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Tax White Paper Task Force
The Treasury
Langton Street
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This is a submission on issues in Chapter 4 of the Discussion Paper (DP): Savings.

I do not represent any interest group and my views are personal.

My answers to the questions are:

Question 18: What tax arrangements should apply to bank accounts and debt instruments held by individuals?

The existing treatments should be retained. Attempts to improve tax consistency between different types of saving by individuals would have an unpredictable outcome. Any proposal for change, other than removing the CGT discount for CGT assets, should be put into the "too hard basket".

Tax enhancement for new Commonwealth bond issues has merit, if it is for long term paper (20-30 years debt), perhaps indexed to inflation, to better provide safe pension streams.

Question 19: To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?
Question 20: To what extent does the dividend imputation system impact savings decisions?

The CGT discount should be abolished. CGT should be imposed at the flat rate of 30%. The taxing point should be at the source of the realisation of the CGT asset. Trusts should be liable to the 30% CGT tax with the exception of complying superannuation funds. There should be no "grandfathering" of the existing system if this change is made.

The trustees of all trust structures should have the option of franking distributions to resident individuals exactly as if the distributions were streamed as franked dividends.

Dividend imputation provides a benefit to the Australian economy and integrity to the tax system. Diversion of the available savings pool to foreign equities is not justifiable.

Question 21: Do the CGT and negative gearing influence savings and investment decisions, and if so, how?

This submission recommends the abolition of the discount and setting a flat rate of 30% for capital gains. See discussion on Questions 18 and 19.

Question 22: How appropriate are the tax arrangements for superannuation in terms of their fairness and complexity? How could they be improved?

This submission does not comment on Question 22 on its terms.

The suggestion is made that unrestricted withdrawal of accumulated benefits on reaching the age of 60 should be cut back so that sufficient capital is preserved to ensure income during retirement is at an appropriate level in harmony with the objectives of a tax advantaged savings system to provide retirement income.

Discussion

Question 18: Bank accounts and debt instruments
Notwithstanding the theoretical arguments in the DP for ending the tax bias against the existing method of taxing savings invested into bank deposits and debt instruments, it is unlikely there would be a net benefit to the economy from an attempted change to have better consistency between all forms of saving by individuals.

If inflation is the main concern in attracting investment into bank deposits and debt securities, the reality is that inflation is so low as to suggest a Keynesian liquidity trap. Mid to long term bank deposits are not freely available but there are indexed securities in the market.

More relevant than inflation is the effect of the 50% CGT discount which favours equities (shares listed on the ASX) and real property. This submission recommends the abolition of the CGT discount for individuals who make profits from the sale of assets (other than traditional securities which do not qualify).

Designs with the aim of consistency in savings decisions by tax incentives will have no certainty of outcome. Behaviour of individuals in the consumption/savings equation in an open market society are difficult to predict due to the large variety of preferences and irrationality (according to recent theories). There are no reliable models of household savings over time and in changing economic cycles.

There are many choices in a modern society for individuals to satisfy their propensity for savings through their life-cycle. (Adam Smith (1723-1790) explained the superiority of buying land with surplus capital over lending at interest). Australians now save by contributing to tax advantaged superannuation, buying listed hybrid securities with franking credits and buying real property on mortgage which is a forced savings plan.

Some form of tax enhancement for new Commonwealth bond issues has merit, if it is for long term debt (20-30 years debt), perhaps indexed to inflation. Purpose issues such as Infrastructure Bonds should be avoided but the thinness in suitable investments for safe pension streams should be considered.

Questions 19 and 20: CGT discount and dividend imputation

There are integrity issues with CGT. This submission comments on two aspects; the rate and 50% discount, and the one year rule.

To put discussions on CGT beyond these comments into context, perhaps in the White Paper, the following are features of the CGT regime often inadequately explained:

- Capital losses are deductible only from capital gains and not from other income such as employment or business income. This means that there is no tax relief for realised capital losses even though the economic capacity of the taxpayer has been reduced by the capital loss. Ideally, gains and losses should be treated symmetrically.

- The CGT discount is not allowed to companies. A" flow- through" mechanism of the discount, to ultimate individuals, is provided for interposed trusts, including unit trusts and collective investment vehicles. The tax law for capital gains realised by trusts is highly complex as the concessions travels through chains of trusts, is subject to uncertainty and requires significant compliance costs for taxpayers as well as the ATO. There is a history of litigation which has not resolved the contested issues.

- "Traditional securities", as defined in the tax law, generally, debt securities, are outside the CGT regime and are taxable as income if a gain is made. Conversely, losses are tax deductible. Such assets are commonly owned by individuals.

- The "lock-in" effect is rarely mentioned even in technical literature. If an accruing capital gain is perceived to be subject to excessive tax when realised, the sale of the property, shares or the business may be deferred unless there is a "roll-over" provision in the tax law. This behaviour is detrimental to an efficient economy which requires assets, especially property assets, to move to their most efficient use. The deferral is not wholly disadvantageous because the owner has an improved capacity to borrow against the higher value of the asset.

CGT discount.

The discount is a simple and efficient method of recognising the cumulative effects of inflation but the 50% rate is no longer fair in an era of low interest rates and causes inefficiencies by misallocating domestic household savings. The discount, even if at a lesser rate than 50%, creates an artificial improvement in the ultimate return of investing in assets which attract the CGT regime. This effect assumes that asset values increase over time.

This is not to deny that inflation does need to be recognised. Inflation erodes the "real" capital value and gain and the economic capacity of the asset owner. Nominal or "paper" gains taxed as ordinary income at the marginal rate in the year of sale seems punitive. However a discount or cumbersome indexation is not justified in the current economic and social environment.

The 50% discount is also a too generous benefit for short term speculative investments of one year plus a day. Low or no inflation and low interest rates inflate asset values without any personal effort and can be regarded as a speculative gain.

The CGT discount should be abolished and CGT imposed at the flat rate of 30% on all net realised capital gains.

The CGT rate
The distinction between: (1) the tax concepts of ordinary income and capital receipts and,
(2) economic income, has been debated extensively without a victory for either side in the debate. Ideally, the Haig-Simons concept of comprehensive income is persuasive and is colloquially expressed as: *a-buck-is-a-buck-is-a-buck.*

The position now is that it is no longer contested that capital gains should be taxed (except in New Zealand in limited circumstances). The issue is the amount of tax to be collected from the "profit". The features of "bunching", inflation and encouragement for productive investments (almost always requiring a long-term commitment) and the *lock-in* effect, dictate that high marginal tax rates are counter-productive to economic efficiency and fairness.

There is also the concern with tax avoidance to escape what is perceived to be a punitive taxation on accumulation of wealth.

The 30% CGT rate aligns with the current corporate rate and would be in the $37,001 - $80,000 band on the progressive rate scale until 2011-2012; the corresponding rate is now 32.5%.

Some increase can be expected in the tax liability of high income earners on capital gains taxed at 30% when compared with the present system with the 50% discount.

A special situation exists for trusts and the observation above is repeated here:

> *Under the existing tax law, flow through concession to ultimate individuals is provided for interposed trusts, including unit trusts and collective investment vehicles. The tax law for capital gains realised by trusts is highly complex as the concessions travels through chains of trusts, is subject to uncertainty and requires significant compliance costs for taxpayers as well as the ATO. There is a history of litigation which has not resolved the contested issues.*

For trusts, the 30% tax should be imposed at the level where the gain is realised. Trusts should be given the choice of distributing the taxed gains with a franking credit attached in the identical way to dividends (assuming the imputation system is not tampered with).

The placing of the taxing point at trust level is recommended to cut through the web of complexity, improve integrity and to ease administrative burdens on both taxpayers and the ATO.

If trusts have the option of franking distributions to resident individuals exactly as if the distributions were streamed as franked dividends, this treatment would deprive individuals of the benefit of offsetting capital gains derived by a trust against capital losses incurred on their own account. This consequence is intentional.

One year rule
If an asset is owned for more than one year before disposal, the CGT rules will automatically apply. There is no distinction between short-term and long-term holdings. This invites manipulation of sale dates and abuse to take advantage of the 50% discount which is unlikely to be detected by the ATO.

The one year rule is exploited especially in the housing sector to take advantage of the "main residence" exemption from CGT. Property "flipping" by living in a property for not less than one year plus one day and then selling, is said to be common for real estate speculators and builders.

The ATO advises that:

> *there is no minimum time a person has to live in a home before it is considered to be their main residence.*

Although many other factors are supposed to be taken into account in ruling whether a residential property or dwelling qualifies for the CGT exemption, for all practical purposes the one year rule is applied by taxpayers.

No submission is made on how to stop abuse of the one year rule.

Dividend imputation
To the extent that (DP page 61):

> ***The imputation system may encourage Australian households to invest more of their savings in companies, particularly Australian companies, than they would otherwise.***

If this is substantiated, it is a highly desirable outcome which would have contributed to the resilience of the Australian economy and the welfare of its residents.

This aspect of imputation is a benefit for the economy because Australia is a chronic importer of foreign capital to supplement inadequate domestic savings. It is against the national interest to encourage Australians to send savings offshore instead of supporting local investment.

Assuming the after-tax return in Australian investments is increased that is more than compensated by Australian tax collections from growth of the Australian economy.

The possibility that Australian households may face an extra layer of tax on savings in foreign equities compared to Australian equities needs explanation to be credible. The Future Fund does not have this experience if media reports are to be believed.

Note on DP discussion of Shares, private companies and trusts
Some aspects of the contents of the DP under this heading are incomplete or inaccurate.

1. Private companies must have internally generated funds to stay in business and/or expand. The reason is that access to capital from the banking sector and financial intermediaries is difficult and often only available at an unacceptable cost of funding and security demands by the lender. The tax system should be supportive of internal funding.
2. When selling a business, a buyer will pay for an estimate of future maintainable earnings, tangible and intangible assets, goodwill and similar but NOT more than the nominal amount of cash representing retained earnings. The sale of cashed up, inactive companies (so called 'Slutzkin' companies) is within the anti-avoidance rules.
3. The belief that trusts provide tax savings not otherwise available is false. Similar results flow for a small family business from partnerships and company structures providing remuneration to family members.

Question 21: CGT and negative gearing
The subject of negative gearing has been the target of so many opinions and so much emotional debate clouding the rational analysis in such publications as the Henry Report that these comments are confined to two areas of design difficulty should negative gearing be abolished or curtailed.

- **First,** the experience of 1985-1986 demonstrated that the necessary "look through" provisions were impractical, too costly to enforce and probably they were ineffectively constructed. It was also necessary to target passive rental income and to exclude real estate developers.

  To enforce the integrity of quarantining interest in excess of net rental income, the tax law included complex provisions to include property interests held through companies, trusts and partnerships where the rental property had a value of 75% or more of net worth on the last day of income. Similar provisions would have to be re-enacted if negative gearing benefits were now to be abolished together with transitional provisions which include anti-avoidance provisions.

- **Second**, for the sake of consistency, it would be necessary to deal with the negative gearing of all investments, not solely rental property investments. If this were contemplated, it would be necessary to "carve-out" investments such financing an active business (i.e. to distinguish from passive investments) through a personal overdraft.

At the time of the effective date for the introduction of quarantining of excess interest as a policy measure against the tax benefits of negative gearing (17 July 1985), there was no capital gains tax. Now there is CGT with a discount and this submission recommends the abolition of the CGT discount of 50%.

Question 22: Owner-occupied housing and superannuation

Owner-occupied housing

The theoretical argument for the taxation of imputed income is strong among economists. But, there are severe difficulties in a practical application. For a start, living in an self-owned property is not an economic activity (normally the subject of taxation) such as barter of goods and services or enjoying an employer granted "fringe benefit".

If taxing imputed rent is properly considered and is to be legislated as gross "assessable income", to conform with the structure of the tax law, there will be a burden on the Federal Budget if aggrieved home owners claim deductions for mortgage interest, depreciation, building amortisation, extravagant house maintenance and improvements, rates and levies and insurance. The ATO would have difficulty in enforcing the law against the avalanche of expense claims and in monitoring self-assessed rental values.

Modelling of imputed rent on owner-occupied housing has in the past forecast a gain to tax collections but the assumptions made are unlikely to be reliable.

Taxing imputed rent might end up as a Government created negative gearing scheme.

Superannuation

In theory, the superannuation system exists to provide income on retirement. In practice, the superannuation system is, in parallel, a "tax preferred" or "tax advantaged" savings scheme for those individuals who contribute to it directly or through their employer. This is acknowledged in the DP.

The legislative regime for superannuation funds complying for tax concessions requires a sole purpose test to be satisfied. **This means the fund needs to be maintained for the sole purpose of providing retirement benefits to members, or to their dependants if a member dies before retirement.**

The Financial System Inquiry states that it was guided by principles which includes (page 94):

> *Government intervention in the superannuation system should support a clear objective to provide income in retirement.*

It is also said (page 98):

> *Given superannuation is both compulsory and a tax-preferred long-term savings vehicle, the Government has a clear role in defining the system's objectives.*

The DP states (page 68):

> *Superannuation is designed to improve individuals' retirement incomes. In doing so, it also reduces pressure on Age Pension expenditures.*

Why then is there no restriction on the cashing out of accumulated benefits by taking a lump sum once the age of 60 is reached? A conflict of objectives should be reviewed.

There is strong anecdotal evidence that pending retirement members plan to withdraw benefits to pay off the housing mortgage, buy a new car, have holidays and so on, so that access to Government pension benefits can be maximised on reaching the statutory retirement age or permanently retiring from employment.

There is a fairness argument that retirees should be able to deal with their own money as they wish.

Nevertheless, a balance needs to be struck between the objective of ensuring income during retirement by preserving capital and access to savings for whatever purpose the retiree wishes to apply.

There should be a restriction to withdraw all or part of the accumulated balance in the superannuation or other retirement fund on reaching the age of 60 rather than converting the accumulated benefits to a pension stream. As a minimum, there should be a penalty for lump sum withdrawals in respect of contributions and accumulated income which have received tax concessions.

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If you have any questions, I will do my best to answer them.

Robert Oser