

Tax Discussion Paper Response

Background-Henry Review

Given the amount of effort that went into the Henry review (Australia's future tax system-Report to the Treasurer) and the calibre of the individuals involved in that review it would be folly to ignore its findings. Accordingly, in areas where the Discussion Paper raises questions that are dealt with in the Henry review it is suggested that the findings (eg in relation to superannuation) be the starting point for the discussion and if a contrary view is to be pursued the reasons be fully explained.

Indeed the reason for the Re think discussion is somewhat unclear given that the Australian Parliament has already the Henry review to assist it in formulating policy. It suggests an ulterior motive. My concern is not ameliorated by the Prime Minister being quoted as ruling out changes to negative gearing when the Discussion Paper refers to not ruling anything in or out.

The Prime Minister's concern seems to be that contributions to the national conversation are about raising taxes. While that may be true in areas such as superannuation, where the changes made by the Howard Government are generally considered unsustainable and not fair, I believe a number of improvements could be made merely to ensure the existing tax laws apply as intended. These should be considered, as noted in the Discussion Paper, in the context that confidence in the tax system can be eroded when people think others are not paying their fair share of tax whether due to concerns over concessions, aggressive tax avoidance or tax evasion activities.

Negative Gearing

Negative gearing is being misused as it was originally intended to facilitate new housing supply. The Discussion Paper points out that deductions claimed for investment properties as a proportion of gross rental income have increased over the last 15 years and are now greater than gross rental income. The tax treatment would seem to be driving investment in real estate and has an impact on housing supply and affordability. Not only is a benefit derived from tax deferral but also a benefit is obtained from the lower capital gains tax rate. The extent of its use and the increased use of interest only loans would suggest that in most cases investments are being made with the tax benefits largely in mind.

Accordingly, I would suggest that a cap be put on the negatively geared interest deduction able to be claimed and that cap be reduced gradually over a 3-5 year period (consistent with the normal term of interest loans) to the intent that negative gearing is phased out as a tax deduction by that time. If the government considers that assistance is necessary to assist in providing new housing then the deduction could be limited to those cases.

“Retrospective” Changes

I have seen many references in the press (often by persons who do know better in a misleading attempt to have their point of view prevail) to changes in tax laws being retrospective when the change in tax will only apply to future income. This is clearly not retrospective tax but it does raise a question of fairness or equity when tax laws change with negative impacts for individuals or entities that have made decisions based on the previous policy. This could be said to be the case whenever there is an increase in taxation.

Furthermore, in the case of negative gearing for example, anyone entering into such an arrangement because of the tax benefit has done so against the background of the Henry review and other commentary that the benefit should be limited.

Phased Transition

However, when a change is made (eg where a government is concerned about the political ramifications), as pointed out in the Discussion Paper, special arrangements are often put in place temporarily to assist with a smooth transition. The Paper goes on to say that, in some cases, ‘grandfathering’ allows past arrangements to be applied indefinitely in existing situations, with the new arrangements applying to all future cases and while grandfathering arrangements can assist those who are negatively affected by a tax change, they can also be a source of enduring complexity in the tax system.

I believe it is difficult to envisage a situation where, from a fairness perspective, grandfathering can be justified on an indefinite basis. A good example is the fact that 28 years after the introduction of capital gains tax some properties still do not fall under its operation-how is that fair? Any government should be able to limit any political downside by a staged introduction in some manner. The reality is that often changes only impact a minority and there is an advantage to those not affected by the decision in that additional revenue is raised. The political problem is often more one of not properly communicating the reasons for the change.

GST

GST is being avoided through the cash economy. The scale of the cash economy is of course difficult to gauge, with various studies suggesting it could be costing anywhere between \$5 billion and \$22 billion a year in lost GST, business tax, PAYE and superannuation contributions.

I appreciate the Tax Office with limited resources is actively engaged in endeavours to recover the lost revenue. I believe that a more aggressive approach is required given how long revenue has been lost on this basis. More resources should be allocated to the identification of those involved and more publicity should be given to the approach being adopted. It may be that a more aggressive regulatory framework is required such as making it an offence to pay a contractor without receiving a receipt. Perhaps some form of release from liability for contractors who own up by a certain date and provide details of their principals who have participated in the tax avoidance might be considered.

In the meantime, it would be unacceptable to consider raising the GST rate to provide the revenue that is currently being lost through the cash economy, particularly given that such an increase would itself increase the amount lost to the cash economy.

Multinationals

The Discussion Paper claims that Australia has been active in ensuring companies are taxed appropriately in Australia, including through some of the toughest integrity rules in the world and the compliance efforts of the Australian Taxation Office working with counterparts overseas.

The Australian Government apparently believes this to be the case as the recent budget foreshadowed minor changes with the expectation that Australia would derive in tax its fair share of revenue earned in Australia.

It is clear from press reporting (eg Michael West in the Sydney Morning Herald) that some multinational companies (eg in the technology, mining, pharmaceutical and media industries) have paid minimal tax relative to their sales attributable to Australia.

The Tax Office has claimed that it will be pursuing certain multinationals for tax said to be owing and that it has had some success in this area already. However the sums involved are minor compared with amounts referred to in the press reporting.

The Discussion Paper points out that a globalised economy means that companies have greater choice about where to locate their activities and assets, including intangible assets and this has increased the opportunities for multinational companies to use legal means to minimise their tax liabilities, through multinational tax avoidance, also known as Base Erosion and Profit Shifting (BEPS). If the press reporting is accurate it would seem that the “legal” means are contrived such as by using profit shifting/transfer pricing and debt loading.

I am surprised that minor changes to Australian law would be sufficient to enable Australia to recover the large amounts of tax that it would otherwise be entitled to if it would derive in tax its fair share of revenue earned in Australia. Time will tell.

I believe that company specific legislation may be required including prescribing an arbitrary basis of tax (eg having regard to the proportion of tax paid in the home jurisdiction of the multinational such as the USA) based on sales. The rate determined should err on the side of being too high with a view to recovering in some small way part of what has been lost by the manner in which the identified multinationals have carried on business. If in the meantime some acceptable laws are agreed by the international community to deal with these issues well and good but I wouldn't envisage international agreement being readily achieved.

Trusts

The Discussion Paper points out it is likely that the tax treatment of different structures is now a key factor in choosing a business' legal structure. This may involve incorporating, or utilising a trust, but more likely it would involve a combination of structures. The primary objective of these structures is often to minimise tax liability by dispersing income to attract either the lowest marginal tax rate or the corporate tax rate.

The Discussion Paper further points out that economically similar activities may end up being taxed differently, depending on professional advice or choice of legal structure. Tax planning of this nature is usually more accessible to higher-income taxpayers, which can contribute to perceptions that the tax system is inequitable. Reforms that result in taxpayers in similar economic circumstances having similar tax liabilities (also called horizontal equity) are likely to make the system as a whole fairer, even when they have no impact on progressivity in the system.

The individual tax rates with a relatively high tax free threshold make the use of trusts even more appealing.

It would seem that the solution may be to tax trusts as a separate entity as if they were a company although this may still be beneficial to high income earners able to use a trust structure.

Income Splitting

A similar problem exists with households. The progressivity of the individuals income tax system applies to taxable income in the individual's hands, but not necessarily to a household's taxable income.

The Discussion Paper notes that this tax outcome is sometimes criticised as 'unfair' as households with the same income pay different amounts of tax but taxing the individual improves the reward for effort for the secondary earner because they get a tax-free threshold, rather than facing the primary earner's marginal rate on their first dollar of income.

Perhaps households should have the option of being taxed as a household with an appropriate change in the tax rates as occurs in some overseas' jurisdictions. This would also lessen the advantages a trust structure holds.

The Family Home

The Discussion Paper states that, 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 on owner-occupied housing or capital gains derived from it. Would house renters agree with this or people with a house in the country or South Australian and Tasmania homeowners if it meant they would pay less tax? It is a benefit for the well-off, particularly those located in Sydney and Melbourne. It also increases the value of houses artificially.

Government Policy

It is generally considered that the tax system be used to in part assist the Government in achieving its other objectives. Accordingly it is difficult to consider the tax system in a vacuum.

The Government should better explain its policy objectives and how the tax system is intended to assist in achieving them. For example, some of the "leaners" may have the wherewithal to earn an income or not have children that they cannot support if they were properly educated and wouldn't implementation of the Gonski Report assist in that objective? Is the tax system required to pay for that implementation or a national disability insurance system or infrastructure or whatever else the Government might have in mind?

Does the Government think it appropriate that the top 10% of earners take home 29.7% (a record) of total income as occurred in 2012 according to the Melbourne Institute of Applied Economics and Social Research? If this trend is continued what sort of society will eventuate and is it one that Australians in general would want?