IPA GROUP

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Tax Reform
Time to Act

POLICY PAPER

Contents

Policy Paper: Taxation reform – time to act

RECOMMENDATION

1. The Government commit to sensible, well considered, wholesale structural reform of Australia's taxation system.

Tax reform has stalled in Australia, in part because most tax discussions have been the subject of political trench warfare. Partisan arguments over reforms will usually result in no change, unless a government has the necessary numbers in both houses of the Federal Parliament to successfully shepherd through reform without the need for unnecessary compromise.

Tax reform has been a key part of successive government's policy agenda to create a tax system that supports higher economic growth and living standards, improves international competitiveness and adjusts to a changing economy, yet there has been little progress to achieve these stated aims.

The final report of Henry Review into taxation was released in 2010 followed by the *Rethink* paper on tax reform in 2015. Despite these efforts, we have not seen movement on fundamental tax reform, instead we have experienced a piecemeal approach to tax policy. Simply tinkering at the edges to create 'stop gap' solutions will not address the need for fundamental reform. The tax system was already failing to address a changing pre-COVID-19 economy and was seen as holding Australia back in fulfilling its economic potential. It represents one of many important levers that the Government has at its disposal to reinvigorate a much-needed growth agenda.

There has been little progress to achieve these stated aims. In recent years, only a few significant tax and superannuation reforms have passed Parliament, most notably the structural changes to individual tax brackets and rates and the multinational tax package. Most other enacted measures represent tinkering at the edges.

As examples, there has been no attempt to fundamentally improve the longstanding problem areas of the taxation of trusts and Division 7A. There has been no legislative action in relation to a much-needed simplification and clarification of individual tax residency rules, despite the initial announcement in the 2021-22 Federal Budget and a consultation paper being released in September 2023. Successive Governments have not enacted the Board of Taxation's key recommendation in relation to corporate tax residency reform which was adopted in the 2020-21 Federal Budget. Various measures to encourage business investment in assets, technological developments and human capital have generally only been temporary (acknowledging that the Future Made in Australia plan proposes some permanent initiatives and incentives, although they are yet to be legislated).

There is an even greater need to reform our tax system to manage long-term fiscal sustainability and our long-term debt position. Worsening global economic conditions, high inflation, higher interest rate and structural expenditure risks, such as ageing, defence, the NDIS, interest servicing costs on debt and transitioning to a green economy will present fiscal challenges in the years ahead. The 2023 *Intergenerational Report* highlights these pressures on our fiscal sustainability.

Pre-COVID, Australia was in a relatively good position fiscally as compared to many OECD countries, with relatively low government debt and a Commonwealth budget almost back in surplus. As a result of the Government COVID response package introduced to support a slowing economy, our debt level has increased in percentage terms much more than most OECD countries. Australia is the only member of the G20 to have increased debt by more than 200 per cent over a period that includes the dot.com recession, the global financial crisis (GFC) and now the coronavirus recession.

With a significant increase in debt, uncertainty around the long run fiscal sustainability, and the high reliance on personal and company tax at the Commonwealth level and property transactions at the State level, our tax system is ill-equipped to manage the economic challenges ahead.

Around 60 per cent of the Commonwealth's tax receipts come through personal and company income taxes, nearly twice the OECD average. Growth in personal tax revenue is driven mainly from bracket creep. High reliance on personal income tax can introduce risks to the budget. Analysis from the Parliamentary Budget Office projects that personal income tax revenue will increase from 12.2 per cent of GDP (at an average rate of 26.1 per cent) in 2023-24 to 14 per cent (at an average rate of 28.2%) in 2034-35, largely due to bracket creep. This represents a disproportionate burden on personal taxpayers in the years ahead unless corrective action is taken, and the tax base is broadened.

The spike in prices in key export commodities in recent years has provided a temporary lift in company receipts from mining related activities. This situation will reverse at some point as commodity prices have begun to decline and will return to normal levels, putting pressure on personal taxes to carry the load.

The base and rate of our GST will also hamper the Government's ability to maximize revenue from this direct consumption tax. The percentage of consumption on which GST is payable now stands at around 47 per cent due to exemptions on food, education, and health. GST exemptions now disproportionately benefit higher income households. To enable governments to support the economy back to health, requires rebuilding the tax base with efficient growth supporting taxes.

The COVID related slowdown has undermined the ability of governments to raise revenue given the disruption to business and personal incomes and changed consumption and saving behaviour. With additional government expenditure to support the economy, governments will be challenged to reinvent their tax systems without stifling economic growth and will need comprehensive tax reform as part of the forward solution.

An effective taxation system should be premised on achieving:

• fairness: that is 'equity' between taxpayers, with respect to ensuring that taxpayers in similar positions bear tax at the same level, but also that tax is borne at a level commensurate with the taxpayer's ability to pay

• efficiency: that is, the system should not encourage the distortion of economic decisions

• simplicity: the system should be relatively easy to understand and place a low administrative burden on taxpayers.

Australia's current taxation regime has arguably moved away from these ideals and can be described as inefficient, technically complex, and often distortive. A tax system exhibiting the above features usually results in high levels of voluntary compliance. Australia relies on maintaining high levels of voluntary compliance which could wane over time if our tax system is not perceived as 'fair'.

Different layers of federal and state taxes also increase complexity. We are riddled with a vast range of inefficient taxes imposed by the State Governments (and each subject to its own legislative regime and rules). Taxes such as stamp duty and payroll tax are distortive and will often discourage business transactions and wage growth, respectively. It has been well documented that 90 per cent of total tax revenue collected by Australian Governments, was derived from only 10 of the 125 taxes paid by Australians each year. Conversely, 10 per cent of tax revenue was contributed by the remaining 115 taxes.

Sensible, well considered, wholesale structural reform of Australia's taxation system is likely to provide an efficient way to manage Australia's road to fiscal recovery in a post COVID world. The need to rebuild our own economy and the unprecedented expenditure used to fund Government stimulus packages requires a sustainable tax base. This need pre-existed the COVID-19 crisis. It is an opportune time to be bold and unshackle the economy from the restraints imposed by our current tax settings.

The OECD has repeatedly warned Australia that it faces a downgraded outlook for living standards over the next 40 years, without structural reforms to arrest the decline in productivity and deal with budget pressures from an ageing population. Part of the structural reforms recommended by the OECD include an overhaul of the GST, and lower tax concessions.

Australia is not alone in expecting a fall in projected living standards, with most major advanced economies coming under pressure from changing population demographics and poor productivity outcomes.

In the interim before wholesale reform of the taxation system occurs, the following key areas within the existing tax system that require immediate attention.

Payday Super and Superannuation Guarantee penalty regime

RECOMMENDATIONS

2. The proposed start date of 1 July 2026 should be deferred to a later year, at a date decided in consultation with employer communities and the digital service providers, to allow all SG ecosystem shortcomings to be addressed.
3. Employers be given 7 days to make SG contributions to employees' superannuation accounts exclusive of the time it takes for funds to respond or match a contribution to a fund member
4. Introduce an automated onboarding form that imports stapled fund or choice fund elections from the ATO directly into an employer's payroll system.
5. . A fairer and proportionate penalty regime must be introduced to differentiate between infrequent late paying employers and deliberate non-paying employers.

The introduction of the Payday Super (PDS) reform in 2026 will be a significant change to the Superannuation Guarantee (SG) arrangements.

Starting from July 2026 the initiative's aim is to synchronise superannuation contributions with the employer's payroll cycles. One of the other stated aims is to enhance the ATO's capacity to proactively detect instances of unpaid or underpaid superannuation. The reform seeks to lessen the reliance on employee complaints, by proactively identifying discrepancies, and enabling swift intervention and resolution.

PDS represents a significant departure from the existing arrangements where the payment of employees' salaries and wages is separate to the payment of their superannuation entitlements. Over 60 per cent of employers pay their SG contributions quarterly, so PDS will be one of the most significant changes to the superannuation system since compulsory super began.

The existing system has many issues that need to be addressed to avoid them being carried over into the new regime. PDS should not proceed without system improvements addressing the current identified drawbacks, otherwise we will be introducing additional unnecessary complexity into the new regime. The use of SuperStream, clearing houses, super choice/stapling and remittance processes need to be refined and streamlined to support the move to near real time payment of SG.

The proposed policy changes will impact a wide range of legislative provisions, employers' compliance requirements, the onboarding of employees with an employer, payment and reporting systems and processes, services provided by intermediaries (including payroll providers, clearing houses and practitioners), and administration by the ATO . As a result, every aspect of the policy and its impact needs to be carefully considered. Otherwise, there is a high likelihood of significant and unintended consequences that may affect employers' ability to comply with the PDS model. Process improvement of the current systems is required as there is only a small window for error corrections to accommodate the proposed more frequent payment of SG.

More frequent SG contributions will lead to higher costs for employers by way of processing costs and higher transaction and servicing costs. In addition, the cashflow consequences for employers cannot be ignored especially for small and medium businesses. The move to immediate payment may pose challenges during the transitional period where the old and new regimes overlap, and some entities, in particular smaller employers, may collapse under this strain, as the proverbial 'straw that broke the camel's back' syndrome.

The current penalty regime for late payment or underpayment of SG needs to be changed. We consider that the Superannuation Guarantee Charge (SGC) model in its current form is overly complex and punitive. The design of the SGC and the associated penalties deter self-rectification, and they therefore operate as a disincentive for employers to voluntarily report and rectify historical shortfalls. One of our key concerns is the draconian application of penalties — in particular, the Part 7 penalty that applies for failure to provide an SGC statement on time — that do not proportionately reflect the loss to employees, employers' best efforts to pay the correct amount on time, or the 'culpability' of employers who are willingly in arrears. We acknowledge that the proposed PDS regime will include a revised SG charge calculation, and that the charge will become deductible.

Under the proposed new PDS rules, a new 'SG charge payment penalty' — of up to 50 per cent of the unpaid SG charge amount — will be imposed for *non-payment of SG charge within 28 days of assessment*. It is currently unclear as to whether this will replace the Part 7 penalty that currently applies for a *failure to lodge the SGC statement* (as opposed to non-payment for the SG charge) which is up to 200 per cent of the SG charge.

The proposed rules will require that SG contributions are received in the employee's superannuation account within 7 calendar days of payday. We are concerned that this proposed timeframe will be insufficient. We understand — from information supplied to us by the ATO — that superannuation funds will have a maximum of 3 days in which to notify the employer with any concerns after the employer sends the contributions. Once the fund replies to an employer, that employer will have only a maximum of 4 calendar days — which will be less in the case of public holidays and weekends — in which to fix any problems. In the event that a contribution cannot be matched to a fund member, the contribution may be returned to the employer upon the lapse of that 3-day period.

We consider this timeframe to be unfair on employers who use their best endeavours to comply with the law. We note that, as the proposal currently stands, superannuation funds will face no consequences for exceeding their 3-day response time limit and that employers cannot compel a fund to respond within the timeframe.

Many employers currently use superannuation clearing houses which adds further risk of delays and errors outside the employer's control.

The PDS and SGC regimes should not penalise employers for errors and delays of other entities — in particular, superannuation funds and intermediaries such as clearing houses and banks.

Given that the Government is in the relatively early stages of the design process, exposure draft legislation and regulations has not been released. Digital service providers are indicating they need a significant period of time to design, test and rollout their payroll solutions, the proposed start date of 1 July 2025 may require reconsideration.

The Single Touch Payroll (STP) system was initially implemented for large employers. Over several years smaller businesses were progressively required to use STP to report data to the ATO, based on their size. This process was quite successful as it allowed technical issues with the design and operation of the STP system to be sorted out by larger entities who typically have the resources and capabilities to undertake this. Small entities then had access to the knowledge that had been gained during the earlier stage.

The closure of the ATO's Small Business Superannuation Clearing House (SBSCH) exacerbates the impact of the lack of time allowed for small businesses to comply with PDS.

A lot of the issues raised above are contained in a joint bodies' submission, in response to the consultation paper '*Securing Australians' Superannuation*' which includes a lot more detail about the issues that need to be addressed as part of the new PDS regime, and the more recent joint submission to the Treasurer (dated 19 December 2024) in response to the release of the Treasury fact sheet.

Process efficiencies

To improve process efficiency, all known existing issues with the SG administration ecosystem need to be addressed before Pay Day Super is introduced. The proposed implementation timeline allows for careful consideration of all the existing inefficiencies to streamline processes under the new PDS regime. The proposed change to a PDS model is complex and its successful implementation depends on a multitude of factors. We trust that the detail included in the joint bodies' submission to the Securing Australians' Superannuation' consultation paper, while drafted prior to the release of the Treasury's PDS fact sheet, will also assist the Government and relevant government agencies to better understand the underlying issues and design the system to best achieve the underlying policy intent while being simpler, more efficient and equitable.

The 7-day timeframe

The PDS 7-day timeframe be reconsidered to make it fair and achievable for employers to meet their obligations. The following are two potential solutions:

- Employers be given 7 days to make SG contributions to employees' superannuation accounts exclusive of the time it takes for funds to respond or match a contribution to a fund member; or
- Under the SuperStream system, employers currently send contributions and relevant data concurrently to superannuation funds. This process could be changed by requiring employers to send contribution data to superannuation funds on payday and superannuation funds to respond within 24 hours requesting corrections or clarifications. Once a superannuation fund and an employer agree that all information and records are correct, then employers would be required to make payment of the contributions by the end of the next business day from that time. Any delay beyond the point at which the payment leaves the employer's bank account until the contributions are received by the superannuation fund should not expose employers to an SGC liability for a situation over which they have no control.

To have a reasonable opportunity of complying with the deadlines, employers will need access to data confirming contributions. The Mid-Year Economic and Fiscal Outlook 2024–25 allocated considerable resources for ATO system development so that it will have 'near real-time visibility as to whether employers have met their obligations'. Employers also need access to this data. We ask that this policy be expanded so that this employer reporting system operates effectively and transparently from the commencement of PDS.

Current experience suggests that the cause of the vast majority of unsuccessful superannuation contributions is incorrect data submitted by employers with a contribution. This could be further prevented by the implementation of one or both of the following recommendations:

- an automated onboarding form that imports stapled fund or choice fund elections from the ATO directly into an employer's payroll system; and/or
- a new SuperStream message type that is able to be used at any time by employers to verify details of an employee's superannuation fund prior to making contributions.

Penalties

Late payment penalties under the existing penalty regime for failure to make SG payments on time need to be revised. PDS represents an overdue opportunity to completely redesign the SG penalty regime, to make it simplified and less punitive for employers trying to do the right thing. It must deter bad behaviour, whilst encouraging employers to quickly identify and fix errors. A fairer and proportionate penalty regime must be introduced to differentiate between infrequent late paying employers and deliberate non-paying employers.

With the introduction of the proposed new SG charge payment penalty, the existing Part 7 penalty should be abolished, with the consequences for failure to lodge the SGC statement incorporated into the proposed SG charge payment penalty. Alternatively, the Part 7 penalty could be replaced with a penalty that more closely reflects the failure to lodge penalty regime which currently applies to non-lodgement of other statements e.g. tax returns and activity statements.

Compliance and cashflow

The proposed start date of 1 July 2026 should be deferred to a later year, at a date decided in consultation with employer communities and the digital service providers

The compliance and cashflow impacts on small and medium businesses warrant consideration of a staggered implementation timetable similar to what was used when single touch payroll (STP) was introduced. The implications on small and medium business entities are not insignificant moving to a PDS model for SG contributions. Amending the 7-day timeframe, as proposed above, would also provide more time for unforeseen issues to be ironed out prior to implementation for all other employers.

As with the introduction STP, a very small number of (mostly) micro-employers may not be able to comply with any new SG payment requirements, be impacted by exceptional or unforeseen circumstances as outlined in PS LA 2011/15 or run their business in an area with no internet service. In these cases, the ATO should be able to administratively exempt these employers, on a case-by-case basis.

Retain-deductibility of GIC and SIC

RECOMMENDATIONS

6. Retain the deductibility of the GIC and SIC by amending the Treasury Laws Amendment (Tax Incentives and Integrity) Bill 2024 to remove Schedule 2.
7. Address the non-payment of tax debts by:
   - Lowering the business tax disclosure threshold; or
   - Increasing the uplift percentages

Schedule 2 to the *Treasury Laws Amendment (Tax Incentives and Integrity) Bill 2024* (the Bill) proposes amendments to deny tax deductions for the general interest charge (GIC) and shortfall interest charge (SIC) from 1 July 2025.

The argument for making SIC and GIC non-deductible is that it increases the cost of tax debt thus, encouraging the likelihood of tax being paid on time and/or increase incentives for all entities to correctly self-assess their tax liabilities. However, it is unlikely that increasing the cost of SIC will impact an entity's ability to correctly self-assess their tax liability and the current after-tax cost of GIC means that many taxpayers already have a strong incentive to pay tax on time. Making SIC and GIC non-deductible will inappropriately increase compliance costs of honest taxpayers. It will also disproportionally impact small businesses who owe $35.2B (or 67 per cent) of collectable tax debt.

The policy intent of both SIC and GIC was comprehensively considered in the Review of Self Assessment (RoSA) – which stated that it did not recommend making GIC non-deductible. The intent of the interest charges is to neutralise the loan benefit that a taxpayer receives due to the late payment of tax. It is meant to put a taxpayer who is late paying tax in the same position as a taxpayer who has paid tax on time. Making SIC and GIC non-deductible increases their impact beyond the neutralisation of the loan benefit. The extra amounts payable due to denial of a tax deduction could be viewed as a penalty which is imposed regardless of the culpability of the taxpayer. RoSA noted that:

GIC is designed to encourage the payment of tax but that the uplift factor is not intended to reflect a financing risk premium, nor to serve as a penalty – noting that GIC is already at an amount that is significantly higher than commercial interest rates available to many taxpayers; and in relation to SIC, taxpayers are unaware of their shortfall debts and the objective of the SIC should be to neutralise loan benefits.

Making SIC non-deductible results in it having a penalty component that is applicable to taxpayers who have made an honest mistake as well as those who have been reckless or deliberately fraudulent. This is not appropriate. RoSA concluded that an interest charge is ill suited to a de facto penalty role.

While taxpayers are able to apply for remission of SIC and GIC, this creates an extra administrative burden who has been trying to comply with the law rather than penalising wrongdoers by using the existing penalty provisions. Increasing the cost of SIC and GIC also creates extra incentive to apply for remission which increases the administrative cost to the ATO.

In retaining the deductibility of SIC and GIC, there are alternative measures which could be taken to address the non-payment of tax debts:

Lowering the business tax debt disclosure threshold

Businesses with tax debts totaling $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, may have their debts disclosed to credit reporting bureaus. The former government originally designed this measure with a much lower threshold of only $10,000 (2016-17 MYEFO).

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. 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. It would also act as a deterrent to non-payment for businesses with smaller tax debts which are currently not subject to this disclosure.

Increasing the uplift percentages

If the Government desires to increase the deterrent effect of GIC and SIC, it could consider increasing the uplift percentages from 7 per cent and 3 per cent respectively while retaining the deductibility of the charges.

Permanent increase in the SBE instant asset write-off threshold

RECOMMENDATION

8. The instant asset write-off threshold be permanently increased to $30,000 with effect from 2024-25.

The permanent instant asset write-off threshold for SBEs with annual aggregated turnover of less than $10 million is $1,000 (s.328-180 of the ITAA 1997).

However, in order to stimulate business investment, the former and current Governments legislated various higher *temporary* thresholds ($20,000, $25,000, $30,000 or $150,000) between 12 May 2015 and 30 June 2024, including removing the threshold entirely from 2020-21 to 2022-23.

Relevantly, these temporary higher thresholds were legislated by way of amendments to the *Income Tax (Transitional Provisions) Act 1997*, with no amendment to the permanent threshold in the ITAA 1997. From 1 July 2024 the threshold reverts to $1,000 (subject to enactment of yet another temporary threshold).

While the immediate tax relief and encouragement to invest delivered by the increases to the threshold were welcomed by the small business community, the constant threshold changes were often marred by uncertainty about the threshold that may apply for the year ahead and sometimes last-minute legislative change, which has made forward planning and budgeting difficult.

The uncapped write-off was legislated to cease on 30 June 2022 and it was extended for a further year. Taxpayers were then subject to a reversion to the $1,000 threshold for 2023-24 — until 28 June 2024 when the measure to temporarily increase the threshold to $20,000 for that year received Royal Assent. It took many months to receive passage through Parliament as the Opposition wanted to expand the measure.

This political disagreement is still ongoing – the failure of the Opposition to support the amending the permanent threshold to $30,000 has resulted in the Senate removing the Schedule introducing another one-year extension of the $20,000 threshold until 30 June 2025 from the enabling legislation in late November 2024. With the federal election slated to occur before financial year end and limited sitting days before the Government enters into caretaker mode, once again small businesses will not have certainty about the tax implications of their capital investment until late in the financial year – if not after.

The threshold has not been at the legislated $1,000 for nine consecutive years — and potentially 10 if Parliament passes legislating enabling either the Government or Opposition's proposed threshold for 2024-25. Over this decade, the cost of fixed assets and the general cost of doing business has increased substantially. A $1,000 cost threshold — including second element costs — for concessional taxation treatment does not hold the same value to businesses that it did a decade ago.

We recommend that the threshold should be permanently increased — by way of amending the ITAA 1997 — to $30,000 with effect from 2024-25. The bringing forward of capital allowances deductions will bring meaningful cash flow relief to small businesses close to the time that they make the substantial funding investment. This will free up cash to reinvest in the sooner rather than later.

While businesses should not make asset investment decisions for tax reasons, they should be able to enter into costly purchases of long-term assets with certainty in relation to the tax treatment and cash flow implications. The recent uncertainty and 11th-hour enactment of temporary thresholds needs to cease. A permanent increased threshold should be legislated so that businesses can plan their investments and cash flow for the years ahead.

Reinstating the small business technology boost and small business energy incentive

RECOMMENDATION

9. We recommend that both the small business technology boost and the small business energy incentive are reinstated.

The small business technology boost provided businesses with an annual turnover of less than $50 million with a bonus 20 per cent deduction for costs incurred to digitalise operations between 7.30 pm AEDT on 29 March 2022 and 30 June 2023. The same businesses were also eligible for a bonus 20 per cent deduction under the small business energy incentive for eligible capital expenditures to improve energy efficiency incurred in 2023-24.

The technology boost incentivises businesses to bring forward capital investments which will enhance their digital capabilities, which provides long-term benefits by improving business efficiencies and opening up new revenue generation opportunities. The energy incentive encourages businesses to prioritise investing in energy efficient assets and ceasing to use inefficient technology which is in line with the Government's broader Future Made in Australia plan, and which would decrease businesses' energy costs in the long run.

Proposed Division 296 tax

RECOMMENDATION

10. The proposed Division 296 measure does not proceed. At a minimum, amendments are made so that:
    - only capital gains which have been realised are subject to taxation; and
    - the threshold be subject to periodic indexation.

The proposed 'Division 296' tax in the *Treasury Laws Amendment (Better Targeted Superannuation Concessions and Other Measures) Bill 2023* is potentially unworkable, particularly:

- the taxation of unrealised gains on fund assets; and
- the lack of indexation of the $3 million threshold.

Subjecting unrealised gains to taxation creates a dangerous precedent. Under Australia's CGT regime, increases in capital value are only taxed once realised — generally upon sale. Exceptions apply to impose tax liability on notional gains only for the prevention of tax mischief — for example certain transfers of ownership for consideration less than market value — but generally a transfer of ownership is required. There is no precedent for taxing unrealised gains where there has been no change in legal or beneficial ownership and no transaction which could be seen to lead to underpayment of tax.

Under the proposed rules, the taxpayer's taxable superannuation earnings for an income year are calculated as the excess of their total superannuation balance as at the end of the income year over the legislated threshold ($3 million). That is, the liability is dependent on point-in-time values. There is no averaging mechanism to take account of market movements during the year. Investments of the superannuation fund may be volatile in the short term, particular for taxpayers who choose an aggressive investment strategy. The taxpayer's total superannuation balance as at 30 June each year may be much higher than the balance that represents the rest of the income year due to short-term market movements.

The tax is proposed to be payable by the individual. Where the taxpayer has insufficient cash, they may be forced to sell assets quickly to pay the Div 296 tax liability. If they do not hold sufficient liquid assets, then they may be forced to sell assets such as their family home or business assets. Alternatively, they may withdraw amounts from their superannuation fund which would be contrary and detrimental to the taxpayer's lawful efforts to save for retirement through superannuation. The taxpayer may also be forced to sell personal or fund assets at a time of depressed market values in order to satisfy the tax payment deadline.

More broadly, this taxation of unrealised gains may disincentivise individuals from directing savings into superannuation, at a time that the Government should encourage Australians to prepare to self-fund their retirement. Additional tax should only be levied on gains which have been realised, i.e. are already included in the superannuation fund's assessable income.

In addition, the lack of indexation of the $3 million threshold will also deter people, particular younger cohorts, from investing in superannuation, as superannuation balances grow. The Reserve Bank of Australia's online inflation calculator shows that a basket of goods and services worth $3 million in 2023-24 was worth around $1.75 million 20 years ago in 2003-04 — a total change of around 71.4 per cent. While the inflation for the next 20 years cannot be foreseen, it is conceivable that a 40-year-old today may similarly find that $1.75 million now will hit the $3 million threshold when they are 60. If $3 million in today's dollars has been determined to be the optimal threshold to meet policy objectives, then the threshold should be indexed so that taxpayers saving for retirement are not unduly disincentivised and subject to additional tax.

Non-arm's length expense rules for specific expenses

RECOMMENDATION

11. ITAA 1997 be amended such that the amount of NALI that arises in respect of an asset in relation to which a non-arm's length specific expense has been incurred is capped at an amount that is proportionate to the mischief and which broadly mirrors the treatment of non-arm's length general expenses.

Retrospective amendments to s.295-550 of the ITAA 1997 ensures that, from 2018-19, non-arm's length income (NALI) of a small complying superannuation fund — including SMSFs — that arises from a non-arm's length *general expense* will be calculated based on the 'twice the difference' approach. Under this approach the NALI amount is effectively capped to twice the difference of the amount actually incurred and the amount that the fund might have expected to incur if the parties had been dealing at arm's length.

However there has been no equivalent change in respect of non-arm's length *specific expenses* that relates to a particular asset. As a result, all assessable income prospectively derived in respect of that asset may potentially be treated as NALI. This may extend to a capital gain derived by the fund on the eventual disposal of the asset (see Example 1 of LCR 2021/2DC). As the law currently stands, a mere $100 of specific expenses could potentially result in the entirety of a capital gain of tens or hundreds of thousands of dollars being treated as NALI. We acknowledge that, in the ATO's view, whether a capital gain is treated as NALI will depend on the nature of the expenditure.

Tax Advisory Board – enhancing accountability and governance

RECOMMENDATION

12. An Australian Tax System Advisory Board be created as recommended by the Henry Tax Review.

Former Treasury Secretary, Dr Ken Henry's Tax review in 2009, highlighted that some improvements could be made to the ATO's governance and accountability, and hence Henry's review recommended an Australian Taxation Advisory Board. In August 2010, the Gillard Government announced that it would establish a Tax System Advisory Board that would advise the Tax Commissioner and the ATO Executive Committee on strategy, direction, culture, organisation, management, compliance planning, staff profile and information technology plans at the ATO, as well as provide a new, direct and in-built voice for business and taxpayer communities in relation to ATO decision making and culture.

After much consultation with the Australian community, a Tax System Advisory Board Consultation Panel released a report in June 2011 to the Gillard Government, in which it provided nine recommendations, one of which was, to establish an advisory board.

The IPA commissioned Deakin University as part of its SME Research Centre to review governance and accountability of similar taxation authorities in the international context.

The research concluded that the governance and accountability of the Australian tax system can be significantly improved by adopting a Tax System Advisory Board. Australia already has an established 'blueprint' for the creation of such an Advisory Board, which was recommended in June 2011, with widespread community support, and which would make adoption of such a board seamless, less costly and less time constrained. Furthermore, several countries (i.e., Canada, Finland, Sweden, UK, USA) have created either 'management boards' or 'advisory boards' that are interposed between the revenue body such as the ATO and the relevant minister such as the Federal Treasurer, to provide a degree of independent advice on the plans and operations of the revenue body and tax administration arrangements in general. Whilst the specific functions of these boards vary between countries, all execute an oversight function and appear to play roles in strategy development, planning and sign-off of formal business plans. Without exception, board members are not involved in issues concerning the tax affairs of individual taxpayers and do not have access to specific taxpayer information. Accordingly, creation of an Australian Tax System Advisory Board would not only improve the oversight and strategic functioning of the ATO, but it would significantly improve the transparency and adherence to the *Taxpayer Charter* which has been recently renamed '*Our Charter*' and make the operations of the ATO more accountable.

The governance and accountability of the Australian tax system can be significantly improved by adopting a Tax Advisory Board. We recommend the creation of a similar Australian Tax System Advisory Board as recommended by the Henry review and the Tax System Advisory Board Consultation respectively.

Reform of individual residency rules

RECOMMENDATION

13. The Government proceed with 'Modernising individual tax residency' in line with the Board of Taxation recommendations

The Australian tax residency rules for individuals, in their present form, have long caused taxpayers to face a heavy compliance burden. This is due to the inherent complexity of the residency tests in Australia's domestic tax law, which demand an analysis that is highly subjective and factual, and where the legal principles are far from clear, and constantly litigated.

This presents considerable difficulties in the context of our self-assessment tax system. Our members tell us that many individuals cannot plan their affairs or manage their tax compliance with certainty. Advisors face significant risk when advising on the residency tests and many will recommend to their clients that they obtain (at significant cost and delay) the assurance of a private binding ruling from the Commissioner of Taxation (Commissioner).

The case for change is strong. The current Australian tax residency rules for individuals can be fairly described as outdated and incompatible with the modern world, where increased global mobility, advances in technology and evolving economic and social norms, have dramatically changed the way that individuals live and work: the world is a very different and much smaller place today than what it was at the time the rules were first introduced some eighty years ago.

In 2019 the Board of Taxation (Board) released its final report *Individual Tax Residency Rules – a model for modernisation* (the 2019 report) to the former Government. The 2019 report made 22 recommendations, the principal recommendation being to replace the income tax residency rules for individuals with the Board's proposed model. On 11 May 2021, the former Government announced that it would replace the individual tax residency rules with a new, modernised framework, based on the model recommended by the Board in its 2019 report. During September 2023, the current Government released the consultation paper titled '*Modernising individual tax residency Rules*' based on recommendations made by the Board to seek community feedback on the proposed development of robust principles that will underpin an enduring framework for an individual tax residency framework. Since then, there has been no exposure draft legislation or further detail on the Government's plan for legislative reform.

The IPA strongly supports the proposal to reform and modernise Australia's individual tax residency rules as contained in the consultation paper. Overall, we consider the Board's proposed reforms to the Australian residency tests for individuals to be positive and superior to the rules which currently apply.

We welcome the focus on greater objectivity in the application of the tests, which we consider will lower the compliance burden for taxpayers when seeking to obtain certainty about their residency position in Australia. By anchoring the rules to matters that can be objectively ascertained, such as physical presence in Australia, taxpayers and their advisors will be better placed to self-assess how the rules will apply to them and their circumstances. Taxpayers will have a more solid basis upon which to structure their affairs and comply with their Australian tax obligations with a greater degree of certainty. We anticipate this will achieve compliance efficiency and should reduce the need, and consequently the cost, for taxpayers to seek administrative assurance in the form of a Private Binding Ruling from the Commissioner. It should also reduce the risk that taxpayers will find themselves in dispute with the Commissioner, which often culminates in litigation.

However, we believe there is considerable scope to reconsider and recalibrate aspects of the proposed rules, to ensure the rules better reflect and respond to the practical circumstances that will be encountered by the majority of taxpayers.

Importantly, we consider there is scope to introduce some flexibility and discretion in the rules, aimed at reducing the risk of the rules producing an outcome that is unjust or unreasonable, without diluting the certainty or objectivity of the rules to a substantial degree for the majority of taxpayers.

One aspect of the reforms which the Board has proposed, which is of greatest concern to our members, is the '45-day requirement' in the secondary commencing residency test.

We consider that a period of 45 days would likely result in a greater number of individuals being considered Australian residents. This is contrary to Treasury's statement in the consultation paper that the proposed model is not intended to capture more individuals as tax residents or raise any additional revenue. This also does not accord with the principle of adhesive residency, which provides that it should be harder to cease, than to become an Australian tax resident.

The 45-day requirement would also increase overall compliance costs, which detracts from the certainty and simplicity sought to be achieved with the proposed model, as any individual present in Australia for 45 days or more in a year would need to consider whether they are a resident under the secondary test, and then consider the application of any relevant international tax treaties.

Based on the feedback we have received from our members, a period of 45 days may stifle inbound economic activity, whereas a period of 90 days would be better aligned with practical experience and circumstances of most taxpayers and will provide greater certainty and a reduced compliance burden for a majority of taxpayers. The consultation paper suggests that the 45-day requirement has an anti-avoidance purpose which is aimed at preventing taxpayers manipulating the rules to obtain an unfair or unintended tax benefit. Respectfully, if that is the policy objective, it can be better achieved by specific and targeted anti-avoidance provisions, which target those taxpayers who look to manipulate the rules, without placing an undue compliance burden on the vast majority of taxpayers who are focused on compliance and desire certainty. Lastly, the interaction of our domestic residency rules with outcomes for countries with which we have double tax agreements, should be within scope, as part of future reforms.

We recommend the Government proceed with 'Modernising individual tax residency' in line with the Board of Taxation recommendations. There are aspects of the Board's recommendations that could be recalibrated, to ensure the rules better reflect and respond to the practical circumstances that will be encountered by the majority of taxpayers. Our submission to the consultation paper titled 'Modernising individual tax residency' released by the Government based on the Board's recommendations provides further detail of our recommendations for consideration.

Reform of corporate tax residency rules

RECOMMENDATIONS

14. The Government announce whether it intends to proceed with the 2020-21 Budget measure.
15. The definition of residency for corporate tax entities should be reformed to remove ambiguity and provide certainty for foreign incorporated corporate taxpayers.

Under the current law, a company is a resident of Australia if it is either:

- incorporated in Australia; or
- carries on business in Australia and either:
- its central management and control (CM&C) are in Australia; or
- its voting power is controlled by Australian residents.

In particular, the CM&C test has been a source of confusion for taxpayers and their advisers. The High Court's 2016 decision in *Bywater Investments Ltd v FCT* [2016] HCA 45 displaced the ATO's previous administrative approach that the exercise of CM&C in Australia cannot on its own satisfy the 'carry on business in Australia' part of the test. In 2018 the ATO amended its administrative guidance in response to *Bywater*.

Subsequently, the former Treasurer commissioned a Board of Taxation review of the corporate tax residency rules. As a result, the former Government adopted the Board's key recommendation in its 2020-21 Budget and announced that it intended to amend the law to clarify the corporate residency test by providing that a company that is incorporated offshore will be treated as a resident if it has a 'significant economic connection to Australia' — a test which would be satisfied where both the company's core commercial activities are undertaken in Australia *and* its CM&C is in Australia.

There has since been a change of government and there has been no progress in relation to corporate tax residency.

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Taxation of trusts

RECOMMENDATIONS

16. A review of the taxation of trusts be conducted as a priority
17. S100A of the ITAA 1936 amended to provide more certainty around what mischief it is targeting, particularly in regard to its application around family trusts.

Trusts are commonly used for holding investments however, Australia is unique in that the use of family trusts as a preferred business structure for small and medium businesses is quite prevalent (there are over 1 million trusts in existence and the majority are discretionary trusts commonly referred to as family trusts).

Despite their popularity, the current taxation of trust regime is overly complex and becoming a compliance burden for taxpayers. It is an antiquated model of trust taxation which is ill equipped to deal with the current commercial environment. There have been many trust law decisions (*Bamford, Carters and Greensill* to name a few) over the last fifteen years, adding more layers to the existing administrative burden or exposing their complexity. In addition, there have been significant changes to some ATO rulings (Unpaid Present Entitlements (UPE's), S100A) relating to trusts. In the absence of an appetite for broad trust tax reform, we need to stem the administrative burden placed on trustees and their advisers. A lot of the small and medium businesses using these structures are not aware of the complex administrative issues associated with their use and are unwilling to pay for specialist services to help them navigate these risks.

Section 100A was a recent example of the complexities around trust administration. Until recently it was a less-known section of the *Income Tax Assessment Act 1936* (ITAA 36). Section 100A essentially targets discretionary trusts. Parliament drafted S100A broadly so that it is pliable and adaptable; only expressly circumscribed by the 'ordinary family or commercial dealing' [s100A(13)] and 'tax reduction purpose' [s100A(8)] conditions. There have been just a handful of cases providing judicial interpretation (six cases in 43 years), most dealing with artificial arrangements, so there has not been much application of its broad potential. The Tribunal decision in Bendel v FCT [2023] AATA 3074 (under appeal) that an UPE owed from a trust to a corporate beneficiary did not satisfy the definition of a loan under s. 109D(3) has caused more uncertainty, being in contrast to the established ATO view. Section 100A is a critical issue in the privately held business and family wealth markets.

One of the permitted exceptions, 'ordinary family or commercial dealing' has historically been broadly interpreted by many to exclude many family discretionary trust situations. The ATO has now adopted a narrow interpretation of when the ordinary family or commercial dealing extension can apply, and by default, broadened the potential scope of S100A, exposing many trusts to potential scrutiny.

The rising compliance burden on small and medium businesses using trusts needs to be addressed. A review of the taxation of trusts is overdue and some balance between upholding the integrity of the existing regime, whilst minimising the compliance burden is urgently needed. Even the ATO is challenged in trying to administer the taxation of trusts and the ongoing changes to case law impacting trusts. The ATO has a dedicated page on its website on the current challenges, *Current issues with trusts and the tax system* | Australian Taxation Office (ato.gov.au).

Given the broad application of S100A and its recent interpretation by the ATO, pursuant to the Full Federal Court handing down its judgment in the Bendel appeal, the provision should be redrafted to provide more certainty around what mischief it is targeting, particularly in regard to its application around family trusts. The updated ATO guidance does not cover all scenarios, so there is added risk of whether such arrangements will be acceptable to the ATO in the event of an audit.

Division 7A: reduce uncertainty around future changes

RECOMMENDATION

18. We recommend that further consultation be undertaken to revisit ways to minimise the operation of Division 7A to businesses that use corporate profits to fund business activities.

The Government has acknowledged that Division 7A needs urgent reform. The previous Government announced in the 2017 federal Budget that amendments would be made to Division 7A incorporating recommendations from the 2014 Board of Taxation's final report on the '*Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936*' (BOT report). The start date was to have been 1 July 2018, although the previous Government deferred the start date again to 1 July 2020. The latest update from the previous Government on Division 7A was on 30 June 2020 announcing that the start date on amendments will now apply from income years commencing on or after the date of Royal Assent of the enabling legislation. The current Government has not progressed the amendments.

Treasury released a consultation paper in September 2018, to seek stakeholder views on proposed amendments to Division 7A. The consultation paper draws on but includes significant departures from the recommendations in the BOT report. If legislated in its current form, there is potential for a substantial increase in compliance costs and tax payable by business entities using trusts for business purposes.

Some key elements of the proposed new regime outlined in the consultation paper include:

- New "simplified" single ten-year loans with interest charged at the Reserve Bank overdraft rate for small business (which is much higher than the current Division 7A rate).
- Not adopting the amortisation model with principal repayments at the 3, 5, 8 and 10 years as recommended by the BOT report and instead requiring annual interest and principal payments.
- Regardless of when a repayment occurs during the income year, interest will be for the full year.
- The transitioning of both 7- and 25-year loans under Division 7A into the new regime. The BOT report had recommended grandfathering (preserving) 25-year loans under the existing arrangements.
- Both existing 7- and 25-year loans will be subject to the new higher overdraft interest rate.
- Existing 7-year loans will keep their current outstanding term when transitioned into the new regime, but existing 25-year loans must be put on new 10-year complying loan arrangements prior to the lodgement day of the company tax return for the 2021 income year.
- The removal of the concept of distributable surplus such that there is no limit to the amount that may trigger a deemed dividend under Division 7A.
- The extension of the review period for Division 7A to 14 years after the end of the income year in which the loan, payment, or debt forgiveness are triggered, or would have triggered, a deemed dividend.

Both pre-4 December 1997 loans (with the benefit of a two-year grace period) and Unpaid Present Entitlements (UPEs) arising on or after 16 December 2009 must be put on new complying ten-year loans. The proposal does not specifically address pre-16 December 2009 UPEs.

The BOT report's recommendation for a once-and-for-all election to exclude loans from companies (including UPEs owing to companies) from the operation of Division 7A (the 'business income election') is not included in the proposed amendments. The consultation paper has taken a selective approach, removing the ability to choose to be excluded from the Division 7A regime, while introducing many of the integrity aspects. Some aspects of the recommendations from the Treasury consultation paper are of a concern such as the removal of the concept of distributable surplus.

We acknowledge that a workable solution will be challenging but the passage of time has exacerbated the situation and has created an enormous amount of uncertainty. Division 7A and UPEs are back in the spotlight following the AAT decision in Bendel which decided that an UPE between a corporate beneficiary and trust did not constitute a 'loan' under s109D(3) ITAA 1936. The Bendel decision challenges the ATO's views in TD 2022/11 and TR 2010/3 before that, which treats these UPEs as loans for the purposes of Division 7A. The Commissioner has appealed this decision to the Federal Court. We recommend that further consultation be undertaken to revisit ways to minimise the operation of Division 7A to businesses that use corporate profits to fund business activities. The BOT report includes a number of recommendations designed to ease the compliance burden associated with the rules that govern distributions from private companies and to lower the cost of working capital for private businesses. This is a good starting point, and we welcome further consultation on the reform of Division 7A.

Black Economy Taskforce

RECOMMENDATION

19. Continue the prioritisation of the outstanding recommendations of the Black Economy Taskforce to maintain momentum in the reform agenda.

The Black Economy Taskforce was a genuinely whole-of-government undertaking, bringing together 20 Commonwealth agencies. The Taskforce report was tabled in 2018 and had 75 recommendations most of which have been supported by the Government. Whilst the Government has made good progress in implementing some of the recommendations, we believe a new sense of urgency is required by policymakers to maintain momentum to protect the integrity of our tax system. Some of the recommendations which the Government has started scoping and require continual prioritisation to fast track their implementation are:

- ABN reforms to strengthen business identity
- extension of taxable payments reporting to other high risk sectors (partially legislated);
- introduction of a cash limit of $10,000; and
- sharing economy reporting regime (now legislated).

We recommend the continual prioritisation of outstanding recommendations included in the Black Economy Taskforce report to maintain the reform agenda to protect the integrity of our tax system. Whilst we understand that these reforms require significant planning and consultation, they are critical to addressing systemic weaknesses in our tax system. The ATO's data on tax gaps indicates there is still more that needs to be done to limit the size of the black economy to a level acceptable to the community.

Fringe Benefits Tax

RECOMMENDATION

20. The FBT system is reviewed and reformed as a matter of urgency.

The IPA supports substantial reform of the FBT system. FBT is highly inefficient and administratively cumbersome. The complexity of the FBT system applies to all small and medium business employer groups, including the not-for-profit sector. There are many entities trying to navigate a quagmire of rules to safely negotiate ways to comply. Whilst it comprises less than 1 per cent of Australia's total annual revenue collections, FBT imposes a significantly disproportionate compliance cost on employers. The FBT rules have become antiquated and need reforming to reflect contemporary work practices and behaviours.

The Board of Taxation has been undertaking a *Fringe Benefits Tax Compliance Cost Review* involving several research initiatives to estimate and identify the basis for FBT compliance costs and opportunities to reduce such costs. The IPA supports this review and recommends that the Government take this opportunity to fundamentally reconsider the FBT in light of its disproportionately high compliance costs and, importantly, to work towards reducing the regulatory red tape. The Government has recently enacted some measures to reduce some of the compliance cost around FBT record keeping. We welcome proposals to allow employers to rely on existing records to substantiate a FBT liability rather than creating additional documents.

An overhaul of the FBT is warranted and overdue particularly if the Government wants to make some inroads to its commitment to reducing regulatory red tape. FBT has the unenviable title of having the highest compliance cost of any tax. It places a significant compliance burden on small and medium business operators. There are anomalies in the FBT rules which have been allowed to exist for too long and should be addressed by any responsible government. The IPA believes that shifting FBT from employers to employees would provide a more equitable solution to many of the current problems. This needs to be done in conjunction with simpler valuation principles which provide definitions or categories to account for non-cash payments. Taxing fringe benefits at the employee level has the potential to deliver greater neutrality in the treatment of cash and non-cash remuneration while reducing the compliance costs for both employers and employees. The Henry review supports such a proposal to simplify the current rules and provide for more transparency. If the incidence of FBT is transferred to employees, then an alternative mechanism for funding FBT tax concessions will need to be considered. These alternatives need to be considered in the interests of simplicity, fairness, and transparency. FBT is imposed at the highest marginal tax rate and based on Government projections (based on the original Stage 3 tax cut modelling), in 2024-25 around 95 per cent of taxpayers will face a marginal tax rate of no more than 30 per cent increasing the urgency for a policy redesign and overhaul of FBT as we know it. Despite the legislated Stage 3 tax cuts, reform of FBT is still urgently needed and is long overdue.

We note that Australia is one of only three countries (New Zealand and India being the others) with an FBT regime. There is plentiful precedent and examples of best practice / traps to avoid from the many industrialised nations which tax benefits in the hands of employees.

Reform small business CGT concessions

RECOMMENDATIONS

21. Increase eligibility by increasing the turnover threshold from $2 million to $10 million.
22. Remove the net asset value test and replace the 15-year exemption, active asset reduction and retirement exemption with one CGT exemption subject to a cap.

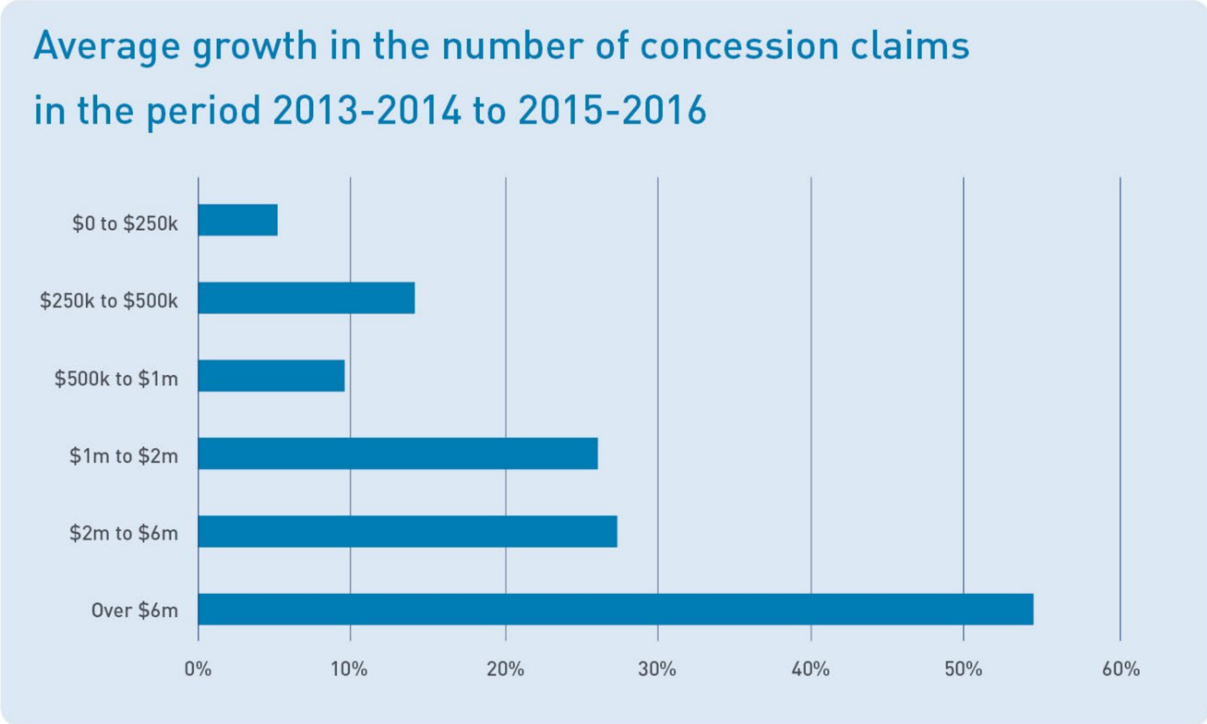
The small business CGT (SBCGT) concessions are, arguably, the most sought after and valued small business tax concession. The SBCGT concessions are a package or suite of four different concessions which enable a small business owner to defer or reduce capital gains on a sale of an active business asset. SBCGT concessions were originally intended to provide a nest egg for retirement and encourage entrepreneurial activity. However, the generosity of the concessions is matched by equally complex legislation that leads to increased compliance costs. The overall cost to the revenue base is substantial and growing and changes are urgently needed to make it sustainable for the future.

SBCGT concessions were never intended to shelter capital gains of the magnitude that we are currently experiencing. As a result, the overall benefit is not as widely distributed across the small business sector with a larger proportion of the benefits being accessed by a relatively small number of businesses. Some of the capital gains being sheltered through the SBCGT concessions are considered to be excessive compared to what the concessions were originally meant to deliver.

The Board of Tax in its report to Government (*Review of Small Business Tax Concessions* March 2019) has identified that the total dollar value of claims made under the concessions grew by 16 per cent per annum over the three-year period 2013-14 to 2015-16, which is, arguably, an unsustainable rate.

In the 2015-16 income year, claims of $1 million or more represented 4 per cent of all claims but accounted for some 38 per cent ($2.37 billion) of total amounts sheltered from tax by the concessions. In the same year, there were 25 claims in relation to capital gains of between $6 million and $10 million and a further 15 claims, averaging $10 million per claim. In the previous income year (2014-15) five claimants claimed concessions on capital gains of $400 million, that is, an average of $80 million per claim.

While all categories of claims are growing over time, claims of capital gains of $6 million or more appear to show the highest rate of growth in recent years in terms of the number of claims and the total value (from $180 million in 2013-14 to $400 million in 2015-16).



Source: Board of Tax, *Review of Small Business Tax Concessions* (March 2019)

The Board in its report has identified a pathway for reforming the SBCGT concessions in a way that will make the system simpler, fairer, and more sustainable. This is achieved by increasing the aggregated turnover threshold to $10 million, repealing the net asset value test (NAVT), and collapsing three exemptions into a single capped exemption. The data noted above has been extracted from the Board's report on Small Business Tax Concessions. This is the latest publicly available information that analyses this tax concession, and we are of the view that the trends highlighted are still prevalent.

The size of the gains that can receive preferential tax treatment do not align with the original policy intent and the concept of fairness and equity. We support increasing eligibility by increasing the turnover threshold from $2 million to $10 million which will allow more businesses to qualify. We also support reducing complexity by removing the NAVT and collapsing the 15-year exemption, active asset reduction and retirement exemption, and replacing them with one CGT exemption subject to a cap. The NAVT calculations add enormous complexity to the current rules and its removal will significantly reduce compliance costs. For this to be economically sustainable, we support the introduction of a cap for the first time, on the size of the benefits that will receive preferential tax treatment under these concessions to ensure a larger proportion of the benefit is not accessed by a relatively small number of businesses.

Expand deductibility rules around education

RECOMMENDATIONS

23. The Government reconsider the proposal to allow individuals to deduct education and training expenses they incur, where the expense is not related to their current employment but is intended to lead to a different income-earning avenue.
24. The small business skills and training boost is reinstated to encourage employers to invest in upskilling their existing employees.

In the 2020-21 Budget, the former Government announced that it would consult on allowing individuals to deduct education and training expenses they incur, where the expense is not related to their current employment. We are supportive of initiatives that encourage individuals to continue upgrading their human capital skills over their working life. In an ever-changing labour market, few expect a job for life, and it will be more likely that individuals will have multiple careers over their lifetime. The increased rate of globalization, and technological change are other drivers that are contributing to the need for continued upgrading of skills. Our current tax settings do not support or encourage the retraining and reskilling once an individual has commenced earning an income in their chosen field.

There are a number of existing support mechanisms for higher education. We see this proposed measure as adding to the current support for higher education but also addressing a void in the existing arrangements for individuals who are currently earning an income and may be unable to access any of the existing support initiatives. For this cohort, the existing tax arrangements represent a deterrent to reskilling. In particular, the requirement for a tax deduction is limited to expenses in gaining or producing assessable income. This limits deductions to an individual's current employment activities that either maintains or improves the specific skills required for that employment or leads to an increased income in the individual's current employment. Education expenses that do not have a sufficient connection to an individual's current employment are therefore not deductible.

We saw this proposal working hand in hand with the exemption for FBT employer provided education. From 2 October 2020, employer-provided retraining and reskilling benefits to redundant, or soon to be redundant, employees where the benefit may not relate to their current employment is exempt from FBT. This allows the employer to bear the cost of retraining and reskilling without incurring FBT. To provide equity to individuals who do not have employer support for reskilling or retraining, it is important to extend a similar tax concession to individuals who undertake further education at their own cost. The benefit to an individual of incurring the cost themselves will, however, be dependent on the individual's marginal tax rate.

There are wellbeing and economic benefits that quality education skills provide, which generally outweigh the cost of providing further support. There is a strong business case for providing additional support especially if it is directed to areas where there is a skills shortage. We are supportive of initiatives that are aimed at improving our productive capacity. There are many skilled individuals who have been displaced and can be easily redeployed into other less affected sectors with retraining. The proposal also bodes well for individuals who wish to continue to work but for a number of reasons may not be able to do so (ie physical limitations, age, mental burnout), or where the Australian need for their experience has been or will be greatly reduced (e.g. car manufacturing) and need to reskill to remain in the workplace. There are a lot of occupations where the physical demands of the job cannot be sustained beyond a certain age, and therefore retraining offers an opportunity to extend an individual's working life. This is particularly relevant if we are looking at a tsunami of baby boomers approaching retirement in the near future. We need to look at ways to add to the supply side of the labour market and this proposal, if properly targeted, can contribute to adding capacity where it is needed. Increasing the ability to claim deductions comes with a cost and therefore there needs to be integrity measures to ensure the proposal achieves good economic outcomes worthy of the tax concession.

ABS data indicates that the job mobility rate (i.e. the rate at which Australians changed jobs) was 9.6 per cent in the 12 months to February 2023 and 8 per cent in the year ended February 2024, with younger workers (aged 15 to 24) being more mobile. Further, the University of Queensland (*'How many career changes in a lifetime?'* published 19 June 2023) notes that an average person may accumulate around 16 jobs in their lifetime, representing between 3 and 7 *careers*. Significantly, this number may be more like 5 to 7 for the current and upcoming generations. It is no longer a society in which it is common to have one job, or profession, for life. Changing jobs and careers is now a characteristic of the Australian workforce. Government policy which financially supports workers in reskilling will encourage more people to contribute to a new chosen industry and to the Australian economy.

We propose, that if this initiative is implemented, that there is a shared risk with the individual who proposes to take advantage of the concession. Quarantining half the upfront deduction until the individual earns income from an activity associated with the retraining is an appropriate model to ensure that taxpayers do not wear the entire cost of the education outlay in cases where the retraining does not result in the furtherance of a new activity. Further, for occupations or vocations that are in short supply, we should allow the full cost to be deducted upfront. Similar in concept to the discontinued 457 visa system, an occupations list that is updated to reflect industry needs can be maintained to incentivize the supply side to target the concession to where it may be most needed. Whatever integrity measures are introduced, we need to ensure that individuals do not take advantage of the relaxation of the tax rules to engage in lifestyle or personal choices subsidised by the taxpayer.

In relation to training and education related to an individual's current employment, we propose that the Government reinstate the small business skills and training boost which previously provided a bonus 20 per cent deduction for eligible expenditure incurred from 7.30 pm AEDT on 29 March 2022 to 30 June 2024. This will encourage employers to pay for their existing employees to upskill, thereby bridging an identified skill gap in the business, or allowing the business to deliver higher value services and offer new revenue-generating services.

We recommend that the Government reconsider the proposal to allow individuals to deduct education and training expenses they incur, where the expense is not related to their current employment but is intended to lead to a different income-earning avenue. The expanded deductibility for education expenses should be subject to appropriate integrity measures to ensure it is targeted and achieves its policy intent.

We also recommend the Government reinstate the small business skills and training boost to encourage employers to invest in upskilling their existing employees.

Small Business Tax Offset (commonly referred to as unincorporated tax discount)

RECOMMENDATION

25. Increase the cap for the unincorporated tax discount to make it a meaningful incentive and apply the tax discount on a 'per business' basis.

The unincorporated small business tax discount was intended to promote neutrality by 'levelling the playing field' between incorporated (mainly companies) and unincorporated businesses (sole traders, partnerships, trusts). The majority of small businesses (up to 70 per cent) operate as unincorporated businesses. These businesses are not eligible to access the small business corporate tax rate. The concession in its current form provides a tax benefit of up to $1,000 per individual taxpayer. In its present form the level of discount is too low to have a meaningful impact.

Year	2019	2020	2021	2022-2027
Company tax rate	27.5%	27.5%	26%	25%
Unincorporated tax discount	8%	8%	13%	16%

Whilst the discount rate is set to increase in line with the cuts to the corporate tax rate, the $1,000 cap remains in place, meaning that most taxpayers will reach the cap amount faster and not benefit from the percentage increase. Changes to the rate of the tax discount will not be accompanied by corresponding increases to the cap which will remain at $1,000.

We recommend the unincorporated tax discount be more targeted and prominent to small business owners by significantly increasing the cap to make it a meaningful incentive and by applying the tax discount on a 'per business' basis. At present, partnerships and trusts can deliver a separate benefit of up to $1,000 to multiple individuals. The savings generated by calculating the concession in this way could be used to finance an increased cap amount. Small businesses have incurred more compliance costs over the years due to digitalisation, cyber security etc and this initiative is a way to compensate such entities for this added burden. Some of these additional burdens are mandatory government initiatives (Single Touch Payroll, complying with Privacy Act etc).

Enhancing Research and Development tax incentives to improve Australia's SME innovation capabilities

RECOMMENDATION

26. As part of the government's Strategic Examination of Research and Development, review the effectiveness of the R&D tax incentive in supporting and improving the innovation capabilities of SMEs.

Innovation is key to Australia's future economic growth as well as development of Australia's sovereign capability. This is reflected in the government's review of Australia's research and development performance to help power economic growth, announced at the last Federal Budget.

Small business is the engine room of the Australian economy. Supporting smaller businesses to undertake R&D activities is crucial to maximise their contribution to economic growth.

In July 2021, the IPA-Deakin SME Research Centre released the *Small Business White Paper: Post COVID Policy Options to Enhance Australia's Innovation Capabilities*, with the primary objective of outlining a number of policy recommendations relating to the R&D tax incentive (R&DTI) scheme to support small business.

In particular, the white paper raised the following concerns:

- The lack of collaborative research that is being undertaken by the Australian small business sector with Australia's world-renowned research institutions.
- There is no government or centralised entity that both specifically promotes SME innovation and provides support to SMEs planning on collaborating with other would-be industry partners and/or research institutions, thereby increasing the difficulty in finding research partners. Accordingly, industry research partners are required to navigate sometimes complex University or research centre collaboration requirements (OECD, 2014), creating significant barriers to research collaboration.
- The current eligibility criteria for R&D activity in Australia are far too narrow as they do not include software-related research activities and development, which arguably hampers the competitiveness of Australia's software industry.

Providing greater support to Australia's smaller businesses undertaking R&D activities is crucial. R&D subsidies offered by government to the business community fundamentally tackle market failures as they primarily incentivize businesses to conduct additional R&D. These tax incentives thereby address potential underinvestment in R&D in a manner that enhances positive externalities (spillovers) to the broader Australian economy (PC, 2007; CIE, 2016; Ferris et al., 2016). However, given significant financial and other economic constraints facing small businesses in Australia, coupled with the absence of federal government policy that is specifically focused on enhancing spillovers from innovation (CIE, 2016; ISA, 2016), the IPA Deakin SME Research Centre provides robust evidence showing that the current R&D tax incentive scheme can be optimised further to promote R&D expenditures, particularly among small business, to enhance externalities from innovation and R&D investment.

It is well documented that the effective costs of conducting R&D are high (OECD, 2018). While limited cash reserves are a characteristic of many SMEs and start-up businesses, and SMEs are generally constrained from engaging in R&D by liquidity shortfalls, there is abundant evidence showing that inefficient or ineffective capital (and venture capital markets, specifically) constrains Australian companies financing additional R&D (Daly, 2013; CIE, 2016; Ferris et al., 2016; ISA, 2016).

To improve the capacity of the R&DTI to support innovation and R&D expenditures among SMEs, the SME Research Centre in its Small Business White Paper 2021 recommended Government do the following. These recommendations are still relevant today.

1. Reverse cuts to the level of R&D incentives for SMEs and revert to the fixed rate incentive (at 43.5 per cent) for SMEs.
2. Implement quarterly reimbursement of R&D offsets, allowing SMEs to more rapidly reinvest offsets in further R&D expenditures.
3. Introduce a premium to the R&DTI for research conducted in collaboration with Australia's world-class research institutions, enabling the benefits of collaborative research.
4. Commence a policy experiment using innovation vouchers redeemable for collaborative research to:
    - Enhance collaboration between SMEs and researchers
    - Address the funding needs of innovative SMEs
    - Help address the perceived cultural barriers between researchers and industry
5. Increase funding to Collaborative Research Centres (CRCs) and CRC-Projects, improving the infrastructure available to businesses to find appropriate research contacts and to collaborate on short-term or long-term research projects.
6. Expand the definition of eligible research to include more elements of software production and provide clear guidance to software companies about eligibility.
7. Expand and encourage the use of Advanced Finding to increase certainty among SME applicants and reduce eligibility risk.
8. Increase the use of policy experiments when making amendments to R&DTI policies, releasing data broadly to encourage post-implementation evaluation of the merits of R&D policies.