

# Topic 1: Introduction

## Key Concept – Assessable Income and Allowable Deductions

Note: In this course we mainly look at federal taxes (rather than state).

\*\*\*In summary, we will be concerned with the following relationships:

- Tax payable = (Taxable income x Tax rate) – Tax offsets; and
- Taxable income = Assessable income – Allowable deductions

Note: Taxable income is in the tax payable equation. Thus, the end goal is to calculate the tax payable.

## Introduction – What is tax?

A tax is a financial charge or other levy imposed on an individual or a legal entity (companies). Note that partnerships and trusts are not 'separate legal entities', and as such in this course we focus on individuals and companies.

Taxes consist of direct tax or indirect tax, and typically are paid in money.

\*Tax – A "pecuniary burden laid upon individuals or property to support the government... a payment exacted by legislative authority". That is, tax is not voluntary, but rather a contribution enforced by regulation.

Tax collection is performed by a government agency. In Australia, the Australian Taxation Office (ATO) is responsible for this task.

When taxes are not fully paid, civil penalties (such as fines or forfeiture) or criminal penalties (such as incarceration) may be imposed on the non-paying entity or individual.

## Purpose and Effects of Taxation

The funds received through taxation are used for many purposes. These include enforcement of law and public order, protection of property, economic infrastructure (roads, legal tender, enforcement of contracts, etc.), public works, social engineering, and the operation of government itself. Most modern governments including Australia also use taxes to fund welfare and public services. These services can include education systems, health care systems, pensions for the elderly, unemployment benefits, and public transportation. Energy, water and waste management systems are also common public utilities.

\*In essence, funds received tax go towards providing social goods and improving society.

## The 4 Qualities

\*\*There are 4 qualities that a tax should aspire to be:

1. Fairness
2. Simplicity
3. Certainty
4. Efficiency

Note: It can be argued that despite taxes aspiring to meet these qualities, they do not actually achieve any of them effectively.

## Fairness

A taxation system should be fair and equitable amongst its citizens. If it is perceived not to be fair this may lead to distrust and tax avoidance.

\*It is important that there is both 'vertical' and 'horizontal' equity:

- *Horizontal Equity* - This means that those people that are in a similar position should be treated equally. Therefore, those with the same income should in fact pay the same tax. It also means that all business entities should be taxed in a similar manner (all companies are charged 30% tax). Whilst this seems to be fair, it only focuses on income earned and fails to consider other factors such as the number of children they need to support, the extent of their HECS debt etc. The government tries to overcome these other factors through concessions and other such initiative, however it demonstrates that whilst people earn the same income, taxing them at the same rates isn't always perfectly fair.
- *Vertical Equity* - This requires persons that are in different financial positions be treated differently. That is, a higher income recipient pays more tax than a lower income recipient. Usually it implies some progression in tax such that the higher-income recipient pays relatively or proportionally higher tax (as we have in Australia).

\*Effectively, in order for fairness to be met, people who are in a similar position need to be treated the same (horizontal equity), and those who are in different financial positions should be treated differently (vertical equity – those better off get taxed more).

In Australia we see progressive tax as bringing about fairness (more you earn, higher proportion of tax you pay – vertical equity).

## Simplicity

The simplicity of a tax, and an overall taxation system, is determined by:

- The ease in which a taxpayer may comply with the Act; and
- The authorities' ability to administer the Act and collect tax.

\*That is, how simple it is depends on whether the taxpayer knows what they have to do to comply with the act and therefore obey the law, and the authorities need to be able to enforce the act and collect tax.

\*\*Despite the goal of simplicity, our Tax Acts have a problem with size and complexity. There are also 2 acts (ITAA97 and ITAA36) which makes things even more confusing.

In relation to size, The ITAA36 and ITAA 1997 rank amongst the largest examples of taxation legislation in the world. The first real step in reducing the size of the ITAA36 and ITAA 1997 was effected by the enactment of Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (Cth). This was in response to the Board of Taxation's identification of over 2,100 pages of inoperative tax provisions, and so many were repealed.

In relation to complexity, the ITAA's have provisions in the Act where their meaning is obscure. For example, the capital gains provisions have further been criticized by the judiciary for their obscurity (*FCT v Cooling*).

One of the key reasons for the size and complexity was that the ITAA 1997 was supposed to replace the ITAA36 as it is so old. However, the new act only changed a bit of the ITAA36 and didn't cover it all, meaning much of the old ITAA36 act is still in operation. This means we have 2 acts (we use the 97 if it has been re-written, otherwise we need to use 36), which can cause a great deal of confusion. Also, sometimes the ITAA36 refers you to the ITAA97 and vice versa.

Note: To separate the 2 acts to know which one we are dealing with; the 97 Act uses a dash to separate it (e.g. s 4-6). The 36 Act uses a full stop type thing (e.g. s4.6).

### Certainty

There are 4 forms of certainty:

- certainty of incidence;
- certainty of liability;
- evasion ratio; and
- fiscal marksmanship

Certainty of incidence - \*Pertains to the ability of taxation authorities to predict who will actually bear the tax burden. It is submitted that, particularly where a taxation system is used for social engineering, introducing a new tax may have unintended effects, such as discouraging a form of trading or encouraging tax avoidance. These unintended changes may dramatically alter the intended incidence of tax amongst the community. Changes may also be positive – the Carbon Tax may promote increased use of alternate energy (solar power etc.).

Certainty of liability – Is adjudged by \*how easily taxpayers may determine their liability and how accurate that determination will be. I.e. Under the self-assessment regime of our Income Tax Acts, ITAA36 and ITAA97, the easier it is for taxpayers to calculate exactly what they are liable for – makes for certainty of liability. \*Unfortunately, given that there are over 125 different taxes this is not really apparent in Australia. It is apparent that this form of certainty is closely connected with the goal of simplicity.

Evasion Ratio - This ratio looks at \*the extent of tax avoidance and tax evasion and the authorities' ability to combat these problems so that the incidence of tax will lie where it was intended. It is therefore closely linked to certainty of incidence.

Fiscal marksmanship - Relates to the \*certainty by which the authorities may predict the amount of tax that will be collected in a particular year. It depends on the number of taxpayers and of course the mix of tax payers. Remembering that companies pay tax at a fixed rate of 30%, whilst individual taxpayers follow a progressive scheme.

### Efficiency

Generally, to be efficient, a taxation system must be:

- Administratively efficient; and
- Neutral.

Administrative efficiency - Taxes should not skew resource allocation across the economy. \*The costs of administering and complying with the Tax Acts should also be minimised.

Neutrality - Neutrality requires that \*a taxation system should not influence individual and business decision making in the market place.