Tax reform: selected issues

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This article builds on the introductory piece authored by Bob Deutsch and is complementary to the article authored by Robyn Jacobson, both of which are published in this issue of the journal.

The article reminds readers of some history, addresses some selected issues in tax, including the problems in the current system, the design of those selected areas and some options to improve the system overall. The areas covered include GST, general business tax issues, tax administration and governance, and complexity. Notably, in these current articles, state taxes have not been addressed. That will be the subject of a separate article soon.

Some history

Many readers will be aware of the tax reform proposals in their own lifetime or working career, the most obvious of which are *Reform of the Australian tax system* (Hawke–Keating) in 1985,[1] *Tax reform: not a new tax, a new tax system*[2] and *Review of business taxation* (Howard–Costello) in 1998 to 2000,[3] and *Australia's future tax system* (Henry review) in 2009.[4] Many readers may even remember the Asprey report[5] which formed the basis of some of the changes that followed in the 1980s and 1990s.

However, readers may not be so familiar with the *Royal Commission on taxation* (the Kerr Commission),[6] the *Royal Commission on taxation* (the Ferguson Commission),[7] the Spooner Committee of Inquiry,[8] and the Commonwealth Committee on taxation (the Ligertwood Committee).[9]

Taking the two lists together, one can observe that there have been enquiries of some sort into taxation almost every decade since Federation. Perhaps the early years can be excused from such an omission on the basis that those in charge were too busy establishing some type of tax system in the first place, and the 1940s were taken up with the Commonwealth effectively taking control of most taxation and the ensuing fights that followed.

In his significant paper "Tax reform: a Tower of Babel; Distinguishing tax reform from tax change",[10] Justice Graham Hill posited that:

> "Reform of the system as a whole will involve a change of one or more of the following kinds:
> - Tax mix — existing taxes
> - Tax mix — the imposition of new taxes
> - Existing taxes — tax rates including deductions and rebates having regard to the tax mix and to promote an equitable distribution of tax burdens
> - Existing taxes — change in tax rates including deductions and rebates to promote an equitable distribution of tax burdens
> - Existing taxes — change in the tax base (for example extension of income tax to include capital gains).
> - Existing taxes — promoting neutrality of the tax system, eg, entity taxation
> - Existing taxes — substantive amendments such as plugging loopholes or removing anomalies, inconsistencies or complexities
> - Existing taxes — procedural or administrative changes to promote simplicity in compliance or administration
> - Existing taxes — simplifying language to improve intelligibility
> - Existing taxes — tax expenditure elimination (or introduction of new concessions designed to promote government economic policy)."

While presented differently, Hill's list covers most of the principles typically identified in approaching tax reform.

As Robyn Jacobson points out in her article, the Henry review identifies both fundamentally efficient taxes, as well as detailing recommendations for specific reforms that are consistent with the principles in Hill's list.

How does this translate to specific issues and areas of the current tax law? In the particular areas covered by this article, the principle behind each area, the design (or scope) and the issues that need to be addressed are discussed.

Goods and services tax

As a proportion of total tax collections

As the Henry review pointed out, consumption taxes are one of the more efficient taxes. It has also been pointed out that, compared to most other jurisdictions, Australia collects a relatively smaller proportion of total tax from taxes on consumption than other countries do. There are two main reasons for this — one is the rate, but the other is the base.

This is not a place to debate the rate. Suffice to say that, whatever the base and rate, careful consideration needs to be given to the impact of the GST on different socio-economic groups and how the social security system needs to be engaged to ensure that those most vulnerable are taken care of.

However, when it comes to the base, it is clear that, in recent years, parts of the economy that are growing (as a share of GDP) more than other parts of the economy are those that are either not subject to GST or not fully so.

Scope/base

What follows are some observation on particular areas that are not at all or not fully subject to GST.

Education

Educational services are GST-free. This was part of the ultimate (negotiated) design of the GST in 2000. The

underlying reason is noble — why tax something so fundamental as education? It is a social good. While those reasons are fair and valid, closer scrutiny is warranted. Most education is government-funded, either directly or indirectly, by one or both levels of government. Accordingly, for many people, the amount paid out of pocket (or perhaps, more correctly, the amount charged by educational institutions) for primary and secondary education is relatively modest. In some states and territories, there is little or no charge by state/territory schools and the systemic Catholic schools charge relatively modest amounts. The high fees of $20,000 per annum and more are charged by private schools (whether or not denominational).

Accordingly, at least insofar as school education is concerned, the imposition of a GST on school fees would impact most on those paying private school fees and very little on those attending state or systemic Catholic schools. The preliminary conclusion, therefore, is that, given those paying private school fees tend to be better off, is it not progressive to impose GST on school fees. In fact, is the lack of GST on those fees regressive?

Naturally, tertiary and pre-school fees give rise to different consideration because of the direct cost imposed, even though in many cases there are other government benefits (eg child-care subsidies) that ameliorate that cost. Further investigation into the impact that a GST would have in such cases is required.

Finally, given the growth in foreign students in Australia, consideration will need to be given to the current regime and whether it is able to adequately address these services which are economically understood as exports.

Health

Similar to the reasons expressed above, there is a need to closely examine the incidence of health costs on different socio-economic groups. There may be variations depending on the nature of the services (be they hospital, specialist medical, para-medical or pharmaceutical) that give rise to certain outcomes, as well as the natural public/private issues that arise in the same way as education.

Additionally, consideration needs to be given to the way that private health insurance engages with the rest of the health system and how that might need to be addressed, both in terms of the incidence and the impact on the level of private health insurance and the potential impact on the public system.

Food

In the current system, there are distinctions between fresh food and restaurant and prepared meals. While fresh food is generally GST-free, restaurant meals (including takeaway) are not. Similarly, pre-prepared meals from supermarkets are also subject to GST.

Consideration of the current impact of these differences needs to be given to understand the impact of any changes. To borrow a concept from another field of law, should the “wagyu and shiraz” of one consumer be taxed more concessionally than the McDonalds takeaway and beer of another?

Financial services

Like most countries, Australia does not impose GST on financial services but rather treats those services as “input-taxed” (or “exempt” in other regimes). The effect is that GST is imposed on the inputs but there is no GST on the services themselves. In other regimes, that might be the end of it. However, in Australia, there is a regime of reduced input tax credits (RITCs) on certain acquisitions by financial services providers.

Whether technology has moved on sufficiently to allow for the application of GST to such services or whether the RITC regime is still appropriate should be part of any review of the scope of GST.

Business tax issues

While there are specific issues relating to small and medium businesses (which will be addressed in Robyn Jacobson’s article), there are issues that traverse large and small business and those that tend to relate only to larger businesses.

Company (and trust) losses

The current structure of the company and trust loss rules is unnecessarily complicated and often hard to apply — even if there is a clear intention that the losses should be available.

Allowing losses to be offset against future years’ income overcomes the artificial construct of a company’s liability being calculated on a single income year when it is in fact an ongoing business. This would be unnecessary had there been a “negative income tax” that would have seen Treasury pay a company in those years when it made a loss (often the argument in favour of the carry back of losses as well). Put another way, Treasury provides the tax credit for the loss sustained in the same way it would otherwise collect (and had been collecting) tax on the profits of that enterprise.

Prior to the existence of any loss limitation rules, the situation would be that an entity made a loss. That loss was available to offset future income and thereby reduce future tax. The loss was treated in this way because of an absence of negative income tax. If the loss continued to be available to the company despite a change in control, the purchasers would have paid the loss-incurring shareholders for the tax value of that loss. That is, the purchasers take the place of Treasury in providing the benefit of the loss offset to the vendor/loss-incurring shareholders. It is unsurprising that the purchaser-shareholders might then expect Treasury to reimburse them for having outlaid that tax value on Treasury’s behalf.

The logic for the current loss limitation regime can be found in the Ligertwood Commission’s report in the 1960s. The argument was that there had been “trading” (a pejorative term) in company losses. This gave rise to the continuity of ownership test, a concession for “genuine” cases through first, the same business test, and more recently, the similar business test, as well as the income injection rules. Originally, the rules only applied to prior year losses, but later rules were introduced to address current year losses. Of course, similar rules were introduced for trusts, but they have been

problematic from the start because of definitional issues around what is a fixed trust or a family trust.

However, seen in the context described above, there is no real "trading" but rather a substitution or agency going on. Given that light, it would be reasonable to completely remove the loss rules.

Perhaps one can determine from the existence of the rules for more than 50 years that the real reason for the introduction of the loss rules was (much like the 1988 superannuation rules) to plug a gap in revenue. If there is a revenue reason to maintain some limitation on losses (and it should be seen as an aberration to good, principled taxation), it would be far easier to have a simple rule that, for example, losses could be recouped over a set number of years only or they could be recouped on a straight-line basis, without the need for the complex continuity of ownership and similar business tests. No doubt, other options could be explored.

Consolidation

Many countries have introduced corporate consolidation tax rules. For most countries, this follows the accounting approach of recognising the separate identity of each entity in the defined group but, like accounting, eliminating intra-group transactions. As a result, the legislation enacting those regimes tends to be relatively direct and easily understood.

Naturally, Australia decided to take a different and unique path. This resulted in detailed and complex rules running to hundreds of pages, the fundamental design of which is to treat the head entity of the defined group as effectively having all of the assets and liabilities, and all of the income and expenses of every entity in the group. Those rules were accompanied by voluminous explanatory memoranda and over 1,000 pages of ATO issued guidance.

Those rules deal with how to address the formation of a group in the first place, entities joining the group, and entities leaving the group. The rules deal with the cost setting of assets that "become" those of the head entity and with the cost of an entity as it leaves the group. Unsurprisingly, the rules are both complicated and give rise to anomalies. For example, in order to determine the cost of assets that "become" those of the head entity, it is necessary to take into account liabilities assumed. Some of those liabilities may be deductible. How then to maintain the fundamental approach that applies across the tax law of only allowing a cost to be taken into account once — either as a deduction or part of a cost base? Again, unsurprisingly, there are even more complicated rules to address this that were further refined after a Board of Taxation Review.[11]

Some of the problems in the regime that have been identified are those arising from the concept in the legislation of multiple entry consolidated (MEC) groups. This is a regime designed to deal with foreign groups that do not have a single head entity in Australia but have a single head entity in a foreign jurisdiction.[12]

The design of the consolidation regime led groups of companies to examine their structures and caused some groups to tidy up ownership structures before electing into the regime. It also caused groups, when setting cost bases of assets of the group, to carefully identify all relevant assets, including those not necessarily recorded on the balance sheet, such as goodwill. This gave rise to the identification of goodwill-like assets that were described as "rights to future income" (RTFI). The allocation of cost base to such assets meant that, rather than significant cost being allocated to goodwill, some cost base would be allocated to an asset (the RFTI) that would expire in time and therefore give rise to a deduction or loss for that amount of cost base. This was seen as a potential significant loss to revenue and was the cause of another Board of Taxation Review.[13]

The cost setting rules (sometimes combined with the MEC rules) have given rise to concern around inappropriate uplifts in cost bases of assets, as well as what are sometimes referred to as "phantom" gains. In the latter case, this is where a "gain" is taxable today because cost base has been allocated to an asset which will be available at a later time but for which there was no identifiable cost (ie outgoing or liability assumed).

The conclusion must be drawn that the consolidation regime as enacted in Australia is a failed experiment, and the rules should be repealed and replaced with a more conventional and simpler approach that does not give rise to so many anomalies.

The challenge, as always, will be how to transition from the existing regime to a newly designed regime.

CGT scope

When designing any tax system, the starting point is to ask whether a particular tax should be comprehensive or whether there should be some exception to comprehensiveness — usually by way of concession to one or more sections of the community or a type of activity.

When it comes to the design of CGT, there is living proof that overly detailed rules can not only give rise to many anomalies (see later in this article), but also that detailed rules can unintentionally move away from a comprehensive base and provide concessions where they were never meant to apply. Thus it is with CGT. The design of, and approach to, the CGT rules are such that they completely miss gains and losses on half of the balance sheet. This is because the fundamental design of CGT was around "assets". The rewrite of the CGT rules into the *Income Tax Assessment Act 1997* (Cth) (ITAA97) added a further unintentionally limiting concept, that of "CGT events".[14] The problem is plugged by many more provisions, including the foreign exchange gains and losses rules (another overengineered set of provisions), the commercial debt forgiveness rules, the limited recourse debt rules, the taxation of financial arrangements, and many more.

That so many rules are needed to address a fundamental design flaw of the principal tax reflects the paucity of thinking about the basic design and the way to address shortcomings. Rather than ask why there is a shortcoming in the first place, the parliamentary kneejerk reaction is to add another set of rules to deal with the single observed issue.

CGT concessions

While the nature of the small business CGT concessions is raised in Robyn Jacobson's article, a few issues remain that require addressing around CGT.

CGT discount

First, the 50% discount for individuals.[15] In the context of business activities (as distinct from passive investment), there is clearly an anomaly between incorporated businesses and those operating through partnerships and trusts and as sole traders. The fact that the CGT discount is available (mostly) in the unincorporated cases and not in the incorporated one gives rise to questions about the integrity of the discount and, naturally, gives rise to costs and time spent on tax planning.

Although not an original design feature of the CGT rules when introduced in September 1985, there was a concept of CPI indexation of the costs of an asset such that only the "real" (after inflation) gain was taxed. The 50% discount was introduced in September 1999 on the basis that it would simplify the CPI indexation approach and that it was a reasonable approximation of inflation at the time. Inflation has subsequently reduced to the point where that reason for such a large discount no longer holds true.

The change to the discount also coincided with a period when there was a growing view that it was necessary to do things to attract capital. That capital was "mobile" and that tax regimes could be used in attracting and retaining that capital. This view was also manifested in some of the recommendations in the Henry review for the reduced taxation of income from capital.[16] However, if the concession was intended to encourage investment in productive assets, it is fair to say that it was poorly targeted. In fact, one might ask whether the concession encourages the wrong kinds of investment and behaviours.

Accordingly, it will be important to look at the CGT discount in any review. Consideration should be given to options for reform, including (but not limited to) reverting to a cost base indexation approach (or none), providing particular incentives for certain types of asset investments, and even the interaction of CGT with other features of a reformed tax system (including how to treat other taxes associated with holding assets).

Taxation of superannuation funds

While Robyn Jacobson's article raises issues around the unnecessarily complicated taxation of superannuation from the individual/member point of view, this section of the present article raises the question about the design of the taxation of superannuation funds.

Readers of a certain age may recall that, to understand the taxation of superannuation funds prior to 1988, it was necessary merely to understand a small number of sections of the ITAA36 mostly dealing with how to ensure that the exempt status of the superannuation fund was maintained. That is, like many countries, the pre-1988 tax treatment of superannuation was an "exempt – exempt – taxed" approach. That is, contributions were exempt (and were effectively "gross" by virtue of the deduction available to the employer), earnings were exempt while ever the relevant conditions were maintained, and the benefits were taxed in the hands of the superannuant.

Without covering the position of the member, the taxation of all funds at the rate of 15% was introduced in the 1988 May Economic Statement as a means to bring forward revenue, offset in part by a more concessionary taxation of end benefits for fund members. However, that taxation was not to apply to the extent that the fund's assets were being used to fund pension obligations. Effectively, an "exempt – taxed – taxed" model was introduced.

Subsequent changes have meant that the taxation of the end benefit has, in most cases, been effectively reduced to zero for those over 60 years of age. Accordingly, we now have a system that is "exempt – taxed – exempt". Although some point to "tax expenditures" published by Treasury as reflecting a very large concession to superannuation, such analysis often incorrectly adds separate items together and therefore overstates the level of that tax expenditure. Nonetheless, one must query whether this is the right setting or a sustainable long-term setting.

The current model is somewhat unique (a recurring theme here?) and clashes with models that operate in other jurisdictions. This can give rise to potential double taxation for both funds and members. Tax treaties are seldom able to address this. Additionally, certain jurisdictions give concessions not just in tax, but also in reporting, where the treatment of the fund or member is consistent with that applying in that jurisdiction (think of the Foreign Account Tax Compliance Act in the United States). This means either an enormous amount of work to explain the nature of the Australian regime and/or seeking a special exemption or treatment. Another compliance cost for no net benefit.

Are the concessions for superannuation funds still appropriate in the context of the whole of the tax system? Should there be a reversion to a simpler regime? There is ample opportunity for high quality reform in this area.

Taxation of financial arrangements

The taxation of financial arrangements (TOFA) regime consists of a set of rules developed over a period of some 20 years that is designed to bring to account gains and losses on financial transactions earlier than might otherwise be the case. Previously, there was a limited attempt to address accruing gains and losses on certain instruments through Div 16E of Pt III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

The TOFA regime consists of a number of components the first of which attempts to classify various "financial" instruments as being either debt or equity — not by reference to their form but by reference to the economic substance of the arrangement. This might be a noble venture, given that the taxation of debt and equity differs in Australia. However, that begs the question of whether such a difference in taxation treatment should exist.

Thus, Div 974 ITAA97 was born. This Division operates on the basis of finding certain features of the relevant instrument and then determining, according to a set of rules, whether the instrument should be treated as "tax debt" or "tax equity".

This was designed to overcome the prior position that issuers of debt or equity could choose the outcome they wanted by picking the legal form that suited them best. Thus, if they wanted the instrument to be debt-like but be treated like equity, they might choose redeemable preference shares

(ignoring any special rules). If they wanted the instrument to be essentially deductible debt but wanted the form to be equity for other reasons (eg capital management and balance sheet presentation), they might choose a participating debt instrument or a convertible note.

Under Div 974, of course, the issuer simply needs to determine what outcome they want and choose the features in Div 974 to achieve that outcome. Is that all that different from the previous position when using legal form to determine the outcome?

Similarly, Div 775 ITAA97 was introduced as a rewrite to Div 3B ITAA36, each dealing with foreign exchange gains and losses. While gains and losses on revenue account were dealt with adequately under the general income and deduction provision of the tax law, and foreign exchange gains and losses on assets were ultimately dealt with under the CGT rules (from 1985), gains and losses on foreign exchange liabilities were not. To solve a minor gap, a regime was developed to take such gains and losses out of the general income and capital rules in the Tax Acts and create a special rule treating all such gains and losses on revenue account.

Of course, this failed to recognise that the reason for foreign exchange contracts was, in many cases, a hedge against an investment denominated in a foreign currency.

As can be seen, this is a regime that, on one view, is completely unnecessary if the CGT rules were properly addressed. However, to give some credit, when designing the overarching TOFA rules in Div 230 ITAA97, there was an attempt to overcome the potential mismatch that the Div 775 rules could give rise to — but it was very narrowly drafted, with the result that, for most taxpayers, it was completely useless.

Division 230 itself is so detailed and complicated, so full of exceptions and special rules, that the end result seems to be an enormous amount of work to bring to account an amount that, in many cases, would have been brought to account anyway in the same income year. To the extent that there was a real timing difference (the reason for the regime in the first place), it is often minor or no more than one year's difference — in some cases, in favour of the Revenue, in others, in favour of the taxpayer. This represents an enormous burden on the economy for very little benefit and needs to be addressed.

Insurance tax

The tax regimes applying to general and life insurance (Divs 320 and 321 ITAA97 and Div 15 ITAA36) have particular complications and peculiarities that are in need of reform.

In the case of Div 321, applying to general insurance activities, the Division represents a codification of the general principles that previously existed. Those principles followed accounting and business principles that underlay the operation of the insurance industry and borrowed from longstanding principles of returning income and claiming expenses. By writing those principles into Div 321, little has been added other than the constrictions of legislated rules that become unwieldy as soon as the accounting principles or general business approaches change. This then requires the industry or the tax administration to try to reconcile those differences which would not really have arisen had the regime been left to the broad accounting and business principles that existed previously.

In the case of Div 320, applying to life insurance companies, the rewrite of special rules from the ITAA36 was originally built on suspicion of earlier practices, which resulted in a regime that still sought to create multiple taxation regimes in the one taxpayer. This gave rise to theoretical legislated divisions which had to then be replicated by business to accord with the tax regime. This is known as the tax tail wagging the business dog.

Again, such an approach has given rise to anomalies and, when added to other theoretical regimes (like consolidation), gives rise to even more anomalies, all of which demand further amendments. This ongoing tinkering with the regime means that it also becomes unwieldy and is proof of the adage that the greater the number of words that are written the more problems that arise.

Division 15 is a specific regime designed to deal with non-resident insurers. It is a relic of a time when large (usually United Kingdom) foreign insurers would compete but, not having a presence in Australia, would not be subject to tax in Australia (one might call it a pre-BEPS (base erosion and profit shifting), BEPS issue). Australia's right to tax has been preserved in double tax agreements (DTAs). It would appear to be contrary to our free trade principles and should be reconsidered in light of subsequent developments.

> *"... proof of the adage that the greater the number of words that are written the more problems that arise."*

International tax

The international tax regime adopted in Australia in somewhat contradictory. While there are concessions that are designed to encourage inward investment (as one might expect from a net capital-important country), those rules collide with regimes that attempt to prevent the shifting of income to foreign jurisdictions via non-fixed trusts.

Recent judicial decisions confirm the limitation of the concession for foreign investors when those flow through non-fixed trusts.[17] Many have argued that this is an anomaly and should be addressed. It raises broader issues about the extent of concessions drafted to encourage investment and the appropriateness of discretionary trusts as a vehicle for such investment. Other jurisdictions would restrict what trusts could be used. Of course, other jurisdictions provide appropriate flow-through vehicles for small business and family investors, such as limited partnerships.

Similarly, the foreign income tax offset rules, designed to reduce double taxation for residents, has recently thrown up anomalies. This occurs where the way in which Australia seeks to tax certain kinds of income differs from the way another country in which an Australian invests chooses to tax

that same amount. Most recently, *Burton's* case[18] resulted in a capital gain that was subject to concessional *rates* of tax in the US also being subject to taxation in Australia, with credit for only half of the US tax paid because the method in Australia meant that half of the gain was subject to tax at full tax rates. This contrasted with all of the gain being subject to lower rates of tax in the US. The net tax paid in each jurisdiction may have even been the same, but the difference in methods gave rise to an anomaly when it came to granting the credit.

Australia's thin capitalisation rules are not only unnecessarily complex and overly prescriptive, but they are also somewhat out of step with the trend in the rest of the world in terms of methodologies applied. This can give rise to mismatches when having to deal cross border. The other feature of the Australian regime that is presently absent are anti-debt creation rules. These once existed in Div 16G ITAA36 but were thought unnecessary to replicate when thin capitalisation was rewritten into the ITAA97.

Tax administration and governance

The Henry review proposed a number of changes designed to improve the governance of the tax system and the "client experience". Those recommendations included:

- a "principles-based approach to tax law design as a way of addressing the growing volume and complexity of tax legislation, and as a way of helping those laws to be interpreted consistently with their policy objectives";[19]
- better oversight of the effectiveness of and costs of compliance with the system,[20] that "[t]he government should, every five years, publish a Tax and Transfer Analysis Statement that analyses and reports on the overall performance and impact of the system, including estimates of efficiency costs and distributional impacts";[21] and
- making better use of data and technology to make it simpler to engage with the tax system, leveraging off existing (and then emerging) systems to allow direct reporting and, in addition, support small business.[22]

While many of these recommendations have been progressed, there is still further work that could be done to minimise the compliance cost for taxpayers. For example, even if the strict technical basis for the final determination of tax liability does not essentially change, it would be possible to develop simpler methods for calculating quarterly instalments of tax.

Further, and hinted at in the Henry review, better integration of the Commonwealth and state/territory revenue agencies could see a significant reduction in compliance and administration costs. Why have multiple reporting of information — especially where taxes are based off the same data?

Commissioner's remedial power

The fact that the Commissioner's remedial power (CRP) exists at all is perhaps an indictment on the system. It was put in place to address the underlying problems that politicians do not really want to address. Thus, it is easier to get the ATO to fix things than for parliament to take responsibility for fixing up the mess it has created. However, the design of the CRP has been hampered from the start. In a departure from the recommended design, parliament decided to handcuff the power to prevent the true original policy intent from being implemented if it were to cost the government of the day any revenue. This must be addressed. However, even more important is the need to address the underlying design of law that gives rise to anomalies that then require the exercise of the CRP.

Complexity

Codified general rules add to confusion

A number of provisions of the Tax Acts essentially codify general taxation principles that were both well understood and followed general business and accounting rules; some of these have been referred to above. It is interesting that, at different times, various studies and bodies (including the Board of Taxation[23]) have looked at how the tax law and accounting could be better aligned. The converse of this is that the law has developed in a way that works in the opposite direction. By codifying particular general principles — sometimes for the avoidance of doubt, other times because the government of the day has determined that the timing of assessability or deductibility should be different to the general principals explained by the courts — there has been added numerous "clarifications" and detailed rules that one suspects adds little to either understanding or consolidated revenue. Thus, we have particular rules in law around:

- royalties;
- return-to-work payments;
- insurance or indemnity amounts;
- profits and losses from profit-making undertakings or schemes; and
- others,

which, for the most part, are designed to only slightly modify (or, in some cases, just restate) what the courts have already given guidance on.

Additionally, there has been a tendency to implement overly detailed legislated rules where ATO guidance would have been sufficient. These include items such as car expenses, substantiation, depreciation rules (there is a whole Subdivision on what is the cost of the asset!), and one of my favourites, non-compulsory uniform rules (or the "make work for the Department of Industry" by requiring registration and approval of uniform designs).

Ironically, in the case of the substantiation rules, it has had the opposite effect of what was originally intended, with a significant growth in the amount of work-related expense claims over the years.

Finally, there seems to be a tendency to be so prescriptive that what was once a single section in the ITAA36 becomes a whole Subdivision in the ITAA97, for example, Subdiv 32-A on entertainment expenses.

Other complexity

While this heading could cover a large number of issues, I note that one has been addressed in Robyn Jacobson's

article on the differential corporate tax rates and the complexity that a superficially simple difference can cause. The second example which deserves some attention is FBT.

The high cost of compliance associated with FBT can be found in two features of the law that emerged during the late 1980s:

1. very broad drafting to capture absolutely everything, then providing limited exemptions; and
2. incorporating highly detailed rules with a view to limiting planning opportunities.

Experience has shown that both techniques are flawed. Drafting so overly-broadly means capturing things that were never intended. Thus, the availability of toilet facilities to an employee would be a taxable fringe benefit but for the specific exemption provided. Accordingly, the FBT law is replete with the most mundane exemptions. Additionally, experience shows that more prescriptive drafting often creates planning opportunities rather than limiting them.

The main issue with FBT is, as referred to in the Henry review (and quoted in the accompanying article), that it taxes the wrong person, more often than not at the wrong rate. I would add that it also taxes things that were never intended to be taxed and impacts on the social security benefits of an employee (think reportable fringe benefits) when they were merely undertaking their normal duties (which could include manning a desk at a client seminar).

Conclusion

There are many opportunities to improve the tax system in Australia, from the significant system design issues to the way in which practitioners have to assist clients to comply with the laws. All aspects need to be addressed, but it is necessary to start with the highest principles and agree on a process to implement the agreed principles and the way in which administration can continue to make the system accessible.

As Albert Einstein is reported as saying, “Everything should be made as simple as possible, but no simpler”.

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10 (2005) 1(2) *Journal of the Australasian Tax Teachers Association* 1.

11 Board of Taxation, *Post-implementation review of certain aspects of the consolidation tax cost setting process*, April 2013.

12 Interestingly, the same treatment is not afforded to commonly owned entities in Australia, particularly SME groups that are owned by the same individuals in the same proportions but not with a common head entity.

13 Board of Taxation, *Review of the consolidation rights to future income and residual tax cost setting rules*, 31 May 2011.

14 For a fuller exposé of the limitations of that approach, see AV Mills, “CGT events — the case for: The current list of 54 CGT events should be removed and replaced with a more coherent conceptually based system”, from The Tax Institute and the Australian Tax Research Foundation Great Australian Tax Debate*,* 16 August 2017.

15 One could add the one-third discount for complying superannuation funds to this discussion, at least in relation to the indexation substitution point. Nonetheless, there are productive investment considerations for superannuation funds as well (even given the context of managing members’ money for the purposes of providing for retirement or death).

16 See, for example, Australia’s Future Tax System Review Panel, *Australia’s future tax system: final report* (Henry review), 23 December 2009, recommendation 14.

17 *Peter Greensill Family Co Pty Ltd (trustee) v FCT* [2020] FCA 559.

18 *Burton v FCT* [2019] FCAFC 141.

19 Australia’s Future Tax System Review Panel, *Australia’s future tax system: final report* (Henry review), 23 December 2009, recommendation 112.

20 Ibid, recommendation 133.

21 Ibid, recommendation 132.

22 Ibid, recommendations 122 to 131.

23 Board of Taxation, *Greater alignment between tax and accounting systems in Australia*. Available at http://taxboard.gov.au/consultation/tax-accounting-systems-in-aus.