SUBMISSION TO THE TAX WHITE PAPER TASK FORCE

Taxation of Surplus Retirement Wealth & Intergenerational Wealth Transfers

Introduction

This submission focuses on a particular aspect of our current taxation and retirement benefits system, namely the absence of effective taxation on the transfer of inter-generational wealth. Both the 2009 report *Australia's Future Tax System* and the recent *Commission of Audit* highlighted the fiscal pressures from an aging population and the preferential tax treatment of assets and income supporting that system.

Why should assets and income preferentially taxed for that good purpose largely escape taxation after that purpose is fulfilled? And why should assets set aside for that purpose be able to be given away before that purpose has been fully met?

It is notable that the discussion paper issued devotes only two paragraphs to this topic, effectively dismissing it from consideration. Not one of the 66 questions posed for examination specifically addresses this issue, despite the recommendation in the 2009 *Australia's Future Tax System* report for greater public discussion of this aspect of non-taxation.

These are good reasons for capital transfers that are surplus to retirement needs to be taxed, grounded in the generally accepted principles of taxation: efficiency, effectiveness and equity.

As Ian Silk of Australian Super has pointed out we are in grave danger of the superannuation system morphing into an estate planning and tax minimization platform for the relatively wealthy. That is not what it is for, and such a perverse outcome throws the burden of taxation back on those least able to pay it.

The Purpose of the Age Pension and Superannuation Savings

The purpose of Australia's pension and superannuation arrangements is to provide all citizens with an adequate retirement income. Additionally, the superannuation component of the system is intended to reduce the need for a government provided pension as well as to increase national savings and thereby provide a pool of capital for investment in productive activities. These are eminently sensible objectives.

Successive Australian Governments and reviews have recognized the very important place the family home plays as a firm foundation for a secure retirement. It is the largest asset – by far – most households will ever own. Most Australians over the age of 65 – 90% of couples, and over 75% of individuals – enjoy the security of owning their own home in retirement. The vast majority of these own their dwelling outright, and the figures suggest that even those still paying a mortgage have only a small balance to pay off. A nil or negligible mortgage balance improves the standard of living of retirees by removing one of the biggest costs any household faces – rent or mortgage payments. Importantly, the family home is generally an appreciating asset – especially when viewed over the long term. So there are good grounds for retaining the privileged place of the family home as part of a comprehensive retirement income policy.

But what is the justification for this privilege extending to the beneficiaries of deceased estates who are not financially dependent on the benefactor? And where financial dependence is established, why should the whole of the value of the family home pass to the dependants, regardless of their actual need and circumstance?

Superannuation is the other major component of the retirement income system that is concessionally taxed for middle and high income earners, both through the accumulation and pension phases. (It is not concessionally taxed for low income earners – a very important point. And it is this group too that is less likely ever to benefit from the tax concessions made for the family home.) Superannuation balances in estates are tax free in the hands of dependants where it can be demonstrated the beneficiary is financially reliant on the deceased superannuant. The definition of 'dependant' as applied in practice is broad, and more importantly there is no assessment of the level of dependence or its duration – so no assessment of actual need. If you meet the test you get the lot. If you do not meet the dependant test, you pay no tax on amounts that were taxed in the super fund, and for most beneficiaries (those on the second rung of the income tax scales or above) an amount capped at 30%. So there is a double benefit: income you have not earned, either not taxed or taxed at well below your marginal rate. And this is only where the benefactor was not nimble enough to withdraw the funds and give them away.

If it were the case that this capital was treated in the same way as most other capital – i.e. accumulated through investment of after tax income taxed at marginal rates, there would be less reason for objection. But we do concessionally tax super, and we allow those benefits to flow to dependent beneficiaries (very broadly defined) without any taxation, and non dependent beneficiaries – in most cases – with very concessional taxation.

A similar situation applies to gifts, which are not taxed, but which are taken into account in assessing eligibility for social security benefits such as the age pension. The principle applied here is perfectly sound – you should not be able to divert resources available to support retirement and thereby qualify for a pension. The current five year rule and assets test are not particularly onerous for those with the ability and foresight to engage in some astute estate planning. But arrangements largely tailored to benefit the already well off in society are hardly fair to the rest, who one way or another have to meet the costs of those extra pension payments.

There may be a good case from an individual's perspective to make a gift to a child, relative or friend or even a worthy cause during their lifetime, but if this comes from the resources set aside for the purpose of providing for retirement it is also a declaration that those resources were surplus to their needs. So it should not escape scrutiny, either for assessment of eligibility for social security purposes or for taxation of intergenerational transfers.

Why Tax Intergenerational Wealth Transfers?

Most people agree that advancement should be based on merit, and that there should be equality of opportunity - for everyone to be given a 'fair go.' And given that 'fair go' we also tend to believe that one is entitled to the benefits of hard work and material success. After all, "we" have "earned" it. Fair enough too.

It should be common ground that the taxation and pension systems should promote personal responsibility, productivity and innovation. It should not penalize thrift, or advantage one part of society over another. Yet in allowing retirement savings and the tax protected family home to transfer tax free to individuals who have no genuine need for them, current arrangements perpetuate the accumulation of wealth by the well off and throw the burden of taxation disproportionately at those who are poorer, without assets, and without ownership of a family home.

In truth, most transfers of wealth to the next generation have not been "earned" by the recipients at all. The claim by some that they have "earned" this income by looking after aged parents is a very interesting one. For the great majority the cost of care for aged parents is met by the parents themselves, and by government funded or subsidized services paid for by taxation. If adult children were really "earning" these transfers of wealth by providing services to their parents the Tax Commissioner would quite rightly declare it as income and tax it at marginal rates. I have no doubt that some people do "earn" their inheritance. These are the people, often of retirement age themselves looking after an aged parent in their own home, or perhaps younger and looking after a chronically ill or dying partner, who have limited income and cannot access quality health and aged care services. They have earned their inheritance, but in most of these cases the legacy will be next to nothing, either because there was little to begin with or because the assets have been exhausted by the end of life.

Estate and gift duties were a significant component of State and to a lesser extent Commonwealth revenues for nearly eighty years. At the time they were abolished the anomalies and exemptions that had been allowed to build up meant that they were inefficient, increasingly ineffective, and in the judgment of many, seriously inequitable. The Asprey Committee agreed with many of those criticisms but argued that a comprehensive and properly integrated system of estate and gift duties, administered by one authority, was an essential component of an efficient and fair system of taxation.

I can only agree. There is room to do more in this area now because at present we do almost nothing.

The Tax in Principle

The proposal is really very simple:

> **Tax transfers of personal wealth other than to partners universally, moderately, and progressively.**

Allowing transfers to surviving partners without tax is appropriate because household assets are usually the creation of the adult partnership in that household – whether married or defacto. Universally because you cannot take it with you, and State based differentials simply promote avoidance behavior. Moderately because nothing else will get up. Progressively because if you believe in merit based advancement and equality of opportunity at all it is impossible to argue for anything less.

The Reform in a Nutshell

Specifically I recommend:

- a comprehensive tax on all transfers of personal wealth greater than $10,000 per annum by individuals without full consideration at market prices;
- for transfers to a partner to be exempted from this tax;
- for the scope of the tax specifically to include the family home;
- for the scope of this tax to apply to estates;
- for the scope of this tax to apply to the establishment of family trusts;
- the base rate of the tax to be pegged to the rate of the Goods and Services Tax;
- for all transfers of wealth greater than $5 million for that part above $5 million and below $10 million to be taxed at the second step in the income tax scales (currently 19 cents in the dollar); and
- for all transfers of wealth greater than $10 million for that part above $10 million to be taxed at the third step in the income tax scales (currently 32.5 cents).

The only other exemption to the principle of universality advocated above is where the transfers are small enough to call into question the net benefits of imposing the tax. This would likely be the case with individuals who have no equity in real property and negligible net financial assets of any kind. The available evidence suggests that this is a relatively small group in our society – after all, only 10% of couples and 25% of single member households have no equity in a place of residence.

I would not exempt charitable donations and trusts from these arrangements. The high threshold proposed for exempt transfers ($10,000, indexed) should accommodate all but the very largest donations, and in the case of these even the 30% rate is not likely to deter charitable donations by those who wish to make them. I accept that the reduced benefits to charities is a cost but one that is justified by the broader benefits to the community as a whole from these reforms.

There is nothing magical about the rates proposed. They are simple and as easily understood and justified as the income tax scales. They are modest – the average Australian resident will never pay more than the base rate. Linking the progressivity of this tax with the income tax scales sets an important principle in place – the burden of taxation cannot be increased for income earners without it also being increased for those who have the good fortune to be wealthy. Both could be taxed more or less progressively, if the Parliament was to so decide, but discrimination of one against the other would breach the equivalence principle established at the outset. The principle of universality and the avoidance of exclusions are important for simplicity, efficiency and effectiveness – something the previous version of this tax scrupulously avoided.

The converse of this proposal is also worth stating: I am recommending that for the vast majority of Australians there should be no tax on the transfer of 90% of the wealth passed on by our parents or benefactors; for the small percentage who are relatively wealthy 81% of their wealth is passed on after tax; and for the very richest in our society 67.5% of their wealth is passed on. Set out this way one really wonders about our commitment to equality of opportunity and advancement on merit. But it represents a step forward from current arrangements.

Other Benefits

A tax on intergenerational wealth transfers is justified fully on equity and efficiency grounds. So even if Australia had no fiscal pressures at all, it would make sense to introduce this tax and to eliminate an equivalent amount of our less efficient taxes.

But that is not the situation we are in. As four *Inter-Generational Reports*, the 2009 report on *Australia's Future Tax System*, and the most recent *Commission of Audit* report make clear, Australia has a long term structural budget problem. To quote the Commission of Audit "…the long-term outlook is ominous due to an unsustainable increase in expenditure commitments." Spending on retirement income – principally the age pension – and tax concessions for superannuation are two of the most significant and fast growing areas of the budget. While the Commission of Audit proposed many significant policy changes to greatly reduce projected expenditures these have not been accepted by the Government or the current Parliament. If expenditure cannot be reined in and put on a more sustainable basis, the alternative to revenue increases is the situation now playing out in Greece.

Revenue increases should be considered as preferable to an unsustainable increase in national debt. Most likely some form of expenditure restraint and some form of additional revenue will be required to manage successfully the demographic and budgetary challenges Australia faces in the decades ahead.

The proposed tax on intergenerational wealth transfers is efficient. It does not punish current saving or reduce consumption or investment by those who created the asset. It reduces two distortions in current taxation arrangements – the privileged position of the family home, and concessionally taxed superannuation – but without affecting the home while it remains the principal place of residence of the taxpayer or their legal partner, and without diminishing retirement savings while those dependent upon them are alive.

It is a tax not easily avoided. The creators of these assets have an incentive to hold on to them, as they do not know for how long they may need them. Potential beneficiaries of the transfer of these assets have a vested interest in their discovery, and in the case of shared estates a vested interest also in their correct valuation. The great majority of these assets, dwellings, cars, superannuation fund balances, bank accounts and shares are all identified on publicly managed or regulated registers, and transfer of ownership cannot occur without legal requirements being met. This is normally achieved through the grant of probate on death, but similar provisions apply to the transfer of real property, shares, even automobiles during one's lifetime.

Common objections to the old scheme were its impact on the family farm and a family owned small business. In both cases the real difficulties were about appropriate valuations and the ability of beneficiaries to pay assessed duties when they lacked the means to do so – other than through sale of the family asset. As what is proposed is a tax on the transfer of the net wealth of an estate, valued at market prices, it should not be difficult for the average beneficiary to secure a loan to pay the assessed tax of 10% of net asset value when they have secured title to 90%. At any rate, if this counts as hardship for a beneficiary I would be pleased to relieve them of it. There may be a case for greater relief such as through a deferred or progressive payment system in cases of genuine hardship, but this would need careful consideration and tight boundaries to prevent being treated as simply a way of reducing the tax liability.

There are other avenues for avoidance, no doubt. Human ingenuity knows no bounds, especially when it comes to tax. But putting cash or bullion under the mattress, especially over the long term, will cause the owner to lose more than a good night's sleep. Manipulation of valuations is a likely candidate for the aspiring avoiders, and this can be dealt with systematically and transparently. Rather than regulations and penalties for breaches the system should have a simple check which enables the Commissioner to pay the declared valuation in cash for any item in a gift or estate transfer that he considers is below market prices. Valuations of land, shares, art works, even automobiles could be checked by market experts, who could offer the Commissioner realistic valuations based on their willingness to purchase the assets proposed to be transferred. Such gifts would need to be valued prior to the transfer so the Commissioner can intervene if necessary, but this could be done expeditiously. In both cases this mechanism would ensure 'truth in valuation' and swiftly end at least the egregious gaming of the system by benefactors and beneficiaries.

The self interest involved in ensuring a comfortable retirement of uncertain -but on average lengthening - duration argues for retention of assets by retirees. The self interest involved in inheriting substantial assets, particularly by multiple beneficiaries, argues for the full identification and correct valuation of assets by executors and beneficiaries.

Taxing gifts – transfers of assets at less than market prices – is, as the Asprey Committee emphasized, a critical element of a workable – and equitable – estate tax system. Gifts can occur over long periods of time, and there is potential for substantial leakage through this mechanism. Whether it would be better to apply a low threshold for tax free gifts, or an annual tax free total, or a lifetime cumulative total is something that should be subject to further study and expert advice. But the choice should be guided by the principles of efficiency, effectiveness and equity.

Overall it benefits the nation, and Government finances particularly, to take a small bite out of the widest possible pool of wealth once a generation, than to impose higher than otherwise necessary income taxes or consumption taxes on the living.

What it Should Deliver

It is difficult to estimate what this reform would generate in terms of revenue, particularly given its progressive nature. Based on the most recent data available on Household Wealth and from the National Accounts I estimate such a reform should generate annual revenues of around $13 billion per annum, and this would grow over time. This estimate is very sensitive to the degree of exemptions granted. As argued above there should be no exemptions for intergenerational transfers, or gifts, though transfers to legal partners (i.e. the surviving partner of a couple) should be exempt.

It should be apparent that this amount, though significant, is not high in the overall scheme of taxation. At the higher estimate it represents only about 4% of Commonwealth taxation receipts, or about the same as that collected from alcohol and tobacco or petrol and diesel fuel excise.

But it also supports a fairer society by reducing marginally the very great advantages already enjoyed by the wealthy, and if allocated wisely, by better supporting those who start life without those financial advantages.

Other Taxation Reforms

While the deadline for submissions addressing other taxation reform issues has passed I wish to place on record my recommendations on a number of those matters. I hope that at least they can be recorded as part of the overall summary of public responses, even if they are too late to shape the policy direction of the White Paper.

The arguments for them have been made by others and there is no need to repeat them here.

For the record:

- The Goods and Services tax should be retained at its current level, but its scope should be universal, i.e. it should extended to cover fresh food, all health and education. There would need to be appropriate compensation for this reform for groups adversely affected.

- ‘Bracket creep’ is the lazy government’s way of closing the gap between expenditures and revenues. It should not continue. The thresholds for changes in the income tax scales should be indexed by average weekly earnings, and this change should be made by legislation.
    - An acceptable variation would be to index the tax free threshold and the next two steps, leaving the top marginal rate to erode and for the increased tax to be paid by those best placed to do so.

- The 50% discount for capital gains on assets held longer than 12 months should be replaced by a system that indexes the cost base by movements in the cpi for all assets held longer than 12 months, regardless of how long they are held.
    - This obviates the need to change negative gearing, which as the Discussion paper notes is only effective as a strategy because of the 50% CGT discount and the long time frames over which investment properties are usually held.

- If an intergenerational wealth and gift tax such as proposed here (universal, modest and progressive) is not implemented, the family home should be subject to capital gains tax on the basis on the arrangements advocated above.

- Again, if an intergenerational wealth and gift tax as proposed here is not implemented, the current five year period for assessing the value of gifts for social security purposes should be extended to ten years, or, preferably, all gifts made after the age of 50 should be taken into account in assessing eligibility for social security payments.

- International efforts to close company tax loopholes should be vigorously supported. No nation benefits sustainably from a permanent erosion of the domestic tax base, to say nothing of the inequities such schemes impose on remaining taxpayers – both individuals and corporations. The principle of taxing revenue in the jurisdiction in which it is earned – as judged by economic value added – is sound and should be upheld internationally.

- There should be complete transparency of tax paid by individuals, incorporated and unincorporated businesses, trusts, and partnerships.

- There is a case for imposing a very small tax on the exchange of data that travels on networks beyond the home or business – an NBN data tax, if you will, collected by ISPs. The tax should be on data volume, not value, as it is the data itself, which contributes to greater economic efficiency and improved personal well being. It is appropriate to tax growing rather than shrinking sectors of the economy, and as several reviews have pointed out to tax activities that cannot be easily substituted or avoided. Although this is suggested as a measure to increase general revenue efficiently, it is also the case that advanced economies are increasingly dependent on data exchanged over the Internet and it is inevitable that this will require further government involvement to assure the integrity of these networks. At a minimum these government costs should be borne proportionately by those using the data carried over the network.

- I believe the most efficient way of changing economic behavior is to change the prices of the goods or services involved. If carbon dioxide and other greenhouse gasses are believed to pose a significant global problem and Australia is to respond it should be by means of a price on carbon consistent with that imposed in other developed economies.

- To the extent these reforms generate additional revenue that in total allow some reduction in other areas of current taxation, the priorities for applying those reductions should be to:
    - Reduce our least efficient taxes – particularly stamp duties.
    - Bring company tax more in line with contemporary international benchmarks.
    - Reduce the second and third steps in the income tax scale.

Conclusion

Australia faces a long term structural budget deficit, one that has grown rapidly and is forecast to increase in size. Our tax base is narrower than desirable, leading to reliance on higher effective marginal tax rates and less competitive company taxes. As a nation we need to address these issues. The demands on the Commonwealth Budget from expenditures and tax concessions related to retirement income are among the largest and the fastest growing, and are not sustainable. It is a similar story for State budgets which must address the growing costs of health care, and in our major cities the infrastructure needs of the 21st century.

At the same time we are growing a system where tax advantaged assets – superannuation and the family home – that are surplus to individual retirement needs are being passed from generation to generation largely without any tax being applied. This advantages the relatively wealthy on an ongoing and cumulative basis.

A society which wishes to put its fiscal house in order, and which truly believes in advancement on merit and equality of opportunity, would go a great deal further than the very modest proposal suggested here for taxing intergenerational wealth transfers. One hopes that this society and this Government will agree to go at least this far.

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July 2015