

SUBMISSION TO HENRY TAX REVIEW

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PREAMBLE

This submission addresses the following tax and related issues - the company tax rate and dividend imputation; a tax on a tax; the Medicare Levy; the CGT rate; negative gearing; and the tax regime on employee share options.

1. THE COMPANY TAX RATE AND DIVIDEND IMPUTATION

Dividend imputation was first introduced to avoid the double taxation of the “same” money when company tax was first paid on an entity’s profit and secondly by a shareholder in the entity on his/her dividend, which must be paid out of profit. Removal of dividend imputation would restore that element of double taxation. Nick Renton has commented that the owners of a company and the company itself are the same and that the separate legal personality of a company is a fiction; I disagree: a company is legally a different entity from its shareholders and to conflate the two is simply incorrect. But looking at the issue from a cash flow perspective, it is unfair to tax company profits and to that extent reduce the pool from which dividends can be paid and then also tax the dividends without giving credit for the company tax paid.

Reducing the company tax rate to 19%, from the current 30%, as has been posited in the press, might have some benefits in making Australia’s company tax rate competitive with other countries’ corporate tax rates, and might as a result lead to higher share prices, if as a result foreign investors find Australia’s corporate sector more attractive. However, replacing dividend imputation with a lower company tax rate is not an equivalent measure, for at least the following reasons:

- The two taxes fall on different taxpayers, and at different tax rates;
- Increased share prices are not necessarily a valid tradeoff for Australian investors against a higher tax on dividends, resulting in lower shareholder income; many investors buy shares for their dividends, not the capital gain, the most obvious category being self-funded retirees. Capital growth is irrelevant or only of long-term benefit to them, whereas the income is critical;
- Attracting foreign investors is said to be a benefit from trading off a lower company tax rate against the abolition of dividend imputation, but a lower company tax rate could be introduced anyway; this would possibly attract foreign investors without at the same time abolishing dividend imputation and harming Australian investors: the two issues are independent and affect different classes of investors;
- It is not the case that dividends will inevitably increase if a lower company tax rate applies, as companies have many demands on earnings, such as the retention of reserves and investment for the long-term growth of the company, and increases in a company’s after tax earnings do not necessarily all flow through to dividends.

I have no issue with the lowering of the company tax rate, but most strongly urge the retention of dividend imputation; even with a lower company tax rate and correspondingly lower franking credits, Australian shareholders will be fairly treated. Foreign investors will still face dividend withholding tax, as they should.

2. A TAX ON A TAX

A tax imposed on a tax is in principle iniquitous, unless there is a clear policy reason to impose it, and I know of no such policy reason. Two examples illustrate this: first, the GST applied on top of fuel excise, and secondly, the fire services levy imposed on certain insurance policies has both GST and State stamp duty imposed on top of it.

GST is in principle imposed on payments for goods and services, though its complexity makes that simple statement somewhat inadequate. But excise is not a payment for a good; it is itself a tax, and may not be retained by the seller of the good. I recognise that excise is a fuel manufacturer's tax, and of course manufacturers are liable for other taxes which add to the cost of fuel, such as payroll tax and stamp duty, but excise is so closely related to the final consumer price of fuels that there ought to be some relatively easy way to deduct it before GST is added. Likewise, the fire services levy is not a payment for a service (only the actual insurance premium is); in both cases the total price (inclusive of GST) includes GST on something which is not the price for a good or a service.

I urge the identification and abolition of all similar taxes on taxes, including GST on other excise payments and on customs duty - and cooperation with the States to do the same with stamp duty.

3. SPECIAL PURPOSE LEVIES

The ABC was once funded (no doubt in part) by radio and then radio/TV licence fees, a special purpose tax. Sense eventually prevailed and the licence fees were abolished and the ABC is now funded, apart from revenue derived from its own commercial efforts, out of consolidated revenue. The Medicare Levy is a similar special purpose levy, which in part funds the health system. The use of the Medicare Levy as a politician's tool to make policy changes to the health system, such as imposing a higher levy on those who do not take out private health insurance, is a misuse of the tax system. If the Medicare Levy were abolished and income tax rates altered to reflect this, there would be far less opportunity for such politicians' games. Removing the Medicare Levy and any other special purpose levies would be an admirable simplification and valuable for that reason alone, and health policy changes and the like would have to be dealt with on their own terms and not by the backhand method of changes to the tax system.

4. THE HALF RATE CAPITAL GAINS TAX

When CGT was introduced, it eliminated at one stroke the incentive for all artificial schemes designed to 'convert' income to capital. The half-rate at one stroke brought it back. If there is one aspect of tax simplification that is most desirable - the discouragement of artifice (and the industry that flourishes on it) - then the half-rate CGT must be abolished and CGT levied on all capital gains at the taxpayer's marginal tax rate. At the same time, indexation of sums subject to CGT should be restored; this is fair as it means that taxpayers do not pay tax on the inflation element of their capital gains, only on the real gain.

5. NEGATIVE GEARING

Negative gearing, where a taxpayer's losses on one income-producing activity are deductible from the taxpayer's income generally, have been identified as a significant and possibly the main cause of excessive share and house prices. If losses from an income-producing activity had to be carried forward and set off against future income from that activity alone, then real entrepreneurial activity would instantly be encouraged and the main cause of those excessive prices would at one stroke be removed. Of course the half-rate CGT compounds this: the two issues can be considered together.

6. EMPLOYEE SHARE OPTIONS

The tax regime for employee share options is excessively complex. However, there is one aspect that is iniquitous.

On the grant of employee share options, an employee has the option of paying income tax on them in the year of grant or later when the options are exercised. Where an employee does not elect to pay tax in the year of grant, but as circumstances turn out, leaves his/her employment before exercising the options, the “Cessation Time” occurs on the employee’s cessation of employment. Income tax then becomes due, even though the employee has received no income from the options. Imposing tax, where there is no income on which the tax can be based, and no other change, such as an underlying change to the nature or ownership of a relevant asset (in this case consisting of the options) is unfair and unreasonable. It would be fair to give the taxpayer the same option at the “Cessation Time” that occurs on termination of employment as he/she has in the year of grant of the options - to pay tax then or on later exercise of the options.

Generally, the combination of income tax at that “Cessation Time” and CGT imposed at the time of the exercise of the options, in the current regime, must in many cases make share options more costly to the employee than simply paying for them on the market out of after-tax income. If deterring the use of employee share options is the policy, then it is no doubt to a certain extent effective; however, in operation it is clearly unfair and seems predicated on the assumption that share prices will always rise - an assumption clearly no longer justified.

CONCLUSION

I urge the Review Panel to consider implementing all these proposals in the interests of a simpler and fairer tax system.

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