SUBMISSION ON A NUMBER OF MISCELLANEOUS TAX ISSUES

SUMMARY

This supplementary submission deals with a number of assorted tax issues.

These are discussed under the following headings:

CAPITAL GAINS TAX

ROLLOVERS

HOUSING

SUPERANNUATION

IMPUTED RENT

FIRST HOME OWNER GRANTS

SUDDEN DEATH PROVISIONS

HEALTH COSTS

LAND TAX ANOMALIES

TAX LOSSES

ANNUITIES FROM TRUSTS

USING GOVERNMENT BONDS TO FINANCE INFRASTRUCTURE HYPOTHECATED TAXES

CAPITAL GAINS TAX

It would 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.

* Investors holding shares which have become worthless in market terms should be able to have them deemed disposed of if they so elect, even in the absence of an actual disposal or a formal declaration of worthlessness by a receiver or liquidator.

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

* To facilitate the rationalisation of the entities related to a family, transfers of assets between them should also at their option and subject to appropriate conditions be disregarded as disposals and acquisitions.

* In the interests of equity, the ability to index the cost base for inflation - a feature of the law which disappeared in the September 1999 tax changes, at least as far as new investments made after that date are concerned - should now be restored.

* Furthermore, this method should be made available to both individuals and institutions. The latter were denied the use of this under the 1985 legislation which brought in the capital gains tax.

* In addition, the same method should be usable in both capital gain and capital loss situations.

* As all companies are ultimately owned by individuals the same rules governing the taxing of capital gains under the discount method should apply to both categories.

ROLLOVERS

The capital gains tax rollover provisions for takeovers should be extended beyond "scrip for scrip", especially in compulsory acquisition cases.

Thus if a cash consideration is received and reinvested in the market within, say, three months, then the shares purchased with that cash should at the option of the investor 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, which rather strangely the present Act does not allow.

Furthermore, the present 80 per cent threshold which needs to be satisfied for the rollover provisions to apply should be removed:

* It is quite unfair to shareholders receiving a bid, as these have no means of knowing, at the time by which they have to make a decision on whether to accept an offer or not, whether that threshold will ultimately be achieved.

* Furthermore, the attainment of this threshold is totally outside the control of any individual shareholder.

* There is no particular logic in denying justice to the unfortunate shareholders in companies in which this completely arbitrary target is not reached.

HOUSING

Under the present legislation the interest on a loan used for investment or business purposes is deductible for income tax purposes, but the interest on a loan used to acquire a borrower's own residence is not. The latter is regarded as expenditure for domestic purposes. Similar provisions also apply to other items of housing outgo, such as depreciation, repairs and maintenance.

Some people regard the lack of deductibility for expenditure related to owner-occupied housing as unfair. They note that the relevant items rank as tax deductions in some other jurisdictions. However, in many cases these jurisdictions also treat imputed rent as taxable income, which makes the tax deductibility of offsetting items more logical.

Furthermore, owner-occupied housing already confers special advantages under the legislation relating to capital gains tax and the social security assets test.

These provisions exist mainly for political reasons and have no economic justification. They encourage many people to stay in far bigger accommodation than they really need and thus needlessly tie up housing which other people would find useful. This also helps to push up prices for both first-time and other home purchasers.

These provisions should be phased out.

SUPERANNUATION

Some people wishing to buy a home for themselves and their families lack the necessary money even for putting down a deposit. They have difficulty in saving money at a faster rate than that applying to rises in house prices, so that their dream of achieving home ownership becomes ever more unlikely.

Yet at the same time they have money tied up in compulsory superannuation - money intended for their retirement in the distant future but which they are not allowed to access at a time when it would be much more useful for a house purchase.

The rules should be changed to allow the stake in a superannuation fund to be used to help acquire a home. After all, a house owned at retirement is just as useful as a retirement asset as a sum of money from a superannuation fund.

In the meantime:

* an owner-occupied house would have added to the family's comfort

* it would have been a good hedge against inflation

* it would also have provided the security of tenure not available to occupiers of rented accommodation.

However, it might be advisable to relax the rules gradually, so that a sudden large increase in the purchasing power available to prospective house purchasers collectively did not push up house prices against their best interests.

IMPUTED RENT

The term "imputed rent" means the market rent that an owner-occupier:

* would pay as the tenant of an equivalent house owned by an arm's length landlord

* would receive as the landlord of an equivalent house occupied by an arm's length tenant.

Taxing imputed rent would put owner-occupiers in the same position as investors actually collecting rent from an investment property or receiving an equivalent return from an alternative investment.

The Australian tax system would be made more equitable if imputed rent were made subject to income tax and the corresponding expenses allowed as a tax deduction. This would make some people better off than under the present system and would make some other people worse off - but it would be fairer approach overall.

The only drawback would be that establishing the correct market rent of a particular property could prove controversial, although no more so than establishing net annual values for municipal council rating purposes.

The present rules give the curious result that in some cases it can be cheaper in after tax terms to own one house as an investment and to live in a completely different house of equivalent value, rather than to live in one's own house.

To illustrate (using a 50 per cent tax rate for convenience):

	Cost Before Tax $	Cost After Tax $
* ABC living in his own house:		
Interest and outgo paid	14,000	14,000
TOTAL	14,000	14,000
* ABC living in DEF's house and vice versa:		
Interest and outgo paid	14,000	7,000

Rent received	-5,000	-2,500
Rent paid	5,000	5,000
TOTAL	14,000	9,500

FIRST HOME OWNER GRANTS

The First Home Owner Grant (FHOG) scheme was established by the Commonwealth government in 2000 to encourage and assist home ownership and to offset the effect of the goods and services tax (GST) on home ownership.

It provides a tax-free lump sum grant to first time home buyers - but not to other persons equally worthy. This discrimination is unfortunate. This grant does not involve a means test and does not involve any maximum price for the house being acquired.

Some states top up the Commonwealth grant by an additional grant of their own.

While no doubt well-intentioned and electorally attractive, these grants are not really a good idea and should be abandoned. They increase the demand for housing but not the supply. By enabling some first home purchasers to spend more money on housing than would otherwise be the case house prices are pushed up and the grant recipients may thus be no better off.

At the same time the higher price levels can adversely affect home purchasers who do not meet the scheme requirements.

Apart from pushing up the prices which first time home buyers are willing to pay, the scheme also pushes up the sums which they are willing to commit.

For one thing, the extra cash in hand no doubt has a psychological impact.

For another, it adds dramatically to the pool of savings which can be used as equity in a home.

To illustrate, a person purchasing a home with the help of a 90 per cent housing loan on mortgage who has saved up, say, $40,000 will then have $47,000 after a $7,000 grant. Subject to sufficient income to warrant such a loan, this might enable a $470,000 purchase rather than just a $400,000 purchase.

Of course, this could also lead to problems down the track if it traps low income home purchasers into overcommitting themselves in regard to the periodical amounts needed to service their loan obligations.

At the very least, it would seem better to pay the grant in the form of monthly or fortnightly instalments.

SUDDEN DEATH PROVISIONS

The legislation contains a number of "sudden death" provisions which provide substantially different outcomes for transactions on either side of an arbitrary threshold, as distinct for phasing in.

A few examples will illustrate this point:

* Capital gains realised on the 365th day after acquisition (366th day if the 29th of February is involved) are taxed at twice the rate of disposals one day later.

* The benefit of franking credits is generally not available under the so-called 45-day holding period rule in respect of ordinary shares held for

46 days, but it is available for such shares held for 47 days.

* Using the figures announced in the May 2008 federal budget, the Medicare levy for persons with inadequate health insurance is $1500.00 for a single person on a taxable income of $100,000 but $2500.02 for a person on a taxable income of $100,001.

* Employers who miss the reporting deadline under the superannuation guarantee charge legislation by even one day face a very serious financial penalty, which is out of all proportion to the gravity of the offence.

Such provisions should be replaced by a mechanism providing a gradual phasing-in.

HEALTH COSTS

In the interests of better transparency, the separate Medicare levy should be absorbed into the general income tax scale. Although parts of the legislation pretend otherwise, this levy is really just a part of income tax.

Its imposition under a separate heading is really quite absurd. The 1.5 per cent basic rate covers only about one-seventh of the total health costs actually being incurred by the Commonwealth. This fraction would be roughly halved if the total expenditures on health by governments at all levels were to be taken into account.

The current Medicare levy rate thus gives the public a totally misleading impression as to the real situation. The actual levy rate would need to be nearer to 10 to 20 per cent to overcome this.

This is mentioned by way of illustration only - it is not being recommended here. Nor is it suggested that the current 31.5 per cent income tax rate including the levy should simply fall to 30 per cent, as this would deprive the government of too much revenue. Rather, the suggestion is that the tax rate just be expressed as 31.5 per cent, without the current official pretence that it is only 30 per cent (and similarly for the other tax brackets).

One other weakness of the present approach comes about because taxpayers with incomes below a defined threshold are exempted from the Medicare levy.

This sounds good, but it is accompanied by a special 10 per cent levy rate for incomes just above the threshold, as part of a phasing-in mechanism.

Thus relatively low income earners are subjected to a marginal tax rate of 25 per cent on part of their incomes.

Of course, this is not the only instance of turning a simple-sounding tax rate into something more complicated. Collectively such devices can produce a remarkably complex picture.

There is also another problem. The existence of the Medicare levy probably encourages the overutilisation of health services.

At the patient level the thinking tends to be "as we have paid for this we might as well use it" and no doubt some taxpayers try to make a "profit" by claiming more in benefits than they pay by way of the levy.

They tend to go to the doctor for minor ailments in circumstances when they would not bother if they had to pay for the visit out of their own pockets.

At the medical practitioner level the thinking tends to be "as extra tests will not be costing our patients very much we might as well order them; even if the additional knowledge gained in this way is only marginally useful, it will at least help to protect us against unwarranted malpractice suits".

LAND TAX ANOMALIES

Land tax should be levied at a flat rate and not on a sliding scale as at present.

If inflation and/or other factors increase rent levels and property values by a certain percentage then land tax can go up by a much higher percentage.

However, the capacity to pay will not have moved up by the same percentage as the land tax.

Aggregation can be another problem. For example, if an investor owning one income-producing property acquires another property of the same value in the same state then that investor's land tax bill will more than double, but the rental income out of which to pay the tax will not have gone up to the same extent.

As a separate issue, the states should make substantially greater use of land tax. Land which is not being used or which is being using inadequately requires public services equally with

properly utilised land and should thus be discriminated against on social as well as economic grounds.

However, in order to minimise the impact on existing land owners and their tenants, any such change should be dealt with on the lines described below.

Unlike the position with other asset classes, the value of land is to a large extent derived from services provided by the community rather than from any effort on the part of its owner. Land in desired locations is a scarce resource.

If one were dealing with a newly established country, one would be tempted to suggest a rate of land tax nearly equal to the ground rent; this would have the incidental effect of substantially reducing the cost of all land (freeholds would in effect become perpetual leaseholds, but there would, of course, be full security of tenure). This would be a great boon to first home buyers.

In the case of an existing country such as Australia, the sudden introduction of a land tax on these lines would obviously be inequitable to existing landowners. However, substantial justice would be done if such a tax were to be legislated for now, but on the basis that the increased collections would start only in 20 or 25 years' time.

The total tax to be raised in Australia need be no different whether one is considering income tax by itself or a mixture of income tax and land tax, as suggested here. Many people would pay much the same total under either approach.

However, a relatively high land tax would encourage the efficient use of land, while a lower income tax would enable any extra effort or risk taking to be rewarded better. The simultaneous attainment of both these objects would be most worth while.

While the existence of a land tax may discourage the acquisition of land by an individual it cannot do this across the board. Land is a necessary ingredient for all modern human activity and thus all land has to be owned by someone.

Thus one significant advantage of land tax is that unlike most other taxes it cannot be evaded.

TAX LOSSES

On the grounds of fairness the transfer of both revenue and capital 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 the parties to such transactions.

To illustrate: If a trust loses $100 and an individual earns $100 then the combined income of both is nil. What is wrong with these two taxpayers getting together and paying nil tax on nil income?

ANNUITIES FROM TRUSTS

Amounts distributed as annuities from trusts are always taxed as income.

While this approach is reasonable in the case of annuities paid from revenue it is quite immoral in the case of annuities paid out of capital sources.

The law should be changed to rectify this anomaly.

USING GOVERNMENT BONDS TO FINANCE INFRASTRUCTURE

Sometimes suggestions are made to the effect that the Commonwealth should issue tax-free bonds to fund some worthwhile project, as that would enable a lower interest rate to be paid and thereby improve the viability of the project.

Such suggestions sound superficially appealing, but they should be strongly resisted. Investors would always seek out whichever of the taxable or tax-free bonds gave them the better after tax return and thus the higher total cost to the government issuing them.

However, the use of taxable bonds rather than taxation to finance the capital cost of major infrastructure projects that are expected to benefit the community for many years to come would make sense.

This would enable both the initial and the ongoing costs of such projects (including interest charges and capital repayments) to be spread over the lifetime of the assets concerned and thus as a matter of fairness to be borne by the generation benefiting from them.

Such bonds would be of interest both to Australian superannuation funds and to capital secure managed funds. They would also appeal to overseas investors wanting to take a position in the Australian currency.

If desired for marketing reasons, they could also be offered to the wider local public under impressive sounding names such as "infrastructure bonds"

or "transport bonds". These could be listed on the stock exchange. (However, the cynical professional investors on the market would no doubt quite correctly regard them just as ordinary Commonwealth or state government bonds.)

HYPOTHECATED TAXES

Hypothecated taxes are taxes specifically earmarked for a particular purpose, usually in a vain attempt to make them more acceptable to the voters. Such imposts are generally regarded by both economists and political commentators as being regressive and far less efficient than ordinary taxes.

The current Medicare levy discussed above is the best-known Australian example of a hypothecated tax.

Hypothecated taxes give the public the appearance of being clearly identifiable and independent of the normal public expenditure processes, as well as being free of political control.

For this reason a Medicare-style levy is sometimes suggested for government expenditure on defence, education, transport, social security and so on.

However, the need for expenditure in these areas is quite unconnected to the level of incomes in the community at any point of time. In fact, in some cases the relationship may be inverse - for example, at a time of recession incomes drop but the requirement of governments for money tends to go up.

For these reasons, a single pool of consolidated revenue would be a much better approach.

A few other examples are worth mentioning in this context.

Some gambling taxes imposed by state governments were brought in with the excuse that they would be used to fund hospitals. However, they were soon diverted to other uses.

It is also suggested from time to time that such taxes should be used to run programs for the rehabilitation of problem gamblers.

Part of the justification for the high excise on petrol was that the money raised would benefit motorists by helping to improve roads. But the actual expenditure on this aspect is far below the revenue being raised.

The final cost to Victorian taxpayers of the rescue of depositors in three Pyramid Group building societies in 1990 was over $900 million. The funds were raised through a three cents per litre levy on petrol sold in Victoria

- an impost which lasted for five years. It is not clear why motorists in particular were made to pay for something which had nothing to do with them.

When payroll tax first came in as a federal tax it was explained as a measure to fund child endowment. Later on the tax was handed to the states and territories, who promptly increased the rate. But by then the nexus had already disappeared.

Municipal councils sometimes impose specific levies on groups of ratepayers

- for example, on shopkeepers in a particular area to fund off-street parking for their customers. Of necessity the cost of such levies gets passed on to these customers in the form of higher prices. Furthermore, the car parks also benefit shopkeepers located just outside the levy area.

Australia some years ago required radio listeners to buy an annual licence to help pay for the national broadcaster. In practice this was very close to a poll tax. The costs of collection and the detection of non-payers were very large in relation to the total revenue raised.

Most existing hypothecated levies should now be abolished and no new ones should be introduced. All projects considered worth while should just be funded out of consolidated revenue.

2008-09-17

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