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Author:
Owen Covick

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Published by: South Australian Centre for Economic Studies
PO Box 125
Rundle Mall SA 5000
AUSTRALIA
Telephone: (61+8) 8303 5555
Facsimile: (61+8) 8232 5307
Internet: http://www.adelaide.edu.au/saces
Email: saces@adelaide.edu.au

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Director's Note

Welcome to the tenth issue of *Economic Issues,* a series published by the South Australian Centre for Economic Studies as part of its Corporate Membership Program. The scope of *Economic Issues* is intended to be broad, limited only to topical, applied economic issues of relevance to South Australia and Australia. Within this scope, the intention is to focus on key economic issues — public policy issues, economic trends, economic events — and present an authoritative, expert analysis which contributes to both public understanding and public debate. Papers will be published on a continuing basis, as topics present themselves and as resources allow.

The author of this paper is Association Professor Owen Covick, School of Business Economics, Flinders University, Adelaide. From February 1992 to June 1994 Owen Covick worked as Ministerial Consultant in the Office of the Commonwealth Treasurer. Prior to that (and again subsequent to it) he spent periods as Ministerial Consultant in the Office of the Commonwealth Minister for Finance. The views expressed in this paper should *not* be viewed as corresponding to those of the Commonwealth Ministers he was responsible to during those periods.

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Michael O'Neil
Director
SA Centre for Economic Studies
April 2004

Enhancing Trust in Australia's Tax System

Overview

In this Issues Paper Owen Covick argues that Australia is divided into two nations as far as personal income taxation is concerned. He explains the institutional arrangements which produce this outcome. In summary, members of families in which most income comes from supplying labour services as employees to arms-length employers are subject to a much tighter "attribution" regime than are members of families in which income from family-controlled entities is the major income source. The consequence is that the former are less able to allocate income across members of their family unit in a way which minimises the tax payable by the family unit as a whole.

This division of Australia into two nations has consequences which are typically regarded as undesirable: it is horizontally inequitable, vertically inequitable, and allocatively inefficient.

In contemplating possible remedies, a common reaction is to seek to more effectively extend the treatment affecting arms length wage and salary earners to members of families deriving their income via family businesses. However, Covick's view is that these efforts are unlikely to succeed. A better alternative, he argues, would be to extend to arms length wage-and-salary-earner households a capacity to establish "quasi-trusts" enabling them to allocate income across the family unit in a manner equivalent to that used by families deriving their income via family businesses.

1. Two Nations[*]

Australia is divided into two nations, as far as personal income taxation is concerned. The same is true regarding income-taxation-like means testing arrangements for government outlays programmes. In one nation ("nation X") are those who are members of family units which derive the bulk of their income from one or more of the following three sources:

- supplying labour in the status of *employees*, to employers with whom they are on a truly arm's length basis;
- supplying financial capital for interest or dividends to entities with whom they are on a truly arm's length basis;
- government transfer payments.

In the other nation ("nation Y") are those who are members of family units which derive the bulk of their income from supplying labour and/or financial capital to entities over which members of those same family units are able to exercise effective control.

Note that what determines which of these two nations a particular individual belongs to involves *not* just the primary source of that individual's "own" income, but also what *family-unit* the individual effectively belongs to, and what that *family-unit* has as its primary source of income. Thus among Australia's university students who would identify to you as their principal source of income the government transfer payments that used to be called AUSTUDY some belong to nation X: for example those whose parents work as wage and salary earners (or do not work at all); while some belong to nation Y: those whose parents are "self-employed" (or who "work in their own businesses").

If we consider the income taxation (and income-taxation-like means testing) arrangements for each of the two nations of Australians separately from one another, what do we find? I would suggest that what we find is surprising. Among those who are entirely within the bounds of nation X (i.e., in family-units which are not recipients of any streams of income from self-employment — whether it be of labour *or* of capital) we have a taxation system which is reasonably simple, is horizontally equitable, and which by and large seems to pass muster under basic tests of allocative efficiency. As far as vertical equity is concerned, it is always possible to complain (in either direction) about just *how* progressive the system should be. But apart from the odd "poverty trap" zone, the system at work *within nation X* does demonstrate overall effective progressivity.

Among those who are entirely within the bounds of nation Y, the picture is almost as benign. Simplicity is not a strong suit. Since some people have circumstances or aptitudes which render the lack of simplicity relatively harder for them to cope with, this weakness overlaps into problems for horizontal equity and thence to problems for vertical equity.

(Horizontal equity is, after all, a necessary but not sufficient condition for vertical equity.) For equivalent reasons the simplicity weakness is also likely to overlap into problems for allocational efficiency, if some types of productive uses of resources are more affected than others by the costs of coping with lack of simplicity. But if we *were* able to find that the costs of coping with the lack of simplicity were "evenly" spread in approximate terms across nation Y (both across its persons and across its productive activities), we would then also conclude that income-taxation (and income-taxation-like means testing) arrangements *within* nation Y are essentially horizontally equitable and pass muster under basic tests of allocative efficiency. We would also find the system to demonstrate overall effective progressivity, but to a lesser degree than within nation X. Indeed the degree of progressivity within nation Y is probably quite markedly below that within nation X.

If we could break free from the habit of viewing all Australians as belonging to the same single nation for income tax (and income-tax-like means testing) purposes, we could to a very large extent break out of much of the perennial arguing and complaining about needing to reform Australia's income tax system, and how we should do so. We would still have the simplicity issue within one of our two distinct nations. But even there at least part of the "problem" is illusory rather than real. Ninety-nine out of a hundred people will tell you they know what "income" is, and that they can spot it when they see it. Sometimes income takes a form that is easy to measure with reasonable precision. Sometimes that is *not* the case.

H.C.Simons' classic 1938 work *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* describes a number of cases which seem to defy practicable measurement to any standard of reasonable accuracy. Any well-trained economist will be able to tell you that "true income" during an interval of time equals the increment to the stock of wealth between the beginning of that interval and its end *plus* the consumption stream enjoyed during the course of that interval. But what sounds on first hearing to be a "crisp" and "tangible" definition, turns out on closer inspection to leave two further questions: what is the definition of the stock of wealth? And what is the definition of "the consumption stream enjoyed during the period"? And you cannot sensibly start to address *either* until you have identified the "unit" whose wealth-holdings and consumption enjoyment you are referring to. As will be argued below, this issue of the "unit" has been given much less attention than it warrants in the last twenty years of taxation debate in Australia. But at this stage my point is that there is no magic wand available that will make the definition and measurement of income as simple in intrinsically complicated cases as it is in intrinsically simple cases. People whose economic activity means they are faced with the unattractive consequences of this have as much a right to complain about it as they do about the heat outdoors in January/February, and as much of a right to expect other people to put their time and energy into "solving" the problem for them.

2. How?

How is it that what appears to be a single unitary system of income taxation for all Australians has the effect of dividing us into two nations, with each of the two facing a quite different *effective* income taxation regime from the other? To make progress on this question, it is useful to begin by noting the following four points:

- in the Australian personal income taxation system the "unit" whose income is assessed and then subjected to the defined progressive rate-scale is the individual;
- when an employer pays wage or salary income to an employee under a truly "arms length" contract of employment it is usually possible for a taxation authority in a country with an institutional framework such as Australia's to enforce (without excessive costs) a system which maintains a one-to-one nexus between the identity of the individual supplying the labour services that gave rise to the income, and that of the individual assessed for income tax purposes as having received that income;
- when an enterprise pays ("or distributes") income to more than one member of a family unit that exercises effective control over the decision-making of that enterprise, it is often very difficult for a taxation authority to enforce (without excessive cost) a requirement that there be a direct nexus between the value of the labour and/or capital funds *provided* by each individual family member and the identity of the family member reported for income-tax purposes as having received the income given-rise-to by that labour and/or capital; and
- when a company which is effectively owned and controlled by one individual or by one family does not fully distribute all of its company-income in dividends each year, one possible motive may simply be to defer the bringing-to-account of those retained earnings in the personal income tax returns of the individuals who are recorded as being the company's shareholders in the year those earnings first become available for distribution.

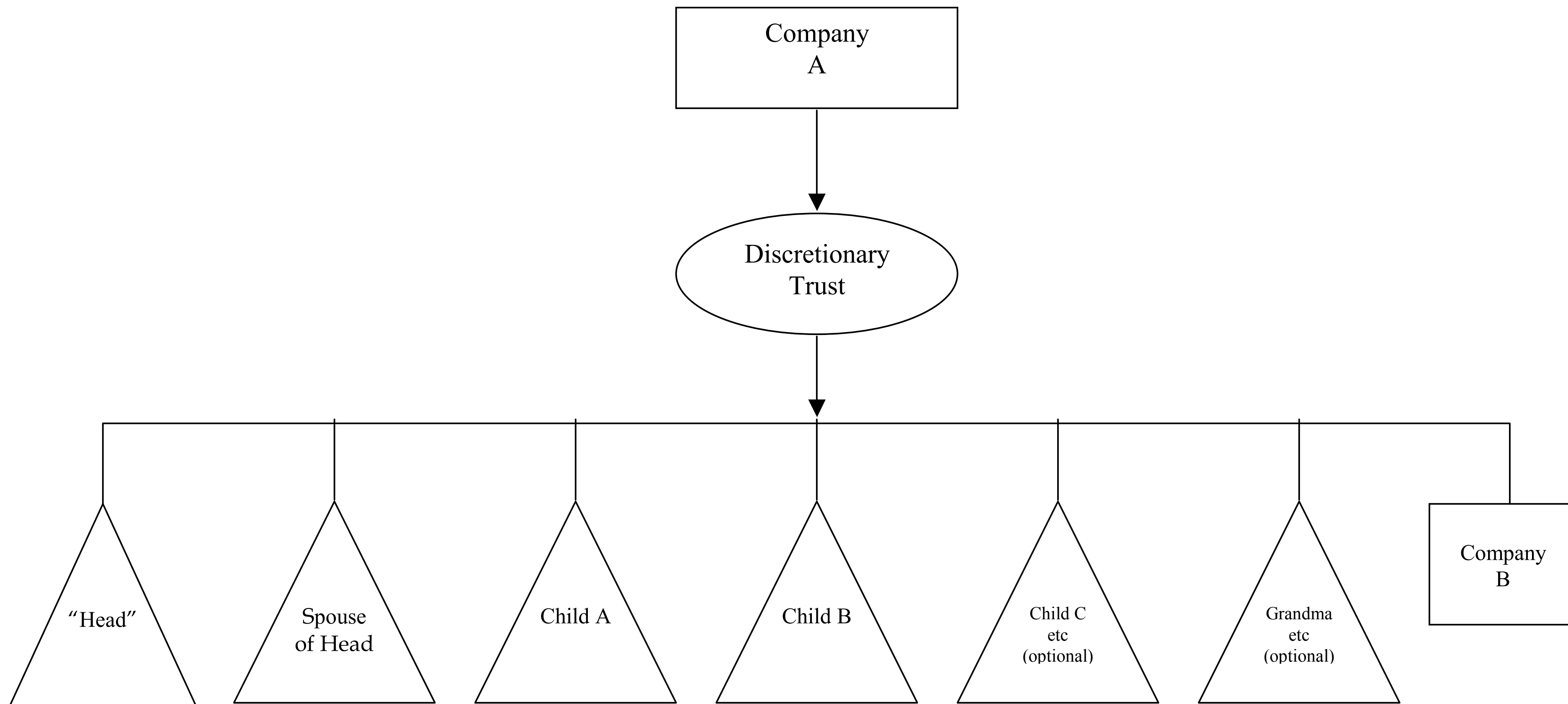
It should be stressed that it is the first three of the above four points that provide the *real* foundation for the dichotomised income taxation (and income-taxation-like means testing) arrangements facing Australians today. The fourth serves to accentuate the dichotomy. But the fact that point four could be quite easily removed from the Australian system (by re-introducing a second tier of company tax for the "excessive" retained earnings of closely-held companies, and providing the affected companies with corresponding additional dividend franking capacity) should not blind one to the fact that doing that alone would still leave us divided into two nations (albeit somewhat less far apart from one another!)

Although it is the first three of the above four points that provide the foundation, it is that wonderful institution *the discretionary trust* which sits upon the foundation and is the principal visible apparatus for holding our two nations apart from one another. But again a warning is needed. If the institution of the discretionary trust did not exist (or could be conjured out of existence) that alone would not, in all probability, cause the two nations to come together and coalesce as one. As long as the foundations are there, substitutes for the discretionary trust apparatus could probably be found — possibly not so cost-efficient in terms of fulfilling the task — but nevertheless holding the two nations firmly apart.

Figure 1 should help explain matters. It depicts the basic "two companies plus one trust" apparatus which has become the norm for Australian family units which derive the bulk of their income from supplying labour and/or financial capital to business enterprises over which those same family units are able to exercise effective control, and where the scale of the overall family unit income can be described as "small to medium". Further up the income scale the core "two plus one" apparatus is typically augmented by further additional modules of trusts and companies. Indeed even at the lower end of the scale, it is now fairly common for a "self-managed" superannuation fund for the family's members to be attached to the basic "two plus one".

The triangles in the diagram depict human beings (or "natural persons", to be formal). These are the members of the relevant family unit. The more "natural persons" you can add in to your family unit, the better. If you are unfortunate enough to be a one person household the apparatus is really only worth using if your income is high and you can make effective use of Company B (or the self-managed super fund that is not shown in this diagram). The oval in the middle of the diagram is a discretionary family trust. Its beneficiaries are the triangles below it *plus* Company B. The trust's trustee is Company A. Company A thus determines each year how the net income of the discretionary trust is divided among the various triangles and Company B. Company A's shares are all owned by the various triangles in the diagram. Usually a dominant and clearly fully controlling shareholding is held by the triangle labelled "head". Sometimes, however, the triangle labelled "spouse of head" has found out what a potentially weak situation this puts that person into, particularly if "head" finds a new "spouse". Pressure might then be exerted for shareholding (and therefore control) of Company A to be more equally split between "head" and "spouse of head". The shares of Company B are owned by the triangles in the diagram. Once again it is probably in the self interest of "head" to own virtually all of those shares for as long as Company B does not pay any dividends. Though if "spouse of head" has spotted the possible consequences of such arrangements for Company A, the same type of pressure is likely to have been applied for "spouse of head" to be a significant shareholder of Company B.

Figure 1



Ideally the discretionary trust in the middle of the diagram should be a "testamentary trust" (for reasons explained below). If your family-unit's business activities have not been running long enough for an appropriate person to have died leaving a will creating the required "testamentary trust", you will have to make do with a non-testamentary trust. If that is the case it becomes particularly important that you find a least one suitable aged (or very unhealthy) relative to draw into the close embrace of your family unit. One of the various types of assistance you will provide to this person (or persons) as part of your campaign of being nice to them is paying for legal advice to help them draw up their will in a way that best provides for their grandchildren/great grandchildren etc., (i.e., an appropriately flexible discretionary testamentary trust).

The trust in the middle of the diagram runs the family business (or to be legally formal, Company A runs the family business in the role of trustee of the family trust — with the controlling shareholder(s) in Company A making the key decisions). It is likely that "head" will be hired as an employee to provide labour services to the business. The other triangles in the diagram may also be signed up as employees and paid wages, and *may* be required to provide labour services to the business — though where they are very small children or extremely elderly (and/or infirm) persons it may be best *not* to sign such family–members up as employees. Some of the triangles in the diagram may be recorded as having made loans to the family business and be recorded as receiving interest payments from the business on account of those loans. Sometimes such interest payments are not actually "paid out" to the relevant triangles but are recorded as having been simultaneously re-lent back into the business. Sometimes the relevant triangles are never told about those transactions. Where it is small children or very elderly persons who have been less-than-fully-informed about such matters, this is unlikely to impede the smooth functioning of the apparatus. But where it is "spouse", or "children" above the age of 18, this can sometimes lead to embarrassing conversations for "head".

Once the trust has debited against the gross receipts of the business activities the costs of goods and services bought in as current business inputs, its wages and interest bills, employer superannuation contributions made, depreciation allowances claimed etc., it must make sure that it "distributes" its remaining net income among the beneficiaries listed in its trust deed each financial year. If positive net income were "retained" within the trust, an unattractively high income tax rate would have to be applied to such monies and a cheque sent to the ATO by the trustee. But "distribution" of net income to beneficiaries need not mean actually handing over money. The sums "distributed" can be simultaneously re-lent back into the business. And sometimes a beneficiary "receiving" and simultaneously re-lending such trust distribution monies may never be told about such transactions. As long as "head" takes steps to ensure that those beneficiaries' personal tax returns meet reporting requirements, this should not impede the smooth

functioning of the family unit's financial apparatus — except in cases where "spouse" or adult children start to raise queries with "head".

If the discretionary trust is *not* a testamentary trust, the trustee must be careful not to make *distributions of net trust income* to any beneficiary under the age of 18 that exceeds a defined fairly modest amount per year. Otherwise an unattractively high marginal tax rate is triggered. But this defined modest amount, and this unattractive marginal tax rate are matters that only affect the distributions of net trust income. They do not normally affect the tax treatment of any interest and/or wage income the same individual might receive from the trust. Thus a very thrifty twelve year old who has systematically re-lent to the trust all their annual modest trust-income distributions from that trust, all their interest-income from it, all of each year's birthday present monies from mum, dad, and grandma, and perhaps even some wage income from the trust, may by that age be taking quite strong advantage of the tax-free threshold in the personal tax scale — particularly if the trust pays a good rate of interest to its creditors. And such a high-thrift twelve year old might even be totally unaware about how systematically thrifty he or she had been!

If the discretionary trust *is* a testamentary trust the trustee has less fine detail to worry about. A spread of distributions among the triangles in the diagram needs to be worked out for each year that takes appropriate advantage of the full normal tax-free threshold and the lower personal marginal tax-rate income bands facing each beneficiary in that year, taking account of any income from other sources that those individuals need to declare on their personal returns.[1] If the amount of net trust income to be distributed in any year exceeds the amount consistent with ensuring that no family member faces a personal marginal tax rate above 30 per cent rate, the residue above that amount can be distributed to Company B. Company B can then pay company tax at the 30 per cent rate on that money and keep the remainder as undistributed earnings. Once again all this talk of "distributions" should not be interpreted as implying that money needs to actually physically change hands. There can be immediate direct re-lending, or perhaps re-lending to other "parties" in the diagram. For example Company B might lend some of its retained earnings to one of the triangles who is a small child who then is smart enough to on-lend the money at a higher rate of interest into the family business. The higher rate of interest might well be warranted by comparing the business risk associated with the loan to the family business with the risk faced by Company B on a loan to a "natural person" with a totally unblemished credit history (and perhaps even an adult guarantor?).

3. What Are The Consequences?

In this fashion the total of the taxable income generated by the activities of the family business controlled by the trustee company (Company A) finishes up being reported as taxable income to the various beneficiaries of the trust (i.e., the various "natural person" beneficiaries plus Company B). In the story as told above, *all* of the taxable income generated by the family business's activity is reported: although some is reported as wage earnings, some as interest earnings and only some as "distributions of trust net income".

Let us imagine for a moment that it is only "head" and "spouse" who supply labour services to the family business and that a reliable economist has estimated that at prevailing market rates for "arms' length" employee labour, head supplied 80 per cent (by value) of those labour services and spouse supplied 20 per cent. Let us imagine, further, that the family has recently obtained reliable information that "head" could readily find work in the arm's length market for employee labour in a post neither more nor less congenial/attractive than working in the family business; ditto "spouse"; and that the overall remuneration to the two of them from doing so — combined with obtaining a market rate of return in the arm's length market for investment funds on the family monies liberated by exiting from the family business — would add up to ten per cent more per year than the family as a whole would receive from continuing the family business arrangement as in Figure 1.

It is most unlikely that such a "bonus" — ten per cent or thereabouts — would be sufficient to make the switch from nation Y to nation X status a step-forward in terms of material living standards for our family. The family would be able to exercise some discretion as to how the investment earnings component of its nation X income was reported among the tax-returns of its various members. But unless a discretionary trust structure were maintained there would be far less freedom-of-manoeuvre from year to year in this regard, and far greater potential for younger family members being able to see "their money" and wanting a greater say in what was done with the earnings on it. But the bigger problem is the fact that so much of the value accruing to the family in respect of the labour services supplied by "head" now has to be reported on "head's" personal income tax return, with an unattractively large segment of it attracting taxation at the highest marginal personal rate. Replacing taxation at zero per cent with taxation at 48.5 per cent (when forgoing use of other family members' tax-free thresholds) does not have to apply to a particularly large segment of the family's overall income for this to outweigh the 10 percent bonus factor chosen for this particular imaginary scenario.

If the paragraph above is broadly accurate as a representation of the taxation consequences facing a family in Australia today contemplating migration from nation Y status to nation X status in the presence of a ten per cent "bonus", we *must* draw the following conclusion once we remove that bonus. With all other relevant economic factors maintained constant — namely the same family members doing the same quantum of the same types of work in posts neither more congenial not less congenial and neither more attractive nor less attractive in their future remuneration, security and congeniality prospects; the same quantum of family net wealth earning an income with the same return and subject to the same risk properties — the migration of a family from nation Y status to nation X status means that a greater overall quantum of income tax is paid by that family. Therefore there is an absence of horizontal equity as between persons in Australia's nation Y and otherwise directly equivalent persons in Australia's nation X.

Comparing family units in nation X with family units in nation Y there is a pattern that families in the latter with somewhat greater income/wealth than families in nation X (and therefore a somewhat greater "capacity to pay" tax) nevertheless pay lower overall quantums of income tax than those less-well-off counterparts. There is also, therefore, a deficiency in vertical equity across the Australian tax system viewed as a whole. The example of resistance to a migration from nation Y to nation X in the face of a 10 per cent pre-tax bonus of income is also strongly suggestive that the dichotomous treatment of Australian's two nations generates allocational inefficiencies.

With nation Y status so much more attractive (other things being equal) than nation X status, it is not surprising that there are significant numbers of Australians keen to migrate from nation X to nation Y, while simultaneously holding as many "other things" as equal as they possibly can. The potential effects of this on aggregate Australian income taxation revenue collected make our taxation authorities (and legislators) understandably keen to place as many impediments in the paths of those would-be migrants as would seem conscionable. That tends to generate adverse shifts in terms of the simplicity features of Australian's income taxation arrangements. When the would-be migrants are not deterred but accept the greater costs associated with attaining (and maintaining) nation Y status, that creates greater allocational inefficiency problems for our economy.

At this stage of the argument, it would be very easy to fall into a trap, or to use a more accurate metaphor to be distracted into following a side-path that takes you nowhere. Going back to the scenario of the nation Y family contemplating migration to nation X status, among the various stated assumptions was that it was possible to obtain a reliable figure for the going market rate of pay in the arm's length labour market for the quantities and qualities of labour services which persons in Australia's nation Y currently supply to the businesses that are owned and controlled

by members of their own family-units. If one were an economist (or spent too much time mixing with that ilk) one might be inclined to the view that the appropriate recipe for bringing Australia's two nations of income taxpayers into one unified nation would be to tax self-employed persons on the basis of the *market value* of the labour services they perform rather than tax them according to the currently existing arrangements (and presumably allow the employing enterprises matching deductibility for the costs imputed).

That is *not* a particularly useful proposition. Trying to measure quantity and quality of labour services provided by family members inside the context of a small-to-medium size family-run enterprise is easier said than done.[2] One problem is how to treat businesses that were doing so badly that they produced significantly negative business "profits" under this treatment. But perhaps most importantly, there is the following: even in the arm's length market for employee labour, there are many persons who are not paid the "going market rate" for the quantity and quality of labour they actually perform for their employers. Some arm's length employees acquiesce to being "exploited" by their employers, and sometimes the situation is the reverse. The income forgone by the "exploited" accrues to, and is subject to tax in the hands of, the "exploiters". It is indeed part of the "true income" of the exploiters. In the case of the family business depicted in the diagram above, the "exploiters" are the children (and possibly grandma). Is there any serious prospect of being able to unravel that situation, and provide equivalence of treatment across all other exploitation situations, as the "solution" to Australian's "two nations" income taxation arrangements?

One further point is worth noting under "consequences". As has already been suggested above, Australia's two nations are not two "castes". What nation a person is born into need not necessarily determine where that person stays for life. Indeed individuals can migrate from one nation to the other more than once in a lifetime. And some individuals maintain a sort of "dual nationality" status, with a foot in both camps. Because the attractions of migration to nation Y status are great (all other things being held equal), but in light of the tax authorities working hard to place impediments in the path to such "minimal change" migration, another type of option can seem attractive to would-be refugees from Australia's nation X. This option goes by the name "home renovation".

For reasons not worth going into here, income accruing to a family by virtue of living in a dwelling which one or more of the occupying family-members directly owns, and income accruing from the "self-employment" of the family's labour and capital resources in improving that dwelling are accorded a special treatment for income-tax purposes. This treatment is colloquially referred to as "tax-free". A more accurate descriptor is "non-assessable/non-deductible". In some cases (particularly with highly geared ownership and/or significant non-capital repair costs) the occupying family would be *advantaged* by being

permitted the imputed income treatment so loved by academic economists. The same type of non-assessable/non-deductible treatment of capital gains/losses on the principal private residence can be viewed as part and parcel of this "special treatment"[3]. Australia's recently-introduced GST applies, in similar fashion, a special consumption tax treatment to the stream of owner-occupier consumption services involved in these owner-occupied dwellings cases. There appears to have been less advocacy by academic economists for imputed-GST on owner-occupied imputed rents at this stage.

This non-assessable/non-deductible treatment means that income accruing from the self-employment of owner-occupier family-members' labour and capital in the "improvement" of their principal residence (or a sequence of such residences) can often be expected to attract an income taxation treatment more "lenient" than that typically applying to middle-to-high income persons in Australia's nation X — although probably not as attractive a treatment as accorded to a similar quantum of income accruing through normal family enterprise business activity to equivalent persons in nation Y. The upshot is that instead of deserting nation X entirely, some families continue to derive their principal income streams from labour services provided to arm's length employers for wages/salary, but then simultaneously devote further significant quantities of family members' labour and financial capital to "home renovation". The *ex post* costs-versus-benefits of this type of home renovation may frequently fail to live up to the *ex ante* expectations. And there is an added downside for the Australian community as a whole from this phenomenon: namely the large quantum of extremely tedious television programmes engendered, aired at what is euphemistically known as "prime time"!

4. Where do we go from here?

The existence of a rift-line between two nations of Australians when it comes to income taxation (and income-taxation-like means testing) arrangements has been noticeable since at least the late 1970s. The Hayden income tax reforms led to a stronger focus on the *individual* as the basic unit of personal income taxation, removing or diminishing some formerly-existing elements of family-unit taxation and also providing a much larger tax-free threshold for *all* Australian tax-residents — with the same generous zero-tax tranche for all *no matter how young*. This threshold has been continually "updated". Today it makes the Australian personal income tax rate scale look dramatically different from its New Zealand counterpart.

In 1980 the then Commonwealth Treasurer, John Howard, sought to combat the damage (or "unintentional consequences") flowing from these features of the Hayden reforms by pressing for a preclusion of all Australian tax residents below the age of 18 from the benefits of the Hayden expansion in the tax-free threshold. Howard ran into major

problems with his proposed legislation, particularly in the Senate. What finished up coming out of the Senate was the removal of the effect of the Hayden expansion in the tax-free thresholds effect insofar as distributions from *certain types of trust* to under-18 year-olds were concerned. But testamentary trusts were specifically excluded from these 1980 reforms. And a series of other loopholes were inserted into Howard's original proposals, hammering a few more nails into the cross of taxation simplicity, and leaving "gums" where his preference may have been for "teeth".

Australia's 1985 tax reform process studiously averted its gaze from the two nations problem. However, one extremely bizarre initiative *was* implemented. Every Australian tax-resident now gets a full income-tax threshold for *every* full year of their residency starting from their year of birth *except for one*. The year in which you "cease full-time education", you get a curtailed tax-free threshold. One hundred per cent of a threshold from birth to that year; one hundred per cent of a tax-free threshold from that point on — but a curtailment pro-rata to the fraction of the year in full-time education for that one single year. So families in Australia's nation Y are wise to be careful about when they record their children as having left full-time education. I would imagine that a remarkably large number of such "children" are reported as going from full-time education into part-time education (combined with part-time work in the family business) on dates in early–to-middle July. And remember that those "jobs" in the family business are helping these youngsters qualify for "independent" status in the means–testing for tertiary education allowance payments.

During the 1985 tax reform process, Treasurer Keating did promise that the government would publish a discussion-paper on the taxation treatment of trusts in Australia. No such discussion paper was ever published. The draft which was prepared by the Public Service and went to the Treasurer's office is presumably gathering dust somewhere, waiting for the 30-year rule to allow it to see the light of day.

The 1998 ANTS documents contained a number of proposals to bring Australia's two nations closer together.[4] But Mr Costello seems to have encountered the same types of problems that hit Mr Howard in 1979-80. The 1998-99 proposals concerning trusts and "personal services" income passing through "interposed entities" were subjected to rounds of further work and "consultation", then modified and then either dropped or implemented subject to further layers of modifications. More nails in the cross of taxation-simplicity! More impediments in the path of would-be migrants from nation X to nation Y tax-status in Australia. But little, if any, narrowing of the gap between those two nations.

So where *do* we go from here? I would suggest that it is now time to give up on the approach that up until now has been that favoured by most reform-minded observers of Australia's two nations income-taxation arrangements. Most reform-minded individuals, I would suggest have tended to come from a nation X background and see the income tax world through nation X spectacles. Their perception is that nation Y people are enjoying unwarranted privileges. Reform is then equated with the removal of (or severe attenuation of) those "privileges". The idea is along the lines: "those nation Y types should be made more like us (in effective tax treatment terms)". From a distance, making the nation Y types into lookalike nation X types might seem a sound plan for removing the divide. But shouldn't the lesson of the last 25 years in Australia be that that is simply *not practicable?* When you have flows of "mixed-income" from the employment of labour and property together in closely-controlled enterprises where the controllers of the enterprise supply both labour and capital to "themselves", you cannot realistically hope to police a viable and "honest" individual-unit income-taxation system.[5]

There is an alternative approach possible. Why not make it easy for income flowing to members of family units in nation X to be treated for income-tax purposes along lines that are functionally equivalent to the treatment accorded to income flowing to members of family units in nation Y?

A purist might wish to argue that a more thoroughgoing shift to the family-unit as the basic unit in the personal income taxation system, in place of "the individual", would represent the more logical approach. But to propose that would seem to run the risk of further years of debate, and no action to reduce the distance between our two nations.[6] In the interests of keeping the proposal as simple and tangible as possible, the following is suggested.

(a) Allow all "heads" of Australian resident taxpayer households (subject to the specific consent of their spouses) to elect for personal income taxation purposes to establish a *quasi* family trust. The beneficiaries would need to be designated – with appropriate signed consents for any who are not minors having as their parent/guardian the "head" of this household.

(b) Allow "heads" of households who have so elected (and also their spouses) to record on their own individual income tax returns deductions for monies designated as being channelled from them into the *quasi* family trust.

(c) Require that "heads" of households who take advantage of (b) also report details of the distribution among its beneficiaries of the *quasi-trust's* "income", and that they pay to the ATO the top marginal personal rate of tax on any of the *quasi-trust's* income that is not thus "distributed".

Clearly the first step that would be required regarding a proposal of this type would be to obtain a reliable estimate of the likely costs to national revenue of its implementation. That figure would also serve as an indicator of the size of the "gap" separating Australian's two nations of taxpayers.

A reasoned debate could then be held on the "mere technicality" of what parallel initiatives would need to be taken to offset the effects on national revenues. Depriving all Australians below the age of 15 of the full benefits of the lowest portions of the personal-income tax rate scale (and having a phase-in from 15 to 18) might provide some of the required offset. The introduction of a second-tier of company tax to apply to the retained-earnings of closely-held "private" companies may be another candidate[7]. Increasing the rate of GST would be one way of balancing the books if the above two offsets still left a significant gap, and would at least have the benefits of simplicity. It would, however, run into the rhetoric about the GST not being a Commonwealth tax.

Denigrators of my suggestion for providing *all* Australians with cheap and convenient access to the tax-benefits of a family trust will no doubt stress the scale of the revenue cost, and the size of the offset task thereby triggered. But if the citizens of a modern democracy were divided into two nations for tax purposes, on grounds of creed, ethnicity, or gender, would anyone seriously cite "cost" as an excuse for doing nothing? Surely if it *were* creed, ethnicity or gender that were segregating Australians into two dramatically separate categories of tax-treatment, there would be public outcry and demonstrations calling for all to be treated equally? I rest my case.

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End Notes

[*] This version of this paper has benefited from the comments of those attending the ATTA Conference at which an earlier version was presented in January 2004, and also from comments by Jim Hancock.

[1] Where the taxable income of a beneficiary plays a part in means testing arrangements for any government-outlays programme which that person benefits (or may benefit) from, that also should be taken into account and trust distributions tuned to ensure that *effective* marginal tax rates above 30 percent are not triggered.

[2] See Covick (1986) and Covick (1998).

[3] For more on the taxation treatment of housing see Covick and Hancock (2002), particularly pp 60-62.

[4] See Commonwealth of Australia (1998) Chapter 3, pp 105-127 and Commonwealth of Australia (1999), Chapters 21 and 22, pp 469-506.

[5] See Covick (1986) and Covick (1998).

[6] For more on the pros and cons of family-unit versus individual-unit personal income taxation see the studies published in Head and Krever (1996), and the references cited therewith.

[7] For a suitable definition of a "closely-held private company" one might look to the definition that applies for the small business capital gains tax concessions.