AUSTRALIAN INCOME TAX SYSTEM

- Goals in designing tax system:
  - **Fairness**
    - Horizontal equity: Tax Payers (**TPs**) in like situations should be treated alike.
    - Vertical equity: TPs in different positions should pay different amounts of tax (this is a step above horizontal equity because some TPs not only have to pay more, but at higher rates).
  - **Efficiency**
    - Taxes should not influence individual choices.
    - Relevant terms:
      - Elasticity: The degree to which individuals, consumers or producers change their demand or the amount supplied in response to price or income changes.
      - Deadweight loss: A loss of economic efficiency caused by an inefficient allocation of resources.
      - Incidence v burden: The person handing money to the Australian Taxation Office (**ATO**) isn't necessarily the person being hurt. E.g. incidence falls on company, and burden falls on employee.
  - **Simplicity**
    - Taxes should be collected with minimum costs whether of administration by government or of compliance by TPs.

ALTERNATIVE TAX BASES

- Options for Tax Base (**TB**) (basis upon which government determines how much each TP must pay):
  - **Income**
    - 1. Haig-Simons 'comprehensive income tax base': Income = Consumption + Change in Wealth
    - 2. Schedular system
      - Income is divided into categories and each category is taxed separately.
      - UK system is schedular in origin, whereas Australia's system is apparently comprehensive in its drafting but not necessarily in operation.
      - Reasoning in UK: prevent tax officials knowing the full extent of TP's income.
  - **Consumption**
    - Are generally levied as indirect taxes on businesses which are passed on to consumers, e.g. GST.
    - Problematic in terms of vertical equity because usually have a flat rate and don't tax saving.
    - Relieve pressures in terms of complexity, avoidance, evasion, and political acceptance.
  - **Wealth**
    - Most countries have this as their TB, but not Canada and Australia. Political events led to the demise of gift and estate taxes in 1982.
  - **Head tax**
    - A uniform tax imposed upon every person in a specific group.
- Australia uses a mix of the above, with the main TB being income. However, our income tax is used to fund programs paid for by social security levies overseas (which Australia doesn't have).

WELFARE ECONOMICS AND TAX POLICY

THEOREMS OF WELFARE ECONOMICS AND TAXES

- 2 theorems explain why taxes and government are needed:
  - 1. Under certain conditions, competitive markets lead to an allocation of resources. There is no change in the allocation that can make someone better off without making someone else worse off (**Pareto Efficiency**).
  - 2. Such possibility can be attained by a competitive economy, provided we begin with a particular distribution of resources among individuals. By taking resources from an individual and giving them to another, it is still possible to have a Pareto efficient outcome.
- Hence, the role of government can be limited to setting lump sum taxes on individuals, to achieve the socially desired distribution of income (first best solution to the tax problem).
  - Note: *Lump sum tax is a tax that doesn't distort competitive prices by making one kind of good relatively more or less expensive than another. Individuals whose income falls will reduce some purchases, and*

individuals whose income rises will increase them, but the outcome is still Pareto efficient. This is because there are changes in behaviour, but only of an income effect.

- Contrast this with differential taxes which distort prices:
    - o E.g. tax on one kind of good but not other goods.
        - ▪ This produces both an income and substitution effect. I.e. the individual buyer buys less taxed goods and more untaxed goods (compare lump sum tax, where individual buys less goods in total but doesn't change the mix of goods purchased).
    - o Result: the efficiency loss is referred to as a deadweight loss (difference between amount of tax that an equivalent lump sum tax would produce and the lesser amount that the differential tax produces).

OPTIMAL TAXATION

- Ramsey Taxes
    - o Ramsey observed that commodities with low elasticity of demand have lower deadweight loss and thus should face higher tax rates. Problem: poor bear a larger burden than rich. Thus, approach dismissed.
    - o However, it was later accepted in 1970s because new models extended Ramsey's original analysis to include redistributive goals.
- Optimal point is where the marginal social gain from the government giving an extra dollar to an individual is just equal to the marginal social loss caused by raising an additional dollar of tax revenue.

TAX RATES

- **Tax Rates 2015-16**. Note: *the below rates don't include the:*
    - o *Medicare levy of 2%; and*
    - o *Temporary Budget Repair Levy, payable at a rate of 2% for taxable income over $180,000.*

Taxable Income	Tax on this income
$0 - $18,200	Nil
$18,201 - $37,000	19c for each $1 over $18,200
$37,001 - $80,000	$3,572 plus 32.5c for each $1 over $37,000
$80,001 - $180,000	$17,547 plus 37c for each $1 over $80,000
$180,001 and over	$54,547 plus 45c for each $1 over $180,000

- **Tax Rates 2016-17**
    - o Government has announced that from 1/7/16, for individual TPs, the marginal tax rate of 37% starts at $87,000 instead of the previous $80,000.
    - o Note: *the below rates don't include:*
        - ▪ *Medicare levy of 2%; and*
        - ▪ *Temporary Budget Repair Levy, payable at a rate of 2% for taxable income over $180,000.*

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$87,001 - $180,000	$19,822 plus 37c for each $1 over $80,000
$180,001 and over	$54,232 plus 45c for each $1 over $180,000

CONCEPTS OF INCOME

STRUCTURE OF THE AUSTRALIAN INCOME TAX LAW

- **Income Tax** = (Taxable Income * Rate) – Tax Offsets (Div 13) (*ITAA 1997* s 4-10(3))
- **Taxable Income** = Assessable Income (Div 6) – Deductions (Div 8) (s 4-15)
- Income categories:
  - Ordinary income (i.e. income according to judicially developed concepts): s 6-5. Categories:
    - Income from services;
    - Income from property; and
    - Income from business.
  - Statutory income: s 6-10
  - Not assessable income: s 6-15
  - Exempt income: s 6-20 [Note: *exempt TPs: Div 50*]
  - Non-assessable non-exempt income (NANE income): s 6-23
    - Carry-forward tax losses are reduced by exempt income but not by NANE income (Div 36).

PARSONS' PROPOSITIONS

- Propositions dealing with **when and how much income** is derived:
  - 1. An item of an income character is derived when it has 'come home' to the TP. The presence of illegality, immorality or ultra vires does not preclude derivation.
  - 2. An item of an income character that has been derived will be income in the amount of its realizable value.
  - 3. The character of an item as income must be judged in the circumstances (*circs*) of its derivation by the TP, and without regard to the character it would have had if it had been derived by another person.
- Propositions dealing with **who** derives income:
  - 4. To have the character of income an item must be a gain by the TP who derived it.
  - 5. There is no gain unless an item is derived by the TP beneficially.
  - 6. There is no gain if an item is derived by the TP from himself (principle of mutuality).
- Propositions defining the **concept of income** according to ordinary concepts:
  - 7. There is no gain if an item is derived by the TP as a contribution to capital.
  - 8. A gain which is a mere gift does not have the character of income.
  - 9. A mere windfall gain does not have the character of income.
  - 10. A capital gain does not have the character of income.
  - 11. A gain which is one of a number derived periodically has the character of income.
  - 12. A gain derived from property has the character of income.
  - 13. A gain which is a reward for services rendered or to be rendered has the character of income.
  - 14. A gain which arises from an act done in carrying on a business, or from the carrying out of an isolated business venture, has the character of income.
  - 15. A gain which is compensation for an item that would have had the character of income had it been derived, or for an item that has the character of a cost of deriving income, has itself the character of income.
- **Income as a Flow (Parsons' Proposition (*PP*) 1 and 5)**
  - There must be a realisation event; a gain is not sufficient (*Abbott v Philbin*).
- **Income as a Gain (PP 4)**
  - *Hochtrasser v Mayes*
    - Facts: Employer reimbursed employee for loss on sale of house incurred due to job transfer.
    - Held: No gain – didn't involve profit. Also no provision of service – more like a gift.
- **No Gain Without Beneficial Entitlement (PP 5)**
  - *The Countess of Bective*
    - Facts: TP received trust distribution to be used for maintenance and education of child.
    - Held: Not income – flow, but no gain. To be a gain, amount must be derived beneficially.
  - *Zobory* (1995):
    - Held: An embezzler is not taxable on interest earned on amounts embezzled because it is subject to a trust in favour of the true owner of the money.
  - *Howard* [2014]: