6 August 2003

Senator Ursula Stephens
Chair,
Senate Economics References Committee
Parliament House
Canberra ACT 2600

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Senate Economics Committee

Dear Senator,

At the recent hearing with regard to your Committee's inquiry into the Australian taxation system, we undertook to provide further information.

Attached are:

- our submission to the Board of Taxation on the tax treatment of discretionary trusts;
- our analysis of the effects of the New Tax System package on Australian households;
- a paper outlining ACOSS policy on reform of superannuation, including its tax treatment.

In response to your question about our costings, I trust the following is helpful.

It should be noted that we made no attempt to model the likely behavioural effects of the proposed changes (for example, shifting funds from a "closed" tax shelter into another one). For this reason, our estimates were developed on conservative assumptions, in cases where they were not based on official estimates. For example, with the exception of the negative gearing proposal, we made no attempt to update "old" data from taxation statistics and other primary sources. This imparts a conservative bias into the estimates.

Recommendation 1. Superannuation contributions

The annual "contributions ceiling" for the proposed savings rebate would be set at such a level as to ensure that the policy is revenue neutral.

ACOSS believes that a "contributions ceiling" set at approximately 12% of average full-time earnings would meet this requirement.

This would also be sufficient to encourage an average wage-earner to voluntarily save 3% of earnings in superannuation, in addition to Superannuation Guarantee requirements. The rebate would offer much greater encouragement to people on less than average earnings - those who need the most encouragement to save more.

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This estimate is derived from a simple model of the cost of existing and proposed tax concessions developed by ACOSS using data from the ABS publication *Superannuation, Australia* and material from Treasury's RIM Group[1]. Results were checked against similar analysis by ASFA.[2] It is likely, in our view, that both our model and the ABS data substantially under-state the extent of salary sacrifice for superannuation by high income-earners. If that is so, there would be scope to increase the proposed rebate, since it is paid for mainly by reducing excessive tax concessions for employer contributions on behalf of high income-earners.

No changes are proposed to the tax treatment of superannuation fund earnings or benefits[3]

Recommendation 2: private companies and trusts

Parts (i) and (ii) are based on estimates prepared by the Review of Business Taxation, which examined a number of proposals to curb tax avoidance through private companies and discretionary trusts. To the extent that our proposals are "tougher" than the RBT's recommendations, the revenue savings should be greater.

Part (iii) is based on official Taxation Statistics for 1998-99. To the extent that these data are out of date, the revenue savings will be greater. Our estimate is therefore conservative.

Recommendation 3: Income splitting

No detailed data is available to assess the likely revenue impact of this measure. We used the Treasury's estimate of the cost of income splitting to the Revenue in its 1985 Draft White Paper on tax reform. That amount was $500 million per annum.

There is little doubt that the cost of income splitting has increased substantially since then, despite the subsequent flattening of income tax scales and the effective prohibition of income splitting with a minor. The explosion of discretionary trusts and private companies since that time suggests that income splitting (for example with spouses) has become much more common, since these entities are the preferred vehicles for that purpose.

Further light could be shed on the *potential* scope of revenue losses from income splitting by a detailed examination of the "matched" data for spouses in recent versions of the Taxation Statistics. However, such analysis would not capture the actual extent of income splitting.

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[1] ABS, *Superannuation, Australia* (Catalogue No 6360); Tinnion J 1998, *Provision for retirement: Who does what?* Retirement Income Modelling Unit, The Treasury, Conference Paper 98/1.

[2] ASFA 2000, *Equity and retirement income provision in Australia.*

[3] It may be desirable to treat contributions in excess of the proposed annual contributions ceiling as "undeducted" contributions for the purpose of determining the tax treatment of benefits derived from those contributions. This would avoid "double taxation" of contributions and benefits.

The ATO is currently reviewing the anti-splitting rules relating to personal service income, and may have collected data for this purpose on the extent of this practice among contractors and consultants.[4]

Recommendation 4: Negative gearing

The estimate for part (i) is derived from work conducted for AHURI by Wood, et al.[5]

The estimate for (ii) is derived from the Taxation Statistics for 1999-00, which yielded an estimate for deductions for negatively geared rental property alone of around $1,000 million.

Taking account of Reserve Bank estimates that the overall level of investment in rental property has more than doubled since then, and the fact that this measure would also reduce deductions for leveraged equities, various agricultural schemes, and collectables, we estimate that at least $2 billion per annum would be saved.[6]

We consider this a conservative estimate, notwithstanding the fact that under our proposals negatively geared investors could still claim deductions against future capital gains.

Recommendation 5: Fringe Benefits

Part (i) is based on estimates provided by the Review of Business Taxation.

Part (ii) is likely to yield only a small revenue saving at this stage, but there is potential for the cost of this concession to blow out in future years.

Part (iii) is based on estimates provided by the Review of Business Taxation.

Recommendation 6: Executive shares and options

There is no reliable data available to precisely estimate the revenue savings from this measure. We used ABS data on Employee Benefits as a benchmark, and made assumptions about the average value of share and options packages for high-income employees.[7]

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[4] In theory, income splitting is currently allowed for investment income but not for earnings.

[5] Wood G et al 2003, *A micro-simulation model of the Australian housing market.* Australian Housing and Urban Research Institute

[6] One prominent "agricultural" tax avoidance scheme using negative gearing was the Budplan scheme. The ATO estimated that this scheme alone attracted $500 million in deductions.

[7] ABS, *Employee earnings and hours* (Catalogue No 6306); ABS, *Employee earnings, benefits and trade union membership* (Catalogue No 6310).

Given the explosion of shares and options packages for executives in recent years, and the substantial value of these packages for a minority of senior executives, the estimate is likely to be conservative despite the fact that these benefits are eventually brought to tax (within ten years!) under the current regime. The 10 year rule provides considerable scope for the recipients to avoid paying tax on these benefits at the top marginal rate.

The widespread avoidance of personal income tax through salary packaging prior to the introduction of the FBT was a major reason for the introduction of that tax. However, superannuation and employee shares and options were among the fringe benefits excluded from FBT. There is little doubt that substantial levels of taxation are being avoided through executive share schemes and it is anomalous that these schemes still sit outside the FBT system.[8]

Applying the FBT to these benefits would ensure that they are brought to tax as soon as they are offered to employees. The $1,000 exemption should be high enough to ensure that employee share schemes that are offered to the majority of employees of a business (as distinct from a small number of executives) would still be viable.

Recommendation 7: Benefit traps

These proposals were modelled for the year 2001, using STINMOD, NATSEM's micro-similuation model.

No account was taken of behavioural effects (especially more mothers entering the paid workforce), which would probably reduce their cost.

On the other hand, their "up-front" cost would be greater if implemented in 2004, as proposed.

We would welcome any feedback from the Committee on the accuracy of these costings.

Should you have any queries about the above material, please contact our Senior Policy Officer, Peter Davidson at this office.

Yours sincerely,

Megan Mitchell
Director

[8] We believe that superannuation should continue to be FBT-free, provided its tax treatment is reformed along the lines described above.