28 May 2015

Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sirs,

I am grateful for the opportunity to make a submission to the task force. Since the publication of the Tax Discussion Paper a number of commentators have been publically advocating the removal of the Capital Gains discount and negative gearing and I would like to ensure that the task force fully considers the ramifications of any changes before moving to the green paper stage of the discussion.

This submission deals principally with the above two aspects of the taxation system but also includes some comments on complexity:

- Capital Gains Tax (CGT) is inherently inefficient, both from an economic and from a revenue raising standpoint. It has many aspects of a transaction tax and therefore increases illiquidity in the property and stock markets, exacerbating asset bubbles and increasing the cost of capital to enterprises.
- CGT is inequitable in that it taxes nominal, rather than real, gains and in that a major realisation may be taxed at higher marginal rates than would have been the case if the gain had been taxed as it accrued.
- The CGT discount mitigates the above aspects of the tax and should not simply be abolished although the task force could consider the adoption of separate, mildly progressive, rates for CGT as is the case in many other countries including the UK and USA.
- This submission argues that properties which are purchased, not to produce net rental income, but only gains on resale, should be treated as trading assets with profits and losses being treated as ordinary income, not capital gains/losses.
- This submission also argues that the complexity of the income tax law should be reduced by greater reliance on accounting standards for the determination of assessable income for businesses and a schedular system for individuals.

<u>Capital Gains Tax</u>

When considering CGT it is important to be aware of the distinction between capital gains and ordinary income taxed in accordance with section 6-5 ITAA97. Capital gains (as adjusted by the discount or indexation) are taxed as statutory income under section 102-5 ITAA97 but are not income in the ordinary use of the word or as defined in case law[1]. In particular, capital assets are held to generate income and

[1] A review of the case law can be found in Michael Flynn, “Distinguishing between income and capital receipts - a search for principle” (1999) *Journal of Australian Taxation* May/June 1999 available from www.buseco.monash.edu.au/blt/jat/1999-issue3-flynn.pdf

when they are sold the right to that income passes to the new owner who will pay tax on that income. Although the proceeds of sale can be seen as compensation for giving up future income, taxing the proceeds of sale in the hands of the vendor would therefore result in double taxation.

CGT is levied on a realisation basis on the nominal gain from purchase to sale of an asset. As a result, CGT is inefficient in economic terms in that it alters the behaviour of market participants by encouraging them to realise losses early and postpone realising gains. This increases volatility and decreases liquidity.

An increase in volatility in capital markets increases the cost of capital to enterprises seeking to raise funds for investment. In addition the reluctance of investors to incur a substantial tax charge by selling investments, even when they suspect that the market value of the investment is too high in fundamental terms, may encourage asset price bubbles. It is important to note that an investor when deciding whether to sell into a rising market has certainty about the tax incurred if they sell but is uncertain as to the possible subsequent fall in the asset price if it does in fact prove to be overvalued.

A significant part of the discussion regarding the CGT discount has focussed on its alleged role in encouraging property market speculation. Based on the above analysis, it could be argued that the imposition of a higher rate of CGT on disposals of investment property would discourage existing holders from selling into an over-valued market and thus encourage property market bubbles and put house prices even further outside the reach of first time buyers.

CGT inhibits the prudent rebalancing of investment portfolios by imposing a significant tax penalty on such activity. It therefore results in individual investors being exposed to greater risk than would otherwise be the case.

CGT is also inefficient in revenue raising terms because it is easy to defer tax simply by deferring realisation of gains. Although the current maximum rate (for assets held over 12 months) of 24.5% does not give much incentive to avoid CGT by realising gains in superannuation funds or companies, a number of commentators have suggested that the 50% discount should be abolished. An effective rate of more than 30% would not increase tax revenue. Taxing gains at 49% would almost certainly result in rich individuals channelling gains through companies and middle income people using their self managed super funds more aggressively for this purpose. Australia's CGT rate (after discount) is already one of the highest in the world. The current effective rate of 24.5% compares with maximum rates of 28% in the UK, 15% in the US and zero in Hong Kong, Singapore and New Zealand. (New Zealand has just announced a 33% tax on gains on property held for less than two years.)

A further disadvantage of CGT in revenue raising terms is that it is heavily pro-cyclical. ATO statistics[2] show CGT collections rising from $6.8 billion in 2004-05 to $16.2 billion in 2006-07 before falling in 2011-12 to a low point of $5.0 billion. Although Keynesian economics would suggest that pro-cyclical taxes are to be encouraged as automatic stabilisers, CGT is not very effective for this purpose as the proceeds of capital gains tend to be re-invested rather than spent, particularly when they arise as a result of portfolio rebalancing.

[2] https://data.gov.au/dataset/e29ef9ca-0d1a-47ec-9e9b-14a79a941511/resource/7d0e7299-93a7-40b0-a27e-94efa88eddf7/download/taxstats2013cgt2netcapitalgainssubjecttotaxbyyear.xlsx

In the absence of the discount, CGT would be inequitable as inflationary gains on an asset held for 10 years would be treated the same as a trading gain on an asset held for 10 weeks. It would also be also inequitable as a gain accrued over a number of years when the owner was on a low tax rate may push them into the 49% rate in the year of disposal. The current Australian tax system, by adding net capital gains to ordinary income before taxing the total at progressive rates is particularly exposed to this inequity. Without the capital gains discount, an investor with other assessable income of, say, $50,000 per year who bought a median priced house in Sydney as an investment in March 2002 for $365,000[3] and sold it in July 2014 for $760,000, would have taxable income that year of $445,000 and pay tax of $187,997 instead of $91,222.

The 50% discount on assets held for more than a year mitigates these failings and was introduced as a simplification when indexation was abolished. It also gives some relief from double taxation of company profits retained for internal investment instead of being distributed with franking credits. This seems to have been forgotten by those commentators who propose the abolition of the discount.

Negative Gearing

Although Division 35 ITAA97 denies a deduction against other income for losses from non-commercial business activities, section 25-25(1) permits the deduction of interest "to the extent that [the taxpayer uses] the money for the purpose of producing assessable income" for passive investment.

Some property investors are so convinced of the inevitability of price rises that they are prepared to borrow to buy an investment property even where the rent does not cover the interest and rental outgoings. To the uninitiated observer such an arrangement would appear to be a non-commercial business activity but in tax law it falls outside the definition of a business activity. Further, it qualifies under section 25-25(1) as the potential capital gain would (if realised) produce assessable income.

It could be argued that if the purpose of an activity is to profit by resale (of the investment property) rather than to receive (net) income from the rental, then it is an "adventure in trade" and the profit should be taxable as ordinary income, not a capital gain.

Either way, the ability to deduct interest from other income clearly (and notwithstanding the arguments put forward in Box 4.2 of the discussion paper) appears to operate as a subsidy to investment buyers compared with potential owner occupiers. It also stands in contrast to the provisions of Division 35 which appear more aimed at small business start-ups (including perhaps the next Hewlett-Packard or Apple Computer) than at hobby farmers.

It is sometimes argued that the subsidy is passed on to tenants through reduced rents. This proposition seems dubious since a large number of landlords are not using negative gearing and market rents would be determined by supply and demand in the overall market. To the extent that negative gearing increases the supply of rental properties and thus forces down rents, this effect is likely to be balanced by more

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[3] ABS median price data
http://www.abs.gov.au/ausstats/meisubs.NSF/log?openagent&641604.xls&6416.0&Time%20Series%20Spreadsheet&DBF6F0912407DCE5CA257DE7000F2351&0&Dec%202014&10.02.2015&Latest

would-be home owners unable to buy their own homes and thus increasing the demand for rental tenancies by a similar number.

<u>Complexity</u>

It might be thought that the move to self-assessment should have been accompanied by a simplification of the tax law in order that individual taxpayers should be able to comply with their obligations quickly and easily. Instead the reverse has occurred. "Ignorance of the law is no excuse", but it is difficult to believe that any non-professional is able to acquire sufficient knowledge of the Taxes Acts to be confident of their compliance with the law.

It is true that the bulk of the law concerns matters unrelated to the affairs of wage earners with no investments, but many Australians do have investments. It is also true that many Australians employ tax agents to assist them in compliance but this is not a perfect answer to the problem: Many agents will not themselves be totally familiar with all sections of the acts and agents still rely on the taxpayer to bring relevant information to their attention, which is difficult for a taxpayer who is not aware of what might be relevant.

There are three main causes of the complexity:

- Rules designed for corporate entities with complex affairs also apply by default to individuals
- The desire to specify how profits should be arrived at for tax purposes independently of generally accepted accounting principles.
- An accretion of 75 years of anti-avoidance legislation

In 1936 it might have made sense to define income for both companies and individuals in the same way. However since then many things have changed, the principal being: (i) The introduction of accounting standards has made corporate financial statements a much more reliable starting point for company tax (as has been recognised in the most recent Taxation of Financial Arrangements provisions) and (ii) the imputation system has turned company tax into a withholding tax.

Once it is accepted that companies and unincorporated businesses can be taxed on profits computed in accordance with accounting standards, subject to the general Part IVA anti-avoidance provisions, individuals could be taxed on a much simpler, schedular system. The income of individuals consists of wages, dividends, rents, interest and capital gains. Only rents and capital gains present significant compliance problems.

The compliance complexity of rental income relates mainly to the treatment of expenses. Many commentators have suggested that deductions from employment income could be replaced with a standard deduction. A similar approach could be adopted for rental income, as is the case in Hong Kong where a standard deduction of 20% is allowed from gross rental income.

Two factors have contributed to the accretion of anti-avoidance legislation: Once it is in place, taxpayers take steps to avoid having it applied to them. This results in reduced pressure for the abolition of the provision, since taxpayers will only suffer from it if they are ignorant of the provision (in which case they may simply be misreporting their income.) The second factor is that although many provisions are no longer required, either because Part IVA would be effective or because of the introduction of CGT, imputation and lower rates of income tax, an individual public servant would have to be quite brave to assert that they could be abolished with no impact whatsoever on revenue.

I attach as Appendix 1 some examples of complexity arising from current legislation. I am pleased to note that since I made a similar submission to the Henry review on this subject, a number of improvements have been made including the recent announcement of a Statutory Remedial Power for the Commissioner of Taxation and the repeal of the Foreign Investment Fund rules.

I attach as Appendix 2 my brief responses to some of the other questions raised in the discussion paper.

Yours faithfully

Robert Kenrick

APPENDIX 1 – EXAMPLES FROM CURRENT LEGISLATION.

The 45 day rule

The provisions of the taxes acts dealing with the 45 day holding period to qualify for dividend franking credits, s.160APHO Income Tax Assessment Act 1936, were part of the 4,100 pages of inoperative tax law repealed in 2006.

This would have been a genuine simplification of the law. It is arguable that there is no case for the provisions which act to stop arbitrage between the cum dividend and ex dividend share prices and thus deprive sellers just before the ex dividend date from getting the full return from their investment.

However s.160APHO underwent a mysterious resurrection in s.207-145(1)(a) of the 1997 Act, which refers to "a qualified person in relation to the distribution for the purposes of Division 1A of **former** Part IIIAA of the Income Tax Assessment Act 1936", of which s.160APHO forms a part.

So were the 4,100 pages repealed, or were they not? Is it legal to define who qualifies for a franking credit by reference to legislation that no longer exists? In any event, practitioners would be ill advised to discard their old copies of ITAA 1936.

ITAA 97 Division 775 - Foreign currency gains and losses

Foreign currency gains and losses can be divided into three categories: profits from a currency trading business which can be calculated and assessed according to normal accounting principles, incidental gains/losses as part of another type of business which are included in normal trading profit by retranslation of balances at the financial year end, and gains and losses on foreign currency balances held by individuals.

Some jurisdictions, such as the UK, do not attempt to tax gains and losses on foreign currency balances held by individuals, presumably on the basis that over time gains and losses will even each other out and the complexity of the calculation (realised/unrealised; matching items in a bank account or retranslation) is out of proportion to the potential revenue, if any. In Australia foreign currency balances were included in taxable assets in the CGT legislation, which gave rise to the problems just mentioned.

In the absence of an election, Division 775 requires a taxpayer to account for foreign exchange gains and losses in overseas bank accounts on a First-In, First-Out basis. At the Senate committee stage, amendments were added to allow taxpayers with less than $250,000 in foreign bank accounts to ignore gains and losses on those accounts. Another amendment allowed retranslation (the standard accounting treatment) instead of FIFO. However both elections need to be made in writing on the effective date of the election. As Australia has a high proportion of overseas born residents, it is possible that there are quite a large number who have foreign bank accounts on which no election has been made (because they are not aware of Division 775) and who are therefore in breach of their obligations under self-assessment. To add to the impression that the legislation has escaped from Alice in Wonderland, having made an election in writing, an individual does not send it to the ATO but files it.

In most overseas markets settlement is on a T+1 or T+3 basis. If a taxpayer buys a foreign share and sells it three years later, the gain/loss (reduced by the discount) is subject to CGT based on the exchange rates on the contract date, but the (usually insignificant) FX gain/loss between the contract date and the settlement date is taxed as income without discount. Because of the different treatment of the discount it is not possible to roll the three gains together and use the settlement date rate for calculating the CGT gain/loss.

The irony of this extremely complex legislation (if the task force do not believe me, I suggest that they try reading Division 775) is that it is totally unnecessary. Traders and corporate entities will calculate their FX profits according to accounting standards and can be taxed on that basis, whereas in the long run individuals are likely to average out at a zero or very small gain or loss.

APPENDIX 2 – ANSWERS TO SPECIFIC QUESTIONS IN THE DISCUSSION PAPER

1. Can we address the challenges that our tax system faces by refining our current tax system? Alternatively, is more fundamental change required, and what might this look like?	It is unlikely that the benefits of fundamental change would outweigh the costs and practical difficulties, particularly in a federal system and with a highly globalised economy. If we could not complete the re-write of the 1936 ITAA, it is unlikely that we could legislate for an entire new tax system.
2. How well does Australia's utilisation of its available taxes align with the evolving structure of Australia's economy and changes in the international economy?	Land tax is an efficient tax which is underutilised in Australia. We have yet to see how successfully GST can be applied to digital imports. Otherwise the current system is fairly effective.
3. How important is it to reform taxes to boost economic growth? What trade-offs need to be considered?	The main impact of taxes on economic growth is by way of the compliance burden.
4. To what extent should reducing complexity be a priority for tax reform?	It should be a major priority.
5. What parts of the tax system are most important for maintaining fairness in the tax system? Are there areas where fairness in the tax system could be improved?	The progressive income tax system is clearly the most important for maintaining fairness. However no system will ever be completely fair to all participants and greater fairness leads inevitably to greater complexity and compliance costs.
6. What should our individuals income tax system look like and why?	We should have a separate, schedular system for individuals.
7. What should our fringe benefits tax system look like and why?	Fringe benefits should be taxed as income in the hands of individuals. Federal government subsidies to hospitals and charities should be explicit, not hidden in the FBT system.
11. How important is tax as a factor influencing people's decisions to work in other countries?	Except for very highly paid individuals, tax is a minor factor. Gaining international experience is a much greater one. However the lower personal tax rates of Singapore and Hong Kong are undoubtedly an encouragement to companies to set up regional offices and financial subsidiaries in those jurisdictions.

	Although Hong Kong has low Salaries Tax rates, the SAR government raises most of its revenue through property transactions and rents are very high as a result.
13. What creates incentives for tax planning in the individuals income tax system? What could be done about these things?	The progressive system creates an incentive for income splitting arrangements (including family trusts.) However the balance is probably about right at present. Raising effective CGT rates above 30% would be likely to increase tax planning activity.
16. To what extent does our fringe benefits tax system strike the right balance between simplicity and fairness? What could be done to improve this?	The current FBT arrangements are neither simple nor fair. Fringe benefits should be taxed as income.
17. To what extent are the concessions and exemptions in the fringe benefits tax system appropriate?	As stated above, subsidies to charities and hospitals should be explicit.
18. What tax arrangements should apply to bank accounts and debt instruments held by individuals?	Ideally a lower rate of tax should apply to offset the effects of inflation (as in the UK.)
19. To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?	Please see discussion in the main letter
20. To what extent does the dividend imputation system impact savings decisions?	It favours investment in Australia rather than overseas, particularly for individual savers. However I would consider this a benefit to society. Overseas investment can be risky as many large corporates have found to their cost.
21. Do the CGT and negative gearing influence savings and investment decisions, and if so, how?	Please see discussion in the main letter.
22. How appropriate are the tax arrangements for superannuation in terms of their fairness and complexity? How could they be improved?	The balance between fairness and simplicity is about right at present, particularly concerning the appropriate taxation of savings. However the 15% rate applied to savings income during the accumulation phase might also be applied to income in the pension phase. This is simpler than trying to

	tax pensions in the hands of retirees, where credit needs to be given for the capital return portion of the pension.
24. How important is Australia's corporate tax rate in attracting foreign investment? How should Australia respond to the global trend of reduced corporate tax rates?	Not very. Ireland's low rate was only important for attracting manufacturing operations supplying the EU. Australia's wage rates preclude a similar advantage to supply ASEAN, for example. Corporate managers are usually judged on EBIT with tax taken as a given. As mentioned above, individual income tax rates for key staff are probably more important, along with "integrity provisions" which accidentally catch expatriates stationed in Australia. RBA figures show the bulk of inward investment is in interest bearing rather than equity funds. We have net outward investment in equity.
25. Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?	Yes, and no.
27. To what extent does the tax treatment of capital assets affect the level or composition of investment? Would alternative approaches be preferable and, if so, why?	It affects SMEs far more than large corporates. In the UK under pre Thatcher regime of100% First Year Allowances and high marginal rates farmers used to go out and buy a combine harvester whenever they had a good year as a method of income averaging.
36. Should the tax system provide a more neutral treatment of income earned on revenue account and capital account? Does the distinction create significant compliance costs for business and, if so, how could it be simplified?	Please see the main discussion.
56. What parts of Australia's tax system, and which groups of taxpayers, are most affected by complexity? What are the main causes of complexity?	Please see main discussion