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SUBMISSION TO THE SENATE ECONOMICS REFERENCES COMMITTEE

THE STRUCTURE AND DISTRIBUTIVE
EFFECTS OF THE AUSTRALIAN TAXATION SYSTEM

INTRODUCTION

This Submission in the main addresses para. (a) of the Terms of Reference: The level, extent and distribution of the current tax burden on individuals and businesses.

An ideal tax system involves the collection of any desired amount of revenue by means which satisfy a number of criteria - such as equity between taxpayers in similar positions, low costs of collection on the part of both governments and taxpayers, and certainty in regard to the rules. The system should also have regard to the ability of citizens to pay. Furthermore, taxes should not inhibit economic growth or foster inflation.

INCOME TAX

Some assorted suggestions, great and small, which should be considered by the Committee in this context are set out below:

* In order to eliminate bracket creep the steps in the income tax scale and all thresholds in the legislation should be adjusted for inflation each year. This indexation should occur automatically and in full and not on an ad hoc basis and only in part.

* Married and de facto couples should be given the option to have each member taxed on half of their combined taxable incomes. The concept of treating couples as one unit is already enshrined in the social security legislation. At present investment income can often be split 50/50 whereas personal exertion income cannot.

* In the interests of better transparency, the separate Medicare levy should be absorbed into the general income tax scale.

* In the interests of administrative simplicity, beneficiaries of public trusts, where these beneficiaries use cash accounting, should be taxed on trust distributions in the financial year in which these are actually received rather than retrospectively in the year to which they relate.

* The income tax and social security systems should be combined both administratively and conceptually, with social security benefits being replaced by negative income tax for those on low incomes and/or with special needs. Such an approach would also eliminate the enormous cost and inconvenience of the present means test.

* Companies should be taxed as though they were partnerships and their shareholders were the partners, irrespective of whether the profits are distributed or not. Such an approach would be much simpler than the current dividend imputation system and it would also ensure a fairer treatment of corporate losses. Because of its importance this matter is discussed in greater detail below.

* Pending this, the top marginal rate of personal income tax and the rate of company tax should be aligned.

* Depreciation deductions should be based on the replacement cost of an asset, and not on its historical cost.

* The amount of interest which is subject to tax in the hands of a lender

or depositor, or claimable as a tax deduction by a borrower, should be adjusted to reflect the reduction in the purchasing power of the money represented by the principal of the loan. However, as this would lead to a different pattern of interest rates, the suggested rules should apply only to loans entered into or renegotiated after the date of the announcement of the change.

* The amount of profit taxed when trading stock is sold should have regard to the cost of that stock adjusted for inflation.

* On the grounds of fairness the transfer of tax losses between taxpayers should be freely permitted. This would mean that in the aggregate tax would be levied only on the actual gains net of losses which have been made by parties to such transactions.

* To the extent that some of the above measures will lead to a loss of revenue an alternative source may need to be found. A net worth tax on selected assets owned by individuals above a stipulated threshold such as $500,000, and levied at a rate of about one per cent non-deductible (or, say, two per cent deductible), could be introduced in order to replace the revenue being foregone and also to encourage the better use of assets. Such an impost would also reflects the greater ability of persons with assets to pay tax.

CAPITAL GAINS TAX

It would also seem highly desirable that certain further reforms to the capital gains tax legislation should be enacted - for example:

* A capital loss realised in a financial year later than that involving a previously taxed capital gain should be capable of being retrospectively offset against that gain.

* Shares which have become worthless should be deemed to have been disposed of even in the absence of an actual disposal.

* Capital losses brought forward and not used up by the time of an investor's death should be capable of being transferred to the beneficiaries of the estate.

* It should not be compulsory to use up capital losses on the first available occasion.

* Interspousal transfers of assets should not be regarded as disposals and acquisitions.

The rollover provisions for takeovers should be extended beyond "scrip for scrip", especially in compulsory acquisition cases. If a cash consideration is received and reinvested in the market within, say, three months then the shares purchased with that cash should be treated in the same way as shares actually received from the bidding company.

The rule should also be extended to cover "notes for shares" and the like.

In the interests of equity indexation of the cost base should be restored and this approach should be made available to both individuals and institutions (the latter were denied the use of this under the 1985 legislation). Furthermore, the same method should be usable in both capital gain and capital loss situations.

TAXING COMPANIES AS PARTNERSHIPS

Companies do not actually pay taxes - only people pay taxes. The reality is that any taxes nominally imposed on a corporate entity are ultimately borne by individuals - by shareholders and/or by customers. Those commentators who for philosophical reasons from time to time urge higher taxes on businesses invariably overlook this important point.

Companies are not actual "persons", except by way of legal fiction. Wealth is really owned only by human beings, either directly or indirectly.

Clearly, all the profits of a company, whether distributed or not, morally and economically "belong" to the shareholders. In the context of the type of sliding scale income tax system being used in this country such profits should accordingly be taxed in the hands of individual shareholders at their marginal rates.

One easy way of doing this would be to extend the current rules and principles applying to the taxation of partnerships also to the taxation of companies. This would remove the anomalies in the present system, as well as greatly simplifying it.

There would be much greater transparency and confusing expressions such as "imputation credits" could disappear from the vocabulary. Furthermore, such an approach would allow the benefit of any tax losses to be passed on to the investors at the time the losses were incurred.

Franking accounts would also go. This concept of a major company asset which has to be recorded on paper but which cannot be included in a balance sheet has always been an accounting oddity.

A reform on the above lines would in addition remove any incentive for Australian companies to relocate themselves overseas.

The intriguing question emerges as to why this simple way of eliminating the previous quite unjustified double taxation of company profits was not enacted in the first place.

These changes would probably be roughly revenue neutral, as the current 30 per cent company tax rate on undistributed profits would be being exchanged for personal marginal income tax rates ranging from nil to 48.5 per cent. Under the imputation system distributed profits are already effectively being taxed at these marginal rates, with company tax merely acting as a withholding tax.

However, even if the changes did not result in complete neutrality then the correct remedy would be to adjust the rate, not to continue using a cumbersome and inequitable system.

Taxing companies as partnership would also have one further advantage for the revenue - it would eliminate the incentive for high income earners to incorporate themselves just to benefit from the lower company tax rate.

The Ralph Committee on Business Taxation advocated a level playing field. It said that it did not make sense for exactly the same investment to attract very different tax treatment simply because it was put through one vehicle rather than another. Such a result violated the tax principle that taxpayers in similar positions should be treated similarly.

UNDISTRIBUTED PROFITS

A number of variations to the above theme are also possible. For example, undistributed profits could be treated in several different ways:

* The company could make no tax payments to the tax office, and merely notify shareholders of the amount to be included in their own tax returns - the equivalent of a partnership retaining profits within the business. This could cause cash flow problems for some persons, as investors would be up for tax on earnings which they have not received in cash - although there are precedents for this in other situations.

* The company could deduct group tax in the same way as suggested below for distributed profits.

* The company could deduct tax at the 48.5 per cent top marginal rate in the system, but this time as a final tax instead of as an advance payment. If the company subsequently wanted to distribute the remaining 51.5 per cent then this would naturally be regarded as an exempt dividend.

GROUP CERTIFICATES

If the government wanted to collect its revenue concurrently with the

actual payment of dividends then this could readily be accommodated through a system of group certificates or their electronic equivalent.

A simple approach would be to deduct tax at, say, 20 per cent for all individual shareholders who supply a tax file number and at the top marginal rate in the system (currently 48.5 per cent) for those who do not. The 20 per cent instalments could then be allowed for automatically at the time of assessment, on the lines used for pay as you go deductions made from salaries and wages.

If desired, a right for pensioners and other low income recipients to have the standard rate of deductions varied could be built into the system.

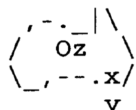
ECONOMIC ASPECTS

The opportunity could also be taken to forcefully encourage companies to distribute to the hilt for economic rather than pure tax reasons.

This could, for example, be done by imposing an undistributed profits tax at an even higher rate than 48.5 per cent - say, at 66 per cent, which is the penal rate currently being applied to the income of minors.

Companies sometimes regard profits retained in the business as a source of cheap capital. It would be far healthier for the nation and it would lead to a better allocation of resources if there were a requirement that all profits had in the first instance to be paid out to the shareholders to whom they morally belong.

These could then make their own investment decisions as to whether to put the money back into the same company or to deploy it elsewhere. Any company wanting extra capital should have to justify this to the market, instead of just passively and paternalistically hanging on to the plough-back.



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