



THE TAX INSTITUTE



2018-19 Federal Budget Submission

15 December 2017



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Mr Matthew Flavel
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By email: prebudgetsubs@treasury.gov.au

Dear Mr Flavel,

2018-19 Federal Budget Submission

The Tax Institute welcomes the opportunity to make a submission to Treasury in relation to the 2018-19 Federal Budget.

We note from the media release issued by the Assistant Minister to the Treasurer, the Hon Michael Sukkar MP, inviting submissions for the 2018-19 Federal Budget¹, that the Government is committed to focusing on budget repair to ensure the Australian economy is on a trajectory back to balance while also supporting fairness, opportunity and security for all Australians.

With this in mind, The Tax Institute submits that the 2018-19 Federal Budget should support growth in the Australian economy as well as making the economy more competitive on the international stage.

We submit that this may be done through a program of tax rate cuts and promoting simplicity and transparency in the tax system, to address the competitive tax disadvantage which currently persists under the prevailing Australian tax architecture, make Australia a more attractive place for foreign investment and stimulate growth in the economy.

1. Personal marginal tax rates

Australians are currently faced with one of the highest personal tax rate regimes in the world, with the top marginal tax rate for individuals at almost 50%. In our view, this is excessive relative to rates imposed in other countries. By comparison with other

¹ Media Release No. 14, 20 September 2017: <http://mss.ministers.treasury.gov.au/media-release/014-2017/>

jurisdictions, our current rate structure only serves to drive skilled Australians offshore to more favourable jurisdictions like the US (with a top personal marginal rate of 39.60%), Canada (33%), and New Zealand (33%), not to mention Singapore (22%) and Hong Kong (15%). This is a significant threat to the available talent pool (ie human capital) in Australia.

The Tax Institute argues that the top personal marginal tax rate should be in line with the highest rates of comparable jurisdictions. We submit that this could potentially be achieved without any detriment to the revenue base primarily through a broadening of the GST base by reviewing the many current exemptions and concessions as recommended below and the income tax base, for example by reducing the CGT discount factor (see below).

a) Marginal rate taxation

As is well understood, the taxable income of individuals is taxed at progressive marginal rates including a tax-free threshold. However, we observe that the rate of tax an individual may actually pay at a certain level of income is impacted by a variety of levies and tax offsets that may apply. That is, the headline marginal rate that may apply can differ greatly to the effective rate of tax ultimately paid by the individual.

This can occur when, for example, the Medicare levy of 2% is added to an individual's applicable rate of tax or the additional 1 – 1.5% is added depending on whether the individual must also pay the Medicare levy surcharge².

Similarly, marginal tax rates are also impacted if low income earners are entitled to a low income tax offset or are relieved from paying the Medicare levy. Marginal rates are also impacted by HELP repayments and the withdrawal of social security at particular levels of income.

Levies and tax offsets affecting the marginal rate of tax that applies to an individual make it difficult for an individual to clearly identify which tax bracket they fall into and therefore what tax rate they face. We submit that the tax system would be simplified if all of these potential variations could be consolidated into the headline marginal rates.

In addition, the impact of bracket creep pushing individual taxpayers up to higher effective tax rates reduces disposable income, purchasing power and the incentive to work to achieve higher levels of income.

The Tax Institute supports the application of a transparent marginal tax rate system to individual taxpayers. The factors that contribute to making the marginal tax rate system non-transparent, for example the Medicare levy and surcharge, should be reviewed. The income level and applicable rate of tax at each income bracket could already take these factors into account. These changes will lead to increased transparency and simplicity with regard to the taxation of individuals.

² Because they do not have sufficient private patient hospital insurance

Where the scale of rates could be reduced overall, this may lead to decreasing the competitive disadvantage Australia currently has in relation to attracting and retaining human capital.

b) Standard deduction for employees

Presently, a myriad of work-related expense deductions is available to employees to deduct against assessable income derived from employment to the extent that PAYG taxpayers are able to navigate the rules to determine the expenses they are eligible to deduct.

The regime for the availability of deductions adds complexity to the taxation of individuals (and to the tax law) and also imposes additional compliance costs on individuals wanting to claim expenses because they have to comply with strict substantiation rules, particularly where there is a private component to the relevant expense. Determining the extent to which, if at all, certain expenses satisfy the nexus test to income adds to the complexity.

Examples of common work-related expenses claimed that have some complexity associated with them include home office expenses, telephone and internet usage expenses and motor vehicle expenses. These expenses are generally associated with the use of private assets partly for income-producing purposes.

The Australian Taxation Office (**ATO**) has issued a raft of guidance on work-related expense deductions generally and for employees in specific industries to assist them to understand what they may be entitled to claim. The fact the ATO has to issue guidance is evidence that the rules around deductibility of work-related expenses can be complex and are not easy to navigate by individual taxpayers without assistance.

Comparable jurisdictions

Certain comparable international jurisdictions operate simpler systems for individuals with simple tax affairs. We refer to the table in the *Australia's Future Tax System – Report to the Treasurer (Henry Review)* released in December 2009 for a summary of this comparison³. Some countries either provide very limited or narrow circumstances where work-related expenses can be claimed while others do not permit them at all.

For example, the UK operates a relatively simple self-assessment system where, broadly, tax is deducted from wages, pensions and savings⁴ at source similar in nature to a 'final withholding' tax. Only individuals who derive other types of income, such as untaxed income or taxable capital gains, or who fall into certain categories of taxpayer, are required to lodge a tax return, meaning that a significant body of taxpayers are relieved from the requirement to lodge⁵. Employment-related expenses may be claimed

³ See the table entitled *Box A1-2: International comparison of deductions for WREs* in Part 2 Vol 1 at p54.

⁴ <https://www.gov.uk/self-assessment-tax-returns>

⁵ <https://www.gov.uk/self-assessment-tax-returns/who-must-send-a-tax-return>

in limited circumstances dependent on whether the taxpayer's claim is for more or less than £2,500⁶.

New Zealand does not require individuals whose earnings are limited to salary, wages, dividends and interest income to lodge a tax return⁷. No deduction is allowed for work-related expenses incurred by employees.

Both the UK and New Zealand systems offer relatively simple regimes for individuals. Australia could draw on elements of these countries' systems to model its own system for individuals, noting however that it would be preferable to introduce a standard deduction rather than amending (ie tightening) the nexus requirements for deductions.

Standard deduction

The Henry Review found that the scope of work-related expenses in Australia is broad by comparison to other countries and consequently recommended the introduction of a standard deduction to cover the cost of work-related expenses (and the cost of managing personal tax affairs) with taxpayers afforded the choice to take the standard deduction or claim actual expenses where the claims exceed the standard deduction with full substantiation⁸.

The Tax Institute supports Recommendation 11 of the Henry Review and recommends that, as a first step towards simplification, the Government should consider introducing a standard deduction for work-related expenses, while retaining the ability to claim actual expenses with full substantiation above a nominated threshold. Treasury would have to consider what would be an appropriate amount for this threshold. In our view, the threshold would have to be at least \$1,000 to be a sufficient incentive for taxpayers to elect to use the standard deduction instead of claiming actual work-related expenses.

To assist with administration, the standard deduction could be factored into the 'Tax Tables' the ATO issues that employers use to determine how much tax to withhold from salary and wages via the Pay As You Go Withholding system. Automatically factoring in the standard deduction to amounts of tax withheld from employees would help to alleviate the compliance burden for individuals.

Alternatively, deductions for work-related expenses could be removed altogether from the system (similar to New Zealand) and a suitable adjustment to marginal tax rates (which we would suggest would be an overall lowering of marginal rates at all levels) could be made to reflect this. Though, the decrease in the marginal rates would need to be significant – at least at a level that would compensate taxpayers for the removal of the deductions. This should increase Australia's competitiveness against comparable

⁶ <https://www.gov.uk/tax-relief-for-employees/how-to-claim>; for claims under this amount, if you do not otherwise fill in a self-assessment tax return, a taxpayer may be able to make the claim by telephone or there is a simple 'P87' online form to claim tax relief; otherwise claims are made through the (relatively simple) self-assessment tax return form.

⁷ <http://www.ird.govt.nz/income-tax-individual/end-year/ir>

⁸ Refer to p56 and Recommendation 11 on p57 in Part 2 Vol 1.

jurisdictions such as the United Kingdom and New Zealand, provided that the benefit of the decrease in marginal rates is greater than the removal of the deductions.

We note this would be a radical departure from the current system. If there is not the ability to make such a radical change to the system, The Tax Institute considers that the preferred option for simplification is to introduce a standard deduction (with the ability to substantiate greater expenses). Simplification of Australia's tax system should encourage the retention of human capital and more investment into Australia which in turn should encourage more growth.

c) Negative gearing and the CGT discount

One of the basic principles of our tax system is that a taxpayer is entitled to a deduction for expenses incurred in gaining or producing assessable income (refer to section 8-1 of the *Income Tax Assessment Act 1997* (Cth)). This is a fundamental principle of the Australian tax system.

There is a perceived distortion in favour of individuals who are in a financial position to borrow money to acquire an asset and deduct the costs associated with holding that asset which exceed the income derived from the asset (ie to negatively gear the asset). The perceived distortion arises because these individuals are able to apply the excess costs associated with holding the asset against income from other sources, thus sheltering that income from tax.

This perception is exacerbated in the instance where the individual is also entitled to claim the 50% CGT discount upon disposal of the asset where the asset qualifies for the CGT discount as a capital asset for income tax purposes.

In our view, the real issue arises from the ability of eligible investors to claim both a discount on a capital gain realised on the sale of a capital asset in addition to deductions⁹ for the costs incurred in holding a geared asset sheltering income from sources other than the holding of the asset.

There are many ways to address this. Reducing the CGT discount would reduce the perceived arbitrage between negative gearing deductions and the tax on the capital gain. Reduction of the discount would be in effect an increase in capital gains tax, which would require investigation into any potential adverse effects on growth and investment of such an increase. However, in our view, a significant reduction of the discount available on capital gains derived by individuals from the current 50% would allow for reductions of

⁹ In theory, such gearing deductions are allowable in full on the basis that total income from the investment (not including discounted capital gains on sale proceeds) over the long term will exceed or at least equal total deductions from the investment. If gearing deductions are being claimed in full in other circumstances, then there is a problem with enforcement of the existing law which could usefully be addressed in conjunction with any proposal to alter the law. In considering alterations to the law, attention should be given to whether the alterations ought to apply equally to those whose investments do become tax positive overall (disregarding discounted capital gains on sale proceeds) as to those whose investments never become tax positive.

marginal tax rates on income. The discount might be reduced to perhaps a 20% - 25% level (which we argue would generally be perceived as being more reasonable by taxpayers who do not own assets subject to capital gains tax).

Prohibiting negative gearing is more complex and arguably distortionary, especially if changes are only made in relation to negatively geared investment properties and not for other investment assets that can be negatively geared.

2. The Corporate Tax Rate

Currently, Australia is in a much less competitive position than it could otherwise be if the lower corporate tax rate of 25% applied. In this regard, the Government should look to move as quickly as possible to having a unified 25% corporate tax rate that applies to all corporate taxpayers in Australia. There are two main reasons for this:

- i) The two-tiered corporate tax rate system has added unnecessary complications to Australia's corporate tax rate system, by for example introducing an eligibility test for the lower corporate tax rate of 27.5% which was previously not relevant when only the one rate of 30% applied.
- ii) Comparable rates overseas are lower as compared to Australia's rates of 27.5% and 30% (depending on the size of the company's turnover). Consider for example the company tax rates of Singapore (17%), Hong Kong (16.5%), New Zealand (28%), United Kingdom (19%).

This complexity and disparity stifles potential investment into the Australian economy, and therefore hampers real economic growth.

3. Other Taxes

a) Goods and Services Tax

The Tax Institute submits that the Government should undertake a comprehensive review of the current exemptions and concessions in the current GST law to determine their ongoing necessity/appropriateness and to ensure that the simplicity and efficiency that is sacrificed by the presence of these exceptions is still justified.

These exemptions and concessions contract the tax base upon which GST could otherwise be applied. In the absence of some (or all) of these exemptions and concessions, the GST tax base would inevitably be broader, thus positively contributing to the GST revenue take. Necessary tax cuts in other areas, for example the personal marginal rates as examined above, might be able to be funded by an increase in GST revenue should the GST revenue take be increased, subject to the agreement of the States and Territories.

However, there are many factors that will need to be taken into account to assess the ongoing requirements of these exemptions and concessions, including a reassessment

of the original policy reason for their inclusion in the first place. There will also be compliance costs for taxpayers to take into account and perhaps the need for grandfathering in some cases in the event of a proposed change of this nature.

b) Fringe Benefits Tax

The Tax Institute considers there is also an opportunity for reform of fringe benefits tax (FBT). Recommendation 9 of the Henry Review made numerous suggestions for how the treatment of reportable fringe benefits could be reformed. This included the following:

- Taxing fringe benefits that are readily valued and attributable to individual employees in the hands of employees through the PAYG system rather than through the FBT system;
- Other fringe benefits, including benefits incidental to an individual's employment, should remain taxable to employers at the top marginal rate.
- Reviewing the FBT exemptions to determine their ongoing necessity/appropriateness and to ensure that the simplicity and efficiency that is sacrificed by the presence of these exceptions is still justified.

Subject to the points above, perhaps more significantly, The Tax Institute also considers that the FBT rate that applies to an employee should be commensurate with the employee's marginal rate to address the inequity that currently exists in the system by applying the FBT rate equal to the highest marginal rate to all employees.

Addressing these matters may serve to help reduce the rate of tax that applies to fringe benefits, expand the taxable base of fringe benefits that may be subject to tax through the FBT and PAYG systems. The flow on effect may be to increase transparency in the taxation of individuals and simplification in the system. Paired together with a decrease in the personal marginal tax rates, this further simplification of Australia's tax system should encourage the retention of skilled human capital and more investment into Australia, which in turn should encourage more growth.

If you would like to discuss any of the above, please contact Senior Tax Counsel, Professor Robert Deutsch, on 02 8223 0011.

Yours faithfully,



Matthew Pawson
President



Tracey Rens
Vice-President

Appendix A

ABOUT THE TAX INSTITUTE

Our members lead the way in tax.

The Tax Institute is Australia's leading professional association and educator in tax providing the best resources, professional development and networks. With over 12,000 members, our mission is to educate and build expertise in tax and to raise the status of the tax profession.

Our growing membership base includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate tax content.

We are committed to propelling members onto the global stage with over 7000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. The Tax Institute has evolved and become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and the taxpayer today.

More than seven decades later, our values, friendships and the unselfish desire to learn from each other are central to our success. The Tax Institute is known for its committed volunteers and the altruistic sharing of knowledge. Members are actively involved ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.