

BRAD

CHAPTER 8



RECOMMENDING CHANGES
TO THE TAXING OF
INVESTMENT INCOME

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Chapter 8: recommending changes to the taxing of investment income

Our tax policy team, Claudia, Brad and Sami, in the Tax Department of their country has worked hard over many months as the secretariat to the Review into Taxation of Investment Income. The tax policy team, and its departmental support group, consulted with the community on the review's draft recommendations, provided advice to the review and was continually required to redraft each chapter of the review's report to government. Also advising the review were the integrated design teams that, at the previous directions of the Tax Minister*, had been working on the tax value approach to redesigning the investment income tax base and on upgrading the country's imputation system of company tax to integration of taxable income. The review's final report to government contains many recommendations for legislative change.

The Tax Review's chairman met with the Tax Minister and provided him with an overview of the review's recommendations, singling out one recommendation that he thought the government should implement above all others.

The team is then asked by their Tax Minister to provide a briefing to him and the Prime Minister on the review's recommendations before the report is released publically.

Despite the tiring months of hard slog, there is much excitement in the team, or at least some in the team, because, after his meeting with the review's chairman, the Tax Minister seems sympathetic towards a major package of genuine tax reforms. The Tax Minister appears moved by the chairman's view that the review's package would increase productivity by having income tax interfere less with commercial investment decisions - and also promote greater fairness.

Consequently, team members, or at least some in the team, are a little nervous, knowing the importance of their briefing to the Prime Minister and Tax Minister.

Remember, also, that the cobbling together over the years of the income tax law in Brad's country bares a striking resemblance to that process in Australia.

A few days after the last session with the Tax Review committee to finalise the review's report

Hey, Brad. How about the recommendation to recast our law that taxes the annual income of a taxpayer's investments using one overarching tax design principle?

That principle is reflected in the default specification of taxable income in the redesign: annual net receipts plus **change in annual values** of associated assets and liabilities - which matches annual commercial profit.

Of course, change in annual **values** in this default is replaced with change in annual **tax values** from change profiles specified by government.



One committee member maintained her disagreement with this, saying no one seeks to tax "comprehensive income" any more.

She made a lot of sense.

She again argued for modular treatment with different tax regimes for companies, so-called "savings", capital gains, superannuation, small business, and so on.

I was right with her.

But the rest of the committee overruled her.



The other members thought she was conflating the "comprehensive" label with the taxing of accrued capital gains across all investments.

They all emphasised again that the general taxation of current-year accrued gains is definitely not being recommended.

They reiterated that under their recommendations, the taxing of current-year accrued gains would only occur in two circumstances: first, where government aligns the tax value of an asset or liability category with a measure of market value, as is done now with discounted zero-coupon bonds; and....

....secondly, if government does not specify the tax value profile of particular asset or liability types at all and, consequently, the tax value default comes into play.





But remember how the chairman initially had doubts about setting the tax value default at market value instead of unchanging zero.

But, eventually, he saw the default's matching of taxable income with commercial profit as crucial in identifying genuine reform options - like the committee's recommended removal of the 50% CGT discount - and also encouraging government to clearly specify the tax value profiles in all investment categories.

Pre-
versus
post-tax
again!

And, egged on by the member from the finance sector, he really latched onto the notion that, across all investments, post-tax return equal to pre-tax return cut by investor's tax rate confirms design that means minimal impact of tax on decisions.



The overall view of committee members was that the term "comprehensive" did have relevance to their approach in the sense of capturing all investment assets and liabilities - leaving no "blackholes" - via a common principled-based specification of taxable income.

They saw their one-page specification of the tax base for all investments* as replacing complexity with simplicity, promoting fairness and seeking minimal impact on investment decisions and, so, maximising productivity benefits.

The chairman espoused the benefits of their principle-based design that fits in with companies' accounting requirements and has government still deciding tax value profiles of assets and liabilities, and any broader special tax treatment - so current tax outcomes need not change.



The committee member from the finance sector again expressed his surprise that people commonly could not see how current CGT design doubles up on concessions: one that ignores year-by-year gains by taxing on realisation; the other by not even taxing all the gain on realisation, based on the spurious argument that a discount is needed to adjust for inflation.

He said it was obvious that any adjustment for inflation on only one category of investment asset or liability is concessional.

He said he had just read the Australian 1985 tax reform paper that gave rise to an inflation-based CGT discount when CGT was first introduced there. And, he reckoned the drafters of the chapter on inflation adjustments - which explains the requirement for adjustments across all assets and liabilities - must have lost the argument over whether or not a discount should apply with their realisations-based CGT**.



* Ch1, p 42.

** Draft White Paper, Ch18 versus Ch 7, respectively.

And, beyond removal of the CGT discount, the member from the finance sector convinced the committee to recommend moving towards including accrued value changes in taxable income where possible.

Yeah, he reckoned that, in his firm, they measure profit that way on a daily basis - and not just for financials!!

Theory gone mad!

I bet you loved his success on getting recommended, drawing on Claudia's analysis*, an in-depth assessment of the practicability of deferring tax on annual accrued gains or losses for **tradable assets** until asset realisation - noting regional governments are doing this for higher land tax on rezoned land - and looking back to get similar effect for **non-tradable assets**.

Some of the committee still queried why allocate companies' annual taxable income to shareholders even when that income is retained for investment purposes - as under integration design so liked by Claudia.

Yes, but then Claudia reiterated how integration flows directly from the committee's over-arching redesign principle of annual taxable income from investments being taxed in that same year at the personal tax rates of the ultimate individual investors....

....which immediately offers potential productivity improvement from getting tax out of investment decision-making. Her immediate examples of that included decisions on debt versus equity funding and whether or not to incorporate.

But, crucially, she convinced the committee integration was practicable.**

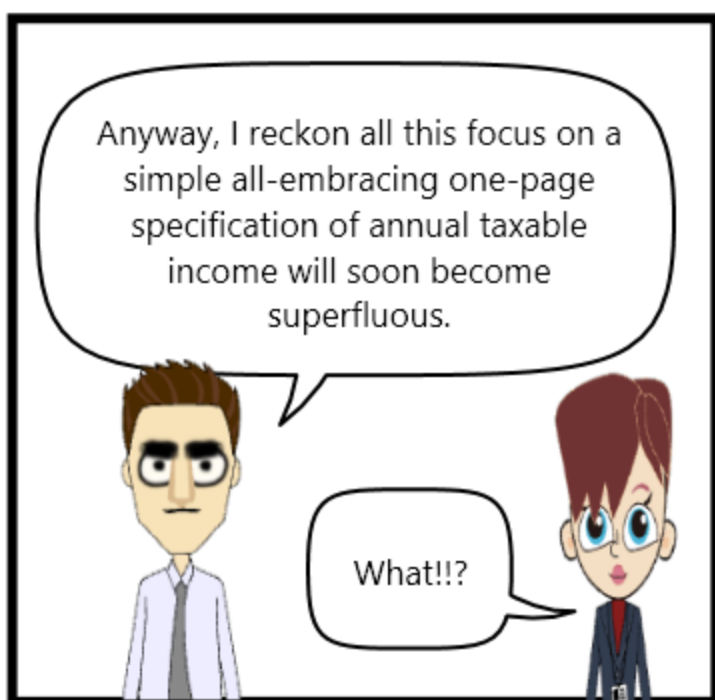
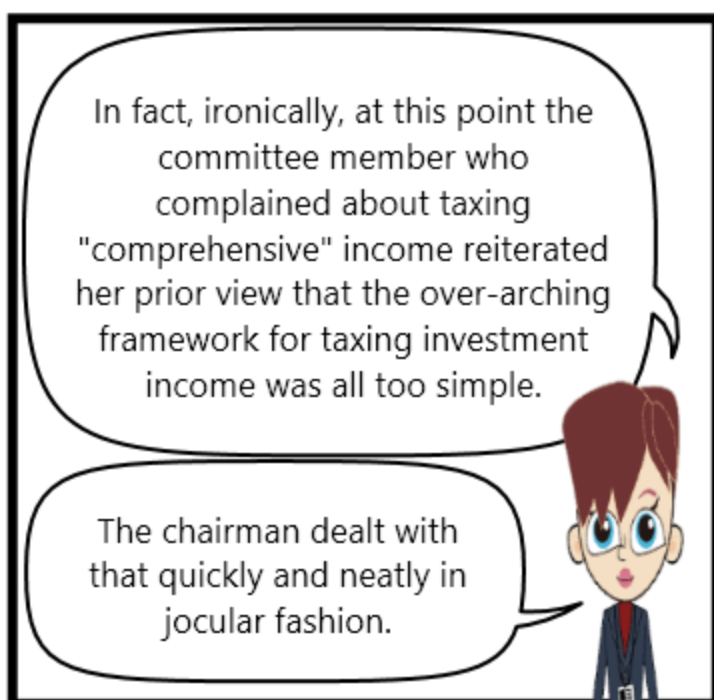
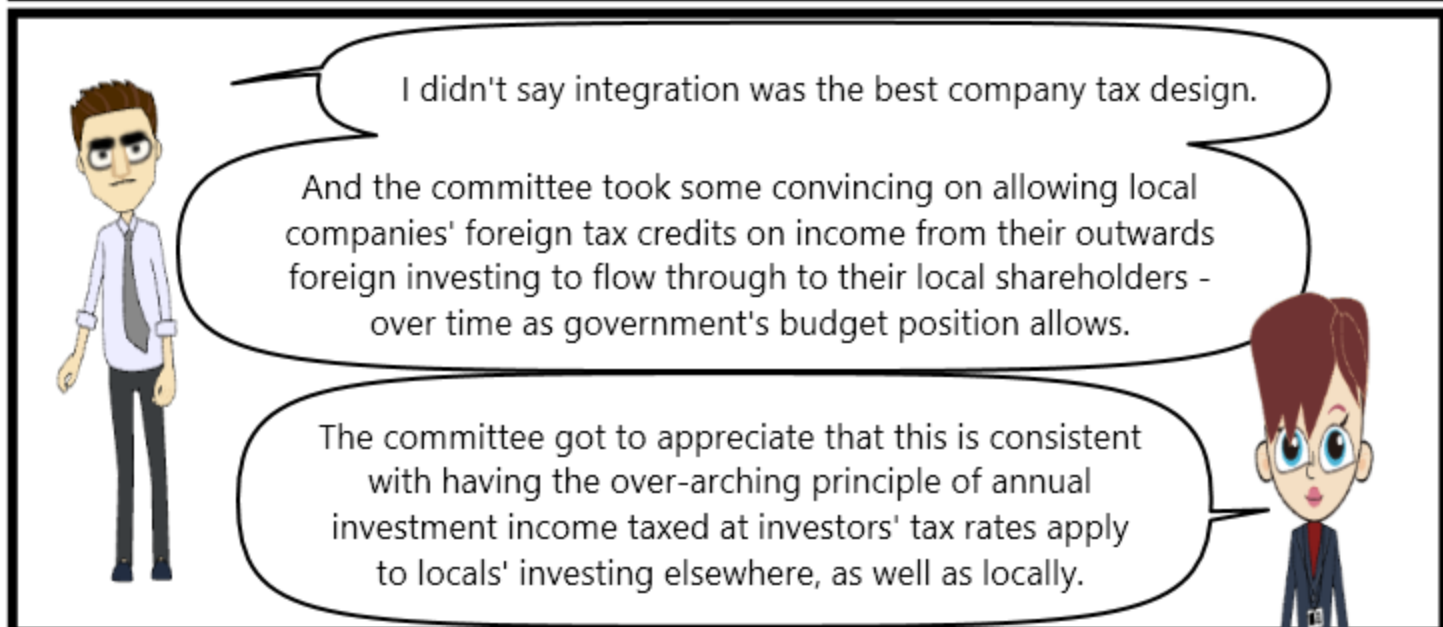
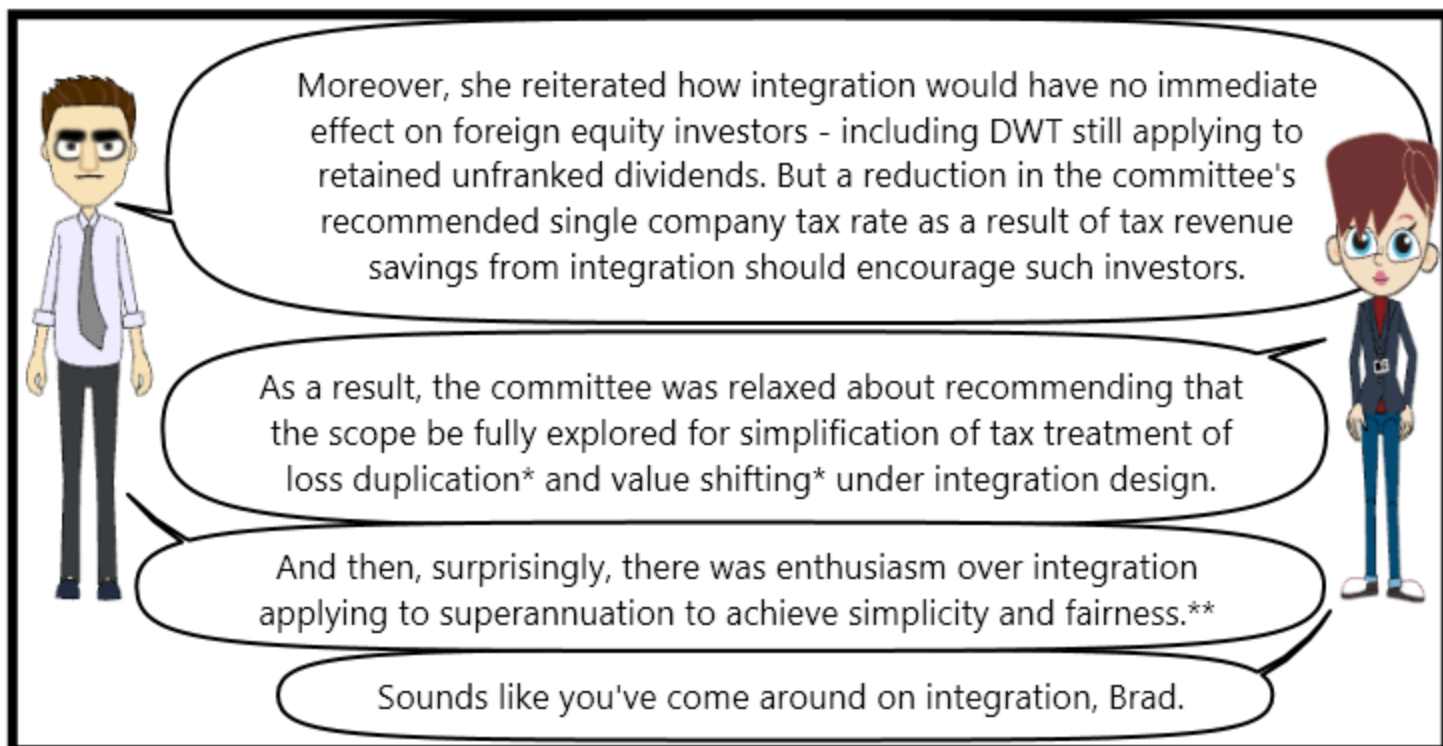
Consequently, Claudia got the committee to appreciate better how this design achieved greater tax parity between companies - be they widely-held or closely-held - sole traders and trusts, particularly fixed trusts.

Mind you, the committee decided to retain unfranked dividends under integration because of tax integrity concerns - even though having, instead, cost base adjustments for distributions of untaxed income would align with fixed trust design and foster simplicity.

But, I must admit, the committee loved how imputation on closely-held companies would deal with complex company trust structures aimed at achieving zero tax via refunds of prior company tax paid on retained profits.

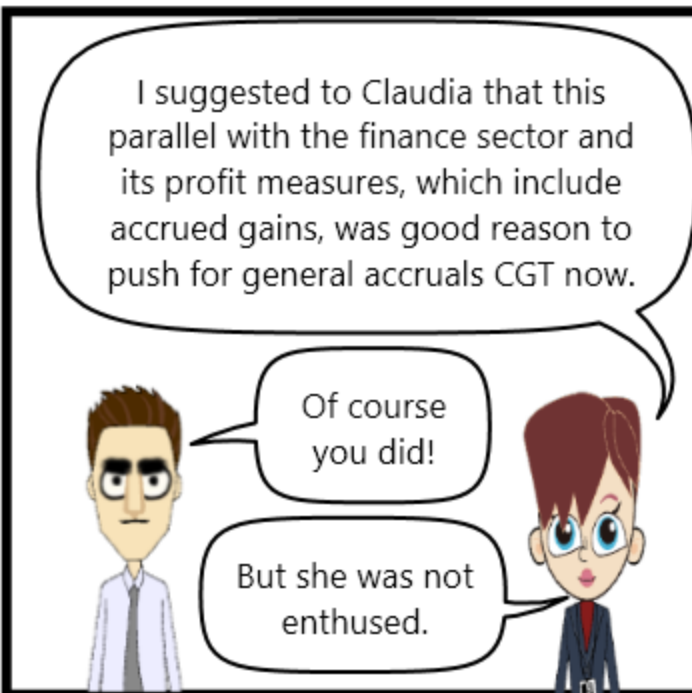
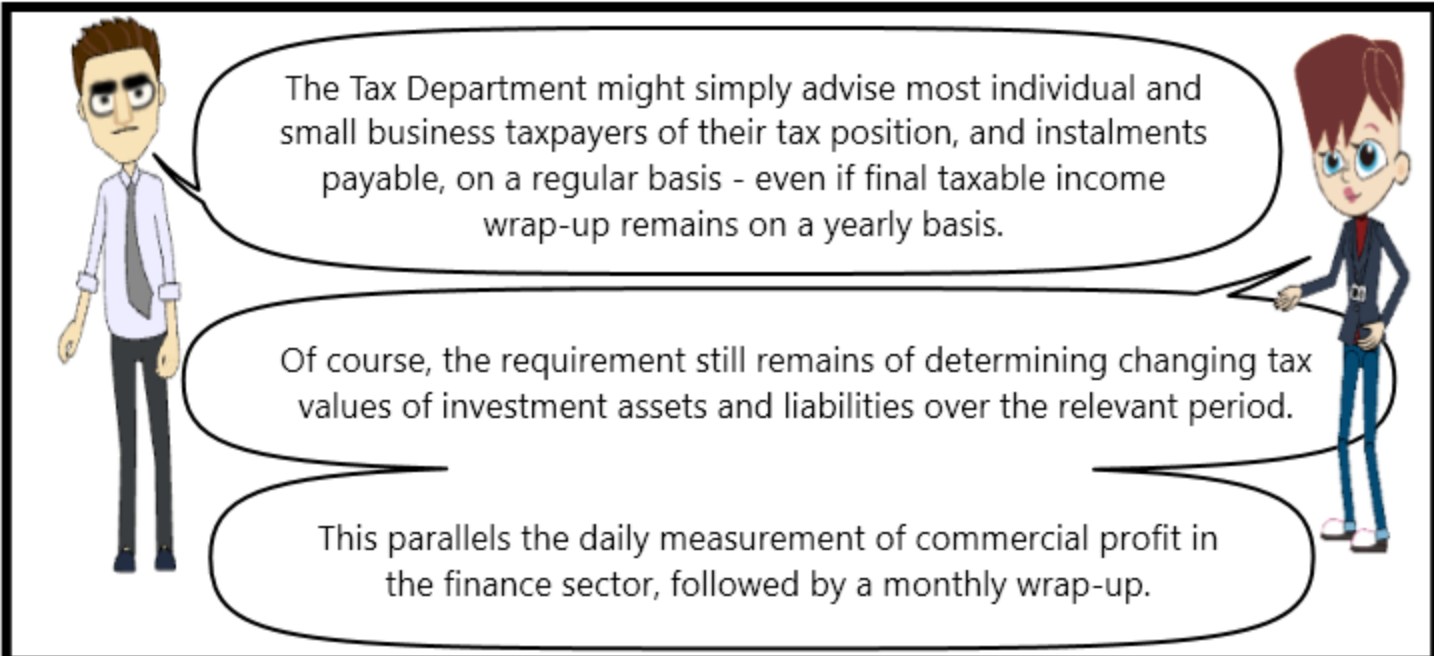
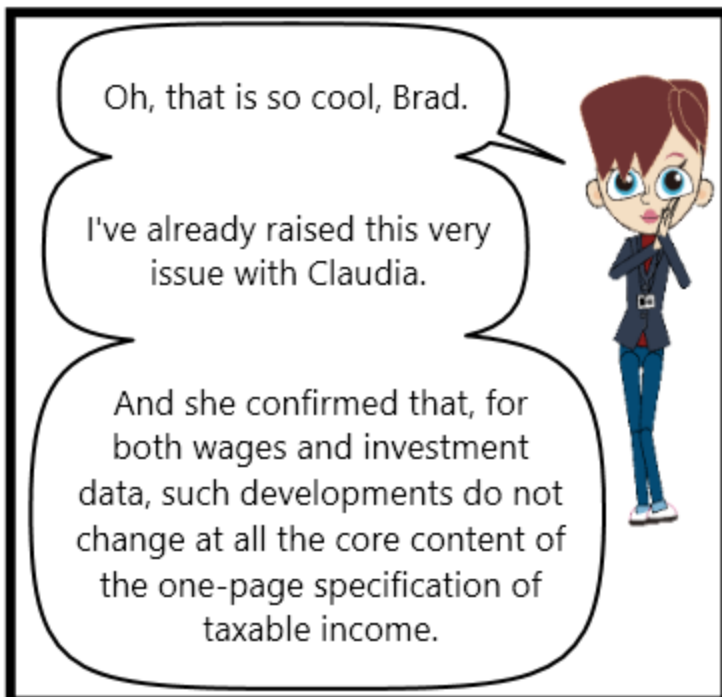
* Ch4, pp 36-38.

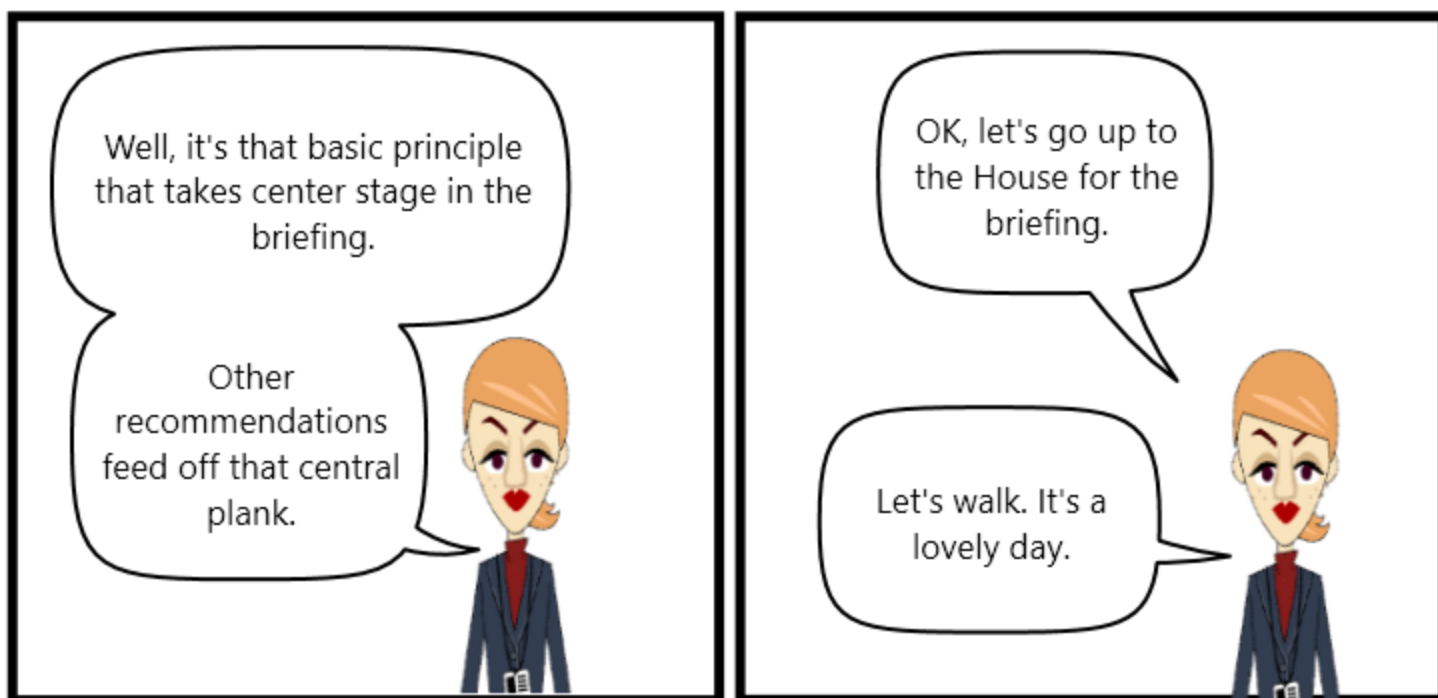
** Ch3, pp 7-30.

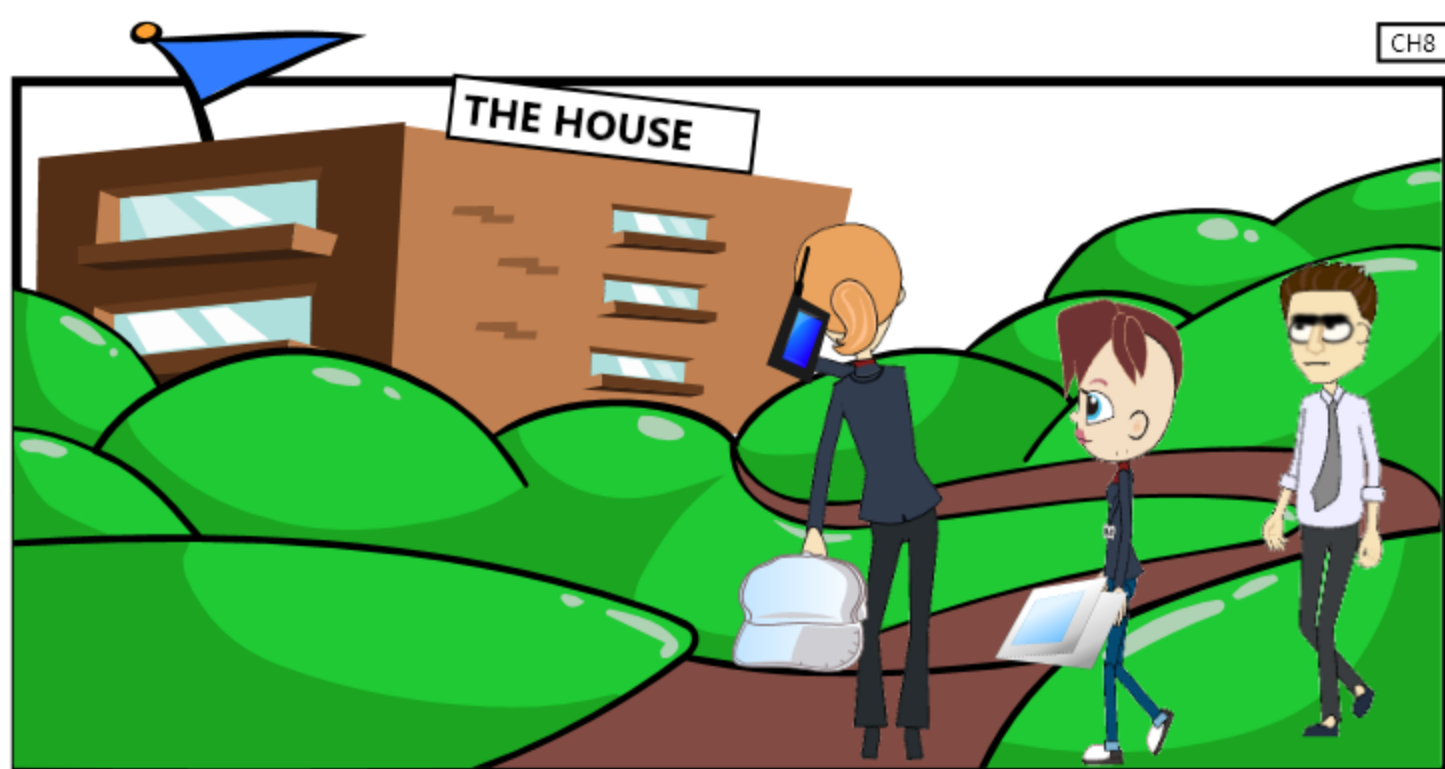


* Ch7, pp 5-7, pp 27-28, respectively.

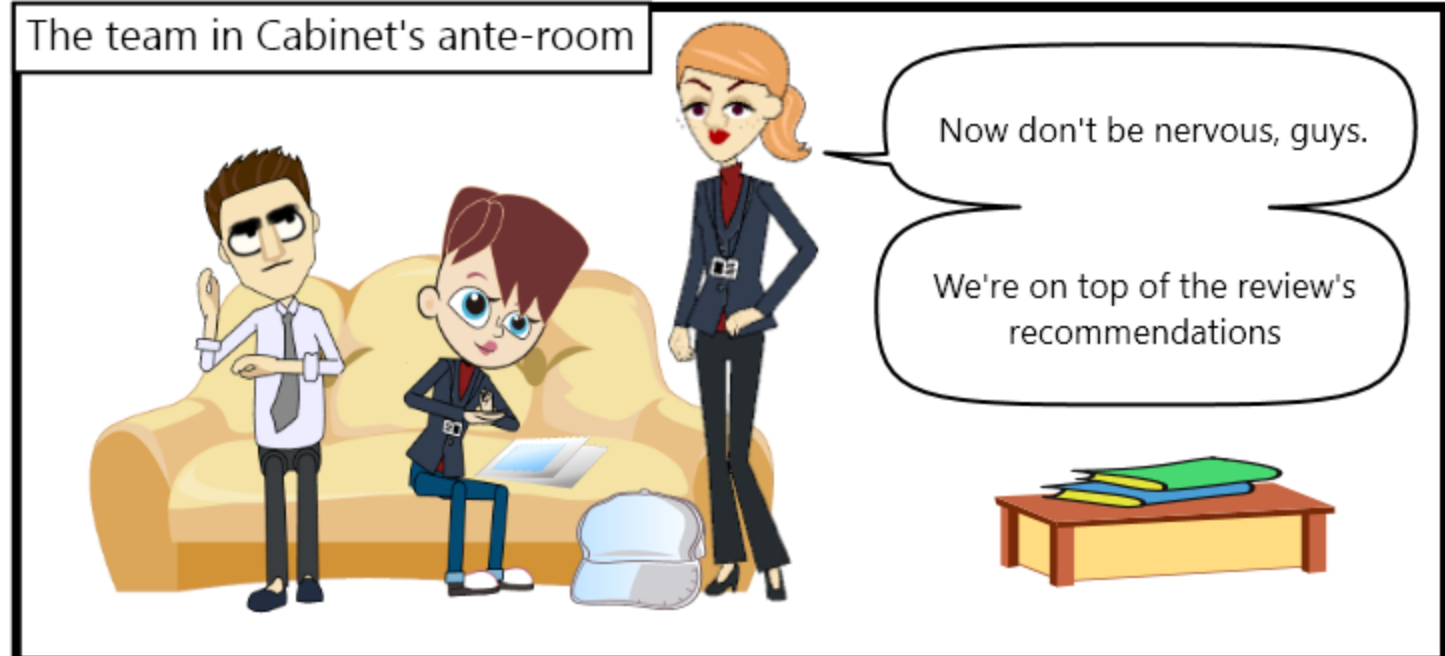
** Ch3, p 31, Ch7, pp 27-28.

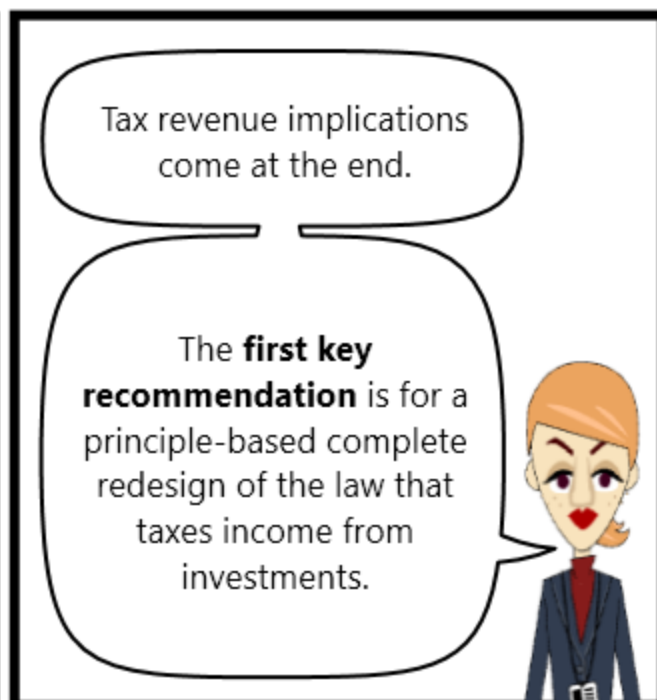






The team in Cabinet's ante-room





10% pre-tax profit

- Annual gross receipts less current costs
- plus
- Annual change in value of assets/liabilities

Benchmark
income tax
base
(commercial profit)

30% tax rate

47% tax rate

7% post-tax profit

5.3% post-tax profit

As motivation for the first key recommendation, here is the result of taxing the investment income or profit of taxpayers each year.

You see that the 10% pre-tax return is cut by the investor's tax rate to give the after-tax return.*

Cutting profit by investors' tax rates across all their investments should see little impact on decision-making, thus maximising productivity.

This outcome would result for all investments, like bank accounts, of course, but also shares and rental properties - but it needs annual **change in value** of all investments to be included in taxable income.



10% pre-tax profit

- Annual gross receipts less current costs
- plus
- Annual change in tax value of assets/liabilities

Practical income
tax base.
Recommended
one-page
specification of
taxable income.

30% tax rate

47% tax rate

??% post-tax profit

??% post-tax profit

Hence, to give practical effect to its **first key recommendation** the review changes "**value**" to "**tax value**", determined by government, in this one-page specification of taxable income for all investments.**

Where tax value profiles are set more generously than value profiles, say, with no change before sale of CGT assets, funds would tend to flow to those assets, distorting investment patterns by offering initially higher post-tax returns than the 7% and 5.3% outcomes for regular debt.



* Ch1, pp 9-11, 16-17, 25.

** Ch1, pp 29-43.

- NET RECEIPTS (GROSS RECEIPTS LESS CURRENT COSTS) + CHANGE IN **TAX VALUES** OF EACH ASSET/LIABILITY
ex cash account but may be reformulated by companies to
- CASH FLOW (GROSS RECEIPTS LESS ALL COSTS) + CLOSING LESS OPENING **TAX VALUES** OF ASSETS AND LIABILITIES
and
- GOVERNMENT DECIDES TAX VALUE PROFILE
but, absent government decision
- DEFAULT SUBSTITUTES CHANGE IN **VALUE** FOR **TAX VALUE**

In more detail, the one-pager for taxable income includes changing tax values for assets/liabilities acquired during the year.*

The review recommends companies be able to choose the reformulation of annual cash flow plus difference between closing and opening aggregate tax values.

This reformulation matches the current tax treatment of trading stock.

Companies would find the reformulation dovetails well with their regular accounting, from where they would get annual cash flow directly.

Only where tax value profiles are not specified in the law for particular assets or liabilities would change in value substitute for change in tax value.



WHY DO THIS?

- PROVIDES THE BASIS FOR A COMPLETE PRINCIPLE-BASED REDESIGN OF CURRENT LENGTHY, COMPLEX LAW
- THE REDESIGN DOES NOT NEED TO CHANGE THE IMPACT OF CURRENT LAW
- BUT, THE CLOSER TAX VALUES ARE TO ACTUAL VALUES, THE LESS TAX IS INTERFERING IN COMMERCIAL DECISIONS

Why this change? You remember, minister, this whole tax review process started when you asked what could be done about our lengthy, convoluted law that taxes investment income?

No change in impact?
Claudia, can you indicate how this might operate in practice?

Hmm.
Hmm.

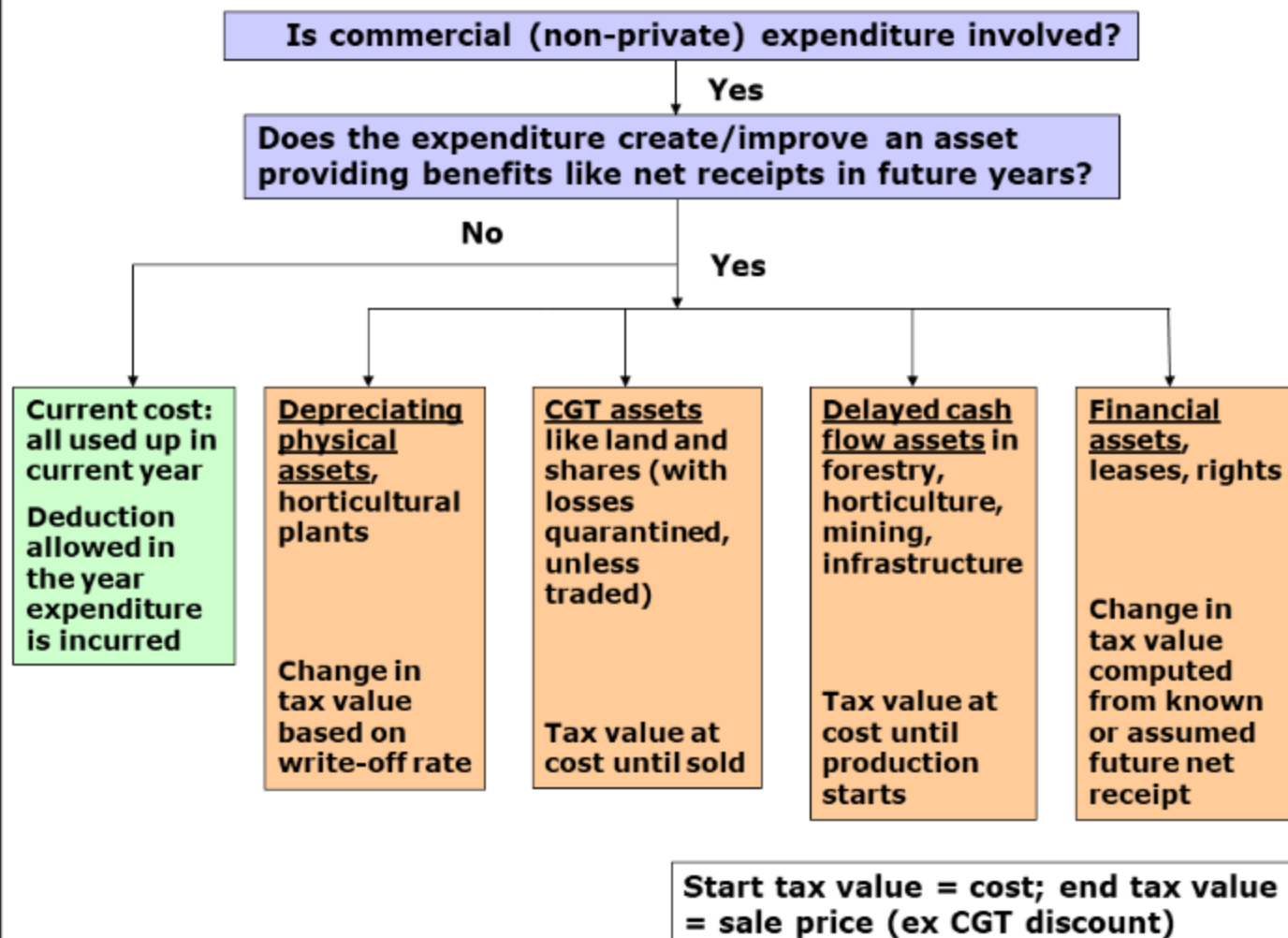
They're not going to buy this theoretical purity.

Oh, this is so exciting!

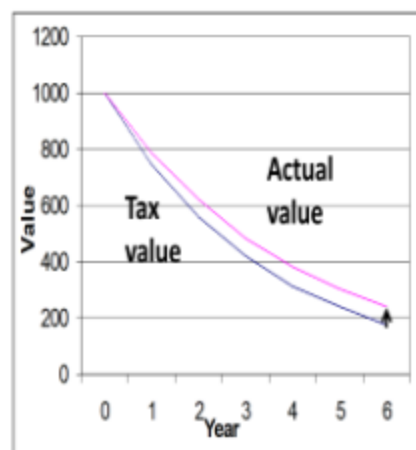
Certainly, minister.



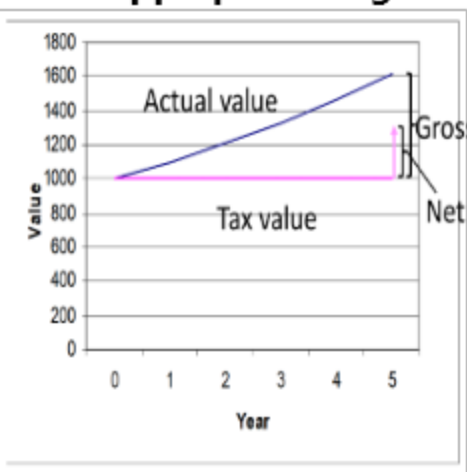
* Ch1, p 42.



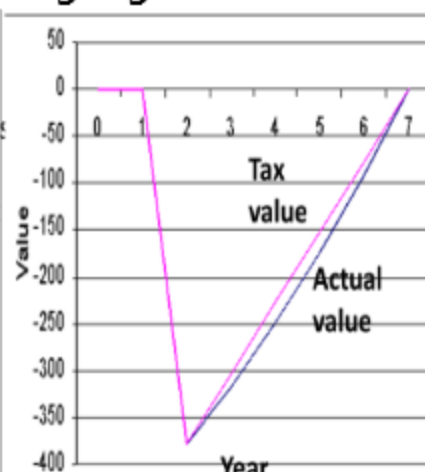
Depreciating



CGT: Appreciating



Right given to use asset

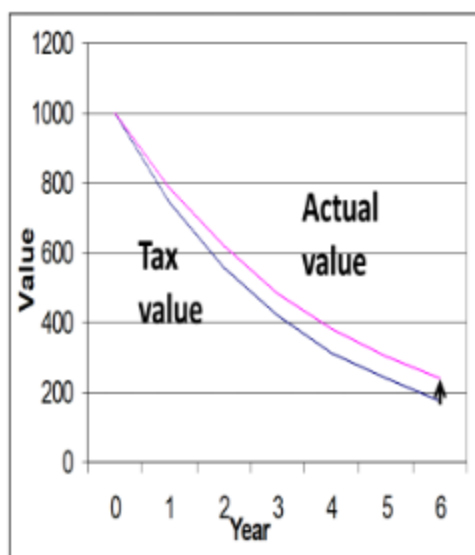


As shown at top, clear definitions of assets and liabilities are crucial, for example, to distinguish capital costs from current costs.

Then, the tax value profile for capital costs depends, like now, on the type of asset involved*, as illustrated for depreciating and CGT assets....

....and for a liability, say, to provide access to land for an up-front fee with its straight-line tax value profile.

Depreciating



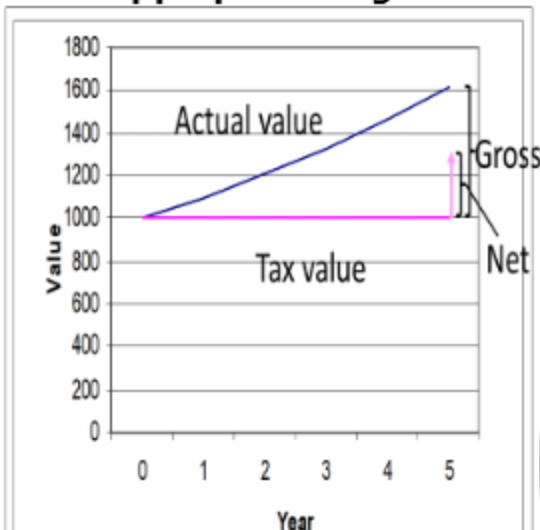
The chart for depreciating assets* has tax value, driven by specified write-off rate, declining at a slightly faster rate than that of actual value.

The difference is reconciled on disposal because end tax value equals disposal price.

This matches current arrangements, with rates of write-off for equipment, horticultural plants, and so on, set to match, as far as practicable, actual rates of decline in value.



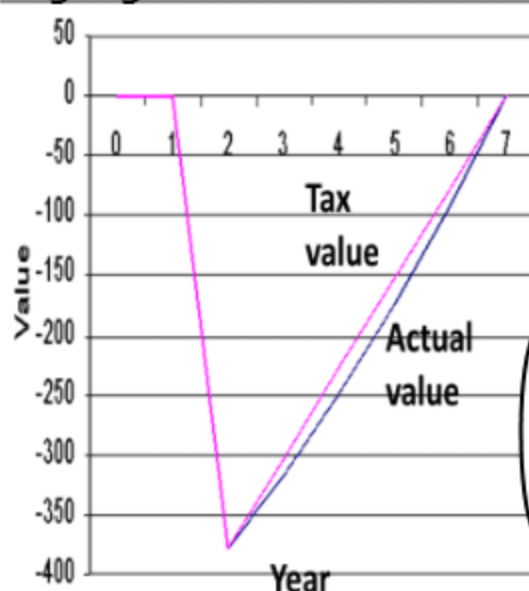
CGT: Appreciating



The chart for CGT assets* has tax value unchanged at original cost until disposal, in contrast to depreciating asset design. And then, on disposal, tax value is shown to be only half way between cost and disposal price to illustrate the effect of the 50% CGT discount, which the committee wants abolished. Adjustments to the general taxable income formula can readily accommodate the current CGT loss quarantining arrangements and, if necessary, CGT discount.



Right given to use asset



The chart for the liability to provide access to an asset for a period** just has the liability's tax value declining to zero in a straight line.

Use of an interest rate could push tax value closer to actual value.

Such design would provide welcome change from CGT's currently applying to an up-front amount received for the right given - though, again, current treatment could be retained via adjustments to the general formula, if necessary.



* Ch4, pp 7-13.

** Ch5, pp 4-7.

Overall, major consolidation and redesign of the law is involved - with much shortening and simplification, say, with CGT and financials.

But impact of the law need not change.



Nevertheless, it would be best for government to specify the tax value profile of each type of investment asset and liability and also to be clear on the reasoning behind those profiles.

Absent profile specification, under recommended redesign, annual change in value would kick in as the profile of tax value change.



And clear reasoning for the profiles would help the courts a lot in their interpretations.

But government may be under extra pressure to explain the tax value methodology chosen in each case.

On the one hand, as discussed, tax value closer to actual value means less interference of tax with the pattern of investment.



And, consequently, higher productivity and long-term growth - consistent with the broad base/low rates adage.

On the other hand, there may be practical issues arising from acknowledgement that annual change in value of investment assets and liabilities is the cornerstone of the new principle-based law.



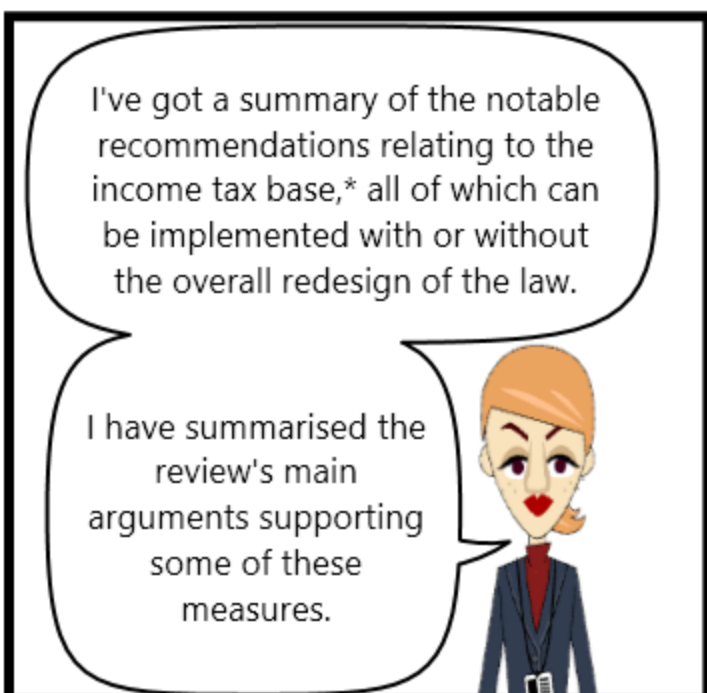
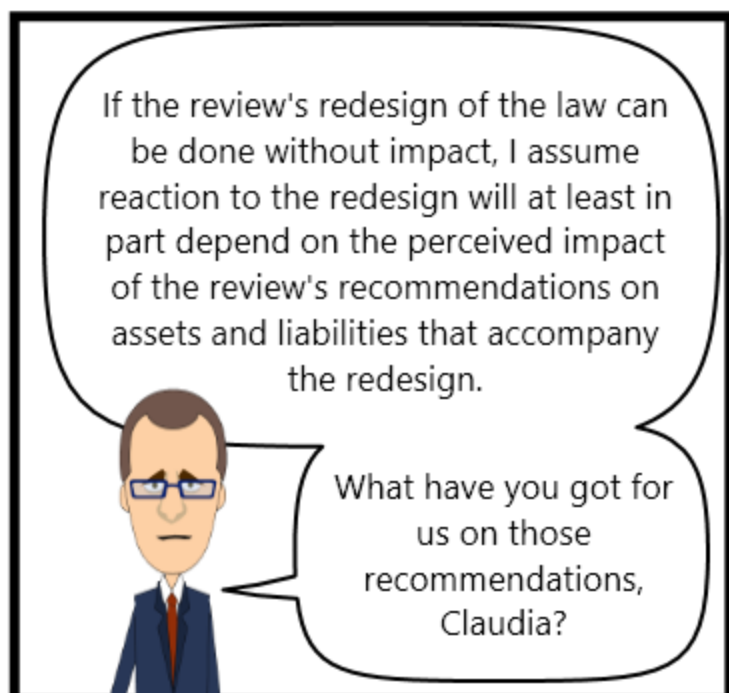
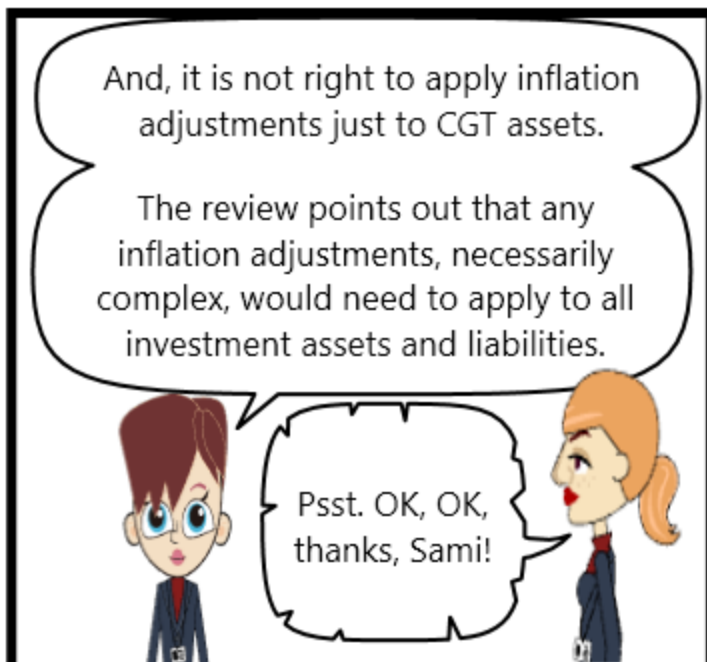
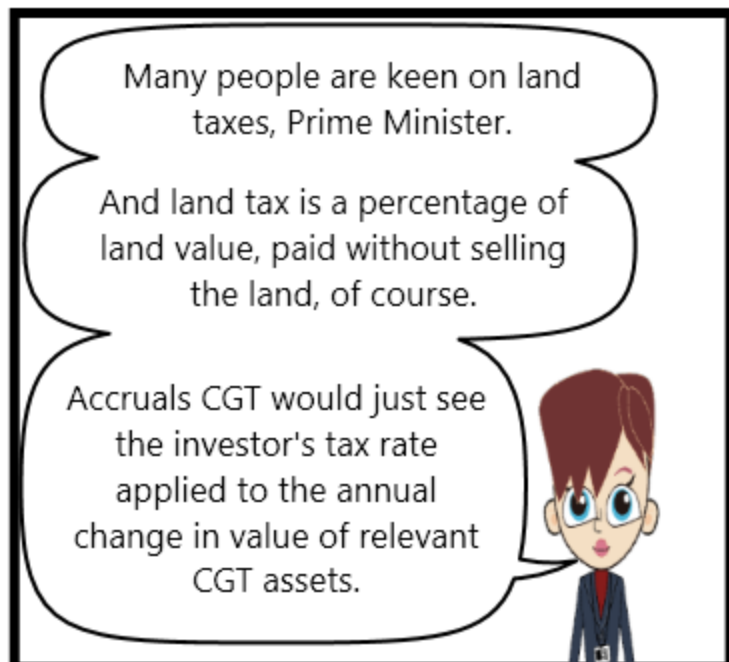
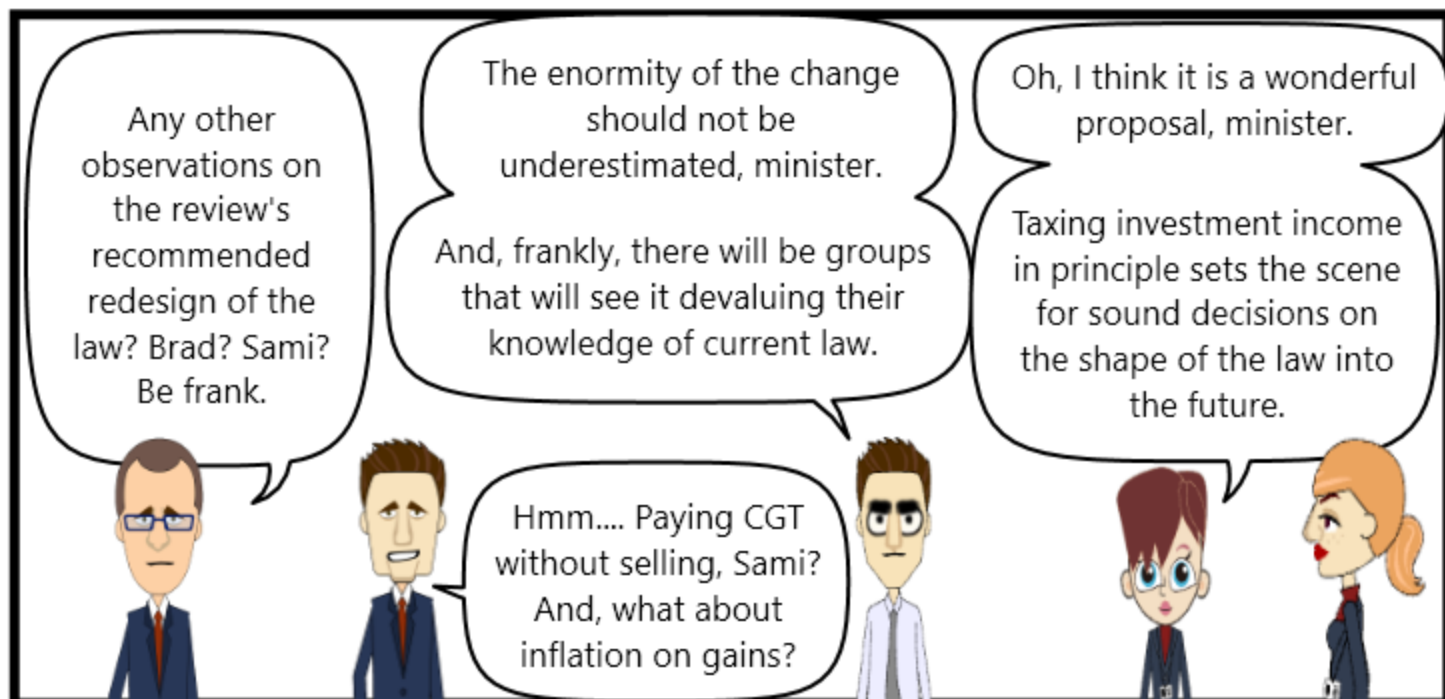
For example, some may be nervous over accruals CGT happening, while others may seek answers as to why this CGT change is not occurring given its productivity benefits.

I know I wanted something done about the length and complexity of the law - and having redesign based on the in-principle idea that income tax law actually taxes investment income each year is a straight-forward position to explain.

I can see how the review's design throws up somewhat contradictory aspects regarding CGT, for example. But, as usual, we just need to explain our decisions on tax value profiles, and special treatment more generally, like the realisations-based CGT and its 50% discount.



Mind you, I have always wondered how much the CGT discount encouraged people to shift their regular income into capital gains. And, I do remember your arguments for removal of the discount and, indeed, taxing accrued gains on a deferred basis.



* Chs 4, 5 & 6.

Depreciating assets

Continue with current approach of seeking to have write-off rates match rate of decline in value.

CGT assets: no 50% discount

Realisations-based CGT concessional from delayed tax on prior accrued gains.

Apply CGT on accrued basis where practical. Assess deferred tax on accruals for tradables; look-back treatment for non-tradables.

No 'simplified' income tax for small business

Simplicity and efficiency comes from uniform set of rules for all.

Reduced boundary lines engender greater clarity for investing with productivity benefits. Best just to provide a sound economy.

No change to "negative gearing"

Tax losses applied to profits required for investment balance.

Problem with rental property is tax loss does not include accrued gain.

Property assets

Separate the taxing and valuing of land and associated buildings.

Ensures tax design of each asset type applies, achieves better investment decisions, provides proper application of building depreciation.

No special treatment of defined "savings"

For tax, saving is investing.

In principle, the same design applies to all investment income.

Bank interest shows common pre- and post-tax return benchmark.

Financial arrangements (TOFA)

Apply tax value re-design attuned for each type of financial arrangement.

Same overarching design for TOFA and tangible assets.

Leasing and rights

Apply standard design within TOFA for associated assets and liabilities - with practical simplifications.

No CGT on up-front payments for swaps of assets or liabilities.

The review provides a lot of detailed analysis supporting its recommendations regarding the income tax base.



Some big changes with widespread impact!! But, I'm starting to appreciate more the simplicity of the general redesign and how that applies to all investments assets and liabilities.

Oh, no! They're buying this economic purity.

Hmm... Hmm...

And I know, during the Tax Review, much consultation has been undertaken, set against draft legislation, consistent with our regular integrated tax design process.

It is easy to explain that annual profit from an investment comprises receipts less regular costs plus change in value of the assets involved.

Everyone knows the yearly profit from shares is not just the dividend income but also the change in value of the shares themselves.

It's that same idea applied to the tax design for each type of investment asset, recognising practicalities involved for each.

And, while recommending in-depth assessment of deferred tax on accrued gains and losses on CGT assets, the review is not recommending that we apply the pure benchmark design blindly. Scope remains for special tax treatment to be given as necessary - like for small business or CGT on shares and property.

Hmm. I reckon I could espouse the virtues of the total redesign of the law based on the practical tax value specification of investment income.

I could explain how the current complex, lengthy and messy law puts a drag on profitability and fairness - and how this can be addressed by principles-based redesign without any accompanying structural changes to the tax base.

OK. Claudia, I'll be interested in the tax revenue savings available for personal tax rate reductions from the recommended tax base changes. Now, what is the second of the key recommendations?

As we have seen, the first key recommendation sets out a principled-based way of specifying taxpayers' annual taxable income from their investments.

The **second key recommendation** is to have annual taxable income taxed at the tax rates of the ultimate individual investor regardless of investment vehicle employed.



Currently, trusts are encouraged to distribute annual taxable income to unitholders or beneficiaries.

And, of course, the annual taxable income of direct investors, sole traders or partners goes straight to their yearly tax assessments....

...consistent with the benchmark principle for redesigning the law.



But in sharp contrast, after income is taxed in a company, it may be retained in the company indefinitely along with associated franking credits.

When it is eventually distributed to locals, at the extreme, company income that would have been taxed at, say, a shareholder's 47% rate when originally earned is not taxed at all when distributed because the shareholder's tax rate then is 0%. In these circumstances, all the franking credits, reflecting prior company tax paid, are fully refunded.



Can companies really achieve that outcome for their shareholders?

Private companies, in particular, are able to arrange such outcomes, Prime Minister.

Complex company/trust structures may be used, with "bucket" companies retaining taxed income with credits until suitable time for distribution.

Oh, they're going to buy this one too!

Consequently, the review recommends upgrading our imputation system to integration of taxable income.*



Integration of taxable income

Companies' annual taxed income allocated to local individual shareholders' tax assessments (based on period shares owned) even when retained.

Retained taxed income reinvested as "attributed" contributed capital.

Impact on local shareholders

Their tax rates apply to allocated taxed income (as with franked dividends):

- those on high tax rates pay extra; and
- those on low rates could get cash refund.

Effect on retained taxed income like current DRPs.

Benefits

Removes tax incentive to incorporate and achieves debt/equity balance.

Removes inequities and improves investment decision-making.

Improves productivity and long-term growth, saves tax revenue and allows a lower company tax rate.

CGT features

CGT tax value of shares increased for allocated taxed income to remove double tax on retentions and decreased for cash distributions to avoid double deductions.

Similar to AMIT adjustments. Best with no CGT discount.

Other basic design features

Simplest design has all cash distributions attracting CGT tax value reduction with no distinction between untaxed income (unfranked dividends) and capital returns. Keep distinction for integrity.*

Two crucial design issues

Two issues that are often given as reasons that integration is not feasible:

1. multiple share classes;
2. non-resident shareholders.

1. Multiple share classes

Separate subsidiaries** or current-year taxed income spread across share classes, reflecting respective capital contributions or face value of preference shares

Special rules for classes with discretionary dividend payouts.

2. Non-resident shareholders

Dividend slips show any cash payments from: (1) attributed current-year taxed income; and (2) "attributed contributed capital account", enabling non-residents' countries to provide credit for company tax on prior retained taxed income.

The review also made a number of observations and extra recommendations relating to integration.



* Ch3, pp 13-14.

** Ch6, p 14.

The review appreciates that the level of our company tax rate should not be so high as to discourage inwards foreign investment.

And, by the way, the review is recommending one rate apply to all local companies - removing the unnecessary complications associated with different rates depending on a company's size.



Under integration, local shareholders are always taxed each year at their rates on their companies' taxable income, with an automatic DRP effect resulting when taxed income is retained.

Consequently, the review notes that, when setting the level of the company tax rate under integration, the focus shifts decisively to the question how much to tax the inwards long-term equity investor.



Another big change. Some taxed without getting cash dividends. Claudia. Has this been done elsewhere? And, are we really able to implement integration here.

A world first!?

You bet.

Nowhere else, minister. But....

Many past tax reviews around the world have viewed integration as the ideal company tax design.* And, our deep experience with imputation means we, and Australia, are uniquely placed to upgrade it to integration.

Moreover, without fanfare, we recently introduced new income attribution rules, which are very similar to integration, for eligible managed investment trusts.**

Current weaknesses could justify shareholder tax on retentions. And, integration offers many benefits like sounder decisions, tax revenue savings and a lower company tax rate. The review clearly believes it is practicable. Hard not to give it a good look over.

Integration would also allow much law elsewhere to be cleaned up and integration could be applied to superannuation, even if integration for companies were **not** implemented.

OK. Let's look at superannuation first.

* Ch3, p 7.

** Ch3, pp 13-14, Ch 6, pp 13-14.

The review is very blunt in its assessment that current superannuation tax design is unfair in each phase*: contribution, accumulation and pension.

It sees the design more as a wealth generator for the well off than a system that reduces the call on the old age pension.



There are arbitrary arrangements, often imposing monetary limits, applied to each phase in vain attempt at removing inequities caused by a fixed tax rate applying in each phase.

The review believes the only way to truly address the inequities is to integrate members' annual taxable income from super with their overall current taxable income.



The review goes on to note that, fortuitously, superannuation fund members already have, or able to have, details of their income tax assessments in their funds' accounts allocated to them by their funds....

....and integrating those annual assessment details with their own personal tax returns would both deal with current inequities and allow very targeted concessions to be applied.

Hmm. Another major change, again with compelling justification.

Could you explain the recommendations and then show us where integration for companies would simplify the law elsewhere?



RECOMMENDATIONS ON SUPERANNUATION

Contribution: Have contributions go into funds after personal tax is paid.

Accumulation: Integrate members' annual taxable income in their (untaxed) funds with their personal tax assessments.

- Members' taxable income from their funds goes directly to their personal tax returns where targeted concessions apply, tilted more towards low income taxpayers.
- No complexities of multiple classes of interests or non-residents, buying/selling ownership interests, etc.

Pension: Abolish current pension phase.

Here is a summary of the main recommendations for the three phases of superannuation.



AREAS FOR SIMPLIFICATION UNDER INTEGRATION INCLUDE:

Dividend deeming rules aimed at preventing private company shareholders and their associates from avoiding tax on company distributions by accessing company profits in other forms.

- Under integration, local shareholders are taxed on company taxable income each year regardless of what happens then.

Provisions aimed at avoiding artificial CGT loss (and gain) duplication and those aimed at artificial value shifting (outside wholly-owned groups subject to the tax consolidation regime, the current design of which is endorsed by the Tax Review).

Shape of off- and on-market share buy-backs coalesces.

The review sees integration providing much scope for shortening and simplification of various parts of the law.*



In addition, were integration pursued, along with early refunds of excess imputation credits as proposed, the review recommends that, once integration is successfully bedded down, it be extended to **distributing co-operatives**.**

In contrast to imputation, integration design would automatically see current-year taxable income of these co-operatives taxed at the marginal rates of members, as can occur now with co-operatives but with complexities involved and differing outcomes possible.

Integration would remove the anomalies, inconsistencies and complexities of current treatment of distributing co-operatives.

**RECOMMENDATIONS ON TAX TREATMENT OF PARTNERSHIPS**

The taxable income of partners be calculated consistently across all assets, notably depreciating and CGT assets.

- The consistent treatment to be based on each partner's proportional interest in each asset, as now for CGT assets.

Partners be prohibited from selling part of their partnership income to related parties (like their wives) who have little or no involvement in the partnership.

- Similar prohibitive anti-income-splitting measures were considered, but not recommended, for family trusts.

And the review also made recommendations on the tax treatment of partnerships*** - consistent with the over-arching design framework but **not** dependent on implementation of integration.



That takes us to the review's recommendations regarding trusts and life insurers. Of these recommendations, only some relating to life insurers depend on implementation of integration for companies.

* Ch7, pp 18, 21, 24-26.

** Ch6, p 44.

*** Ch7, p 45, 51.

The review viewed positively current treatment of resident fixed unit trusts - that is, those where unitholders have a fixed percentage interest in the trusts' income and capital - noting that the treatment aligns well with integration company tax design.

Consequently, recommended changes for local trusts focus on problems arising from the wide scope trustees of discretionary, or family, trusts have to determine which trust beneficiaries may receive annual **distributable** trust **income** and how much - and who is to pay tax on the trust's **taxable income**.

The mismatch between distributable and taxable income can result in some beneficiaries being entitled to trust income while others pay tax on that income. But, simply forcing distributable and taxable income to match has problems.

Discretionary (Family) Trusts

Require trusts' definition of annual income for distribution to beneficiaries be trusts' taxable income adjusted for non-cash and non-taxable amounts - this would:

cut much complexity and excessive flexibility of trustees; and,

align beneficiaries' tax liabilities with their economic entitlements.

So, the proposal is to set distributable income essentially by stripping out non-cash items, like franking credits, from taxable income and adding non-taxable items.*

This closely aligns with cash versus taxable income in tax statements of unit trusts.

It requires tax law to override trust law, which would not be a first.



Technical Changes to Taxation of Trusts

Treat unpaid present entitlements (UPEs) as reinvestment arrangements

Absent integration for companies, refine current dividend deeming measures applying to UPE funds "loaned" to shareholders, to achieve equivalent effects to integration

These measures would replace complexity and uncertainty with principled design

There are also some technical recommendations.**

I mentioned earlier, too, that upgrading imputation to integration would address many problems with complex company/family trust structures.



Can trustees at present really send income to some when others are taxed on it?

Yes, Prime Minister.... If you're ready, I'll move on to life insurers.



* Ch6, pp 24-28.

** Ch6, pp 19-22.

Risk business taxable income

Risk premiums paid by all risk policyholders for current year's cover (incl renewals and new policies)

-

Cash flow

Payouts for claims over covered events plus claims admin costs

- / +

Increase/decrease in actuarially estimated value of claims

Value change of liabilities

+

Taxable income out of investment income from assets held to support risk policy liabilities/payouts

No changes are recommended for life insurers' **risk business**.

The review notes changes resulting from a past detailed review have set taxable income for this business consistent with the review's overarching design principle.*



INVESTMENT POLICIES

Current treatment - insurer taxed on underlying investment income; policyholders taxed in variable, arbitrary and inequitable fashion on accrued bonuses paid on maturity or surrender of policies.

Recommended change - each year insurer gets annual deduction for increase in liability, and policyholder gets assessed on increase in value, from accruing bonuses. Surrender value may be able to be used for life-time/endowment policies.

Result - bonuses treated like a company retaining compounding bank interest under integration.

The recommendations for life insurers' **investment policies** are **only if** integration design is applied to companies.**

Otherwise, competitive neutrality would not be achieved because currently shareholders are not taxed directly on their companies' retained income.



NON-SUPER ANNUITIES

Current treatment - insurer not assessed on income when it is attributable to annuity policyholders; policyholders assessed on the interest component of payouts

Recommended change - insurers assessed on income underlying annuity payments, thus attracting deductions for the annual interest component of those payments

Result - insurers taxed on income underlying annuity payment streams in a way that is consistent with that of providers of similar financial arrangements

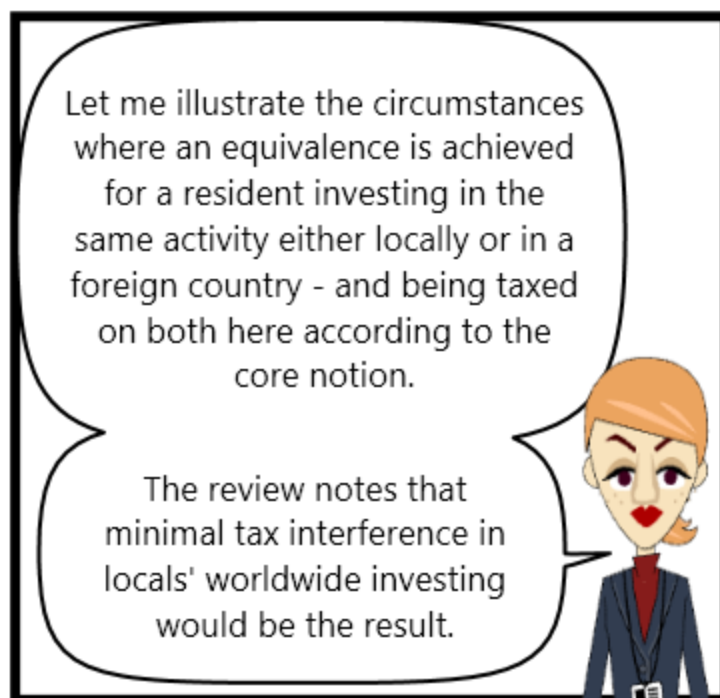
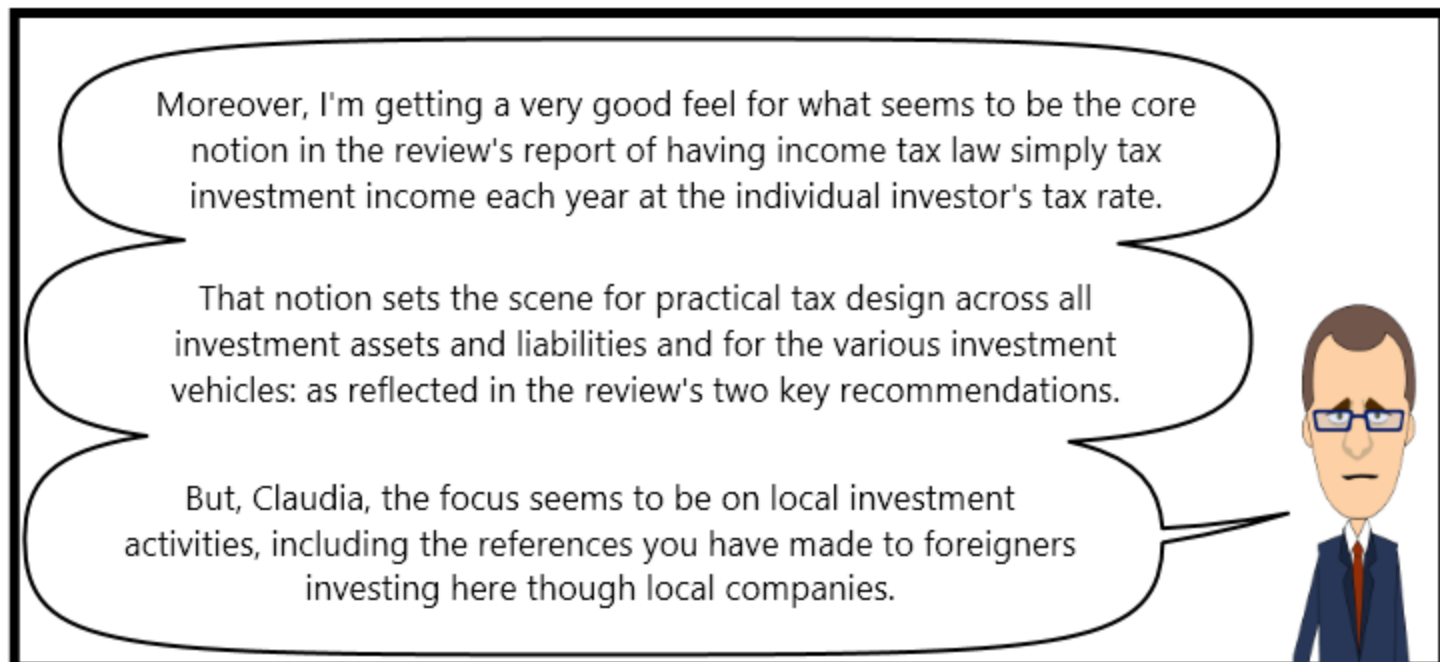
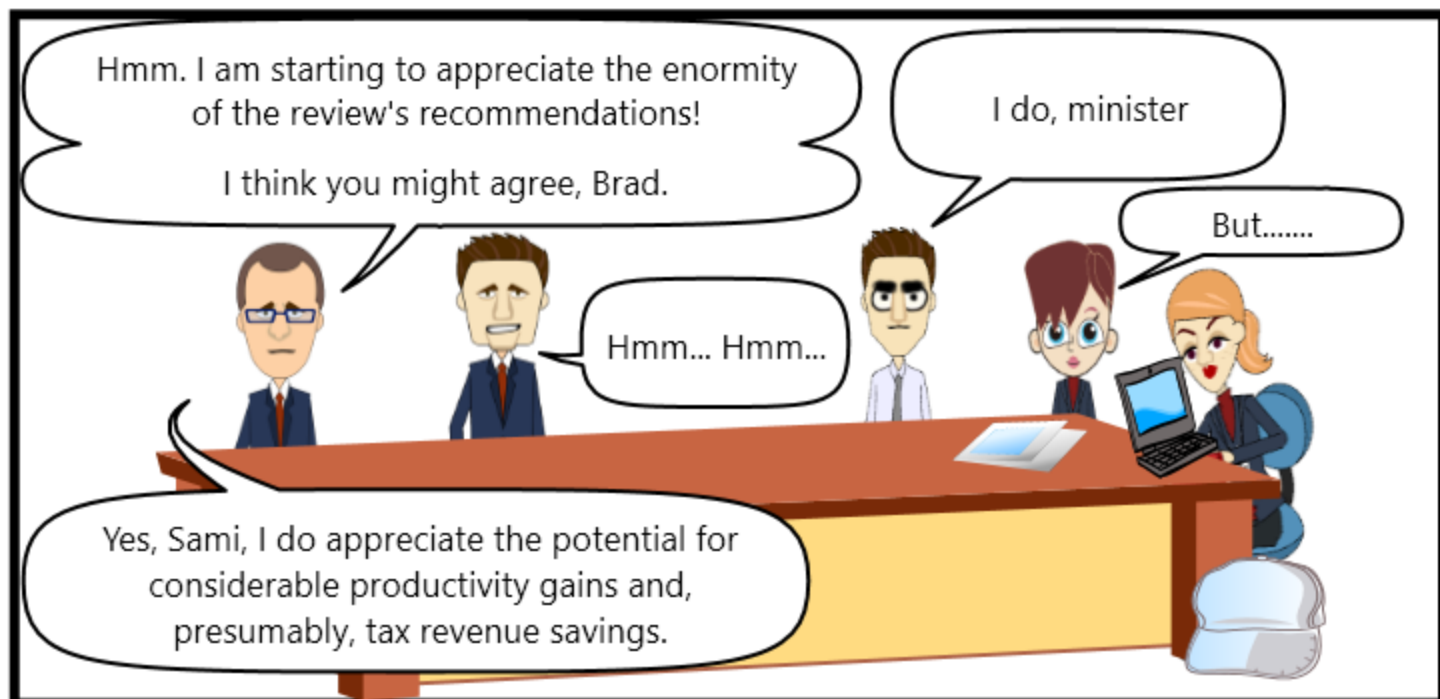
The recommendations for life insurers' **non-super annuities** do **not** require integration to be implemented.**

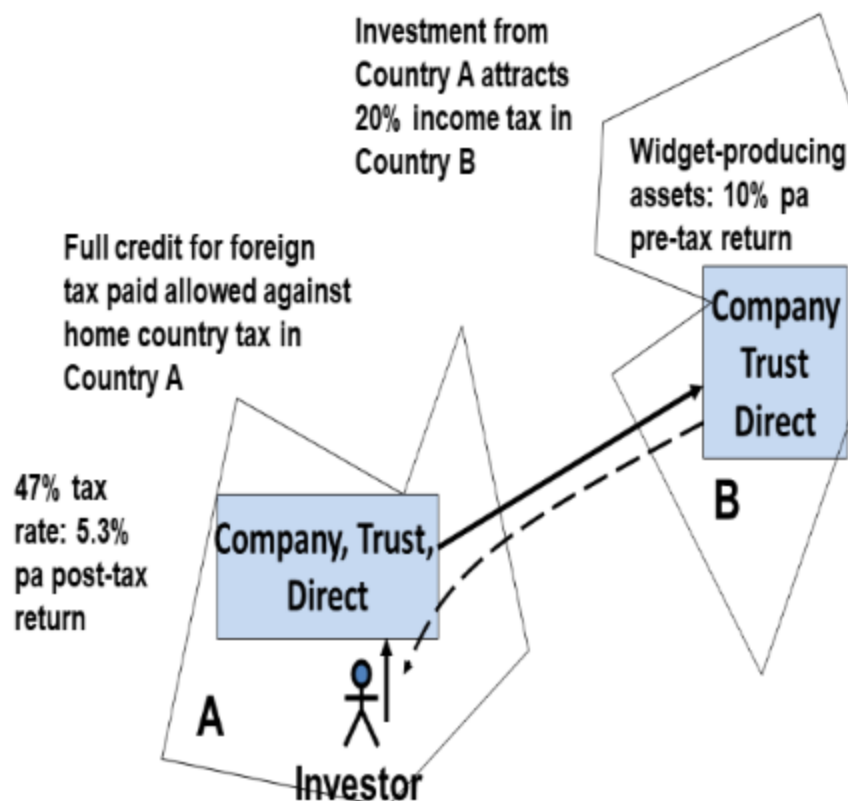
The review notes that, once both investment policies and annuities of life companies are taxed like regular financial arrangements, the life companies would be ready for integration design too.



* Ch6, p 49.

** Ch6, pp 51-54, 59-60.





Here we have our local, Country A, individual on a 47% tax rate putting his money into widget production in Country B.

Investment is direct or via companies or trusts from A then direct or indirect to widgets in B.

The review concludes that foreign tax values of the investment's assets set under our law should be converted to local dollars year by year....

....unless we assess the asset's value change on a realisations basis.*

Tax treatment of outwards foreign investment for minimal impact



Say, set against expected currency movements, a planned **direct** widget investment in Country B offers our resident investor a 10% pa pre-tax return.

If we in Country A provided a full refundable credit for foreign income tax on widget production, our investor pays a net overall 47% tax on the foreign income.

If currency movements match prior expectations** and we apply tax-neutral design***, the local investor earns 5.3% after tax on the investment, exactly the same post-tax return available on a local investment earning 10% pa before tax.



For such investment by a resident company under integration design, the foreign credit would be added to the company's franking credits and immediately flow through to local shareholders' tax returns.

Such change would be highly costly to tax revenue but the review recommends moving in this direction when able to do so.

Now, the same core notion underpinning minimal investment impact translates into the review's discussion of our anti-tax-deferral regimes for foreign trusts.



* Ch5, pp 33- 40.

** Ch5, p 37.

*** Ch1, pp 16-17, Ch8, p11.

Significant changes have recently been made to the so-called attribution regimes for the taxing of our residents' current-year income of certain foreign trusts and companies.

Those regimes seek to attribute current-year income even when not distributed.

Even though tagged "anti-tax-avoidance" regimes, the aim of taxing all current-year income to the ultimate investor, whether distributed or not, matches the rationale behind the review's proposed integration regime for local companies - and that accords with the overarching aim of minimal investment impact.

The review recommends an in-depth assessment of the efficacy of the recently restructured regime set against key policy design principles shown here.

NON-RESIDENT TRUSTS: POLICY DESIGN PRINCIPLES

- (1) Tax locals' current-year foreign trust income where practicable**
- (2) Have mutually exclusive definitions of regimes - each specific to clearly defined structural types of trust**
- (3) Have strong rules for reporting foreign transfers and subsequent income details**

Without downplaying the regime's anti-tax-deferral focus, the first principle accords with that overarching aim of minimal investment impact.

The review identified a series of issues for assessment linked to each of these principles.**



Overall, a lot of significant recommendations. Any way of bringing them all together in a digestible way, Claudia?

Hmm... Hmm...

Yes, minister. The ubiquitous nature of the general principle underlying the recommendations provides the way.



* Ch6 pp 31-40.

** Ch6 p 40.

1. Simplify lengthy, complex law

Redesign law to tax investment income based on general principle

Government decisions replace value profile with tax value profile

Default aligns tax value with value

General principle

Annual investment income in personal tax returns regardless of investment vehicle: net receipts + annual change in value of assets/liabilities

Minimal interference
Maximum fairness
Minimal tax planning

2. Upgrade imputation to integration

Company taxable income allocated to individual shareholders each year even when retained

Apply design to:
• superannuation funds (with concessions in personal tax returns);
• co-operatives;
• life companies.

Get consistency across asset types

Seek to align tax value with value if possible

Much scope for reform with CGT and financials (including leasing and rights and rental properties)

Remove CGT discount. Assess deferred tax on accrued gains/losses of CGT assets.

Consistency across other investment vehicles

Tax as financial arrangements life insurers' investment policies and annuities

Set family trusts' distributable income as adjusted taxable income

Consistent treatment of partners' interests in assets and restrict sale of interests to family

Outwards and inwards foreign investment

Outwards: convert most tax values to local currency each year; where possible, increase crediting of foreign taxes

Inwards: tax revenue savings from integration design allows reduction in company tax rate

The ubiquitous nature of the general principle can be seen in this chart of the review's main recommendations.



TAX REVENUE ESTIMATION

Measure	Revenue impact
Redesign tax code	Neutral
Remove 50% CGT discount	Very large savings
Upgrade imputation to integration	Very large savings
Apply fairness to superannuation	Very large savings
Integrity (eg family trusts, partnerships)	Solid savings

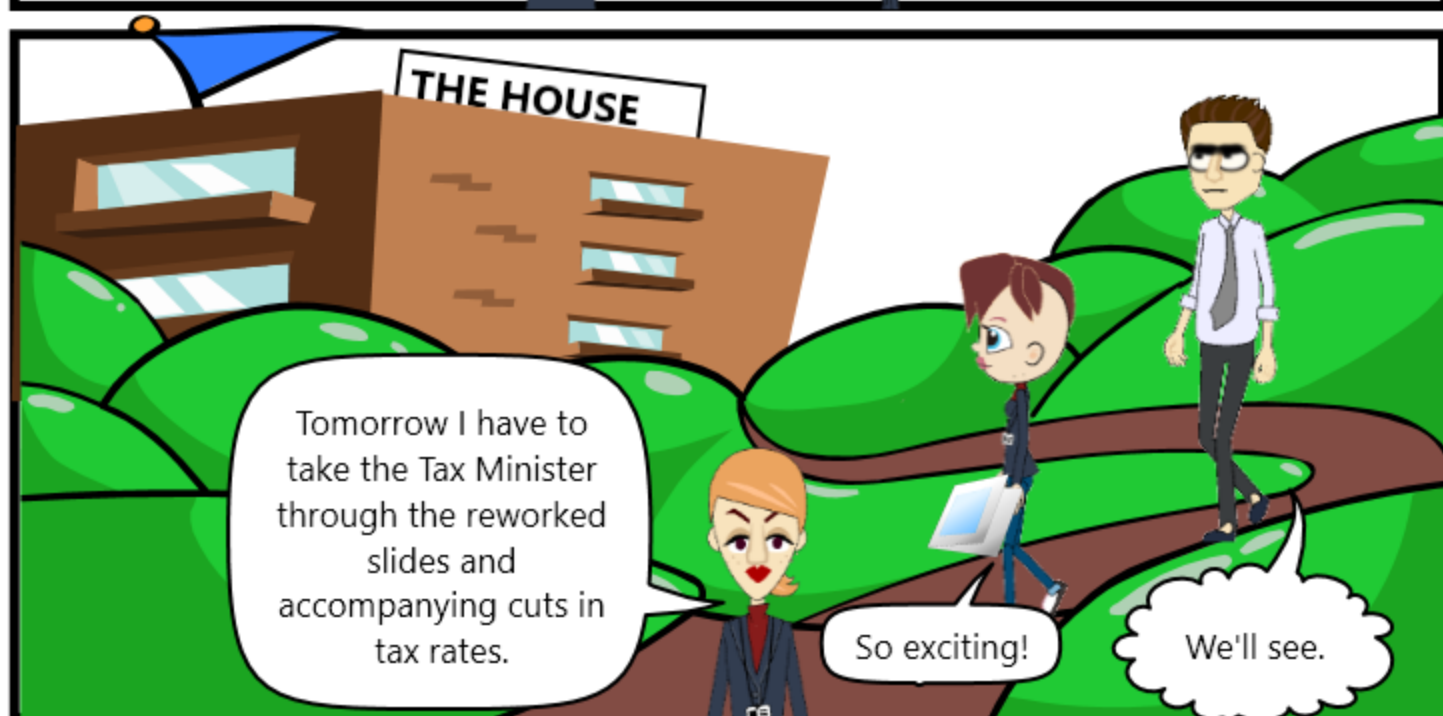
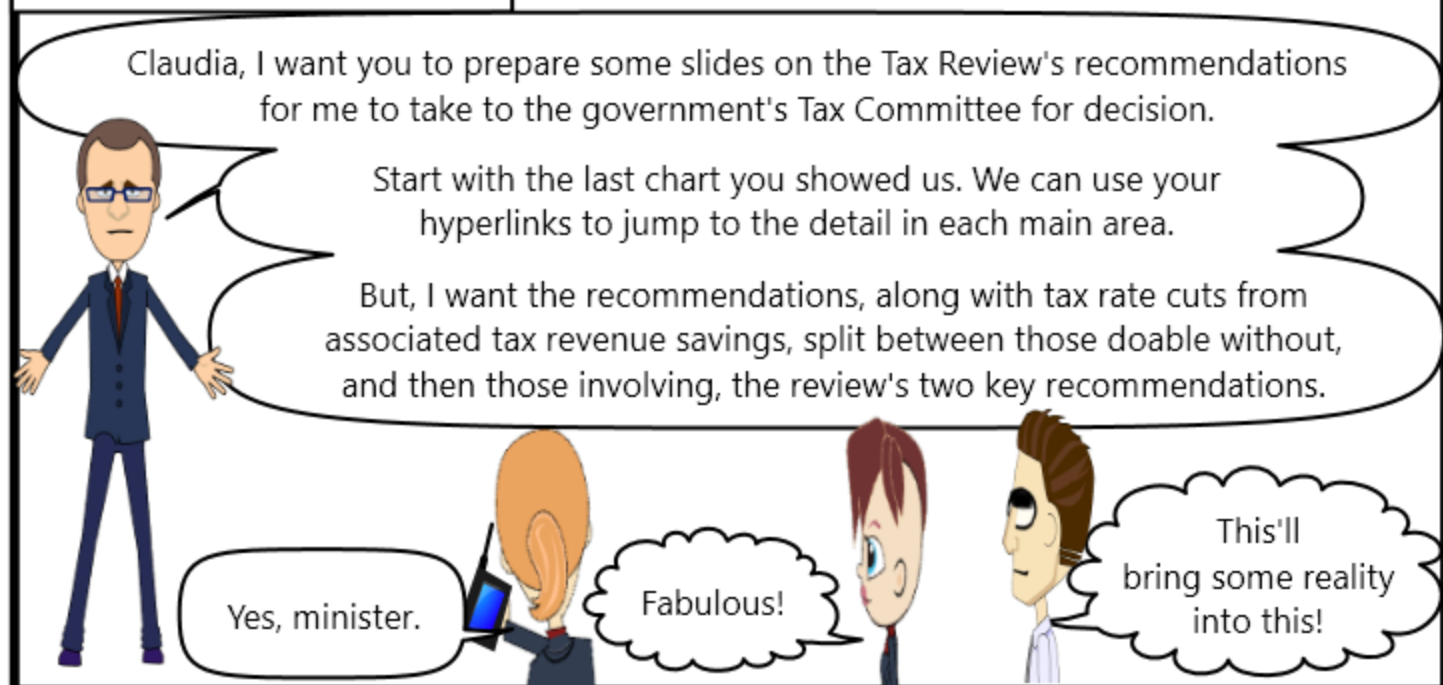
And to conclude, on the tax revenue front, the review estimates significant tax revenue savings overall, absent major changes to foreign tax crediting.

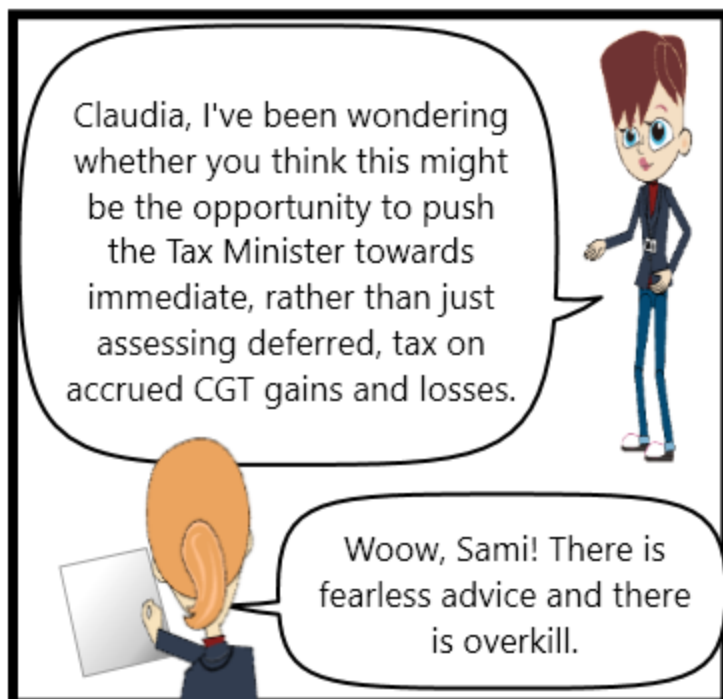
We estimate the tax revenue savings could fund considerable tax rate reductions - again, consistent with the broad base low tax rate adage, or BBLT.





A short time later.....





RECOMMENDATIONS: PHASE I**Investment income tax base**

- (a) Abolish the 50 per cent CGT discount.
- (b) Recognise changing tax values of assets and liabilities associated with leases and rights so that lease premiums and up-front payment for rights are not subject to CGT.
- (c) Abolish the simplified income tax arrangements for small business, removing complexities of artificial boundary lines and different design.
- (d) Value separately for tax purposes land and associated buildings.
- (e) Tax Department to assess practicability of deferred tax on accrued gains/losses of CGT assets: for tradable assets, deferral with interest applied to annual measurements; and, for non-tradable assets, looking back to achieve similar effect when disposal value known.

Collective investment vehicles

- (a) Abolish the lower corporate tax rate attracted by some companies.
- (b) Remove over-bearing unfairness and complexity in superannuation arrangements by: having contributions made after personal tax; including members' annual assessments from their funds' accounts in their own personal income tax returns; and, applying concessional treatment, favouring low-income members, in members' tax returns.
- (c) Achieve consistent treatment across the proportionate interests of partners in partnerships as with CGT assets now and strike out the selling by partners of their interests to related parties who have little or no involvement in the partnerships' operations.
- (d) Align distributable income of family trusts with the trusts' taxable income adjusted for non-cash and non-taxable items, and treat UPEs of fixed and family trusts as reinvestment of capital.
- (e) Treat life insurers' non-superannuation annuities as regular financial arrangements with insurers taxed on underlying income.

Implementation

Tax revenue savings from these recommendations enable the large cuts to personal income taxes (rates and thresholds) shown.

The Tax Minister has decided to take a two-phase approach to recommendations in his submission on the Tax Review for decision by members of the Tax Committee.

The first phase is for immediate implementation. The second phase involves more lengthy consultation.

What! He has gone with assessing deferred tax on accrued gains and abolition of concessional depreciation and trading stock treatment for small business.

And, wow, integrating members' income from their superannuation funds with their own tax returns.

RECOMMENDATIONS: PHASE II

The Tax Department prepare a draft redesign of tax legislation for the taxing of investment income based on practical implementation of the Tax Review's over-arching design principle of current-year commercial profit taxed to individual local investors regardless of investment vehicle.

Investment income tax base

(a) Current-year taxable income of investors to comprise gross revenue less current costs plus change in tax value during year of all categories of investment assets and liabilities (except cash accounts) - with value replacing tax value where no tax value profile is specified.

(b) Companies and trusts to be able to reframe taxable income as cash flow (including capital and current costs) plus change in aggregate tax value of assets and liabilities at start and end of year.

(c) For residents' foreign investments, foreign tax values to be converted to local currency consistent with application of our law to their foreign tax values or income.

Collective investment vehicles

(a) Upgrade the imputation system of company taxation to integration of taxable income, consistent with the Tax Review's recommendations, so that current-year taxed income of local companies is always allocated to shareholders - with unfranked dividends retained, initially at least.

(b) Make consequent amendments to loss/profit duplication, value shifting and dividend deeming provisions aimed at stopping private companies avoiding tax on profit distributions.

(c) Apply integration design to co-operatives, as well as to life companies with consequential amendments to investment policies of life insurers to have insurers get deductions for increases in liabilities while policyholders get assessed on increases in value from accruing bonuses (surrender value used for lifetime/endowment policies).

Implementation

The Tax Department consult widely on the draft legislation.

After the consultations, the Tax Minister bring back to the committee submissions on: final redesign decisions; the scope to reduce the company tax rate and broaden crediting of foreign taxes; and, the Tax Department reviews of (a) the anti-tax-deferral regime for foreign trusts and companies and (b) deferred taxing of accrued capital gains.

These are the Tax Minister's second phase of recommendations.

I'll be going into the Tax Committee with him.



Oh, wow!! Sounds like integrated tax design on steroids!

Just wait for the consultations to hit!



The Tax Committee agreed to all the Tax Minister's recommendations.
The Tax Minister worked the slides a treat.

I got a chance to contribute to the discussion personally when a minister suggested - presumably from his department's brief - that changes to the law over recent years point to a move away from income taxation and more towards expenditure taxation.

When asked by the Tax Minister, I explained how expenditure taxation does not tax regular investment income at all. Then I pointed out that past changes like our CGT regime, full imputation, taxation of financial arrangements and revised superannuation treatment have added to the quality and coverage of our law that taxes investment income - and the Tax Minister's proposals offer to further that process while drawing together current disparate and complex law within a principle-based framework.

So, a great outcome! We will have to get the tax law and administration teams geared up further for immediate changes.

And the Tax Minister wants detailed briefing on his proposed personal tax cuts from Phase I recommendations and on the potential size of the reduction in the company tax rates from his Phase II recommendations.

Much consultation to be done. And we have to get underway detailed assessments of anti-tax-deferral rules for foreign trusts and companies and deferred taxation of accrued gains and losses.

This is big!

GROAN....

Let's get at it!

