13 October 2008

AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sirs,

I am grateful for the opportunity to make a submission to the review panel on Australia's taxation system.

This submission deals principally with two aspects of the taxation system, Capital Gains Tax and the complexity of the Income Tax law:

- Capital Gains Tax is inherently inefficient, both from an economic and from a revenue raising standpoint. It has many aspects of a transaction tax and therefore increases illiquidity in the property and stock markets, exacerbating asset bubbles and increasing the cost of capital to enterprises.
- Capital Gains Tax is inequitable in that it taxes nominal, rather than real, gains and in that a major realisation may be taxed at higher marginal rates than would have been the case if the gain had been taxed as it accrued.
- Capital Gains Tax also imposes a severe and increasing record keeping burden on taxpayers.
- This submission argues that Capital Gains Tax should be replaced by a wealth tax levied at non-confiscatory rates. This would also allow the exemption of interest income from income tax, removing the very high real EMTR discussed in section 8.2 of the Treasury's paper "Architecture of Australia's Tax and Transfer System ("the Architecture paper").
- This submission also argues that the complexity of the income tax law should be reduced by greater reliance on accounting standards for the determination of assessable income for businesses, a schedular system for individuals and the use of extra-statutory concessions to mitigate the anti-avoidance provisions of the taxes acts where avoidance is not an issue.

Capital Gains Tax

Capital Gains Tax (CGT) is levied on a realisation basis on the nominal gain from purchase to sale of an asset. As a result, CGT is inefficient in economic terms in that it alters the behaviour of market participants by encouraging them to realise losses early and postpone realising gains. This increases volatility and decreases liquidity.

An increase in volatility in capital markets increases the cost of capital to enterprises seeking to raise funds for investment. In addition the reluctance of investors to incur a substantial tax charge by selling investments, even when they suspect that the market value of the investment is too high in fundamental terms, may encourage asset price bubbles. It is important to note that an investor when deciding whether to sell into a rising market has certainty about the tax incurred if they sell but is uncertain as to the possible subsequent fall in the asset price if it does in fact prove to be overvalued.

CGT inhibits the prudent rebalancing of investment portfolios by imposing a significant tax penalty on such activity. It therefore results in individual investors being exposed to greater risk than would otherwise be the case.

CGT is also inefficient in revenue raising terms because it is easy to defer tax simply by deferring realisation of gains. Although the current maximum rate (for assets held over 12 months) of 23.25% does not give much incentive to avoid CGT by realising gains in superannuation funds or companies, a number of commentators have suggested that the 50% discount should be abolished. Taxing gains at 46.5% would almost certainly result in rich individuals channelling gains through companies and the middle classes using their self managed super funds more aggressively for this purpose.

A further disadvantage of CGT in revenue raising terms is that it is heavily pro-cyclical. In the past few years rising stock markets have resulted in significant gains on sales of shares. The recent fall in the stock market to levels last seen four years ago is likely to result in significantly lower collections in 2008-09 and lower again in 2009-10. Although Keynesian economics would suggest that pro-cyclical taxes are to be encouraged as automatic stabilisers, CGT is not very effective for this purpose as the proceeds of capital gains tend to be re-invested rather than spent, particularly when they arise as a result of portfolio rebalancing.

CGT also imposes a severe and increasing record keeping burden on investors. Whereas those who invest in real estate are not greatly affected, since records of title have to be retained even in the absence of CGT, investors in shares need to retain contract notes going back to before the introduction of the tax in 1985 and to retain them for seven years after the disposal of last holding in a particular company in order to be able to demonstrate that purchases and sales have been correctly matched according to the ATO's rules.

In the absence of the discount, CGT would be inequitable as inflationary gains on an asset held for 10 years would be treated the same as a trading gain on an asset held for 10 weeks. It would also be also inequitable as a gain accrued over a number of years when the owner was on a low tax rate may push them into the 46.5% rate in the year of disposal. The 50% discount on assets held for more than a year mitigates these failings and was introduced as a simplification when indexation was abolished. This seems to have been forgotten by those commentators who propose the abolition of the discount. As can be seen from the architecture paper Chart 5.9, Australia's CGT rate (after discount) is already at the top of the OECD-10. Since the compilation of Chart 5.9 the UK Finance Act 2008 has reduced that country's CGT rate to 18%.

Wealth Tax

Although in "Anglo-Saxon" countries a wealth tax is considered as the first step towards the socialist revolution, as the architecture paper points out several distinctly non-socialist European countries, including Switzerland, have a wealth tax at a non-confiscatory rate of 1-2%.

I suggest that the review panel consider the practicalities of substituting a limited wealth tax of, say, 1% on real property and financial assets, net of borrowings charged against such assets. Many critics of wealth taxes have cited the high compliance and administration costs of such taxes, but these could be minimised by excluding chattels. The principal private residence should not be exempt but the deduction of mortgage loans from the balance and a reasonable threshold of, say, $500,000 would take most Australians out of charge. For those above the threshold the exemption of chattels would remove most of the compliance burden.

Some measures might be necessary against double taxation of land, both at state and federal level. The simplest measure would be a offset for land tax already paid.

Critics might point out that the exemption of chattels would give rise to tax avoidance, but in general chattels do not produce income. There must be a limit to the extent to which taxpayers would sell income producing assets simply in order to avoid tax (although with the example of managed investment schemes in agriculture and forestry perhaps I am giving too much weight to people's rationality.)

Such a wealth tax would have none of the disadvantages of CGT listed above. In addition, it would enable interest income to be exempt from income tax. As pointed out in the architecture paper chart 8.4, the real EMTR on interest income approaches 100% even on fairly low assumptions for inflation. The experience of the 1970's suggests that the actions governments and central banks are now taking to counteract the severe contraction of credit arising from the collapse of global securitisation markets is likely to lead to inflation approaching 10% in the near future.

Complexity

The architecture review covers a number of areas of complexity in Australia's tax-transfer system: The very high number of state taxes and federal government levies, the large number of targeted means tested benefits and the complexity of the income tax law. Chapter 11 of the architecture review points out that the income tax law extends to 5,743 pages even after the removal in 2006 of 4,100 pages of "inoperative provisions". Unfortunately, knowledge of some of the "inoperative provisions" is still required in order to comply with the remaining provisions (see Appendix.) This submission only seeks to comment on the complexity of the income tax law as set out in ITAA 1936 and ITAA 1997.

It might be thought that the move to self-assessment should have been accompanied by a simplification of the tax law in order that individual taxpayers should be able to comply with their obligations quickly and easily. Instead the reverse has occurred. "Ignorance of the law is no excuse", but do the panel members seriously believe that any non-professional is able to acquire sufficient knowledge of the 5,743 pages to be confident of their compliance with the law.

It is true that the bulk of the law concerns matters unrelated to the affairs of wage earners with no investments, but many Australians do have investments. It is also true that many Australians employ tax agents to assist them in compliance but this is not a perfect answer to the problem: Many agents will not themselves be totally familiar with all sections of the acts and agents still rely on the taxpayer to bring relevant information to their attention, which is difficult for a taxpayer who is not aware of what might be relevant.

There are three main causes of the complexity:

- Rules designed for corporate entities with complex affairs also apply by default to individuals
- The desire to specify how profits should be arrived at for tax purposes independently of generally accepted accounting principles.
- An accretion of 70 years of anti-avoidance legislation

In 1936 it might have made sense to define income for both companies and individuals in the same way. However since then many things have changed, the principal being: (i) The introduction of accounting standards has made corporate financial statements a much more reliable starting point for company tax (as has been recognised in the most recent Taxation of Financial Arrangements Bill.) and (ii) the imputation system has turned company tax into a withholding tax (architecture paper page 261.)

Once it is accepted that companies and unincorporated businesses can be taxed on profits computed in accordance with accounting standards, subject to the general Part IVA anti-avoidance provisions, individuals could be taxed on a much simpler, schedular system. The income of individuals consists of wages, dividends, rents, interest and capital gains. Only rents and capital gains present significant compliance problems.

The compliance complexity of rental income relates mainly to the treatment of expenses. Many commentators have suggested that deductions from employment income could be replaced with a standard deduction. A similar approach could be adopted for rental income, as is the case in Hong Kong where a standard deduction of 20% is allowed from gross rental income.

Two factors have contributed to the accretion of anti-avoidance legislation: Once it is in place, taxpayers take steps to avoid having it applied to them. Thus the Foreign Investment Funds rules are avoided by not investing in FIFs in excess of the "balanced portfolio" exemption. This results in reduced pressure for the abolition of the provisions, since taxpayers will only suffer from them if they are ignorant of the provision (in which case they may simply be misreporting their income.) The second factor is that although many provisions are no longer required, either because Part IVA would be effective or because of the introduction of CGT, imputation and lower rates of income tax, an individual public servant would have to be quite brave to assert that they could be abolished with no impact whatsoever on revenue.

Finally, I recommend that the Commissioner of Taxation be given, and encouraged to use, the power to make extra-statutory concessions, as is the case in the UK. Such concessions would be used to ameliorate the effect of anti-avoidance provisions where no avoidance intent is present, to correct the unwanted consequences of judicial decisions (such as the recent St. George buy-back rights case which the Commissioner believed also applied to genuine rights issues) and to correct the unintended consequences of poorly drafted legislation. I understand that a similar proposal is currently under consideration by government.

I attach as an appendix some examples of complexity arising from current legislation.

Yours faithfully

Robert Kenrick

APPENDIX – EXAMPLES FROM CURRENT LEGISLATION.

The 45 day rule

The provisions of the taxes acts dealing with the 45 day holding period to qualify for dividend franking credits, s.160APHO Income Tax Assessment Act 1936, were part of the 4,100 pages of inoperative tax law repealed in 2006.

This would have been a genuine simplification of the law. It is arguable that there is no case for the provisions which act to stop arbitrage between the cum dividend and ex dividend share prices and thus deprive sellers just before the ex dividend date from getting the full return from their investment.

However s.160APHO underwent a mysterious resurrection in s.207-145(1)(a) of the 1997 Act, which refers to "a qualified person in relation to the distribution for the purposes of Division 1A of **former** Part IIIAA of the Income Tax Assessment Act 1936", of which s.160APHO forms a part.

So were the 4,100 pages repealed, or were they not? Is it legal to define who qualifies for a franking credit by reference to legislation that no longer exists? In any event, practitioners would be ill advised to discard their old copies of ITAA 1936.

ITAA 97 Division 775 - Foreign currency gains and losses

Foreign currency gains and losses can be divided into three categories: profits from a currency trading business which can be calculated and assessed according to normal accounting principles, incidental gains/losses as part of another type of business which are included in normal trading profit by retranslation of balances at the financial year end, and gains and losses on foreign currency balances held by individuals.

Some jurisdictions, such as the UK, do not attempt to tax gains and losses on foreign currency balances held by individuals, presumably on the basis that over time gains and losses will even each other out and the complexity of the calculation (realised/unrealised; matching items in a bank account or retranslation) is out of proportion to the potential revenue, if any. In Australia foreign currency balances were included in taxable assets in the CGT legislation, which gave rise to the problems just mentioned.

In the absence of an election, Division 775 requires a taxpayer to account for foreign exchange gains and losses in overseas bank accounts on a First-In, First-Out basis. At the Senate committee stage, amendments were added to allow taxpayers with less than $250,000 in foreign bank accounts to ignore gains and losses on those accounts. Another amendment allowed retranslation (the standard accounting treatment) instead of FIFO. However both elections need to be made in writing on the effective date of the election. As Australia has a high proportion of overseas born residents, it is possible that there are quite a large number who have foreign bank accounts on which no election has been made (because they are not aware of Division 775) and who are therefore in breach of their obligations under self-assessment. To add to the impression that the legislation has escaped from Alice in Wonderland, having made an election in writing, an individual does not send it to the ATO but files it.

In most overseas markets settlement is on a T+1 or T+3 basis. If a taxpayer buys a foreign share and sells it three years later, the gain/loss (reduced by the discount) is subject to CGT based on the exchange rates on the contract date, but the (usually insignificant) FX gain/loss between the contract date and the settlement date is taxed as income without discount. Because of the different treatment of the discount it is not possible to roll the three gains together and use the settlement date rate for calculating the CGT gain/loss.

The irony of this extremely complex legislation (if the panel do not believe me, I suggest that they try reading Division 775) is that it is totally unnecessary. Traders and corporate entities will calculate their FX profits according to accounting standards and can be taxed on that basis, whereas in the long run individuals are likely to average out at a zero or very small gain or loss. Over the last five years since Division 775 came into force, a taxpayer with a US dollar account would have had a deduction from their assessable income in four out of five years. This year the exchange rate has fallen (so far) back to where it was in 2003, exactly cancelling out the previous translation differences.