BUSINESS TAXATION

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1 Introduction to Australia's Tax System

Australia's Taxation System

OVERVIEW OF THE AUSTRALIAN TAX SYSTEM

Overview

- Federal income tax introduced in Australia in 1915
- **S 51 of the Constitution** allows federal government to pass laws in respect of taxation however taxation is a concurrent power where both State and Federal governments can tax
- **Commonwealth tax** (administered by the ATO): income tax (direct tax), GST (indirect tax)
- **State taxes** (administered by the Office of State Revenue in each state): stamp duty, land tax and payroll tax (indirect tax)

Source of tax law

- **Statute law/legislation**
  - **Income Tax Assessment Act 1936 (Cth) ("ITAA36")**
  - **Income Tax Assessment Act 1997 (Cth) ("1997")**
  - **Income Tax Rates Act 1986 (Cth)**
  - **Fringe Benefits Tax Assessment Act 1986 (Cth) ("FBTAA")**
  - **A New Tax System (Goods and Services Tax) Act 1999 (Cth) ("GST Act")**
  - **Taxation Administration Act 1953 (Cth) ("TAA")**
- **Case law:** decisions of courts and interpretations of legislation
- **ATO rulings**—these are only **binding on the ATO** (not on the taxpayer)
  - Informal source of "law" and ATO's interpretation of the law
  - Different types of rulings: public/private
  - Some ATO material **not** binding on the ATO: practice statements, decision impact statements and taxpayer alerts

JURISDICTIONAL ISSUES

Who must pay income tax and when?	• Income tax is payable by **each individual and company** (and other entities) regardless of residency status: **ITAA97 s 4-1**
	  ○ Individuals—no joint/family filing in Australia
	  ○ Other entities: e.g. trusts
	• The tax or financial year is 1 July to 30 June each year: **ITAA97 s 5-5**

Residency	• Core provisions **s 6-5 and s 6-10** provide common jurisdictional limits to Australia's claim to tax—Australian residents are liable on worldwide income and foreign resident liability is limited to Australian source income
	• Australia's tax **jurisdiction is based on resident and source**—common limitation
	  ○ When Australian resident derives income from a foreign source and the income is taxed in that country—that income is exempt under **ITAA36 s 23AH** and taxpayer receives a FITO
	• **Changing residency:** where taxpayers cease to be Australian residents, assets constituting taxable Australian real property remain within Australia's jurisdiction and other assets experience CGT Event I1 (deemed market value disposal): **ITAA97 s 88-15**
	• **Residents:** taxed on worldwide income (subject to exceptions)
	  ○ Assessed on their ordinary and statutory income from all sources
	  ○ Subject to Medicare levy/Medicare levy surcharge
	• **Non-residents:** taxed on Australian source income (subject to exceptions)
	  ○ Assessed on their ordinary and statutory income from Australian sources
	  ○ Individual residents not subject to Medicare levy/Medicare levy surcharge
	• Different tax rates apply to residents and non-residents and residency for tax purposes is **NOT** same as citizenship/permanent residency for immigration purpose
	
	Definition of "resident" from ITAA36:

2 Income and Tax Accounting

Income

INCOME OVERVIEW	

• **Competing concepts of income:**
  ○ **Accounting**: REVENUE – EXPENSES = PROFIT
  ○ **Economic**: INCOME = CONSUMPTION + SAVINGS (change in wealth)
  ○ **Judicial**: INCOME = “what comes in”—distinguishes from income (flow) and gain (profit)
• Income tax purposes: **ASSESSABLE INCOME = ORDINARY INCOME + STATUTORY INCOME**
 	
Types of Income under ITAA97
• **Ordinary income:** income according to ordinary concepts; no statutory definition: **ITAA97 s 6-5**
• **Statutory income:** specifically specified in legislation: **ITAA97 s 6-10**
• **Exempt income:** not assessable; exempted via legislative provisions: **ITAA97 s 6-20**
• **Non-assessable non exempt income:** provision of the legislation states an amount is non-assessable non-exempt: **ITAA97 s 6-23**
More than one provision may include an amount in your assessable income, but income is only included **ONCE** with statutory provisions prevailing over normal income provisions	

ORDINARY INCOME	
Ordinary income	• As **no statutory definition**—propositions have been developed from past cases with unique factual scenarios • **Negative propositions:** amounts that are NOT ordinary income • **Positive propositions:** characteristics of ordinary income
Negative propositions	Amounts that are **NOT** ordinary income: 1. **Amounts not convertible into money** are not ordinary income 2. **Capital amounts** do not have the character of income 3. **Gifts** unrelated to employer, services of business do not have the character of income 4. The proceeds of **gambling and windfall gain** are not income 5. **Mutual receipts** are not income
Positive propositions	Amounts that **ARE** ordinary income: 6. To be an income—amount must be **beneficially derived** 7. Income is to be judged from the **character it has in the hands of the recipient** 8. Income generally exhibits **recurrence, regularity and periodicity** 9. Amounts derived from **employment** of the provisions of services are income 10. Amounts derived from **carrying on a business** are income 11. Amounts derived from **property** are income 12. Amounts received as **substitutes or compensation for lost income** are themselves income
NEGATIVE PROPOSITION: CAPITAL AMOUNTS DO NOT HAVE THE CHARACTER OF INCOME	

Capital amounts do not have the character of income	• Ordinary income **does not include amounts of capital** which can only be assessed through statutory provisions such as CGT
	• Similarly, **cannot deduct capital amounts** under general deduction provision but need to use specific deduction provisions
	• What is capital?
	  ○ Different approaches have been derived from cases and they are not mutually exclusive
	  ○ **Process/structure –** Dixon J in *Sun Newspapers I*
	  ○ **Mere realisation –** *California Copper Syndicate*
	  ○ Nature of **consideration** given for receipt
	  ○ **Fixed vs circulating** capital

Process/structure approach from *Sun Newspapers*	Dixon J’s Process/Structure Distinction 1. **Character of the advantage sought:** lasting qualities can play a part 2. **Manner in which it is used, relied upon and enjoyed:** recurrence

	• *California Copper Products (in liq) v FCT (1934):* cancellation resulting in **termination of taxpayer's business**—compensation is **capital** • *Kensall Parsons & Co v IRC:* cancelled contract is one of many and a **minor part of taxpayer's business**—compensation is **income** • Compensation or damages received for any wrong or injury are excluded from CGT: **ITAA97 s 118-37**
Compensation for injury	• **Person's income-earning capacity** corresponds to a business entity's structure and is **capital in nature** • *Tinkler v FCT (1979):* compensation for **permanent impairment** is **capital** • *FCT v Smith (1981):* compensation for **loss of earnings** is **income** • Compensation for **personal injury is excluded from the CGT** provisions

POSITIVE PROPOSITION: AMOUNT MUST BE BENEFICIALLY DERIVED

- **Has the taxpayer beneficially derived the income? Is there a right of use and enjoyment?**
  - E.g. unrealised gains are not income
- To be income an amount must have **"come in"** in the sense that it is **beneficially derived** (right to use and enjoy)
  - Precisely when income is derived depends generally on the **application of legal and commercial rules**—courts sometimes recognise **cash basis** and sometimes **accrual basis**
  - Taxpayer who merely has a **right to income has no beneficial derivation of income—** therefore, **unrealised gains are not income**
  - *Warner Music Traders v FCT (1996):* income is not confined to "that which comes in" but **includes accrual basis** as well as **gains represented by reduced liabilities**
- *Constable v FCT (1952):* employer's contribution to superannuation funds are not income to the employee and are **instead taxed in the superannuation fund**

POSITIVE PROPOSITION: CHARACTERISATION IN THE HANDS OF THE RECIPIENT

- *FCT v McNeil (2007):* whether a particular receipt has the character of the derivation of income depends upon its **quality in the hands of the recipient, not the character of the expenditure**
  - In this case—payment made to shareholder under share buy-back arrangement arose out of capital restricting—that did not determine its character
- *Federal Coke Co v FCT (1977):*
  - Commissioner treated payments as assessable income of Federal Coke
  - Per Bowen CJ: "**what is the nature of the receipt in the hands of Federal Coke**? It appears to me to be wrong to ask—what would have been the character of the amounts had they been received by Bellambi?"
  - **Characterisation in the hands of Federal Coke was windfall gain**
    - Federal Coke had **no claim or entitlement to the two instalments** it received from Le Nickel at the instigation of Bellambi.
    - It does not follow that a gift of what would have been income in the hands of Bellambi must necessarily be income in the hands of Federal Coke—Le Nickel executed the 1972 deed notwithstanding there had never been privity of contract between it and Federal Coke—and it was not obliged to pay Federal anything
  - **Tax cannot be avoided by directing that money to be paid to a third party**—in Federal Coke the supply agreement was between Bellambi/Le Nickel and the compensation was beneficially if not in fact derived by Bellambi. **The parent directing payment to be made to a subsidiary cannot change the constructive derivation by the parent**
- **Constructive receipt under ITAA97 s 6-5(4)**
  - "In working out whether you have derived an amount of ordinary income, and (if so) when you derived it, you are taken to have received the amount as soon as it is applied or dealt with in any way on your behalf or as you direct"

POSITIVE PROPOSITION: INCOME GENERALLY EXHIBITS RECURRENCE, REGULARITY AND PERIODICITY

- Income generally will be a **series of recurring or periodic payments** e.g. wages, interest, dividends
  - Certain regular payments may not be income and **one-off payments can be income**

	• *Just v FCT (1949):* periodicity was a dominant consideration where consideration for the sale of property (ordinarily capital even if periodically paid) **was held to be income because regular payments were made for an uncertain period** (indeterminate amount)
POSITIVE PROPOSITION: SUBSTITUTES OR COMPENSATION FOR LOST INCOME ARE THEMSELVES INCOME	
Contract cancellation	• *Heavy Minerals Pty Ltd v FCT (1966):* compensation for cancellation of business contract will be **substitute for income** if the **profit-making structure** is **left intact** • *California Copper Products (in liq) v FCT (1934):* compensation for cancellation of business contract was **capital** as it resulted in **termination of taxpayer's business** • *Liftronic v FCT (1996):* payment for loss of profits rather than destruction of goodwill or earning capacity
Injury/termination of employment	• *Tinkler v FCT (1979):* compensation due to **motor accident**—payments **substitute for loss of income** • *Allman v FCT (1998):* **wrongful dismissal**—payment **substitute for income** that would have been earned
Unliquidated damages	• Some difficulties arise where a **composite of income and capital is paid—lump sums are usually dissected** where the elements can be identified and quantified • Where **unliquidated damages** (loss that is certain by nature but cannot be calculated exactly) are paid in **respect of several claims**—courts have **not been prepared to apportion** • *McLaurin v FCT (1961)/Allsop v FCT (1965):* undissected damages consisting of both a **"capital" component and an "income"** component were treated as **capital** ○ In *McLaurin* the Court held that apportionment could be appropriate where settlement is for distinct claims—at least some of which are liquidated (in that case the lump sum was not assessable)
POSITIVE PROPOSTION: AMOUNTS DERIVED FROM EMPLOIYMENT OR PROVISION OF SERVICES ARE INCOME	
General	• Amounts received in connection with **employment or provision of services will be ordinary income** e.g. salary, wages • Voluntary payments received by employee may also be ordinary income given the reason for the payment **however "mere gifts" are not income** *FCT v Dixon (1952):* **voluntary payments by employer** whilst employee was a solider during WWII to make up the difference between former and army salary assessable as it was **incidental to employment, expected periodical payment and taxpayer relied on the payment.** • *Dixon* case remains important authority for independent tests or indicia for ordinary income (**payment is periodic, expected and used to cover ordinary expenses and made in substitution for lost income**) even where the receipt **does not have a direct nexus** with the source such as employment ○ Where the receipt has all these circumstances—the amount is ordinary income • **If it happened today:** the payments would be assessable ordinary income under **ITAA97 s 6-5(1**) as a periodic or compensation receipt • Argument that the **payment is a fringe benefit**—fringe benefits are all benefits **apart from salary and wages** and include amounts that are cash or convertible into cash (i.e. ordinary income)—if it is a fringe benefit, then the **liability falls on the employer not the employee** • Clear that if in reality a **payment is income**—it does not matter **who** pays it • **Difficulty in characterising amounts paid voluntarily**—need to establish whether circumstances of particular case is/isn't income (wedding present v tip to a waiter)

3 Capital Gains Tax

CAPITAL GAINS TAX

- **CGT is not a separate tax**—assessable income includes net capital gain: **ITAA97 s 100-10, s 102-5**
    - Net capital gains are forms of **statutory income** → CGT is required because **"capital" cannot be ordinary income**
    - CGT was introduced in Australia on **21 September 1985**

Key CGT Concepts

- CGT event
- CGT asset
- Capital proceeds
- Cost base/reduced cost base
- Capital gain/capital loss
- CGT discount
- Exemptions

DETERMINING WHETHER THERE HAS BEEN A CGT GAIN OR LOSS

Basic approach

1. Did a CGT event happen in the year?
    a. **NO** → no capital gain or loss
2. Does an exemption apply?
    a. **YES** → disregard or reduce a capital gain or loss from the event
3. Do the capital proceed exceed the cost base?
    a. **YES** → the excess is your capital gain from the event
4. Does the reduced cost base exceed the capital proceeds?
    a. **YES** → the excess is your capital loss from the event

CGT EVENTS

Did the CGT event happen during the income year?

- Can only make a capital gain or loss if a CGT event occurs: **ITAA97 s 100-20**

List of CGT events

- **Summary list of CGT events: ITAA97 s 104-5**
- **Where two or more CGT events apply: ITAA97 s 102-25**
    - Use the event **"most specific to your situation"** (except **D1 or H2**): **ITAA97 s 102-25(1)**
- Where **D1/H2** apply—apply **D1** first, if not applicable, apply **H2** first: **ITAA97 s 102-25(3)**

CGT Events

Related situation	Contains	Related situation	Contains
Disposal of assets	A1; Div 104-A	Leases	F1-F5, Div 104-F
Use and enjoyment of assets before title passes	B1, Div 104-B	Shares	G1, G3, Div 104-G
End of CGT assets	C1-C3, Div 104-C	Special capital receipts	H1-H2, Div 104-H
Creation of CGT assets	D1-D4, Div 104-D	End of Australian residency	I1-I2, Div 104-I
Trusts	E1-E9, Div 104-E	Other CGT events	K1-K12, Div 104-K
Consolidated groups	L1-L8, Div 104-L		

Relevant CGT events

- **CGT Event A1—ITAA97 s 104-10(1):** disposal of a CGT asset to another person
- **CGT Event C1—ITAA97 s 104-20(2):** loss or destruction of a CGT asset
- **CGT Event C2—ITAA97 s 104-25:** cancellation, surrender or similar endings of intangible CGT asset
- **CGT Event D1—ITAA97 s 104-35:** creating contractual or other rights
- **CGT Event H1—ITAA97 s 104-150:** forfeiture of deposit

CGT Event A1

- **CGT Event A1** occurs if you **dispose** of a CGT asset: **ITAA97 s 104-1(1)**

	• You dispose of a CGT asset if a **change of ownership** occurs from you to another entity—whether because of some act or event or by operation of law: **ITAA97 s 104-10(2)** • The **time of the event** is: **ITAA97 s 104-10(3)** (a) When you **enter into the contract** for the disposal OR (b) If there is no contract—when the **change of ownership occurs** • Operation of **ITAA97 s 104-10(4)** o **Capital gain:** capital proceeds > cost base (capital proceeds — cost base) o **Capital loss:** capital proceeds < reduced cost base (asset's reduced cost base — capital proceeds) • **Example:** sale of shares (if passive investor) or sale of house/land o In June 2010 Kylie enters into a contract to sell land and the contract is settled in October. Kylie makes a $50,000 capital gain which is assessed in the 2009-10 income year (not 2010-11)
CGT Event C1	• **CGT Event C1** occurs if a CGT asset you own is **lost or destroyed**: **ITAA97 s 104-20(1)** • The **time of the event** is: **ITAA97 s 104-20(2)** (a) When you first **receive compensation** for the loss or destruction OR **(b)** If there is no compensation—when is **loss is discovered or destruction occurred** • Operation of **ITAA97 s 104-20(3)** o **Capital gain:** capital proceeds from the loss/destruction > asset's cost base o **Capital loss:** capital proceeds from loss/destruction < asset's reduced cost base • **Example**: o Ezri owns a factory that burns down—she has insurance which compensates her for the loss. **CGT Event C1** happens when the factory is destroyed and the "time of the event" is when she receives payment • If there was no insurance, then the time of the event should be when she discovered the factory had burnt down
CGT Event C2	• **CGT Event C2** occurs where taxpayer's **ownership of an intangible asset ends** by the asset being: **ITAA97 s 104-25(1)** o Redeemed or cancelled o Released, discharged or satisfied o Expiring o Abandoned, surrendered or forfeited o Exercised (if option); OR o Converted (if convertible interest) • **Time of the event:** when the taxpayer enters into the contract that results in the asset ending or if there is no contract, when the asset ends: **ITAA97 s 104-25(2)** • Operation of **ITAA97 s 104-25(3)** o **Capital gain:** capital proceeds > cost base o **Capital loss:** capital proceeds < reduced cost base • **Example:** o Scotty enters a contract with Starfleet to be the exclusive supplier of their transportation for next 10 years and Starfleet terminates the agreement 5 years later. Scotty is paid $5,000 in compensation for early termination o **CGT event C2** happens as Scotty's intangible asset i.e. his rights under the agreement have come to an end o Capital gain is $5,000 less any costs associated e.g. legal fees
CGT Event D1	• **CGT Event D1** arises if a **contractual right or some other legal or equitable right is created in another entity** (restrictive covenants): **ITAA97 s 104-35(1)**

5 Taxation of Companies and Shareholders

WHAT IS A COMPANY?

- *Salomon v Salomon & Co Ltd (1897)*:
  - **Companies are separate legal entities distinct from members/shareholders**
  - May enter into contracts, sue and be sued, own property and continue as the same entity despite changes in ownership
  - Liability of shareholders limited to amount if unpaid on their shares
- **ITAA97 s 995-1 definition of "person"** includes a company → **companies are taxpayers**
- **ITAA97 s 995-1 definition of "company"** includes a body corporate or any other unincorporated associate or body of persons but **EXCLUDES partnership and non-entity joint ventures**
  - Includes bodies incorporated under the *Corporations Act 2001* and unincorporated non-profit associations and clubs

SHOULD COMPANIES BE TAXED?

- Companies are separate legal entities and therefore separate tax entities taxed on taxable income → **"legal fiction" as the "real" taxpayers are the shareholders who are taxed when they receive a dividend**
- **Why tax companies?**
  - If a company is not taxed and **shareholders not taxed until income is distributed**—company **could defer tax indefinitely by retaining income**
  - Taxing both the company and shareholder on the **same profits (classical system) results in double taxation**
- **Types of corporate tax systems**
  - **Classical system:** company subject to tax and shareholders also taxed at marginal rate on dividend
  - **Full integration:** no tax is paid at the company level but net income of company included in assessable income of shareholders on the basis of proportionate shareholders
  - **Dividend exemption system:** company pays tax and dividend is exempt from tax for shareholders
  - **Dividend deduction system:** company pays tax but receives deductions for dividends paid to shareholders who are taxed at their marginal rate
  - **Shareholder relief systems:** credit provided for shareholder by gross-up the dividend by tax assumed to have been paid—occurs whether or not company tax has been paid
  - **Dividend imputation systems**

Example: classical system v dividend imputation system

- **Classical system:** profits are taxed once at the company level and again at the shareholder level
- **Dividend imputations system:** the company pays tax on profits and the dividend received by the shareholder is "grossed-up" up by amount of the tax already paid. The shareholder is then taxed on this "grossed-up" amount at their marginal rate before receiving a credit for the "gross-up" (reflecting the amount of tax actually paid)

	Classical	**Dividend Imputation**
Taxable income of the company	$100	$100
Tax rate @ 30%	($30)	$30
Distribution to shareholder	$70	$70
Gross-up	0	$30
Tax rate @ 47% (highest rate + Medicare levy)	(32.90) (70*47%)	($47) (100*47%)
Less gross-up credit	0	$30
Total tax	$62.70	$47
Tax paid by shareholder	$32.90	$17
Effective tax rate	62.9%	47%

CLASSIFICATION OF INTERESTS IN COMPANIES: DEBT AND EQUITY

- The ordinary routes whereby distributions are included in assessable income are:
  - **ITAA36 s 6(1) defines "dividend"** as any **distribution made by a company to any of its shareholders, whether in money or other property**
  - **ITAA36 s 44(1)** which determines when a dividend is assessable income of shareholder

10 Essay Question Notes

Australia's Tax Mix and Good Tax Design

What is a tax?

- Oxford dictionary definition— "compulsory contribution to the support of government, levied on persons, property, income, commodities and transactions."
  - Taxpayers are compelled by law to pay taxes and are obliged to do even in circumstances where they may not necessarily derive direct benefits in return
- Alternative names: duties, levies, tariffs or charges

Why do governments impose tax?

- The overall purpose of taxation is to raise revenue to provide either social or merit goods
- Social goods: joint (non-rival) consumption and non-excludability
- Merit goods: beneficial to the user, positive externalities (benefits of others) e.g. health & education

Brief History of Australia's Tax System

- **Tax base**
  - At its inception the federal income tax was modelled on the income tax already applying in the States and the US—applying to all forms of income
  - The concept of ordinary income developed both on the form of payment and whether the income could be traced to a source such as labour, business or property → distinct from capital
- **CGT**
  - Prior to 1985 Australia had not CGT—mostly excluded from income tax base
  - 1985 based on equity grounds it was argued that "because real capital gains represent an increase in purchasing power similar to real increases in wages, salaries, interest or dividends they should be included in any comprehensive definition of income"
  - Argument for CGT to improve economic efficiency and reduce tax avoidance—lack of CGT distorted investment towards assets providing returns in the form of capital gain rather than income streams and incentive to convert income into capital gains
    - Lack of CGT created incentives for companies to retain profits resulting in less efficient investment choices from economy wide perspective
  - CGT introduced in 1985 applied to realised gains and losses on assets acquired after 19 September 1985 whilst exempting classes of assets like main-residence
  - 1999—introduction of discount introduced to promote more efficient asset management and improve capital mobility by reducing tax bias towards asset retention; make CGT internationally competitive
- **FBT**
  - Fringe benefits—indirect, non-cash benefits provided to employees
  - Growing trend of remunerating employees with non-cash benefits (especially those on higher incomes)—explicit taxation of fringe benefits introduced in 1986
  - Levied on employers rather than employees to simply compliance and administration—taxed at top personal rate

GOOD TAX CRITERIA

- Derived from Adam Smith's seminal work *An Inquiry into the Nature and Causes of the Wealth of the Nations*
  1. Proportionality/equity
  2. Transparency/certainty
  3. Convenience; and
  4. Efficiency
- Ken Henry's 2010 Tax Review expanded these criteria:
  1. Economic efficient: tax system is neutral in the economy impact
  2. Equity: the burden of taxation should be clearly distributed
  3. Simplicity, certainty and transparency: tax administration and tax compliance should not be onerous—tax legislation and tax liabilities should be certain and easily determined
  4. Sustainability and revenue adequacy: the principal objective of the tax system is to raise revenue and the design of sustainability encompasses environmental, institutional and revenue sustainability

Summary of the good tax design criteria:

- Taxes are notoriously difficult to design with conflicting economic and policy objectives needing to be balanced which often results in a complex and unwieldy taxation framework that distorts taxpayer behaviour. (Bird)
- Derived from Adam Smith's seminal work—the guiding principles for good tax design are often taken to be efficiency, equity and simplicity.
- Given that most taxes create deadweight losses, the taxation system should raise and redistribute revenue at the least possible cost to economic efficiency.
- Taxes on highly mobile factors of production such as labour are distortionary as they stifle productive behaviour—for example, income tax reduces the taxpayer's incentive to earn income and as it is highly mobile, they are able to adjust their behaviour to avoid or minimise their tax payable. (Bird)
- On the other hand, as land is immobile—tax on the unimproved value of land is unavoidable and is neutral to the taxpayer's decision on how to utilise the land. (Bentley)
- Next, where taxes are levied with the objective to redistribute wealth—tax incidence or burden should seek to achieve both horizontal equity where taxpayers in similar financial circumstances pay the same tax and vertical equity where taxpayers who earn more pay higher tax. (Hodgson)
- Finally, to make it easy for ordinary taxpayers to understand and comply with their obligations and entitlements the tax regime must be transparent, straightforward and inexpensive to administer. (Henry Review)
- Presently, 90% of Australian tax revenue is raised from 20 out of 125 different taxes that are levied by both the Commonwealth and State governments—this is the result of adopting a compartmentalised and incremental approach to tax policy and reform inclined towards fine tuning equity objectives at the expense of efficiency and simplicity. In response, the Henry Review has proposed sustainability as the fourth tax design criteria which requires the structural features of the tax system to be durable and adaptable particularly in light of Australia's ageing population. (Henry Review)

Equity and distributive justice: Hodgson article

- Tax and transfer system is one of the tool available to governments to regulate inequities
- Fairness is subjective assessment based on morals and ethics—equity is a fundamental consideration in the development or review of tax policy
- Taxation system is used by government as a tool to improve welfare of society through economic programs or direct redistribution
- Equity = fairness based on the access or distribution of resources necessary for welfare
- A welfare system contemplates redistribution of resources amongst citizens, generally based on need

Trade-offs:

- The tax and transfer system involve trade-offs and tension between equity, efficiency, simplicity, policy consistency and sustainability
- "A holistic review of taxes that aims to achieve the principles of equity, efficiency, simplicity, sustainability and policy consistency is a worthy exercise—the history of tax reform in Australia has shown that it is difficult, if not impossible to satisfy all of these criteria simultaneous" (Wilson-Rogers and Pinto)

Economic rent (Gittins)

- Economic rent is seen as an efficient tax base as it is income on capital derived simply from ownership absent any applied labour—given the supply of land is immobile and scarce, it cannot be distorted by taxpayers supplying less of the tax base in order to avoid paying tax
- Economic rent is the amount paid for any factor of production—land, labour or capital—in excess of the amount it needs to be paid to keep it in present use (opportunity cocst)
- Economic rent are those payments to a factor of production that are in excess of the minimum payment required to have it supplied—income on capital whether in the form of rent, interest, dividends provided that such income is simply remuneration for ownership of the asset independent of any labour

Income tax	• Replacing the 37% bracket with a flat tax rate of 32.5% for earnings between $40K-$200K would create a fairer tax structure and discourage people from

Deductions

NEGATIVE GEARING AND WORK-RELATED DEDUCTIONS

• Government considering a universal cap on income tax deductions that would apply to negative gearing as well as employment related expenses such as self-education, transport, union fees and work-related clothing
• Abolish specific caps on expenses and replace them with an overall ceiling limiting total deductions to a proportion of income → ceiling is $50,000 in the UK or 25% of income; "upper limit—if you set the ceiling high enough, 90% of the population could be unaffected while the big claims would be knocked back"
• Australia's 55 highest earners paid no income tax in 2012-13—Australia is unusual in imposing no total ceiling to the amount of deductions that can be claimed meaning come claims exceed 100% of income; $1M and managed to write their taxable incomes down to $18,200
    ○ Most Australians only claim small deductions, Australians with multiple negatively geared properties are able to claim large proportions of income
    ○ An area of abuse
    ○ Harsher rules apply to many other countries; US imposes a minimum tax rate below which deductions could not reduce tax, Canada only allows legislated deductions and NZ doesn't allow work-related deductions; UK limits deductions more tightly—rental losses can only be offset against other rental income
• Work-related expenses were 19.8 billion in 2012-13 and rental interest deductions were $22.5 billion → UK approach by applying global limit of deductions including work, health, negative gearing, cost of managing tax affairs and donations → would only really impact 0.9% of landlords and 1.3% of those incurring a rental loss

Taxation of Companies & Shareholders

DIVIDEND IMPUTATION SYSTEM	

Advantages and disadvantages	**Advantages**
	• When compared to other systems of corporate tax integration—imputation systems are attractive for the government
	• Ensure that income which flows through company to shareholder is taxed only at shareholder's marginal rate
	• Not biased towards either domestic debt or equity financing
	• Compared with dividend deduction and full integration systems—imputation facilitates greater level of source taxation on income that passes through a company to non-resident investor
	    ○ Dividend imputation countries in the absence of DTAs deny a non-resident shareholder the benefit of franking credits
	    ○ Franking credit denied to shareholder = doesn't infringe non-discrimination article in the OECD Model Tax Conventions
	    ○ When a dividend paid to non-resident is wholly funded from fully taxed corporate income—it will have borne source-country tax at the corporate rate
	    ○ In Australia no WHT is payable where a dividend paid to non-resident shareholder is wholly funded from fully taxed corporate profits
	• Imputation systems shareholders are given franking credits for domestic but not foreign tax paid—domestic companies encouraged to invest in domestic economy rather than offshore
	
	Disadvantages
	• Relative complexity when compared with other systems of corporate tax integration—root cause of complexity is the difference that exists between taxable income of company and distributable profits
	• Decline in international popularity—unusual for them unilaterally to give imputation credits to non-resident shareholders

- Imputation system dont allow payments of foreign tax to generate imputation credits for resident companies—bias against investment by residents in resident companies with taxed foreign income
    - Seen by governments as an advantage due to globalisation of world economy
    - In Europe these features of imputation have led several countries to abandon them on the basis that they may infringe obligations under the EU
- Henry Review: recognised that the increasing globalisation of the Australian economy raised questions about the appropriateness of the current company income tax and imputation systems
    - While existing structure should be maintained for short-medium term—in the longer term business level expenditure taxes could suit Australia

Historical trend--Australia

- Until 1987—Australian maintained a classical company taxation system under which profits were taxed at the company and personal rates
- 1987—introduction of dividend imputation system where resident shareholders receive a credit for tax paid at the company level; elimination of double taxation
    - Where taxpayer's marginal rate is below the company rate, the excess credit can be used to offset tax payable on other income (e.g. wages)
    - Full refundability of excess tax credits for most resident shareholders was introduced in 2000
- Under the imputation system, Australia's company tax system operates as a withholding tax on the income that Australian residents each through Australian resident companies and as a final tax on (mostly Australian source) income earned by non-residents through an Australian resident company or permanent establishment

International trend away from imputation

- Australia and New Zealand are now the only two OECD countries to operate dividend imputations systems
    - Abandonment of imputation system: UK (1999), Germany (2001), Finland (2005), Norway (2006) (partially to do with EU legal issues) but Asian countries Singapore (2003) and Malaysia (2008)
- Notwithstanding the move away from imputation—there has been no clear trend to reduce or remove shareholder level tax relief

	Dividend received by resident from domestic company	Dividend received by resident from foreign company
New Zealand	Imputation system; imputation credits not refundable	Taxed at shareholder's marginal tax rate, no imputation credits available
UK	Dividend tax credit provided; tax rates on dividends lower than tax rates on other income	Same treatment
USA	"Qualified" dividends taxed at 15% for high rate taxpayers, 0% for low-rate taxpayers	Same treatment if dividend paid from a company resident in a country the US has a DTA with
Germany	Substantial shareholders (25%+) taxed on 60% of dividend at marginal rate, other shareholders subject to WHT of 26% on gross dividend	Same treatment
Hong Kong	Exempt	Same treatment
Singapore	Exempt	Same treatment
Ireland	Classical taxation—taxed at shareholder's marginal rate without credit for company tax paid	Same treatment

CLASSIFICATION OF INTERESTS IN COMPANIES: DEBT AND EQUITY

- The ordinary routes whereby distributions are included in assessable income are:
    - ITAA36 s 6(1) defines "dividend" as any distribution made by a company to any of its shareholders, whether in money or other property
    - ITAA36 s 44(1) which determines when a dividend is assessable income of shareholder
    - ITAA36 s 47(1) which deals with distributions by liquidators

- Company tax law contains many rules designed to preserve integrity by limiting the ability of companies taking advantage of inconsistencies in treatment of debt/equity in different countries

Principles for business tax reform

- Policies that remove impediments in the tax system to new investment will enhance productivity across the economy, support growth prospects and living standards
  - **Revenue adequacy:** raise revenue that helps to pay for public services that community relies on
  - **Economic efficiency:** raise revenue in a way that minimises the effect of the tax system on business decisions
    - By distorting investment and production decisions the business tax system can deter investment and lead to inefficient allocation of resources within the economy and detract from Australia's productivity performance and future living standards
    - Business tax should be applied in a way that minimises its impact on business decisions making—what to invest in, how to invest, how to distribute, when to invest
    - Efficiency gains arising from business tax reform will be realised as a result of changes in business decisions which in turn change prices and quantities—different tax reform proposals will affect decision margins in different ways; all feasible options include distortion
    - Efficiency enhancing reforms are more likely to be successfully implemented and sustainable if the rationale for change is clear and well understood by business and the public
  - **Distributional equity:** business tax system and potential reforms should be understood in terms of where the final tax incidence falls among capital owners, owners and consumers
    - Size and openness of economy and existence of economic rents suggest that in the long run most of the burden is borne by labour and consumers with some incidence falling on capital owners earning resource rents
    - Larger share of the incidence of reduction in company tax rate is captured by capital owners
    - System raises revenue by acting as a final tax on foreign investors and imputation as a WHT on domestic investors
  - **Competitiveness**—the business tax system should take into account Australia's integration with the global economy
    - Australia has been a net capital importing country—important that business tax settings take into account potential for tax system to discourage investment
    - Growing importance of outbound investment means the competitive position of Australian business offshore is an important consideration of business tax policy
    - Competitiveness of Australia's business tax arrangements also need to be considered in context of other non-tax factors
  - **Simplicity:** business tax reform aimed at making the system as simple and easy to comply with as possible having regard to often complex business environment, ensure integrity of the system and costs and benefits of any new rules
    - Businesses are more likely to make efficient decisions and response as intended to policy signals if the business tax system is simple to understand and the processes necessary to comply are not unduly complex
    - Simplicity delivers productivity gains by allowing scare resources to be reallocated away from tax compliance and administration; complexity can undermine the integrity of the business tax system—the ongoing integrity of the business tax system is essential to its role in collecting revenue

Extending dividend benefits to foreign investors may address competition concerns

- Lowering the company tax rate and arguing current rate of 30% is not internationally competitive; globalisation makes capital perfectly mobile and marginal non-resident investor will go where corporate tax is the lowest
- Imputation system has problems—franking credits provide little or not benefit to non-residents because the franked portion of a dividend paid to non-residents is exempt from WHT but doesn't generate a tax offset
- High corporate rate across the board is expensive—cut in the rate would apply to all companies and not just those with non-resident investors;