4. Personal taxation

Fair and efficient personal income taxation is essential to position Australia to respond to the challenges and opportunities of the 21st century, particularly population ageing. However, this objective should not be pursued in isolation. Personal tax and transfer policy settings need to complement each other to be coherent and transparent. They should also support the application of modern information technologies to provide a better client experience of the system.

As the largest source of tax revenue, personal income taxation can be an important influence on the choices that Australians make. Reducing the disincentives for people to work and improving their incentives to save is critical to a high growth response to the projected fiscal pressures of population ageing and assisting people to meet their own costs. Narrowing the focus of personal income taxation to raising revenue through simpler and more transparent policy settings would provide clearer signals to people. It would also support greater automation of personal income tax return preparation.

To be sustainable, personal income taxation must also be perceived by the community to be fair. The fairness of personal income tax is fundamental as an expression of societal values and is a prerequisite for people to be committed to the system and prepared to meet their obligations. A fair tax system would feature a progressive tax rate structure, and a tax base that treats most forms of remuneration from working in a consistent manner and that recognises the punitive effect of income tax on the return to savings, particularly in the presence of inflation. Given its vital role as the population ages, retirement income savings should be subject to lower tax rates than other savings.

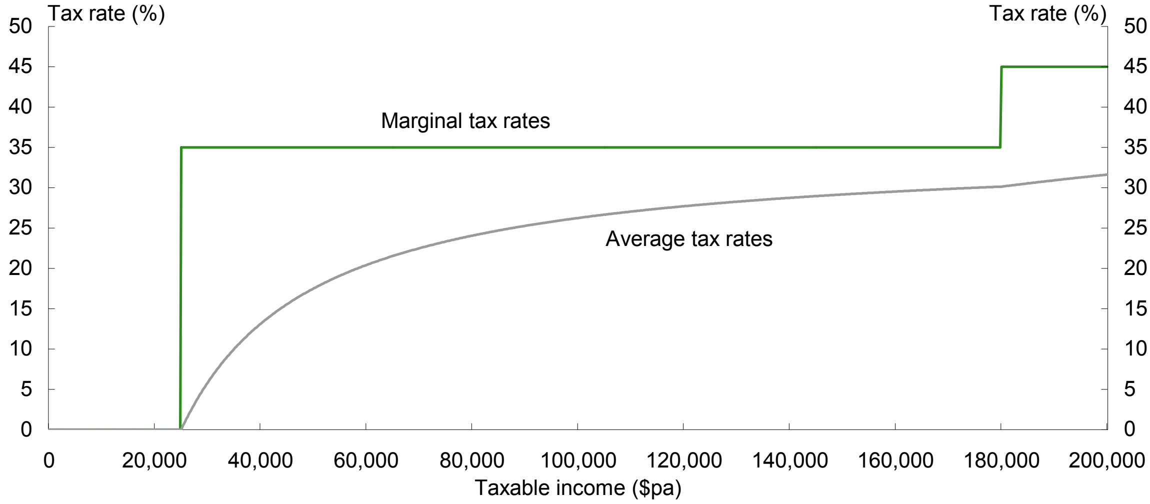
4.1 Fairer, more efficient and simpler personal taxation

The personal tax structure should be the sole means of delivering progressivity in the tax system, supporting the more direct re-distributional role of the transfer system.

The centrepiece of personal taxation would be a simple and transparent personal income tax rates scale. Progressivity would be delivered through a high tax-free threshold and a simple progressive tax rate structure, largely incorporating the Medicare levy and structural offsets — the low income tax offset, the pensioner and beneficiary tax offsets, and the senior Australians tax offset.

Chart 4.1 shows an indicative personal income tax rates scale, with progressivity delivered through a $25,000 tax-free threshold and a constant marginal tax rate of 35 per cent for 97 per cent of taxpayers.

Chart 4.1: Indicative personal income tax rates scale
A simple scale with a high tax-free threshold



Source: Treasury estimates.

There would be minimal reliance on special provisions, such as non-structural tax offsets, to achieve distributional objectives. Any special provisions would be universal, rather than subject to separate means tests. Other offsets could be limited to where they meet an ongoing need that could not be met in a more targeted way.

A consistent tax exemption of all transfer payments would improve the interaction between the personal income tax system and the transfer payments system for the large number of individuals who are subject to both.

The definition of taxable income should be broad. Alternative forms of remuneration for work, including wages, salaries, fringe benefits and employer superannuation contributions, would be taxed in a more consistent manner and with few exemptions. Income from savings would be taxed on a more consistent basis with other income (see Section 4.2).

Fringe benefits that are readily valued and attributable to individual employees should be taxed in the hands of employees through the PAYG system. Other fringe benefits, including those incidental to an individual's employment, should remain taxed to employers at the top marginal rate (and non-reportable for employees). These arrangements would improve the progressivity of the current system, while minimising compliance costs for employers.

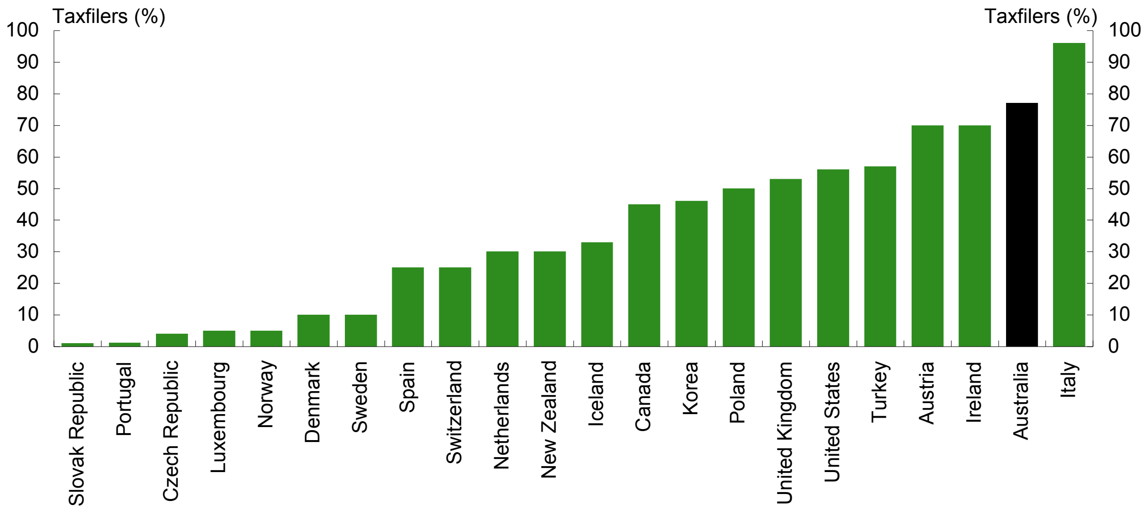
To further ease compliance costs for employers, the scope of fringe benefits that are subject to tax could be simplified. The broad definition of fringe benefits in the FBT law could be reviewed to exclude essential workplace items such as chairs, stationery and toilets. All FBT exemptions should be reviewed to determine their continuing appropriateness, and consideration should be given to excluding fringe benefits from tax where the costs of compliance outweigh equity and tax integrity considerations.

Simpler personal income taxation

Personal income tax compliance has become inordinately complex. This complexity hides its policy intent from citizens. For many people, the personal tax system is complex not only because of the rates scale and the lack of a coherent definition of taxable income, but also because they must deal with a large suite of complex deduction rules, numerous tax offsets and a variety of exempt forms of income.

Seventy-two per cent of taxfilers now seek advice from a tax agent, even though 86 per cent either claim no deductions at all or only claim work-related expenses, gifts and the costs of managing tax affairs. Australia's use of tax agents is high by international standards; second only to Italy's (see Chart 4.2). By contrast, the Nordic countries, which have pre-filling arrangements for tax returns, have low levels of tax agent use.

Chart 4.2: Percentage of taxfilers using a tax agent, 2005



Source: OECD (2005).

An automatic standard deduction should be introduced to simplify people's interactions with the tax system and facilitate much greater levels of pre-filling of tax returns. Work-related expenses are deductible from taxable income, on the grounds that it is fair to assess a person's disposable income taking account of costs they incur in earning that income. While they are the most commonly claimed deductions for employees, and claims have been growing substantially over recent years, they are also one of the key sources of complexity and compliance costs for individuals.

A standard deduction for the great majority of taxpayers would remove their need to collect receipts. A tighter nexus between the deductibility of the expense and its role in producing income would also constrain the scale of work-related deduction claims. To ensure that individuals with more complex affairs or high expenses are not disadvantaged, taxpayers would still have the option of substantiating a claim for all eligible expenses.

These two reforms, together with policy refinement to align income definitions and rationalise the number of personal tax deductions and offsets, would support the pre-filling of tax returns. Significantly, such changes would free most personal taxpayers from having to prepare their tax return, and instead allow them to lodge a default return prepared by the ATO. For most taxpayers, such default returns would only require them to provide minimal additional information or simply confirm the details in order to lodge their return. These reforms would allow personal taxpayers to avoid much of the complexity surrounding their tax return, as well as the expense of a tax agent.

In the longer term, opportunities exist to use 21st century technologies to make the system fairer, easier to comply with and more robust. Policy design should support greater automated reconciliation of tax affairs to reduce or remove the requirement for the taxpayer to collect their own information over the course of the tax year.

4.2 Taxing income from savings

Australia's personal income tax system should continue to represent a hybrid personal income tax, with the main forms of lifetime savings for most Australians — superannuation and owner-occupied housing — taxed at a lower rate or exempt from income tax, but with other savings taxed more consistently to achieve a more productive and better allocation of savings.

Savings invested in owner-occupied housing or superannuation would either be tax-exempt or close to exempt in practice, both being important determinants of people's living standards in retirement. This treatment would be consistent with a progressive expenditure tax benchmark, which exempts the returns to saving. Comprehensive income taxation, under which all savings income is taxed the same as labour income, is not an appropriate policy goal or benchmark.

The essential reason for treating lifetime, long term savings more favourably is that income taxation creates a bias against savings, particularly long-term savings. Taxes on savings income, including the taxation of inflationary gains, can discriminate against taxpayers who choose to defer consumption and save. The longer the person saves and reinvests, the greater the implicit tax on future consumption (see Chart 4.3). These individuals pay a higher lifetime tax bill than people with similar earnings who choose to save less.

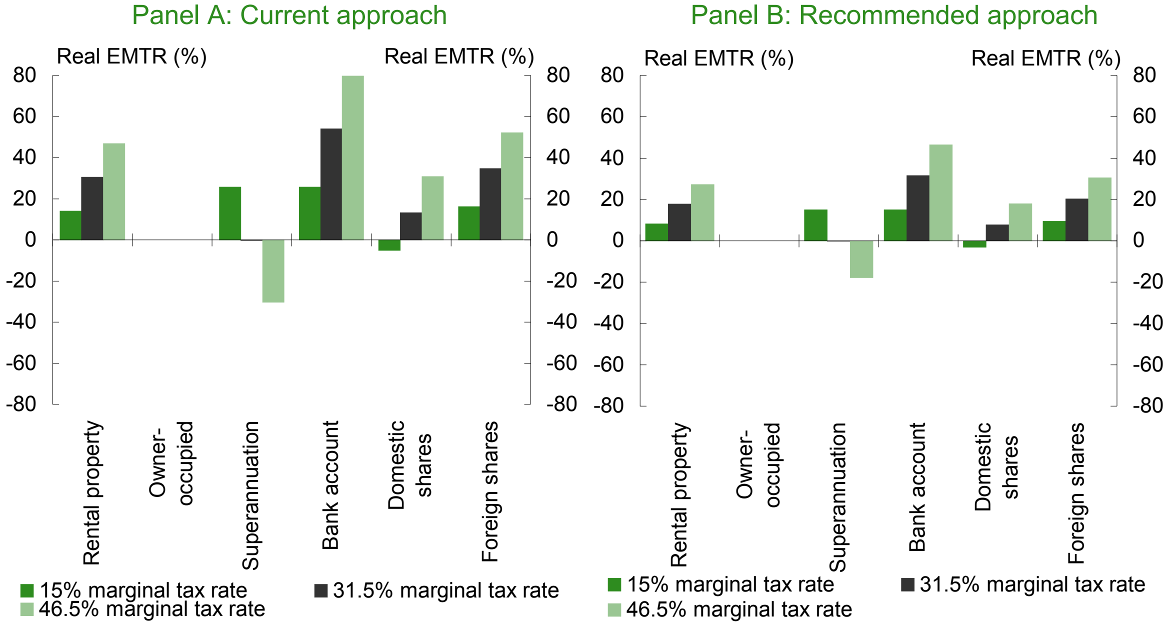
Chart 4.3: Tax wedge on future consumption

Assumptions: Pre-tax interest rate of 6 per cent per annum and a tax rate of 30 per cent.
Source: Treasury estimates.

Current arrangements lead to tax outcomes that vary widely depending on the form of saving undertaken (see Chart 4.4). Interest has the least favourable tax treatment. The entire return, including inflationary gains, is included annually in taxable income, generating an effective marginal tax rate on the real return greater than the statutory marginal personal tax rate. In contrast, shares benefit from the capital gains tax discount, while domestic shares also benefit from dividend imputation.

Rental properties benefit from the differential treatment of gains and losses, driven by the capital gains discount and exacerbated by high levels of gearing. Returns from owner-occupied housing are untaxed, giving rise to a zero effective tax rate. For superannuation, the ability to make contributions out of pre-tax income (rather than post-tax income as for other savings, including your own home), can result in a negative effective marginal tax rate on saving through superannuation.

Chart 4.4: Real effective marginal tax rates for selected asset classes



Notes: The real effective marginal tax rate on saving is defined as the difference between the pre-tax and post-tax return from a marginal investment as a proportion of the pre-tax return (net of inflation). A zero effective tax rate reflects a prepaid expenditure tax benchmark, where saving is undertaken out of post-tax labour income and the return to saving is exempt from income tax. Negative rates for superannuation reflect the reduction in tax from either making contributions out of pre-tax income (current approach) or by accessing the recommended refundable tax offset for contributions.
Assumptions: 6 per cent nominal return; 2.5 per cent inflation; for rental property, 50 per cent of the return is attributable to capital gain, 50 per cent to rental income and the rental property is held for 7 years then sold; shares are held for 7 years then sold; superannuation is held for 25 years and the individual is eligible for a tax-free payout at the end of the period. Does not account for interactions with the transfer system.
Source: Treasury estimates.

There is considerable evidence that such tax differences can have large effects on the assets in which a household's savings are invested (OECD 2007a). The large variations in tax treatment can therefore alter the allocation, ownership and the management of the nation's savings. This can have adverse impacts on overall economic efficiency, capital market stability and the distribution of risk between individuals. The tax advantages from borrowing to invest in a rental property, also relevant for shares, leads to investors taking on too much debt and distorts the rental property market.

A move to a broad 40 per cent discount for income from bank deposits, bonds, rental properties, and capital gains and for certain interest expenses would address these problems by providing more consistent tax outcomes. Savings would be allocated more productively, distortions to rental property and other markets would be reduced, and household investment and financing choices would better suit their circumstances and risk-preferences.

The discount would also provide a means of adjusting for the effect of inflation, which increases the effective rate of tax on savings income.

Phasing in the discount over time would allow investors to adjust to the new tax settings and reduce the potential for market disruption. In particular, a smooth transition for highly geared investors in rental properties would limit any short-term disruptions in the supply of rental properties. However, this should only be adopted following reforms to the supply of housing and to housing assistance.

Extending the uniform discount to dividends and business income could also be considered as part of long-term alternatives to dividend imputation (see Section 5). Doing so could provide an alternative means of avoiding the double taxation of company profits in the hands of shareholders and would further improve the consistency of income tax arrangements for savings income.

In the short to medium term, some areas of the current taxation of savings could be simplified. In particular, the capital gains tax rules should be simplified by excluding some low-revenue generating assets, removing grandfathering rules, and considering a principles-based rewrite of the rules.

In addition, the small business entity capital gains tax concessions should be rationalised and streamlined. The active asset 50 per cent reduction and 15-year exemption concessions should be abolished. The lifetime limit for the retirement exemption should be increased and taxpayers who sell a share in a company or an interest in a trust should be able to access the concessions via the turnover test.

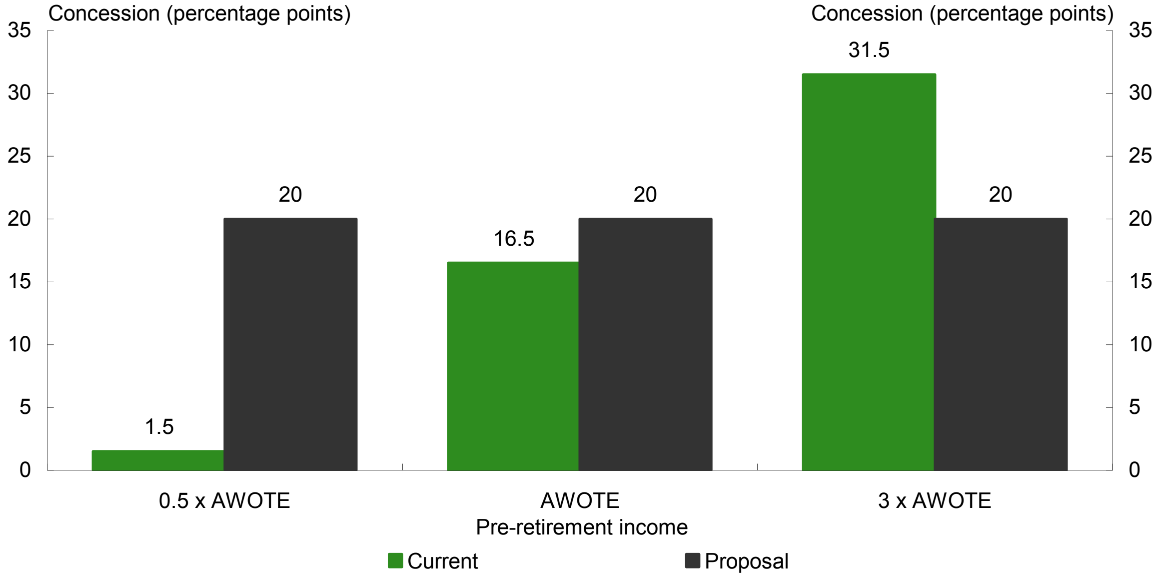
4.3 Improving retirement incomes

The ageing of the population, longer life expectancies and more people interacting with the system pose challenges for the retirement income system. A key finding of the Review Panel's strategic report on the retirement income system, released in May 2009, was that the current three-pillar retirement income system is well placed to deal with these challenges.

Privately funded superannuation will remain a key component of the retirement income system and should continue to receive a concessional tax treatment compared to other savings. However, the current taxation of superannuation favours high-income earners compared to low- and middle-income earners. For example, around 2.5 million individuals receive little or no personal income tax benefit from their superannuation contributions. In contrast, around 200,000 taxpayers (those earning more than $180,000) receive a concession on their superannuation contributions of 31.5 per cent.

Concessions should be distributed more equitably between low- and high-income earners by including employer superannuation contributions in an individual's income and taxing them at marginal rates. A universal uniform concession in the form of a refundable offset could be provided up to a cap. Voluntary contributions should also be eligible for the offset subject to the cap. The tax on superannuation contributions within the fund should be abolished. This arrangement would provide a consistent concession to all contributions irrespective of a person's income (see Chart 4.5).

Chart 4.5: A more equitable concession for contributions
Based on a 20 per cent offset(a)



(a) The chart assumes a single person who does not receive income support. The figures for the current situation are based on the 2009–10 marginal tax rate schedule with Medicare levy. In this case, a person on 0.5 x average weekly ordinary time earnings (AWOTE) has a marginal tax rate of 16.5 per cent, a person on AWOTE has a marginal tax rate of 31.5 per cent and a person on a 3 x AWOTE has a marginal tax rate of 46.5 per cent. AWOTE is currently around $1,200 per week ($62,400 per year). Around half of workers earn less than three–quarters of AWOTE.
Note: The recommended concessions are based on the indicative personal income tax rates scale in Section 4.1.
Source: Treasury estimates.

In isolation from other changes to personal tax, the effect of the recommendation would be to reduce a person's disposable income. However, retirement incomes would increase as the fund would no longer pay contributions tax. In these respects, the effect would be similar to requiring employees to make an additional compulsory contribution into superannuation. Implementation would require consideration of arrangements to address the immediate impact on disposable incomes.

These arrangements should also make the system simpler and more transparent by replacing the different concessions for different types of contributions with one treatment (see Chart 4.6).

Chart 4.6: A more consistent treatment of superannuation contributions

Current contributions tax in fund

Employer		Employee	Self-employed		Spouse	Proposed
Super guarantee	Salary sacrifice	Post-tax	Pre-tax	Post-tax		
15%	15%	N/A	15%	Nil	Nil	NO TAX

Current other personal income tax

Employer		Employee	Self-employed		Spouse	Proposed
Super guarantee	Salary sacrifice	Post-tax	Pre-tax	Post-tax		
Nil	Nil	Marginal tax rate (0 -46.5%)	Nil	Marginal tax rate (0 -46.5%)	Marginal tax rate (0 -46.5%)	MARGINAL TAX RATE (0-45%)[(a)]

Current concession

Employer		Employee	Self-employed		Spouse	Proposed
Super guarantee	Salary sacrifice	Post-tax	Pre-tax	Post-tax		
Marginal tax rate less 15%	Marginal tax rate less 15%	Co-contribution (if eligible). No concession if not eligible for co-contribution.	Marginal tax rate less 15%	Co-contribution (if eligible). No concession if not eligible for co-contribution.	Spouse superannuation tax offset	FLAT-RATE TAX OFFSET

(a) Based on the indicative personal income tax rates scale (see Section 4.1).

Removing the tax on superannuation contributions in the fund would increase the value of superannuation guarantee contributions and could also increase the value of voluntary contributions in the fund. This would lead to higher retirement incomes. Halving the tax on superannuation earnings to 7.5 per cent would further increase retirement savings. These two reforms are projected to result in replacement rates[5] of 88 per cent for a median income earner (approximately 0.75 times average weekly ordinary time earnings (AWOTE))[6] and 76 per cent for an average income earner. Applying the earnings tax to the pension phase would considerably simplify the compliance requirements of superannuation funds.

A structural weakness in the current retirement income system is a failure to provide products that would allow a person to manage longevity risk. The government should support the development of these products and better facilitate their provision by the private sector. This could be achieved through issuing long-dated bonds and removing rules that restrict the development of income stream products. The Review is not convinced, however, that the purchase of such products should be made compulsory.

The government also has a role in improving people's awareness of the retirement income system. This could be achieved by requiring superannuation guarantee contributions to be paid at the same time as wages, linking superannuation records and developing a single portal through which people could interact with government agencies.

---

5 A replacement rate compares a person's spending power before and after retirement (that is, income and fringe benefits after tax is paid). For example, a replacement rate of 75 per cent would mean that a person would be able to spend in a given time period $75 in retirement for $100 spent before retirement.

6 AWOTE is currently around $1,200 per week ($62,400 per year).

4.4 Wealth transfer taxes

A bequest tax would be an economically efficient way of raising revenue and would allow reductions in other, less efficient taxes. It would not affect saving decisions to fund an adequate standard of living in retirement. Saving decisions motivated by the desire to leave a bequest would be affected, but only to a limited extent.

Given the controversial history of bequest taxation in Australia, the Review has not recommended the introduction of a bequest tax, but believes that there should be full community discussion and consultation on the options. Most OECD countries impose bequest taxes — either through taxes on the whole estate or individual inheritances.