28th November 2004

Mr Gary Banks
Chairman
Taskforce on Reducing the Regulatory Burden on Business
P O Box 282
Belconnen ACT 2616

Dear Mr Banks

Reducing the Regulatory Burden on Business

The Taxation Institute of Australia (Taxation Institute) is pleased to provide you with its response to the Regulation Taskforce's call for submissions on reducing the regulatory burden on business announced on 25th October 2005.

The focus of our submission is principally on the regulatory impact of the taxation provisions, which is indicated in the Taskforce Issues Paper as an area of Australian regulation affecting business that comes within the ambit of the Taskforce's review.

In commenting on the regulatory impact of these provisions, the Taxation Institute draws on the experience of our 11,000 members, who range from tax advisers to the small, medium and large enterprise sectors to senior tax practitioners in the legal and accounting professions. Taken together with their clients, our members' views reflect the concerns and opinions of many tens of thousands of businesses throughout Australia.

Prior to the preparation of our submission, we held a wide ranging discussion with Mrs Angela MacRae, Mr Rod Halstead and other representatives from your Taskforce in Sydney on 15th November 2005. We stressed at this meeting that much of the current regulatory burden on business stems from taxation provisions that are misguided or misconceived in the first instance, examples of which are set out in Appendix 1.

To address this, the Taxation Institute strongly believes that we need to focus on improving the processes around the making of our tax laws. In particular, better use of consultation with stakeholders needs to be made in the early stages of the drafting of the law. Experience shows that the end result of such consultation is tax law that is for the most part well formed and workable. The government's recent approach to consultation in the review of Australia's international taxation arrangements is an example of the overall success of this approach.

Subject to our concerns about the need to improve the processes around the drafting of our tax laws, in Appendix 2 we set out a number of examples that reflect the Taskforce's review criteria and illustrate administrative difficulties arising from legislation giving effect to government policy.

These difficulties result in the imposition of unnecessary, and therefore avoidable, burdens on business occasioned by:

- confusing multiple alternatives for notifying the Commissioner of an election, transaction or event, ranging from notifications that have to be lodged and others that are to be kept by the taxpayer, notifications that have to be in a prescribed form and others not and notifications that have to be in writing separately from an income tax return and others can be lodged with or triggered by the lodging of a tax return. The system could be simplified either by using only one form for all elections or an election is deemed to be made on the basis of disclosures in the tax return;
- having to notify third parties of the effect of making a particular notification; and
- compliance measures that make a regime unworkable (for example, there are special pooling rules under the Simplified Tax System (STS) in Division 328 of the *Income Tax Assessment Act 1997* that are intended to simplify the calculation of the deduction for the decline in value of depreciating assets by applying a single rate to the value of a pool of eligible assets. However, STS taxpayers still have to track each asset in the pool because they are required to estimate how much they will use a each asset for a taxable purpose for the first three years after it is added to the pool. This defeats the purpose of having a pool of assets in the first place).

Finally, to reinforce the concerns and examples raised by the Taxation Institute in our submission, a summary of a report entitled *Small business: The first casualty of tax reform compliance costs - A qualitative study of the impact of tax reform on the compliance costs for small business* released at Taxation Institute National Convention, Melbourne, 1 April 2004 can be found in Appendix 3.

Should you have any queries in relation to any of the matters raised in our submission, please contact the Taxation Institute's Senior Tax Counsel, Michael Dirkis, on 02 8223 0011.

Yours faithfully

John de Wijn
President

Appendix 1 – Fundamental problems with the law design process

Set out below are some examples that illustrate the Taxation Institute's concerns with the impact of tax laws that are misguided, misconceived or both.

1. Foreign exchange

The rules in Division 775 are of such complexity and incomprehensibility that they are at risk of being ignored in practice. This does not mean that foreign exchange gains and losses are not being brought to account but, rather, people are favouring common sense accounting-type approaches, rather than trying to divine which particular forex realisation event (FRE) applies to each step of the transaction. It should be noted that there are regulations that have been introduced which add further to the complexity but do admittedly try to find practical solutions. The problem is that such regulations are merely papering over the cracks in the edifice that is represented by Division 775.

In simple terms, the whole concept of FREs simply do not accord with common sense, commercial practice or accounting rules. This is reflected by the huge list of issues that are on the foreign exchange issues' register.

Tony Frost wrote a critical article, published in the Taxation Institute Red Journal (Volume 7, No 4 April 2004) in relation to trading stock – something the affects the vast majority of businesses in Australia, both large and small.

The problem here is that Division 775 was written in response to the decision of the High Court in the ERA decision that was somewhat critical of Division 3B. Division 3B in itself was questionable as a policy matter. Unfortunately, it seems that the reaction was to throw the baby out with the bathwater. This is because it sought to bring to account gains and losses on foreign exchange contracts that were otherwise on capital account as revenue account. This was immediately after the introduction of the CGT rules which, in themselves, contained a level of foreign exchange rules.

In retrospect, it probably would have been simpler to ensure that foreign exchange gains and losses on liabilities that were on revenue account were included in assessable income or allowed as a deduction; everything else was otherwise covered by normal income principles or the CGT rules.

2. Consolidations

Admittedly, the huge volume of legislation and rulings that we now have that represent the consolidation regime is in partial response to the desire of professions to have details of a range of things spelt out. However, one could ask whether or not this was also a response to the particular consolidation system that was adopted (note that only one other country has gone down the path that Australia has). In light of the significant complexity of the consolidation regime, it is highly likely that, in a practical sense, the rules are not being applied by a significant portion of the corporate SME market. This is perhaps not a surprising allegation because there are significant barriers to entry to the consolidation regime. Not only does a business need to pay its adviser and have its internal staff come to grips with the legislation, it is then necessary to go through a cost/benefit analysis to work out whether it is worth adopting the regime. This is despite the fact that significant concessions in terms of roll-overs, loss transfers, etc., were taken away. It is likely that there are many

businesses which should have adopted consolidations, but have just found it too hard to implement or have been so overwhelmed by the volume and complexity of rules that the cost alone was unlikely to outweigh the benefits of adopting consolidation.

3. Loss provisions

There is a risk that the many pages of loss rules, which are the subject of continuing amendment, are in the main, so daunting that many practitioners and taxpayers are not able to come to grips with the finer points of their application. Whilst most practitioners and taxpayers no doubt understand the fundamental concepts around COT and SBT and apply those concepts, it is doubtful whether they go through the myriad of tests contained in Divisions 165 and 166 (even the listed public companies).

These rules continually need refinement (e.g. see the current Tax Laws Amendment Bill on Loss Recoupment Rules) largely because of the amount of detail that has been put into the legislation which provides no flexibility for either the regulator or the taxpayer in coming up with sensible approaches to resolving whether or not a more simply stated test has been passed.

It could well be the case that tax advisers who started practice prior to 1998 are still relying on their knowledge of the operation of sections 80A and 80E to advise their clients. If this is the case, it reflects poorly on the drafting of a set of rules that arguably do no more than create a large number of unnecessarily strict rules around the two fairly simple COT and SBT concepts. It is insufficient for the regulator (in this case, the Tax Office) to have wrung their hands and indicated that the rules did not work, rather than using broader principles and come up with administrative solutions as to making those rules work.

This raises another question as to whether or not there needs to be more significant cultural change.

4. Detailed anti-avoidance rules

As we had indicated in the meeting with the Taskforce, there is a myriad of provisions that are simply forms of anti-avoidance rules. There is an extremely strong general anti-avoidance rule within Australian tax law and it is unnecessary and burdensome for specific anti –avoidance rules to be littered throughout the Act. In particular, it is not difficult to surmise that there is the ability to reduce the size of the Act very significantly were those rules to be deleted.

Appendix 2 – The Taskforce's Main Objectives

The following is a summary of Taxation Institute's concerns as they relate to the Taskforce's main objectives, which is followed by more detailed explanation and examples under the heading of each objective:

A. Areas which are unnecessarily burdensome, complex, redundant

1. Reconsider the trust loss provisions and the use of family trust elections
2. Removal or simplification of simplified tax system (STS)

B. Areas in which regulation should be removed or significantly reduces as a matter of priority

1. Legislative simplicity

1.1 Single small business test
1.2 Fringe Benefit simplification
1.3 BAS simplification
1.4 CGT simplification
1.5 Capital allowance simplification

2. Administrative simplicity

2.1 The absorption costing method for valuing trading stock for taxpayers in the retail and wholesale industries
2.2 Unnecessary labels

C. Non-regulatory options (including business self-regulation) for achieving desired outcomes and how best to reduce duplication and increase harmonisation within existing regulatory frameworks.

1. Interface between taxation and welfare

1.1 Single set of administrative rules
1.2 Other options for deductions/tax offsets

D. Provide practical options for alleviating the Commonwealth's 'red tape' burden on business, including family-run and other small businesses

1. Solutions to the use of family trust elections
2. Ultimate Beneficiary Statements

A. Areas which are unnecessarily burdensome, complex, redundant

1. Reconsider the trust loss provisions and the use of family trust elections

The Government, in attacking issues arising from abuse of loss trusts, introduced in 1998 provisions to counter that abuse in Schedule 2F of the *Income Tax Assessment Act 1936*. As well as introducing a definition of fixed trust that means no trusts are fixed (ie they do not have fixed entitlements under Division 272) they also introduced a narrow exemption from the trust loss provisions for certain family trusts. This exemption involving a family trust election (FTE) is extremely narrow. The exemption was also relied upon when anti-franking credit trading was introduced.

As we believe that the trust loss issues would be countered by Part IVA of the 1936 Act, the preferred solution to the compliance costs imposed is to revisit whether the complex trust loss provisions are necessary in light of the application of Part IVA. Removal of the trust loss provisions would have a simplification flow on and potentially remove the need for the FTE provisions.

(See D. 1 below for specific recommendations to reduce compliance costs associated with FTEs, in lieu of any fundamental reform).

2. Removal or simplification of simplified tax system (STS)

Another area which is long, and in places convoluted, is the STS regime. The STS provisions in *Income Tax Assessment Act 1997* are approximately 27½ pages in length and the Explanatory Memorandum is 84 pages, excluding index and Regulatory Impact Statement. Then there are two Tax Rulings: TR 2002/6: *Income tax: Simplified Tax System: eligibility – grouping rules* (38 pages) and TR 2002/11 *Income tax: Simplified Tax System eligibility – STS average turnover* (33 pages).

Conceptually STS is a potentially concessional tax system that sits on top of and has to interact with the rest of the tax laws. Having an add-on system that delivers concessional treatment of some tax items (prepayments and capital allowances) is not inherently simple. It raises the question of whether some simple concession or rebate the eligibility for, and quantum of, being dependent on a measure of business size would deliver an equivalent benefit without the associated compliance costs.

As stated before, integrity has made the STS system itself complex and potentially impractical. For example STS eligibility is set out in s 328-365 of the 1997 Act, contains 11 terms that themselves have a definition. This illustrates that the basic proposition that eligibility to STS is a simple three point test is misleading.[1] Those three points are tightly defined and potentially complex in their operation. So much so that the ATO has issued the two TR's mentioned previously.

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1 Under subdivision 328-F ITAA 1997 to be eligible to be an STS taxpayer a taxpayer must:

- carry on a business in that year;
- have an average business turnover net of GST (including the turnover(s) of entities that it is grouped with) of less than $1 million, and
- have less than $3 million in depreciating assets held by it and other entities with which it is grouped.

As identified by other writers the government has often proved slow in widening the ambit of tax concessions such as STS.[2] It was identified at the outset of STS that eligibility based on turnover would discriminate against otherwise worthy businesses that operate on large volumes and low margins such as petrol stations. Seemingly confirming the alacrity of concessional legislative response, it has taken till 20 March 2003 for a regulation to be made that provides petrol stations relief from the $1 million maximum turnover threshold for STS (retrospective to 1 July 2001).[3]

From a legislative design perspective, it may be argued that STS has basic design flaws as it ignores commercial reality of small business operations such as asset protection aspects of accounting and business structures.[4] It's stated focus of benefiting 'small businesses with straightforward and uncomplicated affairs'[5] may be too focussed at the micro business end of the spectrum.

This is compounded by concerns over its practicality given the thresholds for entry, the fact that its concessions are indirect and its integrity driven complexities.

The Inspector General of Taxation's [ITG's] priorities adds weight to these concerns. The administrative aspects and application of STS is on the short list of nine matters and is to be reviewed with a view to reducing compliance burden.[6] The ITG Issues Paper that includes consideration of STS records small businesses' particular STS concerns as the:

- turnover thresholds for adopting cash vs accrual accounting methodologies;
- accounting treatment of capital vs revenue items, where they are isolated from accounts to comply with tax laws;
- debt to equity rules that apply to loans to a company by principals of that company; and
- need to modify accounting and information technology systems to match those which are used or required by the ATO.[7]

This is wrapped up in a take it or leave it system sitting beside and interacting with the rest of the tax laws. This then requires a potential user to undertake an analysis to determine whether *on balance* they will be better off. Thus, it is submitted that the failure of STS lies in poor legislative design. This legislative design being informed by a strong revenue protection starting position which points to the tight eligibility criteria and strong integrity focus.

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2 Robert Douglas 'The Simplified Tax System for Small Business – An Overview' (2000) 35 *Taxation in Australia* 28, 30.

3 Income Tax Assessment Amendment Regulations 2003 (No 1) [Statutory Rules 2003 No 39].

4 Brett Bondfield 'A year on in the Simplified Tax System: Has the reality matched the rhetoric?' (2002) 37 *Taxation in Australia* 251 at 252 and brief list of articles describing and analysing STS, 255-256.

5 STS EM, 6.

6 Inspector General of Taxation, Commonwealth, 'January 2004 Work Program Consultation' (29 January 2004). From this list of nine issues four matters have been selected as priorities to be reviewed, being: small business audits; the administrative cost to business of an audit; GST refunds; and the ATO's small business debt collection practices: see Inspector General of Taxation, Commonwealth, 'Upcoming Reviews' (30 January 2004).

7 Inspector General of Taxation, Commonwealth, *ATO/Client Interface Systems* Issues Paper Number 5 (2003), 13.

The removal of the cash accounting requirement still leaves this complexity with the only benefits accelerated depreciation and prepayment.

If this regime was to continue it needs to be holistic.

B. Areas in which regulation should be removed or significantly reduced as a matter of priority

1 Legislative simplicity

1.1 Single small business test

Currently there are numerous tests for small business, limiting the scope of a whole series of concessions. They include:

- a $5 million <u>net value</u> of the CGT assets test (small business CGT concessions);
- a $20 million annual turnover test (for at call loans);
- an average turnover test with a gateway threshold of less than $1,000,000 (Simplified Tax System (STS)); and
- the cash accounting turnover test in GST with a gateway threshold of $1,000,000.

These tests are confusing and need to be simplified into one common test for all small business concessions.

The Taxation Institute is also concerned that all the current test thresholds for small business have not been altered since their introduction. These thresholds need to be increased (and subsequently automatically indexed) as their value has been reduced due to bracket creep caused by inflation and movement in the property and share market values.

1.2 Fringe benefit simplification

Australia's fringe benefits tax regime is complex and resource intensive for employers. In a joint body submission dated 27 October 2004, sent to the Assistant Treasurer and Minister for Taxation, the Hon Mal Brough MP, the Taxation Institute called for the following legislative changes aimed at both simplification and reducing compliance costs. They were:

(a) Car Parking: An optional standard valuation for car parking benefits could be provided for in the legislation.

(b) Travel Costs for Employees working in one city and living in another: These should be exempt from FBT altogether as they are not remuneration related but a business cost of getting the right employees in the right place.

(c) Optional 50/50 split for recreational expenditure: employers should have the option to adopt the 50/50 split method in respect of all recreation expenditure, as is the case for meal entertainment and entertainment leasing facility benefits.

(d) Reportable Benefits confined to Remuneration benefits only: Only benefits that are part of a remuneration package or award should be reported on payment summaries. The excluded benefits would include the travel costs referred to in 2 above. In addition, the law should be amended to provide for an exception from the usual reporting rules where it is impossible to fairly allocate the value of a fringe benefit to individual employees. At a bare minimum as a short-term

solution clearer guidance is required as to an acceptable set of rules for the valuation and attribution of shared cars between employees.

As an alternative or in addition to the above recommendations the following are suggestions

- Where a car is used by more than one employee, the employer be given the option to calculate the statutory formula for the car separately for each employee based on the annualised kms for the period of use by each employee.

- The work related exemption for utilities and panel vans be extended to all cars.

Note that the above two recommendations are for fringe benefits tax generally and not just for reportable benefits.

(e) Reportable Fringe Benefits and Recreation: All recreation expenditure should be excluded from the FBT reporting requirements, as is currently the case for meal entertainment expenditure and entertainment facility leasing expenses.

(f) Reportable Fringe Benefits Threshold: The threshold should be increased from $1,000 to $2,000.

(g) Interaction of GST and FBT and Financial Supplies: The provisions of Division 71 of the GST Act should be reviewed and overhauled.

(h) Reconciliation Difficulties: Difficulties in accounting for fringe benefits would be reduced if taxpayers could record the GST-exclusive value of benefits in the FBT return.

(i) Capping Thresholds: this area requires re-visiting with the view of re-writing these provisions.

(j) Road Tolls: The accounting for road toll fringe benefits is cumbersome and costly. It is suggested that amendment to Section 136(1) of the FBTAA 1986 be made to include within the definition of a 'car expense', 'bridge and road tolls'.

(k) Minor and infrequent rule: The $100 threshold for minor and infrequent exempt benefits is too low. To allow real compliance savings this threshold should be increased to at least $200. This threshold should also be indexed each year.

1.3 BAS Simplification.

There may be ways to further simplify the BAS for small business by reducing reporting on the BAS to a net GST payable /refundable. Having to segregate between GST free, input taxed and GST taxable supplies and capital/non capital acquisitions on the BAS is an administrative nightmare for many small business people. In many cases the figures are entered incorrectly because taxpayers are confused about how to fill out the BAS and this requires correction at the end of the year by the taxpayer's accountant. Often these corrections do not add a single dollar to GST payable. Therefore, we believe there is a strong case to change the BAS reporting requirement to net GST payable/refundable.

1.4 CGT Simplification

There is a need to further simplify CGT. Under the current CGT regime, generally a capital gain or capital loss only arises where an eligible asset is subject to a "CGT event" and the proceeds from that event are greater than or less than the relevant cost base.

This is an example of the introduction of taxing concepts that are more at home in a tax system that is schedular based, which in principle the Australian taxation system is not. It is a well recognised problem with the schedular approach to drafting tax laws that it creates problems in trying to classify whether a particular transaction comes within a particular schedule, or in the case of CGT, a particular event. This can lead to instances where multiple events may apply to a transaction (and therefore requiring a provision to deal with overlap) or a transaction may escape the CGT net simply because no particular event applies.

Rather, what is required is a simple profits-based computation rule which would make much of the current CGT law unnecessary. This would produce consistency and avoid duplication.

1.5 Capital allowance simplification

The uniform capital allowances provisions do not have a de minimus threshold for low value assets, including many items commonly used in an office such as a stapler, filing tray or a manila folder. This means that such minor items may need to be depreciated which gives rise to compliance costs due to the associated record keeping requirements despite the pooling arrangements available. Under the previous law, an immediate deduction could be claimed for assets with a value of $300 or less.

We acknowledge that eligible small business taxpayers (those with an annual turnover of less than $1million) who elect to go into the Simplified Tax System (STS) can enjoy the benefit of a $1,000 de minimus threshold, and non business taxpayers also enjoy a $300 de-minimus write-off. However, many small businesses, do not qualify or do not elect to enter STS cannot benefit.

We submit that an appropriate de minimus threshold be reintroduced for business taxpayers to reduce taxpayer compliance costs in this area. At a minimum, it should be $1,000 level available for STS taxpayers. This would reduce the number of thresholds and create consistent treatment for all business taxpayers and recognise the reality of practice, where such amounts are written-off and overcome the administrative problems associated with still having to track assets in low value pools.

2. Administrative simplicity

2.1 The absorption costing method for valuing trading stock for taxpayers in the retail and wholesale industries

In Practice Statement PS LA 2003/13 and draft Taxation Ruling TR 2005/D11, the ATO is implementing the contentious position of requiring the absorption costing method for valuing trading stock for taxpayers in the retail and wholesale industries.

Contrary to a popular misconception that taxpayers with a gross operating turnover of less than $10 million do not have to implement the absorption costing method, this Practice Statement and draft Ruling only operate to remove strict compliance with the mandated absorption costing regime because, as stated in paragraph 1 of PS LA 2003/13:

> "[t]axpayers not covered by this practice statement will still be expected to use a reasonable and practical basis to correctly bring to account their trading stock",

and in paragraph 27 of TR 2005/D11, the ATO indicates that

> "[t]axpayers with a gross operating turnover of less than $10 million may make an appropriate estimate of the additional costs to be absorbed which need not be based on detailed records of all expenses".

PS LA 2003/13 and draft Taxation Ruling TD 2005/D11 result in the ATO arbitrarily creating rules that are too costly for small business to comply with.

a. Given that the focus of a practice statement should be upon ensuring that ATO practice meets that of the community, it is difficult to see how the ATO can justify imposing additional compliance costs on small business merely arising from a contentious interpretation and application of accounting standards?.

b. We do not believe the ATO has done the cost benefit analysis including:
   (i) the cost of compliance impact on small business in having to take "reasonable and practical" steps to "make an appropriate estimate of the additional costs to be absorbed";
   (ii) the revenue to be gained from effectively imposing the absorption costing method on small business; and
   (iii) the impact of the ATO's proposals on the overall viability small business and their capacity to be able to comply with the ATO's requirements?

2.2 Unnecessary labels

The ATO put forward a proposal to put a compulsory label in the 2005 Partnership and Trust Returns requiring information relating to the disclosure of certain financial arrangements that provided a tax deduction, capital loss, or foreign tax credit. The ATO was motivated to recommend this as a means of obtaining early information on potential schemes.

Given concerns about the targeting of the questions and the resultant compliance costs (which were conservatively valued at $45 million, affecting some 900,000 returns), the Taxation Institute wrote to the Commissioner of Taxation on 25 February 2005 and raised the issue at the 15 March 2005 National Tax Liaison Group meeting. The Commissioner advised that after reviewing the submission on the inclusion of the new compulsory label the Tax Office has decided not to go ahead with this for the 2005 year return forms. However, the issue will be reconsidered for 2006.

C. Non-regulatory options (including business self-regulation) for achieving desired outcomes and how best to reduce duplication and increase harmonisation within existing regulatory frameworks.

1. Interface between taxation and welfare

The Social welfare administrative rules should align with taxation administration rules. So where an extension to lodge is granted by the Commissioner, that extension also applies to FTB

A more fundamental administrative change is also needed to address the fundamental inequity in the system: ie that the Government has removed from ordinary Australians the ability to claim any eligible benefits or additional benefits if more than 12 months has elapsed since the end of the financial year but always has the power to claw back overpayments. These denied benefits are money to which Australian families would otherwise be entitled.

And in addition, it is not only administrative change that is required but it is also imperative that fundamental concepts that underpin the operation of a system are the same, for example the treatment of pensions for tax and social security purposes.

D. Provide practical options for alleviating the Commonwealth's 'red tape' burden on business, including family-run and other small businesses

1. Specific solutions to the use of family trust elections

Although the Government has already made some changes to the operation of the family trust elections (FTE) provisions that have alleviated some of the difficulties being experienced by taxpayers, the Taxation Institute believes there are still a number of instances where the FTE provisions operate inequitably and impact badly on affected families. There are two solutions. The preferred solution, as discussed above (paragraph A.1), is to revisit whether the complex trust loss provisions are necessary and whether Part IVA would apply. Removal of the trust loss provisions would have a simplification flow on and potentially remove the need for these provisions.

The second, less preferred option is to amend the rules to remove anomalies that cause unnecessary compliance costs. The amendments need are to provide a power to revoke an FTE and to allow flexibility in the rules which allow changed family circumstances to be taken into account, particularly in light of the following:

- due to the complexity of the trust loss rules, it is not uncommon for genuine and inadvertent mistakes to be made in making a FTE (e.g., specification of an inappropriate test individual) with harsh and unforgiving consequences (e.g., payment of the family distribution tax at a rate of 48.5% on distributions outside the group). There are instances where taxpayers have made FTEs that were not necessary, thus inadvertently restricting distributions made by the affected trusts. It is particularly inequitable for an FTE remain in place where it has been made unnecessarily and the taxpayers/entities involved have not made distributions outside of the family group and have not benefited from the making of an election (e.g., through the transfer of any losses). These issues have been raised with the Government previously and we would refer you in particular to a submission to the Minister for Revenue and the Assistant Treasurer on 16 November 2004 by the Institute of Chartered Accountants;
- the family group mechanism under the FTE provisions fails to take into account the fact that a high percentage of marriages end in divorce with subsequent re-marriage. Currently, in the simplest situation where the test individual divorces his or her spouse, the former spouse is no longer part of the of the family group and if the test individual remarries, his or her new spouse is also not part of the family group for FTE purposes. The problem is further perpetuated when the test individual dies. In a situation like this, the test individual's second spouse may be a life tenant under the terms of the will and yet the class of people making up the remainder of the estate continue to be the children of the first spouse; and
- it is not clear whether it is possible for an FTE to be lodged in respect of a previous year where the person who should be nominated as the test individual in a prior year is now deceased (PS LA 2004/1(GA) clarifies the circumstances under which an entity which has not lodged a family trust election or interposed entity election may do so in respect of a prior year).

2. Ultimate Beneficiary Statements

Background

With the passing of *A New Tax System (Closely Held Trusts) Act 1999* trustees of closely held trusts are required under Division 6D of Part II of the 1936 Act to disclose to the Tax Office the identity of ultimate beneficiaries presently entitled to net income and tax-preferred amounts to which a trustee beneficiary is presently entitled. Any failure to provide a correct ultimate beneficiary statement in relation to net income will result in the trustee having to pay tax at the rate of 48.5 per cent. These requirements apply to present entitlements created after 4.00 pm on 13 August 1998.

Due the high compliance costs and dire consequence from non-disclosure the Commissioner announced an administrative solution on 27 November 2000 in Media Release - Nat 2000/107 that people do not need to lodge further ultimate beneficiary statements providing they meet the following conditions -

- they have lodged a 1998-1999 year UB statement; and
- they do not have a UB Non-disclosure Tax liability.

However all new unit trusts need to lodge these statements which continues unnecessary compliance costs.

Solution

Repeal Division 6D and replace it with a access notice, where failure to comply results in 48.5% being levied on the distribution. Integrity is maintained and compliance cost only arises in audit situations.

Appendix 3

Summary of 2004 Qualitative Study

Michael Dirkis and Brett Bondfield in a research report entitled *Small business: The first casualty of tax reform compliance costs - A qualitative study of the impact of tax reform on the compliance costs for small business* (2004) released at Taxation Institute of Australia's National Convention, Melbourne, 1 April 2004 found that:

- There are clear and consistent claims and some supporting empirical evidence that the global small business tax compliance costs post-ANTS/Ralph have increased significantly and are probably even more regressive than they were pre tax reform (1998); and

- The cost to the ATO of administering the GST are minor when compared to costs facing small business taxpayers.

The Report concluded that one reading of the Ralph Review's 1999 final report (*A Tax System Redesigned*) is that the Ralph Review appears to have abandoned legislative simplicity, seeking instead to address the additional compliance costs through tax concessions. These concessions were principally the Simplified Tax System and Capital Gains Tax (CGT) concessions for small business.

However, the report concludes that both these measures have failed to adequately compensate for the increased compliance costs. For example, of the eligible taxpayers having lodged their 2002 tax returns (as at 17 April 2003), only 14% have opted into STS.

In order to guard against similar compliance cost blow-outs in the future the Report, against a general recommendation for further debate, recommends the following:

Recommendation 1

> In order for the tax policy to be properly developed, it needs to be made with full knowledge about the cost of compliance of a measure. The Treasury, in consultation with the Australian Taxation Office should develop an enhanced ability to monitor and model the taxpayers' compliance costs in the tax system. This should be supported by technological infrastructure that allows for a timely and methodologically robust monitoring capacity.

Recommendation 2

> In order for the Parliament to be fully informed about the cost of compliance of a measure, a more publicly accountable Regulation Impact Statement (RIS) process needs to be established which sets out taxpayer compliance costs arising from the proposed change so that they can weight up the public good against the compliance costs imposed.

Recommendation 3

> To have in place the capacity to undertake timely, transparent and independent post-implementation reviews of all tax law and policy changes. Although these

mechanisms are available to the Board of Taxation the Board does not review policy.

Recommendation 4

Where the public good is deemed to be more important than the additional compliance costs imposed, Government needs to investigate the feasibility of compensation via a direct concession, via rebate (tax offset), a cash grant (based upon a percentage of turnover or the actual level of cost to the business) or a lower tax rate for business income of small businesses.