

Tax reform: agenda 1

PERSONAL INCOME TAX



A progressive income tax system, where people who earn more pay a greater percentage in tax, sounds great. Peter Davidson explains how it works in practice, where wealthier Australians can 'choose' to pay their tax at a lower rate.

The personal income tax system is, in theory, one of the fairest ways to raise public revenue because it reflects people's ability to pay more effectively than taxes on consumption. In particular, it does not tax those with limited spending power and it takes account of people's income from investments which is strongly skewed towards the better off.

We also have, at face value, a progressive rate scale ranging from the \$6,000 tax-free threshold and 15 per cent rate for part-time workers up to a 45 per cent rate for high income earners.

The reality is different, however. Many of those who should in theory pay tax at the top two tax rates – 37 and 45 cents – can readily avoid doing so by taking advantage of tax shelters. These include:

- the use of private trusts and companies to shelter personal income
- the 50 per cent reduction in marginal tax rates on capital gains
- excessive deductions for loss-making investments in property and shares
- salary sacrifice, for example into superannuation
- 'golden handshakes' that are taxed at much lower rates than ordinary income
- work-related deductions that are skewed towards those on the highest incomes
- poorly targeted tax breaks such as the Health Insurance Rebate.

There is a case for taxing investment income overall at lower rates than wages, in part because investment decisions are more 'footloose' and sensitive to tax than employment decisions. But the tax system is inconsistent in the way it treats different forms of investment and earnings, respectively.

If we taxed different forms of income more consistently, then not only would the system be fairer, it would also be more economically efficient because the tax system would play less of a role in people's choices about how they earn their income. It would be possible to raise the same amount of revenue (or more) using lower tax rates. Previous income tax reform packages have adopted this strategy of 'broadening the base and lowering the rates'. These have attracted public support because although a minority of people (those that currently benefit most from tax shelters) pay more tax, the majority pay less. The nation benefits from a more robust tax system that is capable of raising revenue for essential services.

Table 1 lists some of the main tax shelters and poorly targeted concessions. Their combined cost to public revenue is around \$20 billion per year, or two thirds of the federal education budget.

Effective tax rates for a high-earner (>\$180,000):

- 45% on personal earnings or bank interest
- 22.5% on capital gains
- 15% on employer super contributions
- 15-30% on golden handshakes
- 30% on income retained in a private company
- 15% on discretionary trust income split with a family member employed part-time
- Negative tax rate - on negatively geared investments

Peter Davidson is a Senior Policy Officer at the Australian Council of Social Service (ACOSS).



Table 1: Selected tax shelters and poorly targeted rebates and deductions (2009)

	How tax is avoided	Marginal tax rate for individual in 45% tax bracket	Tax revenue foregone ¹ (\$ millions)
Capital gains tax 50% discount	Income from increased value of assets such as shares and property is taxed at half normal rates	23%	\$8,600m*
Capital gains tax small business concessions	Income from increased value of small business assets is taxed at a quarter of standard rate and not at all if the proceeds of sale are used for retirement	0-11%	\$1,000m ^{2*}
Deductions for expenses for investments in shares, property and agricultural schemes	Taxpayers who borrow to invest in assets that yield capital gains can offset the interest and other costs against their wages (even though these are taxed at higher rates – see above)	Negative (taxes on their wages are reduced)	\$4,000m ³
Termination payments	Lump sum payments of up to \$140,000 on leaving a job (such as golden handshakes) are taxed at low flat rates instead of the taxpayers' marginal rate	Usually 15% (if over 55 years old) or 30% (if under 55)	\$1,500*
Private companies	A business owner or investor can use a company they control to shelter income from tax at the 30% company tax rate	30%	\$1,300m ⁴
Private trusts	A high income earner can divert their income to a trust they control, splitting their income with lower taxed family members and otherwise avoiding tax ⁵	Depends on the structure and the beneficiaries	\$1,000m ⁶
Private health insurance rebate	This 'refund' typically covers 30% of private health insurance costs up to an annual ceiling	Reimburses 30% of premium	\$4,900m ^{7*}
Total:			\$22,300m

* Source: Treasury 2009, Taxation Expenditure Statement (estimate for 2008-09).

Note: excludes superannuation and retirement tax concessions

1. Note that the revenue that could be raised by closing these tax shelters would be less than these amounts, due to behavioural change, the need to take account of special circumstances, and transitional arrangements.

2. Comprising \$560m for the 75% discount on the tax rate, \$95m for the exemption for over-55 yr olds holding assets for over 15 years, \$390m for the exemption for those using the proceeds of sale of business assets for retirement.

3. \$3,000m for rental losses, plus conservatively another \$1,000m for losses on other investments mainly yielding capital gains including shares and agricultural investment schemes. Source: ACOSS calculations using ATO 2009, Taxation Statistics.

4. ACOSS calculations using ATO 2009, Taxation Statistics.

5. Private trusts have also been used to avoid tax by concealing income within complex networks of trusts and companies, by converting other forms of income into capital gains, and by transferring losses from one individual or entity to another.

6. Based on estimate of \$500m in revenue savings (see Review of Business Taxation 1999, A Tax System Redesigned) from the taxation of private trusts as companies (in the second year of implementation of the proposed change - 2001-02) taking account of additional revenue losses from income splitting using these trusts, and the increase in income obtained from private trusts since that time.

7. Comprising \$3,875m (private health insurance rebate) + \$1,050m (income tax exemption for rebate). Sources: Portfolio Budget Statements, Tax Expenditure Statement