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Exposure Draft: Treasury Laws Amendment Bill 2024: Denying Deductions for Interest Charges

The Institute of Public Accountants (IPA) welcomes the opportunity to make a submission in relation to the exposure draft legislation titled the *Treasury Laws Amendment Bill 2024: Denying Deductions for Interest Charges* (the ED) and accompanying draft Explanatory Memorandum.

It is the IPA's view that:

- The Government should not proceed with any part of the proposed measure contained in the ED.
- The GIC and SIC were already designed to be punitive even with tax deductibility.
- The practical implications for many businesses (particularly small businesses) and individuals will be harsh and disproportionate.
- There are existing mechanisms available for the Commissioner to address non-compliance and non-payment which are more tailored to taxpayers circumstances.
- The ATO its currently tightening its approach to debt collection and penalty and interest remission — signalling to taxpayers that there will now be more serious consequences for non-compliance.
- As an alternative to the proposed measure, the Government could consider:
    - lowering the business tax debts disclosure threshold from $100,000
    - increasing the uplift percentages for the GIC and SIC
    - focusing on tax law clarification and simplification and educational campaigns to improve compliance at first instance.

Should the Government decide to proceed with the measure:

- The deductibility of GIC and SIC relating to tax debts referable to income years ending before 1 July 2025 should be grandfathered.
- Deductibility should only be denied for the uplift component.

While the below discussion focuses on income tax assessments, similar issues arise in relation to GIC and SIC imposed on other tax liabilities.

The Government should not proceed with the proposed measure

The IPA submit that the Government should not proceed with the entirety of the proposed measure — i.e. the repeal of s. 25-5(1)(c) and 25-5(7) which currently allow the deduction of GIC and SIC as tax-related expenditures as well as the insertion of s. 26-5(1) which will ensure that GIC and SIC is also non-deductible under the penalty non-deductibility provision.

GIC and SIC already include penalty components

The construction of the GIC and SIC already contain components which, on an after-deduction basis, are punitive to the taxpayer significantly above and beyond the imposition of interest at a level which would serve to adequately compensate the government for the prolonged use of taxpayer funds. The fact that some taxpayers may not be able to obtain 'cheaper' finance does not affect this fact.

The quarterly GIC rate (per annum) is calculated as the 90-day Bank Accepted Bill rate (the base interest rate) plus an uplift factor of 7%. The purpose of the base interest rate is to compensate government for the impact of late payments. The uplift factor's role is to make the GIC rate sufficiently high to encourage the payment of tax liabilities when due and discourage the use of tax debts as a source of finance.[1]

The SIC rate is calculated as the base interest rate plus an uplift factor of 3%. The lower uplift rate[2] acknowledges that taxpayers are usually unaware of the shortfall until the ATO issues an amended assessment, so they may not be in a position to avoid the premium built into the GIC to deter using tax debt as a form of finance.[3]

The statutory GIC and SIC rate formulae, including the uplift factors, were drafted to give effect to the policy intents of the respective charges with the tax deductibility of the charges taken into account. To now deny any deductibility after 20+ years would significantly increase the cost to all taxpayers beyond what was originally considered by the government of the day to be an appropriate level of financial impost or deterrent.

The non-deductibility of SIC is particularly harsh given that the charge is imposed in respect of the period during which the taxpayer is generally not aware of their tax shortfall. Further, for the majority of taxpayers who incur SIC due to inadvertent error, the non-deductibility of the charge is unlikely to compel timely compliance with the law any more effectively than methods to improve compliance at first instance such as legislative simplification and clarification and educational campaigns.

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1 Report on Aspects of Income Tax Self Assessment, dated 16 December 2004, chapter 5.1.

2 Applicable in lieu of the GIC for the period before an assessment is amended.

3 ATO, ROSA in brief — shortfall interest charge, January 2007, page 4.

Disproportionate consequences for taxpayers

The proposed measure will disproportionately impact many small business taxpayers which will have to find alternative tax-deductible finance. These businesses will be at the mercy of the market trying to obtain an unsecured loan. Post-pandemic economic conditions have led to increased input costs and reduced discretionary customer spending and business cashflow have suffered as a consequence. The Payday Super initiative which is proposed to commence on 1 July 2016 is another looming cashflow impost which will significantly impact on this sector.

Not all businesses will be able to find such cheaper sources of finance. Further, taxpayers who make inadvertent errors would not be aware of a tax shortfall (other than in a case of deliberate understating of taxable income) until an amendment to an assessment is issued. In such cases, the non-deductibility of the SIC may not have the expected deterrent effect as taxpayers may not be consciously making a decision to incur SIC for financing reasons.

By making SIC non-deductible, the cost of SIC becomes higher for individuals (sole traders which is what most small businesses are) on higher taxable incomes than those on lower taxable incomes. This may seem equitable as those on higher incomes may have higher capacity to obtain better advice and thus a lower propensity to make mistakes. However, two people who earn $100,000 a year but one has a tax exempt stream of income and the other salary and wages, will have two different taxable income amounts, two different marginal tax rates and thus two different costs of SIC.

In relation to this issue the Review of Self Assessment (RoSA) in 2004 stated "in practice, it is not feasible to fine-tune the interest charge to the circumstances of each taxpayer. Further, it is not feasible to apply differential rates to different market segments (such as individuals, very small businesses and other businesses), because the loan benefit within segments can vary widely. Similarly, because tax deductibility is only one factor affecting the impact of shortfall interest on a particular taxpayer, the Review does not recommend altering current arrangements whereby all GIC is tax deductible."

In the ATO's published observations in relation to the small business tax gap for 2020-21, it was noted that 64% of the gap was generated by taxpayers in the shadow economy. Of this cohort, 5% had clearly made deliberate attempts to underpay tax. That is, most of the gap is referable to a minor and specific cohort of taxpayers making SIC non-deductible increases its cost for all taxpayers regardless of whether the taxpayer's behaviour is reprehensible. The ATO has been increasing its educational and compliance campaigns in relation to the shadow economy in recent years. Where those in the shadow economy genuinely do not understand the extent of their tax obligations or are deliberately avoiding the payment of tax, these issues could be addressed by targeted means rather than significantly increasing costs for all Australian taxpayers with an unpaid tax debt.

RoSA considered the argument that SIC should be set at a high rate to encourage a taxpayer to take steps to ensure that they assess correctly and avoid aggressive interpretations of the law. Respondents to the review, and RoSA overwhelmingly rejected this argument.

A high SIC implicitly assumes the worse cause about shortfalls and becomes, in effect, a strict liability quasi-penalty that applies even when reasonable care is taken. RoSA stated that "an

interest charge is ill suited to such a de facto penalty role" and recognised that the existing administrative penalty regime which takes account both the shortfall and the degree of culpability was better suited for that purpose.

Other mechanisms available to encourage compliance and deter late payment

To deter non-compliance generally, and also to specifically address the minority of cases where SIC is incurred as a result of deliberate avoidance of tax or any form of egregious fraud or evasion, the Commissioner already has a range of statutory tools in the various tax regimes including the general anti-avoidance provisions and a range of specific anti-avoidance rules, harsh penalty regimes for taxpayers, promoters and company directors, and the discretion to not remit any imposed penalties, GIC and SIC. There are also pre-emptive measures such as the issue of public and private rulings to provide certainty and general education campaigns.

In the initial announcement of the measure in the 2023-24 MYEFO the Government stated that denying the deductions 'will enhance incentives for all entities to correctly self-assess their tax liabilities and pay on time, and 'level the playing field for individuals and businesses who already [pay on time]'.

The Review of Self Assessment (RoSA) considered this issue in 2004 and rejected the idea of increasing SIC for that purpose on the basis that the penalty regime — which considers whether the taxpayer took reasonable care — was a more appropriate mechanism.

Removing deductibility from SIC will make it a penalty regardless of culpability. The existing administrative penalty regime is a more appropriate mechanism to improve self-assessment and encourage more timely compliance. There is a range of penalty amounts depending on the nature of the transgression — as much as 75% of the shortfall in the case of intentional disregard, and these penalties are non-deductible. The Commissioner also has the discretion to remit the whole or part of the penalty. The penalty system, which allows the Commissioner to apply the appropriate level of penalty for every taxpayer taking into account the taxpayer's individual circumstances, is a more appropriate and fairer mechanism through which to 'level the playing field' than to deny deductibility for interest charges for all taxpayers.

In recent months the ATO has advised the tax agent community that it has tightened its approach to interest remission, as well as taking more affirmative action to collect unpaid tax debts. The Commissioner also recently indicated [4] that the ATO will be looking closely at penalty remissions.

The affirmative action has been tailored to specific taxpayer circumstances rather than a one-size-fits-all approach. Particularly in the small business sector, this is appropriate due to the diversity of the cohort. The ATO's reconsideration of its approaches to debt collection and remissions will signal to taxpayers that there will be more serious consequences for continued non-compliance under existing laws and practices, without the overly harsh denial of deductibility of the interest charges.

Alternative measures to address non-payment of tax debts

4 Address at The Tax Institute's Tax Summit 2024, 12 September 2024.

Lowering the business tax debt disclosure threshold

Taxpayers carrying on a business with tax debts totalling $100,000 or more which have been overdue for more than 90 days, who are not effectively engaging with the ATO in relation to the debt, fall within the declared class of entities whose tax debt information may be disclosed to credit reporting bureaus by taxation officers without triggering the operation of s. 355-25 of Schedule 1 to the *TAA*.[5] This provision sets out a general prohibition on taxation officers disclosing protected information relating to the affairs of a taxpayer.

This measure was legislated in 2019 with the policy intent to 'reduce unfair financial advantage obtained by businesses that do not pay their tax on time' and 'encourage taxpayers to engage with the ATO to manage their tax debts'.[6]

In its initial announcement of the measure in the 2016-17 MYEFO, the former government announced an initial threshold of only $10,000.

The tax debt disclosure measure has been in place and well known to the business community and the initial design of the measure incorporated a threshold which is much lower than the current $100,000. Accordingly, we recommend that — in lieu of the proposed denial of deductions for GIC and SIC — the Government consider a lowering of the threshold to further its objective of encouraging business tax compliance and reducing reliance on so-called 'free loans' in the form of overdue tax debts. In particular, a lower debt threshold would extend the measure to many more taxpayers that are deliberately avoiding their tax obligations for 90 days or more without penalising all taxpayers which may incur SIC and GIC due to inadvertent errors and with immediate effect. It would also increase public transparency of outstanding tax debts which would act as a deterrent to non-payment for businesses which are currently not subject to this disclosure due to the relatively small size of their tax debts.

Non-business individuals

The IPA acknowledges that the tax debt disclosure measure only applies to business taxpayers whereas the proposed denial of interest deductions also extends to non-business individual taxpayers. We note that the ATO already employs an extensive list of strategies to reduce the 'individuals not in business' tax gap.[7] We suggest that instead of the proposed denial of interest deductions, the Government may address the non-payment of tax by considering opportunities for simplifying and clarifying the existing law for this cohort of taxpayers and their tax agents and further resourcing the ATO's education and compliance campaigns. The two largest drivers

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5 Section 6 of the *Taxation Administration (Tax Debt Information Disclosure) Declaration 2019*.

6 Explanatory Memorandum to the *Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Act 2019*, para. 5.27.

7 Detailed in ATO fact sheet titled Individuals not in business income tax gap — ATO action to reduce the gap (QC 56246), dated 25 October 2023.

of the tax gap are overclaimed work-related expenses and undeclared income, particular cash income from the sharing economy. Continuing to focus on addressing these systemic issues by way of legislative improvement (for example, clarifying how the law applies to the sharing economy) and ATO activity would reduce the incorrect tax returns lodged at first instance.

Increasing the uplift percentages

If the Government considers that it is most appropriate to increase the deterrent effect through the imposition of GIC and SIC, the Government could alternatively consider increasing the uplift percentages from 7% and 3% respectively while retaining the deductibility of the charges.

If the Government decides to proceed with the proposed measure

Should the Government choose to proceed with the proposed measure, we recommend the following amendments to the draft legislation:

Grandfathering of deductibility of charges relating to income years ending before 1 July 2025

The non-deductibility of GIC and SIC is proposed to apply in relation to assessments for income years starting on or after 1 July 2025, i.e. SIC and GIC incurred / imposed on or after 1 July 2025.

Should the Government proceed with the proposed measure, we recommend that the non-deductibility should only apply to GIC and SIC incurred in respect of tax liabilities relating to income years starting on or after 1 July 2025, in order to put taxpayers on an equal footing and to create certainty over the financial consequences of non-compliance or non-payment. That is, GIC and SIC raised in respect of debts relating to income years ending on or before 30 June 2025 should be grandfathered.

Other than in cases involving suspected fraud or evasion, individuals and businesses are generally subject to an amendment period of either two or four years from the day on which the Commissioner gives notice of an assessment.

GIC and SIC raised during the first year, i.e. 2025-26, will — for many business taxpayers — be applicable as far back as the 2020-21 year of assessment, i.e. where the corresponding tax shortfall would have been due during 2021-22. Taxpayers — who have not engaged in fraud or evasion — would be subject to not only punitive GIC and SIC charges compounded daily for up to four years, but also the inability to claim a tax deduction for the entire amount. This would also put taxpayers at an unfair disadvantage compared to taxpayers whose tax shortfalls for the same year were assessed prior to 1 July 2025 and who are able to deduct the entirety of the GIC and SIC incurred.

This timing issue arising from the non-grandfathering is compounded in the situation where either:

- the outcome of an objection, review or appeal is unfavourable to the taxpayer — the period of amendment is unlimited and therefore the daily compounding of GIC and SIC may relate to an income year many years in the past; or
- certain particulars of an amended assessment are further amended to the detriment of the taxpayer — this refreshes the amendment period by a further two or four years — potentially up to eight prior years of charges could become non-deductible.

So, a taxpayer incurring GIC and SIC after 1 July 2025 may face daily compounded charges dating back for much longer than two or four years and relating to a year ending prior to the commencement of the measure — all non-deductible.

Denial of deductibility only for the uplift component

As noted above, the interest charges already contain an 'uplift' component — which is effectively a punitive component — over and above the base interest rate to compensate the public for the use of funds.

The IPA submits that, should the Government be determined to proceed with this measure, it considers the viability of altering the measure such that only the uplift component is non-deductible.

If you have any queries or require further information, please don't hesitate to contact Tony Greco, General Manager, Technical Policy, either at tony.greco@publicaccountants.org.au or mobile: 0419 369 038

Yours sincerely

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