3

Complex legislation

Measuring complexity

Bipartisan complaints

3.1 One of the common themes during the inquiry was the complexity of tax laws and the uncertainty and costs this imposes on the community. Major stakeholder groups, including the Taxation Institute of Australia, CPA Australia, the Institute of Chartered Accountants in Australia (ICAA), the National Institute of Accountants and Taxpayers Australia, made this claim.[1] The Inspector-General of Taxation and the Ombudsman also stated that complex tax laws are imposing significant costs on taxpayers and tax agents.[2]

3.2 The Committee also received evidence that, as our economies and financial arrangements become more complicated, our tax laws will reflect this and become more complicated themselves. The Ombudsman noted:

> Nuanced and sophisticated legislation may be required if administrators are to be able to adequately deal with the variety of different taxpayer entities and interactions, and to achieve government objectives of ensuring that taxation contributes sufficient revenue to fund necessary social and community services.[3]

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1 Taxation Institute of Australia, sub 40, p 2, CPA Australia, sub 36, pp 5-6, Noroozi A, transcript, 28 July 2006, p 66, Cantamessa S, transcript, 28 July 2006, National Institute of Accountants, sub 31, p 2, Greco A, transcript, 25 August 2006, pp 17-18, 23.

2 Inspector-General of Taxation, sub 48, pp 10-11, Commonwealth Ombudsman, sub 38, pp 3-5.

3 Commonwealth Ombudsman, sub 38, p 4.

3.3 The Committee accepts that complex tax laws will occasionally be required. However, the breadth of complaints during the inquiry about complexity, and the comments that stakeholders have made over the last 20 years, demonstrate that this complexity has exceeded necessary levels. For example, Senators and Members across the political spectrum have complained about or acknowledged tax complexity.[4]

3.4 For a number of years, the judiciary has also expressed concern about the complexity of tax laws. In 1990, Justice Hill stated that one provision on which he was ruling was drafted:

> …with such obscurity that even those used to interpreting the utterances of the Delphic oracle might falter in seeking to elicit a sensible meaning from its terms.[5]

3.5 In 1991, a High Court Justice criticised the complexity of the capital gains tax:

> The provisions of s.160M(5), (6) and (7) of the *Income Tax Assessment Act 1936* ('the Act') and provisions to which they are related are extraordinarily complex. They must be obscure, if not bewildering, both to the taxpayer who seeks to determine his or her liability to capital gains tax by reference to them and to the lawyer who is called upon to interpret them … successive administrations have allowed the Act to become a legislative jungle in which even the non-specialist lawyer and accountant are likely to lose their way.[6]

3.6 In 2000, Justice Kirby noted the Court's long standing concern about the complexity of tax legislation:

> This appeal from the Full Court of the Federal Court of Australia concerns the construction of the *Income Tax Assessment Act 1936* ('the Act'). The complexity of the Act has long been the subject of comment and complaint.[7]

3.7 In 2002, a Member of the Administrative Appeals Tribunal found that any deficiency with the way the Australian Taxation Office (ATO) exercised

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4 Hon A Cadman MP, *House Hansard*, 9 October 2006, p 111, Hon P Costello MP, Treasurer, *House Hansard*, 22 June 2006, p 1, Hon D Kerr MP, *House Hansard*, 22 June 2006, p 1, Senator Hon H Coonan, *Senate Hansard*, 20 June 2005, p 15, Mr C Hayes MP, *House Hansard*, 16 August 2006, p 46.

5 Hill J, *FCT v Cooling* (1990) 90 ATC 4472, 4488.

6 Deane J in *Hepples v FCT [No. 2]* (1991) 65 ALJR 650, 657.

7 Kirby J, *FCT v Scully* [2000] HCA 6, para 43.

the Commissioner's discretion was based on the complexity of the legislation:

> The rules are complex and rigid. They cry out for simplification … If blame is to be apportioned, a large part of it must rest with the legislation provisions that dictate the result in this case. At the very least, they are inherently difficult to explain.[8]

3.8 Based on this evidence, the Committee concludes that complexity in tax legislation is a widely recognised problem. The broad political spectrum recognises this complexity. Further, the judiciary has expressed concern about complexity for at least 15 years. This suggests that there are a number of long standing reasons that have contributed to complexity. The report considers this issue further below.

Amount of legislation

3.9 One method of measuring the complexity of a tax system is to count the number of pages of tax legislation. The Committee accepts that this is not a perfect method. For example, the Ombudsman noted that the volume of rulings also needs to be taken into account.[9] Nevertheless, the Committee believes that the number of pages of tax legislation gives a good initial overview of the degree of complexity.

3.10 Figure 3.1 on the next page gives time series data on the number of pages of income tax legislation since the Parliament first passed the 1936 Act. The first point to note from the chart is that this data has not been collected on a systematic basis, so there is a large number of gaps in the data.

3.11 The second point to note is that, sometime after 1970, the rate at which the tax legislation grew started to accelerate. This rate of growth in the income tax legislation appeared to accelerate again in the late 1990s, apparently due to A New Tax System and the plain English rewrite. The latter commenced in 1993, with the Parliament passing the first legislation in 1997.

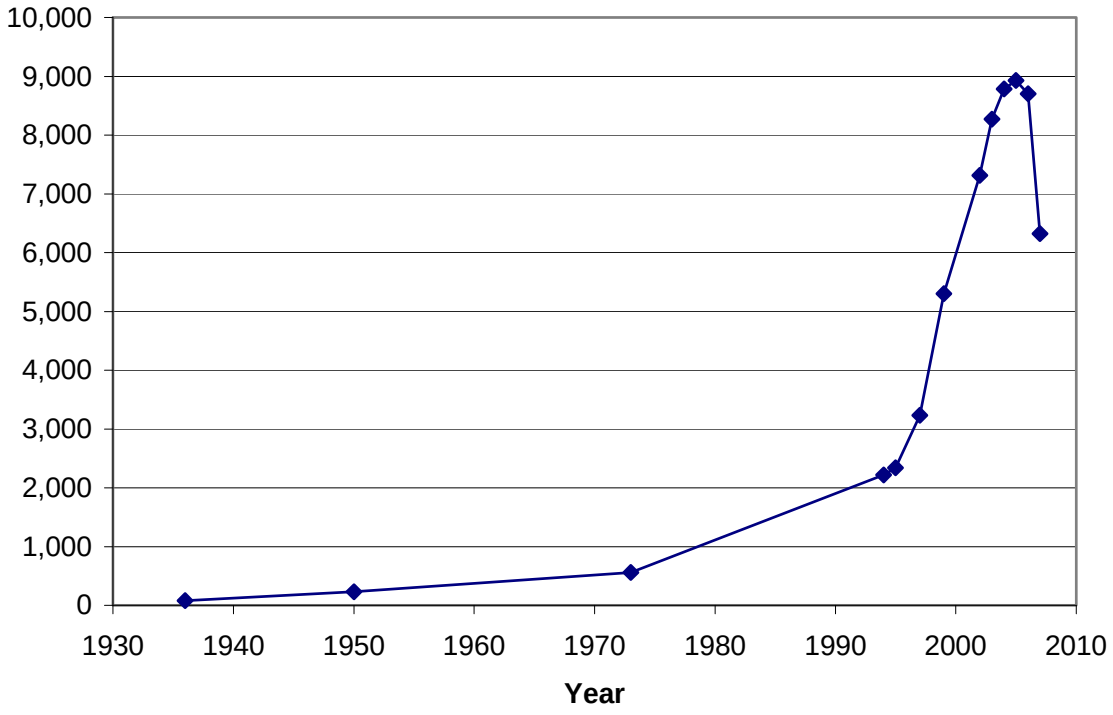
3.12 Since 1997, there have been two main income tax Acts: the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*. These two pieces of legislation contained duplicated provisions, which partially accounted for the increase in the volume of legislation. In November 2005,

8 Associate Professor McCabe, AAT hearing of *Trustee for the Estate of EV Duke v FCT* (2002) 50 ATR 1060, quoted in Wallis D, 'The tax complexity crisis' *Australian Taxation Review* (2006) vol 35, p 278.

9 Commonwealth Ombudsman, sub 38, p 4.

the Treasurer released the Board of Taxation's review of how the income tax laws could be rationalised. The Board did not support a merger of the two Acts, particularly because no consensus existed on the method by which it would be achieved. Instead, the Board recommended that the Parliament repeal the duplicated or inoperative provisions in the 1936 Act.[10]

Figure 3.1 Number of pages of income tax legislation, Australia, 1936 to 2006



Source *Kobetsky M, Dirkis M, Income Tax (1997) Federation Press, p 40 and recent editions of the Income Tax Assessment Act 1936 and Income Tax Assessment Act 1997.*

3.13 The repeal of these inoperative provisions occurred in 2006. This is shown as the drop at the end of the graph.

3.14 There has been some debate about whether this decrease in the volume of the tax legislation has reduced complexity. In its submission, CPA Australia argued that the tax law is effectively unchanged, so the compliance burden remains the same:

> While the Treasurer's recent announcement that the Government would move to reduce tax law by 30% through the removal of inoperative provisions is necessary and useful, the impact on the

10 Board of Taxation, *Identification and possible repeal of the inoperative provisions of the 1936 and 1997 Income Tax Assessment Acts*, (2005) Commonwealth of Australia, p 5.

> overall compliance burden on taxpayers and their advisers of such a change is unlikely to be significant given that the provisions being removed are generally no longer relevant.[11]

3.15 The alternative view is that reducing the volume of legislation must help taxpayers and tax agents to some degree, especially when they do not have a large body of tax experience to draw on. As David Wallis commented, CPA Australia's argument:

> …is based on an assumption of preconceived familiarity with the legislation. What of those who do not know that the provisions are inoperative; who do not know to ignore them? When even without these pages the legislation is of considerable length, their 'inoperative' presence must nonetheless operate overwhelmingly to labour, misdirect, and bemuse the reader who vainly searches the pages in hope of assistance. For new practitioners involved in taxation, the official declaration of inoperative provisions will no doubt prove to be of assistance.[12]

3.16 The Committee is of the view that repealing the inoperative provisions in the tax law has had a significant effect in reducing tax complexity. The fact is that law is law, whether inoperative or not, and remains in force until repealed. There is considerably more work to be done, but the reduced volume of tax laws has been of assistance.

3.17 In 2004, PricewaterhouseCoopers and the World Bank published a comparison of the number of pages of tax legislation of the 20 largest economies in the world. Australia, ranked 13th, was included. The results are displayed in Figure 3.2.

3.18 The graph shows that, by international comparisons, Australia has a highly complex tax system. In 2004, Australia was ranked third out of the 20 largest economies in the world in terms of the volume of tax legislation. Only India and the United Kingdom had bulkier tax laws.

3.19 The figure also shows the effect of the repeal of inoperative tax laws in 2006 with an additional entry for Australia in 2007. Assuming all other countries stayed at their 2004 levels, the repeal means that Australia dropped one ranking to fourth, below Japan. This is consistent with the Committee's earlier conclusion that the repeal of inoperative provisions will be beneficial in addressing tax complexity, but that more is required.

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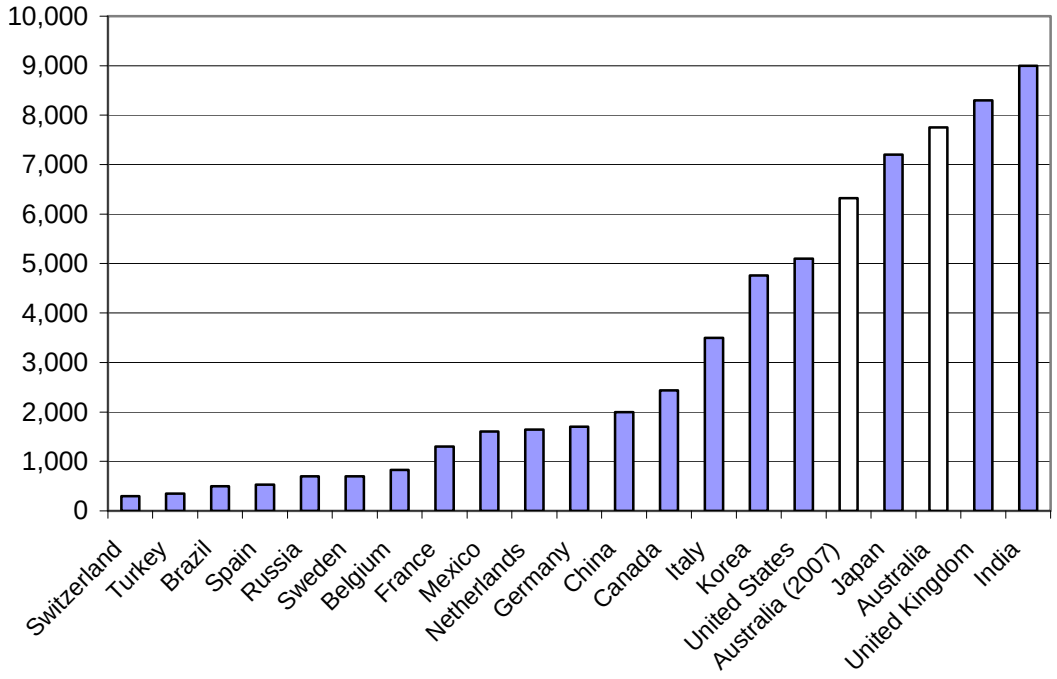
11 CPA Australia, sub 36, p 5.

12 Wallis D, 'The tax complexity crisis' *Australian Taxation Review* (2006) vol 35, pp 277-78.

Figure 3.2 Number of pages of primary federal tax legislation of the top 20 nations by GDP, 2004



Source *PricewaterhouseCoopers, The World Bank, Paying Taxes: The global picture (2006) PricewaterhouseCoopers, p 16, viewed at http://www.doingbusiness.org/documents/DB_Paying_Taxes.pdf on 31 January 2007.*

3.20 Finally, the graph gives an indication of the scale of work remaining. Although international comparisons must always be done cautiously, a possible goal for Australian legislators and governments would be to place Australia at the middle of these rankings. In 2004, the middle ranked countries were Germany and the Netherlands, with 1,700 and 1,640 pages of tax laws respectively. Therefore, a long term goal would be to reduce Australia's tax legislation to approximately one quarter of its current length (from 6,000 pages to 1,500 pages).

Conclusion

3.21 The Committee received evidence that, as financial arrangements become more complex, our tax system must respond and become more complex as well. The Ombudsman stated:

> While clarity and simplicity are admirable goals in legislation and administration, the reality of tax reform may be that the complex nature of our modern life — especially insofar as it involves

> commercial activities and financial transactions — in some senses mandates a degree of complexity.[13]

3.22 The Committee agrees with this comment and accepts that some complexity is inevitable in the tax system. However, the long standing and bipartisan concerns expressed within the community, the large volume of legislation by international standards, and the considerable amount of time spent by tax agents on keeping up to date demonstrates that tax complexity has gone too far. Both Parliament and the Government need to change current practices to deliver a more practical system in the medium to long term.

Causes of complexity

Historical development of tax laws

3.23 In his 2003 paper, Professor Rick Krever gives a historical overview of how Australia's tax laws became so complex. The main theme in the paper is that each participant in the tax system has acted in a logical manner from their own perspective. No particular group has claimed responsibility for the tax system overall, leading to the current arrangements. The groups best placed to have taken overall responsibility for the tax system have been successive parliaments, who must take ultimate responsibility.[14]

3.24 For example, the judiciary has taken a conservative, precedent-driven approach to interpreting tax legislation. Although this is normal judicial practice, it has had unintended consequences. For example, the courts have used principles from the law of trusts to define income for tax purposes. Therefore, some gains that have clear economic benefit are not traditionally defined as income, such as gains from selling investment assets. Another example is the principle of vicarious liability in tort law to decide whether a worker is an employee or not. Vicarious liability revolves around the amount of control that the 'employer' exercises over the 'employee.' However, this test does not examine the economic nature of the relationship, which is probably more relevant for tax purposes.

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13 Commonwealth Ombudsman, sub 38, p 4.

14 Krever R, 'Taming Complexity in Australian Income Tax' *Sydney Law Review* (2003) vol 25, p 468.

3.25 Although these judicial methods have made tax law more difficult to apply, Professor Krever notes that parliaments (and implicitly governments, who usually introduce the legislation) have authority to overturn these decisions by legislation.[15]

3.26 Another key group is the advisers. Many pieces of tax legislation over the years have distinguished particular entities or transactions for the purpose of delivering a tax benefit. Often, accountants and lawyers have changed the legal character of their clients' affairs to obtain this benefit for their clients. One example among many was in the 1970s, where the gains on the sale of shares were tax free. Taxpayers, therefore, sought to extract value from shareholdings on this basis, rather than by receiving dividends. In economic terms, these ways of extracting value from shares are similar. Therefore, it was not difficult to change the legal appearance of the transaction to fit the tax law.

3.27 Some commentators have argued that advisers should exercise professional responsibility and not devise these arrangements. However, where the transactions are legal, the legislature must also bear responsibility for establishing the framework within which these transactions occur.[16]

3.28 Professor Krever also expresses concern about how various public sector groups in the political process have approached tax issues:

- legislative drafters continue to use complex terms and structures in drafting legislation
- Treasury has tended to take 'stop-gap' solutions to legislative repairs, rather than more fundamental reforms
- elected representatives have preferred 'stop-gap' solutions, partially due to the three-year election cycle
- elected representatives have used the tax system to achieve social and economic policy goals, rather than efficiently collect revenue.[17]

3.29 In many cases, the combination of these factors has led to a vicious circle where a legal distinction is enacted and then advisers seek to exploit it:

> Using, or more accurately, misusing, the income tax law as a spending vehicle is undoubtedly one of the largest sources of complexity in the legislation. It has proved impossible to

15 Id, pp 470-72.
16 Id, pp 480-83.
17 Id, pp 483-88.

> deliberately distort investment or consumption behaviour by lowering the tax burden on preferred activities and not invite abuse. Tax law never specifies the intended recipients of concessions; at best it seeks to define the types of transactions or investments that will qualify for tax expenditures. However tightly the boundaries of desired activities and assets are defined, it is inevitable that they will be breached by well advised taxpayers recharacterising the transactions and investments to qualify for the subsidies. This activity, in turn, will lead to complex anti-avoidance measures intended to protect the integrity of the original subsidy scheme. The new legislation will lead to further planning which will lead to further legislation, and the cycle will continue for many years until either the concession is abandoned or is buried within dozens of complex anti-avoidance provisions.[18]

3.30 The idea that a large number of groups are responsible for the current state of affairs was confirmed in evidence. The Taxation Institute of Australia stated:

> I do not point the finger at anyone in particular because all of us are in fact guilty parties in allowing the laws to get to that kind of level in some areas.[19]

3.31 Given that many of the issues of tax complexity stem from tax policy and legislation, addressing it probably needs to occur at a high level. There may be scope for detailed review by a parliamentary committee in future into tax complexity and the means by which simplification can be achieved.

3.32 The ANAO recently examined the use of the tax system to implement spending programs in its recent audit on the tax expenditures statement. In 2006-07, tax expenditures totalled $41 billion. The audit found a number of deficiencies in current practice, including a lack of standards to govern the integrated reporting of outlays and tax expenditures, unreported categories of tax expenditures, and in many cases a lack of reliable estimates for tax expenditures. The ANAO also noted a succession of reviews of tax expenditures. The ANAO stated, 'few of the recommendations of these reviews have been adopted.' This meant each review tended to make the same findings and recommendations as the review before it.[20]

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18 Id, p 488.

19 Mills A, transcript, 28 July 2007, p 54.

20 ANAO, *Preparation of the Tax Expenditures Statement*, Audit Report No. 32 2007-08, 8 May 2008, pp 10-14.

3.33 These long standing difficulties suggest that reform of tax expenditures is overdue. Tax concessions, exemptions and allowances distort and complicate the tax system. Equity and efficiency is often served when the system is made simpler. In February 2008, the Minister for Finance announced a program-by-program review of government spending and tax concessions with a focus on efficiency, transparency and accountability.[21]

The use of exemptions

3.34 Occasionally, drafters of tax legislation have the choice between listing specific items that will attract tax consequences, or to make the arrangement more general and then list a number of exemptions. During the inquiry, the Committee received evidence that the exemption approach is often used and is much more difficult for practitioners to apply. In relation to Fringe Benefits Tax, the Tax Institute of Australia stated:

> The New Zealand model, as originally designed, was quite simple. They asked: 'Where are 90 per cent of the fringe benefits arising?' They then said: 'Let's go after that. Let's make it very specific. They're the bits that we want to tax, and by hitting the employers we'll try and encourage them to cash it out.' That is essentially what the driver was under the original fringe benefit tax rules. The difficulty is that our approach was to go global … and to try and capture everything within the web and then only let little bits out.
>
> By doing that, we have created all these very complex rules… We have really got to the point where we need to ask: 'Where are the big dollars in this stuff? What are the things that we want to chase? Are the little ones really worth it from the collection side?'[22]

3.35 Further, legislators have the choice of deciding how many exemptions to allow for a particular arrangement. These exemptions also add to complexity. The ICAA commented in relation to pay as you go:

> The pay-as-you-go instalment system is probably another one of those examples where we had legislation that was brought in and the effect of it was realised after the event … At the end of the day, now you have a base legislation with so many carve-outs that is extraordinarily complex legislation to read. Something that was

21 Id, p 14.

22 Dirkis M, transcript, 28 July 2006, p 61.

> basically fairly simple for companies and for individuals is now extraordinarily complicated.[23]

3.36 The Committee accepts that governments and legislators make the final decision on structuring taxes. They also introduce exemptions for sound policy reasons. However, the Committee believes that exemptions need to be more widely recognised as a source of tax complexity.

Frequency of changes

3.37 The Committee also received evidence that the rate of changes to the tax laws have added to complexity. In its 2004 pre-election survey, the Australian Chamber of Commerce and Industry asked businesses what are their most critical issues generally. The overall complexity of the tax system was ranked second. The frequency of changes to tax laws and rules was ranked fifth.[24]

3.38 The National Institute of Accountants also argued that the frequency of legislative change has made it harder for the ATO to effectively administer the law, with consequences for taxpayers and tax agents:

> The NIA [National Institute of Accountants], however, believe that the problem lies in the number of new measures introduced at any one time. While this appears contradictory to the NIA's position on supporting personal tax reform, it does however highlight the capacity of taxpayers, tax agents and the ATO to continue to adopt reforms. In other words, for taxpayers and their representative to have certainty in self-assessment, there needs to be a degree of stability in the law.[25]

3.39 Once again, the Committee accepts that governments and legislators are required to meet the needs of the community as they arise and that, on occasions, this may involve large scale or frequent tax changes. However, the Committee believes that there is value in governments and parliaments recognising that such changes significantly add to the compliance burden for taxpayers and tax agents.

Perspective of tax agents

3.40 In November 2004, Dr Margaret McKerchar from the Australian School of Taxation (Atax) at the University of New South Wales conducted a survey

23 Cantamessa S, transcript, 28 July 2006, p 68.

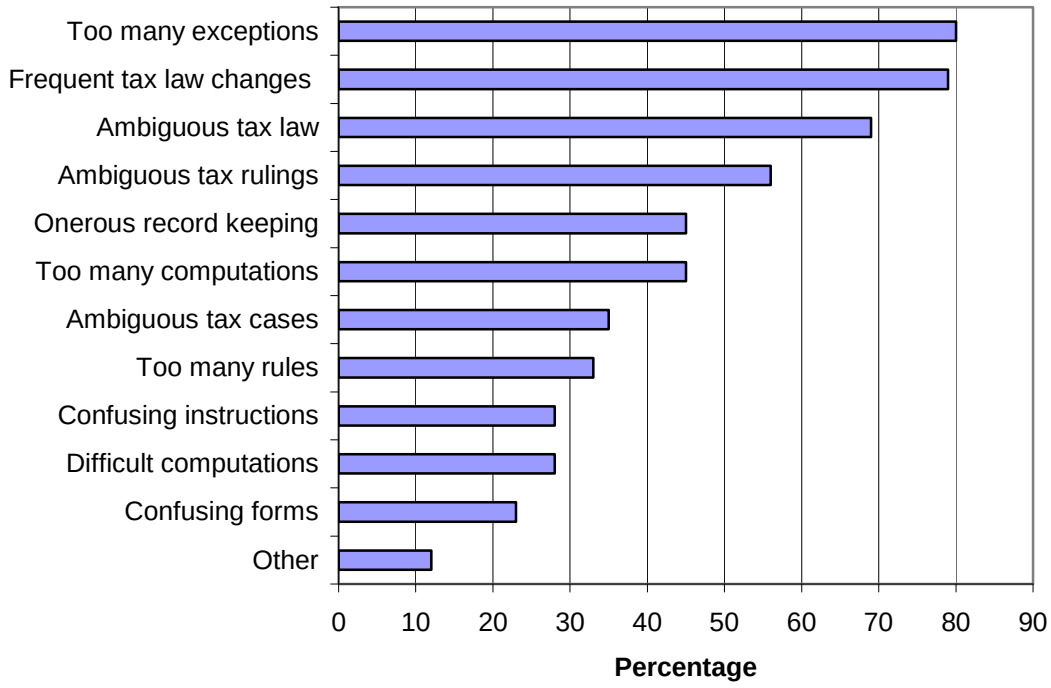
24 Australian Chamber of Commerce and Industry, sub 43, p 5.

25 National Institute of Accountants, sub 31, p 3.

on the complexity of the tax system. She sent an electronic link to the survey to tax agents through the ATO's electronic newsletter, *E-link*.[26] At the time, over 20,000 tax agents received *E-link*. Atax received 221 responses. Although this may not be a statistically valid sample, the results give a useful indication of tax agent experiences.

3.41 The survey included questions about what aspects of the tax system caused the most complexity to them. The results are shown in figure 3.3.

Figure 3.3 Causes of complexity experienced by tax agents, 2004 (%)



Source *McKerchar M, 'The Impact of Income Tax Complexity on Practitioners in Australia' Australian Tax Forum (2005) vol 20, p 538.*

3.42 This survey confirms the earlier discussion. The most commonly cited cause of complexity is the high number of exceptions, closely followed by frequent changes to the tax law.

3.43 The next most common cause of complexity is ambiguity in tax law and rulings. Uncertainty is a particular risk under the self assessment system. Taxpayers are responsible for correctly lodging their return, typically with the assistance of a tax agent. Where taxpayers make an error, they face the prospect of paying penalties and interest if the ATO issues an amended assessment.

26 McKerchar M, 'The Impact of Income Tax Complexity on Practitioners in Australia' *Australian Tax Forum* (2005) vol 20, p 538.

3.44 This resulting complexity has a number of consequences on taxpayers, tax agents, the wider community and the Government. These consequences are discussed next.

Consequences of complexity

Compliance costs

3.45 One of the disadvantages of a complex tax system is that compliance costs increase. One approach in measuring compliance costs is to quantify the time and money spent by taxpayers in meeting their tax obligations and offset this amount by the tax benefits and cash flow effects attached to tax compliance.

3.46 It appears that Atax was the last group to conduct such research (in 1997), funded by the ATO. For the 1994-95 income year, Atax found that net taxpayer compliance costs (that is, excluding the ATO) was $6.2 billion, comprising 7.0% of relevant tax revenue and 1.36% of GDP.[27]

3.47 Extrapolating this result to the present is difficult. On one hand, the tax system has probably become more complicated through growth in tax legislation. On the other hand, the ATO has implemented a number of technological innovations such as e-tax, electronic portals and pre-populated returns that reduce complexity from the taxpayer's perspective. Assuming a pro-rata increase compared with GDP, net taxpayer compliance costs would be $14.2 billion in 2006-07.[28] This is a considerable sum.

Integrity of self assessment

3.48 The system of self assessment places responsibility on taxpayers to ensure their tax returns are correct. However, this principle breaks down when tax law is too complex for taxpayers to understand and imposes prohibitive research costs on tax agents. It is inherently unfair for the ATO to issue an amended assessment with penalties and interest when taxpayers were unable to initially comply.

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27 Evans C et al, *A report into Taxpayer Costs of Compliance* (1997) Commonwealth of Australia, p ix.

28 Australian Bureau of Statistics, *Australian National Accounts: National Income, Expenditure and Product, December Quarter 2007* (2008) Cat No 5206.0, p 21.

Integrity of the legal system

3.49 The legal principle, 'ignorance of the law is no excuse,' dates from Roman times. The rationale for the principle is to prevent parties subject to legal proceedings from avoiding responsibility by stating they were unaware of the relevant law. The traditional assumption underlying the rule is that legislation is properly published and distributed.[29] In the context of this inquiry, however, the assumption now becomes that the law cannot be too complex.

3.50 The Taxation Institute of Australia stated in evidence:

> …one has to query: is it appropriate to have laws that have been criticised by the courts as being horrendously complex and beyond the comprehension of the ordinary taxpayer? …We cannot expect people to comply when it can be nigh impossible to understand the law, and it makes a mockery of the principle that ignorance of the law is no excuse.[30]

Tax agents

3.51 In its submission, the National Institute of Accountants stated that a major cause of complexity in the tax system is the rate at which new provisions are introduced.[31] One measure of the cost of complexity is to assess how much time tax agents spend keeping up to date.

3.52 Margaret McKerchar's 2004 survey of tax agents, discussed earlier, included a question on this. Respondents stated that they spent an average of six hours per week keeping up to date with income tax matters. The survey asked tax agents why they did not spend more time on this activity. The main response (79%) was that they had other work commitments to attend to. Only 7% stated they were fully up to date.[32]

3.53 The Committee accepts that tax agents need to stay up to date with tax laws and that it is something they should do regularly. However, the Committee believes that six hours a week, or 15% of a 40 hour week, places too great a burden on tax agents.

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29 '*Ignorantia juris non excusat,*' Wikipedia, viewed on 7 August 2007 at http://en.wikipedia.org/wiki/Ignorantia_juris_non_excusat.

30 Mills A, transcript, 28 July 2006, p 54.

31 National Institute of Accountants, sub 31, p 3.

32 McKerchar M, 'The Impact of Income Tax Complexity on Practitioners in Australia' *Australian Tax Forum* (2005) vol 20, p 542.

3.54 The Inspector-General of Taxation expressed concern about the sustainability of this compliance burden on tax agents. His submission gives a number of reasons why tax agents find the work unattractive:

> Practitioners are frustrated by the amount of non-value-adding work that they are required to do for the Tax Office and other agencies such as ASIC. Duplication of information gathering across agencies compounds this.
>
> Practitioners are leaving the tax industry for more lucrative fields such as financial planning and valuations.
>
> Practitioners are, as a group, an ageing population. This is compounding the gradual exodus.
>
> Tax practitioner numbers are not replenishing due to overwhelmingly more attractive opportunities and remuneration. People with accounting and related skills are in great demand. Smaller tax practices cannot attract new professional staff and few practitioners have succession plans for their businesses.[33]

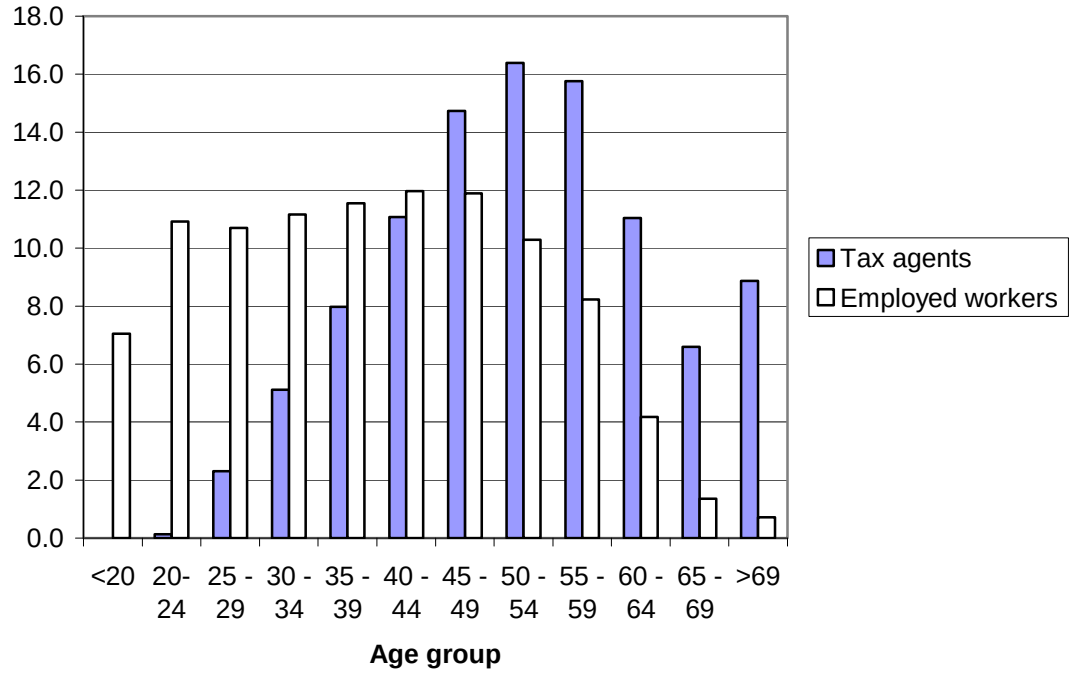
3.55 This burden may have been affecting tax agent numbers. The ATO presented data on the age profile of tax agents to the Committee. Figure 3.4 on the next page compares the age of tax agents against the age profile of the working population. It shows that, on average, tax agents are older than the general population of employed workers. In particular, the main employment ages across the economy are from 20 to 54. For tax agents, this age group is from 40 to 64. Admittedly, the educational requirements for tax agents mean they are unlikely to be fully qualified by the age of 25. However, one would expect significant representation among the 30 to 34 and 35 to 39 age groups.

3.56 The ATO advised the Committee that, over the past few years, the total number of tax agents has stayed constant. This occurred even though many agents have indicated that they would like to retire in the near future. In 2003, 13% of tax agents stated they would like to retire in the next two to three years. This figure increased to 17% in 2005 and 19% in 2007.[34]

33 Inspector-General of Taxation, sub 48, p 11.

34 ATO, sub 50.3, p 41, D'Ascenzo M, transcript, 20 April 2007, p 3, 'A positive future: The latest research results', *the Taxagent*, December 2007, p 5.

Figure 3.4 Age profile comparison: employed workers and registered tax agents, July 2006 (%)



Source *ATO, sub 50.3, p 41, Australian Bureau of Statistics, 'Labour Force, Australia, Detailed - Electronic Delivery, July 2007,' Cat No 6291.0.55.001, viewed at http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/6291.0.55.001Jul%202006?OpenDocument.*

3.57 The ATO also presented to the Committee some of its research into tax agents' job satisfaction. In 2005, 65% of tax agents reported that they were either very satisfied or fairly satisfied with their work, which rose to 73% in 2007. Only 16% and 13% respectively stated they were either fairly dissatisfied or very dissatisfied.[35] This data, combined with the stable number of tax agents overall, suggests that the problem is attracting new personnel to the industry, rather than encouraging tax agents not to leave the industry.

3.58 In evidence, the ATO stated that it has been developing a strategy along these lines:

> There is a focus, which the commissioner has been working through with CEOs [of the accounting and tax professional bodies], on attracting young people to tax work. I am not sure whether there is an issue about attracting people to the accounting profession or the legal profession. The versatility of those degrees these days means that they are very attractive to graduates for a

35 ATO, sub 50.3, p 134, 'A positive future: The latest research results', *the Taxagent*, December 2007, p 5.

> range of opportunities … attracting them to tax compliance work is certainly something we want to engage in.[36]

3.59 Tax agents are important to the tax system for a number of reasons. Firstly, 97% of businesses and 74% of individuals use them,[37] partially due to reasons of complexity. A shortage of tax agents will lead to higher error rates as more taxpayers complete and lodge their own tax returns. Tax agents also encourage an attitude of compliance among taxpayers.[38] A significant drop in the number of tax agents will have a corresponding effect on the integrity of the tax system.

3.60 The Committee is concerned that, if tax work remains relatively unattractive for too long, the industry will eventually lose significant numbers of staff.

3.61 Shortages may increase tax agent rates and attract some people to the industry. However, the Committee is concerned that the unattractiveness of tax work, compared with other work available to law and accounting graduates, means this will only be a partial solution. Reducing the complexity of the tax system will allow practitioners to focus on the core business and financial issues facing their clients, which will make the work more attractive. How governments and future parliaments might achieve this is discussed below.

Addressing complexity

Regulation impact statements

3.62 In *An Assessment of Tax* in 1993, the Joint Committee on Public Accounts (JCPA) expressed concern about the high compliance costs of the Australian tax system compared with the United Kingdom (UK). There, the JCPA estimated that compliance costs in Australia were five to 11 times higher than in the UK. The JCPA recommended that all future tax legislation be supported by a Taxation Impact Statement, which would include compliance costs and an assessment of simplification effects.[39]

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36 Granger J, transcript, 20 April 2007, p 4.

37 ATO, sub 50, p 35.

38 Id, p 46.

39 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, pp 90-91.

3.63 The ATO implemented this recommendation in 1996. Later that year, the previous Government announced a requirement for regulation impact statements for any regulatory proposal affecting business. Although the process for tax measures is roughly the same as for other proposals, they have been given some exemptions from processes due to their commercial sensitivity.[40]

3.64 In January 2006, the Taskforce on Reducing Regulatory Burdens on Business finalised its report, *Rethinking Regulation*. The Taskforce noted a number of reasons affecting the quality of regulations. One particularly relevant to this inquiry is that the costs of regulation are diffuse and 'off-budget.' In other words, a large number of individuals and businesses incur a relatively small amount of compliance costs each, but which add up to a large sum across the economy.[41] The Atax compliance cost study in 1997 demonstrates this has occurred in the tax industry.

3.65 Further, the move to self assessment made taxpayers responsible for accurately complying with tax legislation. This meant that taxpayers bore many of the costs of following complicated tax laws. Moving this responsibility 'off-budget' reduced the incentive for governments and parliaments to enact simple legislation. Because the ATO does not need to initially assess each return, it does not use the tax laws in the same way as taxpayers who experience the full costs of complexity. One commentator has likened the ATO's role to being, 'an armchair critic.'[42]

3.66 The Taskforce concluded that systems such as regulation impact statements have not delivered the benefits initially anticipated. Further, this is common across the country:

> … most governments in Australia have introduced disciplines to limit the effect of these and other influences on the extent and quality of regulation, most notably the Regulation Impact Statement requirements. However, … while sound in principle, the requirements have often been circumvented or treated as an

40 D'Ascenzo M, 'Response to Regulation Impact Statements (RISs) and Compliance Costs' viewed on 7 March 2007 at http://www.ato.gov.au/super/content.asp?doc=/content/22860.htm&pc=001/001/001/002/002&mnu=9861&mfp=001/007&st=&cy=1.

41 Regulation Taskforce, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (2006) Commonwealth of Australia, p 15.

42 Inglis M, 'Is Self-assessment Working? The Decline and Fall of the Australian Income Tax System' *Australian Tax Review* (2002) vol 31, p 65.

> afterthought in practice. The upshot is that they have often not realised their potential to improve the quality of regulation.[43]

3.67 This assessment is consistent with submissions made to the inquiry. Both the Australian Chamber of Commerce and Industry and the Taxation Institute of Australia argued there should be better regulation impact statement processes. Instead of trying to address individual complexity issues the Chamber preferred a systemic approach through improved consultation and regulation assessments.[44]

3.68 The Taskforce made a number of recommendations to strengthen regulation impact statements and regulation in general, including:

- mandating a compliance costing tool in assessing proposed regulations
- tightening 'gate-keeping' requirements for regulatory proposals
- developing broader performance indicators for regulators
- improving consultation with stakeholders, such as establishing consultative bodies and protocols on consultations.[45]

3.69 The previous Government agreed to most of the recommendations, including all those listed above.[46] The Office of Best Practice Regulation (OBPR) has released a range of material that builds on these documents, including the *Best Practice Regulation Handbook*.

3.70 The OBPR, which is now part of the Finance and Deregulation portfolio, has become Government's internal advisor on compliance with the new requirements for regulatory impact statements and associated processes. Generally, they now comprise:

- decision makers such as ministers receive OBPR advice on whether the assessment requirements have been met before making decisions
- the Department of Prime Minister and Cabinet needs the Prime Minister's permission to circulate Cabinet material that does not comply with the assessment processes

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43 Regulation Taskforce, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (2006) Commonwealth of Australia, p 15.

44 Australian Chamber of Commerce and Industry, sub 43, p 5, Taxation Institute of Australia, sub 40.1, p 4.

45 Id, pp 145-75.

46 Australian Government, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business, Australian Government's Response* (2006) pp 75-89, viewed on 7 March 2007 at http://www.treasury.gov.au/contentitem.asp?ContentID=1141&NavID=.

- where a measure is implemented that has not complied with the assessment requirements, any relevant explanatory material should include reference to this non-compliance
- non-compliant measures should be subject to a post-implementation review within one to two years of implementation
- OBPR reports publicly about compliance with the requirements in its *Best Practice Regulation Report*.[47]

3.71 The Committee appreciates that governments have introduced a number of reforms in regulation assessment. However, the Committee is concerned that many of the incentives to over regulate and to move risks 'off-budget' will remain. The *Handbook's* status as a policy, rather than legislation, means that compliance is placed at greater risk.

3.72 The Committee accepts that converting the *Handbook's* requirements into legislation is excessive. From time to time, the community expects governments to move quickly in addressing important issues. What is important is that governments are accountable to the community when they decide to override regulatory assessment processes. Section 39 of the *Legislative Instruments Act 2003* requires explanatory statements to be tabled with legislative instruments. If this does not occur, the relevant minister is to table an explanation for non-compliance. A similar approach can be taken here.

Recommendation 3

3.73 **The Government introduce legislation to require:**

- **the reporting of compliance with the *Best Practice Regulation Handbook* in all explanatory material accompanying a regulatory proposal**
- **a summary of the requirements of the *Best Practice Regulation Handbook* in all explanatory material accompanying a regulatory proposal**
- **the relevant minister to table an explanation with the relevant Bill or Legislative Instrument in either House of Parliament if this reporting of compliance does not occur.**

47 Office of Best Practice Regulation, *Best Practice Regulation Handbook* (2007) Commonwealth of Australia, pp 32, 34-37.

3.74 As Professor Krever noted, Parliament is ultimately responsible for the tax law, and by implication the law overall. In the view of the Committee, the individual Houses of Parliament can improve their own processes in examining legislation. When Bills are referred for committee review, the standard terms of reference are broad. That is, that the provisions of the bill are referred and any other relevant matters. Therefore, regulatory impacts often do not get considered.

3.75 Some Parliamentary review of regulatory proposals already exists, such as the Senate Standing Committee on Regulations and Ordinances. However, this tends to focus more on the status of the provisions as delegated legislation, rather than the Parliament being a gate-keeper.[48] The Committee would like to see Bills and other regulatory proposals being subject to regulatory impact analysis by the Parliament, even if in the early stages it covers more basic topics, such as the consultation process, compliance with the *Best Practice Regulation Handbook* and the robustness of any cost-benefit analysis.

3.76 Therefore, without limiting the right of the two chambers to set terms of reference for Bill inquiries as they determine, the Committee makes the following recommendation.

Recommendation 4

3.77 **The Senate and House of Representatives Procedure Committees examine whether to incorporate regulatory impacts as part of the standard terms of reference for bills inquiries. The Procedure Committees can consider whether to develop a checklist to assist Parliamentary Committees in assessing regulatory impacts.**

3.78 The Committee also wishes to ensure that agencies respond to regulatory assessment requirements by improving their processes at an early stage in policy and legislative development. The earlier agencies enhance their processes, the more likely they are to deliver results.

3.79 The Committee would like to confirm that agencies make these changes to their internal processes, preferably through reporting by an external scrutineer. It appears that the best agency to make such assessments would need direct access to agency records. The agency that has both

48 Senate Regulations and Ordinances Committee, 'Guidelines on the Committee's application of its Principles,' viewed on 11 June 2008 at http://www.aph.gov.au/Senate/committee/regord_ctte/guidelines.htm.

expertise in relation to public sector processes and can access agency records is the Australian National Audit Office (ANAO). The ANAO may wish to consider whether this would be a suitable topic for a performance audit in future.

Drafting styles

3.80 A large part of the tax debate has revolved around whether drafting styles can improve tax laws. In 1990, the then Government investigated whether the tax laws could be simplified through drafting alone. A joint ATO and Treasury taskforce concluded that this would not be effective without first simplifying tax policy. The Government deferred the matter.[49]

3.81 In 1993, the JCPA's report, *An Assessment of Tax,* recommended redrafting the *Income Tax Assessment Act 1936*. This led to the Tax Law Improvement Project (TLIP), commencing in 1993, which developed a radically new way of drafting tax legislation. The *Income Tax Assessment Act 1997* features plain English, diagrams, flow charts, cross references, and examples. The *Taxation Administration Act 1953* also now includes some of these features.[50]

3.82 However, there have been a number of issues in relation to this rewrite. Firstly, a number of parties have argued that, where tax policy is complex, plain English legislation does not reduce this complexity. Rather, it tends to show more clearly the complexity of the tax system. [51] Sir Anthony Mason, a previous Chief Justice of the High Court, has stated, 'plain language on its own is a passport to nowhere.'[52]

3.83 In response, Treasury argued as follows:

> When you say that plain English has not helped, the Tax Law Improvement Project, which resulted in the 1997 act, I think is universally—even by the practitioners—regarded as clearer law to understand than its predecessor in the 1936 act.
>
> When I was a law student it was often said that certain paragraphs of the 1936 act were incomprehensible. They may have been shorter in the sense that they were of fewer pages in length, but it

49 Krever R, 'Taming Complexity in Australian Income Tax' *Sydney Law Review* (2003) vol 25, p 491.

50 Id, p 492.

51 Id, p 493.

52 Taxation Institute of Australia, sub 40.1, p 3.

> is very difficult when you have paragraphs that go without a comma for half a page or a page.[53]

3.84 Perhaps the best way to resolve this debate is to recognise that plain language drafting is a necessary, but not sufficient step in tax law simplification. Deleting inoperative provisions made tax laws clearer but still left much work to be done. The Committee views plain language drafting the same way.

3.85 The second issue is that in 1993 the JCPA did not support a plain English rewrite. Rather, the JCPA supported a tax policy review, which would result in simpler tax policy and then be reflected in legislation. The report states:

> The Committee is of the view, that any attempt to redraft the Act must necessarily look at broader, structural issues within the total taxation system. Simplification, in this context, should concentrate on achieving a tax system which is fair, equitable and economical. The objective must be to reduce the total cost of the taxation system. Consequently a redraft of the Act, while crucial, cannot be successfully achieved in the absence of a fundamental review of the administrative, political and social implications of changes in the Act.
>
> The Committee received evidence concerning a proposal to redraft a particular Division of the Act in a plain English style. The Committee noted the merits of such an attempt but was also cognisant of the significant difficulties raised by such an exercise. In particular, evidence from the Commonwealth's First Parliamentary Counsel highlighted the difficulties of major redrafting, particularly the importance of establishing the underlying policy of the Act and the need to maintain, where necessary, precision.
>
> Consequently, in performing a redraft, the Committee believes the fundamental assumptions underlying the Act, including the basis on which the Act is to be administered and the policy decisions inherent in the Act, should be evaluated, discussed and clarified.[54]

3.86 Earlier in the chapter, the Committee noted the high level of concern in submissions and in evidence about the complexity of tax laws. It is not surprising that the plain language rewrite of the tax laws, occurring under

53 McCullough P, transcript, 9 November 2006, p 53.

54 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, pp 82-83.

successive governments, has not addressed the bulk of the problem. In a comparative analysis of tax reform in the United States, United Kingdom, Australia and New Zealand, Margaret McKerchar from Atax stated:

> In terms of drafting legislation, the experiences of the US, Australia and the UK… clearly demonstrate that improving the readability of the tax laws per se is largely ineffective or at best superficial where the underlying policies are not also reviewed. That is, complex policy, or policy where the objectives are not well articulated, impede the drafting of simple and less voluminous legislation.[55]

3.87 Sir Anthony Mason has taken the view that a number of factors are necessary for tax simplification. He argued that, in New Zealand, successful tax legislation is developed through the following:

> …coherent and consistent policy formulation, transparent consultation, drafting by a drafting unit within the Policy and Advice Division of the Tax Office (not by Parliamentary Counsel or Treasury), purposive clauses and extra-statutory references, general rules to overarch more specific rules and a commitment to modern drafting techniques and to plain language.[56]

3.88 The Committee accepts that principles-based (or purposive) drafting will have a role to play in simplifying tax laws. However, a number of factors are also required. Perhaps the most important of these is consultation on tax policy.

Consultation in legislation

3.89 In *An Assessment of Tax*, the JCPA expressed a strong desire that any legislative rewrite should be done in a spirit of consensus:

> During the Inquiry the Committee noted proposals for the establishment of a specialist committee to oversee a redraft of the Act. The Committee considered such a committee to be too limited given the fundamental significance of the proposal for a redraft. The Committee has concluded that a broadly based task force drawing upon a wide cross-section of skills, experience and the

55 McKerchar M, Meyer K, Karlinsky S, 'Making Progress in Tax Simplification: A Comparison of the United States, Australia, New Zealand and the United Kingdom,' chapter 20 in McKerchar M, Walpole M (eds) *Further Global Challenges in Tax Administration* (2006) Fiscal Publications, p 374.

56 Taxation Institute of Australia, sub 40.1, p 3.

> professions, would represent a suitable vehicle for the performance of this significant duty…
>
> Such a rewrite however, would only be possible with the absolute commitment of all political parties, the bureaucracy, the taxation industry, business and taxpayers generally.[57]

3.90 The current Committee agrees with these sentiments. The best way for government to develop a consensus is to engage with stakeholders and the community. In other words, governments should consult on tax proposals.

3.91 In 2002, the Board of Taxation finalised a report on consultation, which included some recommended principles. These included government:

- committing to consult on developing all substantive tax legislation, unless exceptional circumstances apply
- obtaining early external input in identifying and assessing overall policy and implementation options (before publicly announcing the policy)
- obtaining input from external stakeholders in developing policy and legislative detail
- clearly articulating the policy intent of each new measure at the initial announcement
- releasing a consultation plan for each new tax measure.[58]

3.92 In the *Rethinking Regulation* report, the Taskforce noted that the previous Government adopted the Board's recommendations and this had led to significant improvements in consultation. However, the Taskforce also noted that more needed to be done:

> Nevertheless, based on industry feedback, the Taskforce believes that there is scope to further improve the tax consultation process and to apply more rigorously the Board of Taxation's recommendations.
>
> For example, business has advised that some tax legislation is still being introduced into Parliament with little effective consultation. Any amendments subsequently required can be costly for business to implement and costly for government in terms of the resource-intensive parliamentary processes.

57 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p 83.

58 Board of Taxation, *Government Consultation with the Community on the Development of Taxation Legislation* (2002) Commonwealth of Australia, p iv.

> Other amendments are often made 'just in time', which creates difficulties for businesses developing information technology systems and for business planning and advice.[59]

3.93 Consistent with the Taskforce's findings, the Committee received mixed reports on how Treasury was consulting on new tax measures. The National Institute of Accountants wished to, 'publicly acknowledge the good work the Treasury is doing.'[60] CPA Australia stated in evidence:

> With some exceptions we have written to the board of tax on separately as part of their review of consultation, generally speaking we have quite a healthy consultative environment on a suite of things…[61]

3.94 The Taxation Institute of Australia and ICAA put a different view. In particular, they were concerned that the Government's announcements were too detailed at an early stage. They argued that the Government's initial statement should be more general and that consultation should be used to fill in the policy details. The ICAA stated in evidence:

> One of the problems is maybe even a bit earlier in the piece. We do not get consulted at the pre-policy setting stage, so by the time we get involved the policy has already been set… I think that probably the most important one is that pre-policy setting stage, because once the policy is set your hands are a bit tied. For example, one of the things that were introduced last year … was the loss recoupment measure and the introduction of a $100 million ceiling on whether you can pass the same business test. We do not believe that that measure was properly thought through. The policy behind it is not clear. A review was then ordered of how they can improve the same business test. As I say, sometimes you almost need to go a couple of steps back to the policy setting stage to make sure that what follows is appropriate.[62]

3.95 The Taxation Institute agreed:

> At an earlier stage ministers often come out and make a statement about a change to the tax law and then give a whole lot of detail in relation to it, rather than saying, 'Hang on. The principle or the

59 Regulation Taskforce, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (2006) Commonwealth of Australia, pp 112-13.

60 National Institute of Accountants, sub 31, p 3.

61 Drum P, transcript, 25 August 2006, p 30.

62 Noroozi A, transcript, 28 July 2006, pp 62-63.

> response to a problem that we are trying to achieve is X. Let us then announce that and go away.'[63]

3.96 The Australian Chamber of Commerce and Industry also supported improved consultation.[64]

3.97 Another practice the Committee noted during the inquiry was confidential negotiations between professional associations and Treasury. This occurred in relation to the new legislation regulating tax agents. The Committee understands that Treasury has been conducting confidential negotiations with these groups for two years.[65] Confidential consultations can only represent the views of the individuals that work for the associations and not the views of the members that the associations are meant to represent.

3.98 In evidence, Treasury argued that the particular nature of tax laws means there cannot always be as much consultation as some stakeholders may wish for. In particular:

> Consultation cannot be mandated for every change to the tax system, particularly in cases where there is commercial or market sensitivity, or revenue risk due to tax avoidance. Also, the flexibility government requires in managing the timing of policy change will at times determine the extent and form of consultation that can be undertaken.[66]

3.99 The Committee is concerned that this view might remove an important discipline on Treasury and the Government when developing tax legislation. One of the by-products of consultation is that Treasury is obliged to defend the Government's proposals. The Committee would much prefer this occurred before a Bill enters Parliament. Addressing errors and making adjustments is much easier to achieve during initial development, rather than after a proposal becomes law.

3.100 During the inquiry, the Board of Taxation released a further report on consultation, *Improving Australia's Tax Consultation System*. This report originated in recommendation 7.1 in the *Report of Aspects of Income Tax Assessment* (RoSA). The recommendation was that the Board, in conjunction with Treasury, review international practices with a view to suggesting improvements to the Australian system.[67]

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63 Mills A, transcript, 28 July 2006, p 63.

64 Australian Chamber of Commerce and Industry, sub 43, p 5.

65 Evans A, 'Transparency on training' *Australian Financial Review*, 20 July 2007, p 79.

66 Treasury, sub 51, p 2.

67 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, p 69.

3.101 The Board's 2007 report is different to the 2002 report because it represents an agreed position between Treasury and the Board. The 2002 report stated the Board's views alone. The new report places less emphasis on consultation before announcing the policy intent. The 2002 report stated that government should consult generally unless there are compelling reasons not to do so and that one component of this would be to consult before announcing the policy intent. In contrast, the 2007 report states that government should consult on the detail of tax policy unless there are compelling reasons not to do so. It then adds that government should 'consider whether consultation may be appropriate' prior to announcing the policy intent.[68] In light of the evidence to the inquiry, the Committee prefers the Board's 2002 report on this issue.

3.102 The 2007 report gives some data on confidential consultations. Given the inherently public nature of the tax system, the Committee expects a significant level of public consultation to occur on tax measures. However, of the 58 measures legislated in 2005 on which consultation took place, the Board of Taxation reports there was:

- targeted confidential consultation for 33 measures
- a combination of both open public consultation and targeted confidential consultation or targeted public consultation for 18 measures
- targeted public consultation for five measures
- open public consultation for two measures.[69]

3.103 In other words, 57% of tax consultations in Australia are confidential. The Committee regards this figure as too high. The report itself makes a cogent argument for reducing the number of confidential consultations:

> In recent years a significant proportion of consultations have been conducted as targeted confidential consultations, as distinct from public consultations. While this is appropriate in some cases, there are substantial advantages in public consultations wherever possible. Public consultation ensures that everyone in the community has the maximum opportunity to provide information

68 Board of Taxation, *Improving Australia's Tax Consultation System* (2007) Commonwealth of Australia, pp vi, 3-5, Board of Taxation, *Government Consultation with the Community on the Development of Taxation Legislation* (2002) Commonwealth of Australia, p vi.

69 Id, p 11.

> for government consideration. This potentially improves the quality of the information available to government.[70]

3.104 The Committee agrees with these sentiments. The recommendation in the 2007 report, that consultations be public 'wherever appropriate,' is not sufficient.[71] Treasury and the Government need to take positive steps to conduct tax consultations in public more regularly.

3.105 The Government is aware of these concerns. On 8 February 2008, it announced the appointment of a tax design review panel to investigate these issues, in particular:

- reducing the delay between policy announcement and introducing legislation
- increasing consultation, in particular during the earlier policy development phase
- increasing consultation in prioritising changes.[72]

3.106 The panel is chaired by Mr Neil Wilson of PriceWaterhouseCoopers. It was scheduled to report to government on 30 April 2008.

3.107 This Committee also has its own views of the consultation process for tax laws from the perspective of its members' roles as Senators and MPs. Parliamentarians, including ministers, are not professionally trained in tax law and need help in assessing these laws. Therefore, in addition to devices like Explanatory Memoranda and Bills Digests, the Parliament's committee review system is very important in exposing potential problems with proposed law. However, it appears to the Committee that once Cabinet approves tax proposals, governments expect they will be implemented by all parties, without Parliamentary change. Indeed, much tax law is rushed or waved through. The Committee believes that a more considered and measured approach in Parliament is necessary, including the use of exposure drafts where appropriate.

3.108 In order to improve the consultation process throughout the full development phase of tax laws, and to increase the longevity and stability of legislation, the Committee makes the following recommendation.

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70 Id, p 41.

71 Board of Taxation, *Improving Australia's Tax Consultation System* (2007) Commonwealth of Australia, p 4.

72 Hon C Bowen MP, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, 'Tax Design Panel to Look at Ways to Streamline Process for Changing Tax Laws,' Media Release, 8 February 2008.

Recommendation 5

3.109 **The Government and Treasury improve consultation on tax measures by:**

- **increasing the number of public consultations compared with confidential consultations**
- **increasing the number of consultations conducted prior to the announcement of the policy intent**
- **increasing the use of exposure drafts of legislation, where practicable.**

The review, Australia's Future Tax System

3.110 On 11 May 2008, the Government announced a wide ranging review into the tax system. It will be chaired by the Secretary to the Treasury, Dr Ken Henry and other external members. The terms of reference for the review cover topics relevant to this inquiry, in particular 'simplifying the tax system' (3.5) and 'reducing tax system complexity and compliance costs' (4.4).[73]

3.111 In *An Assessment of Tax*, the JCPA argued that a wide-ranging debate on tax policy fundamentals was a necessary foundation to addressing tax complexity.[74] *Australia's Future Tax System* has the potential to provide this sort of debate and give effect to the JCPA's recommendations from 15 years ago.

3.112 During the inquiry, a number of topics were raised which had a bearing on tax complexity and administration but were not directly within the terms of reference. Given that the Committee received limited evidence on them, the best way forward would be further consultation. The new review is an ideal vehicle for this.

73 Treasury, 'Terms of reference: Australia's future tax system' viewed on 26 May 2008 at http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1376.

74 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, pp 81-84.

Reflecting the economics of a transaction in tax legislation

3.113 As Professor Krever has noted, much tax legislation has established differing tax consequences based on legal distinctions. Tax lawyers and accountants have often been able to change the legal form of transactions to generate a tax benefit. Professor Krever argues that insufficient policy development leads to a reliance on legal forms over economic substance, which leads to avoidance opportunities.[75] On the other hand, Treasury has stated that commercially sensitive and avoidance measures should not be subject to public consultation.[76] It appears that, in some cases at least, Treasury is concerned that an earlier release of a policy may facilitate avoidance opportunities.

3.114 In the view of the Committee, a more robust policy underlying a tax proposal is less likely to present such avoidance opportunities. In other words, Treasury in the past may have been seeking to protect the revenue from insufficiently developed policy.

3.115 The Committee notes that Treasury has recognised the problems caused by basing the tax law on legal forms rather than economic effect.[77] Further, the previous Government made a concerted effort to introduce this type of reform through the tax value method after the Ralph Review. Professor Krever notes that the drawbacks of the tax value method were that some of its internal definitions were not consistent, it retained all existing concessions, and the scale of change was too large to be achieved in a single round of reform.[78]

3.116 The reduction in compliance costs from successfully introducing this type of reform will be billions of dollars annually. Given these potential benefits, the Committee is of the view that it should be canvassed in the discussion paper. If all parties draw on the experience of the tax value method, then the chances of successful reform on this occasion will be increased.

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75 Krever R, 'Taming Complexity in Australian Income Tax' *Sydney Law Review* (2003) vol 25, pp 480-83.

76 Treasury, sub 51, p 2.

77 Hon P Costello MP, Treasurer, *Exposure Draft of the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006, Explanatory Material*, pp 3-8.

78 Krever R, 'Taming Complexity in Australian Income Tax' *Sydney Law Review* (2003) vol 25, pp 498-99.

Recommendation 6

3.117 **In the discussion paper for the review, *Australia's Future Tax System*, Treasury and the review panel include the topic of basing the tax system on financial relationships and economic outcomes, ahead of legal forms.**

The requirement to lodge a tax return

3.118 In Australia, almost 100% of individual taxpayers lodge tax returns. This is high by international standards. For example, in the United Kingdom, the rate is 37%. In New Zealand it is 31%.[79] In approximately half of OECD countries, the vast majority of taxpayers are not required to lodge returns.[80]

3.119 Because lodging tax returns occurs across the economy, reducing the number of taxpayers who do this is likely to generate large reductions in compliance costs. There is scope for *Australia's Future Tax System*, to inform and stimulate debate on reducing the number of taxpayers who need to lodge tax returns.

3.120 The OECD reports that a number of revenue bodies are assisting taxpayers by pre-populating tax returns so that much of the information is already filled in.[81] The ATO has also commenced this practice. The tax system is not necessarily simpler, but it masks complexity from the taxpayer's perspective. Although it is addressing the symptoms of complexity, rather than the causes, this is the most the ATO can do as the implementer of tax legislation.

3.121 In order to remove the need for taxpayers to lodge returns, the key requirement is that there should be no end of year 'squaring-up.' In other words, the amounts withheld throughout the year should equal the amount that the revenue authority would issue as a tax assessment following the lodgement of a return.

3.122 Professor Chris Evans at Atax has listed the four main requirements to achieve this result:

- a simple rate structure, such as a low number of tax rates

79 Evans C, 'Diminishing returns: The case for reduced annual filing for personal income taxpayers in Australia' *Australian Tax Review* (2004) vol 33, p 169.

80 OECD, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006)*, October 2006, p 6, viewed on 31 January 2007 at http://www.oecd.org/dataoecd/43/7/37610131.pdf

81 Ibid.

- a comprehensive and accurate withholding regime
- no work-related deductions or, as the OECD, the *Australian Financial Review* and others have suggested, a standard amount for this[82]
- a limited interaction between the tax and social security systems.[83]

3.123 The Committee received a number of submissions that supported reducing the number of taxpayers who needed to lodge returns.[84] In evidence, Taxpayers Australia and the National Institute of Accountants gave in principle support to reducing the requirement to lodge.[85] In the past, CPA Australia has also supported this view.[86]

3.124 The first of the four requirements is an extension of what traditionally occurs at most Budgets, namely an adjustment of income tax rates. Professor Evans at Atax has conducted research that demonstrates it is possible to generate community support for these changes by setting the rates at the appropriate level and having a low income tax offset.[87] Adjusting rates will also be relevant to the workforce participation goals of *Australia's Future Tax System.*[88] For example, the Committee for Economic Development of Australia (CEDA) has commissioned research showing that increasing the tax free threshold raises workforce participation across the economy.[89]

3.125 Changing the withholding regime is administrative in nature. Simplifying tax rates (while maintaining a progressive system) and improving the withholding regime appear to be matters of implementation.

3.126 The remaining two requirements, however, have more difficulties. For example, work-related deductions are very popular because taxpayers see them as delivering a sizeable tax refund each year. In 2000, the ATO commissioned research on this topic. The researchers concluded:

82 OECD, Economic Survey of Australia, 2006, (2006) Policy Brief, p 6 viewed on 10 August 2007 at http://www.oecd.org/dataoecd/43/35/37201820.pdf, 'Tax-returns system needs simplifying' *Australian Financial Review* 31 January 2007 (editorial) p 54.

83 Evans C, 'Diminishing returns: The case for reduced annual filing for personal income taxpayers in Australia' *Australian Tax Review* (2004) vol 33, pp 175-76.

84 Fehily Loaring, sub 5, p 4, Morris B, sub 35, p 1.

85 Greco A, transcript, 28 July 2006, p 72, Ord G, transcript, 25 August 2006, p 7.

86 Colman E, 'Heavies weigh in to call for tax reform' *The Australian* 21 April 2006, p 4.

87 Evans C, Tran-Nam B, 'Towards systemic reform of the Australian personal income tax: developing a sustainable model for the future' Personal Income Tax Reform Symposium (2007) Paper 3, p 3-25, viewed on 8 May 2007 at http://www.atax.unsw.edu.au/research/pitr-symposium-07/papers/Paper_03-Evans-Tran-Nam.pdf.

88 Clause 4.1 in the terms of reference.

89 Lateral Economics, *Tax Cuts for Growth: The impact of marginal tax rates on Australia's labour supply,* (2006) CEDA Information Paper 84, pp 1, 14.

> Refunds are what the personal tax system is all about for most taxpayers. Maximizing one's deductions is the only thing that makes the system 'work' for ordinary PAYEs because this is the only way to maximize their refund. Certainly, a personal income tax system without refunds would be unpopular. Individual taxpayers are keen to preserve access to refunds because it helps them to preserve a sense of control and a feeling that they have at least a chance to get their 'fair share back' in the form of a refund.[90]

3.127 This view was confirmed in evidence. Taxpayers Australia stated:

> Studies have been done. As far as taking that away from the public is concerned, I think you will get a lot of objections, because it brings closure to the year. They find out how much tax they have actually paid and there is the opportunity to claim work deductions.[91]

3.128 On the other hand, there is a number of significant, valid reasons to discontinue them. Firstly, it will reduce compliance costs through fewer taxpayers lodging returns.

3.129 Secondly, they present a risk to the revenue in the longer term. These deductions have been growing faster than incomes for a considerable period.[92] For example, taxpayers now claim over $10 billion in work related deductions annually. Recent annual increases have been of the order of 9%.[93] If unabated, governments may need to change the rules to support the integrity of the tax system.

3.130 Thirdly, they are the largest deduction claim for individuals and cost the ATO significant resources in the compliance work needed to monitor them.[94]

3.131 Finally, if any such measure is revenue neutral, taxpayers will be better off because they will have a wider choice of items on which to spend the extra amounts of after tax income, rather than being limited to work expenses. Although there is community support for work-related deductions at present, the advantages of removing them should be debated. *Australia's Future Tax System*, is an ideal place to do this.

90 Pedic F et al, *Simplifying Income Tax: A Report on Forty Community Consultations* (2000) p 57, quoted in Evans C, 'Diminishing returns: The case for reduced annual filing for personal income taxpayers in Australia' *Australian Tax Review* (2004) vol 33, p 180.

91 Greco A, transcript, 28 July 2006, p 74.

92 Ibid, Baldry J, 'Personal Income Tax Deductions in Australia, 1978-79 to 1990-91' *Economic Record* (1994) vol 70, pp 424-33.

93 ATO, sub 50, p 20.

94 Ibid.

3.132 The final requirement to reduce the number of taxpayers who lodge tax returns is to limit the interactions between the tax system and government benefits, including social support payments. In Australia, the interactions happen in two ways. Firstly, family tax benefits and other similar payments use the tax system to check each recipient's income estimate so that the Government may apply a means test. The Committee received evidence from Taxpayers Australia that this income test pulls a large number of low income people into the tax system:

> One problem that I see is that the interaction between Centrelink and the tax system complicates everything. People are required to lodge returns because of their Centrelink benefits yet they are well below the tax threshold.[95]

> Every time that we get something like a childcare tax offset it increases the complexity of returns and it means that those people under $20,000 are firmly entrenched, because the only way that they can recover it is to lodge a tax return.[96]

3.133 The other way in which government payments complicate the tax system is through tax offsets and credits. In 2005-06, these amounted to $16 billion for individual taxpayers, out of total net tax payable for this group of $108.7 billion.[97] Examples of the policy areas are private health insurance, seniors, low income, spouses, and medical expenses. Non-personal taxpayers are also entitled to tax offsets and credits. One example is the research and development tax offset.

3.134 Professor Evans has stated that Australia has a large number of tax offsets and credits, particularly in comparison with New Zealand, which has low rates of mandatory lodgement of tax returns:

> … modern tax systems are often used, not merely as the revenue collecting vehicles for which they were primarily designed, but also as agencies for the achievement of the social and political goals for which they were *not* designed. This inevitably causes greater complexity than would otherwise be the case. New Zealand has not escaped this 'modern' trend, but it is less prevalent than is the case with Australia … there is less evidence of the tax offsets, rebates and all manner of other tax expenditures

95 James B, transcript, 24 August 2007, p 49.

96 Culberg A, transcript, 24 August 2007, p 49.

97 ATO, *Taxation Statistics 2005-06* (2008) Commonwealth of Australia, pp 18-20.

> designed to deliver political or social advantage to particular groups that characterise the Australian tax system.[98]

3.135 In its submission, CPA Australia noted the complexity these arrangements impose on taxpayers. It suggested that the Government review its strategy of using the tax system as a delivery vehicle for these payments and benefits.[99]

3.136 In its *Rethinking Regulation* report, the Regulation Taskforce listed a number of design principles for tax legislation. One of these was that direct expenditure, rather than adjusting tax rates, should be used to achieve policy objectives. The Taskforce explained its reasoning as follows:

> Tax is a relatively blunt instrument and is often less efficient in achieving equity objectives than direct expenditures and grants. For example, individual taxable income can be a crude method of identifying taxpayer need, as there are many low-income taxpayers in high-income households. On the other hand, the social security system and payment of grants can use broader eligibility criteria than taxable income, such as family income and assets, to better target those in need.
>
> The tax system is only likely to be preferable when seeking to achieve relatively broad equity outcomes (for example, the use of progressive marginal income tax rates).[100]

3.137 The Committee supports these arguments. Another reason put forward for these changes is that most of these benefits are effectively payments. If they are payments, they should be paid under an appropriation Act. The Committee accepts that there are transparency measures in place for revenue measures such as the budget papers and the ATO's taxation statistics. Revenue measures also usually have a legislative base. However, if an arrangement is essentially a payment made under certain circumstances, then it may be preferable for it to be managed as a special appropriation.

3.138 The final reason why the Committee supports extracting benefits and offsets from the tax system is that, for many of these items, Centrelink already has this role. Using the tax system to deliver them raises questions of duplication.

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98 Evans C, 'Diminishing returns: The case for reduced annual filing for personal income taxpayers in Australia' *Australian Tax Review* (2004) vol 33, p 176.

99 CPA Australia, sub 36, p 12.

100 Regulation Taskforce, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (2006) Commonwealth of Australia, p 112.

3.139 The Committee accepts that there are a number of reasons why governments have used the tax system to deliver these benefits and offsets. Firstly, the ATO holds reasonably accurate information about taxpayers' incomes. It is administratively efficient to use this information when verifying income amounts for applying a means test. Further, the Government can administer many different benefits and offsets from one location. In other words, the ATO has become a 'one stop shop' for government benefits.

3.140 The price of these efficiencies, however, has been to shift considerable costs on to tax agents. The Committee is concerned that governments have taken these decisions with reference only to their own costs and benefits, without considering the impact on tax agents. The Committee reiterates the earlier point that successive governments and parliaments have not taken responsibility for the tax system overall. Rather, they have made decisions on what best suits them and allowed the compliance burden in the community to grow. The profession of tax agent has become less attractive and is attracting fewer entrants. *Australia's Future Tax System* needs to take these issues into account.

3.141 A matter incidental to reducing the number of taxpayers who need to lodge returns is the future of the tax agent industry. During the inquiry, the National Institute of Accountants supported reducing the number of taxpayers required to lodge returns. However, the Institute also suggested that, if this occurred, there should be a structural adjustment package to compensate tax agents for the reduced business.[101]

3.142 The Committee recognises this argument. Successive governments have created the tax agent industry by making their services tax deductible and creating a tax system that requires them. The other view is that tax agents would be well placed to adapt to such a change due to their education and commercial experience.

3.143 On balance, any such structural adjustment would depend on how demand changes for tax agent services, and this depends on how many taxpayers are no longer required to lodge returns. At this stage, it would be sufficient for *Australia's Future Tax System* to recognise this issue.

101 Ord G, transcript, 25 August 2006, pp 12-13.

Recommendation 7

3.144 **In the discussion paper for the review, *Australia's Future Tax System*, Treasury and the review panel include the topic of reducing the number of taxpayers who need to lodge a return, and simplifying the experience for those who need to lodge, in particular:**

- **the costs and benefits of making work related expenses deductible**
- **whether tax offsets, rebates and benefits should be delivered as direct payments, rather than tax measures**
- **examining the number of tax rates and the tax free threshold**
- **improving the coverage and accuracy of the withholding system**
- **whether, if large numbers of taxpayers were no longer required to lodge returns, it would be appropriate to provide structural adjustment assistance to tax agents.**

Harmonising with New Zealand's simpler business tax system

3.145 In evidence, the Taxation Institute of Australia advised the Committee of the different rationales behind the Australian and New Zealand fringe benefits tax systems. In New Zealand, the tax is aimed at the areas likely to generate the most revenue. These include motor vehicles, low interest loans, free or subsidised goods and services, and employer contributions to sickness funds, insurance and superannuation schemes. The Australian approach is to have a global tax and then to make a number of exemptions or 'carve-outs' from this. In practice, the Australian approach is more complicated and imposes more compliance costs.[102]

3.146 A similar outcome occurred with the GST. Australia based its legislation on the New Zealand model but included a much greater number of exceptions. In 2001, the relevant New Zealand legislation totalled 200 pages, but its Australian equivalent ran to 800. This increased volume of legislation increased complexity.[103]

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102 Dirkis M, transcript, 28 July 2006, p 61, New Zealand Inland Revenue, 'Fringe benefit tax on specific categories of benefits' viewed at http://www.ird.govt.nz/fbt/categories/ on 26 May 2008.

103 Stitt R, 'GST and Financial Services,' *Tax Specialist* (2001) vol 4, p 236. The Committee understands that the current GST law is 490 pages long.

3.147 Data on compliance costs suggests that New Zealand has more success than Australia in managing tax complexity. In an OECD comparison of tax systems, the New Zealand authorities overall spent $0.81 to collect $100 of revenue. In Australia, the cost was $1.05.[104] PricewaterhouseCoopers and the World Bank published some compliance indices for national tax systems (a lower score indicating reduced compliance costs). It gave Australia an index of 107 and New Zealand an index of 70 for hours per year compliance time. New Zealand performed significantly better in relation to GST and company tax.[105]

3.148 The Committee believes that there are a number of benefits to examining whether to harmonise aspects of Australia's tax system with New Zealand's. Firstly, there is the potential to reduce compliance costs. Secondly, it will help foster trade between the two countries. Thirdly, it may encourage the development of uniform business taxes in the South Pacific more generally. Although the GST has been excluded from *Australia's Future Tax System*, other taxes could be harmonised with New Zealand's. These points should be raised in the review's discussion paper.

Recommendation 8

3.149 **The discussion paper for the review, *Australia's Future Tax System*, consider the benefits of harmonising with New Zealand's tax system, even if just for particular taxes like fringe benefits tax, or for particular classes of tax.**

3.150 At the very minimum, it should be possible for the Australian and New Zealand Governments to arrange for their Treasuries and tax authorities to exchange staff so that both countries may benefit from each others' experiences in tax law and administration.

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104 OECD, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006)*, October 2006, p 109, viewed on 31 January 2007 at http://www.oecd.org/dataoecd/43/7/37610131.pdf. Generally, care must be exercised in this type of comparison due to the differing functions of national tax authorities. The New Zealand and Australian authorities, however, appear to be sufficiently similar in their operations for this comparison to be useful.

105 PricewaterhouseCoopers, The World Bank, *Paying Taxes: The global picture* (2006) PricewaterhouseCoopers, p 16, viewed on 31 January 2007 at http://www.doingbusiness.org/documents/DB_Paying_Taxes.pdf.

Conclusion

3.151 Among developed economies, Australia's tax system is one of the most complex. This has occurred because each set of interest groups have approached the tax system from their own particular perspective, instead of viewing it as a way of efficiently collecting revenue. Tax advisors have sought to minimise their clients' liabilities and the judiciary have applied established legal definitions from other parts of the law to it. Parliaments have sought to implement spending programs through the tax system and introduced stop-gap approaches as remedial measures.

3.152 While political expediency affects policy decisions, a global perspective would have been more appropriate. The need to take a global view is why many tasks are placed with the public sector. The ATO has responsibility for tax measures that operate in a similar way to the social spending programs that Centrelink is specifically designed to administer. This raises questions of duplication and inefficiency. It has also transferred much of the compliance work to tax agents and taxpayers.

3.153 Another problem with this approach is that Australia has a system of self assessment. Taxpayers accept a certain amount of risk that the ATO may amend their assessments and apply interest and penalties at a later point. A complex system increases the chance of taxpayer error and increases taxpayer risk. The tax system's complexity undermines its own integrity.

3.154 In *An Assessment of Tax*, the JCPA recommended a wide ranging tax review to develop widely agreed policies on tax, which would then form the foundation for tax simplification. Without articulating clear policies, tax simplification is very difficult. The Government's review, *Australia's Future Tax System*, could be the type of review that the JCPA called for in 1993. It could be the most important development in tax simplification.

3.155 Regardless of the outcome of *Australia's Future Tax System*, the tax system will be subject to change in the years ahead. Therefore, the Committee has made a number of recommendations to improve the development of tax policy and legislation. Again following *An Assessment of Tax*, perhaps the most important of these is to improve consultations on specific measures. This includes government consulting before the announcement of the policy intent and increasing the proportion of consultations that are conducted publicly. These changes should help reduce the amount of stop gap measures and help stop the vicious circle of amendment and taxpayer reaction.