Introduction

My submission to the Review of Australia's Tax System covers some aspects of personal income tax that I would like to be included in the review.

I am covering many issues affecting individual taxpayers including Capital Gains tax, the tax treatment of income from ASX listed property trusts, and several areas where I feel that small changes would make large improvements to clarity, simplicity and efficiency and bring the system up to date. Most of the changes I have suggested could be easily implemented and would be more or less revenue neutral.

For each topic I have listed the problems that I would like to see addressed and some suggested changes to the system that would reduce the complexity for taxpayers. The only major changes I am suggesting are to capital gains tax, which is my first topic, and Medicare, my last one. All other suggestions are for minor changes.

I believe that filling out a tax return for ordinary Australians earning wage or salary and investment income, ie non-business income, should be easy enough for the taxpayer to cope with without the need to use a tax agent and should take only a small amount of time to do. The short tax form and e-tax are both great steps in this direction but some further improvements could easily be made.

I have been a Tax Help Volunteer for five years and I see at first hand some of the difficulties that taxpayers have with the current tax system. I have been a share market investor for around fifteen years, I have a self-managed superannuation fund and I have written two books on personal financial management.

I am not however a tax professional or in any way an expert on taxation law, and some of my suggestions may not address the whole complexity of the problem. My priority is to highlight the problems that I see with the system and my suggestions are only ideas for a possible way forward.

Capital gains Tax

Problems with current system
The first Capital Gains Tax system introduced in 1985 involved calculations based on quarterly changes to the cpi and was needlessly complex. The new system that replaced it was probably a bit over simplistic and taxed assets held for over one year the same as assets held for ever.

The main problem that I see with both systems is that the tax is perpetual and records need to be kept indefinitely, with calculations getting more and more complex as time goes on.

CGT currently covers assets bought since 1985, now twenty three years ago, and under current rules this will extend out perpetually as years go on. For share market investments you need to keep original contract notes and, for reinvested dividends and property trusts, every dividend statement. For real property you need to keep every receipt for capital improvements, from major improvements down to buying a picture hook. For assets purchased after 1991 you can also claim some running costs on properties and records for these also need to be kept.

It is difficult for small investors to keep accurate records for this length of time. As well as space considerations for documentation there is also the likelihood of records being lost in house moves or to water damage or white ant attack in sheds.

There is provision for individuals to have their receipts verified by an accountant, but this is costly for small taxpayers and I do not see this as a solution.

The calculations can be daunting for share market investments, with reinvested dividends and tax-deferred income to be accounted. After twenty years you could have forty reinvested dividends to add up for each shareholding. While some taxpayers can use spreadsheets to track their holdings, many retirees with shares do not have computers. Keeping reams of old documents and calculating small tax liability amounts from them, covering decades, is not efficient use of people's time or storage space.

Handling capital gains tax for a deceased estate can be a nightmare. Keeping track of one's own records for several decades is hard enough, sorting out someone else's is sometimes impossible.

If the deceased has not kept excellent records it can be difficult to find the cost base of shares. It is very hard to find records of share prices back more than ten years and the original stock brokers may have long since merged or closed down. The original purchase date for the shares may even be lost, especially where shares have been rolled over in a merger or takeover. The share registries charge a very high fee to provide this sort of information.

For rental properties owned by a deceased estate, the managing agent may have some records, however estate agents tend to come and go over time and the likelihood of an agent having complete records is slim. There may be no records at all for holiday homes except the original capital cost.

Suggested changes

I would like to suggest that CGT does not apply to assets held for more than ten years for individuals and also for SMSF's as both the record keeping and the calculations can become onerous after this length of time. This would ensure that taxpayers had to keep records for a maximum of sixteen years (ie five years after the tax return following the sale of the asset) and would simplify calculations to only ten years of data.

Here is my suggestion for a new method to calculate capital gains that I think would be fair to everyone. It is more complex that the current system but quite easy to understand and far less complex than the original system. It would apply to all individuals and self-managed super funds and would automatically phase out all previous CGT calculation methods after five years.

Lorraine's new capital gains tax

Assets held for less than one year would be taxed at normal rates on the full capital gain as currently.
Assets held from one to two years would be taxed on 90% of the capital gain.
Assets held from two to three years would be taxed on 80% of the capital gain.
Assets held from three to four years would be taxed on 70% of the capital gain.
Assets held from four to five years would be taxed on 60% of the capital gain.
Assets held from five to six years would be taxed on 50% of the capital gain.
Assets held from six to seven years would be taxed on 40% of the capital gain.
Assets held from seven to eight years would be taxed on 30% of the capital gain.
Assets held from eight to nine years would be taxed on 20% of the capital gain.
Assets held from nine to ten years would be taxed on 10% of the capital gain.
Assets held for more than ten years would be CGT free

The current system would stay in place for assets bought before the implementation date, with taxpayers given a choice of either system for these assets. The current system would then naturally phase out after five years when the new system would give a lower taxable capital gain amount. From this point only the new system would be used.

Capital losses could be carried forward and would be applied as now to the pre-discounted amount of capital gain. Capital losses would expire after ten years, but could be applied so that older losses were used up before more recent ones.

Tax Treatment of Listed Property trusts

Problems with current system

Listed Property Trust income needs to be broken down into about fourteen different components and some payments are taxed in two different years. The dividend component received in August is taxed in the year it is received, but the trust income received at the same time is taxed in the previous year.

Components can be unfranked or franked dividends with attached franking credit, interest and Australian trust income, sometimes with a tax credit, foreign income of various types with attached foreign tax credits, foreign capital gains, Australian capital gains calculated in up to three ways, tax deferred income and sometimes a tax free component. Different components of a single distribution are entered in up to ten different places on the tax return. As well as this, investors have to calculate any unused foreign tax credit and carry this forward themselves.

A further complication occurs when property trusts do not distribute the concessional component of the capital gain. Small investors then never actually get the benefit of the discount as they pay tax on the whole amount of capital gain actually received. This practise also requires further calculation for SMSF income as the discount rate for CGT is different for individuals and super funds. This involves grossing up the amount received and applying the lower SMSF discount. This results in the SMSF paying tax on 'phantom' income which is never actually received and never will be, with a compensating adjustment to the tax-deferred income.

To add insult to injury, the tax statements from most property trusts are sent up to three months after the end of the financial year, leaving some investors unable to lodge their returns until October. For taxpayers who are expecting a tax refund this delays receiving it. There is also the problem that at the end of the financial year the taxpayer has only a vague idea of what the components of the distribution are likely to be and is unable to plan their other investments for the best tax outcome.

These problems also apply to unlisted managed funds which have similar distributions. Mum-and-dad and retiree investors should not have to face anything anywhere near this complex to file a tax return.

Suggested changes

Having the tax paid by the company so the shareholder receives franked income as for a Listed Investment Company (LIC) would be my first choice for a solution. The discount on capital gains would be passed on in a similar way to a LIC deduction and the tax-deferred component could be passed on in a similar way to a capital return.

However in the past, proposed changes of this nature to the tax treatment of property trusts have been resisted by some investors who like the tax-deferred component, and the flow through tax treatment, so this may not be a popular solution. I believe this is because the tax-deferred component does not count as income for government pension purposes, although in my suggestion above this would actually still be the case as the tax-deferred income would be treated as a capital return.

I do think that something needs to be done in this area and I do believe a compromise could be reached. I know that the taxation of trusts is a complex area, and an easy fix to this is far beyond my scope, but I have some suggestions to simplify the treatment of the income for small investors with only minor changes to the current system.

As a starting point it would be nice if some way could be found to treat all the income in the year it is received, so that taxpayers know exactly where they stand at the end of the year and can send in their tax return as early as possible if they are expecting a refund. There are some listed property trusts, eg Westfield Group (WDC) that manage to do this, I think this is because their tax year ends earlier. All WDC income is taxed in the year it is received with the distribution paid in August taxed the following June. Would it be possible for all listed property trusts to work on this system?

At the very least close the loophole that allows property trusts to distribute the taxable component of a discount capital gain while retaining the concessional component, as the end result of this is that small investors never actually get the benefit of the discount as they pay tax on the whole amount of capital gain received, and super funds pay tax on income not actually received.

Here are some possible changes to the treatment of the income received which would reduce the complexity.

Treat both the Australian and the foreign income component of the distribution as normal franked or unfranked dividend income and any Australian and foreign tax credit as normal franking credit at least for small shareholders. This would not have all that much effect on revenue as much of the foreign tax credit would be used up anyway by most investors.

Treat the capital gain component as normal dividend income with the discount transferred to unit holders in a similar way to an LIC tax deduction. Treat the tax deferred component as currently so it is effectively a capital return.

That would at least reduce the payments to five components which would be far more manageable for all investors and this would retain the flow through taxation status and the tax-deferred component for those addicted to it.

Capital Gains Tax on Stapled Securities

Problems with current system
The capital gain on stapled securities is calculated by splitting the security into its component company and one or more trusts, calculating the gain on each component separately using a reasonable estimate of the proportion of each, then summing the gains or losses. It also involves keeping separate track of the tax deferred income where the security has more than one trust component. This is a needlessly complex method as the result is almost always exactly the same as it would be if the security was treated in its entirety.

Suggested changes
Since the security is bought and sold as a single entity, it would seem much more logical, and would be far easier, to calculate the gain as the difference in purchase and selling price of the whole security adjusted for any tax deferred income. The current method is just a futile exercise in frivolous arithmetic.

45-day rule for franking credits

Problems with current system
This rule adds needless complexity for individual shareholders, who are extremely unlikely to be involved in offshore trading of franking credits. The current small shareholder exemption limit of $5k in franking credits is far too low, representing an annual dividend income of less than $12k. An investor with total assets of less than $200k, invested in bank shares, would have more than the allowed franking credit limit. Small investors do sometimes have valid reasons for selling parcels of shares held for less than the allowed 45 days, and some investors like to have Put options on shares in their portfolios. I do not see this as in any way 'cheating' the franking credit system.

Suggested changes
I would like to see the small investor exemption from the 45-day rule extended from $5k in franking credit to at least $25k, preferably $50k, where there is only normal purchase and sale of shares involved. A limit of $50k would cover shareholders with portfolios of up to about $2m. I would also like it to be extended to include SMSF's. This exemption would then include the majority of individual investors, self-managed super funds and self funded retirees.

Tax deductibility of Super contributions

Problems with current system
Under current rules (as I read them), an individual taxpayer who earns more than 10% of their income as an employee is not allowed to claim a deduction for their own contributions to super. This discriminates against individuals who do some work as an employee and some as self-employed, as they are unable to take advantage of the full $50k contribution limit. This can be illustrated by the following examples.

John earns $100k as an employee and can contribute $50k a year to his super as a combination of employer mandatory contributions ($9k) and salary sacrifice ($41k).

Thomas earns $100k as a self-employed contractor and can contribute $50k to his super fund and claim a tax deduction for it.

Peter earns $20k working for an employer and $80k as a self-employed contractor. The most that Peter can contribute is the mandatory super provided by the employer ($2k) and part or all of the $20k as salary sacrifice. He is not entitled to a deduction for any further personal contributions.

I see the current system as unfair to Peter.

Suggested changes
I would like to see a system where all taxpayers are allowed a tax deduction for an amount they contribute themselves that takes their total employer and personal contributions up to the $50k limit, regardless of how they are employed.

For example in the scenarios above Peter would be allowed a tax deduction for a further $28k of personal contributions, or for $48k if he does not salary sacrifice any of his $20k salary to super. John would be able to salary sacrifice say $10k and claim a deduction for a further $31k of personal contributions.

The employer would be required to put the employer contribution amount, including any salary sacrifice amount, on the payment summary. The employee would then know when they lodge their return how much they could claim of their own contribution. Most employees would have some idea from their payslips what the shortfall would be and could adjust their personal contributions to suit.

If the employee and employer contributions totalled more than the $50k, any excess would be treated as a non-deductible personal contribution and would not be claimed on the tax form. This would not be any more complex for the super funds as they currently have to calculate any contributions over the $50k limit.

The $300 tax deduction limit for which receipts are not required.

Problems with current system
Many of the taxpayers who come to Tax Help don't have receipts for their deductions but usually know the amount that they spent, so we can claim deductions up to $300. However anyone who is in a union or who pays registration fees (eg nurses, hairdressers) or fees to a professional association or institute is usually over the limit, so we are unable to claim for other items for which there is no receipt.

Suggested changes
I would like to see union and registration fees as well as membership fees for professional bodies and professional associations given a separate deduction category and excluded from the $300 non-receipt limit for work-related expenses. Vehicle expenses are already excluded.

Medicare questions M1 and M2

Problems with current system
From my experience as a Tax Help volunteer, I find that many people find these questions confusing, particularly M2, and they often have no idea why the question is even being asked. Many of the clients that come to Tax Help have filled in their form perfectly by themselves except for this question which they need help with.

The current tax return puts the burden on the taxpayer to determine whether they are in a Medicare family reduction category or whether they are liable for the surcharge.

Suggested changes
I would like to see this question changed so the ATO computer decides who is eligible for a reduction and who has to pay the surcharge. The question needs to be reworded so the tax return form only asks whether you have private hospital cover, details of cover, dates covered if not for the full year, and how many dependant children you have. As the income of the taxpayer's spouse is included on the form, this is all the ATO computer needs to know to work out both the Medicare family reduction amount and any surcharge payable.

Dependants and Separate Net Income

Problems with current system
The rules for dependant children are confusing and are not consistent across questions. Children can be dependants at one question but not at another. At the moment teenagers on youth allowance or who have some weekend employment are not dependants for some questions (eg Medicare M1) but are for others (eg medical expenses rebate). It is absolutely ludicrous to suggest that a child with an income of around $2000 is not dependant on his or her parents.

The SNI calculation for a spouse or child is outdated and over complex with the treatment of franking credit not updated when it was made refundable. This and a few other minor differences add needless complication to the calculation of SNI.

Suggested changes
I would like the definition of dependant children and students to include the higher income limit as currently for the medical expenses rebate, and to be uniform for all tax return questions. This would allow for example, single parents with teenage children receiving youth allowance to get the benefit of the family reduction on Medicare.

The calculation of the SNI for a spouse or other dependent could be simplified to be the sum of taxable income, trust income, exempt government pension income, and the taxed portion of a superannuation income stream for a spouse over 60 years of age. These amounts could be put on the tax form or entered into e-tax, then just summed. This change would then include refundable franking credits in the SNI and allow the usual deductions of charity donations and tax agents and would exclude some deductions. It would simplify the calculation with little effect on the amount of the spouse offset. The spouse offset would be calculated by the ATO from these amounts, not by the taxpayer.

Self Education expenses

Problems with current system
The calculation for this is absolutely ghastly with some or all of the first $250 of the claim excluded according to a formula that reads like rocket science to the average taxpayer.

Suggested changes
Forget the first $250 and allow the whole amount of Category A expenses including all course fees and textbooks as a deduction. This eliminates the complexity entirely. Calculate all other self-eduction deduction expenses in the same way as normal work-related expenses, there are currently some differences.

Zone Offset

Problems with current system
Calculation of a zone tax rebate for taxpayers with dependants is extremely complex, and involves historical notional tax rebates and often several different calculations. There is no problem with calculating the fixed component.

Suggested changes
This is just a suggestion for a starting point. It may disadvantage some groups – I do not have enough information on how much zone allowance is actually paid to determine this.

Allow all taxpayer the normal fixed amount for the zone. Allow a second similar amount for a dependant spouse, regardless of income, unless the spouse is claiming an offset themselves. Also allow a further amount, equal to half the fixed amount, for each dependant child or student, which can be claimed by either spouse but not both.

Education Offset

Problems with current system
Although this is a new rebate, I can foresee that many taxpayers will not have kept the receipts they need to claim this. This will become a rebate for better organised taxpayers, and less organised families will miss out. Most single parents and low income families will also miss out unless the payment is fully rebatable where it exceeds the tax owing.

Suggested changes
Either give everyone with school age children the full rebate, or roll it into the family payment system as a payment at the start of the school year when it would be most useful. Taxpayers who do not receive any Centrelink family payments would still be able to claim it on their tax return.

Pensions and other Centrelink payments

Problems with current system
The tax treatment of pension income is quite complex, with SATO and pensioner rebates making it difficult for pensioners to assess what the real rate of tax will be on their earned income. The interaction of the Centrelink payment system and the tax system can result in high marginal tax rates.

Suggested changes
I would like to suggest that pension income is not included in taxable income, ie it is exempt as the Disability Support pension currently is, and does not need to be put on the tax return form.

The seniors and pension rebates would simply be eliminated. The only disadvantaged group would be seniors with income from employment not receiving a pension. This group could receive a higher rate of the mature age workers rebate. The mature age workers rebate is currently $500 for over 55's. I would suggest extending this to $1000 for workers over 60 years of age and $2000 for workers over 65. Workers over 65 who do not receive any Govt pension could get an additional $500 rebate. These are just suggested amounts and may need adjusting so nobody was any worse off than under the current system.

I would also like to see Youth Allowance and Newstart Allowance made tax exempt as well, but this would need some calculation of the effects on revenue. These allowances are already reduced by Centrelink for any income earned, so taxing them as well can result in high marginal tax rates.

Merge Medicare with income tax

Problems with current system
While for most people the Medicare Levy is quite straightforward, for low income taxpayers it has some complications and the phase-in stage does give quite high marginal tax rates for the affected income range. The surcharge adds further complication.

Suggested changes
I would like to put forward a suggestion to incorporate the Medicare Levy with the income tax system by increasing the tax rates by 1.5% for the two lower tiers and 2% for the two upper ones. This extra half a percent for the top two rates would replace the surcharge and everyone in the top two tax brackets would pay it regardless of whether they had private hospital cover.

When the income tax amount is calculated for the taxpayer, the statement could show tax owing as the total amount with a note indicating how much of this is attributable to Medicare. This would remind people that a portion of their tax is funding health care. Medicare would be transparent to the system apart from this.

Minor adjustments to the low income offset could be made to compensate low income earners who would now be paying Medicare as part of their tax. An offset could be generated to allow for taxpayers who are currently in a Medicare exemption category and to replace the family Medicare reduction. It may be possible to eventually phase these out.

The extra half percent increase that I have suggested for the top two tax brackets regardless of health cover could be offset by increasing the health insurance rebate to 50% for everyone. The scope of the rebate would change so it only covered the basic private hospital portion of the cost plus ambulance cover, and possibly also basic ancillary cover, but definitely not the top ancillary cover. The top cover includes health fund rebates on sports equipment and gym fees. These expenses do not merit a government subsidy.

The rebate could have a fixed ceiling amount for each component based on a national average over all funds for basic hospital, ambulance and a defined level of ancillary cover.

In the current system higher income earners receive a 30% rebate up front on their health fund costs and also avoid paying the Medicare Levy Surcharge. The result is that health fund membership is seen to be effectively free for many high income earners but not for people below the surcharge income threshold.

The tax statistics tables for 2006 on the ATO website indicate that there were nearly three hundred thousand people in Australia who paid the surcharge rather than paying for health insurance. This tends to indicate that the surcharge is of limited usefulness in encouraging people into private health cover. Particularly as many of the health funds offer an option that costs only a little more than the surcharge these people are paying.

My personal belief is that private health insurance is a choice that should be made by an individual or family knowing the costs and benefits involved. Our family has chosen to have health cover, some families choose not to have it. Most funds offer a low cost cover for healthy singles, who can then decide whether it is right for them. I do not believe that people should be ‘fined’ through the tax system by a surcharge if they have a high income but choose not to take out health insurance cover, particularly as this is an undisguised attempt to save costs in the public health system and these taxpayers are already paying more Medicare levy than lower income earners anyway via the normal 1.5% levy.

I can see the problem that if you improve services provided by the public health system then less people will want private cover, but I do not think the surcharge is the answer. I feel that the lifetime cover strategy is far more successful way of encouraging people to take out health insurance while young, and the private health insurance rebate is of great benefit in making health cover more affordable for those who choose to have it. A better solution may be to have a private and public partnership with some public patients treated in private hospitals under Medicare to balance supply and demand and increase the overall efficiency of the health system.

Conclusion

I appreciate that the tax system needs to be complex because people’s affairs are complex, but because something is complex does not mean it needs to be difficult. Some of the current complexity is totally superfluous as it is due to *ad hoc* historical changes and band aid fixes that did not adequately address the underlying issues.

I do feel that improvements could be made in some or all of the areas I have covered that would make the system more up to date and streamlined, fairer and easier for salary and wage earners, and much less complex for mum-and-dad and retiree investors.

I would like to thank the Australian Government for giving the people of Australia the opportunity to submit their ideas to the review of taxation.

Lorraine Graham B.Sc.

Tax Help Volunteer

Working Your Money Wrightbooks 2000
Fast Track Your Mortgage Allen and Unwin 2002