

Tax System Review

Submission for Re:think

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Abstract

To make our tax system simpler and reduce anomalies, this submission proposes the following:

- separate business taxation completely from personal income tax
- by steps, move from having two major business taxes (GST and company tax) to having a single business tax that looks like the GST with an expanded base and higher rate
- adopt principles for reforming personal income tax, particularly in relation to superannuation
- adopt technological measures to make managing tax and superannuation contributions simpler for individuals.

It addresses the following discussion questions from the Re:think paper:

<u>Question</u>	<u>Addressed in sections:</u>
<input type="checkbox"/> What fundamental changes should there be	2, 3, 5.4, 5.5
4 Is reducing complexity a priority	4
5 Fairness in the system	5.1, 5.2, 5.3
6 What the personal income tax system should look like	4, 5
10 Interactions between the personal income tax and the tax transfer system	4.1, 4.2
14 Using tax offsets to deliver assistance	5.2(b), 5.3
22 Appropriateness of tax arrangements for superannuation	5.4, 5.5
25 The dividend imputation system	3.9
34 Dealing with international transfer pricing	3.8, 3.11
38 Special provisions for certain types of business	3.7
42 Providing structures to help small business	2.3, 3.6(a), 3.7 3.8(d), 3.14, 3.15
43 Interaction of personal and business tax systems	2, 3.9, 3.14, 3.15
46 Mechanisms to reduce compliance and complexity costs for small businesses	2, 3.7, 3.14, 3.15
51 Appropriateness of tax settings for the GST	3.1, 3.6
56 – 61 Questions about the causes of, and cures for, complexity	various

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Overview

1.1 Our tax system is too complicated for businesses and for individuals

The Australian tax system is unnecessarily complicated and, as a result, has unnecessarily high compliance costs. The costs in wasted time, wasted money and irritated people are often obvious, but there are also substantial costs to our society when businesses manage their affairs to reduce tax rather than to increase productivity.

In this submission we propose reforms of the taxation of businesses and of individuals that would greatly reduce the complexity and the compliance costs.

To simplify the discussion, we assume that the reforms should leave the total amount of tax paid by businesses and the total paid by individuals at about the same levels.

If the proposed reforms would result in a fairer and more coherent system, and the total revenue to be raised is the same, then the fact that some individuals and businesses would pay more tax than they do now (because others would pay less) is a measure of the distortions of the current system. It does not constitute an argument against making the change. However, people who are adversely affected must be given time to adjust. Our proposals include appropriate transition mechanisms.

1.2 Separating business and personal taxation

Our tax system generally distinguishes between individuals and businesses, but not in a consistent way, and sometimes it does not distinguish between them at all. Many of the complexities and anomalies of our system result from this confusion.

The tax system should make a clear and consistent distinction between businesses on the one hand and the individuals associated with them on the other. This would allow taxes on business and taxes on individuals to be considered separately, so that each could be reformed in the way that is most appropriate.

We propose that business taxation be separated from personal taxation by:

- turning the threshold for registration for the GST into a threshold for payment of the GST, to remove the current disincentive to register a very small business or start-up
- treating any registered business as an entity separate from its owners for all tax purposes, like a corporation or a trust
- removing deductions for business expenses from the personal income tax. A person who wished to claim expenses (other than employment-related ones) would need to register the business and claim them against the taxes on the business.

It would be worthwhile to do this whether or not business taxation is reformed in the way we propose.

1.3 Better business taxation

Moving to a single business tax

One of our main business taxes, the GST, is a pretty good tax. Although Australia's version is more complex than a value-added tax needs to be, it has all the value-added tax virtues—it is comparatively simple to apply, it is hard to avoid, it is economically neutral, there is no double-counting, and it creates few anomalies.

Our other main business tax, the company tax, is a poor one. It is extremely complicated, invites avoidance, and its relationship with the taxation of individuals is confused and full of anomalies.

There is no good reason to maintain two major taxes on businesses when the revenue could be raised just as easily with only one, with reduced complexity and compliance costs.

We therefore propose to move by a series of steps to a single business tax that raises the same total revenue, and looks like the GST with an expanded base and higher rate.

Although the end point is very different from today's system, the individual steps are comparatively small, and would not be difficult to apply over a suitable transition period.

The proposed process

The proposed process is as follows:

- Leave the GST in place, with its revenue distributed to the States, unless and until there is agreement to change it.
- Introduce a General Business Tax (GBT) at a low rate. The proposed GBT consists of a value-added tax that is separate from the GST, but is based on the GST legislation and uses figures that the business must already have calculated for the GST. It would therefore not add to the compliance burden.
- At the same time, reduce the rate of company tax by an amount that would balance the revenue raised by the GBT—an increase of 1% in the GBT rate would be equivalent to a drop of nearly 5% in the company tax rate.
- Each year, increase the GBT rate and decrease the company tax rate until the latter is zero. A suitable transition period might be 6 or 7 years.
- During the transition period, allow businesses with turnover below a certain threshold to opt out of company tax immediately and instead pay the GBT at the final rate.
- Make consequential changes to deal with dividends and capital gains received by foreign investors, leading to an effective withholding tax rate that is equal to the GST rate plus the GBT rate.
- When agreement can be reached to remove zero-rating from the GST, integrate it into the GBT.
- When this has been achieved, consider further reforms or changes to the GBT that affect the way the turnover (value added) is calculated (eg changing the treatment of interest).

The effects

Tax compliance would be greatly simplified for businesses—and a small business would be able to take advantage of the simplification immediately.

Business tax would be the same for corporations and ***unincorporated businesses***.

However, the GBT can be configured to place a ***lower tax burden on small businesses***.

Because the GBT uses the GST rules and treats interest as an input-taxed supply, it will not work with ***banking or money-lending***. It will be necessary to maintain a separate tax for such businesses. However, if such a tax is limited to money-lending businesses, it could be much simpler than the current company tax.

Tax imputation credits for dividends are an artefact of the company tax, introduced to remove perceived inequities. In our view, the solution is a poor one that creates as many inequities as it removes. Our preferred approach would be to allow imputation credits to be phased out with the company tax: value-added taxes like the GBT do not normally give rise to such things. However, if agreement cannot be reached to do this, it would be possible to maintain imputation credits with essentially the same effect as at present.

Negative gearing for businesses is an artefact of the company tax, and would be phased out with it. There would be longer term transition arrangements for existing projects that are dependent on long-term borrowing.

Under other changes that we propose, negative gearing would also disappear from personal income tax.

The GBT, as a value-added tax, is not avoided by *international transfer pricing*.

There would be a *withholding tax for profits and capital gains sent abroad* equal to the GBT (plus the GST while that remains a separate tax). The result would be that any transfers to foreign owners, whether by dividends, capital gains or by use of transfer pricing, would be subject to the same level of tax.

Making business administration easier

We propose administrative measures that would make life easier for businesses, especially small ones.

1.4 Better personal income tax

Our proposed separation of business tax and personal tax, and reform of business taxation, would simplify the tax arrangements for a person who is self-employed or running an unincorporated small business.

Integrating personal tax, superannuation and income support

For an individual, the personal income tax system is only a part of the broader *income system* that determines what he or she pays to the government, or at the government's direction, and what he or she gets out of it. This includes superannuation and income support, and could also cover other kinds of social insurance.

The current income system as a whole is very complicated indeed. As a result:

- it is full of anomalies because different parts have been developed on varying principles that are not easy to reconcile
- an individual cannot deal with the system as a whole, but must address each element separately
- it is particularly difficult for an individual whose income does not come from single source, such as a person who:
 - works for a series of short-term employers, or several at once
 - is partly employed and partly self-employed
 - relies partly on employment and partly on income support or superannuation income

Any substantial reforms need to address the income system as whole, which is beyond the scope of this exercise. However we propose that:

- any changes to the income system, or elements of it, should:
 - tend to ***reduce the number*** of agencies, payment types, rules and exceptions involved
 - follow ***consistent principles*** of the kind set out in this submission
- the ***presentation of the income system*** to the individual should be simplified making use of what technology now makes possible. Even if the income system remains very complicated, the way an individual deals with it, and is presented with information about his or her rights and obligations under it, can be made much easier than it is at present.

Practical measures

We propose two measures that would help ordinary individuals find their way more easily through the maze of our income system:

- a ***PAYG bank account***: an individual with more than one employer would be able to have all salary and allowances paid into a special bank account, from which PAYE tax deductions and superannuation contributions would be made
- a monthly ***income system statement***: an individual would be provided each month with a single statement that summarises his or her income from all sources, tax, superannuation contributions and superannuation balance

The family home

- The special treatment of the family home in our income system means that people who do not own a home, or do not live in one that they do own, are disadvantaged compared to other people whose overall income and assets are the same.
- As there are strong social reasons to maintain the special treatment, we propose that the disadvantage of non-owner-occupiers be addressed by allowing a personal income tax deduction for rent paid for a rented family home. This measure could be paid for appropriately by lowering the general tax threshold.

1.5 Principles for changing the income system

Principles of fairness

The fairness of the income system should be judged as a whole, not individual bits of it.

Fairness is not to be judged minutely – it may need to give way to practicalities.

The fairness of the income system should be assessed in:

- the way it treats two people who are in similar circumstances apart from their income (vertical fairness), and
- the way it treats two people with similar income, but whose other circumstances are different (horizontal fairness).

Vertical fairness requires the system to be somewhat progressive, remembering that progressiveness also needs to be assessed for the income system as a whole, not individual bits of it.

Because the personal income tax system, with its increasing rates, is designed to be progressive, measures that undermine the structure tend to reduce fairness. These include the use of:

- tax deductions to provide for particular needs, rather than rebates or grants
- means tests, especially ones without a taper

Principles for effective superannuation

There needs to be an agreement on what result the superannuation system is intended to achieve for individuals and for our society as a whole. Only on this basis will it be possible to decide how the tax system should deal with superannuation contributions, accumulation of funds and the drawing of superannuation income. If Australia's current measures for superannuation are based on any consistent principles, it is not obvious what they are.

In our view, the following should be the starting point in setting the agreed goals:

- in the long run, superannuation should supply an adequate retirement income for nearly everyone, so that the age pension becomes a safety net needed by only a few
- superannuation should generally be sufficient to enable a person in retirement to maintain much the same standard of living relative to other people as before retirement
- a substantial part of this should be guaranteed by the superannuation system, rather than relying on luck or decisions by the individual. This means that the system:

- must recognise that actual returns on investment are not the same as expected returns, and have an insurance mechanism for sharing returns across the superannuation system
- must recognise that a person's actual life span is not the same as his or her life expectancy, and require the guaranteed part of superannuation income to be provided in the form of a life annuity.

This approach would lead to a tax treatment of the three phases of superannuation almost the opposite of the current one.

It would also lead to a strong bias in favour of life annuities compared with other ways of drawing superannuation.

2 Separating business and personal taxation

2.1 Two subjects of taxation

Our tax system nearly distinguishes between individuals and businesses. Even unincorporated businesses are effectively considered as entities that are subject to tax under the GST, but the distinction is not maintained for income tax, and the personal income tax deals with business profits when they are created by unincorporated businesses. Many of the complexities and anomalies of our system result from the lack of a clear divide between business and individual.

2.2 There needs to be a better separation

The tax system should make a clear and consistent distinction between businesses on the one hand and the individuals associated with them on the other. This would allow taxes on business and taxes on individuals to be considered separately, so that each could be reformed in the way that is most appropriate.

The basis for separation is clear for businesses that are already incorporated or constituted as trusts. However for unincorporated businesses that are not trusts, the system is very tangled. As a business grows, it becomes more convenient for it to be set up in one of these ways, but for a very small business, the costs outweigh the convenience.

2.3 Dealing with unincorporated businesses

We propose that the GST registration system should be modified to:

- make registration a convenience for a small business rather than a burden
- use it to separate unincorporated businesses from their owners for personal income tax purposes

We propose the following process:

- introduce a threshold in the GST, so that no tax is payable by a registered business on the first \$75,000 of turnover. This would remove what is currently a strong disincentive to register a very small business or start-up
- treat any registered business that is not already set up as a corporation or corporate, public or trading trust as an entity separate from its owner for all tax purposes. This would mean that:
 - the business would be taxed as if it were a corporation – it would be subject to GST and company tax, and to any other tax that might replace these (as proposed below)
 - there would be a limit, perhaps proportionate to turnover, on the money that can be held in the business before paying it out as expenses or a distribution of profits to the owner
 - the owner's personal income tax would apply only to money drawn from the business as salary or as distributed profits
 - distributed profits would be treated in same way as dividends for the purpose of any imputation credits
- require banks to offer accounts for registered businesses with facilities that will enable a small business with simple accounts to manage them through the bank account (section 3.15).
- remove deductions for business expenses from the personal income tax. A person who wished to claim expenses (other than employment-related ones) would need to register the business and claim them against the taxes on the business.

It would be worthwhile doing this whether or not business taxation is reformed in the way we propose below.

Having a payment threshold higher than \$75,000 would be a better way to assist small businesses than lowering the company tax rate (section 3.14).

A family or small business trust operating an unincorporated business would need to register the business, which would be treated as a separate accounting entity from the trust (section 3.12).

3 Changes to business taxation

3.1 GST and company tax—are they business taxes?

Most business owners and managers regard the GST and the company tax as being taxes on their businesses—after all, they pay them. However, in various ways, the two taxes are designed on the assumption that, at a higher level of reality, they are taxes on someone else—the consumer for the GST, and the individual final dividend receiver for the company tax. The business is not really a taxpayer at all, just a tax-collector.

It is true that a value-added tax like the GST is usually classified as an indirect consumption tax, because its predominant effect is to increase prices from what they would otherwise be, by an amount that reflects the tax. The Re:think paper states that “While businesses have a legal requirement and incur the compliance burden of collecting and paying the GST, these costs are ultimately passed on to consumers.” This conception is supported by one of the virtues of a value-added tax, the fact if it is levied at a particular rate on all the inputs to a final product, it produces the same revenue as a tax at that rate on the whole of the final product.

The differential rates that are charged on different goods and services are justified on this basis: if it is the consumer who pays the tax, then social justice considerations justify protecting less well-off consumers by having differential tax rates, even if it makes the tax considerably more cumbersome.

The company tax can similarly be classified as an indirect tax on the incomes of the individuals who finally benefit from the profits being taxed. The way that dividend imputation credits operate to give credits in personal income tax for tax paid under the company tax is justified by conceptualising company tax in this way. A corollary is that company tax is viewed as a withholding tax rather than as a tax on business at all.

3.2 Yes, they are business taxes

The important qualification in these classifications is the word “indirect”. When either tax is imposed, it is the business that must pay it, not anyone else. The business can only set its prices at a level that the market will bear. Both taxes will affect the general price level, since all businesses are paying them, but for an individual business, the taxes are simply costs that it must somehow cover, along with its other bills and the salaries of its employees, with the aim of providing the shareholders with a net return that is good enough to make it worthwhile to continue the business.

The actual effect of both taxes on prices, dividends, retained profits and employee remuneration:

- is unpredictable and complicated
- varies greatly between businesses
- varies greatly between consumers, shareholders and employees
- may take a long time to happen.

According to the Re:think paper, less than half the economic burden of the company tax is borne by shareholders in the long run.

A system that treats indirect payers of these taxes as if they were actually direct payers is therefore bound to create discrepancies and distortions. When doing so also greatly complicates a system that would be complicated enough anyway, it is time to rethink those assumptions.

The alternative approach is to:

- treat businesses and individuals as separate entities with two different economic natures;
- treat taxing the two kinds as separate exercises which require different approaches appropriate to those economic natures
- design the taxes so that when money moves from one kind of tax subject to another, the tax treatment is consistent and non-distorting.

This approach makes it much easier to produce a comparatively simple and coherent tax system.

We propose a reform of the business taxes on these principles. On this approach, the business is the true subject of both the GST and the company tax. The taxes have different bases, but they are both ways of extracting revenue from businesses and their activities. The effect of the GST and company tax on individuals may be economically, socially and politically important, but it is indirect and operates only at the aggregate level.

3.3 The GST is a good business tax

The GST has comparatively low compliance costs. It requires more elaborate account-keeping than a small business would need for its own purposes if it paid no taxes at all, but much of the work can be done by computer software once the accounting system and recording procedures are set up.

The economic virtues of a value-added tax are well known:

- it minimises economic distortion
- when the output of one business is the input of another, it automatically avoids double counting of the tax base (the turnover, or value added), and is self-monitoring
- avoidance is difficult
- it works well at the country's borders.

3.4 The company tax is a poor business tax

Income tax on the profits of a business is a poor tax because:

- defining the profits to be taxed is a difficult matter—most of the pages of our tax legislation relate to this question
- partly because of the resulting complexity, there is considerable scope for tax avoidance
- the scope is particularly large for multinational companies using transfer pricing
- profits calculated for the purposes of the tax are not the same as profits for the purposes of accounting standards, a recipe for confusion and wasted time
- profits made in one business may be passed through other businesses on their way to the individual who finally benefits. It may be that this cannot be dealt with in a simple way without either double counting or unmerited exemptions. Australia's method, using dividend imputation and capital gains tax, is certainly not simple, but it is not very effective or coherent either.

The great virtue of a tax on profits is that an unprofitable business does not have to pay it, though the owners of profitable businesses do not seem to get much joy from this reflection. Perhaps they see the tax as penalising businesses that are run more efficiently (and so have more profit).

A significant consequence is that revenue from a profits tax tends to vary greatly with the state of the economy. Economic theory suggests that this could be regarded as advantage of the tax, because it has the effect of providing an automatic economic stimulus when the economy is doing poorly. However, the experience of recent Australian governments in

dealing with the fluctuations of company tax revenue suggests that for practical purposes it is better regarded as another serious shortcoming of the company tax.

3.5 The company tax can't be fixed

The problems described above are inherent in the company tax method.

3.6 The GST could be better

The GST is a good deal more elaborate than a value-added tax needs to be, mainly because some goods and services are zero-rated.

(a) *There should be no distinction between different goods and services*

The justification for the distinction is based on regarding a value-added tax as a tax on the purchaser of goods and services. However, even on this view, if the object is to benefit people with low incomes who purchase zero-rated goods, it is an extremely inefficient way of doing it, because the lower prices are available to everybody, and most of the goods will be purchased by the better off. There may be a case for an increase in income support for those on low incomes if there is an increase in GST rates, to the extent that the increase can be expected to cause price rises that would not be covered by any automatic indexation, but there is no good reason why Coles, BHP, a restaurant chain and a large financial planner should be paying different proportions of their business turnover in tax.

In any case, as we argued in section 3.2, it is more helpful to view a value-added tax simply as a tax on a business. There is nothing in the nature of the businesses producing different kinds of goods or services that would justify having different rates on this basis. Having a single tax base allows the administration of the tax to be much simpler.

(b) *There can be a distinction between different kinds of business*

On the other hand, it does make sense under this conception to treat a commercial enterprise differently from a charity, a non-profit organisation or a non-commercial government agency, if that is thought desirable. Such organisations could be charged reduced rates or none.

Although the default approach is a single rate, it also makes sense under this conception to have a rate structure that differentiates between smaller and larger businesses in the same way as our current individual income tax. For example, to produce a result similar to the Government's proposed differential company tax, the tax on a business's turnover could be set at 5% on the first \$2M and 5.5% on the remainder

As long as the turnover is calculated in the same way for all businesses, differential rates like this require only a simple additional calculation at the last stage. They do not affect the records that have to be kept or the accounting that has to be done, and so do not add to the compliance costs of the tax.

3.7 A single business tax is enough—the General Business Tax

Australia raises less revenue from businesses than most advanced economies. There is no good reason to use more than one mechanism to extract it. In the GST, we already have a mechanism in place that is comparatively efficient and simple. An improved version, as a General Business Tax, could raise all revenue currently raised by the GST and company tax with a standard rate of under 15%. Many economically successful countries have VAT rates that are substantially higher than this.

We therefore propose that Australia should move toward having a single business tax in the form of a General Business Tax. It would raise all the revenue from business that is currently raised by the GST and the company tax. It would consist of a value-added tax that would be levied on the whole turnover (value added) of every business.

It would have a slightly progressive set of rates, eg:

- zero for the first \$75,000 of the turnover
- a lower rate to advantage small business (eg 5% up to \$2,000,000)
- a standard rate (eg 5.5%) thereafter.

The threshold below which no tax is payable would help integration with the personal income tax system (see section 3.14).

Obviously, a single General Business Tax could not be introduced overnight. However, a transition could be made quite smoothly over a reasonable period.

3.8 How to introduce a single business tax

We propose that the transition to a single General Business Tax (GBT) be done in the following way. A 5-year transition period has been used to make the figures simple, but a longer period might be needed.

(a) *Leave the GST as it is until there is a consensus to change it*

The existing GST, with its current limitations, is set up in agreement with the States as a mechanism to provide them with a guaranteed revenue base. It cannot be changed without their agreement, which cannot be assumed.

It must be left in place as it is, with its revenue distributed to the States, unless and until there is agreement to change it.

(b) *Leave the company tax in place, gradually reducing its rate*

The company tax should be left in place as it is, apart from its rate.

In each year of the transition, the general rate should be reduced by 5%. It would be 25% in the first year, and down to 5% in the fifth. In the sixth year, it would cease to operate.

(c) *Introduce the General Business Tax on the GST base, gradually increasing its rate*

The GBT should be introduced as a value-added tax that is separate from the GST, but is levied on turnover that is defined using the existing rules for the GST. It would cover all goods and services that are subject to either the full rate or the zero rate of the GST. Because the GST requires accounting for all inputs and outputs of the business, including those that are zero-rated or input taxed, all the figures that are needed to calculate the General Business Tax will already have been calculated for the GST. There will be no additional compliance burden.

The rate of the GBT should be set at a level that compensates for the reduction in the company tax rate. Each 1% in rate of the GBT is equivalent to nearly 5% in the rate of the company tax. The standard rate should therefore be about 1% in the first year, 2% in the second, etc. In the sixth year, it would completely replace the company tax with a rate of 5-6%.

(d) *Allow smaller businesses to move out of company tax early*

Some businesses will wish to move completely from the company tax to the GBT before the end of the transition period, either for simpler accounting, or because they are paying more company tax than average.

This should be allowed, but, to protect the revenue, it will need to be restricted to businesses below a turnover threshold. As the transition proceeds, the threshold can be raised.

(e) *Merge GST and General Business Tax if and when it becomes politically possible*

If there is an agreement on changing the GST to remove zero-rating of goods and services, the GST and GBT can be merged for all practical purposes, even if a formal distinction has to remain to identify revenue that belongs to the States.

If there are no longer zero-rated goods and services, it would be possible to streamline the administration of the tax.

(f) *Dealing with dividends*

A value-added tax like the GBT and the GST is designed to avoid double taxation of value. Moving from the company tax to the GBT would mean that the dividend imputation credits to avoid double taxation under the company tax would be phased out with the company tax.

However, dividend imputation credits in their current form also carry from company tax into personal income tax, and so there is likely to be opposition to removing them. If necessary, it would be possible to retain a form of imputation credit, either for a longer transition period or indefinitely. Section 3.9 addresses the policy issues.

(g) *Withholding taxes at the borders*

When a shareholder is a foreigner, it should not matter for Australian taxation purposes whether it is a foreign individual or a foreign corporation. In either case the shareholder is acting like a business: investing in Australia and then taking out the return on investment as dividends or as a realised capital gain. Their returns should be taxed, in principle, not as individual income, but as turnover (value added) of their business.

The withholding tax on both dividends and capital gains taken by foreign investors after the transition period should therefore be the sum of the GST and the final GBT rates.

(h) *General Business Tax and GST at the borders*

In principle, any purchase by an Australian of goods and services from abroad should be subject to a purchase tax with a rate equal to the sum of the GST and the GBT rates.

Australia should seek international agreement to establish protocols for assigning an online transaction to a particular jurisdiction for tax purposes.

3.9 Tax imputation credits

(a) *Imputation credits create as much unfairness as they solve*

As we have noted, tax imputation credits for dividends were introduced on the basis that they prevented double taxation of the same income. Even on this basis, they are over-generous.

If the dividends are paid to another corporation, the dividends the second corporation receives from its investment are not pure profit, because there must have been some costs to cover in administration and overheads. The result is that the imputation credits represent more than the tax that the second corporation would actually have been liable for in respect of the dividends had tax not been paid by the first one. They overcompensate, if only slightly.

When applied to dividends paid to an individual, the overcompensation is much greater, because although personal income tax applies the same rules as the company tax, applying them to a natural person has a different economic effect to applying them to the artificial person of a business corporation. If less than half the economic burden of the company tax is borne by shareholders in the long run, as the Re:think paper reports, then less than half the amount of the dividend imputation can be regarded as representing tax the shareholder has already paid. The rest of it is a bonus that allows the shareholder to pay less tax on a particular income than his or her neighbour whose income did not come from dividends.

(b) *They should be phased out with the company tax*

If a business profits tax is replaced by a value-added tax that raises the same revenue, the business stays in the same market position, so its prices will not change, and it therefore stays in the same overall financial position as well. Its profits will no longer be taxed, but they will be smaller by the amount of the value-added tax paid, so the amount that can be paid out in dividends will be the same. Yet if we now apply the “indirect taxes are really paid by someone else” approach, the tax that was previously paid by the shareholder has

now been paid by the consumer. What this shows is that the indirect taxes approach is a very poor basis for making a tax system.

We therefore propose that the idea that taxes are regarded as taxes on the business and not on any one else should be applied consistently, and dividend imputation should be phased out with the company tax.

(c) *If this is not possible, a form of credit can be provided*

However, there is likely to be strong resistance to removing imputation credits. If this cannot be resisted, there will need to be a new mechanism to provide an equivalent tax credit to an individual taxpayer who receives dividends from an Australian corporation.

The mechanism would not need to cover a corporate shareholder once there is no company tax.

The size of the credit would be arbitrary, as there would no longer be a direct link to any business tax, and considerations of fairness to other payers of personal income tax should mean that it is reduced over time.

3.10 Effect on prices

The General Business Tax can be regarded as a consumption tax, and consumption taxes are often objected to because they can be regarded as regressive. There might be calls for compensation measures to correct the regression.

However, in our proposal, the amount of revenue being raised from businesses would remain the same. There should be no overall effect on prices. Unless there are systematic differences in the amount of company tax paid in proportion to turnover in different sectors of the economy, there should be no long-term effect on relative prices either. The transition period will allow adjustments to take place at a rate that will not be noticeable against the background of normal price variations.

There might be an effect on relative prices if zero-rating is removed from the GST, as this would tend to increase the prices of the formerly zero-rated goods and services. If there is a case for adjustment to income support, it can be done in the usual way.

3.11 Effect on international transfer pricing

The result of our proposed changes is that any transfer to a foreign investor, whether as dividends, capital gains, or the transfer of goods and services within a multinational entity, would be subject to the same rate of tax. There would be no economic distortion, or incentives to tax avoidance.

3.12 Treatment of trusts

A trust that is currently a corporate, public or trading trust for the income tax law will be treated in the same way as a corporation under our proposals.

A family or small business trust operating an unincorporated business currently pays GST, but its income is taxed in the hands of its beneficiaries, or at a rate that depends on the beneficiary (eg for children), or at rate of 45% (if not distributed).

Under our proposals, the business would have to be registered, and its accounting separated from that of the trust. Its undistributed income would no longer be taxed, but there would be a limit to its accumulation. If the trustees or beneficiaries wanted a larger accumulation, the business would have to be incorporated.

3.13 Treatment of interest and borrowing

Because the General Business Tax uses the GST rules and treats interest as an input-taxed supply, the GBT liability is not affected by interest payments.

The GBT in the proposed form therefore cannot be applied to **banking** or money-lending. It will be necessary to maintain a separate tax for such businesses. However, if such a tax is limited to money-lending businesses, it could be much simpler than the current company tax.

Negative gearing, and the gearing of investments in general, do not affect tax liability under the GBT.

However, existing businesses have based their plans and created their financial and physical infrastructure on the basis of the current system. If a business has borrowed heavily, and is depending on the reduction in company tax during the years when its interest repayments are high (with the expectation of high profits later), it may need a longer period of transition to adjust to the new system.

Concessions for existing long-term infrastructure projects should be in the form of a deferral of tax liability rather than an exemption from tax, on the basis that such a project would be expecting higher than average profits once the loans are paid off, to compensate for the lower or zero profits during the life of the loans.

3.14 Treatment of small businesses

A business that is not a separate accounting entity from its owner, and so does not currently pay company tax, would now be subject to the General Business Tax raising an equivalent amount of revenue. The owner would still be subject to the same personal income tax on the business profits (although the profits would be reduced by the amount paid in GBT).

This is one of the reasons that our proposed General Business Tax includes a threshold amount of turnover on which no tax is payable. The threshold should be set at a level that ensures that a person with a sufficiently small business would be no worse off (and most would be better off) than under the present system.

3.15 Making life easier for the business taxpayer

(a) Business bank accounts

It would make life easier for businesses, especially small businesses, if their bank accounts were better accounting tools.

We propose that banks be authorised (or, if necessary, required) to offer an account for a registered business that:

- has a distinctive account number that identifies it as a registered business account (eg all numbers are preceded by the letter B for business)
- allows electronic payments and receipts to include descriptions and annotations for the sender and the recipient that are not limited to a few characters
- allows the account-holder with on-line access to the account to edit and add to the descriptions, and to have multiple tags or codes for each entry
- either incorporates basic spreadsheet functions that allow the account-holder to calculate simple accounting sums within the account, or has an electronic format that can be exported very simply to an accounting program

(b) Standardised format for tax invoices

It would make life easier for businesses, and for any individual who has to pay a bill, if the tax invoice had a standard format. We propose that the standard should require basic information, and no other information, to be set out in a standard way at the beginning of the bill.

4 Changes to personal income tax

4.1 The personal income tax in the wider income system

For an individual, the personal income tax system is only a part of the broader *income system* that determines what he or she pays to the government, or at the government's direction, and what he or she gets out of it in money rather than services. This includes superannuation, the pensions and benefits of our income support system, maternity leave and family tax benefits. It would include other kinds of compulsory social insurance if they were introduced in Australia.

The current income system as a whole is very complicated indeed. As a result:

- it is full of anomalies because different parts have been developed on varying principles that are not easy to reconcile
- it is difficult for an individual to deal with because each of these elements is operated by a different agency and he or she cannot deal with the system as a whole
- it is particularly difficult for an individual whose income does not come from a single source, such as a person who:
 - works for a series of short-term employers, or several at once
 - is partly employed and partly self-employed
 - relies partly on employment and partly on income support or superannuation income

4.2 Simplify the system and simplify access

Most substantial reforms need to address the income system as whole, which is beyond the scope of this exercise. However, the first principle that must be applied in making any changes must surely be:

- *simplify the system.*

This is easier said than done. No step in creating the current system was done with the deliberate intention of complicating people's lives. However, it is time to try to ensure that changes actually reduce the complexity of the system.

The income system will remain very complex, but the way an individual deals with it can be simplified. The second principle should be:

- *simplify the presentation* of the system to the individual. Agencies do make substantial efforts to provide information in targeted ways to the particular people who need it, but a good deal more could be done. It does not always look as though they have really considered things from the point of view of the individual faced with the system. Agencies should try to:
 - provide a single point of contact that covers several agencies (ideally a single one for the whole system)
 - deal with inevitable complexities by using systems and calculators that require only simple inputs and give easily comprehensible outputs. While a start has been made, technology now allows much more to be done.

In section 5 we propose more principles that should be applied in any reforms, and discuss the effect they would have on the personal income tax.

In the remainder of section 4 we propose some more limited changes.

For a person who is self-employed or running an unincorporated small business, our proposed separation of business tax and personal tax, and reform of business taxation, would also simplify personal income tax.

4.3 A PAYG system for everyone

To help those tax-payers who do not receive all their income as salary from a single employer, we propose that banks be authorised (or, if necessary, required) to offer an income tax and superannuation management account for individuals that:

- has a distinctive account number that identifies it as such an account (eg all numbers are preceded by the letter T for tax)
- allows electronic payments and receipts to include descriptions and annotations for the sender and the recipient that are not limited to a few characters
- allows the account-holder with on-line access to the account to edit and add to the descriptions, and to have multiple tags or codes for each entry
- is set up to calculate PAYG income tax, using information in the codes, and remit it to the ATO
- is set up to calculate compulsory superannuation contributions and remit them to the person's chosen superannuation funds
- allows the account-holder to direct other automatic payments from the account
- provides a regular statement to the account holder with the information that is required to be on a pay-slip
- includes a mechanism for correcting errors.

The account would receive payments only from the account-holder's employers or other sources of taxable income, such as dividends or distributions from trusts or registered businesses

A person who set up such an account would be entitled to have all cash benefits from an employer, including the amount of the employer superannuation contributions, paid into the account, and the employer would satisfy its PAYG and superannuation guarantee obligations by doing this.

A system like this would also benefit employers, especially small businesses who might be saved administrative costs.

4.4 A monthly position statement for everyone

We propose that either a government agency, or institutions such as banks, be provided with the authority to collect the necessary information to provide individuals who want one with a regular monthly statement, online or on paper, that sets out their status in the income system as a whole, including:

- their taxable income for the month and for the year, and its sources
- any non-taxable income, including pensions and other income support, and its sources
- their tax liability, and the tax they have paid, on the income for the month and for the year
- the superannuation contributions they have made for the month and the year
- their superannuation balance, and at least one indicator of what it represents in prospective retirement income

A standard statement should be short (a single page), and in a form that has been tested and shown to be easily understood.

The indicator that we propose for the superannuation balance is:

- the likely annual income that the superannuation balance would, if allowed to accumulate until the person's standard retirement age, purchase in a life annuity indexed to MTAW, calculated as a proportion of future MTAW and expressed as that proportion of today's MTAW.

The principles behind the choice of this indicator are in section 5.4.

4.5 Treatment of the family home—owners and renters

The special treatment of the family home in our income system means that people who do not own a home are disadvantaged compared to other people whose overall income and assets are the same.

There are good reasons to treat the family home in this way, as a recognition of the social and emotional role that family home plays, and there would be strong opposition to changing it.

We therefore propose to address the disadvantage for taxpayers who do not own their own home—or do own one but live somewhere else—by allowing a personal income tax deduction for rent paid for a rented family home, up to a reasonably high ceiling. Because this is an issue of horizontal fairness, it is appropriate to use a tax deduction (see sections 5.1(b) and 5.2(b)).

It could be introduced in stages. It would be appropriate to balance revenue by reducing, or not increasing, the general income tax threshold.

5 Principles for changing personal income tax

5.1 How to judge whether the system is fair

We regard a system as fair if it treats people who are in a similar situation in a similar way, and treats people in different situations in a way that takes reasonable account of the differences.

In a complex system, it is inevitable that some elements of it will produce results that look unfair in isolation. The fairness of the income system should be judged as a whole, and should not be judged minutely. Fairness may also need to give way to practical considerations.

(a) *Vertical fairness*

If we compare two people who are in essentially the same situation apart from their income, we can call the comparison vertical. Looking at the net tax that the two people pay (that is, the net effect of income tax and various kinds of income support), people are likely to regard the system as fair if:

- the system is progressive or neutral—net tax as a proportion of income should not fall as incomes rise
- small differences in income produce only small differences in net tax—a marginal tax trap is not fair

(b) *Horizontal fairness*

If two people have the same income, but the circumstances that affect how their income translates into a standard of living are different, we can call the comparison horizontal. Examples are:

- living alone or in a household
- having or not having dependents
- having or not having assets that do not produce a taxable income but contribute to the standard of living (such as a family home)
- living in places where the costs of living are different (remote rural, central urban)
- having good or poor health

To be fair, the system should take such differences into account in an appropriate way. The comparisons are more complicated than for vertical fairness, and a consensus on what is reasonably fair may be harder to achieve. However, a system that takes no account at all of things such as these could not be regarded as fair.

(c) *Vertical and horizontal fairness need to be assessed differently*

Generally, we need to be clear about which kind of fairness is being assessed, because

- we apply different standards to the two, and
- fairness cannot and should not be assessed directly as between people who differ in both circumstances and income.

For example, in judging the fairness of provisions of income support for a person with a particular need, we should judge whether the result is fair:

- as between two people on lower incomes, one with the need and one without (horizontal),
- as between two people on higher incomes, one with the need and one without (horizontal)

- as between two people with the need, one on a higher and one on a lower income (vertical),

The comparisons should be made on the basis that the system is to be regarded as acceptably fair in the way it treats two people without the need, one with a higher and one with a lower income (vertical). Otherwise the argument is not about the fairness of the support measure, but about the fairness of the rest of the system.

5.2 The income system as a whole should be progressive

Most of the progressiveness in our tax and income system comes from income tax and income support. Business taxes can generally be seen as having a slightly regressive effect to the extent that they tend to increase prices, because people on lower incomes are likely to spend a higher proportion of their income. This is easily outweighed by progressive elements in the system. Changes to business taxes that do not distinguish between different activities are not likely to change the balance appreciably.

However, a change to the current GST to remove the zero rating from some products would be regressive to the extent that low income individuals spend proportionately more of their income on these products.

(a) *Individual elements of the income system may be neutral or regressive*

Particular elements of the income system may be neutral or regressive, provided that the system as a whole is fair and progressive in its application to individuals. Thus changes to the GST and company tax that are desirable for economic efficiency can be acceptable provided that the balance of the system as a whole is preserved.

(b) *Non-business income tax deductions are normally regressive*

If an income tax covers business income, tax deductions have their proper place in ensuring that the income from the business—its profits—is correctly assessed.

However, personal income tax deductions for any other purpose are likely to be highly regressive in nature because they act on the highest marginal levels of the tax, and so have the effect of reversing the progressive nature of the tax for the income covered. This is exacerbated if people on high rates of tax can get deductions for much larger amounts of income than people on lower incomes.

A deduction may be appropriate where the purpose of the measure is solely to maintain horizontal fairness (eg our proposal in section 4.5), but they should otherwise be avoided. They should not be used to provide incentives to encourage desired behaviour. If incentives are required, they should be in the form of direct payments and subsidies (see below).

(c) *The income system should generally be no less progressive than it is now*

We reject the idea that tax reform should “leave no-one worse off”. That is either a fantasy or a requirement for no reform at all. Our system is full of anomalies and elements that are significantly unfair in how they affect different groups. If one of these is addressed by a reform, those who are currently benefiting more than they should relative to others from that particular piece of the income system will, and should, lose out under the reform, although if the loss is significant, there may need to be a reasonable transition period.

However, the system as a whole should not be any less progressive than it is now. If a change is made to one part of the system that substantially reduces progressiveness, a compensatory change should be made elsewhere.

In general, we favour the limited increase in progressiveness that would result from removing most current income tax concessions that are unrelated to business income.

5.3 Measures to maintain or improve fairness

(a) *Use rebates, not deductions*

If some kind of concession or subsidy is needed to make the system fair in the way it treats people with particular needs, it should not be given by reducing the person's taxable income (with unpredictable and regressive results), but by reducing the person's tax liability directly. Fairness would be more easily served if income tax could be negative in appropriate cases.

The cost of providing the measure in this way can be counted more easily and the basis for giving it better examined and justified.

(b) *Use limits on concessions, not means tests*

A means test without a taper creates a marginal tax trap that violates vertical fairness.

If the measure is there to provide horizontal fairness, for example as between a person with a dependent and one without, a means test, even with a taper, means that the system remains horizontally unfair for people on higher incomes.

If it is necessary to limit the effect of a measure for people on higher incomes, it will normally be fairer to do this by putting a cap on the concessions than by having a means test. This will mean that the measure has a more significant overall effect on the revenue that would have to be recovered elsewhere.

5.4 Principles for setting superannuation goals

(a) *Agreed goals for superannuation are needed*

The tax system and retirement provision are closely intertwined and it is difficult to make proposals about how the tax system should operate unless one has a very clear idea about the retirement provisions that it is to deal with. There needs to be an agreement on what result the superannuation system is intended to achieve for individuals and for our society as a whole. Only on this basis will it be possible to decide how the tax system should deal with superannuation contributions, accumulation of funds and the drawing of superannuation income.

It is hard to see any consistent principles or goals operating in Australia's current measures for superannuation. The following are the principles that we think the goals should be based on.

(b) *The general goal of the system should be to maintain community standards in retirement*

A person's retirement income should generally be sufficient to maintain much the same standard of living relative to other people as before retirement

(c) *Living standards should be measured against current community standards (eg indexed to MTAW)*

Living standards are social and situational. The living standard that should be maintained for a person is the standard relative to other people in our society, not an absolute one. This means that the target incomes used in setting the system, as well as any retirement income streams such as age pension or annuities, should be indexed to a relative measure of incomes such as the MTAW.

(d) *The principal mechanism should be compulsory superannuation*

Compulsory saving is the socially and economically preferable way to provide for retirement income.

The compulsory contributions should ideally be set at a level that will ensure that, for the majority of people, their superannuation will be sufficient to maintain their standard of

living—they will not need a supplement either from the age pension or from voluntary savings.

If this is not politically possible, they should be set at the highest level that is politically possible.

(e) *Voluntary superannuation should be strongly encouraged*

People who have not accumulated the superannuation balance that would be needed for them to reach retirement with an adequate retirement income should be strongly encouraged to make voluntary contributions.

(f) *The system should not rely on savings other than superannuation*

That is, it should not rely on savings that people can access before their retirement to ensure that they can maintain their established standard of living.

(g) *The system should be fair to people with different life trajectories*

The system should deal effectively and fairly with people who do not spend their whole working life in paid employment, especially people who are responsible for children and other dependents.

(h) *Superannuation should not rely on luck or the superannuant's actions*

The system must recognise that actual returns on investment are not the same as average returns—in a statistical distribution of this kind, a majority of the returns will be less than the average. Unless there is an insurance mechanism for sharing returns across the superannuation system, a majority of people will retire with less than they expected; many will have much less and be dependent on the age pension.

(i) *Superannuation should not try to guess an individual's lifespan*

The system must recognise that a person's actual life span is not the same as his or her life expectancy. Unless the major part of superannuation income is provided in the form of a life annuity, large numbers of people will run out of retirement income because they live too long.

5.5 What this means for personal income tax

(a) *Compulsory superannuation should be tax free in accumulation only*

Compulsory super contributions should be set as a required amount to be deposited (as they are now). As long as this is done, whether they are treated as coming from pre-tax or post-tax income does not matter in the sense that it will not change the amount that is going into the superannuation saving system.

Nor does it matter for revenue as a whole. Provided that the overall level of taxation is the same, it doesn't matter whether the system treats contributions as coming from income that is exempt from income tax imposed at a certain rate, or as coming from post-tax income on which a somewhat lower rate has been paid.

However, it does make a substantial difference to the progressiveness of the personal income tax. Making the contributions free of income tax reverses the progression in a serious way (see section 5.2(b)). For this and other reasons, it is better to treat compulsory contributions as coming from post-tax income and adjust the income tax rates appropriately.

In the accumulation phase, since the earnings are not in the hands of the person, it is justifiable to defer any income tax. This also helps build the necessary assets on a lower level of contributions than would otherwise be required. There should be no tax on income in the accumulation phase.

How any retirement income drawn from the assets should be taxed depends on the basis on which the levels of compulsory contributions were set. Ideally, they should be set on the

basis of achieving a pre-tax retirement income that is large enough to maintain the appropriate living standards after being taxed as normal income for income tax purposes. This is not only more socially desirable than having special treatment for retired people, it also makes it much easier to deal with partial retirement and to treat fairly people with additional sources of income. If the levels of accumulation that can be achieved are not sufficient for this, it would be preferable to nevertheless make the income from compulsory superannuation formally subject to tax and to balance this by a higher allowance from the age pension than would otherwise be the case.

(b) *Voluntary superannuation should be tax free in accumulation only*

In principle, voluntary superannuation contributions should also come from post-tax income. If voluntary contributions are to be treated as tax-free in order to encourage them, this can only be defended as fair if it is done on the basis that it constitutes deferred taxation. Any income drawn at the end of the process should therefore be taxable income.

In the accumulation phase, since the earnings are not in the hands of the person, it is again justifiable to defer any income tax. This will also encourage savings to be in superannuation rather than non-superannuation assets.

(c) *Annuities should be favored*

Life annuities should be strongly favoured by the superannuation system because they are the only way to guarantee that the assets saved for retirement will in fact last if the person lives for a long time.

The social benefits of annuities justify making the income from them tax-free in some circumstances. If it is decided that it is necessary to reduce the tax benefits that superannuants currently have in drawing their retirement income, without removing them entirely, the compromise should be to make only income drawn from annuities tax-free, while taxing any income drawn directly from the superannuation assets.