A PARTIAL ANALYSIS OF THE 1999 RALPH REPORT:
THE GOOD, THE BAD AND THE UGLY

A Work in Progress Paper

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1. Introduction

1.1 Background

This paper seeks to review the effectiveness of the tax reforms flowing from 1999 Review of Business Taxation’s Report (known as the Ralph Report).¹ In doing so, this paper selects three aspects of the enacted Ralph Report reforms, the non-commercial loss (NCL) rules², the simplified tax system (STS)³ and the capital gains tax (CGT) discount⁴, and evaluates these reforms having regard to the Ralph Report’s stated policy objectives and the generally accepted tax policy criteria. This paper seeks to bring together these papers to review aspects of the Ralph Report.⁵

The introduction firstly sets out the paper’s aims and then provides the necessary context for the paper by outlining the relevant Ralph Report processes and reforms. Secondly, the tax policy framework is detailed and applied to the NCL, STS and the CGT discount reforms.

1.2 Paper Aims

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³ Div. 328.
⁴ Div. 115.
This paper examines the enacted NCL rules, the STS and the CGT discount that all flowed from the recommendations in the 1999 *Ralph Report*. Leading up to the September 1999 *Ralph Report* and unlike the NCL and STS measures, the CGT reform proposals were subject to much commentary. Following September 1999, the NCL, STS and CGT discount have all been under review by commentators.

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6 Div 35.
7 Div 328: note that this paper focuses on the Review’s core original STS provisions in Div 328. The paper does not extend to the Government’s modifications to the STS to provide a limited two year period of amendment for income tax assessments for the 2004-05 and later income years was for individuals carrying on business per s 170(1) *Income Tax Assessment Act 1936* (Cth) (ITAA 1936). Also, the paper does not review the Entrepreneurs Tax Offset in subdiv 61-J ITAA 1997 that applied from 1 July 2005. This provides a 25 per cent entrepreneurs' tax offset on the income tax liability of certain STS taxpayers where the annual turnover of their business income is $50,000 or less.
8 Div. 115 ITAA 1997. Prior to the CGT discount, capital gains were generally subject to tax at ordinary income tax rates. The CGT discount provided a lower rate of income tax for individuals, trusts and superannuation funds.
professional and Government bodies. This paper seeks to build on this work and provide a systematic tax policy review of the Ralph Report’s reforms that resulted in the introduction of the NCL rules, the STS and the CGT discount. The paper concludes that these reforms highlight a general problem with the 1999 Review of Business Taxation (herein after called the Review). That problem resulted from the Review’s failure to adequately follow its own stated tax policy objectives of economic efficiency, equity, simplicity and fiscal adequacy in formulating its tax reform recommendations.  

1.3 The Ralph Report Reforms

1.3.1 The Review of Business Taxation’s Terms of Reference

The Review’s committee, consisted of three leading businessmen, John Ralph (Chairman), Rick Allert and Bob Joss, and was established in 1998 to make recommendations on reforms to the Australian tax system. Under the terms of reference the committee examined:

…in relation to business entities, the re-designed company tax arrangements proposed to apply to companies, trusts, cooperatives, limited partnerships and life insurers including a move towards consolidated group taxation and the achievement of a consistent treatment of distributions of profit and contributed capital;

(b) in relation to business investments, the extent of reform in the areas of physical assets, financial assets/liabilities and intangibles and the potential use of accounting principles, taking into account the following considerations

(i) the need to encourage business development with an internationally competitive tax treatment of business investments;

(ii) the potential benefits of bringing tax value and commercial value closer together;

(iii) the goal of moving towards a 30 per cent company tax rate;

(c) in relation to CGT (CGT), the scope for:

• capping the rate of tax applying to CGT for individuals at 30 per cent;

• extending the CGT roll-over provisions to scrip-for-scrip transactions; and


13 Review of Business Taxation Report above n 1 at 60.
14 Ibid v-vii.
15 Ibid v-vi.
(d) the Review will need to achieve overall revenue neutrality in respect of (b) and (c) with these changes...

1.3.2 The Review of Business Taxation’s first paper: A Strong Foundation Discussion Paper

The Review’s first publication, *A Strong Foundation Discussion Paper*\(^{16}\) was released in November 1998 and asserted that the business tax system was built on a deficient foundation, stating:\(^{17}\)

The business tax system — an important part of Australia’s taxation system and its broader economy — has been built upon a deficient foundation.

Taxation of business income is beset by a lack of consistency arising from decades of piecemeal and reactive change. That inconsistency distorts business decision-making and reduces Australia’s international competitiveness. The ensuing complexity of the tax law adds significantly to the costs of compliance and administration, fuelling an ongoing cycle in which anomalies and loopholes are exploited and then closed.

Factors evident in the changing business environment, such as increasing globalisation and the growth of electronic commerce, will further expose the weaknesses in the current foundation for the business tax system. The Review believes a strong foundation for the business tax system is essential to support Australia’s long-term growth performance as well as the Government’s specific reforms announced in A New Tax System.

Importantly, this paper set out the following key tax policy objectives:\(^{18}\)

In meeting the Commonwealth’s revenue targets, the business tax system should be designed to meet three national objectives: optimising economic growth, ensuring equity and facilitating simplification.

While government must determine how to balance those objectives in accordance with its broader policy objectives, the national objectives should be given operational effect through principles supporting the policy, legislative and administrative processes characterising the business tax system. Articulation of these supporting principles potentially enables greater clarity in evaluating and improving performance of the business tax system.

Three categories of supporting principle are required: policy design principles to specify key criteria for policy development, legislative design principles to guide tax legislation development, and administrative principles to govern taxpayer interaction with the tax administration. The policy design principles are directed primarily to achieving the growth objective; various principles specifically address fairness concerns; and consistent application of the collective design principles would facilitate simplification.

Relevantly the Review’s discussion paper adopted the same tax policy objectives that are relied upon in this paper to review the NCL, STS and the CGT discount.

1.3.3 The Review of Business Taxation’s second paper: An International Perspective Discussion paper


\(^{17}\) Ibid 13.

\(^{18}\) Ibid 60.
In their second paper, *An International Perspective Discussion Paper, Examining how other countries approach business taxation*, the Review gave guidance on how other countries structure their business taxation systems. This paper was prepared by an accounting firm, Arthur Andersen and provided a comparison of Australia’s business tax system with those of 26 other countries. The second discussion paper though has limited relevance given that this paper does not cover international comparisons of the NCL rules, the STS and the CGT discount.

### 1.3.4 The Review of Business Taxation’s third paper: A Platform for Consultation

The Review’s third paper, *A Platform for Consultation Discussion Paper 2, Building on a Strong Foundation*, consisted of two volumes. The first volume dealt with possible reforms to the taxation of investments and the second considered possible reforms to the taxation of entities, international taxation and the taxation of fringe benefits.

This third paper emphasised a key objective of a redesigned business tax system “is to improve the climate for investment and productivity and to boost employment and the standard of living – by creating a more competitive business environment. This overriding objective will only be achieved through a comprehensive and principled approach to reform.”

Also, this third paper invited the public to make submissions in response to the issues raised. Further, the paper asserted that the Review would discuss these issues with the community and such input would assist the Review in preparing its final report to the Government.

Relevantly, this paper considered non-commercial activities and noted that many taxpayers were claiming business status and business deductions for activities which were essentially private or lifestyle choices. The paper found that these activities were not genuine business activities. The paper further asserted that:

> …options might include measures to ensure losses are quarantined and allowed only against future assessable business income in the same or similar activity (perhaps based on an approach used in the US). …

> All such options would need to be developed with community consultation and structured in such a way as to ensure that legitimate arrangements were not unintentionally denied business deductions.

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20 Ibid iii.
22 Ibid 5-7.
23 Ibid.
24 Ibid 57
25 Ibid.
26 Ibid.
Further, the paper dealt with the taxation of capital gains. The paper examined how capital gains were taxed and assessed the impact of a lower CGT rate. The paper examined whether a lower CGT rate would encourage savings and investment, produce net economic benefits, encourage long-term investment, high-risk investments and attract mobile international capital. The paper then discussed CGT reform options that centred on a 30 per cent capped CGT rate and a stepped rate option that allowed a lower CGT rate on gains from assets the longer the asset is held. The paper also discussed the removal of CGT indexation and averaging as an acceptable trade-off for a lower CGT rate.

It is evident that the Review was in favour of CGT rate relief given their findings from the experiences of the United States of America and the United Kingdom:

...it is noteworthy that the USA and the UK have reduced their effective rates of CGT and have experienced increased investment and business development. The actual degree of causation between these factors may be difficult to determine or measure.

1.3.5 The Review of Business Taxation’s report: A Tax System Redesigned

The Review handed down its report, the *Ralph Report (A Tax System Redesigned More certain, equitable and durable)*, in July 1999. The Report consisted of eight parts and made 280 recommendations. This resulted in sweeping reforms to the Australian income tax system as many of these reforms have since passed into law over a staggered time line since 1999. Relevant to this paper, the Review made the following recommendations.

1.3.5.1 The Review’s Tax Policy Principles

Notably the Review emphasised that the “overarching objective of the Review has been to design a taxation system that will contribute best to economic growth…”. However, in accordance with its first paper, *A Strong Foundation*, the *Ralph Report*
sought to maintain tax revenue neutrality and to achieve the following national taxation objectives:

- optimising economic growth;
- promoting equity; and
- promoting simplification and certainty.

These criteria are used in setting out the tax policy framework and in assessing the NCL, STS and CGT discount.

### 1.3.5.2 Non-Commercial Losses

In accordance with the findings of the third paper, *A Platform for Consultation*, the *Ralph Report* in Recommendation 7.5 called for the introduction of non-commercial loss restrictions on small business. The primary rationale for this reform was to improve the integrity of the taxation system by restricting loss deductions for hobby style taxpayers. This recommendation resulted in the introduction of the NCL rules in Div 35 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997).

### 1.3.5.3 Simplified Tax System

Recommendations 17.1-17.4 of the Report advocated a new STS for small business. The measures provided for an alternative cash accounting system, a simplified and accelerated depreciation regime and a simplified trading stock regime. These measures were introduced to assist small business by way of a simpler tax system given the regressive impact of tax compliance costs. This recommendation resulted in the introduction of the STS in Div 328.

### 1.3.5.4 CGT Discount

Further, Recommendations 18.2-18.3 called for the introduction of a CGT discount rate for individuals, trusts and complying superannuation funds. The main rationale for this reform was to encourage investment. This recommendation resulted in the introduction of the CGT discount in subdiv 115-A.

### 1.3.5.5 Board of Taxation

Relevantly, the Review in Recommendation 1.4 proposed the establishment of an advisory Board of Taxation (the Board) to review the ongoing development of the business tax system against the national taxation objectives as set out in the proposed...
Charter of Business Taxation.\textsuperscript{45} This would overcome the concern of the “largely piecemeal approach which has evolved in relation to the development of business taxation policy…”\textsuperscript{46} The Board would undertake the following functions:\textsuperscript{47}

- draw on the knowledge and expertise of the business sector, including from professionals and advisers, and provide government with a source of independent and timely advice on the development and implementation of sound business taxation policies;
- be the guardian of the proposed Charter of Business Taxation containing the national taxation objectives and taxation design principles, and recommend changes necessary to ensure the Charter remains contemporary;
- be a source of informed advice on appropriate consultative processes in relation to ongoing business taxation issues;
- monitor and report on the performance of the business taxation system — and, in this regard, of the Treasury, the ATO (Australian Taxation Office) and the OPC (Office of Parliamentary Counsel) — against the objectives and principles set out in the Charter; and
- conduct an annual review of the application of the policy framework and processes relating to the general and specific anti-avoidance rules, to be published as part of the Board’s annual report…

The Government subsequently moved to establish the Board in August 2000 with the Board having the following mission:\textsuperscript{48}

Recognising the Government’s responsibility for determining taxation policy and the statutory roles of the Commissioner of Taxation and the Inspector-General of Taxation, the Board’s mission is to contribute a business and broader community perspective to improving the design of taxation laws and their operation.

The Board provides advice to the Treasurer on:\textsuperscript{49}

- the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design;
- improvements to the general integrity and functioning of the taxation system;
- research and other studies commissioned by the Board on topics approved or referred by the Treasurer; and
- other taxation matters referred to the Board by the Treasurer.

Relevantly, the Board reviewed the NCL measures as set out below.

1.3.5.6 Progressing the Integrated Tax Code

The Review also recommended (Recommendation 2.2) the adoption of an integrated tax code using an integrated tax design business process for business tax policy and legislation.\textsuperscript{50} The Review asserted that:\textsuperscript{51}

\textsuperscript{45} Ibid 102: “The Charter has at its core three national taxation objectives: optimising economic growth; promoting equity; and promoting simplification and certainty.”
\textsuperscript{46} Ibid 119.
\textsuperscript{47} Ibid.
\textsuperscript{49} Ibid.
When fully implemented, the Code will provide a vast improvement over the structure of the current taxation laws and make them far easier to use. The Code structure will include:

- a legislative guide to the taxation laws included in the Code, explaining what the Code is, how to navigate around it, what Acts are within it, what those Acts do, and how they are linked;
- a common dictionary to ensure consistency and greater standardisation of concepts across the Code; and
- standardised provisions that have application across the various Acts included in the Code.

The enacted NCL, STS and the CGT discount rules are reviewed below having regard to the integrated income tax code and the integrated tax design business process.

### 1.3.5.7 Ongoing Review of Tax Preferences

Notably, the Review recommended that tax preferences be periodically and systematically reviewed against the objectives for their introduction.\(^5\) The Review stated:\(^6\)

> Tax policy design principle 10, proposed in A Strong Foundation (page xxi), suggested that ‘Tax incentives should only be provided following a formal assessment of their net impact on the national taxation objectives and only where assessed to be an essential or superior form of government intervention.’ This principle is attached to the proposed Charter of Business Taxation (see Recommendation 1.3) and should apply equally to all existing as well as proposed new tax incentives. …

In some cases, preferential taxation treatment can have adverse economic efficiency consequences. Special treatment can also compromise the structure and integrity of the law. Without proper evaluation, the true cost to the nation of these provisions cannot be ascertained.

The processes for the evaluation and review of tax expenditures will be facilitated through the collection of appropriate information from taxpayers — the subject of Recommendation 3.10.

This paper will examine whether the enacted tax preferences in the STS and the CGT discount rules have been periodically and systematically reviewed against their objectives.

### 1.3.5.8 Removal of Accelerated Depreciation

Recommendation 8.1 sought the removal of accelerated depreciation rates.\(^5\) The Review found that such a policy would improve tax neutrality as:\(^6\)

> …accelerated depreciation provides significant benefits to capital-intensive industries such as mining and manufacturing while being of little benefit to service industries such as finance,
tourism or retailing. This means that (scarce) resources may be diverted away from activities that, in a tax-neutral environment, would have otherwise attracted them.

The Review though found that it was difficult to gauge the economic impact of removing accelerated depreciation given the many winners and losers that would be created from such policy. The Review though suggested that under this policy the government could directly assist losers such as capital intensive projects considered to be in the national interest.

However, the Review concluded that removing accelerated depreciation would greatly improve the integrity and structure of income taxation, stating:

- It will remove the need to define the policy and legislative boundaries between those assets that qualify for accelerated depreciation and those that do not. For example, plant and equipment (as defined in the tax law), excluding cars, benefit from accelerated depreciation, but intangible assets do not.

- It will reduce the need for complex anti-avoidance rules. For example, section 51AD of the 1936 Act was primarily a response to the indirect accessing of accelerated capital allowances by tax-exempt bodies. Removing accelerated depreciation will remove the need for complex leasing rules to police the boundary between taxable and non-taxable entities.

This recommendation for the abolition of the accelerated depreciation rates will be examined in the context of the STS.

1.3.5.9 Revenue Neutrality

Overall the Review estimated that the proposed tax changes would broadly have a neutral impact on tax revenue as shown in the following table:

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56 Ibid.
57 Ibid.
58 Ibid.
59 Ibid 698, Table 24.1.
Table 1: Revenue implications of Review’s recommendations

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<tr>
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<th></th>
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</thead>
<tbody>
<tr>
<td>Company tax rate (%)</td>
<td>$36</td>
<td>$34</td>
<td>$30</td>
<td>$30</td>
<td>$30</td>
<td>$30</td>
</tr>
<tr>
<td>Loss of revenue from A New Tax System measures as a result of reducing company tax rate(^a)</td>
<td>-10</td>
<td>-190</td>
<td>-680</td>
<td>-320</td>
<td>-370</td>
<td>-380</td>
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<tr>
<td>Cost to revenue of reducing company tax rate on existing base</td>
<td>-1,160</td>
<td>-2,840</td>
<td>-2,740</td>
<td>-2,740</td>
<td>-3,030</td>
<td></td>
</tr>
<tr>
<td>Total cost of company tax rate reduction</td>
<td>-10</td>
<td>-1,350</td>
<td>-3,520</td>
<td>-3,060</td>
<td>-3,100</td>
<td>-3,410</td>
</tr>
<tr>
<td>Removal of accelerated depreciation</td>
<td>40</td>
<td>1,150</td>
<td>2,220</td>
<td>2,300</td>
<td>2,610</td>
<td>2,550</td>
</tr>
<tr>
<td>Other changes to taxation of investments</td>
<td>10</td>
<td>390</td>
<td>770</td>
<td>120</td>
<td>-100</td>
<td>-300</td>
</tr>
<tr>
<td>Total revenue from changes to taxation of investments</td>
<td>50</td>
<td>1,540</td>
<td>2,990</td>
<td>2,420</td>
<td>2,520</td>
<td>2,260</td>
</tr>
<tr>
<td>Changes to taxation of income from entities</td>
<td>-60</td>
<td>-660</td>
<td>-360</td>
<td>-410</td>
<td>-240</td>
<td>-290</td>
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<tr>
<td>Small business measures</td>
<td>-520</td>
<td>-530</td>
<td>-210</td>
<td>-330</td>
<td>-420</td>
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<td>Integrity measures</td>
<td>530</td>
<td>1,030</td>
<td>980</td>
<td>980</td>
<td>990</td>
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</tr>
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<td>CGT reforms</td>
<td>160</td>
<td>170</td>
<td>100</td>
<td>50</td>
<td>-30</td>
<td></td>
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<td>FBT reforms</td>
<td>10</td>
<td>-210</td>
<td>70</td>
<td>100</td>
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<td>High level design reforms</td>
<td>-30</td>
<td>220</td>
<td>210</td>
<td>290</td>
<td>280</td>
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<tr>
<td>Growth Dividend</td>
<td>50</td>
<td>100</td>
<td>200</td>
<td>300</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>Revenue impact of package</td>
<td>-30</td>
<td>-270</td>
<td>120</td>
<td>30</td>
<td>540</td>
<td>-20</td>
</tr>
</tbody>
</table>

\(^a\) The estimates incorporate the impact of base broadening on revenue gained from trusts at the recommended company tax rate; that is, the measure is costed against the Review’s recommendations.

The tax revenue impacts of the NCL, STS and the CGT discount are reviewed in the following analysis.

1.4 Legislation Overview

1.4.1 Non-Commercial Losses

*Background*

Prior to Div 35 the Commissioner could not order a taxpayer on how to run their business affairs even if the business operations remained unprofitable.\(^{60}\) Thus taxpayers were permitted to claim deductions for losses on business activities and

\(^{60}\) *Tweddle v FCT* (1942) 180 CLR 1; 2 AITR 360; 7 ATD 186.
such losses could be offset against other assessable income.\textsuperscript{61} This, however, created a number of problems. Firstly, it has proved difficult for taxpayers, tax practitioners and tax administrators to determine whether certain small scale businesses were genuine businesses as opposed to hobby and/or lifestyle type activities. This difficulty arose from the nature of the tests applied to determine whether a business is being carried on.

Whilst the ITAA defines\textsuperscript{62} a ‘business’ to include ‘any profession, trade, employment, vocation or calling, but does not include occupation as an employee.’ This definition is merely inclusive\textsuperscript{63} and does not provide any guidance for determining whether a particular activity constitutes a business. As evident in the Full Federal Court in Ferguson v FCT\textsuperscript{64} the Courts have only provided guiding principles as to whether a taxpayer is carrying on a business. Accordingly, there is no definitive approach as to what constitutes a business. Rather, the determination of a business is the result of a process of weighing up of a number of relevant factors. However, this approach still creates great difficulty for taxpayers with small hobby type activities that have some elements of business and lifestyle characteristics. Consequently the vagueness of this definition has resulted in a plethora of cases\textsuperscript{65} on business activity and a number of taxation rulings from the Australian Taxation Office.\textsuperscript{66}

Secondly, under the self assessment system of income taxation certain taxpayers took advantage of the uncertainty of what constitutes a business and claimed deductions for losses on small business type activities that really amounted to hobby or lifestyle choices.\textsuperscript{67} This provided an effective tax shelter for taxpayers facing the top marginal income tax rate of 48.5 per cent including medicare levy (for the income year ending 30 June 2006 and earlier years)\textsuperscript{68} that conducted loss making lifestyle activities such as hobby farms, part time car racing and part time yacht charter activities. The pursuit of such activities sometimes lacked any genuine intention to make a profit and appear to have been conducted with some business flavour sufficient to pass the scrutiny of the Australian Taxation Office. Consequently, the Australian Taxation Office had considerable difficulty in differentiating between genuine business and hobby farms given the resource constraints.\textsuperscript{69} This is evident given the time intensive nature of such audit work and dispute resolution. Further a number of liberal interpretations by the courts\textsuperscript{70} in accepting small scale primary production activities as businesses hampered the Australian Taxation Office’s efforts in preventing such tax avoidance.

\textsuperscript{61} The main exception to this rule applied to losses from negatively geared rental property from 17 July 1985 to 30 June 1987, sub-div G of Div 3 of Part III ITAA 1936.
\textsuperscript{62} s 995-1 ITAA 1997.
\textsuperscript{63} FCT v St Hubert’s Island Pty Ltd (1978) 8 ATR 452, 455 per Stephen J.
\textsuperscript{64} 79 ATC 4261.
\textsuperscript{65} For example see: FCT v Walker 85 ATC 4179; Ferguson v FCT 79 ATC 4261; Martin v FCT (1953) 90 CLR 470; FCT v Stone 2005 ATC 4234; Puzey v FCT [2002] FCA 1171, 50 ATR 595; FCT v Sleight [2004] FCAFC 94, 55 ATR 555.
\textsuperscript{66} See Australian Taxation Office Taxation Ruling TR 97/11; TR 2005/1.
\textsuperscript{68} The top marginal income tax rate is 48.5 per cent including medicare levy for the income year ending 30 June 2006.
\textsuperscript{69} Australian Treasurer Media Release 074 above n 57.
\textsuperscript{70} In Walker a taxpayer with only one Angora goat was held to amount to a primary production business activity and in Ferguson a taxpayers owning 5 cows was held to be carrying on a business.
Relevantly, the Australian Taxation Office does not appear to have ever evoked the general anti avoidance provisions in Part IVA ITAA 1936 against such hobby businesses. Part IVA would have potentially applied to many of these hobby activities given the lack of commercial purpose and the considerable tax benefits obtained in deductible losses.

**Overview of Legislation**

The NCL provisions in Div 35 ITAA 1997 apply from 1 July 2000 to each and every income year in which an individual taxpayer (whether alone or in partnership) carries on a relevant business activity.\(^71\) As the provisions require an individual to be carrying on a business, Div 35 does not extend to losses from negatively geared passive investments such as property or shares.\(^72\)

The key loss deferral rule in s 35-10(2) treats business losses attributable to the business activity as not having been incurred in the year. The losses are quarantined to the next year that the activity is carried on. Thus such business losses can not be used to offset other income.

Subsection 35-10(1) provides that the rule in s35-10(2) applies for an income year to each business activity carried on by an individual (alone or in partnership) unless one of the following exceptions apply:\(^73\)

(a) the individual's business activity meets one of the four tests in s35-30 (assessable income test), 35-35 (profits test), 35-40 (real property test) or 35-45 (other assets test) for the business activity for that year;  
(b) the individual comes within the Exception in s 35-10(4) for that year; or  
(c) the individual is covered by an exercise of the Commissioner's discretion in s 35-55 in relation to that business activity for that year.

If these requirements do not apply the loss is quarantined and can only be offset against future profits from the business activity.\(^74\)

**The four tests exemption**

If any one of the following four tests are satisfied a taxpayer will avoid the NCL restrictions. The assessable income test\(^75\) requires that the amount of assessable income from the business activity for the year is at least $20,000. The profits test requires\(^76\) that the business activity makes taxable income in three of the past five income years, including the current income year.

Also, the rule in section 35-10 does not apply to a business activity for an income year if a taxpayer uses at least $500,000 of real property or interests in real property on a continuing basis in carrying on the activity in that year. Further, the rule in section

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\(^{71}\) s 35-10(1).  
\(^{72}\) s 35-10(1). The provisions only apply to individuals carrying on a business.  
\(^{73}\) s 35-10(1).  
\(^{74}\) Ibid.  
\(^{75}\) s 35-30.  
\(^{76}\) s 35-35.
35-10 does not apply to a business activity for an income year if the total value of assets that are counted for this test and that are used on a continuing basis in carrying on the activity in that year is at least $100,000.\textsuperscript{77} This test includes depreciable assets, trading stock, leased assets, trademarks, patents and copyrights but excludes real property, cars, motor cycles and similar vehicles.\textsuperscript{78}

\textit{The Primary Production and Professional Arts Exceptions}

The NCL limitations do not apply if the business activity is a primary production business or a professional arts business and the taxpayer’s assessable income (excluding capital gains) from other sources that do not relate to that activity is less than $40,000.\textsuperscript{79}

\textit{The Commissioner's discretion}

Where none of the above four tests are satisfied the Commissioner may exercise his discretion not to apply the NCL provisions in the following two circumstances.\textsuperscript{80} Firstly, the business activity was or will be affected in that or those income years by special circumstances outside the control of the operators of the business activity, including drought, flood, bushfire or some other natural disaster.\textsuperscript{81}

Secondly, the because of its nature and objective expectation discretion may apply. This discretion has the following three requirements:\textsuperscript{82} Firstly, an individual must have started to carry on a business activity.\textsuperscript{83} Secondly, the business activity has started to be carried on and ‘because of its nature’, it has not yet satisfied one of the four tests set out above in ss 35-30, 35-35, 35-40 or 35-45.\textsuperscript{84} Thirdly, there must be an objective expectation, based on evidence from independent sources (where available) that, within a period that is commercially viable for the industry concerned, the activity will either meet one of the four tests or produce a profit.\textsuperscript{85}

1.4.2 Simplified Tax System

\textit{Background}

In 1996 the Government embarked on a campaign helping Australia’s then 860,000 small businesses from the constraints of crippling taxes and red tape with the establishment of the Small Business Deregulation Taskforce.\textsuperscript{86} Notwithstanding the efforts of the taskforce the income tax laws have expanded from some 3,000 odd pages of legislation in 1996 to over 10,000 pages in 2006. Thus it is not surprising that attempts were made to simplify the tax system for small business with the

\textsuperscript{77} s 35-45.
\textsuperscript{78} Ibid.
\textsuperscript{79} s 35-10(4).
\textsuperscript{80} s 35-55(1).
\textsuperscript{81} s 35-55(1)(a).
\textsuperscript{82} s 35-55(1)(b).
\textsuperscript{83} s 35-55(1).
\textsuperscript{84} s 35-55(1)(a)(i).
\textsuperscript{85} s 35-55(1)(b)(ii).
voluminous tax reforms flowing from the 1999 Ralph Report and the introduction of the goods and services tax on 1 July 2000.

**Overview of Legislation**

The STS was introduced on 1 July 2001. The STS originally involved a cash accounting regime as an alternative to accrual accounting, simplified accelerated depreciation regime and a simplified trading stock regime for eligible small businesses.

However, the STS though did not prove to be very popular with small business with only 27 per cent take up. Thus modifications have recently been made to the system to make it more attractive to small business with the introduction of the entrepreneurs discount, extended roll-over relief available for partnerships, changes to STS accounting, limited amendment periods, and higher small business thresholds.

**1.4.3 CGT Discount**

**Background**

Prior to the CGT discount net capital gains were generally taxed at a taxpayer’s marginal income tax rate. Although, under CGT averaging, individuals and certain trustees could average their net capital gains to reduce the bunching effect of an accumulated capital gain. Also, the CGT provisions freely permitted a taxpayer who owned a CGT asset for at least 12 months to index the cost base of the asset for inflation in calculating a capital gain. The indexation commenced in the quarter when the expenditure on the cost base was incurred and ceased in the quarter when the CGT event occurred.

**Overview of Legislation**

For CGT events happening after or on 21 September 1999 Div 115 provided a significant reduction to the amount of CGT, with its 50% CGT discount for

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90 Subdiv 328-C ITAA 1997.
91 Subdiv 328-D
92 Subdiv 328-E
93 Subdiv 328-F
95 Subdiv 61-J.
96 ss 328-220, 328-243, 328-247, 328-250, 328-253, 328-255.
97 ss 328-115 to 328-120, 328-440.
98 s 170(1) ITAA 1936.
100 Div. 114 ITAA 1997.
101 s 114-1.
102 s 115-15.
individuals and trusts. A 33 1/3% CGT discount also applied to superannuation funds. The new Div 115 though replaced the former averaging and indexation concessions.

Section 115-5 provides that a discount capital gain is a capital gain that meets the following basic requirements:

**Basic requirements**

1. The capital gain must be made by an individual; or a complying superannuation entity; or a trust.

2. The capital gain must result from a CGT event happening after or on 21 September 1999.\(^{104}\)

3. The capital gain must have been worked out using a cost base that excludes indexation.\(^{105}\)

4. The capital gain must result from a CGT event happening to a CGT asset that was acquired by the entity making the capital gain at least 12 months before the CGT event.\(^{106}\) The following ten CGT events though do not obtain the CGT discount: D1, D2, D3, E9, F1, F2, F5, H2, J2 and J3.\(^{107}\)

**Anti avoidance rules**

Also, there are two anti avoidance rules for the 12 month holding period. Section 115-40 provides that where the CGT event occurred under an agreement you made within 12 months of acquiring the CGT asset the CGT discount will not apply. Section 115-45 excludes a CGT discount for capital gains from certain disposals of equity interests in companies or trusts where the taxpayer could not have otherwise accessed the CGT discount if the taxpayer directly owned the underlying assets of the company or trust.

**The discount percentage**

The discount percentage for an amount of a discount capital gain is 50% if the gain is made by an individual or by a trust and 33 1/3% if the gain is made by a complying superannuation entity.\(^{108}\)

**Special rules for trusts**

Special rules for trusts apply so that the CGT discount is appropriately traced through to beneficiaries receiving capital gains and that company beneficiaries do not receive

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104 s 115-15.
105 s 115-20.
106 s 115-25. Note s115-30 provides special rules about time of acquisition that deem earlier times of acquisition where assets are acquired under certain roll-over provisions.
107 s 115-25(3).
108 s 155-100.
Access to the CGT discount was expanded to include assets realised by listed investment companies on or after 1 July 2001.  

1.5 The Tax Policy Criteria

Over two hundred years ago Adam Smith produced four functional criteria for assessing a tax system.  

Equality: when ability to pay is taken into consideration, a good tax should distribute the burden of supporting more or less equally among those who benefit from government.

Convenience: The time and manner of payment, should be as convenient as possible for the taxpayer.

Certainty: The amount of tax that is due, the method of payment, and the deadline for payment should be clear so that each taxpayer can be certain about his or her obligations.

Efficiency: The cost of administering the tax should be as low as possible so that a large fraction of what is taken from the taxpayers pocket is not used up in collecting taxes.

Today, a similar set of functional criteria is well accepted in Australia and internationally. Accordingly, this paper uses four functional criteria: fiscal adequacy, economic efficiency, equity and simplicity, to assess the enacted NCL rules, the STS and the CGT discount as follows.

2. Fiscal Adequacy

Fiscal adequacy refers to the ability of taxation law to finance government expenditure. Fiscal adequacy is a fundamental requirement for a tax system given the government’s need for revenue to ensure good governance.

From an income tax point of view, fiscal adequacy is maximised by taxing comprehensive income (also known as economic income) since this provides the widest possible definition of income. The Haig-Simons formulation of economic income defines income as the increase in net economic wealth between two points of time.  

109 ss 155-200 to 115-225.
110 Subdiv 115-D. A listed investment company is an Australian resident listed company that has at least 90% of its assets in allowed investments that include shares, units, options, rights, certain financial instruments and goodwill, s.115-290.
112 Review of Business Taxation Report, above n 1, 9,13; J Waincymer, Australian Income Tax Principles and Policy, (2nd ed, 1993) 26; J Alm, ‘What is an “Optimal” Tax?’ (1996) XLIX National Tax Journal 117, 117. Alm stated ‘A central issue in public economics is the appropriate design of a tax system. Such a system is usually viewed as balancing the various desirable attributes of taxation: taxes must be raised (revenue-yield) in a way that treats individuals fairly (equity), that minimizes interference in economic decisions (efficiency), and that does not impose undue costs on taxpayers or tax administrators (simplicity)’.
113 Kenny Capital Gains Taxation for New Zealand n 5 at 290.
114 Nichols v Ames, 173 US 509 (1898), 515, the United States Supreme Court stated: The power to tax is the one great power upon which the whole national fabric is based. It is as necessary to the existence and prosperity of a nation as is the air he breathes to a natural man. It is not only the power to destroy, but the power to keep alive.
time plus consumption during that period, where consumption includes all 
expenditures except those incurred as a cost in the earning or production of income. In order to calculate the increase in net economic wealth taxpayers will need to calculate the market value of their net assets at the beginning and the end of the income tax year.

This creates a number of problems with this tax base that necessitate certain adjustments. Firstly, for practical administrative reasons, the difficulty in valuing such assets as human capital and personal rights to superannuation warrant departures from this tax base. Other departures are required to take account liquidity difficulties in paying annual income taxation on the appreciation of illiquid assets such as real estate and business assets. Whilst, it is beyond the scope of this paper though to definitively set out a fully detailed ideal measure of economic income, it is clear that in respect of income taxation fiscal adequacy is optimised by a comprehensive income tax base.

2.1 Non-Commercial Losses and Fiscal Adequacy

On fiscal adequacy grounds Div 35 provides a small but significant quantum of tax revenue. The Review estimated that the loss restrictions would increase tax revenue as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>2000-01</th>
<th>2001-02</th>
<th>2002-03</th>
<th>2003-04</th>
<th>2004-05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Revenue Gain</td>
<td>$50m</td>
<td>$310m</td>
<td>$240m</td>
<td>$200m</td>
<td>$180m</td>
</tr>
</tbody>
</table>

The Treasury’s Tax Expenditures statement though provided the following estimate for the tax expenditure involved in the exemption for primary producers and artists with less than $40,000 of other assessable income.

<table>
<thead>
<tr>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Revenue Loss</td>
<td>$150m</td>
<td>$90m</td>
<td>$100m</td>
<td>$105m</td>
<td>$105m</td>
<td>$105m</td>
<td>$105m</td>
<td>$105m</td>
</tr>
</tbody>
</table>

Compared to the estimated savings from the NCL loss restrictions the primary producer and artists exemption appears to be very costly. Further, some

116 Kenny Australian Taxation, Ethics and Social Capital above n 5 at 111; Review of Business Taxation Platform for Consultation above n 21 at 12.
117 Ibid.
118 Review of Business Taxation Report above n 1 at 722.
commentators are skeptical about the estimated tax revenue savings from Div 35 given the opportunities for taxpayers to manipulate the NCL exemptions.\footnote{\textit{120}}

**2.2 Simplified Tax System and Fiscal Adequacy**

The STS clearly damages fiscal adequacy. The Review estimated that the STS would result in the following tax revenue losses:\footnote{\textit{121}}

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowing cash accounting</td>
<td>-$220m</td>
<td>-$320m</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Simplified depreciation</td>
<td>-$60m</td>
<td>-$270m</td>
<td>-$180m</td>
<td>-$320m</td>
<td>-$420m</td>
</tr>
<tr>
<td>Delayed removal of accelerated depreciation and balancing charge rollovers</td>
<td>-$240m</td>
<td>$70m</td>
<td>-$30m</td>
<td>-$10m</td>
<td>-$10m</td>
</tr>
<tr>
<td>Total</td>
<td>-$520m</td>
<td>-$530m</td>
<td>-$210m</td>
<td>-$330m</td>
<td>-$420m</td>
</tr>
</tbody>
</table>

However, the Treasury’s 2005 Tax Expenditures statement provided a lower estimate of the revenue losses probably reflecting the much lower than expected take up of the STS by business, as follows:\footnote{\textit{122}}

<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Revenue Loss</td>
<td>$10m</td>
<td>$420m</td>
<td>$420m</td>
<td>$250m</td>
<td>$250m</td>
<td>$200m</td>
<td>$200m</td>
<td>$190m</td>
</tr>
</tbody>
</table>

Whilst the STS tax revenue losses are small compared to total Commonwealth tax revenue,\footnote{\textit{123}} they are not insignificant.

**2.3 CGT Discount and Fiscal Adequacy**

The Review estimated that the CGT discount (including the freezing of indexation and the abolition of averaging for individuals) would only result in moderate tax revenue losses as follows:\footnote{\textit{124}}

<table>
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<tbody>
<tr>
<td>Douglas Farmers nil Commissioners Nil above n 10 at 390-392.</td>
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<tr>
<td>Review of Business Taxation Report above n 1 at 722.</td>
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<tr>
<td>Australian Taxation Statistics 2003-04</td>
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<td></td>
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<tr>
<td><a href="http://www.ato.gov.au/content/downloads/70906_2004CH2SUM.pdf">http://www.ato.gov.au/content/downloads/70906_2004CH2SUM.pdf</a>, 7. Total Commonwealth revenue for 2004-05 was $214,850 million. Thus the STS revenue loss in 2004-05 is only 0.1 per cent of tax revenue.</td>
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<tr>
<td>Review of Business Taxation Report above n 1 at 722.</td>
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<tr>
<td>Year</td>
<td>2000-01</td>
<td>2001-02</td>
<td>2002-03</td>
<td>2003-04</td>
<td>2004-05</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax Revenue Loss</td>
<td>$140m</td>
<td>$180m</td>
<td>$140m</td>
<td>$120m</td>
<td>$40m</td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

It is clear though that the CGT discount has proven to be very costly to tax revenue as the following Treasury estimates have subsequently illustrated:

**Table 7: Estimated tax expenditures from the CGT discount 2001-05**

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated tax expenditure from the CGT discount ($ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000-01</td>
<td>1.31</td>
</tr>
<tr>
<td>2001-02</td>
<td>1.81</td>
</tr>
<tr>
<td>2002-03</td>
<td>1.81</td>
</tr>
<tr>
<td>2003-04</td>
<td>1.81</td>
</tr>
<tr>
<td>2004-05</td>
<td>1.91</td>
</tr>
</tbody>
</table>

The CGT discount has an enormous influence over CGT collections as seen by the size of the revenue loss $2.03 billion in 2004-05 compared to CGT revenue of about $6.75 billion in 2004-05.

### 3. Economic Efficiency

Ideally a tax system should have a neutral impact or promote economic growth or efficiency. Economic efficiency is important since the tax system ‘can significantly influence the efficiency with which Australia’s natural resources, capital and labour are used’.

From an income tax point of view the Review’s business taxation design principles advocated that ‘the tax base adopted should be as close as possible to comprehensive income’. This enhances neutrality and thus economic efficiency. The Review though acknowledges that certain departures from comprehensive income are justified. Other commentators advocate tax preferences for specific activities to...

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125 Australian Taxation Office, Annual Report 2004-05
126 Review of Business Taxation Report above n 1, 105.
128 Review of Business Taxation Report above n 1 at 111; Review of Business Taxation Platform for Consultation above n 21 at 28, points to the benefits of comprehensive income: ‘the imposition of income tax to raise revenue would have minimal impact on investment choices; the law could be far simpler and clearer; tax avoidance opportunities would be kept to a minimum. Business could focus on commercial choices rather than spend time and resources seeking to minimise liability.’
129 Ibid.
130 Review of Business Taxation Platform for Consultation above n 21 at 12; ‘While the comprehensive income tax base may never be implemented in practice, most successful market economies use that base in designing and evaluating the performance of their operating income tax systems...Not surprisingly, the prospect of unbridled application of the conceptual comprehensive income tax base
promote economic growth. They argue that taxing economic income has an adverse impact on savings, investment, capital accumulation, economic growth, risk taking, entrepreneurial activity, new ventures, equity financing, international competitiveness and foreign investment. Overall this paper considers that the income tax system should form a close proxy with the comprehensive income ideal.

3.1 Non-commercial Losses and Economic Efficiency

In the context of neutral income tax system Div 35 would enhance economic efficiency if it restricted departures from the taxation of economic income. However, it only succeeds in doing this to the extent that the rules restrict deductions for hobby and lifestyle activities. This will lead to a more efficient allocation of resources away from such private pursuits into productive assets.

Unfortunately, many lifestyle type activities are not affected by the NCL provisions given the generous exemptions in the four tests in s 35-30 to 35-45. The provisions favour small parcels of expensive farming land (probably located close to capital cities) worth more than $500,000 over larger but more commercially orientated rural properties worth less than $500,000. This is evident in the following example:

**Example 1**

Mary lives in the Hills near the Adelaide CBD and runs a small herd of cattle on her small farm where she lives and has made losses for the last 10 years. She works in the city as a medical specialist and employs a part time farm hand. The farm land is worth $600,000 and thus the NCL provisions do not apply. (If the farm land was worth less than $500,000 Mary could pass this test by ensuring that she had $100,000 of plant and equipment or at least $20,000 of farm assessable income.)

Also, there is a bias towards capital intensive plant and machinery businesses and trading stock with the $100,000 Other Assets minimum test. Further, high turnover businesses are favoured with the $20,000 assessable income test. In this way this Div 35 focuses on an individual’s assessable income rather than taxable income.

Additionally, small primary producers and professional artists carrying on a business with a significant lifestyle element but with other income of less than $40,000 are also exempted as seen by the following example:

**Example 2**

In all circumstances attracts taxpayer concern – especially in relation to liquidity, valuation, volatility, loss offset and effects on international competitiveness.

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132 Ibid.

133 Review of Business Taxation Report above n 1 at 295.

134 s 35-45.

135 s 35-30.
George is a landscape artist and has made losses for the last 3 years of $10,000 on average. He also works part time as a bar man and earns $39,000 a year. The NCL provisions will never apply since George ensures that his other income is less than $40,000.

Since the rules are not targeted at lifestyle activities, many genuine micro businesses that ought to be able to offset losses are restricted, yet other genuine larger scale businesses are unaffected. Also, passive investors are not affected.

There are a number of reasons why the NCL provisions would discourage business expansion and diversification. Firstly, any losses from new activities that are not of a similar kind will be potentially limited under Div 35. Secondly, dissimilar activities will generate onerous compliance costs associated with the compilation of separate financial statements for various business activities. Thirdly, quarantined losses are lost where a business restructures from a loss making individual to a corporate structure. Douglas concluded that:

…possibly the most deleterious impact of the provisions will be on innovation and risk taking in agriculture and the broader community. Economic theory suggests that the tax system is neutral to risky projects providing there are perfect loss offsets. The provisions reduce already imperfect loss offsets.

Overall this all appears to be highly inefficient, and out of step with the Ralph Report's stated aims of taxing comprehensive income and of taxing similar transactions in a similar manner. The NCL measures work to deter taxpayers from starting genuine new businesses or expanding an existing business into a new area whilst many hobby / lifestyle businesses are unaffected.

Submissions to the Board of Taxation

In its submission to the Board, Taxpayers Australia provided real examples of how the NCL provisions discourage small business. The following example illustrates the disincentive that Div 35 provides to a taxpayer who does not meet any of the four tests or the exceptions and who undertakes a new business venture.

Example 3

A musician who is also employed with an income of over $40,000 plays live music at venues and is in a partnership which produces a music CD. The musician is unable to write off the losses as a musician (high depreciation and transport costs), although the skills and instruments are the same, against CD profits as future batches are produced. This is because he is deemed to have dissimilar businesses as the industry codes, which the ATO uses to classify business incomes, are different – by 1!

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136 The NCL rules only apply to individuals carrying on a business, s35-10(1).
137 s 35-10(1)-(3).
138 Douglas Farmers nil Commissioners Nil above n 10 at 389; Cooper Tax Reform Non Commercial Losses above n 10 at 162.
139 s 35-10(1), (2).
140 Douglas Farmers nil Commissioners Nil above n 10 at 392.
141 Review of Business Taxation Report above n 1 at 111-112.
142 Taxpayers Australia above n 10 at 1-2.
143 s 35-10(2).
Outcome: The musician is reconsidering the future of both businesses due to the tax paid on the deferred losses.
Issue: Industry codes are an issue and a potential minefield for taxpayers subject to tax audits.

The following example illustrates the harsh impact of Div 35 on a taxpayer who incurs losses on a new business activity just prior to retirement.144 The example also shows how novel or innovative ventures will face difficulties in obtaining the Commissioner’s discretion under s35-55.

Example 4

A university lecturer who has had the threat of reduced funding causing early retirement collected sufficient information to write several books. He self-published and had modest success but did not make a profit. He chose to prepare the books for sale directly on the internet without printing. The high costs of preparation were incurred in one financial year but the income will flow in over many years as it is useful for reference without obsolescence. As each book is placed on the virtual bookshelf by a USA internet book store there are no further expenses and all income is devoid of a variable cost. The taxpayer’s claim to offset his expenses against his other income was denied. A request was made for the Commissioner to exercise his discretion; however it failed as essentially it was not a primary production business. There was no experienced person or industry body in this new type of publishing who could satisfy the ATO as to the typical nature of the expenses.

Outcome: The taxpayer threatened, as he could not claim the losses, to take the business offshore and not declare the income with a possible loss of an export business.
Issue: The taxpayer's marginal tax rate has dropped from 47% to 17% following his retirement, so the tax losses have lost 63% of their value.
Issue: No comparable industry figures were available due to the specialised nature of the business, so the taxpayer suffers for being innovative.

Taxpayers Australia then asserted that “The legislation provides certainty – certainty that it will kill off many genuine small businesses”.145 The Taxation Institute of Australia similarly argued that “…the NCL provisions have the potential to deter people from investing in and carrying on a business…”146 The Institute of Chartered Accountants also found that the measures permanently quarantine losses when a sole trader incorporates.147 This “means the business is not being operated through the most effective business structure, and stifling its growth potential.”148

Rural Industries Research and Development Corporation Research

The Rural Industries Research and Development Corporation149 (RIRDC) recently released a report on the economic effects of income tax law on investments in Australian agriculture and the impact of Div 35. Relevantly, this report focused on the role of income taxation in sharing the investment risk and benefits of investors and Government.150

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144 Ibid.
146 Taxation Institute of Australia above n 10 at 2.
147 Institute of Chartered Accountants above n 10 at 3.
148 Ibid.
149 RIRDC above n 10.
150 Ibid 15.
The RIRDC referred to research by Domar and Musgrave\textsuperscript{151} who found that higher rates of income tax that allowed full deductibility of losses may encourage investment in risky businesses and investments. RIRDC also referred to Stiglitz’s research\textsuperscript{152} Stiglitz found that if the market risk is subject to market failure and thus full loss offset would improve efficiency by encouraging greater efficiency.\textsuperscript{153} The RIRDC found that given the high levels of market failure, especially for novel industries, that both of these studies supported full loss offset, stating:\textsuperscript{154}

...full (immediate) deductibility of losses from a new venture will increase demand for risky assets and that:

- given failure in the market for risk, this is probably a good thing
- in any event, income tax is based on net income not gross income and in this context the delineation and differing treatment of ‘new’ versus ‘continuing’ ventures is fraught
- the differing treatment of loss offset by type of enterprise has market and hence efficiency consequences.

The RIRDC further noted research by Wood\textsuperscript{155} that showed that the agricultural activities were more risky than other industries. Notably, Australian Bureau of Agriculture and Resource Economics (ABARE) farm surveys showed that about 95% of farm businesses are sole traders or partnerships and thus are potentially subject to Div 35.\textsuperscript{156} Thus the RIRDC concluded in respect of Div 35 “From an efficiency point of view, it appears likely that this provision will have a negative impact on innovation in new and emerging industries and in farm diversification.”\textsuperscript{157} Additionally the RIRDC observed that investment in novel industries would be riskier than agriculture.\textsuperscript{158}

### 3.2 Simplified Tax System and Economic Efficiency

Again, in terms of a neutral income tax the STS would enhance economic efficiency if it restricted departures from the taxation of economic income. However, the STS impedes economic efficiency since it provides a number of departures from the taxation of comprehensive income through its tax preferences that are restricted to certain taxpayers carrying on small businesses.

Businesses that satisfy the eligibility criteria are ahead since they can choose whether to enter the STS and thus optimise their tax planning opportunities. For example small business with an annual business turnover of $1,000,000 or greater can not take advantage of the STS.\textsuperscript{159} Also, highly capital intensive small businesses with deprecating assets of $3,000,000 or more do not qualify. This favours certain small

\textsuperscript{153} Ibid at 279.
\textsuperscript{154} RIRDC above n 10 at 23.
\textsuperscript{156} RIRDC above n 10 at 25.
\textsuperscript{157} Ibid vi.
\textsuperscript{158} Ibid 24.
\textsuperscript{159} eg. Small businesses with high turnover and low margin are affected, such as liquor outlets and service stations.
businesses over medium to larger size businesses, breaching the Review’s goal of neutrality.\textsuperscript{160}

Additionally, under the original STS cash accounting system, taxpayers with large amounts of debtors compared to creditors will benefit from the STS given the tax deferral advantages. Previously, business income included debtors whilst under the STS only cash receipts are included as business income. This benefit though will generally only provide a one off cash saving for small business. Certainly this will be the case where small business retains a similar debt profile. For example grape growers that are paid in three instalments over April, July and September will defer income on a cash basis.\textsuperscript{161} Builders, professional firms and manufacturers are also likely to be in the same situation.\textsuperscript{162}

However, taxpayers with large amounts of creditors compared to debtors will incur a cash flow problem from entering the STS since deductions for creditors are generally excluded. Many retailers will fit into this situation.\textsuperscript{163} The STS system was extended to accruals taxpayers to enable those taxpayers to obtain the STS tax preferences.\textsuperscript{164} Again the STS cash accounting system benefited certain businesses at the expense of others, again violating the Review’s goal of neutrality.\textsuperscript{165}

In particular, under the STS accelerated depreciation provisions capital intensive small businesses appear to have the most to gain. The STS general pooled depreciation rate is 30\% and an immediate deduction is available for assets costing less than $1,000. Further, under the STS businesses can acquire an asset on the last day of an income tax year and obtain an immediate 15\% deduction. For example farmers will enjoy a 30\% depreciation rate under STS as opposed to a 22.5\% non-STS rate for tractors and harvesters.\textsuperscript{166} Miners, manufacturers and tradespeople will also be likely to benefit from higher depreciation rates under the STS.\textsuperscript{167} As noted previously,\textsuperscript{168} the Review’s Recommendation 8.1 asserted that accelerated depreciation provides significant benefits to capital intensive industries such as mining and manufacturing rather than service industries and this breaches neutrality. Thus scarce resources are diverted away from activities that would have otherwise attracted them.\textsuperscript{169}

Further, under the STS taxpayers can take advantage of the 12 month prepayment rule that provides full deductions for prepaid expenses incurred in respect of a period of service not exceeding 12 months. Again this tax preference does not extend to certain taxpayers outside the STS as deductions for such prepayments must be amortised over a long period of time and this again breaches neutrality.

\textsuperscript{160} Review of Business Taxation Report above n 1 at 111-112. 
\textsuperscript{161} Snook above n 11 at 89-90; Martin above n 11 at 251. 
\textsuperscript{162} Ibid. 
\textsuperscript{163} Ibid. 
\textsuperscript{164} ss 328-115 to 328-120, 328-440. 
\textsuperscript{165} Review of Business Taxation Report above n 1 at 111-112. 
\textsuperscript{166} Snook above n 11 at 89-90; Martin above n 11 at 251. 
\textsuperscript{167} Ibid. 
\textsuperscript{168} See para 1.3.5.8. 
\textsuperscript{169} Ibid.
The trading stock rules though will only benefit very small businesses given the $5,000 trading stock variation threshold. It is thus submitted that the trading stock provisions though would have an insignificant economic impact given the low threshold.  

Overall, the STS impedes neutrality and thus economic efficiency since it creates many winners and losers. For those eligible to join the STS, the larger and more capital intensive small businesses will gain most benefit from the depreciation benefits. Also, small businesses with a large amount of debtors and prepayments will obtain greater tax savings. Larger businesses that are not eligible to join are disadvantaged. The smaller businesses with low amounts of depreciable assets, debtors and prepayments will obtain little benefit from the STS (such as retailers and the services industry). Also, taxpayers with low amounts of taxable income such as new small businesses and struggling small businesses will not obtain much benefit from the STS tax preferences.

Given the numerous losers under the STS it is not surprising that the Government has moved to extend the benefits of the STS. The entrepreneurs discount was introduced to target micro businesses who obtained little benefit from the STS given their low income tax liabilities and small scale. Also, the STS cash accounting regime became optional so as not to disadvantage accruals basis small businesses. Recently, the eligibility criteria were eased to allow more small businesses into the STS. However, the growth of these tax preferences has only exacerbated the departures from the Review’s goal of taxing economic income.

### 3.3 CGT Discount and Economic Efficiency

Under a comprehensive income tax base all forms of income should be taxed similarly. In particular, since capital gains are a form of capital income, they should be taxed in a similar manner to other types of capital income such as interest, dividends and rent and this would allow capital to achieve the highest possible rate of return. To exempt or lightly tax capital gains will lead to a misallocation of capital.

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170 Review of Business Taxation Report above n 1 at 722; The Review did not provide an estimate for any tax revenue losses or gains from the STS trading stock rule which suggests a minimal impact on business.

171 Explanatory Memorandum, Tax Laws Amendment (2004 Measures No.7) Act 2005, para. 1.3 stated: “In the 2004 election policy statement Promoting an Enterprise Culture, the Government announced a number of measures designed to foster the entrepreneurial spirit of small businesses. The Government stated that it would provide further incentive and encouragement to small businesses - particularly those that set up and operate from home - through the introduction of a tax offset for entrepreneurs. This proposal is targeted at very small, micro and home-based businesses that are in the STS.”

172 Ibid.


174 C Sanford, ‘Taxation and social policy: an overview’ in C Sandford, C Pond, R Walker (eds), Taxation and social policy (1980) 164; A J Auerbach, The taxation of capital income 1983, 9. Auerbach states: One point that is commonly made is that the introduction of a differential tax on capital income from different sources is deleterious to social welfare because it induces inefficiency in production arising out of a misallocation of capital.
Numerous Australian commentators have noted the significant economic costs of capital gains tax preferences. Head\(^{175}\) outlined the distortions caused by Australia’s selective tax concessions for retirement savings, imputed rent and capital gains. He found that far from promoting growth, these provisions have only served to produce an extremely conservative pattern of saving and investment unsuited to the requirements of a dynamic and growing economy.\(^{176}\) Groenewegen\(^{177}\) similarly noted the economic distortions stemming from the failure to tax capital gains. Dixon\(^{178}\) also concluded that the gross misdirection of resources into property with low yields and tax avoidance schemes in the late 1970s would not have occurred if a CGT had been in place in Australia.

Additionally, Freebairn\(^{179}\) asserted that failing to tax capital gains penalises investment in risky ventures and favours large conglomerates over small enterprises. Krever\(^{180}\) noted that the seventy years experience in Australia of exempting CGT suggested that CGT exemptions are an inefficient tool for directing investment towards entrepreneurial activities. Rather it leads to low risk investment in real estate or blue chip shares.\(^{181}\) Further, Krever noted that a CGT preference extends beyond productive Australian assets to foreign shares, real estate and Australian holiday homes.\(^{182}\) These arguments would similarly be relevant to a partial exemption such as the CGT discount.

Following the commencement of CGT in 1985, the introduction of the CGT discount in 1999 imposed certain economic distortions. This policy appears to have contributed to an over investment in housing. Warren asserted that the CGT discount and other property tax concessions has resulted in the Australian economy’s over reliance on the property sector for economic growth given the strong multiplier effect of the building boom and has led to a property price bubble.\(^{183}\) This creates further economic problems since a policy change that removes the capitalised value of tax concessions would in turn damage the building industry, lead to loan defaults and lower consumer confidence.\(^{184}\) Also, the Reserve Bank of Australia Deputy Governor, Glenn Stevens\(^{185}\) warned that the housing boom was a threat to the durability of Australia’s long economic up swing.\(^{186}\)

\(^{176}\) Ibid.
\(^{181}\) Ibid.
\(^{182}\) Ibid.
\(^{183}\) N Warren, ‘No easy way to unwind negative gearing’ (2003) Issue 2 Tax Matters, Atax, University of New South Wales 7.
\(^{184}\) Ibid.
\(^{186}\) Ibid.
International evidence of the misallocation of resources from CGT preferences

Sandford\textsuperscript{187} noted that the 1960s and 1970s saw burgeoning government expenditures and increasing government intervention in many countries based on over-optimistic assumptions of how the government could influence society and the economy for the better. Concerns over the economic and social costs from the tax distortions flowing from these interventionist policies heralded a worldwide change in economic philosophy in the 1980s.\textsuperscript{188} This philosophy saw a revival of belief in the efficacy of markets and the need for tax neutrality.\textsuperscript{189} Countries pushed back the role of the state’s influence in the economy and deregulated, freed exchange rates, privatised, promoted competition and improved the efficiency of the public sector.\textsuperscript{190} Sandford found that this not only greatly affected the capitalist world but also ‘undermined the socialist planned economies’.\textsuperscript{191} This movement illustrates the widespread support for neutral tax policies and suggests the acceptance of the goals of comprehensive income taxation, and the full taxation of capital gains.

A number of United States analysts have noted the economic distortions created by CGT preferences. McGee\textsuperscript{192} concluded that a CGT rate cut is nearly always more beneficial to the existing firm rather than the new start ups. In many cases the cut will decrease new firm investment.\textsuperscript{193} McIntyre et al\textsuperscript{194} found that a CGT preference is incoherent and will remain that way until Congress defines the scope of the preference and matches it to a public policy.

McIntyre et al queried why should a CGT preference encourage a hoarder of gold coins or a passive real estate investor.\textsuperscript{195} Gordon and Slemrod’s\textsuperscript{196} analysis of 1983 income tax returns suggested that moving to uniform tax rates on real capital income would raise revenue and improve efficiency.

Kay and King\textsuperscript{197} reviewed the impact of the United Kingdom income tax laws finding that they have a great impact on household portfolios. Over the last 25 years the proportion of personal wealth held in the form of privileged assets such as houses, life insurance policies and pension funds, rose from 29% to 64%.\textsuperscript{198} Over the same period the personal holdings of shares and marketable securities fell by almost 75%.\textsuperscript{199} Thus they concluded that preferential tax treatment for gains made from certain assets has had a major impact on the allocation of resources.\textsuperscript{200}

\textsuperscript{188} Ibid.
\textsuperscript{189} Ibid.
\textsuperscript{190} Ibid.
\textsuperscript{191} Ibid.
\textsuperscript{193} Ibid.
\textsuperscript{194} M McIntyre, F E A Sander, D Westall editorial comment in M McIntyre, F E A Sander, D Westall (eds) Readings in Federal Taxation, (2nd ed, 1983), 400.
\textsuperscript{195} Ibid.
\textsuperscript{197} J A Kay, M A King, The British Tax System 1990, 105.
\textsuperscript{198} Ibid.
\textsuperscript{199} Ibid.
\textsuperscript{200} Ibid.
Sandford found that tax concessions to house owners raised the value of homes providing capital gains to owners but reduced the capacity of would be purchasers. Also, concessions given to housing, life insurance and pensions in the United Kingdom divert savings to safe investments rather than riskier and innovative investments. He asserted that this provides the strongest argument for neutrality, via a progressive consumption tax or a comprehensive income tax.

The South Africa Department of Finance noted the many distortions created in the economy from the failure to tax capital gains as one of the primary reasons for the introduction of CGT in 2001.

The Review

However, the Review’s third paper was somewhat cautious in identifying any economic benefits associated with a CGT discount, stating:

11.8 Assessment of the costs and benefits of such proposals is extremely difficult as it needs to take into account the full range of taxpayer responses. These are frequently hard to identify and often impossible to quantify. For example, it is likely that investment switching from assets providing returns in the form of ordinary income to assets providing returns in the form of capital gains will have some adverse impact on economic efficiency and growth. Whether this is likely to be more than offset by the dynamic gains from the additional investment in capital gain producing assets ultimately comes down to a matter of judgment given the difficulty of measuring such effects.

11.9 It is often argued that there is a greater propensity to save income earned in the form of capital gains than income earned from personal exertion. However, the objective evidence is inconclusive on this point. Nonetheless, it is noteworthy that the USA and the UK have reduced their effective rates of CGT and have experienced increased investment and business development. The actual degree of causation between these factors may be difficult to determine or measure.

The Ralph Report though confidently pointed to the economic benefits of a CGT discount, stating:

A structural shift in capital taxation for individuals

The Review’s recommendations for capital gains taxation are designed to enliven and invigorate the Australian equities markets, to stimulate greater participation by individuals, and to achieve a better allocation of the nation’s capital resources. In the first three or four years of the new regime there is likely to be considerable extra turnover on Australian equity markets as equity holders respond to reduced lock-in by realigning their portfolios. Even in the medium to longer-term, the Review expects a heightened level of realisations activity amongst individual shareholders and CIVs [Collective Investment Vehicles]…

4. Equity

Equity concerns the degree of fairness in taxation law. The Ralph Report asserted that ‘equity is a basic criterion for community acceptance of the tax system.’

201 Sandford et al Taxation and social policy above n 174, 4-5.
202 Ibid.
203 Ibid.
205 Ibid 598-602.
A widely accepted and fundamental principle of social justice that demands equal treatment for people in similar circumstances (this is known as horizontal equity). Horizontal equity requires the determination of a tax base, to measure similar circumstances so that an appropriate amount of tax be imposed on a taxpayer. Accordingly, most commentators have defined the tax base by a taxpayer’s ability to pay. Ability to pay could be based on income or wealth or a combination thereof. To ensure equity, the tax base should, however, be defined as comprehensively as possible, so as to include both income and wealth.

Thus the formulation of economic income has become a widely accepted means of defining ‘ability to pay’, as this approach includes both income and wealth gains. However, certain departures are required to take account differences between economic income and a person’s ability to pay. For example, this tax base fails to take into account the size of existing wealth holdings, so additional wealth taxes such as gift and death taxes would be needed to satisfy the ability to pay criteria. Further, a person with ill health who spends most of their income on medical expenses and care will have a lesser ability to pay than a healthy person on the same economic income. Again, it is beyond the scope of this paper to definitively set out a fully detailed ideal measure of economic income or ability to pay. This paper though asserts that the income tax base should form a close proxy to economic income as this better reflects a taxpayer’s ability to pay.

As horizontal equity concerns the equal treatment of equals, as a corollary, vertical equity is required to ensure that tax imposed on people in different circumstances is also fair. Most countries have progressive rates of income tax, so as to try to ensure that a person with a greater ability to pay, pays not only more tax, but at a higher income tax rate. Vertical equity requires both progressive income tax rates and a tax based on the ‘ability to pay’. This can be a somewhat less rigorous ideal than horizontal equity though as there maybe little agreement in the level of progressivity in the income tax rate scales.

Additionally, this paper advocates that as a matter of equity that income tax laws must be compulsory. That is, income tax loopholes must be removed and tax administrators must be given sufficient resources and powers to ensure that people pay the appropriate amount of income tax.

4.1 Non-commercial Losses and Equity

The NCL provisions generally promote horizontal and vertical equity to the extent that they deny taxpayers claiming losses from lifestyle activities. Horizontal equity is enhanced as seen by the following example.

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206 Review of Business Taxation Report above n 1 at 105.
209 Ibid 364.
Example 5

Before the NCL provisions two taxpayers, A and B on the same salary, $100,000 would face different income tax bills if one of the taxpayers, A operated a $20,000 loss making lifestyle farm and claimed deductions. The hobby farmer A would pay $8,950 less income tax including medicare levy in the income year ended 30 June 2006. Under the NCL regime and where none of the exemptions in Div 35 apply the losses would be quarantined. Thus both taxpayers would pay the same amount of income tax thus satisfying horizontal equity.

Vertical equity is also improved as seen by the following example.

Example 6

Taxpayer, C on the top marginal tax bracket obtains a greater benefit from the hobby farm losses under the old regime. A hobby farm loss of $20,000 from a top marginal rate taxpayer C would save $9,700 income tax including medicare levy in the income year ended 30 June 2006. Whereas taxpayer D with a taxable income of $30,000 after the loss, would only save $6,000.

However, such improvements to equity only occur where the NCL rules apply, that is, only to hobby / lifestyle activities and not genuine businesses. Many small businesses will satisfy the NCL exemptions and thus losses from hobby / lifestyle activities remain deductible. Higher income and wealthy taxpayers211 are likely to pass these tests. Relevantly, the Treefarm Investment Managers recommended the abolition of both the Real Property and the Other Asset tests since these “…are not measures of commerciality or even commercial purpose, they discriminate in favour of the already wealthy, and they can actually increase rather than prevent tax abuse.”212 This breaches horizontal equity as seen by the following example:

Example 7

X and Y are on the same salary of $100,000 but X claimed $20,000 in losses from a lifestyle farm. X satisfied the real property test. Thus the hobby farmer X would pay $8,950 less income tax in the income year ended 30 June 2006. Thus horizontal equity is breached as both have the same ability to pay yet Y pays more income tax.

This also breaches vertical equity as seen by the following example:

Example 8

211 Kelly, S., ‘Wealth on retirement – latest estimates for Australia’ paper presented to the 9th annual colloquium of superannuation researchers, University of New South Wales, 9-10 July 2001, published by National Centre for Social and Economic Modelling, University of Canberra www.natsem.canberra.edu.au, 15, The top ten per cent of the Australian population have 43% of the total wealth with the wealthiest fifty per cent having 90% of the wealth; Douglas Farmers nil Commissioners Nil above n 15 at 392; Kenny Australian Taxation, Ethics and Social capital above n 7 at 119-120.

212 Treefarm Investment Managers above n 10 at 2.
W has a salary of $100,000 and V has a salary of $70,000. W and V operate a $20,000 loss making lifestyle farm and claimed deductions. W and V both satisfy the real property test. W on the top marginal tax bracket obtains hobby farm loss deduction of $20,000 and saves $9,700 income tax including medicare levy in the income year ended 30 June 2006. Whereas taxpayer V only saves $6,840.

Taxpayers Australia provided a real example of the inequity in Div 35 as certain taxpayers are able to easily manipulate the NCL provisions.213

**Example 9**

A share trader in the heady years of tech stock trading has done no trading in subsequent years however his stocks of unsold shares are falling in value. As he values his stock on a market basis he has a taxable loss which he is unable to claim. He can overcome this by simply carrying out one $20,000 trade on one day, which makes his assessable income $20,000 and he is therefore able to satisfy the first test.

Issue: Some taxpayers can easily manipulate the rules.

Another inequity created by the loss restrictions is evident in the harsh impact on genuine micro businesses as seen by the following real example provided by Taxpayers Australia.214

**Example 10**

A small refrigeration mechanical contractor with a turnover of $42,000 makes a taxable profit of $12,000. To supplement his income he plants potatoes on a debt free acreage in years when he believes the rain will be sufficient to produce a crop. Due to drought conditions his crop fails. His potato growing expenses cannot be claimed because:

- His assessable income (for a sole proprietor this is his/her turnover) is over $40,000.
- The Commissioner cannot exercise any discretion although the drought is an unusual event because his income would never exceed $20,000 from this source, he cannot rely on a profit 60% of the time and the land is not worth $500,000.

His taxable income was $12,000 but he spent $6,000 planting the crop, leaving him with only $6,000 to live on and a taxation liability of $1,000 which he had no ability to fund and is still not able to pay.

Issues: If the refrigeration mechanic was an employee who received a salary of $30,000 pa, he would have been able to claim the potato growing losses, as his assessable income would have been less than the stipulated $40,000.

Outcome: The taxpayer cannot take the risk of planting again, therefore sells the land to pay the tax and it is taken out of production.

As noted in the example, a salary wage earner with less than $40,000 of salary and wage income would not be affected by Div 35,215 this is unfair. Also, as set out previously, other loss making taxpayers are unaffected by Div 35. If the small refrigeration mechanical contractor in the above example had incurred a $6,000 rental property loss, the loss would offset his other income since Div 35 does not apply to passive income activities.216 This is also unfair.

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213 Taxpayers Australia above n 10 at 1-2.
214 Ibid.
215 s 35-10(4).
216 s 35-10.
Such inequities were highlighted by Douglas\textsuperscript{217} and in the submissions to the Board’s review.\textsuperscript{218} In its submission to the Board, Taxpayers Australia Inc considered that the measure was “…punitive and drastic to some owners of genuine small businesses caught by this legislation.”\textsuperscript{219}

4.2 Simplified Tax System and Equity

It is apparent from the above economic analysis of winners and losers that the STS breaches horizontal and vertical equity. Horizontal equity is violated as seen by the following example.

Example 11

Two small business food retailers, A and B operate in competition in the same shopping centre and have the same taxable income, $100,000, and pay the same amount of income tax in the income year ended 30 June 2006. However, A having an annual turnover of $900,000 elected to join the STS and obtains depreciation and cash accounting benefits that reduces A’s taxable income to $90,000. B can not join the STS since B’s annual turnover is $1,500,000. This is inequitable since both taxpayers have the same ability to pay but pay different amounts of income tax.

Vertical equity is also damaged since a taxpayer on the top marginal tax bracket obtains a greater benefit from the STS rules than a lower income taxpayer. For example:

Example 12

Taxpayer, C on the top marginal income tax bracket obtains a greater benefit from the STS. C with extra depreciation deductions of $20,000 under the STS would save $9,700 income tax including medicare levy in the income year ended 30 June 2006. Whereas D with a taxable income of $30,000 after extra depreciation deductions of $20,000 under the STS would only save $6,300 income tax including medicare levy in the income year ended 30 June 2006.

Given that most of the larger small businesses would be operated by the high income and wealthier taxpayers\textsuperscript{220} the breach of vertical equity must be substantial. The STS provisions clearly damage the integrity of the income tax laws.

In the light of these inequities it is not surprising the Government has moved to increase the number of small businesses that can obtain tax benefits from the STS. However, the greater availability of the STS tax preferences the greater the damage to horizontal and vertical equity.

4.3 CGT Discount and Equity

\textsuperscript{217} Douglas Farmers nil Commissioners Nil above n 10 at 387.
\textsuperscript{218} Taxation Institute of Australia above n 10 at 2,6; Taxpayers Australia above n 10 at 1-6.
\textsuperscript{219} Taxpayers Australia above n 10 at 5.
\textsuperscript{220} Kelly above n 211 at 15.
The CGT discount seriously undermines both horizontal and vertical equity as demonstrated by the following examples.

**Example 13**

X who earns interest income of $50,000 and pays $11,610 income tax (including medicare levy) in the income tax year ended 30 June 2006 will be in a horizontally equitable position with Y who realises a capital gain of $50,000 and pays $11,610 income tax. However, if only 50% of Y’s capital gain is taxed, horizontal equity will be breached as Y only pays $3,735 income tax, yet both have the same ability to pay.

Also, the CGT discount breaches vertical equity as demonstrated by the following examples.

**Example 14**

A high income earner, M at the top marginal income tax bracket of 48.5% (including medicare levy), earns $70,000 of undiscounted capital gains and pays tax of $18,750 income tax in the income year ended 30 June 2006. A taxpayer, N, with a top marginal income tax bracket of 31.5% (including medicare levy), earning $50,000 of salary pays $11,610 income tax. Thus vertical equity is maintained. However, if M is only taxed on 50% of the capital gain, M will pay income tax of $6,885 whilst N pays $11,610. Thus vertical equity is breached.

Further, if both taxpayers receive a discounted capital gain, the high income earner obtains a greater benefit from this exemption as seen below.

**Example 15**

P a high income earner at the top marginal income tax rate of 48.5% receives a $10,000 50% discounted capital gain and thus obtains a tax saving of $2,425 as a result of the CGT discount. Q on a 31.5% marginal income tax rate receives a $10,000 50% discounted capital gain only saves $1,575 of income tax.

As the above examples show, the CGT discount has an ‘upside down effect’ in providing the greatest benefit to asset holders. Given the high concentration of wealth in Australia this preference results in significant losses to vertical equity. The benefit of the CGT discount is highly skewed since 10% of the population have 43% of the total wealth and 50% having 90% of the wealth. The bottom half of the population only have 10% of the wealth, whilst the poorest 10% have no wealth at all.

Further, under the CGT discount with no limit on negative gearing, the interest paid on investment loans is fully deductible. Thus a dollar of interest expense that

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221 Ibid.
222 Ibid.
223 Ibid.
produces $1 of capital gain reduces the investor’s taxable income by 50 cents. Deferral of capital gains under a realisation CGT offers even a greater profit, since the interest is fully deductible in the current period when it is incurred, yet the capital gains are deferred until realisation.

The CGT discount was expected to have a huge impact of tax arbitrage. The Government’s initial estimate of $100 million per annum tax revenue losses was far too low. Evidence from the Senate enquiry pointed to a massive loss of tax revenue. At the time of the Ralph Review, Krever found that the reforms would have a revenue leakage of hundreds of millions of dollars. Evans considered the reforms could transform the positive revenue estimate of $350 million into a significant revenue leakage of $5.5 billion in a worst case scenario. Treasury estimates have clearly proven to be too low as the tax revenue lost on the CGT discount for individuals and trusts amounted to about $2 billion in 2004-06.

5. Simplicity

Commentators have noted that simplicity cannot be easily defined. Cooper found that simplicity has elements of predictability, proportionality, consistency, compliance, administration, coordination and expression. Tran Nam defined simplicity as ‘the ease (difficulty) with which the correct tax liability can be determined, collected and enforced’.

Simplicity can also be measured in a number of ways. For example, Tran Nam set out four methods of measurement:

- how simple is tax legislation written;
- how simple is the content of the tax legislation;
- how taxpayers and tax administrators respond to the tax law and
- how expensive it is to operate the tax?

The first three methods of measurement proposed by Tran Nam are very difficult to quantify. For example, a tax law may be simply written, such as the definition of ordinary income in s 6-5(1). Yet defining ordinary income is a highly complex task as seen by the hundreds of court cases involving ordinary income. Similarly, simple content in the legislation can give a misleading impression of its simplicity.
Also, a complex piece of legislation that replaces a myriad of judicial principles may be simpler. Additionally, behaviour is undoubtedly an important aspect to be taken into account in designing a tax law. Whether taxpayers comply with a law is an indicator of whether it is understood, but again this is difficult to measure. The same applies to measuring the responses of tax administrators.

The most rigorous and the generally accepted measure of simplicity seeks to identify the operating costs of a tax law.^235^ Operating costs consist of compliance costs of taxpayers and the administration costs of the government. Simplicity can, theoretically at least, be measured by estimating these operating costs, and dividing this amount over the amount of tax revenue. It follows that simplicity will improve where the operating costs or this ratio falls.

Compliance costs can be defined as the costs ‘incurred by taxpayers, or third parties such as businesses, in meeting the requirements laid upon them in complying with a given structure and level of tax.’^238^ These costs will include the costs of keeping records, preparing taxation financial statements and taxation returns, obtaining tax advice, undergoing tax audits, tax planning and disputes.

Taxes, though, can provide benefits to taxpayers that may offset these costs. Firstly, such compliance costs are tax deductible and thus compliance costs should be reduced to take into account the value of the tax deduction. Managerial benefits are provided as a result of improved business decision making flowing from tax law compliance. The record keeping and financial information requirements of tax laws provide taxpayers with better information to make business and investment decisions. Further, taxes such as capital gains tax provide a tax benefit in the deferral of tax payable. This should also be taken into account. Compliance costs can thus be represented by the following equation:

\[
\text{Compliance costs} = \\
\text{costs of taxpayers complying with tax laws} - \\
\text{minus tax deductibility benefit of compliance costs} - \\
\text{minus managerial benefits to taxpayers} - \\
\text{minus benefit of tax deferral}
\]

Taxation administration can be categorised into four types of Government activities: tax policy, design and planning, tax law drafting and enactment, Australian Taxation Office costs, and tax dispute resolution. Administration costs can thus be represented by the following equation:

\[
\text{Administration costs} = \\
\text{costs of taxpayers complying with tax laws} - \\
\text{minus tax deductibility benefit of compliance costs} - \\
\text{minus managerial benefits to taxpayers} - \\
\text{minus benefit of tax deferral}
\]

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235 Tran-Nam *Tax Reform and Tax Simplicity* above n 229, 244-246.
236 Ibid 245.
237 Ibid.
241 Under the CGT regime the income tax liability generally does not crystallise until the taxpayer disposes of the asset, ss102-5, 102-20, 104-10(1) ITAA 1997.
242 Tran-Nam *Assessing the Revenue* above n 231, 332-333.
tax policy, design and planning costs
plus tax law drafting and enactment
plus Australian Taxation Office costs
plus tax dispute resolution

The compliance and administration costs of a tax will vary according to its design.

From an income tax point, a comprehensive income tax base provides some simplification to the income tax laws. The Review\textsuperscript{243} noted such benefits, stating:

\begin{quote}
…the imposition of income tax to raise revenue would have minimal impact on investment choices; the law could be far simpler and clearer; tax avoidance opportunities would be kept to a minimum. Business could focus on commercial choices rather than spend time and resources seeking to minimise liability.
\end{quote}

Additionally, the \textit{Ralph Report} stated: ‘A major consideration in the formulation of the Review’s recommendations has been to remove anomalies and inequities between the treatment of economically similar transactions. This will allow significant simplification of the tax system.’\textsuperscript{244}

For example, having regard to capital gains, commentators\textsuperscript{245} similarly note that taxing capital gains and other types of income differently creates considerable complexity as taxpayers seek to transform income into concessionally taxed capital gains. Such costs are reflected in the results of a 1994 survey\textsuperscript{246} on the 1991 Swedish tax reforms that broadened the tax base and lowered income tax rates. The survey found that households actually spent less time on tax compliance in the years after the tax reforms. The more comprehensive the design of income tax the lower the compliance costs.

However, as noted previously, a comprehensive income tax would impose significant valuation and liquidity problems and thus some concessions must be made to ensure the practicality of the income tax system. Nevertheless, after adjustments are made to alleviate such concerns an income tax base that is a close proxy to the comprehensive income ideal appears to offer significant simplicity benefits.

\section*{5.1 Non-commercial Losses and Simplicity}

Given the limited quantitative data on the NCL compliance costs of taxpayers and the NCL administration costs of the government this paper primarily relies on a qualitative analysis. This examination also refers to research on NCL operating costs commissioned by the Board and conducted by the Australian Taxation Studies Program (ATAX) from the University of New South Wales and accounting firm, BDO Kendalls.

\textsuperscript{243} \textit{Review of Business Taxation Platform for Consultation} above n 21 at 28.

\textsuperscript{244} \textit{Review of Business Taxation Report} above n 1, 16.

\textsuperscript{245} \textit{Kenny Capital Gains Taxation for New Zealand} above n 5 at 288.

5.1.1 Compliance Costs

Costs of taxpayers complying with Div 35

The following qualitative assessment on taxpayer compliance costs is made on Div 35 based on how simple is tax legislation written, how simple is the content of the tax legislation and how taxpayers and tax administrators respond to the tax law.\(^\text{247}\)

**How simple is tax legislation written and how simple is the content?**

A complex piece of legislation that replaces a myriad of judicial principles can improve simplicity but Div 35 fails to replace the former regime and its judicial principles in ascertaining whether an individual is carrying on a business. The issue of whether a business is being carried on still needs to be resolved in applying Div 35 so this major area of uncertainty remains. Rather Div 35 has added another layer of complex income tax legislation.

The NCL measures introduce new problems such as the need to determine what businesses are of a similar kind.\(^\text{248}\) Where an activity consists of two or more businesses that are of a different kind then the taxpayer must produce separate profit and loss statements for these activities.

Further there is the issue of determining whether an activity is subject to Div 35 since it constitutes a very small or micro business. That is whether the activity fails to pass one of the four tests in section 35-30 to 35-45. Additional complexity arises in respect of the application of the four tests to partnerships. Some simplification could have been achieved if this new categorization of micro or small business activity was included in the ITAA’s dictionary in s 995-1. Such a standardised definition would then have application across the various Acts as contemplated in the Ralph Report’s recommendation for an integrated tax code using an integrated tax design business process.\(^\text{249}\) Further, as seen by the example of post cessation business loss situations and interaction with the STS, Div 35 has certain inconsistencies with the operation of the ITAA 1997.

There is also uncertainty in determining whether an individual falls within the primary production or professional artists exemption. Further, complexity arises in respect of the application of these exemptions to partnerships.

Further uncertainty is created with the Commissioner’s discretion for special circumstances and the inherent vagueness of what constitutes “special circumstances”. More uncertainty is evident in the Commissioner’s discretion for lead time and the meaning of terms such as “because of its nature”.

**How taxpayers respond to the tax law?**

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\(^{247}\) Tran-Nam *Tax Reform and Tax Simplicity* above n 229, 244: provides these three alternative approaches to analysing simplicity to an operating costs based measurement.

\(^{248}\) s 35-10(3).

\(^{249}\) Review of Business Taxation Report above n 1 at 129: Recommendation 2.2.
Individuals running loss making businesses self assess the application of Div 35 in their income tax returns. If they satisfy one of the four tests or fall within the exemptions the completion of the income tax return information is a relatively straightforward matter and the losses are deductible. Also, where they do not satisfy any of the four tests or do not fall within the exemptions the completion of the income tax return information again is easy and the losses are quarantined.

However, taxpayers that need to obtain the Commissioner’s discretion have to apply for a private binding ruling. This involves the completion of lengthy and highly technical application forms. The application form for the special circumstances discretion requires evidence of the special circumstances and must state which of the tests would have been met but for these circumstances. Also, the application form for the lead time discretion requires comprehensive information about the business activity, business plans, independent evidence, income and expenditure projections. Obtaining independent evidence for new or novel industries will create real problems for taxpayers.

As the Board of Taxation noted, the costs and information requirements of applying to seek the Commissioner’s discretion under s35-55 “can be high in relation to potential deductions…” The Board further observed the level of uncertainty created by the need to determine which activities are similar activities and thus can be grouped. This reflected the findings of the BDO Kendall report, noted above. As the Ralph Report found, such compliance costs are highly regressive and thus it is evident that Div 35 impacts harshly on the compliance costs for many micro businesses.

**Tax deductibility benefits**

However, this increase in compliance costs may be offset by tax deductions available for an individual running a loss making business that is not subject to Div 35. Unfortunately, for an individual running a loss making business where Div 35 applies the increased compliance costs will be quarantined.

**Managerial benefits to taxpayers**

There may be some managerial benefits from better record keeping and accounting practices flowing from the NCL rules. Taxpayers may benefit by the need to produce profit and loss forecasts for proposed businesses in seeking the Commissioner’s discretion under s35-55(1)(b) and this will discourage unprofitable activities. Similarly, the need to separate out profit and loss statements for taxpayers carrying out two or more businesses that are of a different kind under s35-10(3) will also discourage such unprofitable activities.

**Benefit of Tax Deferral**

Since Div 35 operates to restrict income tax deductions the rules provide no opportunity to defer income tax.

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250 Board of Taxation Post-implementation Review n 10 at para.1.18
251 Ibid 1.19.
252 Review of Business Taxation Report above n 1 at 73-75.
ATAX Research

The Board commissioned ATAX to produce a report to identify, estimate and evaluate the operating costs of Div 35.\(^{254}\) ATAX thus established focus groups, undertook sample selection, sent out questionnaires to taxpayers and tax practitioners and analysed the responses. ATAX found that the compliance costs of Div 35 would not be significant, stating:\(^{255}\)

- Overall transitional and recurrent compliance costs and administration costs associated with Division 35 are not significant.
- Individual taxpayer compliance costs were either non-existent or mostly of a transitional nature.
- Tax practitioners have borne most of the compliance costs that do arise.

BDL Kendalls Research

Additionally, BDO Kendalls were engaged to provide an evaluation of the NCL provisions as against the Board’s criteria.\(^{256}\) BDO Kendalls surveyed the literature, surveyed practitioners and conducted focus group discussions with accountants.\(^{257}\) They found that the measures prevented revenue leakage and that much of the legislation is reader friendly.\(^{258}\) However, they found that some aspects of the legislation were not expressed in a simple, comprehensible and workable manner. These included the grouping of business activities, the evidence required for the Commissioner’s discretion and the way the level of income is determined for a business activity.\(^{259}\) Notably, they found that two thirds of respondents considered that the rules did not prevent unintended consequences of a substantive nature.\(^{260}\) Also, many of those surveyed reported that the four tests in Div 35 did not take account of taxpayer circumstances and commercial practices.\(^{261}\)

5.1.2 Administration Costs

Tax policy, design and planning costs

Given the concise nature of the NCL legislation\(^{262}\) it is apparent that the tax policy, design and planning costs would not have been significant.

Tax law drafting and enactment

\(^{254}\) Australian Taxation Studies Program (ATAX), Law Faculty of The University of New South Wales, ‘Report to the Board of Taxation Post-implementation Review on the Operating Costs of Non-commercial Losses’ http://www.taxboard.gov.au/content/noncommercial_losses/Chapter_5.asp.

\(^{255}\) Board of Taxation Post-implementation Review n 15 at para 5.37.

\(^{256}\) BDO Kendalls, ‘Report to the Board of Taxation Post-implementation Review on an Evaluation of Non-commercial Losses Against the Board’s Review Criteria’ http://www.taxboard.gov.au/content/noncommercial_losses/Chapter_5.asp.

\(^{257}\) Board of Taxation Post-implementation Review n 10 at para 5.44.

\(^{258}\) Ibid 5.46.

\(^{259}\) Ibid 5.46.

\(^{260}\) Ibid 5.49.

\(^{261}\) Ibid 5.51.

\(^{262}\) Ibid.5.44.
Similarly the costs of drafting the NCL rules would not have also been very costly given that it is succinctly written into 6 pages of legislation. Since Div 35 has only been subject to a number of minor amendments these changes also would not have added greatly to these costs. Also, the relatively short 14 page explanatory memorandum would not have been expensive.

**Australian Taxation Office costs**

It is evident though that the ATO has incurred substantial costs in administering the NCL rules given the number of taxation rulings, fact sheets, questions and answers, guides, application forms and private binding rulings produced. The complexity of Div 35 is evident from an examination of these numerous publications. For example, TR 2001/14 runs to 35 pages and TR 2003/3 runs to 11 pages. The Australian Taxation Office also needs to provide ongoing audit checks, private rulings, taxpayer advice and educational seminars.

As noted above, in exercising the discretion in para 35-55(1)(b) the Commissioner must take into account the nature of the activity and its expected viability. Thus taxpayers will provide lengthy and technical application forms to the ATO to ascertain whether Div 35 applies. Edited versions of these rulings known as Case Decision Summaries are published on the ATO website. These private rulings usually run to 15 to 20 pages and thus are indicative of the high administration costs that are involved.

Additionally, the Commissioner will incur costs in addressing the uncertainty created by the need to determine which activities are similar activities and thus can be grouped.

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269 Edited versions of these private rulings are available at the ATO website http://law.ato.gov.au/atolaw/browse.htm?toc=02:CDS.
270 § 35-10(3).
Tax dispute resolution

As noted above, the issue of whether a business is being carried on still needs to be resolved in applying Div 35 so this major area of uncertainty and disputation remains. Further, the NCL measures introduce new borderlines and thus creates new areas of disputation. For example this will occur in determining: what businesses are of a similar kind, whether one of four tests apply, or whether the Commissioner should exercise the discretions for special circumstances or lead time.

Taxpayers will seek to avoid Div 35 by utilizing various ‘game playing’ strategies. For example, taxpayers will obtain optimistic sales volume and sales price forecasts and downplay expenses in applying for private binding rulings in respect of the Commissioner’s discretion in s 35-55(1)(b). Other taxpayers will obtain friendly values of real estate or other assets required to satisfy the tests in ss 35-40 and 35-45. Overall, it is submitted that the many new borderlines created by Div 35 will lead to greater levels of disputes between taxpayers and the ATO.

ATAX Research

ATAX found that the administration costs were manageable finding that the “ATO has been able to cope with the provisions without undue administration costs.”

5.2 Simplified Tax System and Simplicity

Again, given the absence of any known quantitative research into the compliance costs or administrative costs associated with the STS this paper undertakes a qualitative review.

5.2.1 Compliance Costs

Costs of taxpayers complying with STS tax laws

There does not appear to be any considerable compliance cost saving for small business entering the STS given the complexity of the legislation in Div 328 which runs for 27 pages and includes complex transitional, entering and leaving, annual turnover, grouping, depreciation pooling and anti avoidance rules. This complexity is also evident in the 63 page explanatory memorandum and 5 page supplementary explanatory memorandum.

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272 s 35-10(3).
273 ss 35-30 to 35-45.
274 Secretary, Department of Employment, Education, Training and Youth Affairs v Barrett (1998) 82 FLR 524: The ordinary meaning of “special circumstances” were held to be circumstances that are outside the ordinary or normal course of business.
276 Board of Taxation Post-implementation Review n 10 at para 5.37.
277 Explanatory Memorandum, New Business Tax System (Simplified Tax System) Act 2000
278 Supplementary Explanatory Memorandum, New Business Tax System (Simplified Tax System) Act 2000
Tax deductibility benefits

If the STS results in greater compliance costs this will be offset by the tax deductions obtained.279 Conversely, if the STS achieves its aim and reduces compliance costs the tax deduction benefits will fall.

Managerial benefits to taxpayers

There appear to be few managerial benefits from better record keeping and accounting flowing from the STS. In fact the STS only encourages taxpayers to abandon proper financial reporting by: using a cash basis instead of accruals; using accelerated depreciation instead of effective life; and in not carrying out stock takes. For example small business will still be required to furnish financial accounts in order to obtain finance. Management will need proper accounts for financial and management accounting purposes. Additionally, where a small business elects to take up the STS cash basis for s6-5 and s8-1 they will still have to use accruals for many types of statutory income and deductions. Using both cash and accruals will only add to complexity.

Benefit of Tax Deferral

The primary compliance benefit for small business taxpayers appears to be cash flow savings from tax deferral by utilising the cash accounting and accelerated depreciation rules. There will also be tax savings for STS taxpayers with significant levels of prepaid expenses. As noted in the tax revenue losses above, these tax savings are not insignificant.

5.2.2 Administration Costs

Tax policy, design and planning costs

It is apparent that given the complex detail of the STS noted above, that significant costs would have been incurred in developing the tax policy, designing and planning.

Tax law drafting and enactment

The costs of drafting the STS laws would have also been significant given the volume and complexity of the rules that originally ran to 26 pages of legislation280 and 63 pages of explanatory memorandum.281 As noted above, the STS has also been subject to numerous amendments that have also added to these costs.282

Australian Taxation Office costs

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279 ss 25-5, 8-1 ITAA 1997.
280 Div 328.
282 See para. 1.4.2.
It is evident that the ATO has incurred substantial costs in administering the STS given the number of taxation rulings, determinations, ATO Interpretative Decisions and fact sheets and other publications produced. The Australian


TD 2003/24 Income tax: Simplified Tax System (STS): what amount is returned as assessable income by an STS taxpayer in relation to an assessable payment to them that has been subject to the Pay As You Go withholding rules in Division 12 of Schedule 1 to the Taxation Administration Act 1953?; TD 2003/25 Income tax: Simplified Tax System (STS): does paragraph 328-105(1)(a) of the Income Tax Assessment Act 1997 (ITAA 1997) apply to an amount received by an STS taxpayer, but not yet derived as ordinary income under the ordinary operation of section 6-5 of the ITAA 1997?; TD 2003/26

Income tax: Simplified Tax System (STS): for which income year should an STS taxpayer claim an income tax deduction for an amount withheld under the Pay As You Go withholding rules in Division 12 of the Taxation Administration Act 1953?; TD 2003/29 Income tax: Simplified Tax System: can an entity that has notified the Commissioner of its choice to stop being an STS taxpayer for an income year, later cancel that choice for that year?; TD 2003/30

Income tax: Simplified Tax System: can an entity that has notified the Commissioner of its choice to become an STS taxpayer for an income year later revoke that choice in respect of that year?; TD 2003/31 Income tax: Simplified Tax System: can an entity notify the Commissioner of its choice to become, or stop being, an STS taxpayer for an income year, after it has lodged that year's income tax return?


Simplified Tax System (STS): accounting method - timing of deductions for amounts paid by B-pay; ATO ID 2003/343 R&D tax offset: 'R&D group turnover' - licence fees payable over more than one year of income; ATO ID 2003/375 Simplified Tax System (STS): Short-term hire agreement; ATO ID 2003/389 Simplified Tax System (STS) capital allowances - continuing STS pool deductions after a business ceases; ATO ID 2003/910 CGT: Rollover of depreciating assets from a partnership (STS taxpayer) to a wholly-owned company; ATO ID 2003/1005 Non Commercial Losses: other assets test - assets that have been pooled under the Simplified Tax System (STS); ATO ID 2004/89 Simplified Tax System (STS): Capital Allowance - estimate of taxable purpose proportion of an asset - first year in STS; ATO ID 2004/125


Simplified Tax System (STS) - partner in partnership; ATO ID 2004/651 Simplified Tax System (STS): assets expected to be let predominantly on a depreciating asset lease; ATO ID 2004/710; Simplified Tax System (STS): accounting method - timing of deduction for discount expense on Commercial bills with a term of less than 12 months; ATO ID 2005/202

Capital Allowances: balancing adjustments - roll-over relief - transfer of assets from a discretionary
Taxation Office also as needed to provide ongoing audit checks, private rulings, taxpayer advice and educational seminars.

Also, as noted above, entering and leaving the STS is not a simple matter and brings significant maintenance costs to the Australian Taxation Office since the STS requires taxpayers to make an application to the Australian Taxation Office to re-enter the STS.

**Tax dispute resolution**

The STS introduces new borderlines and thus creates new areas of disputation. For example this will occur in determining whether small businesses are eligible to join or rejoin the STS. As commentators have noted, such tax benefits as seen in the STS will encourage avoidance and evasion as taxpayers seek to exploit the depreciation and cash accounting tax benefits. It is submitted that this will lead to greater levels of disputes between taxpayers and the ATO.

5.3 CGT Discount and Simplicity

5.3.1 Compliance costs

Evans et al were commissioned by the Australian Taxation Office to estimate compliance costs for Australian taxpayers in respect of federal tax in the 1994-1995 tax year. Using a large mail survey, the social compliance costs were estimated at $10.4 billion or 11.9 per cent of all tax revenue and 2.29 per cent of GDP. After trust to a unit trust; ATO ID 2006/218 Are prepaid audit fees 'excluded expenditure'?; ATO ID 2006/227 Entrepreneurs' tax offset and personal services income – partnership; ATO ID 2006/228 Entrepreneurs' tax offset and personal services income - company.

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286 Simplified tax system (STS) overview. NAT 3956; Simplified tax system: what is in it for my business? NAT 04590; The simplified tax system - a guide for tax agents and small businesses NAT 6459; Changes to the Simplified tax system; STS - is it for you? STS - is it for you?; Eligibility Simplified tax system: calculating STS average turnover (NAT 5174); Simplified tax system: calculating STS group turnover; Simplified tax system: grouping rules; Simplified tax system: fuel retailers and STS group turnover; Am I in business? NAT 2598-01.2003; Simplified tax system: accounting methods NAT 3957; Simplified tax system: the 25% entrepreneurs' tax offset; Simplified tax system: simplified depreciation rules NAT 4824; Simplified tax system: boat hire arrangements and simplified depreciation; Simplified tax system: partnerships and roll-over relief; Simplified tax system: simplified trading stock rules NAT 4107; Prepaid expenses - taxpayers in the simplified tax system - fact sheet; Review of your assessment and record keeping; Worked example 1: calculating depreciation and the entrepreneurs’ tax offset; Worked example 2: calculating depreciation and the entrepreneurs’ tax offset; Worked example 3: trading stock, deductions for depreciating assets and prepaid expenditure; Worked example 4: calculating depreciation and the entrepreneurs’ tax offset; Worked example 5: calculating depreciation and the entrepreneurs' tax offset; Worked example 6: change of accounting method and calculating the entrepreneurs’ tax offset; Worked example 7: change of accounting method, calculating depreciation and the entrepreneurs' tax offset; Entrepreneurs' tax offset – personal services income; Entrepreneurs’ tax offset – STS group turnover.

287 Kenny Australian Taxation, Ethics and Social Capital above n 5 at 112-118.


taking into account the tax deductibility benefit and cash flow benefits from tax
deferral, compliance costs fell to $6.2 billion, or 7 per cent of tax revenue and 1.36
per cent of GDP\textsuperscript{290}. Two and one half million business taxpayers incurred 75 per cent
of the compliance costs and 7.3 million individual taxpayers incurred the other 25 per
cent of costs.\textsuperscript{291}

As noted previously, there is only limited research into Australian income tax
compliance costs but the data generally shows that compliance costs are high. Evans
et al\textsuperscript{292} estimated the compliance costs for Australian taxpayers in respect of federal
tax in the 1994-1995 tax year.

Relevantly, the survey found that only 1.2 per cent of 1,528 personal tax (non-
business) respondents received CGT income in 1994-1995 tax year.\textsuperscript{293} Of these, 583
used paid tax practitioners but only 4.5 per cent used a practitioner because of a need
for CGT advice.\textsuperscript{294} Rather, personal taxpayers mainly sought practitioners so as to
prepare the income tax return.\textsuperscript{295} Personal taxpayers spent 18 minutes on average per
annum in maintaining CGT records which was only 2 per cent of time spent on tax
compliance.\textsuperscript{296}

The survey found that business taxpayers generally had little exposure to CGT.\textsuperscript{297}
There were 2,462 business taxpayer respondents with 3.5 per cent having frequent
CGT issues, that is four or more times a year.\textsuperscript{298} Another 19.6 per cent of business
taxpayers had occasional CGT issues (1-3 times per week).\textsuperscript{299} Others never dealt
with CGT (48.4 per cent), or failed to respond to the question (28.5 per cent).\textsuperscript{300}
Business taxpayers spent four hours per annum on average on CGT matters out of a
total of 90.7 hours.\textsuperscript{301} Only 4 percent of their time was spent on CGT.\textsuperscript{302} Thus CGT
was not a significant compliance cost, with estimated as costing $155 million out of
$4.6 billion in total business compliance costs.\textsuperscript{303} Significantly, when compared to
CGT revenue of $994 million, compliance costs were high, being 15.59 per cent of
CGT revenue.\textsuperscript{304}

The compliance costs for CGT and other federal taxes are set out in the following
table:\textsuperscript{305}

\begin{table}
\caption{Compliance Costs for CGT and Other Federal Taxes}
\begin{tabular}{|c|c|}
\hline
Tax Type & Compliance Costs (Millions) \\
\hline
CGT & $155 million \\
Other Federal Taxes & $4.6 billion \\
\hline
\end{tabular}
\end{table}

\textsuperscript{290} Ibid. \\
\textsuperscript{291} Ibid. \\
\textsuperscript{292} Evans et al above n 288. \\
\textsuperscript{293} Ibid. \\
\textsuperscript{294} Ibid. \\
\textsuperscript{295} Ibid. \\
\textsuperscript{296} Ibid. \\
\textsuperscript{297} Ibid. \\
\textsuperscript{298} Ibid. \\
\textsuperscript{299} Ibid. \\
\textsuperscript{300} Ibid. \\
\textsuperscript{301} Ibid. \\
\textsuperscript{302} Ibid. \\
\textsuperscript{303} Ibid. \\
\textsuperscript{304} Ibid. \\
\textsuperscript{305} Evans et al above n 288 at 54-57.
Table 8: Australian Federal tax Compliance Costs:

ATAX research

<table>
<thead>
<tr>
<th></th>
<th>Income tax (not including CGT)</th>
<th>Capital gains tax</th>
<th>PAYE</th>
<th>Sales Tax</th>
<th>Prescribed payments system</th>
<th>Fringe Benefits Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of total federal compliance costs</td>
<td>42%</td>
<td>3.3%</td>
<td>14.8%</td>
<td>11.2%</td>
<td>10.3%</td>
<td>6.2%</td>
</tr>
<tr>
<td>Percentage of revenue yield</td>
<td>6.5%</td>
<td>16%</td>
<td>1.3%</td>
<td>4.7%</td>
<td>22%</td>
<td>10.5%</td>
</tr>
</tbody>
</table>

The table demonstrates that CGT compliance costs are generally significantly more expensive than other taxes when compared on a percentage of revenue yield basis.

Evans et al\textsuperscript{307} were further commissioned by the Australian Taxation Office to furnish annual updates of compliance costs for 1997-1998, 1998-1999 and 1999-2000 based on random stratified samples of over 3,000 taxpayers. The 1997-98 figures have been produced and indicate significant changes to CGT compliance costs for business taxpayers compared to 1994-1995.\textsuperscript{308}

The annual internal labour time spent on CGT issues rose from 2 hours to 27 hours.\textsuperscript{309} This meant that CGT internal compliance time increased from 4 per cent of all internal time to 13 per cent.\textsuperscript{310} It was estimated that CGT compliance costs for business taxpayers had risen from 3.3 per cent of all business compliance costs to 10.2 per cent.\textsuperscript{311} The data also suggested that the CGT compliance costs as a ratio to CGT revenue yield remained high at 13.1 per cent.\textsuperscript{312} Notably over this time, the number of business taxpayers receiving capital gains increased from 290,380 in 1994-1995 to 762,679 in 1997-1998.\textsuperscript{313} The increase in compliance costs may be attributable to the large increase in business CGT payers or it may be due to CGT changes such as the new business exemptions,\textsuperscript{314} roll over\textsuperscript{315} and retirement reliefs\textsuperscript{316} introduced on 1 July 1997. As Evans notes:\textsuperscript{317}

\textsuperscript{306} Ibid at 17, 31, Compliance costs equated to the costs of taxpayers complying with tax laws, including external advisers and the taxpayers own time and costs, less tax deductibility benefits, and less cash flow benefits; This compliance costs equation though does not reflect the following compliance benefits. Firstly, compliance with CGT will provide managerial benefits through improved record keeping. Secondly, these compliance costs are offset by temporary and permanent tax savings provided by the deferral benefit (that is the benefit of deferring the payment of CGT at the time of realisation) and CGT exemptions (for example the small business CGT reliefs in Division 152).

\textsuperscript{307} Evans et al above n 288 at 167.

\textsuperscript{308} Ibid 167-168.

\textsuperscript{309} Ibid.

\textsuperscript{310} Ibid.

\textsuperscript{311} Ibid.

\textsuperscript{312} Ibid.

\textsuperscript{313} Ibid.

\textsuperscript{314} Ibid.

\textsuperscript{315} Ibid.

\textsuperscript{316} Ibid.

\textsuperscript{317} Ibid 168.
...the greatest increase in personnel involved in CGT internal time was at the level of business proprietors and directors – those who would tend to have the greatest stake in determining whether the new reliefs were applicable and in accessing the reliefs where possible. It may be an ironic conclusion (but one that is nonetheless intuitively true) that the introduction of concessional treatment to the tax regime can often lead to increased compliance costs. The same can be true of choice – the more choice a taxpayer has, the greater the likely compliance costs as the taxpayer explores each possibility to obtain the optimal tax outcome.

However, the study found no significant increase in CGT compliance costs for personal (non-business) taxpayers. The number of personal taxpayers receiving capital gains increased from 270,531 in 1994-1995 to 709,880 in 1997-1998. More respondents obtained paid tax assistance as a result of CGT, up from 4.5 per cent to 5.2 per cent. Overall though CGT record keeping time fell from 2 per cent of total compliance time to less than half of 1 per cent.

Evans further surveyed Australian tax practitioners regarding their attitudes to the compliance costs of the Australian CGT. Relevantly, he found that the survey showed that the compliance burden faced by personal taxpayers is directly influenced by the design features of CGT.

Relevantly, tax practitioners very strongly agreed that the “CGT legislation is complex” (82 out of 94 respondents). Further, they also very strongly agreed that “compliance costs for CGT do not relate to the amount of the gain” (84 out of 94 respondents). Importantly, they very strongly disagreed with the statement “compliance costs for CGT are lower now than they were five years ago” (69 out of 94 respondents). Also, there was strong agreement for the statement “compliance costs for CGT do not closely relate to the size of the transaction” (81 out of 93 respondents).

Further, Evans asked practitioners to assess the impact of 18 possible drivers for CGT complexity. The results were tabled as follows:

Table 9: Drivers of CGT compliance costs – descending order by mean

<table>
<thead>
<tr>
<th>Rank</th>
<th>Factor</th>
<th>No.</th>
<th>Mean score</th>
<th>Frequency of citation (raw)</th>
<th>Frequency of citation (weighted)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>(c) complexity of legislation</td>
<td>93</td>
<td>7.6</td>
<td>54</td>
<td>128</td>
</tr>
<tr>
<td>2</td>
<td>(q) the no. of rules and exceptions</td>
<td>93</td>
<td>7.3</td>
<td>23</td>
<td>40</td>
</tr>
</tbody>
</table>

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318 Ibid.
319 Ibid.
320 Ibid.
321 Ibid.
324 Ibid.
326 Ibid.
327 Ibid 21-22.
328 Ibid 22.
The major driver of compliance costs was the complexity of legislation. Other important influences were the number of rules and exceptions, frequently changing legislation, record keeping requirements, poor legislative drafting and the small business concessions.

Evans concluded that the CGT compliance costs are high compared to the tax payable and the tax revenue collected. He also inferred from the tax practitioner responses that CGT compliance costs were higher in 2002 than five years ago, in 1997, prior to the enacted Ralph CGT reforms. Evans also concluded that CGT compliance costs are high in comparison to the costs involved with other taxes.

Thus these studies suggest that the CGT discount with its 28 pages of complex rules have added to the complexity and thus to the compliance costs of taxpayers. Although given the findings from Evans these extra costs may not be substantial.

5.3.2 Administration costs

There exists limited information about Australian administration costs given that the Australian Taxation Office does not provide a separate costing for CGT. Evans though provides the following table that shows the administration costs in the United Kingdom and Australia as a percentage of revenue yield:

<table>
<thead>
<tr>
<th>Year</th>
<th>UK Capital gains tax</th>
<th>UK All taxes</th>
<th>Australia Capital gains tax</th>
<th>Australia All taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-91</td>
<td>2.10</td>
<td>1.70</td>
<td>3.64</td>
<td>1.14</td>
</tr>
</tbody>
</table>

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331 Ibid 25.
332 Evans Operating Costs above n 289 at 171.
<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>3.80</td>
<td>3.91</td>
<td>5.90</td>
<td>3.62</td>
<td>4.10</td>
<td>2.68</td>
<td>2.30</td>
</tr>
<tr>
<td>CGT</td>
<td>2.06</td>
<td>2.09</td>
<td>2.14</td>
<td>1.81</td>
<td>1.70</td>
<td>1.57</td>
<td>1.41</td>
</tr>
<tr>
<td>STS</td>
<td>4.15</td>
<td>3.28</td>
<td>1.78</td>
<td>2.61</td>
<td>2.61</td>
<td>2.77</td>
<td>1.64</td>
</tr>
<tr>
<td>CGT/STS</td>
<td>1.26</td>
<td>1.25</td>
<td>1.21</td>
<td>1.13</td>
<td>1.03</td>
<td>0.92</td>
<td>0.85</td>
</tr>
</tbody>
</table>

Some caution must be exercised in relying upon these figures. Firstly, the UK figures were obtained from the annual reports of UK Inland Revenue and annual Taxation Statistics from the Australian Taxation Office. Thus other government administration costs incurred outside of the UK Inland Revenue and the Australian Taxation Office are excluded. Secondly, when interpreting UK figures it should be noted that such foreign research may not provide a good indicator for Australian tax administration given the differences in foreign tax regimes, taxpayer behaviour and tax administration. Thirdly, given the absence of a CGT costing by the Australian Taxation Office, Evans estimated the administration costs based on number of taxpayers with CGT compared to the overall number of taxpayers. Also, the CGT/yield ratio needs to be read carefully since it fails to take into account the integrity role of a CGT in preventing the transformation of ordinary income into exempt capital gains. As previously noted, a CGT prevents significant leakage from the income tax system.

The table firstly shows that for both countries the administrative costs of all taxes as a percentage of all tax revenue are falling over the eight year period. Secondly, the table shows that CGT administration costs as a percentage of CGT revenue is highly volatile. This appears to be the result of the instability of CGT revenue is highly volatile. This appears to be the result of the instability of CGT collections that move with the performance of the share and real estate markets. Thirdly, and most importantly the administration costs of CGT as a percentage is significantly greater than the all taxes administration costs percentage. This is not surprising given the impact of CGT complexity on compliance costs.

However, the quantum of the impact of the CGT discount and other related reforms on administration costs is unknown. The CGT discount involved significant set up costs associated with tax design and drafting by Treasury, introducing and maintaining legislation by Parliament and the administration start up costs of the Australian Taxation Office. Also, it can be inferred that the CGT discount and its complex rules would have contributed to ongoing administration costs.

6. Conclusion

This partial analysis of the Ralph Report has firstly revealed how costly the Review’s tax preferences have proven to be. In particular the CGT discount has shown that the Ralph Report significantly underestimated its projections of tax revenue losses. From a fiscal adequacy point of view the STS and CGT discount reforms both fail this goal.

333 Ibid.
334 For example, Parliament and Treasury costs.
335 Evans Operating Costs above n 289 at 171.
although the NCL rules provide some support. This further suggests that the Ralph Report overstated its achievement of revenue neutrality.

The Ralph Report asserted that its recommendations would result in an increase in national income of around three quarters of one per cent of gross domestic product (GDP) in the long run. However, from an economic efficiency point of view all three reforms create numerous winners and losers and this has impeded neutrality. In particular the CGT discount and the STS concessions both appear to be a backward step. Although, certain economists argue that some unquantifiable economic benefit are obtained from the CGT discount. The NCL provisions could assist economic efficiency if the rules were targeted more directly at hobby lifestyle businesses rather than genuine business. Given the Review’s inability to estimate tax revenue effects the estimated impact on GDP is considered to be dubious.

On equity there are problems with all of the reforms as they all breach horizontal and vertical equity. In particular the CGT discount has had a profound and negative impact on equity given the great size of the tax expenditure. Again the NCL provisions could assist equity if the rules were targeted more directly at hobby lifestyle businesses rather than genuine business. Notably the unfairness in these reforms contributes to the growing inequality within the Australian community.

The NCL and the STS have added to tax law complexity for small business taxpayers as evident by the mass of ATO literature accompanying these reforms. Unfortunately such costs are highly regressive for small business. The CGT discount though may not have impacted greatly on simplicity given the ease of the calculation for most individuals and trusts. However, it is likely other complexities will emerge as taxpayers exploit this loophole through various tax effective arrangements.

Overall, it is concluded that the enacted 21 September 1999 Ralph Report’s NCL rules, the STS and the CGT discount all generally failed the Review’s own tax policy criteria. This is indicative of a general problem associated with the Review and the Ralph Report.

Other cracks have emerged in the Ralph Report which advocated an integrated tax code and standardised provisions. The NCL and STS rules though could have been better integrated with the income tax and the goods and service tax rules and dictionaries.

The Review also recommended that a Board of Taxation be established so as to act as the guardian of the Charter of Business Taxation. In that way the reforms could be improved as the people became aware of the day to day practicalities. However, to date the Board of Taxation has only reviewed one of the three reforms, the NCL measures. Unfortunately the Board of Taxation’s NCL review and its strict terms of reference did not extend to a deeper analysis and consider the impact of the reforms having regard to the objectives of the Charter of Business Taxation.

336 Review of Business Taxation Report above n 1 at 728
337 Kenny Australian Taxation, Ethics and Social Capital above n 5 at 119-120.
340 Ibid 102-103.
Other recommendations of the Review appear to be ignored. For example the Review’s call for the ongoing review of tax preferences does not appear to have happened. Rather the Review greatly extended certain tax preferences such as the CGT discount and the STS. Also, the recommendation for the removal of accelerated depreciation sits rather oddly with the STS reforms. As noted above, the Review’s goal of revenue neutrality also seems misplaced given the extent of the under estimations of the tax revenue losses from the CGT discount.

Whilst the complexity and scale of the reforms and the tight timelines for the completion of the Ralph Report and associated papers provided great challenges to the Review, overall the Ralph Report and the post implementation review processes could have been greatly improved. The Government’s experiment in contracting out tax reform to the business sector has imposed serious costs on the community whilst the economic benefits appear to be largely unknown.

It is submitted that any future tax reform committee should consist of members with wider community representation and that a more gradual and consultative approach be employed in drafting reforms. Unless such community representation is obtained and effective post implementation review processes followed there appears to be little hope for any real tax reform.

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341 Ibid 275.
343 Ibid 18.