CHAPTER 2

PROVISIONAL TAX UPLIFT FACTOR

2.1 The provisional tax uplift factor (PTUF) is the amount by which the previous year's taxable income of an unincorporated business is increased for the purposes of calculating provisional tax in that business's rent year of income.

2.2 It is necessary to bear in mind that the provisional tax uplift factor (PTUF) is essentially a method of bringing forward anticipated tax receipts. It is therefore a timing device and not an impost. The amount of for which provisional tax payers are liable at the end of the day will not affected in dollar terms by the PTUF, regardless of its quantum or form. What will be affected is <u>when</u> that money will be paid.

2.3 The PTUF was introduced in 1980-81 at 7.5 per cent, rose to 12 cent, before being installed in section 221YA(1) of the ITAA at a default rate of 10 percent, subject to Parliamentary discretion. Parliament set the PTUF at 8 per cent for the two previous financial years. The Government is proposing that for 1995196, it will again be 8 per cent.

2.4 Should a provisional taxpayer consider that his/her taxable income not increase by the amount predicated in the PTUF, or that his/her taxable income will decline during the remainder of the forthcoming year, taxpayer has the option of lodging an application to vary provisional If that variation understates actual income by more than 15 per cent, then the onus is on the taxpayer to make a case for a claim as to why that underestimation occurred, otherwise they are subject to penalties.

Rationale

2.5 The rationale for the PTUF is based on the expected average annual growth in income subject to provisional tax over the following !rat years. The joint submission by the Australian Tax Office and the Treasury states in relation to the PTUF that:

> The level of aggregate income that should be subject to provisional tax is difficult to predict with accuracy. For this reason, it is preferable not to place undue emphasis on a specific forecast or estimate in setting the provisional tax uplift factor. Rather the [PTUFI should, on average, over time and across taxpayers, represent a reasonable reflection of the growth in income of provisional taxpayers. The 8 per cent uplift factor for 1994-95 has regard to the expected average annual rate of growth in income subject to provisional tax over the next several years ...

2.6 The Treasury advised the Committee of the factors that were taken into account in formulating the PTUF for 1995-96, as follows:

> It is done on the estimates of income growth for the major items fitting into that category. Affecting that are a range of issues. Inflation is an important one but it is by no means the sole influence. If 1 can look at the three major categories that we have already spoken of [property income (including interest), other business, primary production] 1 can give you some general indications of the factors influencing those.

As it currently stands, income from property and from other business are the two major elements, with primary production accounting for about 10 per cent; **so** the first two categories account for about **45** per cent [each] of total provisional income at the moment.

Within property income, the major element there would be interest and non-dwelling rent income, followed by dividends and rental income. If you think of the components which are influencing that, interest rates and growth in the stock of assets would be the prime determinants of interest receipts there.

For the normal situation, you would have growth in assets which would be more in line with nominal growth in the economy than simply inflation. Interest receipts represent an element of real return relative to inflation so normally interest levels are significantly in excess of inflation as well. If you look at current experience, interest receipts are growing at something like 17 per cent in the year to December - the latest information we have - well in excess of inflation rates.

If we think in terms of the other major category, other business income - this is primarily the receipts that businesses obtain - in general one would think of that again as growing in line with nominal GDP growth adjusted for any movements in real earnings relative to productivity growth. In the year to December, which again is the latest information we have, that sector grew at around a little under eight per cent.

When you think in terms of projected real rates of growth in the economy of around **33/4** per cent and an inflation rate of four per cent, and with real earnings projected to move in line with productivity - so there is no significant shift in wage or profit shares - then the earnings of the other business sector would be expected to approximate nominal income growth significantly in excess of the inflation rate.

In the area you have already mentioned as being a particularly volatile one, the primary production sector, we have had very marked declines in income in the year just coming to an end as a result of the drought. With projections of the drought easing successively over the next couple of years, volume growth should be exceptionally strong. With prices projected to rise somewhat in excess of the general inflation rate, the projected income growth there is particularly large,

So taking these three sectors together, certainly the growth in each of them should be in excess of inflation and the aggregate growth is in line with the uplift factor as suggested.'

Efficacy of the PTUF

2.7 By Treasury's own admission, outcomes have not matched predictions:

If you looked at the actual data, you would find that in a lot of cases their provisional tax uplift factor, compared to what actually happened, varied quite a lot. On that basis, the record is not good .

2.8 Looking at the actual data supplied by the Treasury, it reveals little if any correlation between the PTUF and the actual annual changes in taxable income for all provisional income earners. 3 Table 2.1 displays estimates by the Treasury, based on National Accounts data, about the annual change in income subject to provisional tax compared to the PTUF used for each year. Table 2.2 **SHOWS** the picture when ATO figures, based on taxpayer return data for taxable individuals, are used. When these figures were tested to see how the outcomes (all income subject to provisional tax) fitted the predictions (the PTUFS), it was found that the predictive value of the model used to calculate the **PTUFs** was poor and
was worse than if a constant PTUF had been used for every year.

Table 2.1: Treasury estimates based on National Accounts data.

Types of Income Subject to Provisional Tax (percent annual change)

Year	PTUF	All Income	Property (including interest)	Other Business	Primary Production
1988-89	12%	15.9%	21.8%	12.9%	2.0%
1989-90	10% (a)	10.2%	18.2%	1.4%	2.1%
1990-91	10%	-4.3%	1.6%	-1.25	-45.1%
1991-92	10%	-2.9%	-14.5%	12.4%	23.5%
1992-93	8%	0.9%	-10.8%	14.3%	11.0%
1993-94	8%	5.5%	-0.3%	7.8%	25.5%

Table 2.2: ATO data based on taxpayer return data for taxable individuals.

Types of Income Subject to Provisional Tax (percent annual charge)

Year	PTUF	All Income	Property (including interest)	Other Business	Primary Production
1988-89	12%	25.2%	32.2%	17.7%	16.5%
1989-90	10% (a)	-1.1%	-2.2%	1.1%	-3.7%
1990-91	10%	-11.0%	-6.3%	-6.0%	-59.2%
1991-92	10%	-7.8%	-18.1%	6.8%	-0.1%
1992-93	8%	1.5%	-8.5%	8.6%	44.7%

(a) Uplift factor not used in 1989-90 because the amending legislation lapsed.

2.9 Whichever figures are used, it is apparent that the annual fluctuations in the income of the provisional income tax paying population of over 1.5 million taxpayers are substantial, even when averaged across the entire sector. When the figures are broadly broken down into the income types, these fluctuations are even more pronounced. They would also be reflected at the level of individual small businesses.

2.10 The Committee acknowledges the thoroughness employed by Treasury in attempting to take into account the widest range of relevant considerations when formulating a PTUF, but points out the subjectiveness of the process as evidenced by the need to utilise indicators such as long range weather forecasting:

> With projections of the drought easing successively over the next couple of years, volume growth in the primary production sector should be exceptionally strong .

2.11 The figures in Tables 2.1 and 2.2 demonstrate the underlying premise of continued annual growth in provisional incomes to be simplistic, even on the broadest average. Clearly, even during the limited lumber of years represented in the Tables, there have been one or more bears of growth and one or more years of contraction, both on an aggregate and sectoral basis. *Furthermore, the volatility manifest across and within the provisional income sector casts considerable doubt upon the appropriateness of the averaging process implicit in the PTUF, as currently applied.*

2.12 These doubts are reinforced by the Treasury's exposition of the factors which are taken into account in calculating the PTUF (paragraph 2.6). The provisional taxpaying sector is by no means a uniform group of taxpayers. The only commonality within the sector is that they are unincorporated recipients of business income.

2.13 Treasury pointed out that an 8 per cent PTUF was below the growth in income of a number of provisional taxpayers who:

are not required to vary upwards when their incomes are rising significant

2.14 The recommended remedy for provisional taxpayers whose growth

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in income was expected to be less than 8 per cent was to lodge a request to vary their provisional tax instalments. The Committee received a considerable amount of evidence concerning the usefulness of this facility and has found it to be deficient in its current form.

2.15 Firstly, many provisional taxpayers had fluctuating incomes which were very difficult to predict more than a few weeks ahead, let alone most of a year, if a taxpayer wishes to lodge a variation early in their accounting period. Consequently, as pointed out in a number of submissions and in evidence, many provisional taxpayers would not be in a position to lodge a request to vary until the final quarter of their accounting period because the 15 per cent margin of understatement allowed under the legislation was far too narrow for these taxpayers. As demonstrated in the case study of provisional tax (Chapter 1), this would very likely create considerable hardship for taxpayers who suffer reductions in income, as their provisional tax assessment may be based on what may well be much higher levels of income from a previous year.

2.16 About 12 per cent of provisional taxpayers lodge variations although doing so may necessitate additional accountancy fees. This places an extra burden on a taxpayer who is already likely to be in tighter financial circumstances.

2.17 The ATO, in evidence, stated that a provisional taxpayer who was expecting a growth in income greater than 8 per cent was not required to lodge a variation, although they were technically eligible to do so. It was extremely rare' for a variation to be lodged in these circumstances. There is no obvious logic behind this apparent *laissez fare* attitude, as a provisional taxpayer who did not lodge a request for a variation when they anticipated an upturn in their income, was implicitly understating their income. These taxpayers therefore gained a twofold advantage - firstly, by not incurring accounting costs associated with lodging a variation, and secondly, by deferring tax on the extra income until much later. In contrast, the provisional taxpayer who had lodged a variation because of an expectation of reduced income, may well be placed at a twofold disadvantage: accounting costs associated with lodging a variation, and a penalty if their actual income is understated by more than 15 per cent.

2.18 This is clearly unfair to businesses experiencing declining incomes. However, the Committee does not believe that this should be addressed by requiring variations to be lodged by provisional taxpayers expecting higher than PTUF-average increases in their taxable income. This would simply compound the unfairness as it would extend the narrow requirements involved in lodging variations to all provisional taxpayers.

Consequences of a High PTUF

2.19 As noted by the ATO:

> Provisional tax is generally paid either in a single instalment in the last quarter of the income year, or in quarterly instalments. This compares with PAYE taxpayers who are subject to deductions from their income as it is earned through the year. If the (PTUF) is set too low, this will provide a timing advantage to recipients of income subject to provisional tax compared to PAYE taxpayers and other recipients of income which has tax deducted at the time of receipt. Of course, an uplift factor in any given year will be too high for the individual circumstances of some taxpayers….This is accommodated through the arrangements that allow taxpayers to approach the (ATO) to vary the provisional tax for the year.

2.20 Thus the implications of setting the PTUF too low and consequent loss of revenue is of major concern to the ATO just as the problems associated with it being too high are of major concern to provisional taxpayers.

2.21 However, as the ATO acknowledges:

> The reality is that, at an individual taxpayer level, there will probably be a great number who will be below that average and far fewer who will be in excess of it, as the table points out

2.22 In other words, the rates at which the PTUF have been set since 1991 have resulted in the ATO never having lost any net provisional tax revenue, and in fact considerably exceeding what was required to be remitted in advance by provisional taxpayers in some years (Tables 2.3 and 2.4). Thus the ATO has had a considerable benefit from the PTUF being, on average, too high.

Table 2.3 Cases with provisional credit only that exceeds primary tax.

YEAR	NUMBER OF TAXPAYERS	PRIMARY TAX ASSESSED ($m)	PROVISIONAL TAX ($m)	EXCESS PROVISIONAL CREDIT ($m)
1991	238	1,806	1,165	641
1992	206	1,432	905	530
1993	236	1,670	1061	609

Table 2.4 Cases with provisional credit only that is less than primary tax.

YEAR	NUMBER OF TAXPAYERS	PRIMARY TAX ASSESSED ($m)	PROVISIONAL TAX ($m)	EXCESS PROVISIONAL CRED ($m)
1991	238	1,806	1,165	641
1992	206	1,432	902	530
1993	236	1,670	1061	609

Alternatives to the Current PTUF

2.23 While the Committee accepts the premise that provisional income will vary from year to year, - generally (that is: over multiple, not single years) in the direction of growth, the main problem in adopting this as the standard for calculating the PTUF is in the averaging process. Whatever figure is chosen as an uplift factor, there will always be a large number of businesses with higher income growth, and a large number of businesses with lower income, simply because it is an average. In other words, the aggregated nature of the PTUF coupled with the volatility in the rate of means that only very few provisional taxpayers will ever record a growth in taxable income at the level of the PTUF within the year of income in question. Those recording a growth higher in taxable income than the PTUF forecast will enjoy the advantages conferred on them by a low PTUF, while those taxpayers with a lower than PTUF-anticipated growth in taxable income will incur the disadvantages described above.

2.24 The imposition of a factor which attempts to express an average rise in projected income upon this numerically very large, disparate and volatile section of the business is clearly inappropriate.

2.25 There are a number of alternatives. The first is to abolish the PTUF. While such a measure would undoubtedly be popular with provisional taxpayers, the deferral of over half a billion dollars of revenue would probably rule this out as a likely possibility in the short to medium term

2.26 Another possibility would be to use historical data to extrapolate a growth rate. For example a five or ten year (or even longer) historical rolling average moments in the taxable income of provisional taxpayers is one possibility. While this has the advantage on relying only on actual data, its shortcomings are essentially the same as the current PTUF in that an average is being applied to groups which are characterised by large fluctuations in annual incomes

2.27 The Committee does not support the notion of applying a different PTUF to each part of the provisional taxpaying sector, and endorses Treasury's view that such an approachmight subject many provisional taxpayers to the complications involving the use of two or more PTUF's.

2.28 A constant PTUF could be used every year. As noted above, this would have the advantage of having a better predictive value. Its drawback is that it has all the problems of the current PTUF, and represents no more than an in-principle projection of annual income growth

2.29 One option examined at length by the Committee is to recognise the volatility in the provisional taxpaying sector of the business community and to tailor the uplift fact to this feature. In other words, each provisional taxpayer could have a personalised uplift factor derived directly from information in that taxpayers previous returns. This measure would be more effective in ensuring that parity is established with wage and salary earners as fashioning individually tailored PTUFs would be more consistent with the circumstances of each individual provisional taxpayer.

2.30 An uplift factor derived solely from previous annual changes in taxable income represents an extrapolation which, like the current PTUF, may not correlate with actual movements in taxable income for provisional taxpayers for the year in question. It does, however, have the advantage of expressing some of the circumstances of each and every provisional taxpayer, and is based solely upon easily derived facts and information. Coupled with a reform of the rules governing the lodgement of applications to vary provisional tax, it may represent an alternative structure which could more accurately, and flexibly, bring provisional taxpayers into an equitable regime vis-a vis wage and salary earners.

2.31 This option also addresses the situation with respect to retirees receiving incomes from fixed interest investments and who are subject to provisional tax. As their incomes will generally be more predictable, individually tailored PTUFs will be more likely to reflect the eventual actual rise in their taxable incomes.

Conclusion

2.32 Almost all the submissions and evidence received from the private sector, as well as one of the three submissions received from the public sector, opposed the current level of the PTUF, the most frequently stated reason being that the PTUF was far in excess of inflation. Those that did not advocate its abolition, generally recommended that the PTUF be fixed at either the current or projected inflation rate.

2.33 The Committee supports the inflation-linked approach at this stage. Its main advantage compared to the current approach is that it anticipates a growth rate in incomes subject to provisional tax which is less likely to be higher than the actual growth in incomes of the majority of provisional taxpayers.

Recommendation 2.1:

The Committee recommends that the provisional tax uplift factor be set at a level no higher than the current or projected annual movement in the Consumer Price Index.

2.34 The above recommendation is favoured by the majority of the Committee, that is: by the Coalition and Democrat members. In considering its position in relation to the provisional tax uplift factor, the Committee also considered the possible framework of the alternative discussed in paragraphs 2.29 to 2.31 above. That framework is set out below. The majority members of the Committee believe that the Government should examine this option.

An Alternative - The Individual Uplift Factor

(i) The provisional tax uplift factor be abolished in its current form and replaced by individual provisional tax uplift factors which are calculated by using a five year average based on the movements in the taxable income of each provisional taxpayer for the previous five years, or less if the taxpayer has not been paying provisional tax for that length of time;

(ii) such an uplift factor should be capped at a level to be determined by Parliament;

(iii) either:

(a) two applications to vary provisional tax be allowed annually; or
(b) applications to vary provisional tax should allow a margin of error greater than the current 5 per cent (perhaps 25 per cent) to reflect the volatility of annual changes in the movements in the taxable incomes of the provisional taxpayers; and

(iv) if, and only if, suggestions (i), (ii), and (iii) above are accepted, that provisional taxpayers be required to lodge variations if they
1 reasonably expect that their taxable income will *increase* by an amount greater than the margin allowed as a result of recommendation (iii) above.

2.35 The Government members of the Committee do not support recommendation 2.1 nor the suggested option described above. The views of Government members about the provisional tax uplift factor are set out in the attached minority report.

Penalties

2.36 The Committee does not consider it reasonable for a culpability factor to be added to the penalties which are applied to most small businesses who understate their taxable income when lodging an application to vary provisional tax. Instead, the amount of tax owing as a result of such an understatement should be subject to maximum commercial rates of interest.

Recommendation 2.2:

The Committee recommends that the only penalty for understating taxable income when lodging an application to vary provisional tax be a levy calculated by applying the highest commercial rate of interest to the unpaid tax resulting from understated income.