Future Party

Future Party Submission
to the 2015 Tax White Paper

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Executive Summary

The Future Party believes that there are a number of reforms that the government can undertake to improve the taxation system, making it fairer and increasing revenue for important projects. These reforms are aimed at reducing opportunities for tax minimisation through investment and superannuation. Doing so will end the distortionary taxation treatment of certain assets, which have lead to great increases in the price of some assets - in particular, housing. Many of these changes have been suggested previously Australia's Future Tax System Review (known generally as the Henry Tax Review). We believe it is time that the government implemented these improvements to the tax system to end these minimisation strategies.

Capital Gains Tax Discount & Negative Gearing

- Abolish the 50%, 12-month discount
- Restore the CPI-indexation of capital gains
- Retain negative gearing
- Investigate ways to reduce “lumpiness” for more equitable taxing of capital gains
- Tax capital gains on owner-occupied and investment properties equally
- Apply a CPI deduction to interest on bank accounts, such that only interest above CPI is taxed

Land Value Tax

- Introduce a Land Value Tax on the unimproved capital value of land
- Abolish Stamp Duty

Superannuation

- Place a cap on accumulated super of $2 million (CPI-indexed) per person
- Remove non-concessional contribution caps for over-50s

Capital Gains Tax Discount & Negative Gearing

Keep negative gearing, scrap the Capital Gains Tax Discount

Negative gearing gets a beating in the media for causing increases in the price of housing. We at the Future Party believe that there is a more complicated reason why negative gearing is problematic: its combination with the 12 month Capital Gains Discount.

All income is a form of return on capital

Whether it's interest from a savings account, dividends from share holdings, or wages and salaries that reflect human capital - the skills and abilities people have - all income ultimately flows out of some form of capital. A capital gain on an appreciating asset represents income, like any other.

All forms of income should be taxed the same way

In an ideal tax system, to the greatest extent that is practical, the different types of income should not be treated differently - they should all fall under the same scheme of progressive, marginal, personal income taxation.

First, as a matter of **efficiency** - taxing any form of income advantageously induces people to overinvest in generating that type of income, creating a *deadweight loss* - an economic cost to society of the tax beyond the amount of revenue raised.

Second, as a matter of **equity** - differential treatment can give rise to unfairly differential outcomes. Preferentially taxing capital gains is one of the most *regressive* types of tax concession imaginable, because of all the types of income there are - wages, bank interest, Centrelink benefits, etc - poorer and marginalized Australians have the *least* access to capital gains.

Capital gains typically accrue over long periods of time, unlike other forms of income which are more typically earned on a weekly or monthly basis. The tax system must obviously take this into account, but not in a way that provides distortionary or unfair tax breaks.

How negative gearing works

If there are expenses in running an investment (such as maintenance or interest paid on loans) and they exceed the revenue made by the investment (such as rent), then you can reduce your other income by that amount. For example, if a rental property makes $30 000 in rent in a year, but the owner pays $50 000 in maintenance and interest payments and so makes a $20 000 loss that year, then the investor can subtract that $20 000 from the taxable income they get from their regular job.

Essentially, the idea of negative gearing allows people to make a loss in one year, which reduces their income in that year. If the investment makes a profit in later years it will be taxed then (either through tax on earnings or on capital gains).

How the Capital Gains Tax discount works

When you buy an asset, and sell it for more money than you bought it for, the asset has made a *capital gain*. As money has been made on the investment, you need to pay tax on it and that tax is paid at your marginal tax rate.

Under the current taxation scheme, there is a concession applied: if you held the investment for longer than 12 months you would qualify for the Capital Gains Tax Discount. The Capital Gains Tax Discount decreases the amount of the gain you are taxed on by 50%, essentially resulting in a 50% reduction in the tax you pay on that income.

Why do we have a Capital Gains Tax Discount in the first place?

The Capital Gains Tax Discount originates from the idea that when we calculate capital gains, we have to take into account inflation, i.e. we should tax only the real increase in the value of the asset.

An asset that only keeps up with inflation doesn't actually increase in real value. For example, imagine you have an investment worth $10 000 in 2015. In 2016 you sell it for $10 300 (or a 3% increase) and the consumer price index goes up by 3%. In 2016 you can only buy about the same amount of things for $10 300 that you could with $10 000 in 2010.

Prior to 1999, the cost base of assets for CGT purposes was adjusted according to the Consumer Price Index (CPI). This was a complicated calculation to do with pencil and paper: it required investors to determine when money was invested, when it was taken out, and what the inflation adjusted value of the invested money was at the time of selling the asset. At the time, the introduction of the flat 50% CGT Discount was justified on the grounds that the calculation was too difficult. A simple 50% reduction in the capital gains when calculating taxable income therefore resulted in a 50% reduction in taxes paid.

What's wrong with a Capital Gains Tax Discount?

The Capital Gains Tax Discount is essentially a tax hand out to people who own capital: people who are wealthy enough to generate their income by buying and selling capital assets (held for longer than 12 months) end up paying a lower tax rate on that income than those who work to earn the same amount of money. In this way, the Capital Gains Tax Discount causes distortions in the way people invest money, particularly with regards to investment in residential property, and this has implications for housing affordability.

The original purpose for the CGT discount no longer exists-

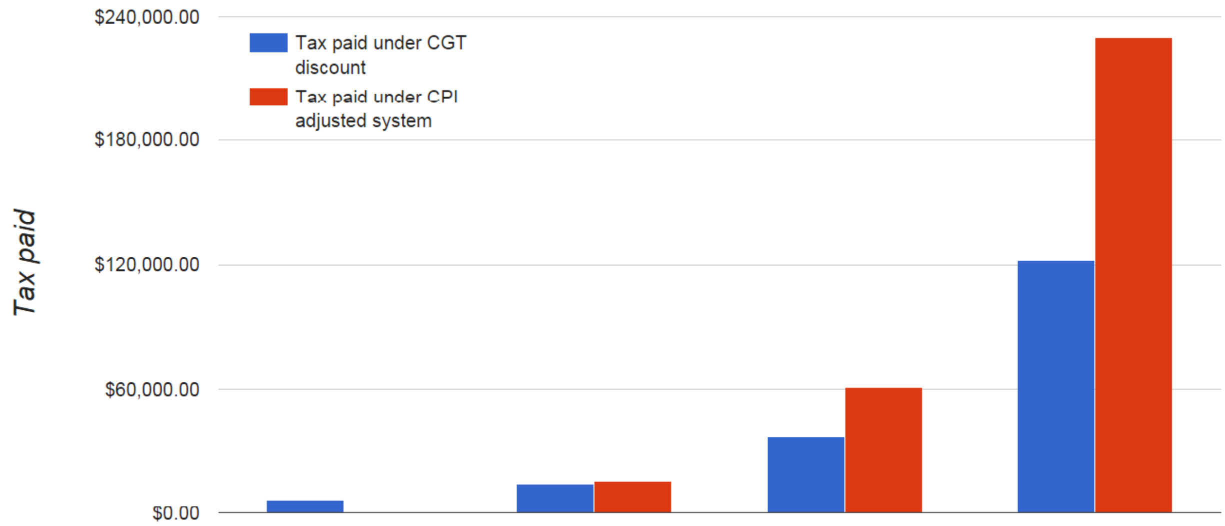
When the CGT discount was first introduced to replace the more complex indexation method, it may have been possible to successfully argue that the benefits of making capital gains easier to calculate outweighed the distortionary impact of the discount. In the era of cloud computing and ubiquitous apps that we live in today however, this argument no longer holds water.

The current CGT discount is too generous

In the figure below, we show how excessively generous the Capital Gains Discount is in comparison to a CPI adjusted system. An asset is assumed to have been purchased for $100,000 and held for 10 years. CPI is assumed to grow at 2.61% (20 year historical average) and the individual is assumed to be earning enough to enter the top marginal tax bracket (47% marginal tax rate). As the CPI adjustment varies depending on the percent return on investment, we consider four investment scenarios:

1) Returns are equal to CPI growth (no change in asset value in real terms)
2) 5% annualised growth
3) 10% annualised growth
4) 25% annualised growth

Difference in tax paid under a 50% discount CGT system and under a CPI adjusted CGT system



Initial purchase price	$100,000.00	$100,000.00	$100,000.00	$100,000.00
Assumed growth rate (annual)	2.61% (average CPI over 20 years)	5%	10%	20%
Final asset price	$129,382.43	$162,889.46	$259,374.25	$619,173.64
Capital gain	$29,382.43	$62,889.46	$159,374.25	$519,173.64
Change in tax paid under fairer CPI adjust system	-100%	7%	63%	89%

The figure shows that people who own assets that only keep up with the CPI are taxed too much (when they shouldn't be taxed) while people who own assets that increase in value greatly pay approximately ***half the tax*** that they would under a CPI adjusted CGT system.

Note that this modelling does not take into consideration when capital gains take an individual into higher tax brackets. Under such situations, individuals may pay even less than half the tax that they would expect to pay under a CPI adjusted system.

Recommendation 1: *That proper CPI-indexed taxation of capital gains be restored, with the flat 50% discount abolished.*

Recommendation 2: *Investigate mechanisms by which moderate income earners may minimize their exposure to high tax liabilities from "lumpy" capital gains income streams.*

For instance, it may be worth considering a general scheme whereby capital gains on large assets are recognized as income over more than one taxable year, (e.g. the same number of years for which the asset was held) In this way, a typical person on a mid-range marginal tax bracket whose savings are mostly tied up in a few large assets can experience capital gain events without paying nearly all their tax on that income at the top marginal rate.

Taxation of housing

The Australian housing market does not need tax breaks and subsidies to bring ever more money chasing after it. It needs more supply, through planning, development and land use reform.

Owner-occupiers of housing already receive a large effective tax break - namely, the value of their imputed rent. If you have an income producing asset (including yourself), and from that income you pay rent, the cost of your housing is not a tax deduction - you pay the full rate of tax on the income. However, if the asset in question happens to be your own home, in which you live (in lieu of charging a tenant rent), the value that the asset generates does not count as income. Effectively, your rent is now being paid by a completely tax free form of income.

Increasingly, home ownership is beyond the reach of the young and the poor, so this becomes another subsidy to the well-off. We are facing a generation for whom "the family home" will not be a politically sacrosanct asset, because the family home will be rented. Given this, a 0% rate of taxation for capital gains is unconscionable.

Recommendation 3: *Apply normal capital gains treatment to all housing, both owner-occupied and investment; taxing gains to the improved value of; or, if land taxation is not implemented (see Land Value Tax section), the total value of all housing.*

Owner occupiers should be given means to record costs associated with significant value improving expenditures (e.g. the construction of a new storey on a house) in their personal income tax return. In this way, owners aren't penalised for improving their homes, only the real capital gain is taxed.

Bank interest

Recommendation 4: That bank interest on deposits be eligible for a CPI indexed discount, in which a bank will be able to declare “non-taxed” and “taxable” interest. The tax payable on interest will be determined as the amount that brings the interest above the rate of CPI. Interest rates that are below the CPI will not be eligible for a carryforward “interest loss”.

Inflation causes money to lose value with time. What we can buy with $100 in a year will generally be less than what we can buy with $100 today. It is for this reason that interest earnt on bank deposits do not represent pure profit; rather, some of the interest earnt on deposits represent the decreasing value of money with time.

We recommend a system that is simple and treats capital gains income and interest income fairly.

To simplify the calculation of taxable bank interest, the CPI adjustment is performed at the date that the interest is paid. The CPI adjustment rate will not be the real CPI, as it takes some time for that figure to be calculated accurately. Instead, the Australian Taxation Office (ATO) will provide a CPI adjustment rate based on recent historical averages and trends. For example, the ATO may say that the nominal CPI adjustment of bank interest is 2.5% PA. Although real CPI may be higher or lower than the estimated level determined, we believe that the simplicity in calculation is more important than perfect adjustment.

Some additional rules may need to be determined at a later date. For example, it may be necessary to provide some legislative guidance as to how to calculate the interest rate. Basing interest on the maximum value deposited in that account for the period over which interest rates are calculated (e.g. a month) will allow the account holder to claim more CPI adjustment than they are entitled to. We believe that this is an unlikely not impossible strategy that banks could use to provide advantageous taxation positions for their clients.

Calculation Example 1
Consider an account that earns $1000 in interest in a year, and interest is calculated annually. Let us assume that the interest rate is 4% PA and CPI is 3% PA. The ratio of these rates is 0.75. The bank will indicate to the account holder that they have accrued a "taxable interest" of $250, and non-taxable interest of $750.

Calculation Example 2
Consider an account that earns $100 in interest in a month, and interest is calculated monthly. Let us assume that the annual interest rate is 4% PA and CPI is 3% PA. The monthly interest is calculated as being 0.327% per month. The monthly CPI adjustment is 0.247%. The ratio of these values is 0.755. The bank will indicate to the account holder that they have accrued a "taxable interest" of $250, and non-taxable interest of $75.50.

Land Value Tax

Why tax land?

We believe that taxing land is an economically efficient, fair, easy and environmentally friendly way to pay for infrastructure that we all desire. Land is a good candidate for taxation because it is hard to move.

Economically efficient

We believe that land tax is an effective way to pay for infrastructure, and we aren't alone. The Henry Tax review recommended it in 2010, yet no government has taken up the proposal.

Landowners are getting free infrastructure

We believe landowners have been getting somewhat of a free ride. Land has value and it tends to increase with time. Land does not increase due to scarcity alone; we have plenty of it in this country! The main reason land increases in value is due to increased connection to infrastructure. This infrastructure includes schools, roads, public transport, hospitals, etc. This infrastructure is largely built, or at minimum facilitated, by government funding through taxes.

The current system sees value transfer from poor to rich

Having a new train station pop up somewhere close to your front door is the property owner's equivalent of winning the lotto. Yet we pay taxes to build infrastructure, whether we own land or not. As such, a person who does not own land, but pays taxes is having some of their tax value transferred to landowners, which seems unjust if we consider that landowners are typically more wealthy than those who are not.

Land tax incentivises infrastructure development

We often hear people complain about not having a train station or a school nearby. Land tax creates an incentive to continually improve infrastructure and increase the quality of life of residents. Infrastructure projects that have a net positive increase in value to society (e.g. infrastructure that unlocks value through increased economic activity or saves the community money) will have a positive impact on land values. Those increased land values will in turn increase tax revenue that will pay for the infrastructure built.

Fairness

In particular, the infrastructure that is built will be paid for in a fair way, that is decided primarily by market prices. It can be hard to tell how infrastructure will add value to the occupants ahead of time. By taxing land, we get people to contribute to infrastructure projects that actually add value to their land. For example, improving adding a new train line to the western suburbs will primarily improve land value in the western suburbs.

Good for the environment

Land tax makes for efficient use of land. In particular, putting 4 units on a block instead of a single house would attract the same amount of land tax. Less land used means less farmland and bushland ripped up for suburbs. The increased population density means less time spent travelling, greater efficiency of public transport (and therefore greater use of ti) and less land used for roads per person.

Land tax also discourages the practice of unproductive land banking, where owners buy lots and hold on to them for many years. By taxing the land, it turns the land into a liability unless it is generating value for the owner. This will prevent land from lying dormant, which can drive up local land prices while decreasing the population of the area which has negative consequences (such as increased potential for crime).

Don't we already pay land tax in the form of stamp duty?

Yes, but it is the wrong approach. In particular stamp duties, being levied at a fixed rate per transaction rather than as a rate over time as with a land tax, create an incentive to buy and sell property less frequently. The number of transactions in the property market is decreased. These lost transactions have value. For instance they correspond to people upsizing or downsizing their home as their family circumstances change, or moving to towns with better job prospects. Economists refer to all these potential benefits left unrealised due to a tax as the deadweight loss.

Stamp duties, furthermore, are levied (unlike a land tax) on the improved value of a property (which includes if you do things like install a home theatre in your house). The aim of land tax is to not tax people's personal improvements to their home, but to pay for the infrastructure that services a plot of land.

Superannuation

The Future Party has two core proposals to improve superannuation, which we believe will make it fairer, decrease its use as a tax minimisation strategy for the very wealthy, and still allow it to achieve its objective of reducing the burden of the aged pension on the taxpayers of the future.

Why give tax concessions to super in the first place?

The tax concessions offered to superannuation investments are intended to give people an incentive to put money away for the future. Super's compulsory nature forces people to save, but to be most effective it also needs to encourage people to put away additional money over and above the compulsory amount. By giving savers a tax concession that incentivises them to fund their own retirement, the government can reduce the amount it will need to pay on the aged pension when those people retire. The result is a small reduction in tax revenue today in exchange for a larger reduction in age pension cost in the future.

What's wrong with the current tax arrangements?

Above a certain level of wealth, we can assume that a person will not rely on the age pension to fund their retirement, nor will they require tax incentives to encourage them to save for the future. Yet at present, the same concessional tax rates apply to an investor with a balance of $10 million - enough to fund ten comfortable retirements - as they do to someone with $100,000, which is barely enough to last a decade of modest retirement.

The Future Party believes that superannuation should not be used as an intergenerational tax haven. Under the current superannuation rules, the mechanism by which people are prevented from transferring excessive wealth into superannuation is through annual contributions caps. Unfortunately, although the contributions cap is still quite large ($180,000 for after-tax contributions) some people who make the majority of their earnings later in life (such as those who have a career change or defer their careers to act as primary child carers) and are limited in their ability to save for retirement early on in their careers, are prevented from contributing enough later in their career due to the contribution caps.

Other proposals that have been put forward to limit the tax concessions available to wealthy superannuation investors, such as Labor's proposal (http://www.alp.org.au/fairer_super_plan) that any earnings in super above $100K would be taxed more heavily in pension phase, are difficult to administer and also have the effect of punishing investors with more modest balances if they happen to experience a one-off year of strong investment returns.

We need a more effective way to achieve the dual objectives of encouraging the majority of people to save for retirement and preventing the very wealthy minority from exploiting the system to reduce tax.

The Future Party proposal

Our proposal is to put a cap of $2 million (indexed to inflation) on the total size of each individual's superannuation balance and to remove the non-concessional contributions cap for people aged 50 and over.

We believe that $2 million can provide a retiree with ample funds for their retirement. With this amount invested in a lifetime annuity, a retiree could generate an annual income of around $75 000 per year (inflation adjusted) for life, even in the current low interest rate environment. If we make the reasonable assumption that people who have large super balances also wholly own their primary residence, then an annual income of $75 000 provides ample funds for a very comfortable retirement.

Under the Future Party's proposal, concessional contribution caps (contributions made from an individual's pre-tax salary) will remain at their current levels; however, the cap on non-concessional contributions (contributions made after tax) will be removed for people over 50. This will allow people who have a late start on their saving to "catch up" later.

What about people with multiple super funds?

The cap will be applied across the sum of all the balances. This can be easily administered by the ATO who collect information from all funds that can be consolidated based on people's Tax File Number.

What happens when you hit the cap?

If, at the end of the financial year, a member's superannuation balance breaches the $2 million cap, the member must withdraw the excess above $2 million within 12 months. These withdrawals will be treated as assessable income for the member and will be taxed at the member's relevant marginal tax rate.

Will this cause problems with illiquid assets? For example, if a SMSF holds a property will the fund be forced to sell it?

No. The fund may sell other assets, or may use loans against an illiquid asset to pay out the excess.

How will this be implemented? Will there be a transition period?

For the vast majority of Australians, the proposed changes will have absolutely no impact on their superannuation savings.

Those with balances above $2m however, will need to reduce their balances to below $2m, and the Future Party proposes allowing investors a 12 month period in which to do so. For investors in a retail, corporate or industry superannuation fund, this will be a simple withdrawal of funds from their account; however, for those who hold illiquid assets in a self-managed superannuation fund (SMSF), this is not so straightforward. For these investors, the proposal would allow for a one-off transfer of ownership of assets from an SMSF to an individual (an in specie transfer), meaning the fund would not have to liquidate the assets. Such a transfer would be classed as a CGT event, and the fund would be required to pay tax on any capital gains, but any stamp duty amounts payable for the transfer of ownership would be rebated.