

Section 1 The importance of the middle market

1.1 Summary of key points

- **Pitcher Partners have specialised in advising taxpayers in the middle market for over 24 years.**
- **While many label middle market taxpayers as being small taxpayers, this classification is not reflective of the middle market. The middle market comprises privately owned companies and trusts, together with their owners.**
- **As a collective group of privately owned entities, the aggregate size of the middle market taxpayer group is as large and significant as public groups in Australia.**

1.2 About Pitcher Partners

- 1.2.1 Pitcher Partners is an association of independent accounting firms, located in Melbourne, Sydney, Perth, Adelaide and Brisbane. The association has over 90 partners and more than 1000 professionals located around Australia.
- 1.2.2 Pitcher Partners was formed in 1991, previously having been the Private Business Services Practice of KPMG. The creation of Pitcher Partners was driven by a strategic decision to provide specialist advisory services to taxpayers in the middle market. For over 24 years, we have continued to specialise in our services to this core market.
- 1.2.3 Pitcher Partners is the largest Melbourne accounting practice outside of the Big 4. We are also the single largest lodger of tax returns in Australia. Accordingly, this submission provides our views on the middle market, taking into account our experience in dealing and working with taxpayers in this market space.

1.3 Identifying the middle market as privately owned groups

- 1.3.1 This submission is focused on a large segment of taxpayers in the Australian economy, being taxpayers that can be identified as a “closely held” group of entities. We refer to this group as the “middle market” or collectively as “private groups”.
- 1.3.2 The types of entities within this group typically include closely held listed and public companies, large family businesses, small to medium enterprises and high wealth individuals.

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- 1.3.3 Historically, our taxation system has sought to separately classify entities based on whether they are privately owned or publicly owned. The definition of a private company stems back to the commencement of the 1936 Tax Act, where the original definition of a private company was found in section 103. A private company was defined as one that was controlled by seven or fewer persons, being neither a company in which the public had a substantially interest or a subsidiary of a public company.
- 1.3.4 Over time, this definition has evolved, whereby the delineation as between private and public companies and trusts (broadly) examines whether 20 or fewer individuals control 75% or more of the relevant company or trust.
- 1.3.5 The application of many of our taxation provisions are based on the identification of private and public groups. For example, Division 7A only applies to private companies. The loss recoupment provisions have special rules that apply to widely held companies (inclusive of public companies). Furthermore, trusts that are public unit trusts need to apply special rules to determine whether those trusts should be taxed as companies.
- 1.3.6 Historically, the identification of private and public groups for income tax purposes has been largely driven by integrity concerns. However, many of the compliance saving provisions in our Tax Act have also been drafted with reference to private or public groups.
- 1.3.7 While companies have historically been established and used for commercial reasons (e.g. to limit the liability of owners), integrity provisions (such as Division 7 and Division 7A) have been introduced over time to protect the individual marginal income tax base where profits are accumulated in companies. This issue has not been seen as being prevalent to public companies, which are unlikely to be used as a vehicle to shelter income from being taxed at individual marginal tax rates.
- 1.3.8 Likewise, for public trusts, integrity provisions were drafted to ensure that public companies did not convert to trusts to avoid paying corporate tax. Accordingly, integrity provisions (such as Division 6B and Division 6C) have been introduced to protect the corporate tax base from flow-through taxation.
- 1.3.9 In addition, other measures such as the family trust election provisions and the company loss recoupment rules, provide shortcuts to closely and widely held groups as compliance saving measures.
- 1.3.10 What the above highlights is that most of our tax laws require a distinction to be drawn between private and public groups. Furthermore, most of the compliance issues associated with the middle market can be linked to provisions that apply to private groups.
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- 1.3.11 The delineation of private and public groups based on a closely and widely held test acknowledges the difference between the commercial and taxation characteristics of each of these groups. We believe that the identification of these two groups will continue to be relevant under our taxation system simply due to the vast difference between the objectives and requirements of these two groups.

1.4 The importance of the middle market

- 1.4.1 To outline the importance and significance of the middle market, we have summarised the ATO's published statistics on companies and trusts in Australia, based on lodged tax returns as at 30 June 2013.
- 1.4.2 At a high level, the middle market sector, comprising of entities that are privately owned, is one of the largest sectors of the Australian economy. These statistics show that private groups incur more employment costs on aggregate as compared to public companies in Australia. They also show that there are as many "large" private companies as there are public companies. The following tables provide further detail on the ATO statistics.

(a) Privately owned corporate groups

- 1.4.3 As at 30 June 2013, there were 854,740 taxpaying companies in Australia, with 90.35% of all such companies being privately owned.
- 1.4.4 Further, we note that there were almost as many large private companies (i.e. greater than \$100 million turnover) as compared to publicly owned taxpayers. Importantly, the private company group sector employs and pays salary and wages at a comparable level to public groups. The economy raises a significant 38.08% of its corporate tax revenue from companies that are privately owned.
- 1.4.5 The following table provides a further comparison of private trusts as to public trusts based on the ATO statistical information.

Relevant statistics ¹	Private	Public	Other
Large taxpayers with greater than \$100 million turnover (number).	1100	1110	N//A
Large taxpayers with greater than \$100 million turnover (percentage).	49.75%	50.21%	N/A

¹ ATO Taxation statistics 2012–13: Companies: Table 6: Selected items, by taxable status, residency status, company type and company size, 2012–13 income year.

Relevant statistics ¹	Private	Public	Other
Number of taxpayers per classification (number)	772,265	8,500	73,975
Number of taxpayers per classification (percentage)	90.35%	0.99%	8.65%
Total salary and wages paid by classification (\$billions)	\$164.002B	\$169,283B	\$5.409B
Total salary and wages paid by classification (percentage)	48.42%	49.98%	1.60%
Taxable income per classification (\$billions)	\$104.716B	\$154.409B	\$4.952B
Taxable income per classification (percentage)	39.65%	58.47%	1.88%
Total tax payable per classification (\$billions)	\$24.099B	\$37.769B	\$1.408B
Total tax payable per classification (percentage)	38.08%	59.69%	2.23%

(b) Privately owned trusts

1.4.6 Trusts are used predominantly by privately owned groups. Of the 753,735 trusts that lodged tax returns for 30 June 2013, 99.41% comprised of non-public trusts. The main use of public trusts has been in relation to managed investment trusts and investment vehicles, whereby those trusts have been classified by the ATO as public unit trusts².

1.4.7 Not only are there a significant number of trusts that are used by privately owned groups, these trusts are significantly large as a collective group of taxpayers. Privately owned trusts hold more in gross assets than trusts that are publicly owned. Furthermore, privately owned trusts generate close to the same amount of taxable

² Per the ATO classifications, a public unit trust for this purpose is a trust whose units are listed on a stock exchange or offered to the public or held by 50 or more persons. A unit trust is not a public unit trust if 20 or fewer persons hold 75% or more of the beneficial interest of the income or the property of the trust.

income (\$94.077B) as privately owned companies (\$104.716B). They also incurred a significant \$42.906B of salary and wage costs for the 30 June 2013 income year. When compared together with privately owned companies, the total salary and wages paid by this group exceeds that of public groups.

1.4.8 The following table provides a further comparison of private trusts as to public trusts based on the ATO statistical information.

Relevant statistics ³	Private	Public	Other
Taxpayers by classification including all sizes (number)	746,415	4,480	2,840
Taxpayers by classification including all sizes (percentage)	99.03%	0.59%	0.38%
Total net assets reported in tax returns (\$billions)	\$287.386B	\$632.581B	0.768B
Total net assets reported in tax returns (percentage)	31.21%	68.70%	0.08%
Total gross assets reported in tax returns (\$billions)	\$1,129.663B	\$785.403B	\$2.937B
Total gross assets reported in tax returns (percentage)	58.90%	40.95%	0.15%
Total salary and wages paid by companies in group (\$billions)	\$42.906B	\$0.083B	\$0.027
Total salary and wages paid by companies in group (percentage)	99.74%	0.20%	0.06%
Taxable income per classification (\$billions)	\$94.077B	\$25.212B	\$0.116B
Taxable income per classification (percentage)	78.79%	21.11%	0.10%

³ ATO Taxation statistics 2012–13: Trusts: Table 6: Selected items, by taxable status, residency status, company type and company size, 2012–13 income year.

Section 2 The commercial context for middle market taxpayers

2.1 Summary of key points

- **When considering reform options, it is important to note that tax reform cannot be done in isolation and that the impact of commercial considerations need to be taken into account.**
- **Importantly, key commercial considerations for privately owned groups include the ability to access to finance, asset protection, family succession, privacy of information, and the ability to access advice and advisors. It is therefore critical that tax provisions or tax reform be mindful of these issues and concerns.**

2.2 Introduction

2.2.1 While this submission discusses tax reform options for the middle market, it is important to outline the commercial issues and other related issues that are relevant to taxpayers in the middle market. As tax reform measures could have positive or negative implications for any of these issues, we highlight that it is important for these issues to be considered in the context of any reform package.

2.2.2 These items, that are relevant to any tax reform considerations for the middle market, include (amongst other things): access to finance and equity; asset protection and risk issues; family succession; privacy of information; and access to advisors. These issues are critically important for taxpayers in the middle market group and therefore reform options should (as best as possible) complement and take into account these factors and issues.

2.2.3 The following sections provide some background in relation to each of these issues and the reason why these issues are important to be considered in the context of tax reform.

2.3 Access to finance

2.3.1 Unlike public groups (which have extensive access to capital markets inclusive of debt and equity), private groups have limited access to either equity or debt markets. Numerous government reports have focused on this issue⁴.

⁴ See for example the Parliamentary Joint Committee on Corporations and Financial Services “Access for Small and Medium Business to Finance”, April 2011.

- 2.3.2 While the Government is keenly pursuing options that will help to increase access to finance in the middle market (e.g. through proposed equity crowdfunding reforms), middle market taxpayers are often dependent on using formal bank financing and internal funds to finance growth and expansion.
- 2.3.3 Retained profit accumulations and personal savings are therefore two significant components of internal finance for privately owned groups. The ability to generate such funds and redeploy those funds into business activities and ventures is therefore a critical consideration for taxpayers in the middle market.
- 2.3.4 However, currently Division 7A acts as a significant impediment to using retained profits of a private company to finance activities of other related businesses and investment entities in the group. As private groups are reliant on internal funds, Division 7A can treat the use of those funds as an unfranked dividend, resulting in an additional cost of 49% to business activities.
- 2.3.5 Due to constraints in accessing other forms of finance, this has become a significant issue for middle market taxpayers.

2.4 Asset protection and risk issues

- 2.4.1 Unlike owners of public groups (being the general public at large), owners of private groups are required to risk almost everything. A closely held family group that starts a business will be required to invest personal funds as capital, provide personal guarantees and indemnities, hold the shares in the business entity (as shareholders) and run the business as directors and managers. Accordingly, owners of private groups carry a lot of risk when starting a new business.
- 2.4.2 These risks can often act as a significant deterrent for people seeking to enter the market, especially where personal assets become “at risk” – for example, the family home. Asset protection is therefore a key consideration of middle market taxpayers.
- 2.4.3 As a part of asset protection, middle market taxpayers legitimately attempt to quarantine risks by quarantining activities into different entities. Furthermore, different vehicles are chosen to help ensure that risks can be isolated as best as possible. This can be done by way of establishing a company, which (via the corporate veil) can help to provide an ability for the company’s liabilities to be limited to the share capital of the company. Similarly, discretionary trusts can be used, whereby the additional advantage of a discretionary trust is that owners of the business are not required to hold assets in their personal names (i.e. there are no shares held in a discretionary trust).

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- 2.4.4 The desire to protect assets can often result in the choice to use certain entities and can (in many cases) result in complex business structures where the private group has diverse operations. As private groups cannot typically consolidate their affairs for taxation purposes, this can give rise to the operation of very complex provisions that apply to transactions as between group entities.
 - 2.4.5 Division 7A is one of those provisions. However, other provisions include the “income injection” rules in the trust loss provisions for intragroup transactions, the debt equity provisions for intragroup loans, the 45-day holding rules for intragroup dividends, the loss recoupment provisions for trading losses. It also can result in complexities in applying trust deeds for the purpose of distributing profits to other group entities.

2.5 Family succession

- 2.5.1 One key consideration for privately owned groups is succession, especially in relation to various business operations and assets that are held by the private group for multiple family members.
- 2.5.2 There are significant considerations for middle market taxpayers that stem around succession planning. For example, this can often require segregating assets or businesses into different classes (to be held for different people into the future). It can also require consideration of appropriate structures that facilitate an exit, should the key family person pass away.
- 2.5.3 There are limited rollovers that allow one structure to move to another, or to allow for trust cloning (or trust splitting). While the small business concessions provide some limited forms of restructuring, they are only really available for micro-type businesses.
- 2.5.4 Furthermore, the 80 year perpetuity period for trusts (in States other than South Australia) means that trusts that hold assets and businesses have a finite life. This may give rise to a significant future tax liability when the trust is required to be dissolved. As there are over 700,000 taxpaying trusts in Australia, this is a major issue in terms of the future dissolution of trusts in Australia and in terms of the future treatment of assets held for the benefit of family members.

2.6 Privacy of information and financial reporting

- 2.6.1 Unlike public groups, private groups are simply that – “private”. Assets are held on behalf of a small number of investors. Users of such information are typically limited to the owners and the financial institutions. Accordingly, private groups are not

generally known as being “reporting entities” for the purpose of preparing financial statements.

- 2.6.2 While many private groups are required to lodge company accounts with ASIC, the levels of disclosure and the information required to be reported is often much less as these groups are not considered to be “reporting entities” in accordance with the accounting standards.
- 2.6.3 As outlined by recent proposed changes to the tax transparency provisions, significant issues can occur if there is a requirement to disclose private tax information to the public.
- 2.6.4 Furthermore, there are a large number of tax provisions that have been drafted on the basis that accounting principles are to be applied to the relevant taxation law. This includes the tax consolidation provisions, the TOFA provisions, and the thin capitalisation provisions (to name a few). These provisions require the full use of AIFRS general purpose financial reports, which can create an undue compliance burden for taxpayers in the middle market.

2.7 Access to advisors

- 2.7.1 Privately owned groups can range from very small to very large groups. However, privately owned groups do not typically have large accounting and tax teams supporting their reporting and compliance functions. This occurs for various reasons, but predominantly because public disclosure requirements of a private group are substantially less than that of a public group. Furthermore, as the costs of compliance are already quite substantial, private groups typically cannot afford to have substantial teams working solely on compliance of the group.
- 2.7.2 The effect of this, however, is that it is very common for an in-house accountant to be responsible for both the financial reporting and tax obligations of the private group. From a cost efficiency perspective, many private groups cannot afford to have an internal tax advisor employed by the business. Accordingly, disproportionate compliance costs can be incurred by middle market taxpayers when complex laws are introduced. This is because middle market taxpayers are required to seek advice on the measures.
- 2.7.3 Historically, the provisions that apply to middle market taxpayers have been horrendously complex. The level of integrity applied is often disproportionate to the risk to the revenue. In many cases, small middle market taxpayers are typically required to apply the same provisions that large public companies are required to apply (e.g. tax consolidation). Furthermore, some of the legislative provisions that are specific to private groups are drafted in a very complex manner, which are not intuitive and difficult for middle market taxpayers to understand and apply.

Examples include Division 7A, the trust loss provisions, the value shifting provisions, the unrealised loss provisions – just to name a few.

- 2.7.4 Where this occurs, the complexity of the provisions (without appropriate advice) can lead to what is called involuntary non-compliance. For these reasons, middle market taxpayers are keen to ensure that tax rules are drafted in a simple and concise manner so that they can be easily applied and understood. To increase

Section 3 Complexity of the current tax system for middle market taxpayers

3.1 Summary of key points

- **The Australian taxation system is a complex taxation system. Middle market taxpayers face disproportionately high compliance costs.**
- **The system of taxing income sources and tax structures on an item by item basis has been around since the commencement of the 1936 Tax Act. While source and structure rules (in isolation) make sense, they can give rise to systemic issues that undermine and obscure various policy objectives in the tax system.**
- **We believe that the application of different tax rates and tax provisions to different structures is one of the primary drivers of complexity in the tax system for middle market taxpayers.**
- **A possible option that could address this issue is the Dual Income Tax system. This option is outlined in Section 5 of this submission. As there are potential significant benefits to the tax-transfer system that could be achieved through moving toward a Dual Income Tax system – in particular, simpler and more efficient taxes – we believe that the review should seriously consider this as an option for reform.**
- **We highlight that there are a number of additional key drivers giving rise to significant complexity in our tax system.**
- **The tax provisions are drafted in an unnecessarily complex manner for small taxpayers. We recommend a review of complex measures to consider whether carve-outs or shortcuts could be applied more readily and systemically to such taxpayers.**
- **There are a number of very complex tax incentives. We question the appropriateness of those measures (e.g. the small business CGT concessions). We recommend a review to determine whether they can be replaced with some simpler rules.**
- **Middle market taxpayers cannot readily and easily consolidate their affairs, giving rise to higher compliance costs such as multiple (and unnecessary) income tax returns. We would recommend an appropriate review of the tax consolidation measures, or specific middle market consolidation rules, with the aim of reducing red tape.**
- **Finally, significant complexity occurs in applying multiple taxation regimes to basic small business taxpayers. These multiple regimes include the income tax regime, the GST regime, the FBT regime, the excise tax regime, the payroll tax regime, the Workcover regime, the PAYG regime, the taxable payment annual reports regime, the trustee beneficiary reports regime, etc. We would recommend systemic reform be considered to reduce the number of taxes or tax bases.**

3.2 Introduction

- 3.2.1 The Australian taxation system is a complex taxation system. This is a significant issue for taxpayers in the middle market, especially as taxpayers in this space have limited access to specialist advice (both internal and external). Not only do small and middle market taxpayers face disproportionately high compliance costs compared with public groups, in many cases the compliance costs are disproportionate to the revenue at risk.
- 3.2.2 We believe that it is important to outline and consider some of the complex provisions that are encountered by taxpayers in the middle market. It is also important to also consider some of the drivers of complexity for middle market taxpayers.
- 3.2.3 We believe that identifying these two main aspects can assist in providing various options that can be used in reforming the tax system for middle market taxpayers.

3.3 Complexity of the current provisions

- 3.3.1 There are some very complex provisions that apply on a daily basis for taxpayers in the middle market. We cannot go through all of the provisions in this submission and believe it is beyond the scope of this submission to do this.
- 3.3.2 However, we have identified a number of provisions in this submission that cause the most angst amongst taxpayers in the middle market. These provisions include: Division 7A, the trust taxation provisions, the taxation of financial arrangements, the tax consolidation provisions, the loss duplication and value shifting provisions, the trust loss provisions, the 45-day imputation provisions, capital / dividend integrity provisions, and the significant number of integrity provisions that apply to private groups (in general).
- 3.3.3 Many of these provisions are discussed throughout this submission, but (as a general comment) we highlight that these provisions are extremely complex in nature and difficult to apply.
- 3.3.4 What is important to highlight is that these provisions typically apply to all taxpayers, in the same manner without shortcuts, irrespective of the size of the entity. Accordingly, a micro taxpayer is required to apply the same tax consolidation provisions that are applied to the largest listed public company in Australia. Furthermore, a simple transaction can sometimes require a taxpayer to navigate through multiple integrity provisions making those simple transactions very difficult to comply with. For example, a simple repayment of a loan can result in the consideration of: the debt / equity provisions (Division 974); the non-share dividend

provisions (Division 974); the capital and dividend streaming provisions (section 45A and 45B); the imputation provisions (Division 200 to 207), etc. While we understand that these provisions are aimed at targeting loans that are “quasi-equity” and thus are intended to provide some level of integrity, we note that the degree of integrity that is applied is disproportionate to the risk associated with the transaction (i.e. the risks associated with repaying a loan).

3.4 Identifying structural reasons for complexity

- 3.4.1 While it is easy to identify complexity within the current tax system for middle market taxpayers, it is harder to identify the underlying causes of such complexity.
- 3.4.2 In our review of the system, we have narrowed a significant component of complexity down to two main sources. These are tax structure and tax rate differentials in our tax system.
- 3.4.3 The Australian taxation system has developed over time by first identifying a structural form (e.g. a company, trust, partnership, superannuation fund, etc). Once the form is identified, the tax system seeks to impose tax (at a certain rate) on income based on either the type of structure or the owners of the structure.
- 3.4.4 For example, a trust is able to apply the discount capital gain rate of 50% if the amounts are distributed to beneficiaries, while companies are unable to tax capital gains differently from other profits.
- 3.4.5 Likewise, the corporate taxation system imposes a 30% corporate tax rate at the company level to encourage companies to accumulate profits, with franking credits attached to dividends when profits are distributed to the shareholders as a dividend (to avoid double taxation). A trust on the other hand, is penalised for accumulating profits by being taxed at the top marginal rate (a penal rate) and is required to pass through all income to beneficiaries in order to tax the beneficiaries on the income of the trust estate.
- 3.4.6 Companies and trusts are used (intermittently) by private groups. Many private groups tend to use special purpose trusts as they provide benefits in relation to asset protection and risk isolation, succession planning and privacy of information. However, as trusts are penalised for accumulating profits at the top marginal tax rate, the use of a trust (on its own) does not enable profits to be accumulated and taxed at the lower company tax rate. This can have a detrimental effect on the overall cost of working capital that is reinvested in a business of the private group.
- 3.4.7 Over time, this has resulted in many trusts distributing to a corporate beneficiary to allow profits to be accumulated and taxed at a 30% rate.

3.4.8 The difference in treatment of a trust and corporate vehicle in this regard has given rise to some of the most complex set of provisions, including Division 7A. Division 7A is founded on protecting the corporate tax base from the use of profits that have been taxed at the corporate rate. These provisions only apply to “private companies” and do not apply to “public companies”. Accordingly, these provisions need to be applied by all middle market taxpayers, no matter the size. These concerns and comments are echoed by the Board of Taxation in its recent report to Government⁵:

In their current form, the rules in Division 7A are complex, inflexible and costly to comply with. They fail to achieve an appropriate balance between ensuring taxpayers are treated fairly, promoting voluntary compliance and discouraging non-compliance. They can also operate as an unreasonable impediment for businesses operating through a trust that wish to fund their growth by reinvesting profits back into the business.

3.4.9 Division 7A is only necessary, as a set of provisions, where the system differentiates between income classes and structural types. Accordingly, the use of corporate profits by a trust (irrespective of the reason) is currently considered an integrity issue by the system and is penalised at top marginal rates.

3.4.10 We note that Division 7A is not the only integrity provision that is aimed at protecting the structure and tax rate. Examples of other provisions that are founded on the same structural issues include Division 6C (public unit trust provisions aimed at protecting the corporate tax base), section 100A (as a trust integrity measure), section 45B (as a corporate dividend integrity measure) and the share capital tainting provisions in Division 197 (as a corporate dividend integrity measure).

3.4.11 In many cases, we also note that a set of provisions can apply to different structures in a different manner (or in a manner that is not considered complimentary). For example Subdivision 204-D of the imputation provisions prevents a company from streaming dividends to its owners (shareholders). However, Subdivision 207-B of the imputation provisions allow a company to pay a franked dividend to a trust, which can in turn stream such dividends to its owners (beneficiaries). While the policy behind both sets of provisions make sense (in isolation), they give rise to significant complexity for middle market taxpayers seeking to understand these differences and in applying the provisions.

3.4.12 While many of these provisions provide integrity to the system (in isolation), the complexity of the provisions is regressive. Accordingly, the complex nature (coupled with the draconian effect of a breach of such provisions) means that uninformed taxpayers are unable to properly apply and understand such provisions.

⁵ Board of Taxation, “Post Implementation Review of Division 7A of Part III of The Income Tax Assessment Act 1936: A Report to the Assistant Treasurer”, November 2014, pg vii.

- 3.4.13 On the other hand, well informed taxpayers that are well advised on the application of the provisions can appropriately apply structures within the acceptable boundaries of the provisions. Therefore, well advised taxpayers can still structure business activities so that they access the 30% corporate tax rate, whilst holding capital appreciating assets in trust structures providing access to discount capital gains.
- 3.4.14 It is therefore important to highlight that many of these issues occur simply because the tax system recognises different structures, recognises those structures differently from the owners of those structures, and applies different tax rates depending on source and nature of that income. We believe that a systemic solution that removes the structural and tax rate bias could help to address these issues. One possible solution is a Dual Income Tax system, which (in effect) would be aimed at removing this tax rate and tax structure biases in the system. This potential solution is discussed in Section 5 of this submission.

3.5 Other key drivers

- 3.5.1 In addition to tax rate and tax structural issues, there are a large number of additional issues giving rise to complexity of the tax system for middle market taxpayers.
- 3.5.2 We believe that these can be summarised as being attributed to: (a) provisions that are drafted with unnecessary complexity for smaller (less sophisticated) taxpayers; (b) a lack of appropriately targeted incentives that apply in the tax system; (c) an inability for middle market taxpayers to appropriately consolidate affairs; and (d) the complexity associated with applying multiple taxation regimes.
- (a) Unnecessary complexity of provisions for smaller taxpayers
- 3.5.3 Many taxpayers in the middle market are not considered large taxpayers. For example, 98.94% of all companies are classified as “small” (i.e. having a turnover of less than \$10 million). Likewise, 99.42% of all trusts are classified as small. Accordingly, only a very small percentage of companies and trusts are classified as either being medium, large or very large.
- 3.5.4 In many cases, tax provisions are introduced to address certain risks in the tax system which are material and potentially significant. However, in most cases, those provisions are applied to all taxpayers, including small taxpayers where the revenue at risk is often negligible.
- 3.5.5 There are numerous examples of such provisions. For example, the controlled foreign companies (CFC) provisions apply to any taxpayer that controls a foreign

company, irrespective of the size of taxpayer, the size of the investment, the jurisdiction of investment, etc. By way of another example, the tax consolidation provisions require all entities to complete an allocable cost amount (ACA) calculation for each subsidiary that joins the group, without any shortcuts or other compliance saving mechanisms.

- 3.5.6 Typically, the severity of the provision is disproportionate to the risks (both in terms of probability and materiality), such that the costs outweigh the potential benefits when applied to smaller taxpayers. Furthermore, in many cases, the general anti-avoidance provisions (Part IVA) or other integrity provisions may be capable of addressing the issue. Due to the lack of exclusions or shortcuts, smaller taxpayers are thus faced with high costs of compliance in the application of many provisions, in many cases creating a barrier of entry (e.g. on the use of the tax consolidation provisions).
- 3.5.7 We therefore believe that the review of the taxation system needs to seriously consider the ability to provide a simpler and less onerous system for smaller taxpayers, whereby appropriate carve-outs or simpler rules can be applied by such taxpayers. We believe that the system should also expand the definition of a small taxpayer, whereby the current \$2 million turnover threshold only covers micro-business. This threshold does not appropriately consider the balance between integrity risks and compliance costs for taxpayers that are not otherwise “large”.
- (b) A lack of appropriately targeted tax incentives
- 3.5.8 Over time, a number of tax incentives have been introduced into our taxation system. Incentives include the small business CGT concessions; credits and rebates for certain taxpayers (e.g. dependent rebates or zone rebates); research and development offsets; and special income tax rates and depreciation concessions for small taxpayers.
- 3.5.9 A number of these incentives have been politically driven and have been introduced for the benefit of a particular sector of the public. However, over time, as governments have moved on, the objective of many of these tax incentives have become questionable in terms of whether they are providing the most efficient use of our scarce tax dollar resources.
- 3.5.10 The introduction of an incentive or concession typically involves significantly complex rules to ensure that the concession are not used inappropriately. This generally gives rise to some very complex legislation. An example includes the small business CGT concessions. In its recent review, the Board of Taxation observed that

the eligibility criteria are “exceedingly complex and difficult for small business to navigate”⁶.

In particular, the rules governing eligibility for the small business CGT concessions are exceedingly complex and difficult for small businesses to navigate.

- 3.5.11 Due to the targeted nature of an incentive, complex rules are often accompanied with the incentive, even in cases where the incentive appears relatively straight forward. By way of example, even the small business \$20,000 depreciable asset write-off is accompanied by a set of complex integrity provisions that require an understanding of: (a) whether the entity is carrying on a business; and (b) what constitutes a connected entity and (or) affiliate entity for the purpose of determining the size of the entity.
- 3.5.12 We highlight that a measure such as the \$20,000 depreciable asset write-off has a total revenue cost of \$2.05 billion over a two year forward estimate period, equating to an approximate decrease in the corporate tax rate of 1% per annum (if such a rate were limited to private companies).
- 3.5.13 In our view, tax incentives in the tax system create enormous complexity. Systemically, the government should consider reviewing all incentives provided to middle market taxpayers, with an option to replace such incentives with a cut in the corporate rate of tax for private companies. We believe that significant compliance savings could be achieved by this measure alone.
- (c) An inability to consolidate tax affairs
- 3.5.14 Many private groups in the middle market consist of a number of entities. This is typically the result of numerous factors, including both commercial and taxation reasons.
- 3.5.15 That is, a private group may use multiple special purpose vehicles to conduct business operations, whereby the risks of an enterprise can be quarantined in a special purpose vehicle. This is a common requirement in the building and construction industry as well as other like industries. This type of choice facilitates and encourages efficient risk taking.
- 3.5.16 Furthermore, to the extent that a private group runs a business (or businesses) as well as holds passive assets, a private group would typically use a combination of companies, trusts and partnerships within the same group.

⁶ Board of Taxation, “Review of Tax Impediments Facing Small Business: A Report to the Government”, August 2014, pg 68.

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- 3.5.17 Unless the group can form a tax consolidated group, which is very difficult for entities in the middle market, it is highlighted that this often results in significant compliance issues. That is, entities within the group are all required to prepare income tax returns and recognise intragroup transactions.
- 3.5.18 While tax consolidation provides an opportunity for consolidating tax affairs, the tax consolidation provisions do not cater for middle market taxpayers appropriately. As acknowledged by the Board of Taxation review on tax consolidation⁷, there has been little take up in the middle market, as the rules are currently not drafted to allow middle market taxpayers to apply the tax consolidation provisions.
- 3.5.19 For those taxpayers with five or more entities within the group, we believe that significant compliance benefits could be achieved if the group could consolidate for tax purposes.
- (d) Complexity in applying multiple taxation regimes
- 3.5.20 A taxpayer in the middle market needs to manage its compliance with a significant number of legislative regimes, both State and Federal.
- 3.5.21 For example, a typical taxpayer in the middle market is required to lodge (one or more) income tax returns, GST returns, FBT returns, excise tax returns, payroll tax returns, Workcover annual returns, PAYG returns, payroll tax returns, taxable payment annual reports, trustee beneficiary reports, etc. This is a significant amount of red tape that is required for a typical small business taxpayer.
- 3.5.22 While each of these regimes raises revenue for both the State and Federal Government, we question whether this is the most efficient means of taxing middle market taxpayers and whether the benefits outweigh the significant compliance and red tape for middle market taxpayers.
- 3.5.23 We believe that complexity could be significantly reduced to the extent that systemic tax reforms could reduce the number of taxes imposed on taxpayers in the middle market – or at a minimum, the number of tax bases. We believe that it is therefore critical to consider the merits of removing inefficient state taxes and replacing this with a simpler tax (such as an increase in the GST rate).

⁷ Board of Taxation, Post Implementation Review into Certain Aspects of the Consolidation Regime: A report to the Assistant Treasurer, June 2012.

Section 4 The objective of tax reform

4.1 Summary of key points

- **The objective of tax reform should be a simpler and more efficient tax system, which supports and encourages economic growth.**
- **We believe that isolated changes within the tax system could have the reverse effect, in that they could increase compliance and complexity. Isolated changes should not be recommended without appropriately considering all of the interconnected ramifications of such a change.**
- **We support the consideration of systemic changes to our tax system in order to address some of the fundamental issues identified in Section 3 of this submission.**
- **Any reforms should be cognisant of the commercial and economic factors that are important to middle market taxpayers, as outlined in Section 2 of this submission.**

4.2 Introduction

- 4.2.1 In the previous sections we have highlighted that the current system is complex and that we believe there is merit in examining the key drivers of complexity. However, we also note that tax reforms can (in themselves) create uncertainty and can be very costly for middle market taxpayers to implement.
- 4.2.2 For middle market taxpayers, it is therefore crucial that tax reforms meet an appropriate objective and that they do not cause an undue compliance burden on taxpayers unnecessarily.
- 4.2.3 From a middle market perspective, there are a number of key reasons for considering tax reform in the current climate. One of the most significant of these would be to reduce the current levels of red tape and compliance costs being encountered by the middle market and to create a more efficient system for collecting revenue.
- 4.2.4 We also believe that with a decline in corporate tax collections, an increase in the levels of B2B internet sales platforms and an increase in internationalisation of smaller taxpayers, reforms are necessary to ensure that Australia remains competitive and that the country continues to be able to maintain its ability to collect its share of global tax revenues.
- 4.2.5 We therefore believe it is appropriate to consider tax reform options that can help to achieve and meet these objectives. However, we caution that any benefit that

can be realised from reform options must be balanced with the costs of reform on the middle market.

4.3 Care should be taken for non-systemic changes

- 4.3.1 As outlined in the previous sections, the Australian tax system is very complex and interconnected. It includes income taxes, indirect taxes, personal and business taxes.
- 4.3.2 Changes and policy decisions relating to one part of the system that is designed to achieve certain objectives can interact with other parts of the tax transfer system in a way that can undermine those objectives or perhaps (more likely) place stress on other parts of the tax system. In many cases, integrity provisions that are introduced to prevent unintended consequences can lead to significant complexity and unintended consequence of their own.
- 4.3.3 To demonstrate, we refer to question 24 of the Discussion Paper, which requests one to consider the following question with respect to corporate taxation.
24. How important is Australia's corporate tax rate in attracting foreign investment? How should Australia respond to the global trend of reduced corporate tax rates?
- 4.3.4 In isolation, while many would argue for a lower corporate tax rate in Australia, we highlight that any change in the corporate tax rate would also increase the differential between the top marginal tax rate (49%) and the corporate tax rate. This rate differential would place additional pressure on taxpayers seeking to use corporate entities for non-business purposes – for example as corporate beneficiaries of trusts, as passive income entities and by individual workers seeking to access the corporate tax rate.
- 4.3.5 In turn, this would place additional pressure on Division 7A and the personal services income rules to control the use of corporate vehicles as a protection to the corporate tax base. This could have the effect of increasing the level of integrity provisions that would be required to protect the corporate tax base and the reduction in the tax rate, thus giving rise to further complexity and compliance issues.
- 4.3.6 We outline our view on possible non-systemic changes in detail in Section 7 of this submission. In most cases, we highlight that such changes are likely to create a number of complex issues in our system.
- 4.3.7 As one of the key objectives of tax reform will be to simplify the tax system for middle market taxpayers and reduce red tape, we are concerned with the implementation of significant non-systemic changes (such as a reduction to the

corporate tax rate). We believe that isolated changes throughout the current system is likely to increase the complexity of the tax provisions as a whole.

4.4 Considering systemic solutions

- 4.4.1 Based on the problems that are may occur if isolated changes are made to the tax system, we believe that it will be critical to at least consider systemic options of reform that may assist in the reduction of red tape and compliance costs for middle market taxpayers.
- 4.4.2 In the previous section, we identified a number of systemic problems and potential systemic solutions that could be considered. One of those options outlined is a Dual Income Tax system which could be considered as a part of a reform package for middle market taxpayers. The details of such a system and its impact is outlined in Section 5 of this submission.

Section 5 Considering a Dual Income Tax system for the middle market

5.1 Summary of key points

- **Complexity in the Australian taxation system is driven by a differentiation of tax structure and tax rates for various forms of income.**
- **A Dual Income Tax system could provide an appropriate tax reform option for taxpayers in the middle market whereby the flat rate of tax aims to remove these biases that are in our tax system.**
- **By equalising the income tax rate for the majority of income classes, significant complexity could be removed from the system. This measure could help to reduce the complexity associated with choosing a different tax structure and could also potentially remove the need for complex provisions such as Division 7A.**
- **Complex provisions such as the small business CGT concessions could also be potentially removed, as the “capital income” discount rate (together with a superannuation life time limit) could act as a simple replacement under a Dual Income Tax system.**
- **However, moving to a Dual Income Tax system is likely to result in a decrease in income tax collections. The introduction of such a system could therefore need to be accompanied by an increase in revenue from more efficient taxes, such as the GST.**

5.2 Overview

- 5.2.1 This section of the submission provides an outline of a potential option for reform that is intended to deal with tax rate and tax structure bias. This potential option, being a Dual Income Tax system, combines progressive taxation of labour and transfer income with a lower flat tax on all capital income. Essentially, the system aims to provide rate equality over various forms of income, without differentiating between different types of structures.
- 5.2.2 Furthermore, neutrality as between a broad range of capital income is aimed at achieving neutrally as between savings income, removing arbitrage and reducing some of the incentives that are attached to negative gearing.
- 5.2.3 The purpose of this submission is simply to highlight the potential benefits of a Dual Income Tax system and suggest that this option be considered as a part of the review process due to its potential to possibly address many of the concerns raised in Section 3 of this submission.

- 5.2.4 We also note that a Dual Income Tax system would have broader implications for taxpayers other than middle market taxpayers. However, that being said, we believe that a major beneficiary of such a change would be taxpayers in the middle market.

5.3 Broad features of a potential Dual Income Tax system

- 5.3.1 One of the main objectives of a Dual Income Tax system is the alignment of income tax rates. In its purest form, the tax rate on capital income is aligned with the corporate tax rate (or the business income tax rate). These rates are also aligned with an appropriate marginal tax rate⁸.
- 5.3.2 Furthermore, to achieve tax neutrality as between saving and investment income, the capital income tax base is broadly established.
- 5.3.3 The “Australia’s Future Tax System, Report to the Treasurer” recommended aspects of the Dual Income Tax system to be adopted for capital income. In particular, Recommendation 14 suggested a move to a 40% discount on savings income including interest, rent and capital gains. Essentially, the discount percentage is the difference between the top marginal rate and the corporate tax rate.
- 5.3.4 By simply aligning tax rates, the system aims to remove bias that occurs from trying to derive income in different structures and in different form.
- 5.3.5 To demonstrate a potential application of the Dual Income Tax system that could be applied to middle market taxpayers, assume that the top marginal income tax rate is 50%. Assume that a discount of 40% is offered on capital income, in line with the Henry recommendation. This would set the capital income tax rate (being a final tax) at 30%. This would also set the corporate tax rate (being a non-final tax) at 30%, whereby the corporate tax rate is available to business income. Assume that a non-refundable imputation system is applied to dividends paid to the owners. Furthermore, assume that the marginal tax rate for the majority of taxpayers was also set at 30%. These rates would achieve a form of rate equality as between different structures and different types of income.
- 5.3.6 The following example is used to demonstrate the application of this high level proposal on rate equalisation under a Dual Income Tax system.

Example 1 – Application of the Dual Income Tax system

Assume that a family group holds capital appreciating assets and bank savings accounts. For the X1 income year, assume that a capital gain of \$100,000 is

⁸ Sørensen, P.B., “Dual Income Taxes: A Nordic Tax System”, Department of Economics, University of Copenhagen, pg 2

generated, together with \$20,000 of interest income. Furthermore, assume that the family group operates a business which generates a profit before tax of \$500,000. Two family members also work in the business and are paid a franked dividend of \$100,000 each.

Applying the Dual Income Tax system to this example, the capital income (i.e. the capital gains and savings income) would be taxed at a final rate of 30% irrespective of the structure chosen. Approximately \$36,000 of tax would be paid on this income. The business profits would be taxed at 30% (as a non-final tax) and thus approximately \$150,000 of business (corporate) tax would be paid. Finally, the two individuals would not pay additional tax on the receipt of the franked dividends (given the marginal tax rate would equate to the corporate tax rate). Essentially, all income in this example would effectively be taxed at a 30% income tax rate.

- 5.3.7 The example demonstrates that all income would be taxed at a single rate of 30%. Furthermore, irrespective of whether the assets and the business activities are held by trusts, companies or individuals, the same amount of tax would be paid. In a very simple case such as this, tax neutrality could be achieved as between rate and structure. We believe that the above example is typical of most private group structures and thus would help to alleviate a number of complexities and problems faced in our income tax system by middle market taxpayers.

5.4 Removing structural characterisations

- 5.4.1 Currently, many of the complex tax issues discussed in this submission are due to our tax system seeking to tax entities in a particular way. Division 7A and corporate taxation issues demonstrate this issue.
- 5.4.2 In implementing a Dual Income Tax system, there would be less of a need to tax income based on the actual form of the structure.
- 5.4.3 In a broad sense, there are currently two forms of entity taxation. The first form is a retention system (used by companies) and the second form is a flow-through system (used by trusts and partnerships).
- 5.4.4 There is also a hybrid system (which can be found in jurisdictions such as the US) where an entity is taxed on accumulated profits, whereby deductions are provided for distributions paid.
- 5.4.5 Currently, the Australian taxation system applies a system based on its form. However, our system also contains certain provisions that allows one to apply a different set of rules to the same structure.

5.4.6 For example Division 5A and 6C allows partnerships and trusts to be taxed like companies on a retention basis. Likewise, Division 830 allows companies to be taxed as partnerships on a flow-through basis.

5.4.7 These provisions demonstrate that any structure should be capable of applying either a retention or a flow-through system based on a common set of principles and rules (as to members, taxable income and the treatment of distributions).

5.4.8 Accordingly, we believe that there is merit to remove the historical application of entity taxation and replace this with a system that allows either a retention basis or a flow-through basis for all vehicle types. This would allow a trust to be able to access the corporate tax rate (without a corporate beneficiary) and a company to be able to access flow-through taxation (without the use of a holding trust).

5.5 Adjusting marginal tax rates (a detailed example)

5.5.1 One advantage of a Dual Income Tax system is that it can provide for greater neutrality of income tax rates. However, this would require some form of an adjustment to the marginal tax rates in order to achieve this rate neutrality.

5.5.2 To provide a detailed example of how this might work, we have reviewed the current marginal tax rates and considered whether it would be possible to align the marginal tax rates with a corporate rate and a capital tax rate.

5.5.3 In doing this, we examined the number of taxpayers that earned income over \$147,746 and the potential cost of adjusting the tax rate to 30% for those taxpayers. The following table is taken from the ATO statistics for 2012-13⁹ and shows the number of taxpayers that derive income over a certain income amount.

Income threshold	Number of taxpayers below threshold	Number of taxpayers above threshold
\$147,746	8,908,295	568,600
\$159,256	9,003,065	473,830
\$174,247	9,097,830	379,065
\$191,846	9,192,585	284,310

⁹ Taxation statistics 2012–13 Individuals: Percentile distribution of taxable individuals, by taxable income and gender, 2012–13 income year.

Income threshold	Number of taxpayers below threshold	Number of taxpayers above threshold
\$228,153	9,287,355	189,540
\$312,500	9,382,125	94,770

5.5.4 The above table shows that there are a small number of individual taxpayers in Australia deriving income of between \$150,000 and above (i.e. 568,600 taxpayers). It would therefore seem feasible to be able to consider aligning the marginal tax rates for the majority of individual taxpayers by adjusting the marginal rate down from 41% or 49% to 30% for a number of these taxpayers.

5.5.5 We have attempted to estimate the revenue cost that would be associated with of changing the tax threshold for income derived over 37,000 down to a flat tax rate of 30%. The following table outlines our estimates. We have also based these estimates on reducing the Medicare levy and the budget repair levy to nil.

30% marginal tax rate band	Estimated revenue cost
\$37,000 - \$147,746	\$13.6 billion
\$37,000 - \$159,256	\$14.8 billion
\$37,000 - \$174,247	\$16.1 billion
\$37,000 - \$191,846	\$17.3 billion
\$37,000 - \$228,153	\$19.0 billion
\$37,000 - \$312,500	\$21.3 billion

5.5.6 The above table indicates that this proposal is likely to involve a significant revenue cost. However, the potential benefits to the system through a decrease in complexity would still (in our view) be worth considering as a part of this review.

5.5.7 Accordingly, we believe that if this option has merit, that the Government should consider alternative revenue sources or collection, including increasing the GST tax rate to compensate the revenue. Our views on this aspect are contained in Section 6 below.

5.6 Interaction with the small business concessions

- 5.6.1 Many writers support the Dual Income Tax system as (theoretically) it is a simpler system to apply and has the potential to reduce complexity in the system. Such writers argue that there is no need for complex incentives such as the small business concessions¹⁰ and that tax revenues would be better deployed in reducing the corporate tax rate (being a simpler incentive for middle market taxpayers).
- 5.6.2 In relation to the small business concessions, we tend to agree with these observations. That is, we highlight the significant complexity associated with these provisions and that it is unclear whether the provisions meet an appropriate objective.
- 5.6.3 We note that if a Dual Income Tax system were to be introduced, there is an argument that the benefits provided by the Dual Income Tax system would (in effect) be a substitute for the benefits provided by the small business concessions. For example, the active asset CGT concession would be replaced by the ability for all entities to apply a capital gains tax rate of 30%, irrespective of the structure chosen. In many cases, this would result in a lower tax rate than the application of the current small business concessions, whereby the CGT discount rate is currently diluted where a company derives a capital gain subject to the active asset CGT concession¹¹.
- 5.6.4 Furthermore, the complex retirement component of the small business concessions could be replaced by a simpler system that would be available to all business owners.
- 5.6.5 For example, the retirement exemption could be replaced with a lifetime contribution amount of \$500,000. This is in line with one of the proposals suggested by the Board of Taxation report¹².

6.49 Another proposal for reforming the small business CGT concessions would involve removing the current threshold eligibility requirements and allowing all individuals to receive all capital gains made on active assets free of CGT up to a prescribed cap. The cap could apply to capital gains realised over a person's lifetime or for a shorter period of, say, ten years.

- 5.6.6 We believe that this proposal has significant merit. While this exception would be available to all taxpayers (as highlighted by the Board of Taxation), limits could be

¹⁰ See Freedman, J. "Reforming the Business Tax System: Does Size Matter? Fundamental Issues in Small Business Taxation", Thomson Reuters, 2009.

¹¹ This is because the discount component that is paid out on liquidation is treated as a capital gain subject to tax in the hands of the shareholder.

¹² Board of Taxation, "Review of Tax Impediments Facing Small Business: A Report To The Government", August 2014, pg 70.

placed on the ability to use the lifetime cap. For example, the use of the lifetime cap could be limited to individuals with a superannuation balance of less than a certain threshold (e.g. \$1 million).

- 5.6.7 By implementing the above changes, we highlight that the complexity of the small business regime would be replaced with a simple capital discount rate to all disposals of capital assets and a simple superannuation contribution system for active asset disposals. We believe that this alternative (that would complement a Dual Income Tax system) would greatly assist in the reduction of compliance costs.

5.7 Revenue implications of a Dual Income Tax system

- 5.7.1 It is likely that a Dual Income Tax system will (in itself) result in revenue costs. At a high level, we have estimated the following impacts to the revenue.
- Potential costs to the revenue from changes to the marginal tax system.
 - Potential tax savings from a reduction in the discount capital gains tax rate from 50% to 40%.
 - Potential costs to the revenue associated with extending the capital rate to other forms of savings income and other forms of entities (e.g. companies).
 - Potential tax savings from a reduction in the benefit of negative gearing (i.e. as capital income would be taxed at a lower rate).
 - Potential tax savings from repealing the small business concessions.
- 5.7.2 We highlight (also) that it would be possible to lower the corporate tax rate under a Dual Income Tax system and limit this corporate tax rate reduction to private companies. For example, if the corporate tax rate were reduced to 27% for private companies, this would be accompanied by a top marginal tax rate of 45% (i.e. assuming a discount of 40%) and a capital tax rate of 27%.
- 5.7.3 As noted earlier, a simple reduction in the marginal tax rates to 30% could cost between \$13 billion to \$22 billion. This amount would further increase to the extent that both the corporate tax rate and the marginal tax rate were also reduced to a lower rate (say to 27%, applicable only to private companies).
- 5.7.4 Due to the potential magnitude of this cost, we note that a Dual Income Tax system would likely need to be funded by an increase in more efficient taxes, such as the goods and services tax. Assuming the GST base is kept constant, this could give rise to additional revenue of around \$27 billion if the rate were to be increased to 15%. This is discussed in further detail in Section 6.

5.8 Other aspects of a Dual Income Tax system that could be considered

- 5.8.1 There are other aspects of a Dual Income Tax system that have been introduced in other jurisdictions in an attempt to reduce instances of double taxation and double losses for taxpayers. These rules are aimed at removing loss and gain duplication, and are a substitute for provisions such as tax consolidation and loss duplication provisions.
- 5.8.2 For example, some jurisdictions apply an imputation system to business profits that have been taxed at a corporate rate. We note that there would be less of a requirement to provide for refundable franking credits to the extent that most taxpayers would be on an income tax rate equivalent to the corporate tax rate.
- 5.8.3 Some jurisdictions (e.g. Norway) have introduced cost base adjustment provisions, whereby the basis of the taxpayer's investment in the entity is increased by virtue of taxed profits that have been retained in the company and reduced by virtue of distributions that are made.
- 5.8.4 Similarly, a rate of return allowance (RRA) or an allowance for corporate equity (ACE) are mechanisms that have been introduced in various jurisdictions to help to alleviate double taxation under a Dual Income Tax system. An ACE has also been used to help to reduce possible integrity issues associated with converting business income to capital income (such as interest). The ACE could therefore provide a cap on the amount of total deductions (such as interest) available on the "total capital" of the business, inclusive of share capital.
- 5.8.5 As many European countries have applied some form of a Dual Income Tax system, it is possible to leverage from this experience.

5.9 Integrity rules important for a Dual Income Tax system

- 5.9.1 We note that a Dual Income Tax system would still require a number of integrity rules.
- 5.9.2 For example, personal services income rules may be needed to ensure that labour income is not converted to business profits. We note that the Australian personal services business rules already provide for this protection and would likely be a feature of a Dual Income Tax system. That being said, to the extent that labour income is taxed at the same rate as corporate profits, this protection mechanism would only protect against inappropriate deductions from being claimed.
- 5.9.3 Under a Dual Income Tax system, rules may be required to ensure that income is not inappropriately reclassified from labour or business income to capital income. By

way of example, by taxing interest income at a flat final tax rate of 30% as compared to business income (which would be taxed at 30%, but subject to imputation), there could be an incentive to convert share capital into loan capital. However, jurisdictions have attempted to deal with this by way of introducing an ACE, or by considering simplified domestic thin capitalisation provisions (limiting the level of overall related party borrowings).

- 5.9.4 Integrity rules (such as Division 7A) may still be required to prevent inappropriate personal access to profits by individuals, where such profits have been taxed at the business rate. However, under a Dual Income Tax system, we believe that there would be an opportunity to greatly simplify Division 7A. This is because, in many cases, the personal tax rate would be equal to the corporate tax rate. Therefore, a smaller proportion of the population would benefit from seeking to access corporate profits.

Section 6 Goods and Services Tax

6.1 Summary of key points

- **In order to consider appropriate tax reforms in this review, such as the potential to implement a Dual Income Tax system and reduce marginal tax rates, additional revenue would be required to compensate for costs to the revenue. We would therefore support changes to the GST rate to compensate for this.**
- **Australia currently has a very low GST rate of 10% as compared to the average of 19.2% in OECD countries.**
- **Based on declining corporate revenues and increase GST revenues, we believe that increasing the GST rate provides a potential solution to the current budget deficit problems and in addressing some of the problematic cross border issues.**

6.2 Introduction

6.2.1 Over the last number of years, Australia has experienced a declining corporate tax base. Furthermore, since the GFC, Australia has continued to run budget deficits. The current tax system is unlikely to return to a surplus for some time and many would question whether this could occur under Australia's current taxation system based on globalisation.

6.2.2 In addition to this, tax reform options are likely to cost significant amounts of revenue as demonstrated in the previous sections. In our view, it is therefore unlikely that there can be a real possibility of tax reform in the current circumstances where such reforms are likely to cost revenue.

6.2.3 We therefore believe that it is appropriate to consider the possibility for increasing the GST rate in Australia as a part of the tax reform process and thus would support this move if it led to measures that simplified the existing tax system for middle market taxpayers.

6.3 The GST rate

6.3.1 The unweighted average GST rate for OECD countries was equal to 19.2% as at 1 January 2015¹³. In comparison, Australia has not changed its standard GST rate of 10% since the introduction of this tax in 2000, and has retained a number of

¹³ Rates of Value Added Tax (General Sales Tax) - Table 2.A2.1. (1976 - 2015. Updated June 2015) in effect in OECD countries, reporting both the applicable standard rate and any reduced rates

exemptions. In contrast, 20 OECD countries have raised their standard VAT/GST rate at least once in the last five years.

- 6.3.2 In its Economic Survey of Australia in December 2014 the OECD said that the GST rate should be increased by at least 5% because Australia is falling behind other advanced economies in lowering the tax burden on household incomes and businesses.
- 6.3.3 The OECD has made a similar recommendation in the Country Notes section of its Going for Growth report¹⁴ as part of the measures that Australia can take to improve the efficiency of the tax system. In this report the OECD states that consumption “taxes are relatively low while income taxes are heavy. This partially reflects a high headline company tax rate, especially for a capital-importing country like Australia.”
- 6.3.4 The OECD thus has recommended that Australia should reduce “the corporate tax rate as part of a wider reform that also envisages raising the currently low rate of goods and services tax (GST) and/or widening the base.”
- 6.3.5 We believe there is significant merit in considering these recommendations. To the extent that rate equalisation (and thus income tax reductions) can assist in reducing and removing complexity and horizontal inequity in the tax system, we believe that the Government should consider this reform package together with an increase in collections from GST.

6.4 Revenue implications on increasing the GST rate

- 6.4.1 As Australia has moved significant in terms of consumption, a move towards increasing GST would provide a mechanism for dealing with declining revenues. By way of basic analysis, in recent years, the corporate tax base has steadily declined. However, in comparison, GST collections have grown on average by 5.32% since 2004-05 to 2013-14.
- 6.4.2 Furthermore, there has only been one period of decline in GST collections, being negative 0.89% during the GFC (2008-09 reporting period). For the period of 2013-14, GST collections rose by 6.38%. The statistics demonstrate that the GST is a far stabler revenue collection method in a consumption economy as compared to corporate taxes.
- 6.4.3 Whilst the economic impact of various tax exemptions or concessions are very difficult to accurately analyse, in the recently released Tax Expenditures Statement

¹⁴ <http://www.oecd.org/economy/growth/going-for-growth-australia-2015.pdf>

2014 Treasury estimates that the 'cost' to the Revenue of various GST concessions such as Food and Health amount to over \$16 billion in 2015/16.

- 6.4.4 In 2013, the Grattan Institute produced a report entitled "Balancing budgets: tough choices we need" which stated that about "\$13 billion a year could be raised by extending the GST [i.e. at the current rate of 10%] to cover private spending on fresh food, health, education, childcare, water and sewerage, while increasing welfare benefits to reduce the effects of the change on those worst off."
- 6.4.5 Based on Federal financial relations: budget paper no. 3: 2014–15, the total GST revenue is forecast to be around \$54 billion in 2014/15. Using this number as a base, increasing the GST rate to 15% could increase gross revenue by around \$27 billion to a collection amount of \$81 billion. Furthermore, increasing the rate to 17.5%, being closer to OECD averages, could result in approximately \$95 billion in gross revenue collections from GST, an increase of approximately \$41 billion.
- 6.4.6 In practice, any GST rate increase will probably need to be accompanied by increased welfare payments to mitigate the effects of this increase on those worst off. It may also have a negative economic impact on Gross Domestic Product ['GDP']. Based on the Grattan Institute report mentioned above, increased welfare payments could consume about 10 per cent of the extra revenue raised and an increase in the GST rate could have a negative economic impact on GDP of at least \$0.8 billion for every \$10 billion of revenue raised. However, we note that this analysis was considered in isolation of income tax cuts (which would be proposed under a Dual Income Tax system outlined in this submission).
- 6.4.7 That being said, it would seem that potential increases in GST would far outweigh and compensate for costs associated with the rate increase. Furthermore, as income tax cuts proposed under the dual income system would be targeted at those earning \$150,000 or less, it would also assist in compensating for any increase in the cost of living for those taxpayers. Given that this can be achieved without broadening the base of GST, it would mean that additional welfare payments could be more targeted to those taxpayers in the lower income tax brackets.

6.5 Using GST rate increases to tackle cross-border issues

- 6.5.1 We note that increasing the GST rate also has the benefit of tackling cross border taxation issues associated with consumption of offshore products and services in Australia.
- 6.5.2 In terms of considering this as an alternative mechanism of reform, it may be worth considering recent retail cases, where (by way of example) retail businesses owned by offshore companies return a very low overall margin in Australia (e.g. 2.5% to 5%). While transfer pricing modifications could potentially increase the profit

margin reported in Australia, we note that an increase in the GST rate would significantly increase revenue collections well in excess of transfer pricing mechanisms.

- 6.5.3 By way of example, assume a retail business has \$4,000 of sales income and (after paying interest, royalties and other fees to its offshore parent) generates a net taxable profit of \$400 (representing a 10% profit margin). Tax payable is therefore equal to \$120 at the standard corporate tax rate.
- 6.5.4 An increase in the GST rate with respect to this business to 17.5% would increase revenue collections by \$350. To achieve this same increase in corporate tax revenue, through transfer pricing and other BEPS reforms, would require one to increase the profit margin by \$1166. This would constitute a net profit margin of 38%.
- 6.5.5 In terms of revenue collections, a GST rate increase would therefore be far more effective in increasing revenue collections as compared to transfer pricing mechanism.
- 6.5.6 With Australia looking to including digital downloads as part of a taxable supply in Australia, we believe that the two measures would have a significant impact on revenue collections in Australia and thus would be a more effective means of raising revenues as compared to income taxes.

Section 7 Non-systemic change

7.1 Summary of key points

- **As outlined in the previous sections of this submission, we believe there is significant merit in trying to identify key drivers of complexity in the tax system and in seeking to provide systemic solutions to such problems.**
- **From a systemic perspective, we have outlined the option of considering a Dual Income Tax system in Section 5, which we believe could help to remove significant complexity in the tax system for middle market taxpayers.**
- **As outlined in Section 4, we have also outlined the options of considering systemic changes such as: (a) a detailed review of potential carve outs for smaller taxpayers; (b) a reconsideration of tax incentives in our tax system (with an option to replace them with a reduction in corporate tax); (c) an appropriate and targeted extension of tax consolidation for middle market taxpayers; and (d) the replacement of inefficient taxes with a simpler streamlined indirect tax (e.g. GST).**
- **To the extent that systemic changes are not to be considered and (instead) isolated changes to specific tax areas are put forward as recommendations by the Task Force (i.e. non-systemic changes), we would like to express our reservation with such an approach.**
- **As outlined in this section, we believe that non-systemic changes could result in increased complexity and compliance issues for taxpayers in the middle market, simply due to the flow-on effects that an isolated change can have on other tax and commercial areas of our system.**

7.2 Goods and Services Tax

- 7.2.1 Our views on increasing the GST rate is contained in Section 6 of this submission. As noted in that section, we highlight that this is one area that Australia should be looking at closely in terms of reform. In particular, we highlight that revenue collections have consistently increased from period to period, with only one period noting a small decline in revenues (during the GFC).
- 7.2.2 In our view, there is therefore merit in considering an increase in the GST rate irrespective of the reform model chosen. Due to the sizeable potential increase in revenue collections, a GST increase could assist in deploying revenue to other areas of the economy, to provide the revenue to fund income tax cuts as well as to offset potential reductions in State taxes. We would therefore support the consideration of a GST rate increase in line with OECD averages.

7.3 Superannuation

- 7.3.1 There are approximately \$1.8 trillion in assets held via our superannuation industry. Accordingly, superannuation is an area where the Government could be tempted to increase revenue collection.
- 7.3.2 However, we highlight that care needs to be taken with any changes to superannuation or reforms to superannuation.
- 7.3.3 A large sector of our financial markets is supported via investments held in superannuation funds. Accordingly, changes to the taxation of the super-industry could have significant impacts on our financial services sector.
- 7.3.4 In the past, tax changes have been prospective only. We note that this is now starting to create a complex system with many transitional rules.
- 7.3.5 The Discussion Paper raises questions with respect to superannuation, especially in relation to incentives provided to savings income, especially in relation to higher income tax earners as a proportionate tax rate.
- 7.3.6 However, to the extent that a Dual Income Tax system (i.e. a discount on savings income) is not considered as part of the review, we note that the tax incentives are critical to encourage retirement saving and encourage people to use the superannuation system for retirement purposes.
- 7.3.7 As taxpayers are not able to touch super until their retirement age there must be an incentive to entice people to lock their funds away for a long period of time. Furthermore, increasing age based limits may also result in additional dis-incentives to save for retirement using super.
- 7.3.8 We note that changes have been made to the superannuation system in recent times that have broadly removed a number of incentives that would otherwise have been obtained by higher income earners.
- 7.3.9 Accordingly, while further work could be done on considering the tax incentives of the superannuation industry as a part of the White Paper review, we are unsure of the extent to which major reform will be beneficial to the income tax system if this review were to be done in isolation.

7.4 Negative Gearing

- 7.4.1 While negative gearing and the capital gains tax regime are important considerations for those making investment decisions, we are concerned with any significant change that could be made to these items in isolation.
- 7.4.2 We highlight that two of the most important industry sectors in Australia are currently the property sector and the financial services sector. Any significant change to these two items that has a major impact on saving choice could have a detrimental economic impact.
- 7.4.3 On this we highlight that the construction industry is a significant industry in Australia. From statistics provided by the ABS [document 1301.0]:
- In 2011-12, over \$10 billion in revenue tax collections were raised from the construction industry.
 - The total production of the Construction industry, as measured by industry GVA (in volume terms), reached \$102 billion in 2010–11.
 - In 2010–11, the Construction industry's share of the total production of goods and services in the Australian economy was 7.7%.
 - The industry employed an average of 1,033,900 people, 3% higher than in 2009–10.
 - Construction services was the largest employer, with an average of 695,100 people in 2010–11.
 - We are significantly concerned that any change to detract from construction in Australia could have ramifications for the million plus employees in this industry.
- 7.4.4 Accordingly, due to the potential economic impacts of major changes to savings (through negative gearing and changes to CGT) we would not provide support for these options.

7.5 State and Other Taxes

- 7.5.1 We support reforms considerations around inefficient and complex state taxes. However, we believe that it will be very unlikely that Australia will see state tax reform without an increase in the GST rate.
- 7.5.2 We believe that there is significant merit in coupling a removal of certain state taxes with a GST rate increase. We refer to Section 6 which contains our comments on GST rate, as well as our comments above at Section 7.2.

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- 7.5.3 We caution against any move to introduce state income taxes. In our view, based on the experiences in countries like the US, compliance would not only be difficult and time-consuming but we query how much additional productivity would actually be generated nationally through tax competition amongst the states.

7.6 Fringe Benefits Tax

- 7.6.1 In 2013-14, total collections from FBT were only equal to \$3.96 billion. This is not significant compared to total tax revenue collections. On an initial review, one may consider that the FBT system is insignificant and therefore could question its relevance in our current taxation system.
- 7.6.2 However, evidence suggests that FBT is mainly packaged to remove the FBT tax cost and thus revenue is collected via the PAYG system rather than through the FBT system. Therefore, the FBT system acts as an integrity measure to the PAYG system rather than a revenue collection mechanism.
- 7.6.3 Accordingly, shifting to "employee" tax rather than "employer" tax may not significantly change compliance, whereby rules will be required to ensure that benefits to employees are appropriately taxed.
- 7.6.4 We believe that the only real compliance difference may be a reduction in the requirement to lodge an FBT return. It would probably also reduce the requirement to salary package to reduce FBT to nil.
- 7.6.5 That being said, there would still need to be an annual reconciliation report for the purpose of the PAYG system to determine benefits provided. We would also expect the amount to be reported on an employee's group certificate.
- 7.6.6 On the whole, we believe that there is some merit in considering a review of FBT, to the extent that: (a) simpler methods of valuation and rules can be provided; (b) it is possible to apply FBT to individual employees; and (c) reporting and the payment can be shifted to employers under a PAYG system (on an annual basis). We note that this may not be achievable, given that some benefits are global benefits and not employee specific. However, to that extent, a consideration of these benefits and the system applying to those benefits could address those issues.
- 7.6.7 Some essential industries with limited financial resources rely on FBT concessions to attract qualified staff. Any changes to, or reduction of the concessions available under, the FBT system would have to ensure those industries are given the ability to still motivate staff through means other than salary increases.

- 7.6.8 For example, based on the first report on charities registered with the Australian Charities and Not-for-profits Commission [‘ACNC’] there are more than 900,000 full time or part time staff employed by charities. In this regard, according to the report 20% of charities were exempt from paying FBT and 63% were eligible to receive a rebate of FBT.
- 7.6.9 Although we are not completely convinced of the benefits of changing the FBT system back to a PAYG system, we see some merit in reviewing the system in attempts to reduce compliance (e.g. around valuations, the determination of the benefit value and reporting / FBT return lodgement).

7.7 Capital Gains Tax

- 7.7.1 There has been discussion about possible reforms to the CGT regime, especially around the CGT discount. For example, some commentators have called for the total removal of the CGT discount whilst others have mentioned replacing it with a phasing-in discount percentage the longer that an asset is held.
- 7.7.2 Again we stress that care needs to be exercised around any significant proposed amendments to the CGT regime that occur in isolation, especially given superfund and investor reactions that could occur to possible changes.
- 7.7.3 In particular, removing the CGT discount could have a detrimental effect on asset class selection and could move investors from “capital gain” type securities (e.g. shares) into non-capital gain type “interest” securities (e.g. bonds etc).
- 7.7.4 We note that whilst the earlier Henry Review made 4 recommendations in this area “to provide a more consistent treatment of savings income, to reduce opportunities for tax arbitrage and to reduce incentives for investors to take on too much debt, while broadly compensating for the effects of inflation, particularly for interest income”, it did not advocate for the removal of the CGT discount - merely a reduction in the discount from 50% to 40%:

Recommendation 14:

Provide a 40 per cent savings income discount to individuals for non-business related:

- net interest income;
 - net residential rental income (including related interest expenses);
 - capital gains (and losses); and
 - interest expenses related to listed shares held by individuals as non-business investments.
- 7.7.5 Based on this, while we note that the current capital gains tax rules are particularly complex, with that complexity compounded by various exemptions and the grandfathering of previous provisions, we do not believe that any fundamental

changes should be made to the CGT regime in isolation without thorough consultation on (and 'road testing' of) the proposed changes.

7.8 Dividend imputation

- 7.8.1 As a starting point, we highlight that the imputation system provides a transfer pricing safeguard for many outbound Australian businesses. That is, the imputation system encourages income tax to be paid in Australia in order to pay franked dividends to shareholders in Australia. Accordingly, from a transfer pricing perspective, an Australian business can avoid significant double taxation if profits are reported in Australia and tax (subject to imputation) is paid in Australia (as compared to tax payable in an offshore jurisdiction which is not creditable to shareholders of the Australian company).
- 7.8.2 Accordingly, we note that modifications to imputation could have revenue ramifications to outbound business operations. These issues could potentially be dealt with if other rules were developed. For example, foreign income tax offsets could be provided to investors to the extent that dividends are paid to the investors in the current year (e.g. similar to the CFI rules). We note that this would still come at a revenue cost to the Government (as there would be little incentive to increase domestic income under transfer pricing mechanisms).
- 7.8.3 While Australia is one of the few countries in the world that has a full dividend imputation system (Canada and New Zealand being notable other countries with similar regimes), a number of countries provide shareholder level tax relief. For example, the United States introduced dividend tax relief in 2003 and other countries exempt resident shareholders from further tax (for example, Singapore and Hong Kong).
- 7.8.4 Based on an OECD analysis of the overall statutory tax rates on dividend income in OECD member countries it would seem that in order to remain attractive / competitive as a location for share investors, Australia may need to explore other options [such as a reduced tax rate on dividend income] if dividend imputation was to be abolished.
- 7.8.5 A change to imputation could have a significant impact on selection of asset classes for superfunds and could significantly impact value of the fund. Any changes to this area would need to be considered carefully. For example, refundable imputation credits are a positive return for superfunds. The removal of this return could result in share equities being substituted for other types of investments.
- 7.8.6 Therefore, a removal of imputation in isolation could redirect superfund money to fixed income securities and could result in oversupply of shares / equities, reduction in stock market price and reduction in superfund value.

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- 7.8.7 Accordingly, this could set a chain reaction, which could have indirect consequence for fund values. We are quite concerned about any such ramifications that could occur if imputation were to be removed.
- 7.8.8 The removal of imputation would in our view have a significant impact on savings decisions. To avoid these market impacts, the removal of imputation would need to be coupled with other reforms - e.g. a drop in the corporate tax rate, a special dividend rate for dividends paid and/or a lower income tax rate on dividend income.
- 7.8.9 The removal of imputation would also require complexities to be worked out in relation to the interaction with our WHT system.

7.9 Income tax rates

- 7.9.1 Australian income taxes are generally high as compared to OECD standards. In particular, according to the OECD Revenue Statistics and Consumption Tax Trends 2014 data for Australia: “the structure of tax receipts in Australia compared with the OECD average is characterised by:
- Higher revenues from taxes on personal income, corporate income and property.
 - A lower proportion of revenues from taxes on goods and services.
 - No revenue from social security contributions, but Australia has higher revenues for payroll taxes compared with OECD as a whole.”
- 7.9.2 Per a recent analysis prepared by the Tax Foundation (a US based research think tank) using OECD data, the Australian company tax rate is well in excess of the OECD average of 25.5%.
- 7.9.3 As highlighted earlier, in the Country Notes section of it’s Going for Growth report the OECD states that “income taxes are heavy [in Australia]. This partially reflects a high headline company tax rate, especially for a capital-importing country like Australia.”
- 7.9.4 The OECD thus recommends that Australia should reduce “the corporate tax rate as part of a wider reform that also envisages raising the currently low rate of goods and services tax (GST) and/or widening the base.”
- 7.9.5 We understand that the Government may not wish to consider corporate rate cuts in industries where property is immovable (e.g. mining and property). However, it is possible to implement income tax cuts for one sector (e.g. private companies) in isolation of other areas (e.g. public groups).

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- 7.9.6 In this regard, a number of OECD countries have targeted small business corporate tax rates including Canada, France, Japan, the United Kingdom and the United States.
- 7.9.7 A number of countries also have special taxation regimes to encourage various types of income. For example, in recent years several European countries have provided tax incentives to encourage companies to make profits from their intellectual property by reducing the tax paid on those profits - including Ireland, France, Belgium, Hungary, Luxembourg, Netherlands, Spain and the United Kingdom.
- 7.9.8 However, one of the key issues that occurs with a reduction in the corporate tax rate is the pressure that is placed on integrity provisions such as Division 7A. Accordingly, any reduction in the corporate tax rate would require appropriate consideration to integrity rules such as Division 7A and whether such measures could be improved and made to work more efficiently.
- 7.9.9 We believe that it would be worthwhile considering a reduction in income tax rates, however as outlined in this submission this would be a difficult measure to implement in simple isolation.

7.10 International Tax

- 7.10.1 International tax reform should be considered together with other areas of reform outlined above. Our broad comments are as follows.
- 7.10.2 While the imputation system encourages income to be disclosed in Australia, we note that the current imputation system can be quite punitive where income is derived in an outbound jurisdiction.
- 7.10.3 That is, outbound investment results in tax free dividends to an Australian company (taxed in a foreign jurisdiction), which is then taxed as an unfranked dividend upon payment to the Australian shareholder. This results in double taxation, being tax in the offset jurisdiction and tax in Australia, without any ability to apply foreign tax credits.
- 7.10.4 Accordingly, we note that a modified system could be considered to better target to outbound investment to address the issues of double taxation. By way of example, an ability to flow through FITOs to shareholders of Australian companies could help to alleviate the extent of double taxation suffered through an interposed Australia company.

- 7.10.5 The current high corporate tax rates may also not encourage inbound investment. That is, the current system results in a tax rate of 30% to non-residents, with limited or no FTCs to offshore shareholders.
- 7.10.6 A reduced corporate tax rate together with a withholding tax system (whereby foreign tax credits may be available in offshore jurisdiction) could further support or encourage inbound investment. We believe that these issues and options should be considered as part of international tax reform.
- 7.10.7 By way of example, dividends paid from current year profits could be tax deductible in Australia, whereby a special withholding tax could be applied to such dividends paid (i.e. to encourage foreign investment).
- 7.10.8 Whilst we acknowledge that there is currently a detailed worldwide review underway to address Base Erosion and Profit-shifting ['BEPS'], we believe that there is an urgent need to restart the now stalled reforms to our Controlled Foreign Company ['CFC'] rules in order to make them more competitive. Our rules are simply too complex for the middle market and discourage middle market taxpayers from expanding offshore.
- 7.10.9 In relation to the recent tightening of the Australian thin capitalisation rules from 75 per cent to 60 per cent of Australian assets (i.e. from 3:1 to 1.5:1 on a debt to equity basis), we believe that the Government should consider accelerating the introduction of a more accessible arm's length test to not unfairly penalise businesses that are not excessively geared having regard to their own circumstances.