ACOSS proposals for personal income taxation

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The Government recently commissioned a report on international comparisons of Australia's tax system to assess priorities for tax reform. This *ACOSS Info Paper* shows that Australia is a low taxing nation. It argues that tax reform is needed, not to reduce the *overall level* of taxation, but to raise revenue more fairly by closing tax breaks which enable high income earners to pay tax at less than their marginal tax rate. It proposes that eight of these tax breaks be closed to save $8 billion in public revenue. This could be used to improve services, and ultimately to reduce rates of tax for all taxpayers.

Australia is a low taxing nation by the standards of wealthy countries with comparable government services and infrastructure:

- Australia is the eighth lowest taxing nation among the 30 OECD member nations, ahead of only Mexico, United States, Japan, Korea, Ireland, Slovak Republic and Switzerland.[1]
- A single average wage earner without children pays the same proportion of their overall income in income taxes - 24% - as a similar worker in the United States. [2]
- At 47%, our top marginal income tax rate is around the average level for the OECD nations.[3]

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[1] OECD, *Revenue Statistics.*
[2] OECD 2006, *Taxation of wages, in OECD Taxation data base.*
[3] Owens J 2005, *Tax Reform: An International Perspective*, OECD-IEF seminar on Tax Reform Trends Madrid, May 2005.

As outlined in our Budget submission last month, ACOSS believes that repairing our ailing health education and welfare services, and reducing the high child care fees facing many working families, should be a higher priority for this year's Budget than another round of tax cuts.[4] Four rounds of tax cuts have already been announced over the last six years. They include $87 per week in tax cuts that will be received by high income earners (on more than $125,000 per year) from July this year.

Tax reform is needed, not to reduce the *overall level* of taxation, but to raise tax more fairly. Currently there are a number of anomalies and breaks in the tax system which enable high income earners to have income taxed at much less than their marginal tax rate. Setting aside legitimate deductions, it is unfair that most ordinary wage and salary earners pay tax at their marginal rate while a relatively well off minority who have access to sophisticated tax advice can take advantage of tax breaks to legally avoid their obligations. In a fair income tax system without these tax breaks, all income – minus legitimate deductions - is taxed at the taxpayer's marginal tax rate, whether it comes from wages, investments, or privately owned companies or trusts.

A fair tax system in which all taxpayers actually pay tax at their marginal rate has the following advantages:

- It's fairer for ordinary wage and salary earners.
- More public revenue could be raised to improve services for everyone, even if tax rates were eventually lowered.
- The economy would operate more efficiently because biases in the tax system that favour one form of investment over another would be removed. One recent example of this problem was the inflationary effect of 'negative gearing' on house prices in recent years.

This paper identifies eight major tax breaks used by high income earners and shows how more than $8 billion in annual tax revenue would be saved by closing them (see tables 1 and 2 below). The eight tax breaks are:

1. Tax breaks for 'termination payments' (e.g. golden handshakes)
2. Sacrificing salary for company cars or child care
3. Sacrificing salary for employer superannuation contributions
4. Claiming personal expenses as work related expenses
5. Negative gearing
6. Sheltering income in a private company
7. Sheltering income in a discretionary trust
8. Splitting income with a family member

A number of similar proposals to close tax breaks was advanced in February 2006 in a discussion paper published by the Business Coalition for Tax Reform.[5] ACOSS welcomes this contribution to the tax debate.

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[4] ACOSS, *Fair choices, ACOSS Budget recommendations.* March 2006.

[5] Business Coalition for Tax Reform 2006, *Personal income tax reform – public discussion paper.* See www.bctr.org.

Table 1: Eight income tax loopholes and how to close them

Tax concession	How it works	Recommendation for change	Savings to be made with recommendation (per year)
1.) Tax breaks for 'termination payments' (e.g. golden handshakes)	High income earners leaving a job pay a maximum of 15% or 30% tax on their lump sum termination payments (e.g. 'golden handshakes'), even if the payment is not superannuation and can be spent immediately.	*Tax lump sum termination payments other than superannuation at marginal tax rates.* *Extend the special tax free threshold for redundancy payments to these other termination payments.*	$250 million[6]
2.) Sacrificing salary for company cars or child care	Fringe Benefits Tax (FBT) for company cars for employees is levied at a discounted rate. Most of the benefit of this tax break goes to high-income employees who sacrifice taxable salary for a company car. Child care provided on employer's premises is exempt from FBT, encouraging employees to sacrifice taxable salary for child care.	*Tighten the formula for calculating the value of 'car' fringe benefits.* *Remove the limited exemption from FBT for child care services provided by an employer.*	$1,200 million[7] (Some of this could be used to raise Child Care Benefit for all users of child care, as recommended in ACOSS paper, *Fair Start*).[8]

[6] Treasury's Tax Expenditure Statement (2005) estimates that these tax breaks will cost $505 million in 2006-07. Offset against this is the cost of extending the special tax free threshold.

[7] See Tax Expenditure Statement (2005). The *Review of Business Taxation's* final report (1999) made a number of proposals to tighten the statutory formula for valuation of car fringe benefits for FBT purposes.

[8] See ACOSS (2006), *Fair Start: 10-point plan for early childhood education & care.* ACOSS Info Paper No 383.

3.) Sacrificing salary for employer superannuation contributions	Employer contributions to superannuation are taxed at a flat rate of 15% instead of the marginal tax rate that would normally apply.	*Tax employer superannuation contributions along with other earnings at marginal tax rates. Introduce a tax offset (rebate) for all superannuation contributions that offsets tax on a fixed proportion of contributions up to an annual limit (e.g. 100% for contributions up to $250 per year plus 25% for additional contributions up to $6,000 per year)* This would provide more support for low and middle income earners and less for high income earners than the present system.	$2,400 million[9]
4.) Claiming personal expenses as work related expenses.	High income earners claim work related deductions for expenses that also involve personal consumption such as cars, and overseas conferences in luxury resorts. They can also claim the cost of university fees for courses relevant to their work, yet an employee in a low skilled job cannot claim the costs of study to improve their future career, because such study is not relevant to their current employment.	*Tighten the rules for these expenses by:* *- imposing flat dollar caps on claims for 'luxury' expenses such as overseas conferences* *- tightening the formulas for car expenses[10]* *- abolishing the deduction for work related education.* We do not advocate the abolition or capping of all work related expenses.[11]	$400 million[12] (Savings should be used for a training account or credit to assist adults with the costs of further education and training.)

[9] Treasury estimates the total cost of tax concessions for super contributions from employers, self employed people and spouses in 2006 is $9,533 million, of which we estimate half goes to people on the top two tax rates. The proposed changes would reduce overall tax breaks for contributions for high income earners by about half, saving $2.4 billion. This would be redirected to low and middle income earners via the proposed superannuation contributions tax offset, which would replace all other tax breaks for contributions.

[10] If business use exceeds 5,000km, car expenses can be claimed, without substantiation, by claiming one third of actual expenses, 12% of the car's original value, or by using the 'cents per kilometre' method.

[11] Such proposals would unfairly affect many low and middle income earners with legitimate work related expenses, and create a major anomalies between the tax treatment of work related expenses for employees and self employed people.

[12] Total value of work related expense claims in 2002 was $10.2 billion, reducing tax paid by approx. $3.7 billion. The self education deduction reduced tax paid by approx. $240 million. Work related expenses rose by 100% from 1993 to 2002, compared with 63% growth in taxable wages and salaries. The biggest growth areas have been cars and travel, which are claimed disproportionately by high income earners.

	Investors in property, shares, plantations and similar assets can deduct all of their investment expenses (e.g. bank interest) from their wages, at ordinary tax rates. Most of the income from such investment is capital gains, which are only taxed years later when the asset is sold, and at half the person's income tax rate.	*Only allow such investors to deduct these expenses against income from the same class of investments (e.g. rent received, capital gains or dividends), not from their wages.*	$2,400 million[13]
6.) Sheltering income in a private company	By diverting their income to a private company, high income earners can: - pay tax at the lower 30% corporate tax rate, as long as the income is 'retained' in the company - split their income with family member shareholders. Closing the gap between the corporate tax rate and top personal tax rate is not a realistic solution to this problem (see attachment)	*Tighten the 'alienation of income' rules that allow people to shelter their own earnings from tax in a private company or trust.*[14] *Reintroduce a previous rule that taxed income 'retained' in private companies at a higher rate than the company income tax rate – up to the top marginal tax rate plus Medicare Levy.*[15]	$1,300 million

[13] ACOSS calculations, based on data from Taxation Statistics for 2002/03. Rental losses claimed by taxpayers doubled from 1997 to 2002, to $4.6 billion, and would have risen strongly since then. The top 3% of taxpayers on $100,000 or more claimed 20% of rental loss deductions in 2002.

[14] Under rules introduced in 2000, workers can still shelter their earnings in private companies or trusts provided the business has its own premises, or employs other workers, or advertises and provides services to three or more clients, or is paid by results. This is a much wider set of exemptions than proposed by the Government's *Review of Business Taxation's* final report (1999).

[15] The former tax on retained earnings in private companies was legislated in Division 7 of the Income Tax Assessment Act until the late 1980s. It was designed to discourage taxpayers from taking advantage of the gap between the top personal income tax rate and the lower corporate tax rate by retaining income in companies which they controlled. It was no longer considered necessary when the top marginal tax rate and corporate tax rate were (briefly) aligned in the late 1980s. Although the gap between these tax rates opened up again a few years later, the former 'Division 7' tax on retained earnings was not restored. If introduced now, it would encourage the owners of private companies to distribute the company's income back to themselves every year as wages or dividends – which would then be taxed at their marginal tax rate.

7.) Sheltering income in a discretionary trust	Personal income diverted to discretionary trusts can still be effectively controlled by the taxpayer, yet it is no longer taxed as their income. It can be directed to any one of the trust's beneficiaries each year at the taxpayer's discretion. This makes it an ideal structure for income splitting or concealment of taxable income. Unlike the shareholders of companies or the beneficiaries of 'fixed trusts' (e.g. public unit trusts), the beneficiaries of a discretionary trust enjoy the full benefit of any tax breaks obtained by the trust (e.g. depreciation allowances for investment by the trust in real estate).	*Either:* *Tax the income of discretionary trusts more like company income (imposing a 30% tax up-front), or:* *Tax the income of discretionary trusts more like that of public 'unit trusts', by imposing Capital Gains Tax on any income passed through the trust to beneficiaries that does not attract their ordinary marginal rate of tax (e.g. due to depreciation allowances).*	$400 million[16]
8.) Splitting income with a family member	Income is diverted to a low-income family member (usually a spouse), often on the pretext that they are employed by the taxpayer's business. This is usually done though a structure such as discretionary trust, which enables the taxpayer to retain effective control over the income	*Apply a set of rules that 'attribute' this income back to the tax-payer instead of the other family member. Similar rules already apply in respect of income that is split within partnerships where partners receive a fixed share of income.*	$500 million[17]
Total Savings from implementing recommendations			$8,850 million

[16] *Review of Business Taxation* final report (1999) and ACOSS calculations. Not including cost of income splitting – see below.
[17] ACOSS calculations.

Table 2: Eight income tax loopholes – what high income earners save

Tax break	Reduction in the effective tax rate for high income earners	Typical saving for person earning over $125,000 ($ per year)
1.Tax breaks for 'termination payments'	From 47% to either 15% or 30%[18].	Data not available
2. Sacrificing salary for company cars or child care	Depends on value of car/child care.	$1,100[19]
3. Sacrificing salary for employer superannuation contributions	From 47% to 15%.	$6,000[20]
4. Work related expenses	From 47% to 0% on salary affected by deduction.	$2,220[21]
5. Negative gearing	From 47% to 0% on salary affected by deduction.	$4,900[22]
6. Sheltering income in a private company	From 47% to 30%, or another family member's tax rate	Data not available
7. Sheltering income in a discretionary trust	Variable	Data not available
8. Income splitting with a family member	From 47% to another family member's tax rate if income is split (e.g. a low-income spouse).	$3,200[23]

[18] 15% if the taxpayer is 55 years or over, 30% otherwise.

[19] In this example, an employee sacrifices $12,000 in salary for a company car costing $40,000 used mainly for private purposes and driven 25,000kms per year. FBT paid by the company is $4543. Income tax that would have been paid by the employee is $5,640. Source: *Could be time for a gear change on FBT and the company car,* The Age 3/02/06.

[20] The example here is a high income earner ($125,000) receiving 9% compulsory employer contributions plus 6% salary sacrifice contributions.

[21] Estimates based on *Taxation Statistics*, 2002-03.

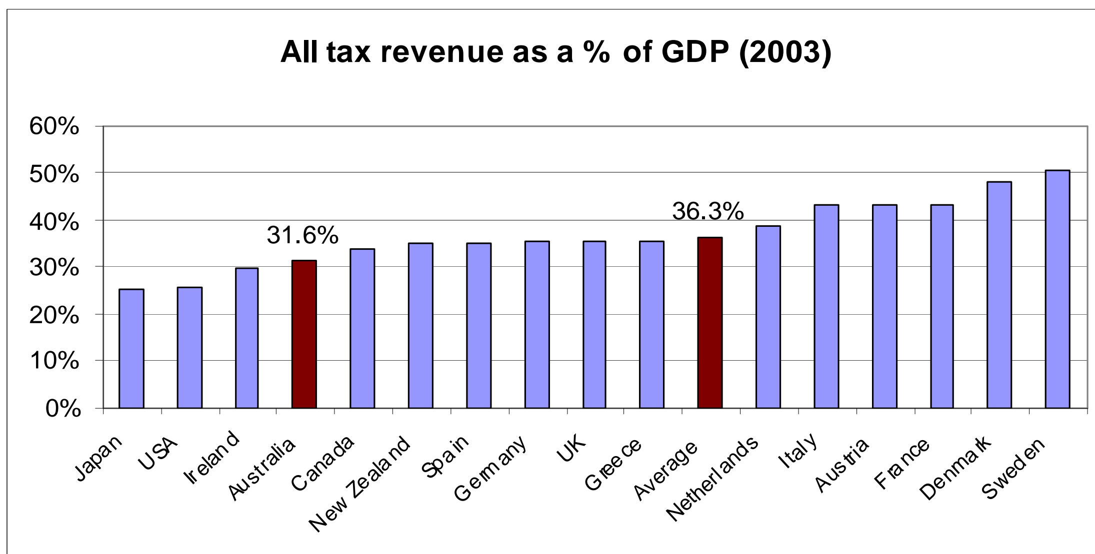
[22] Estimates based on *Taxation Statistics*, 2002-03, for rental property losses only.

[23] In this example, a self employed taxpayer earning $125,000 pays his partner $10,000 to provide secretarial services for the business, which they own jointly. He arbitrarily increases her rate of pay to $20,000 (and the business's income falls by $10,000) to take advantage of the gap between his marginal tax rate (47%) and hers (15%).

Attachment 1:

International comparisons of tax levels

Australia is the eighth lowest taxing nation among the 30 OECD countries. In 2003, tax collections by all levels of Government in Australia were 31.6% of Gross Domestic Product (GDP), compared with an average across the OECD countries of 36.3%.[24]



Australia also collects less revenue from income and social security taxes than most OECD countries: 17.5% of GDP compared with an OECD average of 22.1%. The main reason for this is that, unlike most other wealthy countries, the Australian Government does not collect social security taxes from employers and employees. Our social security system is financed from general tax revenue (see graph below).[25]

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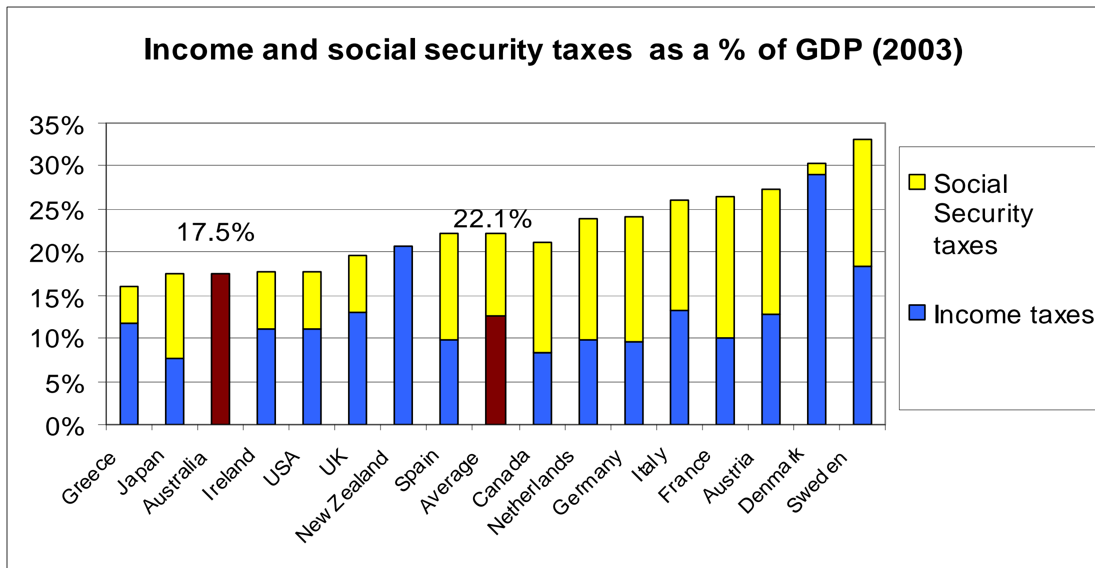
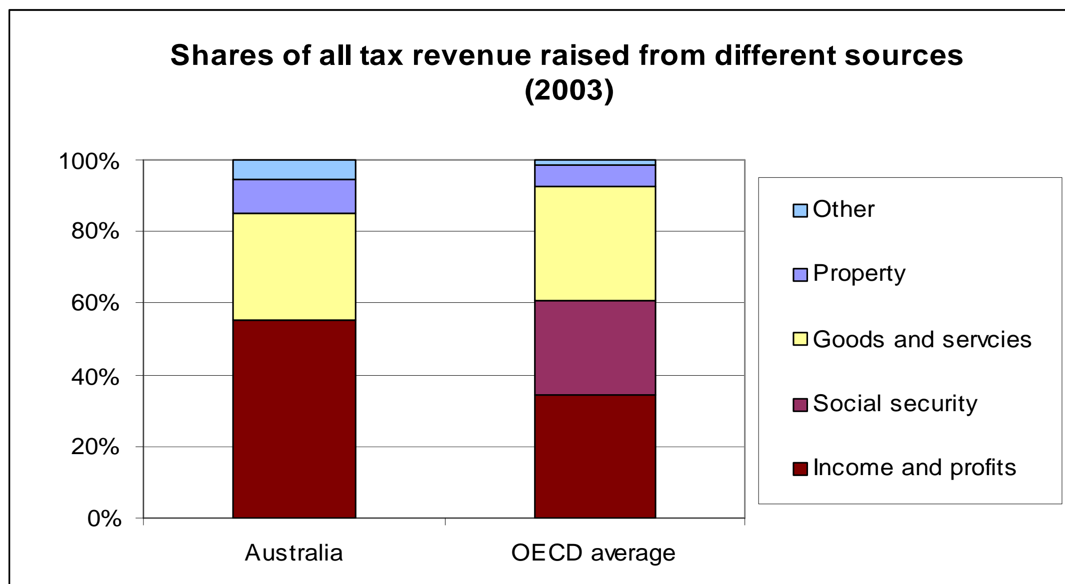
[24] *OECD Revenue Statistics*. The OECD uses the following statistical conventions to produce these estimates: social insurance levies on employers and employees are treated as taxes, and state and local government taxes are included. When these taxes are taken into account, Australia is a low taxing jurisdiction because we have no social security taxes or state income taxes. Our social security system is funded from general taxation. The OECD excludes Australia's 'superannuation guarantee' contributions by employers from these figures because, unlike overseas social insurance levies, these contributions are collected by private superannuation funds on behalf of the fund member.

[25] *OECD Revenue Statistics*.

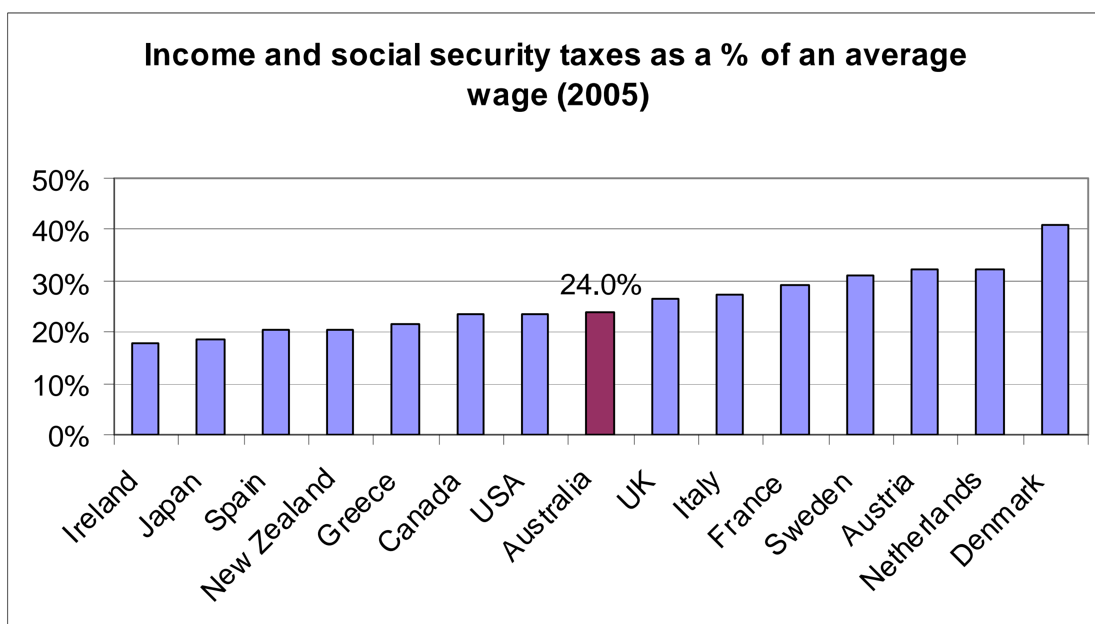


When account is taken of the social security taxes levied on employees' income in most other OECD countries, Australia does not rely relatively heavily on income taxes, as some argue. Conversely, Australia does not rely substantially less on taxes on consumption (goods and services) than the average OECD country. The graph below shows the proportion of all tax revenue collected from these and other sources in Australia, compared with the OECD average.[26]



[26] OECD, *Revenue Statistics*

A full time worker on an average wage (approximately $50,000) pays about the same proportion of their overall income in tax (24.0%) as a similar worker in the USA (23.6%). In both countries they pay less tax than in most other OECD countries (see graph below). The reason that American full time workers pay a similar proportion of their overall income in tax to those in Australia is that American workers must pay social security taxes and state and local government income taxes, as well as the federal income tax. According to the OECD, typical social security and state and local taxes in the USA account for a larger proportion of the overall income of an average full time worker in the US than the 'headline' federal income tax (5.8% state and local taxes, 7.8% social security taxes, compared with 10.0% in federal income tax). [27]



Australia's top marginal tax rate is not out of line with those applying in most OECD countries:

- At 47%, it is close to the average for OECD nations, which was 44% in 2004.
- From July 1 2006, the top rate will not apply until income exceeds $125,000 per year, comprising just 3% of Australian taxpayers.
- In 2004, the marginal tax rate facing workers on 167% of average earnings ($88,880 in Australia) was above the median (middle) level for all OECD countries. This rate was 48.5% in Australia (including Medicare Levy), compared to an OECD median rate of 41.2%. However, hhen the increase in Australia's top tax threshold is implemented from July 2006, Australia should rank close to the middle of the OECD countries on this measure, as the marginal tax rate for a worker on this level of income will then be 43.5% (including Medicare Levy).[28]

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[27] OECD 2006, *Taxation of wages* in *OECD Taxation data base*.
[28] OECD 2005, *Taxing wages*.

Attachment 2:

Never the twain shall meet? Why aligning the top personal tax rate and the corporate tax rate is not a realistic option

The top personal rate of income tax is 47% but the corporate tax rate is only 30%. Some argue that this gap must be closed by reducing the top personal rate to 30%, to stop tax avoidance. That is, taxpayers can divert their personal earnings or investment income into a private company which they control, to enjoy the benefit of the lower corporate tax rate.

Income cannot be sheltered indefinitely in a private company. As soon as the company 'pays' the taxpayer (in wages or dividends) tax is levied at the taxpayers personal income tax rate. However, owners of private companies have found ways around this problem: by retaining income in the company from one year to the next, by taking out personal loans from the company, by using the company's assets for personal consumption, and by splitting the company's income with a family member (e.g. a spouse) on a lower tax rate. Complex anti-avoidance rules have been developed to counter some of these strategies, but they don't work perfectly.

Aligning the corporate and top personal tax rates is not a realistic strategy to resolve the problem. It would cost $11 billion per year to reduce the top personal tax rate to 30%. High income earners would exclusively enjoy a large windfall gain. For example, a taxpayer on $500,000 would save over $1,000 per week in tax.

Apart from the unfairness of such a policy, it is not realistic. In 2004, only one of the 30 OECD countries has a top personal tax rate equal to its corporate tax rate: the Slovak Republic. In only two other countries, the United States and Mexico, are they closely aligned.[29] The main reason for this is that international competition to attract corporate investment is greater than competition to attract high paid workers. Even highly skilled workers are not as mobile between nations as company income and investments.

This is illustrated by the Australian experience. Australia briefly aligned its top personal and corporate tax rates in 1987. To do so, the Government increased the corporate rate as well as reducing the top personal rate. However, pressure to cut the corporate tax rate soon emerged, led by a reduction in corporate tax rate in the United States a few years later. That pressure intensified during the recession of the early 1990s. The outcome was a sharp reduction in the corporate tax rate in Australia, from 49% in 1988 to 30% today (see graph below). The two tax rates were aligned for a few years only.

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[29] Owens J 2005, *Tax Reform: An International Perspective*, OECD-IEF seminar on Tax Reform Trends Madrid, May 2005.

Rather than pursue the unattainable goal of a top tax rate equal to the corporate rate, the most practical way to close the gap is to reintroduce the system of taxation that applied to privately owned companies before the two tax rates were briefly aligned in the 1980s. Division 7 of the Taxation Act contained a provision that was designed to encourage the owners of a private company to distribute the company's profits each year to its wage earners and shareholders (generally, to themselves) rather than retain them in the company. An 'undistributed profits tax', roughly equal to the gap between the corporate rate and the top personal rate, applied to profits retained within private (not publicly listed) companies. A set of 'retention allowances' applied to exempt from the undistributed profits tax income that was necessarily retained in a private company in order to run a business.

This provision was abolished in 1988 because it was no longer considered necessary when the two tax rates were aligned. A similar provision should be introduced now to stem tax avoidance through private companies. The undistributed profits tax should be equal to the gap between the top personal tax rate plus Medicare Levy, subject to allowances for 'retentions'. This would perform a similar function to a special tax that applies to income retained within trusts, which in effect forces the trustee to distribute the trust's income to the beneficiaries each year, so that it can be brought to tax in their hands. If the owner of a private company normally pays income tax at a lower tax rate than 47%, they could arrange for the company to distribute all of its annual income to them as wage earners or shareholders, where it would be taxed at their personal tax rate.

This reform would make it uneconomical for high income earners to use private companies to shelter income from tax, unless it was distributed to other family members as shareholders. A separate reform to prevent such income splitting would be necessary to address this problem.