Simple Tax is Better Tax

Submission to Re:think – Better tax system, better Australia

By Lorraine May 2015

Executive Summary

The current tax system is needlessly complex. To some degree tax needs to be complex because people's financial affairs can be complex, however much of the current complexity is due to *ad hoc* historical changes and band aid fixes that did not adequately address the underlying issues.

Things could easily be improved without needing a rewrite of the whole tax system. Some of the major issues with income tax are

- The very high marginal tax rates faced by some pensioners that discourages both employment and saving for this group.

- The self-education deduction is needlessly complex to calculate and subsidises education for high income earners but not for low or nil income earners trying to gain job skills.

- There is a cap amount available for concessional super contributions, but not all taxpayers can take advantage of it as the amount they can contribute themselves depends whether they are employed or self-employed. Small changes to the rules would allow everyone to contribute up to their allowed amount if they wish to.

- The Medicare levy has had a lot of changes to make it do things it was never originally intended to do, such as encouraging higher income earners to take out health insurance. The phase in of the Medicare levy results in high marginal tax rates, and the surcharge causes needless complexity. It would be possible to enormously simplify the tax system just by integrating the Medicare levy with the tax rates.

- A flat tax rate would make every aspect of tax far simpler, but this would need to be implemented without disadvantaging anyone. I have put forward a way this could be done leaving everyone slightly better off. I have shown that it would in fact be a feasible alternative to the complex tax brackets and Medicare rates that we have now and could well be revenue neutral.

- I have covered tax on superannuation, capital gains tax, negative gearing and the forty-five day rule for share dividends in separate submissions, so I will not include them here although they all need some improvement.

Taxing Pensioners

The problem

Pensioners can face very high effective marginal tax rates on income earned from both employment and savings.

For every dollar earned above the allowed threshold, they are losing 50c in pension and are paying an effective tax rate of up to 41.5% on the remaining 50c.

This high rate is a combination of tax at 19%, the phase in of the Medicare levy at 10%, and loss of the senior tax offset which reduces at 12.5% for each dollar over the threshold. This is a total of 41.5%.

The net effect of this is that some pensioners lose 70.75c for each dollar they earn up until the Medicare levy has completely phased in and 66.75c for each dollar thereafter.

There is little incentive to take on part time work if you are unlikely to earn any meaningful amount of extra income. The system is so complex that some pensioners would have no idea how to work out how much they would benefit by taking on some part time employment.

The solution

If we make the pension amount tax free, then pensioners could earn up to the usual $18,200 before they became liable for tax. At least then they would only have the 50c loss in pension to take into consideration if they were earning only a small amount. The SATO would be eliminated. The marginal tax rate above the threshold amount would still be high, but that could be improved by changes to the Medicare levy that I have outlined below.

Self Education

The problem

The calculation for the self-education expenses deduction is needlessly complex. It also gives a greater benefit to high income earners than low income earners and no benefit at all to those who are studying to enter the workforce rather than already being employed.

The solution

We could eliminate the requirement to reduce the amount claimed by $250. This would get rid of most of the complexity in one go. There would be no calculation needed to reduce the $250 by other non-claimable expenses.

The deduction could be replaced by a tax offset of 30% of the costs incurred, so everyone received the same benefit regardless of their income. This would encourage low income earners to improve their work skills.

The offset could be applied to any vocational course that improved people's work skills regardless of whether it was relevant to their current employment.

This would encourage everyone to participate in courses that would improve their work skills in areas outside of their normal employment and this in turn would increase the flexibility of our workforce and lead to lower unemployment.

Tax deductibility of Super contributions

The problem

Under current rules 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 $35,000 contribution limit ($30,000 if they are below fifty). This can be illustrated by the following examples.

John earns $100,000 as an employee and can contribute $35,000 a year to his super as a combination of employer mandatory contributions ($9,500) and salary sacrifice ($25,500).

Thomas earns $100,000 as a self-employed contractor and can contribute $35,000 to his super fund and claim an income tax deduction for it.

Peter earns $15,000 working for an employer and $85,000 as a self-employed contractor. The most that Peter can contribute is the mandatory super provided by the employer ($1,425) and part or all of the $15,000 as salary sacrifice. He is not entitled to a deduction for any further personal contributions as he earns more than 10% of his income from employment.

The current system is 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 limit for their age, regardless of how they are employed.

For example in the scenarios above Peter would be allowed a tax deduction for a further $18,575 of personal contributions, as well as his mandatory super and salary sacrifice. John would be able to contribute the $25,500 himself and claim a tax deduction for it instead of salary sacrificing the amount through his employer.

Most employees would have some idea from their payslips what has been contributed for them and could adjust their personal contributions to make up the allowed amount.

Integrating Medicare

The problem

Medicare has become far too complex. The phase in stage results in very high marginal tax rates for those affected by it.

The Medicare levy reduction depends on family income, number of children and whether the children are actually dependents or have some youth allowance or other income.

The Medicare levy surcharge is complex, depending on numbers of days covered by private hospital cover, the number of children, the income of the taxpayer’s partner, any amount salary sacrificed and any deductions for rental or other investment losses.

The Medicare levy surcharge is also used to encourage higher income earners to take out private health insurance and thus be exempt from the extra tax.

The Medicare levy is not paid at all by some groups, most notably non-residents.

The Medicare levy is not covered by some tax offsets, notably the offset available to those with super paid form an untaxed source. While their rebate covers the income tax they owe it does not offset their Medicare levy liability even where the unused rebate exceeds that liability.

The solution

We could integrate Medicare into the tax rates by adding a small amount to each tax bracket. This would need to be slightly higher than the 2% to make up the shortfall that results from Medicare applying from the first dollar earned, but income tax applying only above a threshold. It would need to be higher for the top tax brackets as some of those taxpayers also pay the surcharge and we would need to cover this extra amount.

The decrease in complexity would far outweigh any inequality this may cause.

The Medicare levy phase in would be eliminated thus removing the current very high marginal tax rate at the phase in.

We would still want to encourage high income earners to take out private health insurance and I would suggest a flat refundable tax rebate of $1,000 would apply to anyone with private hospital insurance. This would totally cover the cost of basic hospital insurance for most singles and encourage them to take it up. It would replace the current health insurance rebate and could be deducted by the fund when the insurance cost was paid.

Adding back investment losses and salary sacrifice super would no longer be required for either surcharge calculations or for calculating the health insurance rebate. Most taxpayers would no longer need to put their partner's income on their tax return.

Flat tax

The problem with a flat rate of tax is that those on higher incomes would pay less tax and as we would not want those on lower incomes to pay more, it could never by itself be revenue neutral. The difference would need to be made up somehow.

There would be significant benefits, however, and some of the difference would be made up from people having more incentive to work longer hours and less incentive to minimise their tax, so there would be more income declared and therefore more tax collected.

Lining up the top tax rate with the company tax rate would mean all individual and business income was taxed at the same rate and some tax minimisation schemes would no longer be relevant.

A flat rate of 30% so that personal income tax was the same as the company tax rate would be ideal, with a tax free threshold to ensure that lower income taxpayers paid no more than at present. Those worst affected would be taxpayers with income of around $37,000, the point where the tax rate of 21% increases to 34.5% including the Medicare levy.

To ensure that no low income earner paid more tax than at present we would need to set the tax free threshold to $25,000. All taxpayers would pay 30% tax on every dollar earned above this amount. This rate would include Medicare levy which would no longer be a separate charge.

Those earning under $25,000 would save up to $1,222 in tax, however this group should really not be paying tax anyway as $25,000 is a very low income.

The minimum reduction in tax would be $82 for those earning $37,000. All other tax payers would be better off by more than this amount.

If we assume the average income is around $60,000 with a potential tax saving of $1,347 and we have 7 million taxpayers, then the cost to revenue would be around $9.5bn. However this is only a rough estimate.

But suppose we treat the $25,000 tax free threshold as an offset of the $7,500 tax that would normally be owing on this amount. This offset could then phase out at 5% for incomes between $50,000 and $200,000. Under this scenario the tax saved at $60,000 reduces to $847 and the cost estimate reduces to around $6bn.

However this does have the disadvantage that this income bracket would actually be paying 35c for every dollar earned, rather than 30c.

In practice the cost to revenue of this tax system would be lower than this as a lower tax rate would encourage people to work longer hours and there would be less incentive to minimise tax. These effects could well make the system revenue neutral with no other adjustments.

Here is a table of how the old and the new tax systems would compare.

The first two columns are the taxable income and the tax including Medicare levy (but not surcharge) under the current system.

The third column gives the tax that would be payable if all income over the $25,000 threshold was taxed at 30%.

The fourth column is the same 30% rate but now the tax offset of $7,500 reduces by $50 for every thousand dollars earned in excess of $50,000.

The fifth and sixth columns are the tax saved at each income level for each of these scenarios. The minimum amount of tax saved is $82 for an income of $37,000 which falls between the increments shown on the table.

This does illustrate however, that flat tax at 30% would be a feasible alternative to the complex tax brackets and Medicare rates that we have now.

Income	Tax current	Tax at 30%	With Offset	Tax Saved	Tax saved with offset
20000	0	0	0	0	0
25000	1222	0	0	1222	1222
30000	2247	1500	1500	747	747
35000	3272	3000	3000	272	272
40000	4747	4500	4500	247	247
45000	6522	6000	6000	522	522
50000	8297	7500	7500	797	797
55000	10072	9000	9250	1072	822
60000	11847	10500	11000	1347	847
65000	13622	12000	12750	1622	872
70000	15347	13500	14500	1847	847
75000	17047	15000	16250	2047	797
80000	18747	16500	18000	2247	747
85000	20672	18000	19750	2672	922
90000	22597	19500	21500	3097	1097
95000	24522	21000	23250	3522	1272
100000	26447	22500	25000	3947	1447
105000	28372	24000	26750	4372	1622
110000	30297	25500	28500	4797	1797
115000	32222	27000	30250	5222	1972
120000	34147	28500	32000	5647	2147
125000	36072	30000	33750	6072	2322
130000	37997	31500	35500	6497	2497
135000	39922	33000	37250	6922	2672
140000	41847	34500	39000	7347	2847
145000	43772	36000	40750	7772	3022
150000	45697	37500	42500	8197	3197
155000	47622	39000	44250	8622	3372
160000	49547	40500	46000	9047	3547
165000	51472	42000	47750	9472	3722
170000	53397	43500	49500	9897	3897
175000	55322	45000	51250	10322	4072
180000	57247	46500	53000	10747	4247
185000	59572	48000	54750	11572	4822
190000	61897	49500	56500	12397	5397
195000	64222	51000	58250	13222	5972
200000	66547	52500	60000	14047	6547
205000	68872	54000	61500	14872	7372

In Summary – Lorraine's Tax Reform Wish List

Finally here is a summary of the changes I would like to see to the current tax system. These have been covered either here or in the previous submissions I have sent to the review.

- Superannuation has become a tax haven for the very wealthy who enjoy tax free pension mode income that can be millions of dollars a year. I covered this in my submission titled *Better Pensions, Better Super, Better Australia*. Even if you do not like my solution, at least do something to fix this problem, so we do not end up with an unsustainable situation where no-one over sixty pays any income tax except on employment income.

- Capital Gains tax should be eliminated for assets held for a very long time. The record keeping burden on taxpayers who bought assets thirty years ago outweighs the benefit of the tax levied. Under the current system these records would need to be kept forever as inherited assets keep their original cost base. I covered this in a previous submission *Capital Gains Tax Turns Thirty*, suggesting that the tax is extinguished after at most twenty-five years but preferably ten.

- The forty-five day rule affects franking credit on share dividends was introduced to stop trading of franking credits with offshore investors. Anyone with franking credit greater than $5,000 and all SMSF's are affected by the rule. Forty-five days is too long and the $5,000 limit is too low. The forty-five days could be reduced to fourteen days for small investors or the limit increased to $25,000. This would apply to both individuals and SMSF's. I covered this in *Forty-five Days is Too Long.*

- Changes could be made to negative gearing and rental income in general so landlords become a constructive part of ownership of housing infrastructure and are no longer considered demons whose only interest is to reduce their tax. I looked at this in *Negative Gearing Redeemed*.

- Pensioners can face very high effective marginal tax rates on income earned from both employment and savings. For every dollar earned above the allowed threshold, they are losing 50c in pension and are paying an effective tax rate of up to 41.5% on the remaining 50c. This needs to be addressed so pensioners are encouraged to remain in part time employment if they wish to.

- The self-education deduction is needlessly complex to calculate and subsidises education for high income earners at a higher rate than low income or nil income earners trying to gain job skills. Eliminate the complex calculation by including the first $250 in the allowable deduction. Also change this deduction to a 30% tax offset and apply it to all vocational study whether relevant to the person's current employment or not.

- There is a cap amount available for concessional super contributions, but not all taxpayers can take advantage of it as the amount they can contribute themselves depends whether they are employed or self-employed. Small changes to the rules would allow everyone to contribute up to their allowed amount if they wish to.

- The Medicare levy has had a lot of changes to make it do things it was never originally intended to do, such as encouraging higher income earners to take out health insurance. The phase in of the Medicare levy results in high marginal tax rates, and the surcharge causes needless complexity. It would be easy to simplify income tax by integrating the Medicare levy with the normal tax rates and using a different way to encourage take up of private health insurance.

- A flat tax rate would make every aspect of tax far simpler. I have put forward a way it could be done and shown that it would be a feasible alternative to the complex tax brackets and Medicare rates that we have now. It may even be revenue neutral with no other adjustments.