

1 June 2015

Tax White Paper Taskforce
The Treasury
Langton Crescent
PARKES ACT 2600

Dear sir/ madam

Enclosed is a copy of my submission dealing with proposals for future tax reform. If there are any questions I can be contacted by email.

Yours sincerely

Richard Highfield

Rethink: Tax Discussion Paper—Summary of Proposals

As observed at the outset of the Government's discussion paper *Rethink*, tax reform is a key part of its policy agenda to build jobs, growth and opportunity. In this respect, reforms to respond to a number of specific tax system challenges outlined in the paper are central to achieving these objectives on behalf of the wider community. In particular:

1. Corporate tax rates have become uncompetitive, especially with Australia's Asian neighbours, and are now an impediment to further foreign investment, while also negatively impacting the investment capacity of domestic companies.
2. Personal tax rates are relatively high, especially at low and medium income levels, and can be expected to reduce participation incentives as the impacts of unaddressed bracket creep grow, while acting also as an increasing incentive for tax evasion and avoidance practices.
3. Tax laws are unnecessarily complex for the vast bulk of citizens and result in a significant compliance burden, while potential reform opportunities have not been fully realised despite promises made.

Proposals

This submission sets out a small number of proposals for consideration and draws on observations set out in the discussion paper, along with the writer's own specific observations, data, and arguments. While a comprehensive program of tax reform action is clearly warranted, in my view there are two priority areas for attention: 1) under-utilisation of the Goods and Services Tax (GST) for national revenue-raising purposes, at considerable community costs; and 2) the complexity of the personal income tax (PIT) and resultant compliance burden for citizens, in particular salary and wage earners and the growing population of retirees.

The submission also makes an additional proposal that would also contribute to lowering marginal rates of income tax for the broader community.

Proposal One (Goods and Services Tax)

Achieving the necessary reductions in both the standard rate of corporate income tax and marginal rates of the personal income tax will require substantial alternate sources of revenue. The two most obvious sources of this replacement revenue are the GST and income tax base broadening measures, especially in respect of the PIT.

As argued in the submission, Australia's GST has failed to live up to expectations, and at considerable community costs. ***In short, it has proved to be a poor investment for national revenue-raising purposes.*** Significantly, it fails to tax a large swathe of personal consumption expenditure as a result of its extensive range of exemptions that benefit all citizens, from those at the lowest income levels to those at the top of the income scale. While the potential regressive impacts of a broad-based consumption tax are recognised, the submission argues that ***the most appropriate means of addressing such concerns is through the provision of compensation measures that are adequate in value, well targeted, permanently transparent, and sustained over time.***

The submission accordingly proposes measures to broaden the GST's base and, at some stage, an increase in its standard rate. To increase the prospect of wide community support, it is essential that the measures be accompanied by appropriate compensation arrangements, as outlined.

Proposal Two (Personal Income Tax)

Despite numerous past promises from both sides of Government, and various attempts and incremental initiatives over many years aimed at achieving major simplification, Australia's PIT system continues to be characterised by significant tax compliance costs, as evidenced by official research findings and the high and growing use of tax professionals. ***It does not need to be this way!***

As noted in the submission, many other countries (e.g. Denmark and Sweden) have made significant advances in this area, with a combination of legislative and technologically-driven reforms. There is no valid reason why Australia cannot mirror this success.

The Australian Tax Office has made good progress towards establishing the technological environment required that would enable it to prepare fully completed returns for the majority of taxpayers. However, as discussed in the submission, the prevalence of specific types of deductions and the high usage of tax professionals stands in the way of making "transformational" progress. This particular issue was the subject of examination in the previous Government's review of the tax system (i.e. Australia's Future Tax System (AFTS)) and was the subject of a number of specific recommendations, all of which continue to be relevant.

The submission accordingly proposes consideration of tightening the rules for WRE deductibility, the introduction of a standard deduction for specific deduction items, and the creation of a legislative framework to support the preparation of fully-completed tax returns. In consideration of these matters, it also encourages policy-makers to take a holistic view of the potential benefits from all of the proposals made.

Proposal three (Capital Gains Tax)

A factor contributing to high marginal rates of PIT is the range of concessions which are made—often referred to as 'tax expenditures'—and their significant "costs" in terms of foregone revenue.

One such concession is the 50% discount provided on net capital gains in respect of assets purchased after September 1985 and held for at least 12 months. While the discount was purportedly introduced in 1999 to simplify the computation of net capital gains, it also had the effect of providing a far more concessional approach for the taxing of net capital gains in respect of assets held for relatively short periods (i.e. less than five to six years). It is therefore not surprising that over time this form of saving has become extremely popular among those best placed to take advantage of it, but at considerable and growing community cost in the form of foregone tax revenue.

While a discount can be justified on simplification grounds, a case for a reduction in the size of the discount can be made. A considerably reduced discount would also lessen the appetite for negatively-geared investments, a feature of the current PIT system that has become a concern to many parties interested in tax reform. The submission accordingly proposes that the level of discount be more closely aligned with movements in the rate of inflation.

Richard Highfield
31 May 2015

Richard Highfield is an advisor on tax system design and administration and serves also as an Adjunct Professor with the UNSW School of Business. Previously, he was senior advisor with the OECD's Centre for Tax Policy and Administration from 2003 to end-2014, and with the IMF's Fiscal Affairs Department from 1997 to early-2003, and a Second Commissioner of Taxation with the Australian Taxation Office (1993-1997).

Tax reform proposals

Subject area: Goods and Services Tax (GST)

Proposal

- 1) Enhance the tax mix of Australia's tax system by increasing reliance on the GST as a source of Government tax revenue; initially, this should be achieved by broadening the GST's base to encompass the existing main exemption items, with a higher rate (e.g. 12.5%) applied shortly thereafter to permit further income tax reforms.
- 2) Take adequate steps to achieve community and political support for 1) by ensuring that its introduction *is accompanied by well-targeted, adequate, transparent, and sustained compensation for low income earners.*

Relevant discussion questions

- Q2. How well does Australia's utilisation of its available taxes align with the evolving structure of Australia's economy and changes in the international economy?
- Q51. To what extent are the tax settings (that is, the rate, base and administration) for the GST appropriate? What changes, if any, could be made to these settings to make a better tax system to deliver taxes that are lower, simpler, and fairer?
- Q54. To what extent does Australia have the appropriate mix of taxes on specific goods and services? What changes, if any, could improve this mix?
- Q55. To what extent are the tax settings (i.e. the rates and bases and the administration) for each of these indirect taxes appropriate? What changes, if any, could be made to these indirect tax settings to make a better tax system to deliver taxes that are lower, simpler, and fairer?

Key points

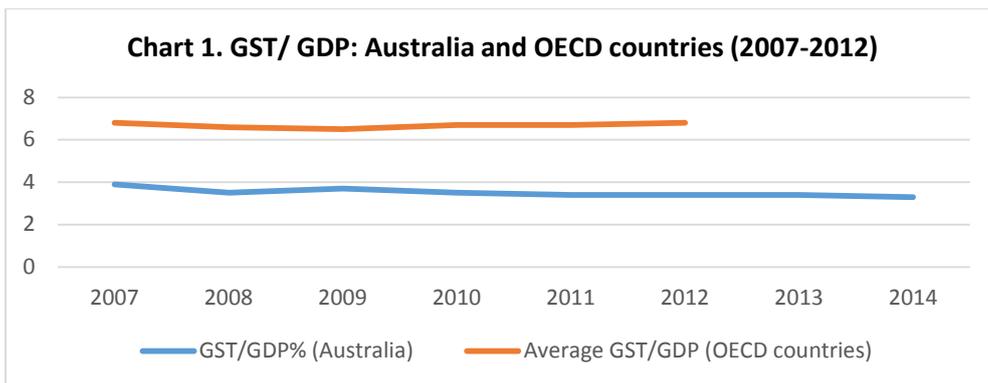
- As widely recognised within international comparisons of tax systems in advanced economies and acknowledged in the discussion paper, Australia's tax system is characterised by a relatively high reliance on direct taxes and a relatively low dependency on indirect taxes; as such, and bearing in mind Australia's overall tax burden, marginal rates of tax for both the PIT and CIT are relatively high which has a number of negative consequences, while the GST's standard rate is relatively low, which also has a number of negative consequences.
- Contrary to its widely quoted description as "a broad-based consumption tax", comparisons of Australia's GST base with its international peers leads to a quite different conclusion—the GST tax base is relatively narrow which contributes to its low overall revenue productivity.
- Exemptions are generally regarded as an inefficient means for addressing the regressive impacts of broad-based consumption taxes; furthermore, while exemptions arguably "protect" low income recipients from tax imposition they also directly reward those on high incomes with the capacity to pay such imposts.

- **A combination of low revenue productivity and relatively high compliance and administration costs results in Australia's GST being a relatively poor investment for national revenue-raising purposes.**
- Ideas for reforming the GST (i.e. by base broadening and/or by adopting a higher rate) are highly contentious and further consideration in a major tax reform context will inevitably encounter fairly wide political and community opposition; for this reason, this writer **strongly advocates an accompanying regime of compensation arrangements that are well targeted, fair in value, permanently transparent, and sustained over time.**

Background

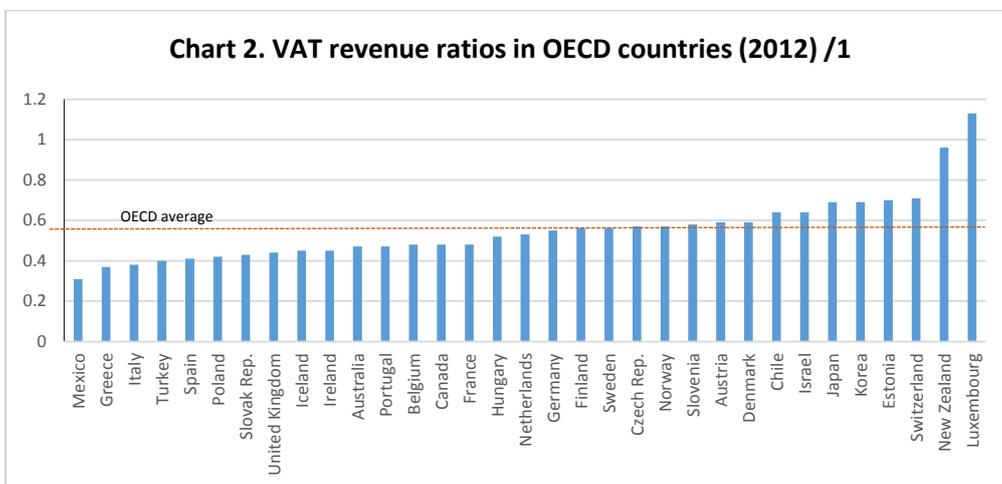
The introduction of the GST was accompanied by considerable fanfare regarding its expected transformational impact on Australia's tax landscape and economy. However, reflecting on 15 years' experience since its introduction and on the GST system now in place, one can only conclude that such expectations have been far from realised, as evident from the following observations, a number of which are also highlighted in the **Rethink** discussion paper:

- GST revenue has declined marginally over time and is well below average OECD levels (see Chart 1):



Source: *OECD Revenue Statistics*, 2014

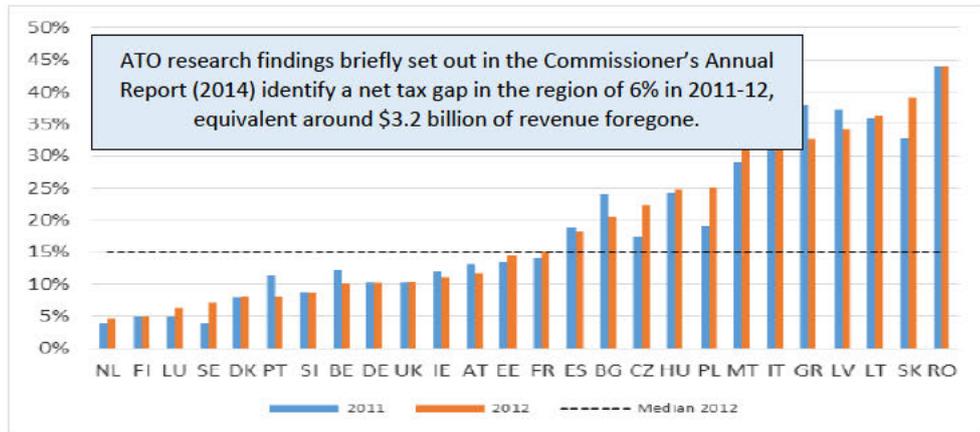
- Contributing to the low revenue productivity of the GST is its taxable base, which is relatively narrow, as seen from computations of the OECD's VAT revenue ratio (see Chart 2):



Source: *Consumption Tax Trends*, OECD, December 2014

- Also relevant to revenue productivity is the GST “tax gap”—the difference between the estimated amount of tax payable where there is full compliance and the amount actually paid. While Australia’s GST performs reasonably well on this measure in comparison with many OECD countries, the amount of revenue foregone is not insignificant (see Chart 3):

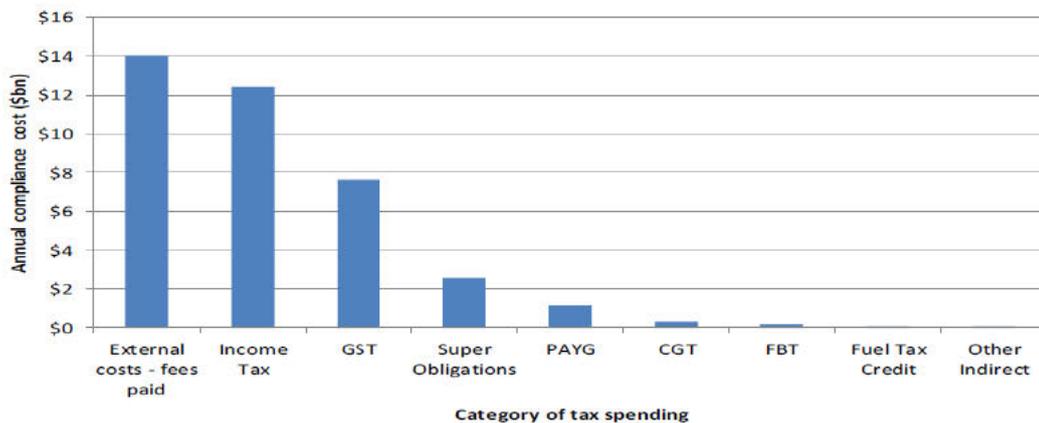
Chart 3. The VAT gap in EU member countries (2011 and 2012)



Source: 2012 Update Report of Study to Quantify and Analyse the VAT gap in the EU-27, prepared for the European Commission, 2013.

- Like most VAT systems, the compliance costs of Australia’s GST are relatively large—estimated by Treasury in 2015 at almost \$8 billion per annum, which is around 14% of annual net GST revenue (see Chart 4). Compliance costs at this level result in the GST being the most costly of the main taxes in a relative sense and, needless to say, are a major burden on business, especially the SME sector.

Chart 4. Tax compliance costs by type of tax



Source: Stocktake and Audit of Regulation: Final Compliance Costs Report, Treasury, March 2015

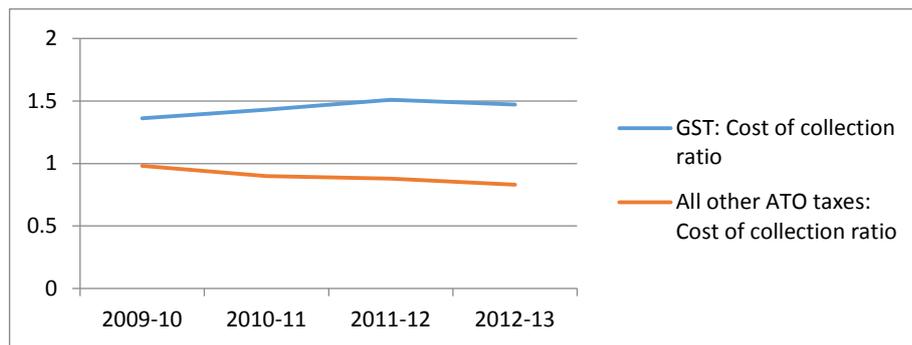
On this particular aspect it is worth noting that research in some areas of the business sector point to an even higher level of tax compliance costs:

“Our research has found the compliance burden of GST is costing small businesses a staggering \$13.7 billion a year in time and productivity. By removing the current ATO requirements to allocate various “No GST” codes to every transaction businesses incur, the Government could significantly reduce the time consuming and costly red-tape burden that

is weighing small business down” (Tim Reed, CEO of MYOB, as reported in Australian Financial Review, 21 May 2015.)

- Reflecting the staged-by-staged approach to revenue collection that is a feature of VAT-type systems such as the GST, most businesses in Australia must be registered for GST and monitored by the ATO, which contributes significantly to the ATO’s administration costs. Compared to the administration costs incurred by the ATO for all the other taxes it administers, the GST is relatively more costly by a factor approaching 50% (see Chart 5). Improving the GST’s revenue productivity potential by base broadening and/or raising the standard rate will appreciably improve the return on this investment.

Chart 5. Australia: Administrative costs of the GST and other ATO-collected taxes



Sources: GST Administration Annual Performance Report (*various years*), ATO and Tax Administration 2013 and 2015 (*forthcoming*), OECD.

This combination of relatively low revenue productivity, relatively high compliance and administration costs, and not to ignore some revenue leakage, inevitably lead to one overriding conclusion—the GST with its current settings is a relatively poor investment for national revenue raising purposes.

Ideas for reform

For the sorts of reasons outlined, a strong case can be made for GST base broadening and, most likely, a rise in the standard rate for a myriad of benefits (e.g. reductions in PIT and CIT marginal rates of tax). There will of course be resistance and, in some quarters, wholesale opposition to such reforms due to concerns for the regressive impacts of GST reform on lower income-earning citizens. There is legitimacy to such concerns. However, the case for reform will be considerably stronger if appropriate compensation arrangements accompany an overall set of reforms.

As to what would constitute “appropriate” compensation can be viewed from a number of angles but this writer would suggest that the following factors are important considerations in garnering broad community support for change:

1. **Adequate in value**—The amount of compensation should be reasonable for those most impacted;
2. **Well-targeted**—Compensation should be directed to those most in need;
3. **Permanently transparent**—Deserved recipients should receive regular reminders that they are in receipt of compensation for the purposes intended; and
4. **Sustained over time**—Government should give a commitment that such compensation will not be withdrawn or unreasonably reduced.

Concerning the factors mentioned in 2,3 and 4 consideration should be given to the idea of a GST credit, in principle along the lines of a measure adopted in Canada (see Box 1), that could be delivered (but while remaining transparent) with the payment of family tax benefits and Government pensions (e.g. age, disability, and unemployment). Essential requirements would include that the amount of credit is fair in value, well targeted, and permanently transparent in the regular communications with recipients.

Box 1. Canada's GST Credit

The GST/HST credit is a non-taxable quarterly payment that helps individuals and families with low and modest incomes offset all or part of the goods and services tax/harmonized sales tax (GST/HST) that they pay.

The credit is paid quarterly for each tax year, in July, October, January and April, on or around the fifth day of those months. The amount of the credit is based on each family's net income, plus the number of dependent children. The CRA does not consider the credit taxable income. Application for the GST/HST credit is elective through federal tax returns, though it can be claimed only by one spouse or other member of a household.

To receive the GST/HST credit, one must be a resident of Canada as defined by the CRA for tax purposes. In addition, one must meet one of three additional criteria: you are at least 19; you are married or have a common-law partner; or you have one or more children with whom you live.

Sources: Canada Revenue Agency and TurboTax.

Subject area: Personal income tax (PIT)

Proposals

- 1) Tighten the rules for deductibility of work-related expenditure, in line with the arguments made in the AFTS report.
- 2) Simplify tax system administrative requirements for around 60-70% of PIT taxpayers through a combination of legislative and administrative changes entailing:
 - a) The introduction of a standard deduction covering 60-70% of PIT taxpayers to eliminate the need for itemised deductions in respect of specific items of deductible expenditure.
 - b) Establish the requisite legislative framework that will enable the ATO, with appropriate technological support, to fully prepare annual tax summaries/assessments for the 60-70% of personal taxpayers with relatively simple tax affairs, thereby dispensing with their existing obligation to individually prepare and lodge their own tax return.

Introduction of the proposal in 1) would produce additional revenue for related reforms and improve the equity of the tax system among the population of employee taxpayers. Introduction of the proposal in 2) would produce significant savings for taxpayers in terms of reduced compliance costs, increase the capacity of the tax advisory profession to provide more value-adding services to those taxpayers who require and deserve increased assistance (e.g. small businesses), and (needless to say) result in enormous kudos to Government.

Relevant discussion questions

- Q6. What should our individuals income tax system look like and why?
- Q15. To what extent do our arrangements for work-related expense deductions strike the right balance between simplicity and fairness? What could be done to improve this?
- Q49. What, if any, administrative arrangements could be simplified that would result in similar outcomes, but with reduced compliance costs?
- Q59. In what ways can reforms of tax administration best assist in reducing the impact of complexity on taxpayers? Are there examples from other countries of tax administration reform to reduce the impact of complexity that Australia should adopt?
- Q61. Could administrative responses — such as embracing technology, harnessing data and taking the whole-of-government approach to administration — help address the issue of tax system complexity?

Key points

- Despite numerous attempts and various “incremental” initiatives over many years aimed at achieving major simplification—refer Annex 1—Australia’s personal income tax (PIT) system continues to be characterised by significant tax compliance costs, as evidenced by official research findings and the high and growing use of tax professionals.
- With around 44% of all PIT returns lodged and processed generating little or no tax, but significant compliance costs for the taxpayers concerned, ***full automation of the end-of year tax reconciliation process should be seen as an urgent priority.***
- The incidence of deduction claims for work-related expenditure by taxpayers with taxable incomes in the ranges \$37,000 to over \$150,000 exceeds over 90%, suggesting considerable potential for some level of standardisation and simplification.
- Considerable amounts of revenue are being foregone through over-claimed work deductions which are likely to be in the region of 15%, and now so pervasive as to be beyond the administrative control of the ATO.
- Many other countries have made advances in this area, with a combination of legislative and/or technologically-driven reforms. Denmark and Sweden are examples of countries with a PIT system similar to Australia’s, but where the vast bulk of personal taxpayers receive at year-end a fully completed tax return (that for most is received online) and which simply requires their validation, with minimal compliance effort; ***there is no valid reason why Australia cannot mirror this success.***
- Contrasted with past efforts on thinking about reform in this area, achieving major simplification will require a different strategic thinking approach, ***including a more holistic assessment of the overall potential benefits and costs.***

Key issues to be addressed

Drawing on past experience, a major impediment to transformational reform is tax deductions and, in particular, their prevalence within the vast bulk of personal tax returns. The main “culprits”, in a

tax simplification context are: 1) Employees' work-related expenses; 2) Gifts to approved charitable institutions; and 3) Tax agents' fees.

Work-related deductions

The obstacles to transformational reform presented by the prevalence of work-related deductions are well documented in the AFTS Review Report and mentioned briefly in the Rethink discussion paper:

AFTS Review Report (with writer's underlining)

"The law for WREs is complex (supported by numerous ATO decisions, determinations and rulings). While the general principles are simple, many tax rulings, court rulings and legislative provisions underpin their application. WREs impose a compliance burden on individuals and practitioners and add to administration costs for the ATO.

Under the current framework, there are significant difficulties in correctly quantifying work-related costs, in apportioning expenses between income-earning purposes and private purposes, and in defining and claiming the deductions. These complex arrangements constitute one of the impediments to further pre-filing of tax returns and, ultimately, removing the need to complete a tax return for a large number of employees. There is a high degree of variation in WRE claims among individuals with identical occupations and income levels. This variability could be explained by: some taxpayers over-claiming (including expenses that might be private, domestic or capital in nature), given the limited ability of the ATO to audit WREs; some taxpayers interpreting expenses that are incurred in performing their job differently from other taxpayers (raising issues of complexity and transparency in the system); and differences in employer behaviour, where some employers pay for a particular type of expense while other employers do not" (Personal Tax, Volume 1).

Rethink discussion paper

"Compared to some other countries, Australia's tax system is relatively generous in respect of work-related expense (WRE) claims, which are widely utilised. In 2011-12, around 8.5 million people claimed WREs totalling nearly \$19.4 billion, although around 38 per cent of tax filers had claims of less than \$500. Under Australia's approach individuals are able to claim a broad range of WREs against their assessable income as long as they are used for work. To reduce compliance burden and allow greater use of pre-filled income tax returns, Australia has in the past considered, but not proceeded with, a 'standard deduction' on WREs [...]

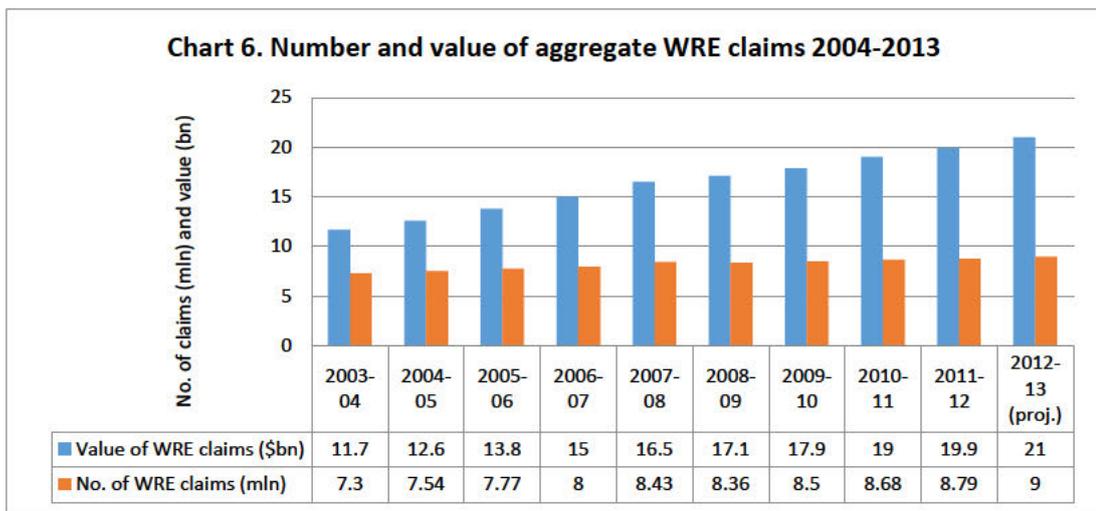
The approaches of some other countries are more prescriptive or limited. For example, the United Kingdom specifies a tighter nexus on WREs and limits deductions to those that are incurred wholly, exclusively and necessarily in the performance of an employee's duties, although the compliance burden associated with substantiating deductions remains. New Zealand 'cashed out' WRE deductions in the late 1980s by providing income tax cuts in exchange for disallowing WRE deductions. This has been a major driver of compliance savings by reducing the number of people needing to file a tax return — in the 2012 tax year around 1.25 million individual tax returns were filed in New Zealand out of an estimated 3.3 million individual tax payers (page 54)"

What the data shows

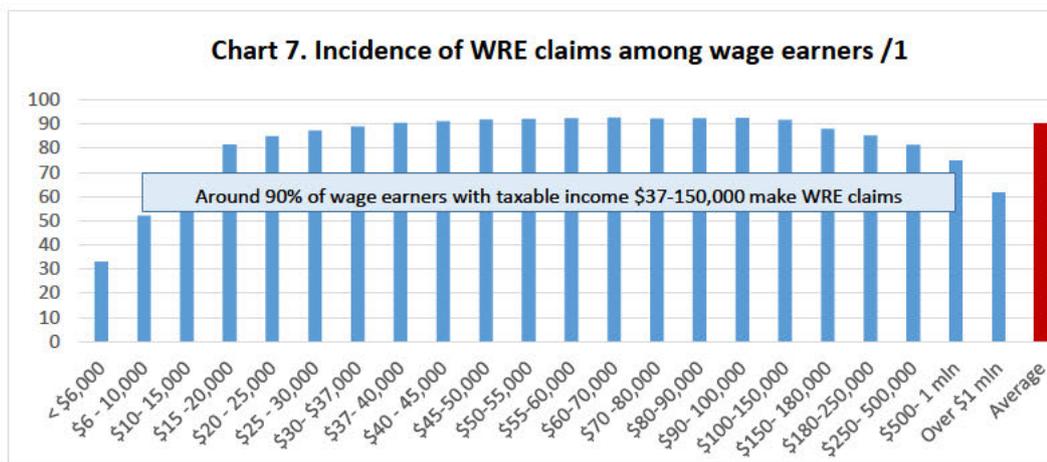
Drawing on tax return data for 2012-13 and 2011-12, it can be shown that:

- Aggregate WRE claims continue to grow (Chart 6 refers).

- For taxable incomes between \$37,000 and \$150,000 the incidence of WRE claims, as a share of those reporting wage income, is consistently in excess of 90% (Chart 7 refers).
- Claims for WRE, on average, rise with income (Chart 8 refers).
- Over 3 million wage earners make WRE claims for motor vehicle expenses amounting to over \$8 billion, despite the fact that travel expenses to and from an employees' workplace are generally deemed private for tax purposes and are therefore non-deductible (Chart 9 refers); while many employees can justifiably point to the legitimate use of their motor vehicles for work purposes, it is extremely difficult to comprehend how this population could extend to anywhere near 30% of employee taxpayers.

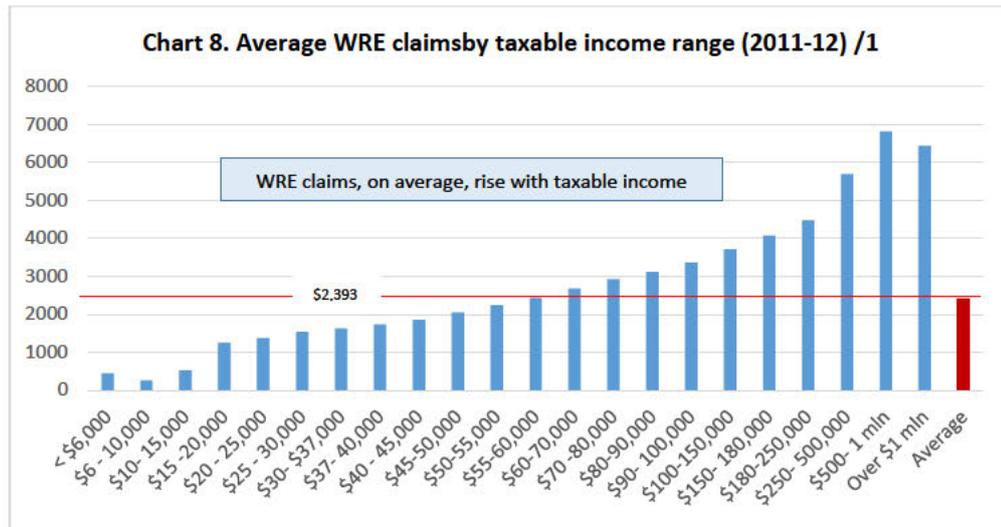


Source: Taxation Statistics 2012-13

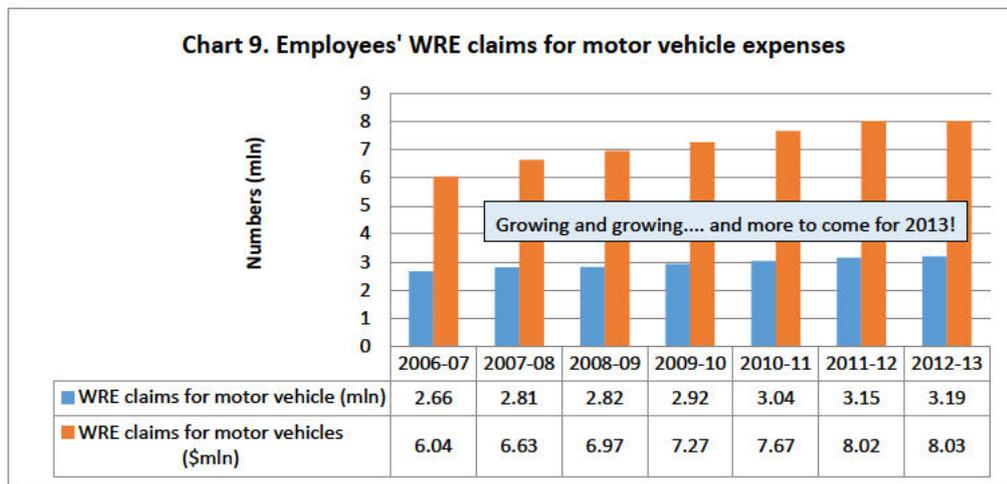


Source: Table 11, Taxation Statistics 2011-12, ATO.

/1. For taxable resident taxpayers in 2011-12: number of WRE claims as a proportion of wage earners.



Source: Taxation Statistics 2011-12, ATO
/1. For taxable resident taxpayers in 2011-12.



Source: Table 2, Taxation Statistics 2012-13, ATO.

While the ATO does not publish compliance related-data on the incidence of over-claimed WRE deductions, its compliance program publications have consistently drawn attention to ongoing compliance issues. Based on this writer's experience and overseas compliance research findings (e.g. from Canada) dealing with deduction items that are not subject to systematic third party validation, as is the case with the vast majority of WRE expense items, ***the incidence of over-claimed deduction items in Australia is likely to be in the region of 15%; for 2014-15 tax returns would represent around \$3.5 billion of over-claimed deductions, and around \$700-800 million of tax revenue.***

Gifts to approved charitable institutions

The AFTS Review Report made observations on the rationale of providing deductions for gifts and in the context of compliance burden reduction efforts made a recommendation that the threshold for deductibility should be raised from \$2 to \$25.

Drawing on the most recently published data and historical growth patterns (refer Annex 2), the number of itemised claims for gifts for FY 2014-15 can be projected to number around 4.8 million, for claimed expenditure totalling around \$2.5 billion. Significantly, as evidenced by tax return data (Annex 2, Table 3 refers) over two thirds of aggregate gift deduction claims are for relatively small

amounts (i.e. below \$250) although representing only around 11% of the value of deductions claimed.

Tax agent usage and tax agents' fees

As noted in the AFTS report, the costs to taxpayers of managing their tax affairs are deductible, whether they are business taxpayers, salary or wage earners, or investors. This deduction is important in recognising the compliance costs imposed by government on individuals, and can be seen as one of the direct costs of the tax system. However, as also highlighted in the AFTS report, Australia's tax system is characterised by a relatively high usage of tax agents, which on the basis of the most recent data appears to be growing (see Chart 10), notwithstanding stated policy directions and some related initiatives intended to simplify the compliance burden.

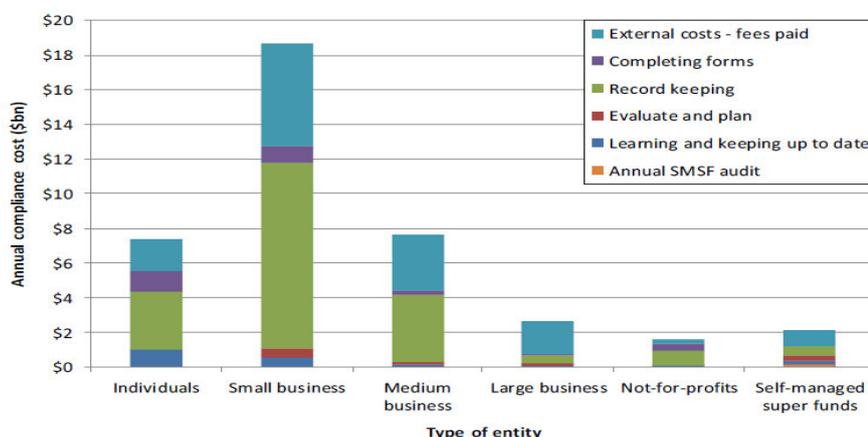


Source: Table 4, Individuals, Tax Statistics 2012-13

Given this very high usage rate and the costs to taxpayers of keeping records etc., it is therefore not surprising that the aggregate compliance burden attaching to Australia's PIT is significant—most recently estimated at \$7.3 billion per annum, equivalent to around \$560 for citizen lodging an annual tax return (see Chart 11). As noted in Treasury's report (page 23):

“The chart shows that the most costly activities for individuals are record-keeping and external fees. The cost of record-keeping is concentrated in income tax and it is very likely that external fees primarily reflect charges by tax agents for the preparation of tax returns.”

Chart 11. Tax compliance costs by entity and activity



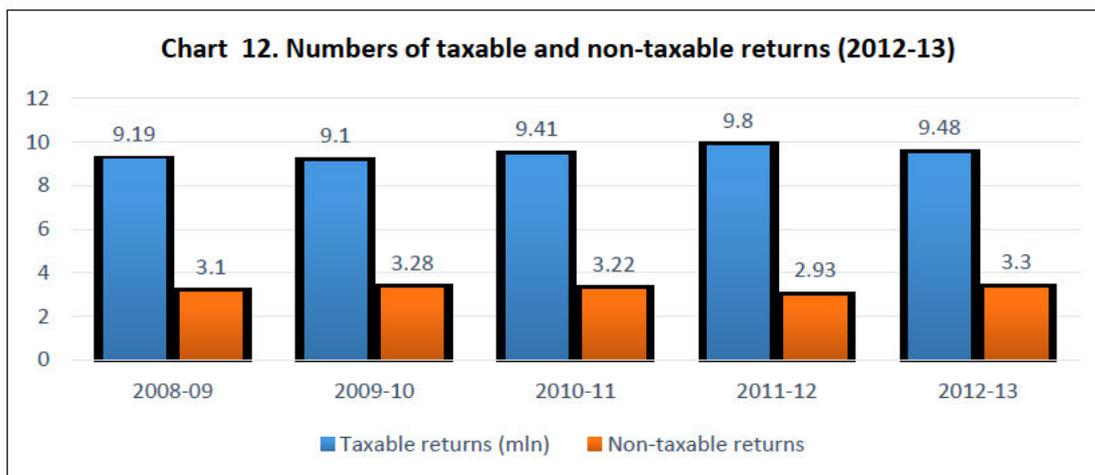
Source: Stocktake and Audit of Regulation: Final Compliance Costs Report, Treasury, March 2015

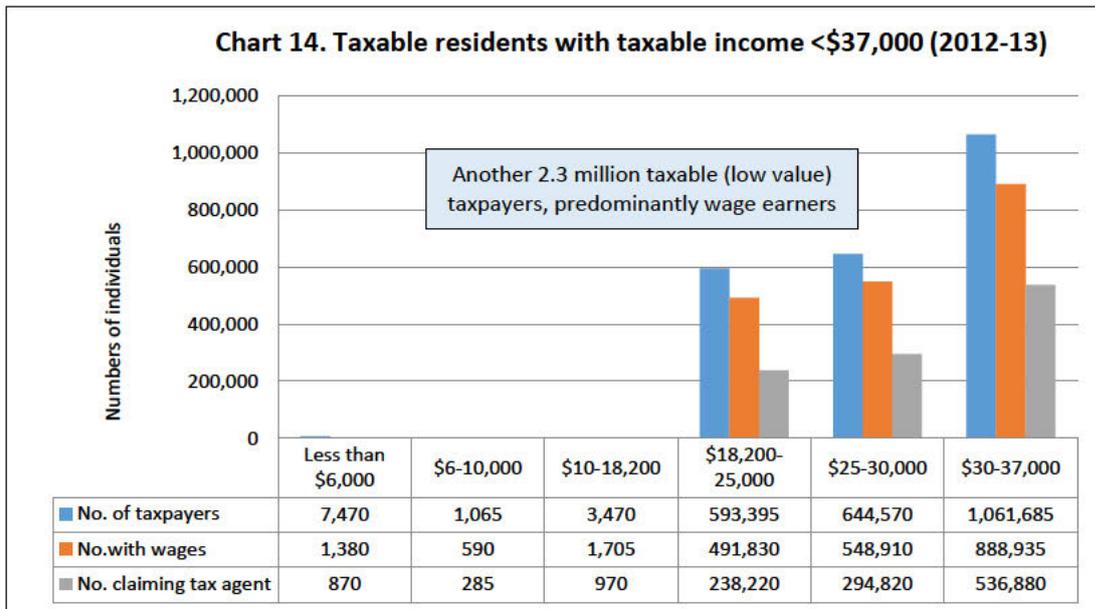
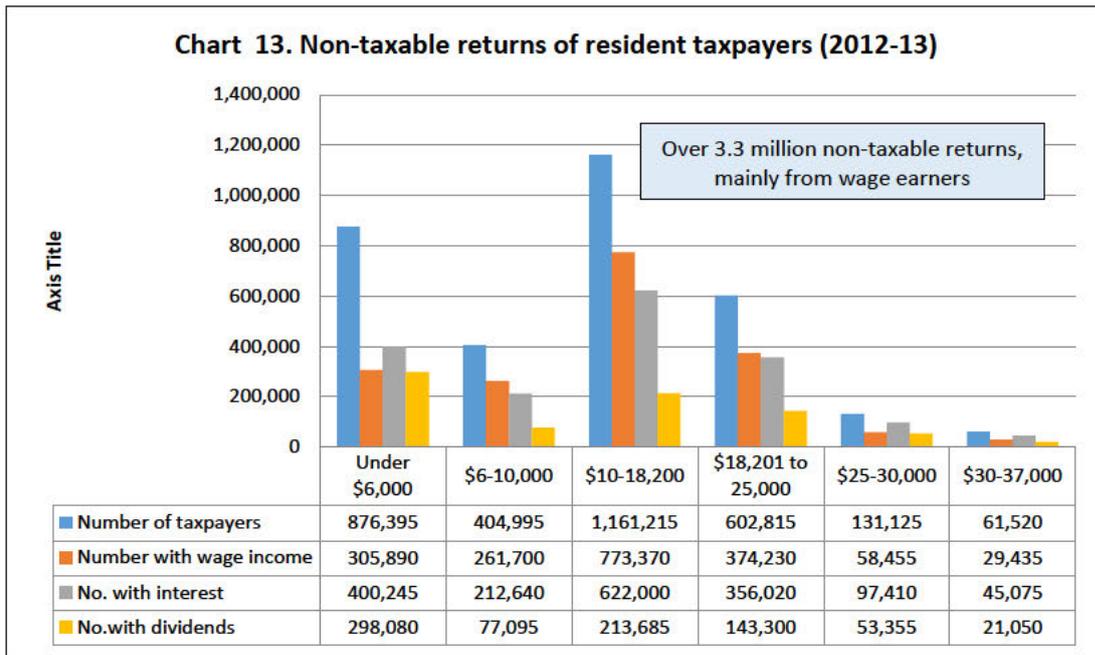
With compliance costs of the magnitude indicated, it can be seen that there is a significant reform challenge to be addressed.

A related issue—the large numbers of returns with little or no tax

An important additional argument for transformational reform arises when account is taken of the relatively large numbers of tax returns received that entail little or no net tax, but which generate significant compliance costs for the taxpayers concerned and administration costs for the ATO:

- The proportion of tax returns generating no tax (i.e. being non-taxable) has, on average, exceeded over 25% for the five income years up to 2012-13 (Chart 12 refers).
- Non-taxable returns are predominantly lodged by salary and wage earners (e.g. casual income, part time workers) and citizens with small amounts of investment income (Chart 13 refers); somewhat surprisingly, over one third of these citizens engage a tax agent thereby incurring additional compliance costs which for some cannot be offset with a tax benefit (i.e. deductibility for tax purposes).
- Around 44% of tax returns (i.e. both non-taxable and taxable) are received from citizens with taxable income below (\$37,000), generating relatively little tax (i.e. around 2.8% of total net tax); again somewhat surprisingly, over 30% of these citizens engage the services of a tax agent (Chart 14 refers).
- Assuming a modest compliance cost of \$400 for each of all the returns received with an assessed taxable income below \$37,000 produces an annual compliance cost of over \$2.2 billion, a staggering amount when viewed in an overall tax system and community context.





A different strategic approach is required for achieving major simplification

Previous thinking and efforts aimed at achieving simplification in this area have been driven largely by adopting a “bottom up” approach. In short, consideration of—

What (incremental) changes are needed to the existing arrangements (both legislative and administrative) to achieve the stated reform objective?

Such an approach has been unsuccessful over the last decade and this experience suggests is not appropriate in the context of thinking about future transformation due to its inability to meet narrowly-focused politically-driven criteria around numbers of “winners and losers”. For example, the AFTS Review Report proposal for a specific form of standard deduction was seen as resulting in too many “losers” when viewed from the narrow perspective of achieving a largely breakeven

revenue outcome. However, it is not clear that such a conclusion took a holistic view of all of the factors relevant for the context in which the original proposal was made, for example:

1. Aggregate deduction claims for WRE are, under the arrangements then and still prevailing, **likely to be overstated by around 15%** (which in 2015 is equivalent to over-claimed deductions of around \$3.5 billion); judgments around ‘winners and losers’ need to pay regard to this unwarranted “benefit” of the current arrangements.
2. The AFTS proposal for a standard deduction was accompanied by an additional recommendation that the rules for WRE deductibility be tightened; this was not done.
3. In an environment where tax returns are fully prepared by the ATO for the vast bulk of taxpayers, **a large proportion of deduction claims for tax agents fees would “simply disappear”** and present a fair saving in aggregate to taxpayers; in addition, significant reductions in tax compliance costs could reasonably be expected to result from eliminating the requirement for the majority of taxpayers to keep tax records, prepare a tax return, and/or make the efforts entailed with engaging tax professionals to provide this service.
4. Other savings in taxpayers’ compliance costs.

In the context now presented with the Government’s ‘Rethink’ program, **this writer advocates a “top down” approach to thinking about simplification reforms, one where it is a fundamental objective that the vast majority of personal taxpayers with relatively simple tax affairs should be freed from the obligations to keep detailed records of income and deductions and to prepare and lodge an annual tax return on their behalf.** Viewed along these lines, the primary question to be answered is:

What would the design of the tax system need to look like to achieve this outcome?

Ideas for reform

Since 2007, the ATO has made good progress towards establishing the technological environment (i.e. systems and processes) required that would enable it to prepare fully completed returns for the majority of taxpayers. Progress has been made, although there is scope for improvement, in establishing reasonably efficient processes for capturing large volumes of third party income reports from employers, financial institutions, and government bodies. A system of prefilling tax returns is well established and taxpayers are familiar with the process of relying on income data accumulated for them by the ATO to prefill their tax returns, while user interfaces have recently been enhanced, and more is planned, to encourage further take-up. Finally, adequate security and authentication mechanisms appear to be in place.

However, as already noted the prevalence of deductions and high usage of tax professionals stands in the way of making transformational progress and remains to be overcome. For the reasons set out quite succinctly in the AFTS Review Report this writer strongly advocates the concept of a standard deduction for employee taxpayers that rises in line taxpayer incomes, but one which would also encompass deductions for gifts, and which is subject to threshold provisions in order to permit taxpayers with abnormally high claim patterns to continue to make itemised deductions (Box 2 refers to the kind of model envisaged, as recommended in the AFTS report).

Box 2. The AFTS Review Reports' recommendation for a standard deduction

Longer term reforms should be made with a view to creating a simpler and more transparent system. Policy changes should support simplification by facilitating fully automated preparation of tax returns. Using information that is reported by a third party such as an employer or financial institution is an important part of this, rather than relying on information that has to be collected by the taxpayer over the course of the tax year [...]

However, the current arrangements for deductions, particularly for WREs, place a considerable compliance burden on many taxpayers. To simplify individuals' interaction with the tax system and to facilitate much more pre-filling of tax returns, an automatic standard deduction should be introduced.

Taxpayers would be provided with a standard deduction as part of their pre-filled tax return, unless their claim for WREs (excluding tuition fees that should be separately deductible) and for the cost of managing their tax affairs exceeds a claims threshold and they choose to claim their actual expenses with full substantiation. The standard deduction should be the default option. Taxpayers could opt out of the standard deduction and claim higher total expenses where these are above the claims threshold [...].

The standard deduction would consist of:

- a) nominal base amount available to those with labour and/or capital (non-business) income who do not elect to claim itemised expenses (WREs, including some self-education expenses, and cost of managing tax affairs) above a minimum claim threshold; and
- b) a proportion of labour-related income up to a capped amount (the claims threshold).

While the increasing value of the standard deduction would reflect the fact that expense claims rise with income, the value of the tax concession should ultimately be set so as to bring most taxpayers into the standard deduction. The level of the standard deduction would need to be set with regard to changes in the requirements for expense deductions. Taxpayers with high expenses above the claims threshold would be able to claim expenses above the claims threshold with full substantiation (and subject to the new requirements for expense deductions).

Source: AFTS Report, Volume 1 (Personal Income Tax)

Subject area: Capital Gains Tax

Proposal

In the interests of revenue mobilisation, lowering marginal rates of income tax, and improving tax system equity, the CGT discount should be reduced to a level more closely aligned with movements in the rate of inflation (e.g. 5% per annum up to a maximum of 50% after 10 years).

Relevant discussion questions

- Q19. To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?
- Q21. Do the CGT and negative gearing influence savings and investment decisions, and if so, how?

Key points

- -A discount on capital gains can be justified on the grounds that it offsets the impacts of inflation on asset values over time; it can also be reasonably argued that the flat discount

approach introduced in 1999 takes account of this and is certainly simpler than the system of annual indexation it replaced.

- However, a flat discount of 50% on gains in respect of assets held over one year seems excessively generous for assets purchased and sold within relatively short time frames (e.g. up to 5 years).
- Consideration should be given to devising an approach for determining assessable capital gains that: 1) reflects a more realistic assessment of the erosion of asset values; and 2) is relative simple to apply in practice.

Background

A capital gains tax exemption applies to 50 per cent of any nominal capital gain made by a resident individual or trust where the asset has been owned for at least 12 months. For assets acquired before 21 September 1999 and held for at least 12 months, an individual or trust may instead choose to be taxed on the difference between the disposal price and the indexed cost base frozen as at 30 September 1999.

When originally introduced in the mid-1980's, the law on CGT made provision for the annual indexation of asset values in order to take account of inflation when calculating net gains on the disposal of an asset. Rates of indexation were formulated on an annual basis and only applied to assets held for over 12 months. The system of indexation was frozen as of 21 September 1999. In its place, a CGT discount of 50% was introduced for net capital gains that:

1. Are made by an individual, complying super entity, trust etc.
2. Result from an event happening after 21 September 1999.
3. Be worked out without the cost base being indexed.
4. Result from a CGT event happening to a CGT asset owned by the taxpayer for at least 12 months.

The law was subsequently amended in 2012 to prevent the discount being available to non-resident taxpayers.

The cost of the CGT discount and who benefits

Treasury's Annual Statement of tax expenditures provides a costing of the revenue foregone/ expected to be foregone as a result of the CGT discount. Set out hereunder are data from Treasury's forecasts in 2000 – see Table 1 – and the latest published statement (2014) released in late-January 2015 – see Table 2. Treasury's statement (2014) indicates that the estimate is of 'medium' reliability. To place the projections into context, Table 3 sets out the value of actual net personal income tax collections for selected years covering 2000-01 to 2011-12.

Table 1: CGT discount for individuals

1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Estimates (\$m)				Projections (\$m)			
-	-	-	-	860	1,180	1,290	1,420

Source: Table 5.1. Tax Expenditures 2000

Table 2. CGT discount for individuals and trusts: Estimate of tax revenue foregone (\$m)

2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
4,410	4,930	4,080	4,250	5,800	6,150	6,840	7,600

Source: Tax Expenditures Statement 2014 (January 2015), Australian Treasury.

Table 3. Net collections (\$m) of personal income tax (2000-01 to 2012-13)

2000-01	2004-05	2008-09	2012-13
76,729	106,219	122,360	156,300

Source: Commissioners Annual Reports 2006 and 2012

The data provided reveals that the CGT discount comes with a considerable and growing cost to tax revenue, approaching \$6 billion in the current financial year and growing at around 10% in the following years out to 2017-18. Significantly, the data also shows that while personal income tax collections have roughly doubled in the period 2002 to 2013, the value of revenue foregone from the CGT discount has more than trebled, no doubt reflecting the attractiveness of the measure. Of course, the estimates of the cost of this tax expenditure are made on a 'gross' basis and do not take account of allowances for inflation of asset values, as occurred under the prior CGT regime.

Statistical data pertaining to reported income and deductions of personal taxpayers for the 2012 financial year are set out in Annex 3. Significantly, they reveal that:

1. From the total population of personal taxpayers, individuals with taxable income over \$180,000 (representing 8.7% of taxpayers):
 - Report 50.8% of aggregate net capital gains;
 - Report 46.2 % of aggregate franked dividends;
 - Report 11.6% of gross interest;
 - Claim 20.1% of deductions for personal superannuation contributions; and
 - Claim 27.3% of deductions for gifts.
2. Of the 293,000 taxpayers with taxable income over \$180,000, the number reporting net capital gains was less than 40,000.

Taking all of the data presented, there are indications that tax system design has contributed to a shift to capital gains-producing investments, in particular among wealthier individuals, which comes with increasing and growing costs to the revenue. This trend raises some important questions in a budgetary context where the pressure for revenue mobilisation has become critical and in a broader tax policy context:

- Can a tax expenditure of this nature and magnitude be justified?
- Does the growth in revenue foregone raise issues of equity in the sharing of the overall tax burden?
- What are the distortionary impacts and implications on investment decisions at large?
- Is a less generous form of discount more appropriate in the prevailing circumstances?

Proposal for reform

1. In the interests of revenue mobilisation, greater equity, and general base broadening objectives to reduce marginal rates of tax consideration should be given to reducing the CGT discount. For example, adoption of a proposal reducing the discount from 50% to 5% for assets held over 12 months, rising by a further 5% each year up to a maximum of 50% after ten years, would be more realistic and equitable, while retaining the benefits of a more simplified approach to the calculation of net capital gains than occurred under the original regime.

Proposal 1: Personal Tax Administration

Recent history in personal tax simplification

Ideas for major simplification of Australia's personal income tax system that would benefit the majority of personal taxpayers (i.e. employees) can be traced back to the Asprey Committee of the 1970's. While there has been a series of incremental enhancements over the decades (e.g. self-assessment, electronic filing, and pre-filing of tax returns) the fundamental elements of the system prevailing in the 1970's still remain for the vast majority of PIT taxpayers—taxpayers must keep records (especially re deduction items), and prepare and lodge an annual tax return. A summary of the more recent ideas advanced in this space and the outcomes achieved are set out below:

<p>May 2007— Treasurer's Budget Speech</p>	<p>Government announcement <i>(with underlining by this writer)</i></p> <p><i>"Tonight I am also announcing a programme <u>to dramatically simplify income tax returns for the next financial year commencing on 1 July 2007. Taxpayers will be able to go online to access an income tax return prepared by the Commissioner of Taxation, including income from salary and wages, interest, dividends, information on private health insurance, and any benefits paid from the Government, including the family tax benefit.</u></i></p> <p><i><u>If the taxpayer is satisfied with this pre-prepared statement, they will be able to click online and file their return without any further action.</u> If there is additional information to provide, this can be added to the pre-prepared return. This will be available for the 9 million taxpayers who currently lodge their tax return electronically, either directly or through a tax agent. There are 10 million taxpayers in Australia."</i></p> <p>Outcome</p> <p>Additional resources were made available to the ATO to develop and administer a system for pre-filing tax returns as they are prepared by taxpayers. However, there was no recognition whatsoever of the underlying need for accompanying legislative reform to address itemised tax deductions <u>claimed by over 95% of taxpayers and which cannot be prefilled in tax returns.</u></p>
<p>2007-08</p>	<p>System of prefilling is refined and expanded but underlying legislative obstacles remain.</p>
<p>September 2007</p>	<p>Change of Government.</p>
<p>2008</p>	<p>Government announces fundamental review of Australia's tax system</p>
<p>2009, AFTS Report (Henry Review)</p>	<p>A range of recommendations are made to streamline the PIT system which, if fully adopted, will contribute significantly to the goal of simplification:</p> <ol style="list-style-type: none"> 1) Recommendation 11: Tighten rules for WRE deductibility. 2) Recommendation 12: Introduce a standard deduction in respect of work-related deductions and tax agent fees. 3) Recommendation 13: Raise the minimum threshold for gift

	<p>deductibility from \$2 to \$25.</p> <p>4) Recommendation 123: Majority of Australians to be freed of the requirement to <u>prepare and lodge</u> an annual tax return.</p> <p>Recommendation 6 of the AFTS Review Report proposed elimination of a range of tax offsets which, if adopted, would also have facilitated the major streamlining envisaged.</p>
2009-10	System of prefilling was further refined and expanded but underlying legislative obstacles remained.
May 2010 Treasurers' Budget	<p>Government announcement</p> <p><i>“Mr Speaker, the tax cuts and other initiatives in this Budget continue to ease the cost-of-living burden carried by working families. But the families I speak to right around the country don’t just want more financial security; <u>they also want more time with each other.</u></i></p> <p><u>So we have decided to provide taxpayers the choice of a standard deduction instead of the hassle of shoeboxes full of receipts and the costs of professional assistance.</u> This means less time with the Tax Pack, more time with loved ones, and for 6.4 million Australians it also means a bigger tax refund.</p> <p><i>The standard deduction will be phased in over two years so that \$500 will be available to taxpayers from 1 July 2012, increasing to \$1,000 from 1 July 2013. This is a key step towards a ‘tick and flick’ system of pre-filled tax returns that will make life easier for working families at tax time.”</i></p> <p>Government proposal</p> <ol style="list-style-type: none"> 1) Announcement of a limited (and different) form of standard deduction to that recommended by AFTS, to be implemented in two steps. 2) No action was to be taken concerning recommendations 11 and 13.
2011	<p>Government action</p> <p>The Government releases a discussion paper and accompanying legislation for its proposed standard deduction.</p> <p>Outcome</p> <p>The Governments proposal for a standard deduction was subject to considerable criticism, including by this writer, on the grounds that it was poorly targeted and excessively costly, and with its relatively low threshold would have had limited overall impact.</p> <p>In responding to this writer’s proposal for adoption of relevant AFTS recommendations Treasury observed in a letter to the writer:</p> <p><i>“The Government decided to implement a different design for the standard deduction to that presented in the AFTS Review Report. The standard deduction presented in the Report would have made some taxpayers worse</i></p>

	<i>off, particularly those whose work-related expenses were greater than the proposed standard deduction but less than the proposed claims threshold. The standard deduction being implemented is also simpler than that set out in the AFTS Review report.” (Letter from Rob Heferen, 11 June 2011.)</i>
2012 budget	The Governments proposal for a standard deduction is formally withdrawn.
2011-12	System of prefilling further refined and expanded but underlying legislative obstacles remain.
2014	A research paper <i>Personal taxpayer compliance costs: Recent evidence from Australia</i> (Tran Nam, Evans, and Lignier (2014)) summarises its overall findings: <p>“The study demonstrates that personal taxpayer compliance costs have grown over the past 17 years, whether measured in absolute terms or relative to tax revenue or Gross Domestic Product (GDP). For example, average real personal taxpayer compliance costs (whether gross or net) rose by about 73 per cent in the period from 1995 to 2012. Most of the increase in tax compliance costs is attributable to the costs of tax advisers. The findings of this study suggest that various technologically driven simplification initiatives undertaken by the government (such as e-tax and pre-filled income tax returns) have not been sufficient to slow down the growth in personal tax compliance costs.”¹</p>
2013-14	System of prefilling further refined and expanded but underlying legislative obstacles remain.
2013-2015	ATO staffing levels are reduced by over 4,000 FTEs, in part reducing its capability to mount compliance programs for this segment of taxpayer.
March 2015	Government releases its tax reform discussion paper <i>Re:think</i> seeking ideas for a fundamental review of Australia’s tax system. The executive summary of the report encapsulates a clear message of the approach encouraged for thinking about tax reform and the review’s overriding goals (<i>with writer’s underlining inserted</i>): <p><i>“Over the last 40 years Australian governments have initiated many reviews of the tax system. Those reviews have shaped the taxes we have today. But as the world continues to change, our tax system is confronted with new challenges. <u>These challenges invite us to think creatively about the kind of tax system that will enable us to better realise the opportunities before us. In commencing this tax review, the Government will be considering every worthwhile idea, even if it does not fit neatly with the existing set of major taxes we now have. Through this tax review we will develop a better tax system that delivers taxes which are lower, simpler and fairer. A tax system that encourages productive endeavour.</u>”</i></p>

¹ Tran Nam, B, Evans, C and Lignier, P 2014, 'Personal taxpayer compliance costs: Recent evidence from Australia', *Australian Tax Forum: a journal of taxation policy, law and reform*, vol. 29, no. 1, pp. 137-171.

Personal Income Tax—Tax system metrics

Table 4. Tax return data—employment income and work-related deductions

Financial Year	Wage income reported in returns		Deductions for work expenses in tax returns			% of wage earners with WRE	Growth (year 2004=100)		
	Value (\$bn)* (1)	Number of taxpayers (No. mlns) (2)	Value (\$bn) (2)	Claims (no.mlns) (3)	Average claim (\$) (4)		(1)	(2)	(3)
2004	326.8	8.9	11.7	7.30	1,602	82.0	100	100	100
2005	351.3	9.1	12.6	7.54	1,678	82.9			
2006	376.3	9.3	13.8	7.77	1,776	83.5			
2007	408.2	9.7	15.0	8.00	1,875	82.5			
2008	449.5	10.2	16.5	8.43	1,957	82.6			
2009	469.3	10.1	17.1	8.36	2,045	82.8			
2010	490.1	10.1	17.9	8.50	2,105	84.2			
2011	529.4	10.3	19.0	8.68	2,189	84.3			
2012 **	560.6	10.4	19.9	8.79	2,264	84.5			
2013 **	572.3	10.2	19.8	8.51	2,327	83.4	175.2	169.2	116.5

Source: ATO Taxation Statistics 2012-13 (published April 2015).

*Employment income is the total value of wages and salaries (including allowances) reported in tax returns. It does not include lump sum payments made on retirement/ resignation from employment.

** The values reported for these years will increase in subsequent years as further late lodged returns are received.

Table 5: Individuals- returns by lodgment type, 2008-09 to 2012-13

Category	Numbers of returns received by lodgment type (millions)				
	2008-09	2009-10	2010-11	2011-12	2012-13
Agent	8.75	8.79	9.03	9.22	9.39
e-tax	2.31	2.35	2.50	2.59	2.83
Other self-preparer	1.22	1.24	1.09	0.91	0.55
Totals	12.29	12.38	12.63	12.73	12.77

Source: Table 4, Individuals, Tax Statistics, 2012-13 (published April 2015).

Table 6. Individuals – gifts or donations, by amount, 2010–11 to 2012–13 income years

Gifts or donations claimed	2010–11		2011–12		2012–13	
	no.	\$m	no.	\$m	no.	\$m
\$1 – \$25	1,102,095	16	875,985	13	884,175	13
\$26 – \$50	800,215	34	801,010	34	767,615	33
\$51 – \$250	1,566,790	201	1,543,850	198	1,542,420	199
\$251 – \$1,000	1,001,350	512	995,910	508	1,021,025	522
\$1,001 – \$5,000	284,400	539	280,600	532	292,825	555
\$5,001 – \$10,000	24,320	165	24,295	165	25,070	171
\$10,001 – \$25,000	10,225	150	10,210	150	10,915	160
More than \$25,000	4,375	595	4,515	641	4,765	640
Total	4,793,775	2,212	4,536,370	2,242	4,548,810	2,293

Source: Table 11, Individuals, Tax Statistics, 2012-13 (published April 2015).

Proposal 2: Capital Gains Tax

Box 1. Selected statistical data on income tax and the Capital Gains Tax (CGT)

1) Net capital gains

Declared net capital gains of all personal taxpayers		Declared net capital gains of all personal taxpayers with taxable income > \$180,000			
No. (m)	Value (\$m)	No. (m)	Value (\$m)	No. as a % of all taxpayers	Value of gains as a % of all net gains income
0.424	9,188	0.037	4,670	8.7	50.8

2) Income from franked dividends

Declared franked dividends of all personal taxpayers		Declared franked dividends of all personal taxpayers with taxable income > \$180,000			
No. (m)	Value (\$m)	No. (m)	Value (\$m)	No. dividend declarations as % of total	Value of declared dividend income as a % of total value
2.955	19.899	0.153	9,190	0.05	46.2

3) Gross income from interest

Declared gross interest income of all personal taxpayers		Declared gross interest of all personal taxpayers with taxable income > \$180,000			
No. (m)	Value (\$m)	No. (m)	Value (\$m)	No. as a % of all taxpayers	Value of income as a % of interest income
7.147	16.973	0.21	1,971	2.9	11.6

4) Deductions for personal superannuation contributions

Total superannuation deductions by all personal taxpayers		Total personal super deductions by taxpayers with taxable income > \$180,000			
No. (m)	Value (\$m)	No. (m)	Value (\$m)	No. as a % of all claims	Value of deductions a % of all deductions
0.185	4,400	0.024	886	13.0	20.1

5) Deductions for gifts (2012)

Total gift deductions by all personal taxpayers		Gift deductions by taxpayers with taxable income > \$180,000			
No. (m)	Value (\$m)	No. (m)	Value (\$m)	No. as a % of all claims	Value of deductions as a % of value of all claims
4.536	2,242	0.164	611	3.6	27.3

6) Who bears the CGT burden among personal taxpayers (2009 to 2012)

Income year	% of taxable individuals with net capital gains and taxable income > \$180,000	% of net CGT gain reported by these taxpayers	% of estimated tax on net gain paid by these taxpayers
2011-12	10.7	54.0	68.7
2010-11	9.3	54.6	69.6
2009-10	8.3	45.6	60.8
2008-09	7.6	46.2	62.3

Sources: ATO Revenue Statistics 2012, 2011, 2010 and 2009.