that the client is seeking, or on an on-going basis.*
5. *The Code does not give guidance to practitioners as to how to protect themselves if they need to sack clients to ensure they are not in breach of the Code.*

Hopefully the legislation will deal with these issues before it is implemented. Overall, the new tax agent regime will enhance the status of tax professionals and give confidence to the public to use tax agent services.

The Henry Tax-Transfer Review

On 11 May 2008, the Australian Treasurer announced a full review of the tax-transfer system. The purpose of the Review is to create a tax structure that will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century. The Review will consider whether Australia's tax system contains appropriate incentives for workforce participation and for individuals to save and to provide for their future, including access to affordable housing. The Review will assess how the tax system affects 'the promotion of efficient resource allocation to enhance productivity and international tax competitiveness and reducing tax-system complexity, compliance and costs' (CoA, 2008). Public submissions were made to the Review by the end of October 2008. The Review will be conducted in several stages that will provide a final report to the Treasurer by the end of 2009 (Treasury, 2008b).

The White Paper on Carbon Pollution Reduction Scheme

The Australian Government is not alone in its concern about sustainability and the environment. In December 2008 the Australian Government released a White Paper following the July 2008 release of a Green Paper entitled the 'Carbon pollution reduction scheme Green Paper' (Department of Climate Change, 2008). The CPRS aims to reduce carbon pollution from the atmosphere and allow carbon pollution trading permits.

The White Paper proposes a unit system that will allow Australian emissions units to be registered on a national registry with a unique identification number and the year in which it will expire. These units can be surrendered or transferred and thereby

traded as a financial product under the *Corporations Act 2001* and will also attract GST as a taxable supply or input taxed. These units would be available for purchase at regular auctions. A tax deduction will be allowed when the units are purchased and then assessed when surrendered or sold. The permits on hand at the end of the year will be treated like trading stock, whereby the deduction is deferred until surrendered or sold unless the difference in opening and closing stock of units is five percent or less. The paper does not determine whether the units will be valued at historic cost or market value.

The government intends to introduce a Bill through parliament in early 2009, and expects the law to come into operation in 2010.

Comparison of Recent Australian and UK Tax Policies

The UK tax reforms have also been similar to that of Australia in terms of income tax and corporation tax rates being lowered.

In the context of small business taxation policy, the trend is to incorporate small businesses in order to achieve lower regulatory costs and other related advantages. This raises the issue of personal services (labour) income being converted into capital income, with ensuing anti-avoidance provisions usually being introduced. In the UK such provisions, especially the personal service company (PSC) legislation, encountered definitional difficulties and were seen as 'contentious and complex and, until 2007 at least, not very effective' (Crawford & Freedman, 2008).

The UK has tried a number of approaches to small business in the past decade with little success and with a variety of unforeseen negative consequences. In the UK, the differences between tax and National Insurance Contributions for individuals as employees and small business creates an incentive to be self-employed rather than an employee, and incorporated rather than self-employed. Thus the UK experience has led Crawford and Freedman to conclude that '… the tax system should not seek to favour one legal form over the other' (Crawford & Freedman, 2008). This is reflected in current UK policy to encourage 'all businesses to grow' without distortion by means of an annual investment allowance for the first GBP50,000 for expenditure on plant and machinery from 2008-09 (Crawford & Freedman, 2008).

Australian tax policy on small business can learn much from past and current UK policies and also current research (Pope, 2008). The UK has very strong small business lobby groups that are '… vociferous and forceful when it comes to tax policy …' and '… create a sense of distrust in the tax system even if the number of people affected by a change is relatively small' (Crawford & Freedman, 2008). The same applies to Australia.

Crawford and Freedman emphasise that any thorough assessment of small business tax policy needs to take into account the effects upon employment, self-employment and incorporation, and upon both personal and business taxation. They

conclude strongly in favour of neutrality between legal forms. Thus, taxation incentives should not affect a person's choice of adopting a particular legal form to conduct business, and government should only provide small business with targeted tax incentives where there is a clear case of market failure. On both equity and efficiency grounds an overall tax system free from distortions is the best approach. A very strong argument is that many small business owners may prefer a simpler system with lower levels of tax, yet this is difficult in our political system as politicians often provide incentives for political reasons (Crawford & Freedman, 2008).

Since 1997 the UK Government has reduced the corporation tax rate to 30 percent from 1999-2000 and to 28 percent in the 2008 Budget. The UK Government set its parameters in consultation documents entitled 'Large business taxation: The government strategy and corporate tax reforms' released in July 2001 and 'Corporation tax reform' released in August 2003 (Inland Revenue, 2003). The Australian Corporations tax rate of 30 percent was considered competitive in 2000, but is now considered high compared to the OECD average of 26.6 percent and the UK Corporation Tax rate of 28 percent (Corporate Tax Association & Ernst & Young, 2008).

The UK Government's objectives in undertaking the reforms were similar to that of Australia's Ralph Review in terms of reducing tax distortions and removing outdated and ineffective restrictions. In particular, the UK Government has considered the reform of the scheduler system of taxation being applied to companies with the option of full pooling of all sources of income or pooling all sources of trading income and income from property. The UK Government also examined the different tax considerations between trading and investment companies. The UK Government's objective was to move to a more coherent, consistent and comprehensive system for the taxation of capital profits and relief for capital expenditures in order to reduce distortions in the system.

The *Finance Act 2000* worsened the UK's tax regime for international companies, and companies such as Vodafone and BAT threatened to move the base of their operations out of the UK (Gorringe, 2001). The business community put pressure on the UK Government to take corrective measures. The UK Government therefore issued a consultation paper in July 2001, stating its views that the corporate tax system in the UK keep pace with changes in the global business environment, but not be distorted by tax considerations (Inland Revenue, 2001).

The consultation paper identified that the UK Government had already taken some measures to attract foreign investment by cutting the corporate tax rate from 33 percent in 1996-97 to 30 percent in 1999-2000 and modifying the dividend imputation system by abolishing the Advance Corporations Tax to remove tax distortions. The UK Government made group relief more flexible, allowing multinational groups the flexibility to structure themselves. It introduced a new onshore pooling system, enabling groups to get maximum relief for foreign taxes without the need to arrange

their holdings in overseas subsidiaries through complex offshore structures (Inland Revenue, 2001). In Australia the dividend imputation system needs to be modernised as Australian companies with Australian shareholders expanding overseas have an uncompetitive environment and face pressure to relocate offshore (Corporate Tax Association and Ernst & Young, 2008).

As far as personal income tax is concerned in the UK, a starting rate of 20 percent was reduced to 10 percent in 1999-2000. The income tax rates on earned income has remained the same from 2000-01 to 2007-08 (10% starting rate, 22% basic rate and 40% higher rate). From 2008-09, the basic rate will reduce from 22 percent to 20 percent. Unlike the UK, the Australian higher income tax rates have been significantly reduced from 2000-2001 to 2007-2008, and thresholds increased at all levels apart from the first (tax-free) threshold of $6,000, as discussed earlier.

The UK also modernised their welfare system by introducing Child Tax Credit in April 2003 to provide support for low-income families with children, which replaced the Working Families Tax Credit that had operated since 1999. Using the income tax system rather than means testing, the Child Tax Credit provides a single, seamless system of support for families with children (HM Treasury, 2002).

The mortgage interest tax relief in the UK has been diminished since 1991 to its total abolition in April 2000. Australia does not provide relief for mortgage interest on principal private residence. Savings in the UK are encouraged by Personal Equity Plans introduced in 1987 and a Tax-Exempt Special Savings Account introduced in 1991. The Australian Government provides assistance to first home buyers through the First Home Owners Scheme that has been in operation since July 2000. The grants were provided to 69,000 eligible home buyers worth $6.2 billion up to 2006-07.[28] Effective from 14 October 2008, the Australian Government has committed to a $14,000 boost benefit in addition to the $7,000 grant to eligible newly constructed home buyers.

The superannuation reforms in Australia are yet to be tested in terms of sustainability and adequacy. The problems with the UK superannuation system are of great concern, as powerfully demonstrated by a recent High Court decision which affected 85,000 people who lost their pensions when the companies they worked for were liquidated between 1997 and 2005. In the UK, the statutory framework played a significant part in allowing the Defined Benefit Fund schemes to be underfunded. The Ombudsman has criticised some of the UK Government's discretionary policies, such as the abolition in 1997 of the system of tax credits given to pension schemes that gave effect to the shortfall that resulted in the schemes.[29]

Similarly to Australia, the UK has conducted a major tax study named 'The Mirrlees Review: Reforming the tax system for the 21st century'.[30] A group of international experts and researchers have undertaken a comprehensive study into the characteristics of a good tax system for any open developed economy of the 21st century and assessed the extent to which the UK's tax system conforms to these ideals.

The next round of tax reforms are likely to be shaped by the government's Henry Review in Australia and, possibly to a lesser extent, the Mirrlees Review in the UK. Both reviews are likely to be overshadowed by the domestic economic situation in their respective countries and the overall world economic outlook. Significant tax reform is undoubtedly much more difficult during a time of recession or very low growth. In addition to reforms relating to sustainability and the environment, retirement policies may also come under scrutiny.

Conclusions

Australia has, arguably, largely caught up with other OECD countries in terms of having successfully introduced a GST of 10 percent in July 2000 and reduced, to some extent, its reliance on personal income taxation revenue. The former now accounts for around 13 percent of all government tax revenue whilst the latter accounts for a still significant 38 percent, down from 43 percent in 2000-01. Significantly, company income taxes now account for around 21 percent—up by 7 percent since 2000-01—reflecting the strong economic growth of the period. However, a decline in this revenue stream in the next few years as the economy slows may prove problematical.

The major reform over the past seven years has been in the area of taxation of superannuation, with Australians now enjoying tax-free retirement pensions once they are over the age of 60. The triple-based taxation of superannuation at the entry, fund and exit stages has now been reduced to only two (entry and fund), which is a long overdue reform that brings Australia into line with most other advanced economies.

Australia has also reformed its taxation of small business, although many of the changes in the early part of this decade were cosmetic and could be politically motivated. Some of the reforms were complex and as a result small businesses could not take advantage of them. This led to still further reform and a standard eligibility threshold of $2 million being introduced in the *Tax Laws Amendment (Small-Business) Act 2007*. Other reforms included recommendations from the Review of Income Tax Self Assessment, the major being a limitation period of two years for the tax office to amend assessments for most individuals and four years where tax avoidance is involved.

Looking ahead, Australia has three main challenges, all inter-related, in the taxation field. First is the overall review of the efficiency of the tax-transfer system under the Henry Tax Review. Significant reform will entail a complex package featuring both winners and losers in the short term. Without ensuing major legislative reform, the 18-month review will become just another bureaucratic exercise. Second, the introduction of a phased-in carbon reduction emissions trading scheme, planned to start in 2010, will impose high overall costs including high regulatory/tax compliance costs on business that will flow through to consumers. The issue of compensation, much of it probably to be delivered through the tax system, will become important. Third, unlike the UK, Australia has a federal system of government with a high vertical

fiscal imbalance that continues to impose complexities and constraints on the tax system as well as high business compliance costs. A considerable challenge is the extent to which the Henry Review can recommend realistic reform in this area that can be implemented politically within the context of the Australian constitution.

Similarly, the UK continues to grapple with its role within the European Union and the ensuing tax and related policy challenges, including emissions trading. It remains to be seen, over the next decade, the extent to which Australia and the UK can deal with the similar and very different challenges that they both face in determining their tax policies.

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Notes

1 Positive comments on this paper were received in a detailed letter from a former British High Commissioner to Australia shortly after publication.

2 These have been minimal apart from the abolition of some state stamp duties with low tax revenue, an outcome of the tax reform, 'Not a new tax, a new tax system' in *A New Tax System (Indirect Tax Consequential Amendments) Act 1999* and, more recently, some progress on state payroll tax harmonisation initiated by New South Wales and Victoria.

3 See Dirkis and Ting (2006) for a stock take of the business tax reform process where they state that between June 1999 and 2006 in excess of 290 taxation, superannuation, excise and license fee Bills were introduced into parliament.

4 All references to amounts of money in this paper refer to Australian dollars unless otherwise stated.

5 The Australian annual inflation rate varied between 2% and 6% over the period. It was 3.2% in the year to June 2000 compared with 4.5% in the year to June 2008. Inflation data accessed: 5 Nov 2008 from <http://www.rba.gov.au/Statistics/historical_cpi_data.xls>
6 The data relates to all Australian taxes, although the majority of the tax is collected by the Commonwealth.
7 The Federal Government released a policy document on 15 October 2001 entitled 'Securing Australia's prosperity'.
8 This was not a government White Paper but an industry White Paper.
9 One reason for a high Australian investment in comparable tax countries could be due to the design of the Australian tax legislation.
10 Includes a summary of the issues raised by the Australian Government in the consultation paper.
11 The Australian Government in the Explanatory Memoranda to the Tax Laws Amendment (Simplified Superannuation) Bill 2006 stated that based on 2004/05 tax returns, around 152,000 taxpayers will not have to lodge tax returns.
12 A superannuation benefit paid to a person aged 60 and over is not assessable income and is not exempt income. 'Non-assessable non-exempt' income is defined in section 6-23 of the *Income Tax Assessment Act 1997* and it means that the person does not have to pay income tax on it (i.e., it is tax free).
13 Individuals over the age of 50 were entitled to a concessional treatment on contributions up to $105,113 for 2006-07. The $50,000 limit under the new reforms would have disadvantaged them. Therefore from 2007-08 until 2011-12, a transitional arrangement will entitle them to a concessional treatment on $100,000. This will revert to $50,000 per annum from 2012-13.
14 Section 292-25 of *Income Tax Assessment Act 1997*.
15 Section 292-80 and sections 292-85(1) and (2) of *Income Tax Assessment Act 1997*. Also note that people aged 63 and 64 can contribute $450,000 in the 2007-08 year but will then be unable to make further non-concessional contributions until 2010-11 tax year.
16 Its chairperson was Garry Banks. The Banks taskforce, entitled 'Rethinking regulation', was released to the public on 7 April 2006 and made 178 recommendations. The government accepted 158 of these recommendations.
17 These were for income tax, GST, CGT, Fringe Benefits Tax and Pay-As-You-Go.
18 Treasury emphasises an ongoing review of the tax system with a view to minimizing complexity whilst ensuring the balance of risks is appropriate. The current Henry Review, due to be completed late 2009, will be an *acid test* of Australian Government resolve on the issue of reducing systemic tax complexity.
19 Section 2-5 of Tax Laws Amendment (Tax Agent Services) Bill 2007.
20 Section 60-15 of Tax Laws Amendment (Tax Agent Services) Bill 2007.
21 Section 30-10 of Tax Laws Amendment (Tax Agent Services) Bill 2007.
22 Submission from the Taxation Institute of Australia on Exposure Draft of the Tax Agent Services Bill 2008 and accompanying materials, 30 June 2008. Extracted from: <http://www.treasury.gov.au>
23 Section 30-10(2) of Tax Laws Amendment (Tax Agents Services) Bill 2007.
24 Section 30-10(6) of Tax Laws Amendment (Tax Agent Services) Bill 2007.
25 Section 30-10(7) of Tax Laws Amendment (Tax Agent Services) Bill 2007.
26 Section 30-10(9) of Tax Laws Amendment (Tax Agent Services) Bill 2007.
27 Section 30-10(12) of Tax Laws Amendment (Tax Agent Services) Bill 2007.
28 Australian Government Budget 2006-07 at: <http://www.budget.gov.au/2006-07/bp3/html/bp3_main-05.htm>

29 *R v Secretary of State for Work and Pensions ex parte Bradley and Others* [2007] EWHC 242 (Admin).

30 The project is chaired by Sir James Mirrlees. Publications can be accessed from: <http://www.ifs.org.uk/mirrleesreview/publications.php>