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Enhancing Trust in Australia's Tax System

Author: Owen Covick

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Director's Note

Welcome to the tenth issue of *Economic Issues*, a series published by the South Australian Centre for Economic Studies as part of its Corporate Membership Program. The scope of *Economic Issues* is intended to be broad, limited only to topical, applied economic issues of relevance to South Australia and Australia. Within this scope, the intention is to focus on key economic issues — public policy issues, economic trends, economic events — and present an authoritative, expert analysis which contributes to both public understanding and public debate. Papers will be published on a continuing basis, as topics present themselves and as resources allow.

The author of this paper is Association Professor Owen Covick, School of Business Economics, Flinders University, Adelaide. From February 1992 to June

Enhancing Trust in Australia's Tax System

Overview

In this Issues Paper Owen Covick argues that Australia is divided into two nations as far as personal income taxation is concerned. He explains the institutional arrangements which produce this outcome. In summary, members of families in which most income comes from supplying labour services as employees to armslength employers are subject to a much tighter "attribution" regime than are members of families in which income from family-controlled entities is the major

1. Two Nations*

Australia is divided into two nations, as far as personal income taxation is concerned. The same is true regarding income-taxation-like means testing arrangements for government outlays programmes. In one nation ("nation X") are those who are members of family units which derive the bulk of their income from one or more of the following three sources:

- supplying labour in the status of *employees*, to employers with whom they are on a truly arm's length basis;
- supplying financial capital for interest or dividends to entities with whom they are on a truly arm's length basis;
- government transfer payments.

In the other nation ("nation Y") are those who are members of family units which derive the bulk of their income from supplying labour and/or financial capital to entities over which members of those same family units are able to exercise effective control.

Note that what determines which of these two nations a particular individual belongs to involves *not* just the primary source of that individual's "own" income, but also what *family-unit* the individual effectively belongs to, and what that *family-unit* has as its primary source of income. Thus among Australia's university students who would identify to you as their principal source of income the government transfer payments that used to be called AUSTUDY some belong to

2. **How?**

How is it that what appears to be a single unitary system of income taxation for all Australians has the effect of dividing us into two nations, with each of the two facing a quite different *effective* income taxation regime from the other? To make progress on this question, it is useful to begin by noting the following four points:

- in the Australian personal income taxation system the "unit" whose income is assessed and then subjected to the defined progressive rate-scale is the individual;
- when an employer pays wage or salary income to an employee under a truly "arms length" contract of employment it is usually possible for a taxation authority in a country with an institutional framework such as Australia's to enforce (without excessive costs) a system which maintains a one-to-one nexus between the identity of the individual supplying the labour services that gave rise to the income, and that of the individual assessed for income tax purposes as having received that income;
- when an enterprise pays ("or distributes") income to more than one member of a family unit that exercises effective control over the decision-making of that enterprise, it is often very difficult for a taxation authority to enforce (without excessive cost) a requirement that there be a direct nexus between the value of the labour and/or capital funds provided by each individual family member and the identity of the family member reported for income-tax purposes as having received the income given-rise-to by that labour and/or capital; and
- when a company which is effectively owned and controlled by one individual or by one family does not fully distribute all of its company-income in dividends each year, one possible motive may simply be to defer the bringing-to-account of those retained earnings in the personal income tax returns of the individuals who are recorded as being the company's shareholders in the year those earnings first become available for distribution.

It should be stressed that it is the first three of the above four points that provide the *real* foundation for the dichotomised income taxation (and income-taxation-like means testing) arrangements facing Australians today. The fourth serves to accentuate the dichotomy. But the fact that point four could be quite easily removed from the Australian system (by re-introducing a second tier of company tax for the "excessive" retained earnings of closely-held companies, and providing the affected companies with corresponding additional dividend franking capacity) should not blind one to the fact that doing that alone would still leave us divided into two nations (albeit somewhat less far apart from one another!)

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functioning of the family unit's financial apparatus — except in cases where "spouse" or adult children start to raise queries with "head".

If the discretionary trust is not a testamentary trust, the trustee must be careful not to make distributions of net trust income to any beneficiary under the age of 18 that exceeds a defined fairly modest amount per year. Otherwise an unattractively high marginal tax rate is triggered. But this defined modest amount, and this unattractive marginal tax rate are matters that only affect the distributions of net trust income. They do not normally affect the tax treatment of any interest and/or wage income the same individual might receive from the trust. Thus a very thrifty twelve vear old who has systematically re-lent to the trust all their annual modest trust-income distributions from that trust, all their interest-income from it, all of each year's birthday present monies from mum, dad, and grandma, and perhaps even some wage income from the trust, may by that age be taking quite strong advantage of the tax-free threshold in the personal tax scale — particularly if the trust pays a good rate of interest to its creditors. And such a high-thrift twelve year old might even be totally unaware about how systematically thrifty he or she had been!

If the discretionary trust is a testamentary trust the trustee has less fine detail to worry about. A spread of distributions among the triangles in the diagram needs to be worked out for each year that takes appropriate advantage of the full normal tax-free threshold and the lower personal marginal tax-rate income bands facing each beneficiary in that year, taking account of any income from other sources that those individuals need to declare on their personal returns.¹ If the amount of net trust income to be distributed in any year exceeds the amount consistent with ensuring that no family member faces a personal marginal tax rate above 30 per cent rate, the residue above that amount can be distributed to Company B. Company B can then pay company tax at the 30 per cent rate on that money and keep the remainder as undistributed earnings. Once again all this talk of "distributions" should not be interpreted as implying that money needs to actually physically change hands. There can be immediate direct re-lending, or perhaps re-lending to other "parties" in the diagram. For example Company B might lend some of its retained earnings to one of the triangles who is a small child who then is smart enough to on-lend the money at a higher rate of interest into the family business. The higher rate of interest might well be warranted by comparing the business risk associated with the loan to the family business with the risk faced by Company B on a loan to a "natural person" with a totally unblemished credit history (and perhaps even an adult guarantor?).

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by members of their own family-units. If one were an economist (or spent too much time mixing with that ilk) one might be inclined to the view that the appropriate recipe for bringing Australia's two nations of

permitted the imputed income treatment so loved by academic economists. The same type of non-assessable/non-deductible treatment of capital gains/losses on the principal private residence can be viewed as part and parcel of this "special treatment". Australia's recently-introduced GST applies, in similar fashion, a special consumption tax treatment to the stream of owner-occupier consumption services involved in these owner-occupied dwellings cases. There appears to have been less advocacy by academic economists for imputed-GST on owner-occupied imputed rents at this stage.

This non-assessable/non-deductible treatment means that income accruing from the self-employment of owner-occupier family-members' labour and capital in the "improvement" of their principal residence (or a sequence of such residences) can often be expected to attract an income taxation treatment more "lenient" than that typically applying to middleto-high income persons in Australia's nation X — although probably not as attractive a treatment as accorded to a similar quantum of income accruing through normal family enterprise business activity to equivalent persons in nation Y. The upshot is that instead of deserting nation X entirely, some families continue to derive their principal income streams from labour services provided to arm's length employers for wages/salary, but then simultaneously devote further significant quantities of family members' labour and financial capital to "home renovation". The ex post costs-versus-benefits of this type of home renovation may frequently fail to live up to the ex ante expectations. And there is an added downside for the Australian community as a whole from this phenomenon: namely the large quantum of extremely tedious television programmes engendered, aired at what is euphemistically known as "prime time"!

4. Where do we go from here?

The existence of a rift-line between two nations of Australians when it comes to income taxation (and income-taxation-like means testing) arrangements has been noticeable since at least the late 1970s. The Hayden income tax reforms led to a stronn5.1(x)-8.52to ri(onn5.5t)0.8(m' us5Tc0.0)

problems with his proposed legislation, particularly in the Senate. What finished up coming out of the Senate was the removal of the effect of the Hayden expansion in the tax-free thresholds effect insofar as distributions from *certain types of trust* to under-18 year-olds were concerned. But

So where do we go from here? I would suggest that it is now time to give up on the approach that up until now has been that favoured by most reform-minded observers of Australia's two nations income-taxation arrangements. Most reform-minded individuals, I would suggest have tended to come from a nation X background and see the income tax world through nation X spectacles. Their perception is that nation Y people are enjoying unwarranted privileges. Reform is then equated with the removal of (or severe attenuation of) those "privileges". The idea is along the lines: "those nation Y types should be made more like us (in effective tax treatment terms)". From a distance, making the nation Y

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