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29 January 2010

Budget Policy Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Email: prebudgetsubs@treasury.gov.au

Dear Sir/Madam

2010-11 Pre-budget Submission

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide its response to the Treasurer's Media Release dated 27 November 2009 calling for submissions regarding priorities for the 2010-11 Budget.

The Taxation Institute has summarised the issues which it considers should be a priority for the Government to consider below. These issues are discussed in more detail in the appendix.

1. Ensuring business viability

- Clarify the taxation of trusts
- Clarify the policy position regarding encouraging foreign investment
- Increase scope of the investment allowance incentive
- Clarify the taxation treatment of earnouts
- Clarify the Commissioner's powers to apply refunds against debt due but not payable
- Allow imputation credits to flow through family trusts that are in loss positions
- Ensure taxation laws do not impede funding from the Islamic banking sector

3. Reducing compliance costs

- Complete the re-write of the *Income Tax Assessment Act 1936*
- Remove unnecessary tax provisions
- Clarify the operation of the imputation rules

4. Promoting fairness

- Review the tax rates for non-residents
- Review ATO debt recovery powers

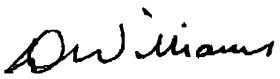
5. Climate change

- Extend concessions to cover geothermal energy
- Tax incentives to encourage water conservation
- GST free treatment for emissions trading units

Finally, the Taxation Institute would welcome an invitation to participate in any Budget lock-up on 11 May 2009, prior to the Treasurer's Budget speech to the Parliament and the public release of the Budget papers. The Taxation Institute has participated in the 2005 to 2009 lock-ups. Given that our 15,000 tax practitioner members throughout Australia (ranging from small rural and suburban accountants to senior members of the bar specialising in tax) rely upon our report of key budget measures affecting their clients, it is crucial that we are able to report this in a time efficient manner.

Should you have any queries with respect to any of the matters raised above, please do not hesitate to contact David Williams on (02) 9958 5121 or the Taxation Institute's Tax Counsel, Angie Ananda on 02 8223 0011.

Yours faithfully



David Williams
President

APPENDIX

Taxation Institute of Australia
Pre-Budget Submission 2010-11

1. Ensuring business viability

The Taxation Institute recommends the following initiatives aimed at ensuring ongoing business viability in both the domestic and international contexts in light of the global financial crisis.

1.1 Clarify the taxation of trusts

The need for urgent clarification of the taxation of trusts has been highlighted by the recent case of Bamford and the recent issues in relation to the treatment of unpaid present entitlements to corporate beneficiaries under Division 7A.

Special leave has been granted for the High Court to consider two issues in relation to the Bamford case:

- Firstly, the meaning of the expression "income of the trust estate"; and
- Secondly, the meaning of the expression a "share" of the income of the trust estate.

The Bamford case concerns trust law issues in relation to which there have been differing views and uncertainty for many years. The decision of the Full Federal Court in Bamford offered clarity regarding the meaning of a "share" of trust income. The Court concluded that a "share" of trust income refers to a beneficiary's proportionate interest in the income. However, the decision did not provide sufficient clarity regarding the meaning of the expression "income of the trust". The decision resulted in uncertainty regarding how trusts and beneficiaries are taxed.

Given the uncertainty following the decision of the Full Federal Court and the fact that both the taxpayer and the Commissioner argued for special leave to be granted, the grant of leave to appeal to the High Court in the Bamford case was not surprising.

The Taxation Institute hopes that the High Court will take the opportunity to clarify the law in this area in a manner that will have broad application which is capable of providing guidance for taxpayers and their advisers. However, the Taxation Institute has serious doubts about whether the Bamford case (as decided by the High Court) will have any substantive affect in reducing the uncertainty in relation to the taxation of trusts.

Accordingly, the Taxation Institute urges the Government to undertake a comprehensive review of the taxation of trusts.

1.2 Clarify the policy position regarding encouraging foreign investment

The TPG Myer case highlights some issues which are a source of uncertainty for foreign investors and, in particular, foreign private equity funds. The Taxation Institute considers that the uncertainty is centred on three main issues:

- Whether profits are characterised as revenue or capital in nature;
- The source of profits; and
- The application of Part IVA when interposed entities are used to invest into Australia.

The uncertainty created by the TPG Myer case and the subsequent determinations released by the ATO (TD 2009/D17 and TD 2009/D18), have a discouraging effect on foreign investment in Australia (including by private equity funds). In this regard, the Taxation Institute considers that foreign and domestic private equity funds have an important role to play in invigorating and promoting an efficient economy.

The Taxation Institute considers that the approach taken by the ATO in the TPG Myer case and the following tax determinations are inconsistent with the policy of encouraging foreign investment. The policy of encouraging foreign investment is illustrated by the changes to the CGT treatment for non-residents that were introduced under Division 855.

The Taxation Institute recommends that the policy position on this issue should be clarified. Further, there should be clarification specifically in relation to the application of the policy to private equity funds.

1.3 Increase scope of the investment allowance incentive

The Taxation Institute welcomed the extension of the investment allowance in 2009. In 2010/11, the Taxation Institute considers that the investment allowance should be extended for long term infrastructure.

In this regard, the Taxation Institute notes that the investment allowance only applied to assets in relation to which Division 40 of the *Income Tax Assessment Act 1997* (**ITAA 1997**) applied. This meant that capital works for amounts that can be deducted under Division 43 of the ITAA 1997 did not qualify for the investment allowance. In the interests of encouraging businesses to proceed with their investment plans as a boost to business investment and the Australian economy generally, the Taxation Institute recommends that this incentive is extended for the 2010/11 year in relation to long term infrastructure expenditure that is deductible under Division 43.

1.4 Clarify the taxation treatment of earnouts

Where there is future uncertainty about the likely economic performance of the asset being sold/acquired, the use of an earnout formula creates a greater incentive for the transfer of the asset to take place as it promotes a "fairer value" for both parties. In other words it aids the efficient functioning of the market place. Unfortunately, where the taxation treatment is uncertain and continues to be uncertain this detracts from the efficient functioning of the market place and leads to a less than optimal outcome for the economy as a whole.

The Tax Office's Draft Ruling TR 2007/D10 on earnout arrangements has caused uncertainty for many businesses. This ruling has now been in draft form for 3 years. The Taxation Institute considers that it is appropriate for Government to make a policy decision in relation to the treatment of earnouts.

In this regard, the Taxation Institute does not support the ATO's proposed treatment of earnout arrangements as described in TR 2007/D10. However, in the event that Government decides to accept the ATO's position from a policy and legal perspective (ie that an earnout is treated as two distinct assets), the Taxation Institute submits that both assets should have access to all relevant concessions (ie small business concessions, pre-CGT treatment for pre-CGT assets and the ability to access the CGT discount) if the disposal of the original asset would qualify for the concessions.

1.5 Clarify the Commissioner's powers to apply refunds against debts due but not payable

Currently the Commissioner is empowered to apply refunds against tax debts due but not payable. Where this occurs large compliance costs may be incurred where the taxpayer needs to seek a refund of the resultant over payment where the payment, which has not been processed at the time the offset occurs, has already been made in respect of the debt.

Such an offset power should not exist as a matter of course and should only be available where there is a poor payment history and the payment is at risk. As well as imposing high compliance costs, the current process creates cash flow difficulties for businesses and creates a disincentive against lodging any form early that gives rise to a tax liability. This disincentive goes against the spirit of regular progressive lodgement of forms.

1.6 Allow imputation credits to flow through family trusts that are in loss positions

Although trusts are in effect a flow through entity, there is no mechanism currently that allows franking credits to flow through the trust to the beneficiaries when the trust is in a loss position. This is inconsistent with provisions, applicable from 1 July 2000, that allow resident individuals and certain other entities to a refund of imputation credits where a taxpayer's total imputation credits attached to franked dividends exceed the taxpayer's income tax liability for the particular income year in question. Currently, under these provisions, a resident trustee is only eligible for a refund of excess imputation credits where the trustee is liable to be assessed under section 99 of the ITAA 1936.

This is a significant problem presently for rural Australia, where the increasing trend of the formation of incorporated rural co-operatives and the holding of the primary producer's shares in trust have resulted in the loss of excess imputation credits at a time when primary producers could well do with the extra income.

1.7 Ensure taxation laws do not impede funding from the Islamic banking sector

As a capital importing country it is crucial that sources of funding are available from the widest possible sources. However, our current taxation laws impede the ability of Australians to seek funding from the Islamic banking sector. There are two areas of concern, security of mortgage and the payment of interest.

First, there are issues that arise in respect of property financing. Instead of a traditional home loan, an Islamic financer will purchase a home selected by his Muslim customer and effectively rent that home to the customer over a period. This is then accompanied by an option to purchase the home at the conclusion of that period. The Arabic term for this agreement is *ijarah-wa-iqtina*. However, the transfer of the property to the client is subject to capital gains tax, which is an impost that would not be applied to a traditional home loan. The financer, naturally, passes the CGT onto the customer implicit in the financer's margin.

The second area of concern is the payment of interest. Although it is an oversimplification to say that Shari'ah law generally forbids usury (the receipt or payment of interest), the provision of interest payments as part of our tax law can create problems. For example, where a Muslim-controlled private company makes loans subject to Division 7A they are not then able to avail themselves of section 109N, which relates to excluded loans, because that would involve charging interest on the loan, and may be forced into a situation where Div 7A deems a dividend. One solution would be for the company to make no loans, but in a competitive market that would then disadvantage a Muslim-owned business as against a non-Muslim-owned business.

Similarly, a Muslim employer may make loans to employees subject to FBT as a loan benefit. A non-Muslim employer would have the option of charging interest on the loan with the result that there is no fringe benefit; however a Muslim employer is not permitted to do this. There is of course, a tax rate differential – a Muslim employer would be forced to pay FBT at 46.5%, while a non-Muslim employer would be taxed on the interest income at their marginal rate, which is likely to be less. .

In a related matter, a Muslim employer may provide a car benefit. If the employer has paid cash for the car, but accounts for the FBT under the operating cost method, they are obliged to calculate an amount of imputed interest to represent the opportunity cost of capital. This is purely a notional calculation, and therefore the imputed interest itself should have no further ramifications for the employer. However, it could be regarded as unfair that a Muslim employer must may FBT on an imputed interest amount, the benefits of which would be denied them by their religious beliefs.

To overcome these problems taxpayers attempt to disguise a return on a private investment as a management fee, or some other kind of fee for services provided. In this situation, if the fee is in fact for services provided, it would appear that it may raise issues under Part 2-42 of the *Income*

Tax Assessment Act 1936 (**ITAA 36**) related to personal services income. If it were characterised as a return on investment, this would not be the case.

Finally, all taxpayers are subject to GIC in circumstances where the law allows the Commissioner to impose it. This may not necessarily be through any fault of the taxpayer. For example, it may be due to an assessment amended either by the Commissioner or by the taxpayer. It would seem that Australian law therefore requires a Muslim taxpayer to break his faith and pay interest.

These problems are common to other jurisdictions, but most, like the United Kingdom, have amended their laws to accommodate these differences. In many cases the terminology has been changed so that interest is not described as interest, rather it is phrased as a penalty (although, for other reasons, the categorisation as a penalty in Australia would involve flow on consequences which would suggest the use of some other terminology to address the issue).

Therefore, given that these change have little or no revenue impact as many of the changes required are to the form of the law rather than its substance the Taxation Institute urges the Government to remove the impediments in the current tax laws to the utilisation of funding from the Islamic banking sector.

2. Reducing compliance costs

The Taxation Institute recommends the following initiatives to assist in alleviating the impact of the global financial crisis on businesses and individuals through reducing tax compliance costs.

2.1 Tax law re-write

The Taxation Institute recommends that the Government initiate a program to conclude the rewrite of the ITAA 36 into the ITAA 97.

The Taxation Institute considers that the rewrite will reduce complexity and simplify the taxation law. To date the rewrite has been a long and drawn out process. The Taxation Institute recommends the completion of the project should become a priority for Government.

2.2 Remove unnecessary tax provisions

In light of the Australia Future Tax System review, the Taxation Institute also recommends that the Government initiate a comprehensive methodical review of our tax laws to remove all unnecessary provisions.

The Taxation Institute acknowledges that the *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* removed a lot of the deadwood from our tax legislation with the removal of a tranche of inoperative provisions. However, we nevertheless believe that this is only the first step. There is now an opportunity in the 2009-10 Budget to go beyond the boundaries of this initial clean up and provide appropriate funding for a methodical review of all our tax laws to remove unnecessary and redundant provisions.

To progress this type of review, the Taxation Institute produced the report in 2006, *Beyond 4100 - A report on measures to combat rising compliance costs through reducing tax law complexity*. The report focuses on identifying generic causes of complexity in the Australian income tax system and provides specific examples of complexities that may be regarded as being attributable to each generic cause. The report successfully builds on the work already undertaken in removing inoperative provisions.

The Taxation Institute developed a series of detailed case studies illustrating the effects of the combination of multiple causes of complexity in the operation of the current income tax rules which appear in the report. Our report's recommendations focused on the following four areas:

(i) repeal provisions rendered unnecessary by subsequent developments in the law;

(ii) repeal or redraft provisions whose literal meaning is rarely or never enforced;
(iii) rationalisation of rules through the adoption of common or more general rules; and
(iv) proposals relating to de minimis rules.

The recommendations are designed to impact favourably on compliance cost reduction at no or negligible cost to the Revenue.

The Taxation Institute calls upon the Government to instigate a comprehensive and methodical review of our tax laws with a view to reassessing the effectiveness and relevance of all tax provisions. This review could be carried out through a task force established specifically for this purpose or under the direction of the Board of the Taxation.

2.3 Clarify the operation of the imputation rules

With the introduction of the Simplified Imputation System into the ITAA 1997 in 2002 (via by the *New Business Tax System (Imputation) Act 2002)*, the former imputation rules in Part IIIAA of the ITAA 1936 ceased to have application from 1 July 2002 (refer former section 160AOAA of the ITAA 1936). However, not all the imputation rules were incorporated into the ITAA 1997, in particular the so-called 45 day rule. Despite this occurring the ATO has maintained that the rules continue to have operation (see Taxation Determination TD 2007/11). The situation is further confused with the passage of the *Inoperative Provisions Act,* which deems Part IIIA to be inoperative from 14 September 2006. This is leading to unnecessary compliance costs and community uncertainty.

The Taxation Institute urges the Government as a matter of priority to complete the rewrite of imputation rules in the ITAA 1997. If a shareholding rule is still required then the period should be replaced by a 15 day rule as recommended by the Review of Business Taxation (Recommendation 6.7, *A Tax System Redesigned* (1999)).

3. Promoting fairness

The Taxation Institute recommends the following initiatives to improve the equity of our current tax regime.

3.1 Review the tax rates for non-residents

For the 2009-10 year, the tax rate for non-residents with taxable incomes of $0-35,000 is 29%. Other than slight increases in the threshold at which the next highest rate of 30% begins the 29% rate itself has been in place since prior to 1990. In 1990, Australian residents were also taxed at 29% at reasonably low income levels ($12,600 - $19,500). Since 1990 the low income rate for resident individuals has been reduced several times, with the rate for the 2009-10 year being 15% for income from $6,000 - $35,000.

It would appear that we are taxing non-residents at almost double the rate of residents at low income levels where the comparative rate of taxation in the non-resident's country of residence is not uncommonly far less than 29%. With the Government's plan of reducing residents' personal income tax rates this inequity will become greater.

In the UK the starting rate band is 10%-20%, in the US it is 10-15%, in New Zealand it is 12.5-21%. No different rates are applied to non-residents in these countries.

It is accepted that many of our tax concessions, such as the $0-$6,000 zero tax rate threshold, low income offsets and spouse offsets should not be available to non-residents. However, it does seem to be an oversight to leave the low income tax rate for non-residents at the same level since the 1990s.

There would be some cost to the Revenue in adjusting the non-resident tax rate in line with resident tax rates. On an individual basis, it would seem these groups are paying a

disproportionate level of tax in Australia on their Australian income. The Taxation Institute requests Government consider aligning low income non-resident tax rates with those of residents.

3.2 Review ATO debt recovery powers

The Taxation Institute considers that the ATO's debt recovery powers should be limited where there is a legitimate dispute on foot. Further, the Taxation Institute considers that the ATO should not be able to obtain an advantage over other ordinary creditors by the use of garnishee notices. In this respect, the Taxation Institute considers that the Government should consider implementing changes to the ATO's debt recovery powers in relation to these issues.

Under the present taxation laws the ATO may recover an assessed tax liability notwithstanding the legitimacy and strength of the taxpayer's case in the disputed assessment. A Court must accept on production of a notice of assessment that the tax is due and payable and cannot go behind the assessment. The assessment can in the normal course only be disputed by Part IVC of the *Taxation Administration Act 1953* proceedings (*FC of T v Futuris Corporation Limited* [2008] HCA 32). The ATO may petition for bankruptcy of the taxpayer based on a judgment debt founded on the conclusive notice of assessment. The Court has the discretion to adjourn a bankruptcy hearing pending resolution of the disputed assessment by way of the objection process. If the Court cannot be persuaded to adjourn the bankruptcy proceedings then the dispute may only be continued by the trustee in bankruptcy choosing to do so. Such cases are rare.

The Taxation Institute considers that the ATO has an advantage given to it by the conclusive nature of the assessment (and those provisions in the law which disentitle the Federal Court or Tribunal from deferring recovery action while considering a Part IVC dispute) not available to ordinary creditors. This may prejudice ordinary creditors who must in the usual case defer bankruptcy proceedings while their debt is disputed in the Courts. It can also prejudice taxpayers who have legitimate disputes with the ATO by moving them to compromise the dispute more readily than they would otherwise do. In this sense, ordinary creditors are disadvantaged.

The Taxation Institute respectfully submits that a Court or Tribunal hearing a Part IVC dispute is best placed to determine whether the taxpayer has substantive grounds for disputing the assessment (rather than a Court considering a bankruptcy petition) and should be given the opportunity to determine whether the collection action by the ATO should be deferred. Further, it is suggested that the ability of the ATO to commence recovery proceedings should be subject to the determination of objections lodged by the taxpayer.

In regard to garnishee notices under section 260-5 of the *Taxation Administration Act 1953,* the principal cause of concern to the Taxation Institute is that the service of a notice on a third party gives the ATO de facto priority over ordinary creditors. This is confirmed in *FC of T v Bruton Holdings Pty Ltd* [2009] HCA 32. Apart from certain limited exceptions (such as Division 9 of Part VI of the ITAA 36) the policy of the tax laws is that the ATO should rank as an ordinary creditor so that other ordinary creditors are not disadvantaged. The use of section 260-5 garnishees notices would appear to be inconsistent with this policy.

The Taxation Institute recommends that the priority position of the ATO should be reviewed and inconsistencies remedied.

5. Climate Change

The Taxation Institute suggests that there are some climate change related tax issues that benefit from immediate consideration in the context of the 2010-11 Budget.

5.1 Ensure that current tax laws do not impede development of alternative energy sources

As renewable and alternative energy sources are crucial to any carbon reduction strategy it is important to ensure that the development of alternative energy sources is not impeded by the

current tax laws. For example, it will be necessary to consider the capital allowances treatment of investments in low-emissions technologies and other expenditure aimed at emissions reductions.

The environmental protection activity immediate deduction in section 40-755 currently has no application where expenditure is incurred on activities to prevent, fight or remedy general greenhouse gas pollution (see Register of Private Binding Rulings Authorisation Number 72229). Many activities that will be undertaken in response to climate change are likely to fall into this category and are therefore unlikely to be deductible under section 40-755.

Similarly, as the tax law stands at the moment there is divergent tax treatment for geothermal when compared to hydrocarbon exploration tenements and assets. The operative provisions of Division 40 (40-30, 40-80 and 40-730) of the ITAA 1997 do not include expenditure referable to geothermal exploration as activities that qualify for deduction within the Division.

The Taxation Institute consider that the various tax provisions that apply to the traditional mining and petroleum industries (within Division 40 ITAA and the Fuel Tax Credit scheme) should be extended to the geothermal energy industry. The Taxation Institute considers that access to these concessional mining taxation rules is essential to ensure that geothermal is not at a comparative financial disadvantage to the traditional mining and petroleum industries.

Further, this area of activity was not contemplated at the time of enactment of the provisions and is only in recent years coming to prominence as new energy sources are being sought. It is now time for the provisions to be amended to treat expenditure referable to geothermal exploration tenements and assets in line with hydrocarbon tenements and assets to ensure that those investing in this activity are not at a disadvantage.

Other direct incentives could also be provided to support the development of renewable energies. This could involve providing accelerated deductions for tax depreciation in relation to capital investment in specific renewable energies. This approach is adopted in a number of other countries. For example, France allows tax depreciation over 12 months for equipment utilised in certain wind power projects.

5.2 Tax incentives to encourage water conservation

The Taxation Institute recommends that the Government should consider introducing further tax incentives to encourage water conservation. Such incentives may involve deductions for covering canals to prevent water evaporation. It is clear that expenditure on such infrastructure will provide significant benefit to the reduction of loss of water due to evaporation and enable the better management of a critical scarce resource.

5.3 GST free treatment for emissions trading units

The decision, as reflected in the Carbon Pollution Reduction Scheme (Consequential Amendments) Bill 2009 (**Consequential Amendments Bill**), to treat permits as a taxable supply needs reconsideration as little weight has been given in the Government's *Carbon Pollution Reduction Scheme: Australia's Low Pollution Future White Paper* (**White Paper**) and the associated compliance cost of the measures combined with the finance cost.

Currently finance trading markets do not apply GST to the items traded (share, options, etc). As a result they will need to incur substantial costs in developing systems that are able to capture the GST in an electronic trading environment where sellers are not aware of the identities of buyers. This makes the use of tax invoices in their current form problematic, in particular in a mature system with foreign entry where the CPRS permits will be GST free supplies when acquired by foreigners. It was these compliance difficulties that convinced the New Zealand Government to exclude permits from the GST net despite having a goods and services tax (GST), which applies to virtually all supplies of goods and services.

The case for GST free treatment equally applies in Australia. We note that although the markets are intended be closed to world trade for the first five years, the Consequential Amendments Bill contemplates export of emissions units. Therefore, by imposing the associated compliance cost to set up the systems with a chance of abandonment in five years times is short sighted. The system needs to be designed with that mature system in place.

Another concern is that the treatment of permits as being taxable will result in a permanent increase in the working capital requirements of companies (of $1.15 billion in 2010) to fund the GST between the time of purchase and the BAS lodgement time (somewhere between 22 and 53 days) when the GST input credit is allowed. Businesses will be forced to recoup the high funding costs by higher prices to consumers.

Although it is assumed in the White Paper that for all businesses this cost will be offset by the cash generated by charging higher prices for affected goods and services not all businesses will be able to increase prices. This assumption does not work for exports (where prices are determined on the world market), except in the minor case of EITE industries, nor in domestic industries where prices cannot be strongly influenced by just the larger players who have CPRS liabilities.

An example is the oil industry where it is proposed that the price adjustment is only going to reflect an average price of carbon for the preceding six months period. The sheer number of permits required to be purchased by the oil companies to meet the expected emissions (over 100 million tonnes) will require purchase of permits close to the time of the emission, potentially at prices greater than the average for the preceding six months. Potentially, the companies may need to purchase credits at the $40 cap, yet the price charged to customers would be substantially lower and would not be recoverable from customers. Given profit margins in the oil industry were about 2.2 cents per litre in 2007 and will be lower in 2008 there is no margin for error. The GST finance cost merely adds to these risks.

Finally, the proposed GST treatment is far from simple as illustrated by the following table.

Circumstance	**GST treatment**
Buying or selling a permit	Taxable supply
Supply of free permit	No GST (no consideration)
Import or Export of permits	No GST (out of scope or GST free)
Government Cash Grant	No GST (no supply)
Surrender of a permit	No GST (no consideration)
Payment of a penalty	No GST
Use of financial derivatives of permits	Input taxed supply (financial supply)

From the above table, it is clear that some transactions are taxable and others are not. There is an overall increase in complexity, administration and tracking costs by not making all transactions GST Free. Distinguishing between the different types of transactions increases the likelihood of processing errors, rework, penalties etc for no added value.

In summary, in light of:

- the compliance and financial cost;
- the imposition of GST in circumstances where there is no intention to raise GST revenue;
- the provision for the export of permits; and
- the fact that an agreement on 19 March 2009 on the terms of reference to explore harmonising the design of the CPRS and the New Zealand Emissions Trading Scheme was reached;

the Taxation Institute urges the Government to reconsider the decision to charge GST on emissions trading units.

* * * *