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Dear Sir/ Madam

**PREBUDGET SUBMISSION: IMPROVING TAX SYSTEM INTEGRITY AND
STREAMLINING PERSONAL INCOME TAX ADMINISTRATION**

Further to the media release issued by the Assistant Treasurer, the Hon Michael Sukkar MP on 30 September 2019, the attachment sets out a range of measures presented for consideration in the context of the 2020-21 Commonwealth Budget. In brief, the measures suggested are directed largely at achieving significant reductions in the income tax gap and streamlining administration of the personal income tax, resulting in savings to both taxpayers and government.

Yours sincerely


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PREBUDGET SUBMISSION: IMPROVING TAX SYSTEM INTEGRITY AND STREAMLINING PERSONAL INCOME TAX ADMINISTRATION

During 2017-18 and 2018-19 the Australian Taxation Office (ATO) continued the release of findings from its tax gap research program, including for the individuals income tax and the corporate income tax. The latest overall summary of findings released can be found on the ATO's website at https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Australian-tax-gaps-overview/?page=6#Tax_gap_program_summary_findings.

The aggregate results published to date reveal a tax system under some stress, with revenue leakage—aggregate net tax gap findings—estimated to have been in the region of \$28 billion for 2015-16. When the complete set of findings is released, covering all taxes administered by the ATO, **aggregate revenue leakage is projected to have exceeded \$30 billion (between 7-8 percent of the estimated tax base)**. These losses in government revenue do **not** include any flow on impacts to other government programs (e.g. means-tested transfer payments and collection of HELP loan repayments through the tax system).

Over recent years, the Government has announced a range of measures and passed accompanying legislation to improve tax system integrity (Attachment 1). While these are all positive developments that should favourably impact later year tax gap findings, in my view the level of annual aggregate revenue leakage justifies further reforms to reduce the overall incidence of non-compliance. While it is not possible to eliminate all tax non-compliance there are a number of obvious weaknesses in the current tax system that can no longer be ignored.

To date, the ATO has released tax gap findings for income taxes on a 'taxpayer segment' basis, while most tax revenue reporting at a government level is on a 'heads of revenue' basis. Tables 1-3 (Attachment 2) present details of published net gaps on a heads of revenue basis, while Table 4 reveals disaggregated information concerning the tax gap for individuals not in business to help place some of the issues raised in this submission into context. From all of the data and findings presented, some important points to note are set out below:

Individuals Income Tax

- Revenue leakage for 2015-16 is estimated at \$17.8 billion, representing approximately 8.6 percent of the overall estimated tax base (Table 1). For the segment of taxpayers defined as 'individuals not in business' the estimated gap findings (i.e. \$8.4 billion and 6.4 percent) are particularly poor, noting that the income tax incorporates a range of features intended to secure high levels of compliance (i.e. tax withholding at source on employment income and extensive third party reporting) in respect of these taxpayers. While there are complications in making international comparisons, the published tax gap estimate for this cohort of taxpayer is more than double, in relative terms, similar estimates published by revenue bodies in some other advanced economies (e.g. the United Kingdom).¹

¹ Analysis provided by me for the ATO suggests that UK tax gap for this segment of taxpayer, based on official HMRC published reports, is less than 3 percent. Features of the UK tax system that contribute to this outcome include 1) around two thirds of individual taxpayers—largely employees—are not required to file annual tax returns (and claim itemised deductions) and instead receive an annual personal tax summary from HMRC; 2)

- The major source of non-compliance and associated tax revenue leakage for individuals not in business is ***over claimed deductions for work-related expenses (WRE) that constitute over 40 percent of the estimated tax gap for this segment of taxpayer***; based on ATO data, it can be shown that between 30-40% of deductions claimed for WRE are not allowable at law. Other significant contributors to revenue leakage are understated net rental incomes and cash-in-hand wages (Table 4).
- While of concern, the net tax gap for small business taxpayers is in line with findings observed in other advanced economies; the Government's initiatives over recent years to expand the Taxable Payments Reporting regime to a range of prescribed industries, effective from July 2018 and July 2019 (Attachment 1), should assist address some of the noncompliance reflected in the published results.
- ATO amendments, reflecting the outcomes of its programs to detect and deter noncompliance, constitute a small fraction (i.e. less than 8 percent) of the overall gross tax gap and indicate that legislative responses, rather than new or expanded administrative measures, are needed to secure the significant improvements that could potentially be realised.

Corporate Income Tax

- Estimated revenue leakage reported to date for 2015-16 amounted to \$3.7 billion, approximately 6.6 percent of the estimated tax base (Table 2). However, this outcome is incomplete as it is yet to formally include the findings of tax gap research for medium-sized businesses and those businesses with links to high net worth individuals which, together, are expected to represent tax revenue leakage of \$778-1,692 million (as reported on the ATO's website). In total, the net gap for this tax appears to have been in the region of \$5 billion for 2015-16.
- While of concern, the net tax gap for small business (corporate) taxpayers of 12.1 percent—substantially higher in a relative sense than for 'large corporates'—is in line with findings observed for other advanced economies.

Goods and Services

- The estimated net tax gap for Australia's GST has been in the region of 7-8 percent for each of the six income years up to 2018, representing net revenue leakage of between \$4-5 billion annually. While the ATO describes this outcome as.... *"in line with the comparable best performing European Union (EU) member countries, and compares well with the United Kingdom estimate"* I question whether this is a valid comparison given Australia's GST does not have to confront the particular sorts of tax compliance challenges that are experienced by economies within the EU's common economic market (e.g. an absence of customs borders) and the extensive use by EU member economies of higher standard GST/VAT rates and reduced

restrictions on allowable deductions in respect of negatively-geared rental properties; 3) wider use of withholding (e.g. bank interest); and 4) limitations on deductible work-related expenses.

rates. A more valid comparison would be with a country such as New Zealand where its GST, albeit with a much broader tax base, has a tax gap below 5 percent.²

- A feature of ATO's administration of the GST is that while the incidence of amendments in revenue impact terms from its compliance activities is very significant in relative terms, and substantially higher than the corresponding ratio for income taxes, there is no trend of improving compliance, suggesting that the 'compliance gaps' may be largely structural in nature. The anomalous treatment of food under Australia's GST is inevitably a contributing factor to the estimated tax gap.

In summary, based on the findings announced to date these three taxes represent over 90 percent of the estimated aggregate tax gap and should therefore be priority areas for review in a budgetary context.

Potential Integrity and Streamlining Measures

Individuals Income Tax

1) Deductions for work-related expenses

Over the last decade I have made numerous submissions to various government and parliamentary inquiries, as well as to the annual pre-budget submission process, on the case for and benefits from a major program of personal tax simplification. Central to most of my submissions has been a proposal for fundamental reform of deductions for WRE on the following grounds:

- 1) Deductions for WREs are subject to a high incidence of incorrect claims by taxpayers, for many facilitated by the engagement of tax agents, resulting in significant revenue leakage that is at a level beyond the administrative control of the ATO.
- 2) Reform of WREs that eliminated the vast bulk of itemised deduction claims in taxpayers' tax returns would constitute a major step towards full automation of personal tax administration for most taxpayers and deliver substantial savings to taxpayers and government.
- 3) Existing laws and administrative arrangements present significant compliance costs that at the end of the day are borne by the community at large.

These ideas for reform are far from radical. There are many advanced economies (e.g. Denmark, Sweden, Finland, Netherlands, Norway, and Singapore) that already offer fully-prefilled returns/ personal tax statements to the majority of their taxpayers, with such arrangements facilitated by legislative provisions that negate the need for itemised deduction claims for WREs and other outlays.

² While New Zealand's tax administration has not published any tax gap estimates, there is other published data pointing to very high levels of GST compliance. For example, the OECD's regularly publishes computations of the VAT revenue ratio (VRR) for all its member countries. The VRR for New Zealand in 2014 to 2016 was in the range of 0.95 to 0.96, which is highly indicative of a very low net tax gap (i.e. below 5 percent). The corresponding ratio for Australia was 0.48 to 0.50.

With the ATO's tax gap research findings validating concerns for the scale of revenue leakage,³ it is now time in my view to consider the legislative reforms required, ***a conclusion that official government reviews and other studies have publicly supported.***

In 2009-10, the Committee undertaking the review of Australia's Future Tax System (AFTS) examined the issue at some length and made specific recommendations for substantive reform:

- **Recommendation 123:** Pre-filled personal income tax returns should be provided to most personal taxpayers as a default method of settling their tax affairs each year.
- **Recommendation 11:** A standard deduction should be introduced to cover work-related expenses and the cost of managing tax affairs to simplify personal tax for most taxpayers. Taxpayers should be able to choose either to take a standard deduction or to claim actual expenses where they are above the claims threshold, with full substantiation.
- **Recommendation 12:** There should be a tighter nexus between the deductibility of the (WRE) expense and its role in producing income.

Support for reform of deductions for work-related expenses (WRE) can also be found in the discussion paper for the Government's 2015 tax reform exercise RETHINK, in the report of the House of Representatives Standing Committee on Tax and Revenue titled *Taxpayer Engagement with the Tax System*,⁴ and in the Inspector General of Taxation's recent study *The Future of the Tax Profession*.⁵ In its 2017 report titled *Report on the Inquiry into Tax Deductibility*, the House of Representatives Standing Committee on Economics also acknowledged that there were major issues to be addressed concerning WRE and recommended more fact gathering to help determine the nature of the response required. In my view, the ATO's subsequent release of tax gap research findings now provide all of the evidence required to confirm the seriousness of the issue and the urgency for reform action. Not to act soon will, in my view, amount to negligence.

How should WRE be reformed?

In my view, reform of WRE should be driven by two major objectives:

- 1) To substantially reduce the level of revenue leakage from over-claimed WRE deductions; and
- 2) To significantly reduce the numbers of taxpayers who are required to make itemised claims for personal WRE deductions in their tax returns, thereby enabling substantially increased automation of the tax system (as envisaged in the AFTS study report).

³ Since the release of its 'individuals not in business' tax gap research findings the ATO has intensified its compliance activities with, reportedly, some observed impact on growth in the numbers and value of WRE claims. While this is welcome news such advances represent a small fraction of the overall revenue leakage attributable to over-claimed WRE and may not be sustained over time.

⁴ *Taxpayer Engagement with the Tax System*, House of Representatives Standing Committee on Tax and Revenue, August 2018, Canberra, Page iv.

⁵ *The Future of the Tax Profession*, Inspector General of Taxation, November 2018, Recommendation 5.2.

In addition to generally tightening the rules for deductibility of WRE, as recommended by the AFTS study report, action is required to reduce the high incidence of itemised deduction claims, suggesting consideration of the following sorts of approaches:

- 1) The introduction of a minimum threshold above which taxpayers could make itemised WRE claims for any excess of WRE deductions over the threshold, subject to substantiation requirements; the minimum threshold would be set at a reasonable level (e.g. \$2,600 (equivalent to deductions of \$50/ week) to eliminate the large volume of relatively low value claims; or
- 2) Provision of a standard deduction for taxpayers declaring employment income that is calibrated to accommodate most employee taxpayers (e.g. 1.5% of employment income), while permitting itemised claims (with substantiation) that exceed a threshold, say, \$2,600.

While I have previously advocated for reform along the lines of 2) above, the extremely high rate of non-compliance among WRE claims evident from the ATO's random audit program suggests to me that the more ruthless approach envisaged by 1) is justified. Also, the option in 1) may have political appeal from the viewpoint of maximising the potential for reductions in marginal tax rates and as a tax simplification/ burden reduction measure. Reform of WRE along the lines suggested would also result in additional revenue savings from a substantial reduction in the use of tax agents by employee taxpayers and revenue foregone with deductible tax agents' fees. Freed from preparing millions of tax returns for employee taxpayers, the tax agent profession could devote increased attention to the small business segment of taxpayers where their assistance is clearly required.

It is my recommendation that, in addition to tightening the rules for deductibility of work-related expenditure, a reform along the lines of the option in 1) above be considered as part of a broader package of tax rate reductions/ tax simplification initiatives, and arguments around "winners and losers" largely discounted given that the significant incidence of non-compliance in the current system renders such arguments specious.

2) Understated net rental income from real property

As indicated in the ATO's published tax research findings and in Table 4 of the Attachment, understatements of net rental income from real property are significant and contribute to tax revenue leakage. This should hardly be surprising—***neither gross rental income nor interest paid on mortgages, the major expense item in respect of such income, are subject to any form of third party reporting to the ATO that applies for other categories of income.*** For the 2016-17 income year, over 2.2 million taxpayers reported \$44 billion of rental income and claimed deductions against such income of over \$47 billion, including \$22 billion in respect of mortgage interest paid to lenders.⁶⁷ The Government responded in the 2017-18 Budget to address one aspect of non-compliance with net rental income (i.e. travel expenses) but the gap research findings indicate that much more can and should be done.

⁶ ATO Tax Statistics 2017.

⁷ When account is taken of the rental income and deductions reported in partnership and trust returns, the value of income and deductions that potentially could be subject to third party reporting reaches almost \$120 billion per annum.

Under current tax laws, a wide variety of income types and other amounts are subject to third party reporting obligations to the ATO and a number of these are far less significant in \$ terms than rental income, much of which is collected via intermediaries. While there is limited third party reporting concerning non-income items, financial institutions already are obliged to report interest income and it does not seem a significant burden to introduce a reporting obligation for mortgage interest paid, given the incidence of negative gearing and tax revenue at risk.

It is my recommendation that third party reporting obligations be established in respect of rental income collected by intermediaries (e.g. real estate agents, Airbnb) and interest charged by financial institutions in respect of loans on residential property.

3) Gift deductions

Gift deductions, and the many millions of relatively small deductions, are another source of revenue leakage and compliance burden. Furthermore, their sheer volume stands in the way of full automation of the personal tax return assessment process.⁸ My personal preference would be to remove deductibility for gifts from the tax system and provide for a more direct and transparent means of providing government benefits to approved charitable organisations, as seen in some other countries. This would be consistent with Government reforms over recent years to improve the transparency and accountability of this sector.

If such a reform is deemed “too big a step”, the minimum gift amount subject to tax deductibility should be raised substantially above the current level of \$2 to, say \$100 per charity per annum, and/or alternately brought within the ambit of the suggested standard deduction.⁹ This would eliminate the relatively large volume of low value claims, a fair proportion of which are generally not able to be substantiated by taxpayers.

Goods and Services Tax

Reform of GST continues to be raised in the media and in other quarters, an inevitable outcome given that, in comparison with the vast majority of other advanced economies, Australia makes relatively low use of the GST for revenue raising purposes. From my experience and observations:

- It is simply inconceivable that Australia has created a tax that can never be reformed; general taxes on personal consumption are used widely around the world and their use has grown over recent decades; of particular note, over 70% of OECD member countries that administer a system of VAT/GST have adjusted their standard rate (for almost all, upwards) over the last decade.
- Australia’s chosen course to substantially underutilise the GST for Government revenue raising purposes means that marginal rates of income tax must be substantially higher than might otherwise be the case, not only acting as a disincentive but also adding to the risk premium attached to acts of non-compliance—each one dollar of unreported income or over claimed deduction can represent a maximum of \$0.47 of foregone income tax revenue.

⁸ According to ATO Tax Statistics 2017, around 4.6 million claims for the income year 2017, with approximately 66% of claims below \$250. The total value of deductions claimed was \$3.4 billion.

⁹ The AFTS study also recommended that the minimum threshold for gift deductibility be raised from its then current level of \$2.

- Australia's ageing population requires further thought be given to future sources of Government revenue and the overall tax mix.
- The current tax treatment of food under the GST is anomalous and inevitably contributes in part to the GST gap, given the opportunities it creates for the misclassification of food products.
- At 7-8 percent, the estimated net tax gap for Australia's GST is unacceptably high; Australia's GST can and should be doing much better.

While I appreciate that moving quickly on this matter is difficult and may appear impracticable, the Government needs to thoughtfully develop a medium/ longer term strategy for GST reform, as part of a broader tax reform strategy. The potential of GST reform is significant—even with a relatively modest increase in the basic rate, a GST designed to tax all food products and other goods and services current subject to the GST at a standard rate of 12.5% could conceivably raise an additional \$25-30 billion per annum, and providing significant revenue for income tax reductions, compensation of citizens on low incomes, or other government requirements.

Attachment 1

Recently Announced and Implemented Measures to Improve Tax System Integrity

Budget	Announced measure	Estimated revenue impact (\$m)				
		2017-18	2018-19	2019-20	2020-21	2021-22
2016-17	Tax Integrity Package — a new diverted profits tax		100	100		
	Tax Integrity Package — establishing the Tax Avoidance Taskforce	768	1,284	1,610		
2017-18	Tax Integrity Package — Black Economy Taskforce: Extension of the Taxable Payments Reporting System to contractors in the courier & cleaning industries			146	194	
	Tax Integrity Package — Black Economy Taskforce: one year extension of funding for ATO audit and compliance activities	442	86	43	19	
	Tax Integrity Package — improving the integrity of GST on property transactions		200	220	240	
	Reducing Pressure on Housing Affordability — disallow the deduction of travel expenses for residential rental property		160	180	200	
2018-19	Black Economy Package — Expansion of the taxable payments reporting system (TPRS) to the following industries: a) security providers and investigation services; b) road freight transport; and c) computer system design and related services.			95	330	365
	Black Economy Package — new and enhanced ATO enforcement against the Black Economy		525	736	856	931
	Black Economy Package — removing tax deductibility of non-compliant payments (e.g. unreported employee's cash wages.			No estimate	No estimate	
	Personal Income Tax — ensuring individuals meet their tax obligations. This measure will continue four income matching programs that would otherwise terminate from 1 July 2018 to allow the ATO to detect incorrect reporting of income, and provides funding for new compliance activities.		217	290	308	308
2019-20	Extension and expansion of the ATO Tax Avoidance Taskforce on Large Corporates, Multinationals and High Wealth Individuals			176	1,226	1,554

Sources: Budget Papers 2016-17 to 2019-20.

Table 1. Individuals Income Tax—Tax Gaps (2015-16)

Measure	Individuals Not in Business	Individuals in Small Business	High Net Worth Individuals	Totals (to date)
Tax paid (\$m)	124,067	64,502	Not yet available	188,569
Net gap (\$m)	8,444	9,309	Not yet available	17,753
Theoretical tax liability (\$m)	132,511	73,811	Not yet available	206,322
Net gap (%)	6.4	12.6	Not yet available	8.6
Amendments (\$m)	645	735	Not yet available	1,380
Gross gap (\$m)	9,089	10,044	Not yet available	19,133
Gross gap (%)	6.9	13.6	Not yet available	9.3
Taxpayer population	10,458,472	3,717,912	Not yet available	14,176,384

Source: ATO website (October 2019)

Table 2. Corporate Income Tax—Tax Gaps (2015-16)/1

Measure	Small Business	Medium Business	Large Corporates	Totals
Tax paid (\$m)	12,896	Not yet available	39,764	52,660
Net gap (\$m)	1,778	Not yet available	1,958	3,736
Theoretical tax liability (\$m)	14,674	Not yet available	41,772	56,396
Net gap (%)	12.1	Not yet available	4.7	6.6
Amendments (\$m)	237	Not yet available	1,960	2,197
Gross gap (\$m)	2,014	Not yet available	3,918	5,932
Gross gap (%)	13.7	Not yet available	9.4	10.5
Taxpayer population	958,000	Not yet available	5,400	963,400

Source: ATO website (October 2019).

Table 3. Goods and Services Tax—Tax Gaps (2013-18)

Element	2013	2014	2015	2016	2017	2018
Gross gap (\$m)	6,567	6,556	6,789	7,435	7,064	7,276
Amendments (\$m)	2,509	2,497	2,550	2,279	2,351	2,282
Net gap (\$m)	4,058	4,059	4,239	5,156	4,712	4,995
Tax paid (\$m)	48805	51840	55134	57511	60950	63,560
Theoretical liability (\$m)	52864	55899	59373	62667	65662	68555
Gross gap (%)	12.4	11.7	11.4	11.9	10.8	10.6
Net gap (%)	7.7	7.3	7.1	8.2	7.2	7.3

Source: ATO website (October 2019).

Table 4. Individuals not in business- allocated gap category amounts (2016)

Income/deduction category	Gap	% of gross gap	Author's Comments
WRE	4,045	45	Over 9 million claims annually; no third party reporting; extremely low incidence of taxpayer audits
Rental income/deductions	1,523	17	Over 2 million taxpayers with this income; no third party reporting; extremely low incidence of taxpayer audits
Cash wages	1,362	15	Potentially impacted by black economy measure from July 2019 but further actions may be needed
Other income	558	6	
Offsets, credits, levies	421	5	
Other non-detection elements	305	3	
Non-pursuable debts	214	2	
Other deductions	152	2	
Gifts/donations	151	2	Over 4.5 million claims annually; no third party reporting; extremely low incidence of taxpayer audits
Capital gains	-10	0	

Source: ATO Tax Gap Technical Guide 2019.