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**Tax White Paper Task Force**

**The Treasury**

**Langton Cres**

**PARKES ACT 2600**

**WHITE PAPER ON REFORM OF TAX SYSTEM**

**SUBMISSION**

**Introduction**

1. This submission is in response to the Discussion Paper released on 30 March 2015, inviting interested people in the Australian community to become involved in a national conversation on tax reform.

Scope of Submission

2. The submission focusses on Section 4 of the Paper; ***“Savings”****,* and in particular on the tax treatment of owner-occupied (family) homes. It critically questions the Paper’s off-hand exclusion of tax on these significant assets from consideration as part of the Review.

3. It suggests that the family home be treated as any other financial asset, with deemed earnings included as income for both tax and welfare eligibility purposes.

4. It also suggests that this tax be collected and retained by each of the States and Territories, to address the current vertical fiscal imbalance, and as a substitute for other taxes.

Terms of Reference

5. In the absence of formal Terms of Reference, the Discussion Paper effectively fulfils that role by setting out the general scope of subjects under consideration. In 2008, the *Australia’s Future Tax System Review (Henry Review)* did have Terms of Reference, in which the Rudd Government also included similar objectives of *“lower, simpler and fairer taxes”.* But those Terms of Reference also ruled out consideration of the GST and preservation of tax-free superannuation payments. That limitation was quite properly criticized; how could a thorough review rule out some of the most important components of a tax system for other than political purposes?

6. It was therefore encouraging to read that in this discussion, the Government will: **“Rule nothing in or out. Options can start to be ruled in or out as part of the options (green) paper”.** (Executive Summary; page 5).

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7. But wait; there’s more. On page 67, the paper then states: **“Given the central importance of the home for Australian families, there is a strong consensus that it would not be appropriate to tax either the imputed rent or capital gains from it”.** Really? What consensus? How disappointing to repeat what the Rudd government was criticized for. Why have these already been ruled out?

8. The current government has also ruled out consideration of negative gearing of properties or the tax treatment of superannuation, the latter well after the Discussion paper specifically called for comments on thesubject. These are two other important subjects that should be included if “nothing is to be ruled in or out” of the Review!

9. Despite these political restrictions, it is recommended that the Task Force does keep everything on the table. Proper and thorough Tax Reform is a long-term consideration, and Governments and their leaders come and go. What is politically unacceptable today may become very acceptable tomorrow, and if this review is to have any value, all aspects of the current tax system need to be considered for the future.

Current Tax Treatment

10. Chart 4.1 (p.60) shows the nominal effective marginal tax rates for various savings vehicles. Currently, savings in the family home are exempt from all tax, including on capital gains. This results in distortions in both the tax system, and the welfare transfer system.

11. Personal Income Tax and Company Tax accounts for almost 60% of total Australian taxes, including Commonwealth, State and Local Government taxes. Only 5% comes from Land and Property taxes. This is a huge distortion when 43% of total household assets are held by households in the value of their family home; and 5.2million (67%) of households live in their own home.

12. By comparison, as at 31 March 2014, the superannuation sector held $1.8 trillion in assets; more than the total market capitalization of the Australian Securities Exchange ($1.6trillion at 30 April 2014). As superannuation assets account for only 15% of total household assets, the **net total value** of Owner-occupied homes is in the order of

$5.2 trillion. This is confirmed by the ABS Eight Capital City Index at 31 December 2014 which estimates the total (not net) value of dwelling stock at $5.4 trillion.

13. While it may be argued that Owner-occupied homes are not financial assets, that is an arbitrary classification, not supported by logic. In fact it is suggested this is for political convenience, rather than fact. For example, what is the real difference to other prescribed financial assets such as government bonds, listed equities, preserved superannuation, loans or gold bullion? Some assets may be more liquid than others, or may not produce regular cash income. But all of these assets benefit from growth in capital value and the promise of longer term capital gain, as does an investment in a family home. In the event a cash income is required by an owner, all assets are equally as valuable as collateral to secure a loan, annuity or reverse mortgage.

Value of a Family Home

14. There is an intangible value of the family home. This includes security of tenure in older age, reduced cost of living when cash flow reduces in retirement, and emotional attachments which may have been built up over many years. But what is the limit to the cost of achieving these objectives. Few would argue that a home with a value of several millions

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is necessary for a comfortable retirement. In many cases, it could be argued that retention of a high value home, and even further investment in that home, has more to do with estate planning. This is encouraged by the current tax system which exempts this significant asset base from tax on both imputed income and capital gains on the family home.

15. It is submitted that a reasonable tax-free limit for an investment in a family home be established as the **mean net value, as determined by the ABS.** This should be designated as the “threshold” adjusted annually in accordance with ABS determined values. As at

31 December 2014, the ABS estimates that the average (mean) price of residential dwellings is **$572,000**.

Deeming Income

16. Currently, financial assets are deemed to earn 3.5% as income for the purposes of the pension assets test, and the same could be applied to family homes, for income tax and welfare eligibility purpose. With the current personal income tax-free threshold of $18,200, and in the absence of other income, the owner of a home below a net value of $520,000 would not pay any tax on deemed income applied to that home ($18,200/0.035).

17. It is therefore recommended that income for personal tax and welfare payment purposes be deemed as 3.5% of the net value of all owner occupied homes above that threshold. This has the following advantages:

17.1 It is equitable and progressive. For example, if the first $520,000 (the threshold) is exempt from deeming, only those homes above that level would pay more. A home with a value of (say) $1million would be liable for deemed income tax of about $3000 per year. Not a lot for someone with assets of at least $1.0 million.

17.2 It would encourage downsizing of homes for retirees, and take pressure off the rapidly escalating price of dwellings. Similarly, it would discourage over-investment in dwellings simply because of their capital gains exemption.

17.3 Owners wishing to remain in a high value home would be more inclined to use part of their equity to produce a cash income, thereby reducing reliance on the aged-pension. This could include reverse mortgages to provide an annuity or other investment income.

17.4 The proposed system (deeming) does not in itself lead to higher taxes, if the revenue generated is used to eliminate other less desirable taxes, such as stamp duty, payroll taxes, or high income tax rates

17.5. It is easily adaptable to assessment of income for welfare eligibility.

17.6 Importantly, over **$5 trillion** of otherwise unproductive assets become utilized as income earning investments for the benefit of all Australia.

Tax Efficiency

18. If the above recommendation was adopted, it would be necessary to determine the **net** **value** for all owner-occupied dwellings in Australia. This would require a system to determine both the Capital Improved Value (CIV), and any amount owing on each property.

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19. All States already have a valuation system in place for local government rating purposes which could be used as the basis for determining CIV. In fact, Victoria and South Australia already use CIV as the basis for assessing local government rates. Western Australia and Tasmania use an Annual Value method, for which CIV is the main factor, and this can easily be adapted to calculate net value. Queensland and New South Wales currently use site value which would require some modification. As suggested in para 24 below, all States

may be encouraged to adopt CIV as a national uniform method, which would enable value determination without any additional cost to existing systems.

20. For fully owned dwellings, the CIV would be Net Value for deeming purposes. In other cases, taxpayers would be required to provide evidence of the value of amounts owing to lenders. This is not dissimilar to providing evidence of interest earned on bank deposits.

Vertical Fiscal Imbalance

21. In 2013-14, the Commonwealth provided the States with grants totaling $95.3 billion, which amounted to 24% of total Commonwealth expenditure. This contrasts with only $50.3 billion of GST which was collected by the Commonwealth on behalf of the States during the same period. Interestingly, about $45 billion of the grants were specific (tied) grants for health and education.

22. This Vertical Fiscal Imbalance (VFI) has long plagued Australia’s federal system, brought about by the Commonwealth collecting most tax revenue, when the States have most of the spending obligations. While the Constitution still allows the States to collect Income Tax, the practice was ceded to the Commonwealth in 1942 as part of the WWII war effort, which was also consistent with Sect 51 (ii) of the Constitution. However, it seems the States still retain that power if they choose to. (It is also noted in passing that the Constitution does not confer powers over Health and Education to the Commonwealth, which makes the current tied grants of $45 billion for those purposes somewhat ludicrous).

23. It is therefore recommended that all tax from the deeming of income from Owner-occupied homes be collected by local governments, on behalf of the State in which the property is located. This revenue should be retained by each State **as Income Tax**, and be offset by a reduction in Commonwealth Income Tax and Commonwealth grants to the States.

24. The advantages of this recommendation include:

24.1 a significant reduction in the Vertical Fiscal Imbalance which currently exists in Australia, with an ability to assign greater accountability for expenditure;

24.2 use of an existing system of revenue collection, thereby increasing the efficiency of overall tax collection;

24.3 enhancement of the Federal system of government by at least reducing the current “Blame Game”;

24.5 the opportunity to reduce or eliminate other inefficient or undesirable taxes; and

24.5 an inducement for the States to adopt a uniform method of assessing local government charges (taxes).

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Summary of Recommendations

25. The recommendations in this submission are:

25.1 All matters relevant to reform of the Tax System be considered (“kept on the table”).

25.2 Owner-occupied homes with a net value above the mean value be treated as any other financial asset, and that deemed income on any excess be included for both income tax and welfare eligibility.

25.3 Deemed income on owner-occupied homes, above the threshold, be collected through the existing local government rates system, and retained by the States as Income Tax Revenue, without horizontal tax equalization (as occurs with GST).

25.4 Income Tax on deemed excess value of owner-occupied homes be used as an offset by reducing other taxes (both State and Federal) as was done with the introduction of the GST.

Conclusion

26. It is submitted that the above recommendations would result in **lower, simpler and fairer taxes.**

**Robert Ludlow**