Supplementary Submission to the Review of Business Taxation

Association of Superannuation Funds of Australia

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Executive Summary

ASFA is concerned that a number of proposals being raised in debate about capital gains tax reform would lead to both inequities and inefficiencies. More specifically, a number of options in the Discussion Paper which purport to provide relief from capital gains tax could more accurately be described as redistributing the burden of the CGT from those who can and should pay to those less able to pay.

Superannuation funds have large holdings in both absolute and relative terms in growth assets such as shares and property. In 1996-97 funds declared over 40 per cent of the reported capital gains, and paid nearly 30 per cent of the CGT collected.

Given the importance of superannuation funds as payers of CGT, ASFA suggests that the impact on funds of any proposed changes to indexation and other provisions should be given very careful consideration.

Removal of indexation would increase superannuation fund tax liabilities by over $125 million a year and reduce member balances by the same amount, leading to both inequities and inefficiencies. Over 8 million superannuation fund members in effect would be required to pay for a CGT rate decrease flowing to fewer than 600,000 asset wealthy individuals. Further, superannuation funds would be discouraged from investing in long term infrastructure projects and in venture capital.

Another problem with abolishing indexation and reducing the CGT rate applying to individuals for relatively recently acquired assets is that this would provide individuals with an incentive to transform income into capital gains, thereby eroding the income tax system and generating inequities.

Scrip-for-scrip rollover relief is not a high priority for superannuation funds. Any proposals for this would need to be carefully designed, and should not allow individuals to attach CGT free status to shares acquired as part of a takeover.

While some averaging may be appropriate for individuals given the “lumpiness” of many capital gains, ASFA supports modifications to the provisions to avoid abuse and the extension of averaging beyond what is required to provide for a reasonable level of smoothing of taxation on capital gains.

ASFA acknowledges that there are grounds for better integrating capital losses into the CGT regime. However, given that easing of current arrangements could give rise to avoidance problems, a large cost would be involved and efficiency concerns are not major, reforms in this area are not considered to be of high priority. ASFA would not support the removal of indexation as an appropriate trade-off for an easing in the restrictions of the treatment of capital losses.

Background

ASFA is a non-profit, non-party political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. As such it is the "Voice of Super".

ASFA provided a submission in response to Discussion Paper 2 of the Review on 7 April 1999. That submission focussed on issues of direct and immediate relevance to superannuation funds. These issues included the tax treatment of Pooled Superannuation Trusts, collective investments, investments underlying pensions and annuities and the superannuation business of life companies.

ASFA is making this supplementary submission to deal with the specific issue of capital gains taxation. It has come to ASFA's attention that a number of parties providing submissions to the Review have or will propose that significant changes be made to capital tax arrangements, with the increased revenue flowing from these changes being used to finance changes to the capital gains tax system or elsewhere in the tax system. The Review also has specifically invited submission to address the relative importance of alternative forms of capital gains taxation.

If changes to capital gains taxation were neutral in their overall incidence in that all taxpayers would receive some tax benefit for any change that increases their capital gains tax obligations, then ASFA would have no specific objection to such changes being considered. Equally, ASFA would have no objection if capital gains tax relief at the individual level were funded by other changes in individual tax arrangements. **Proposals that are entering public debate appear to be based on superannuation funds and some other taxpayers paying substantially more capital gains taxation with the benefits of increased revenues flowing to certain classes of individual investors and/or to business more generally.**

In essence, a number of options which purport to provide relief from capital gains tax could more accurately be described as redistributing the burden of the CGT. For instance, applying a rate lower than personal income tax rates to a higher tax base (due to withdrawal of indexation) redistributes from those who hold assets for a long time to those who hold them for a relatively short time. Providing relief at only the individual level and funding the costs of this by general changes to CGT provisions also involves a redistribution from companies and superannuation funds with capital gains to individuals.

ASFA considers that the Review should consider the ramifications of any to change the structure of the capital gains tax very carefully.

Superannuation funds and the capital gains tax

Superannuation funds are responsible for a large proportion of the taxable capital gains reported to the Australian Taxation Office, and of the total capital gains tax paid by taxpayers. Superannuation funds have large holdings in both absolute and relative terms in growth assets such as shares and property. For instance, superannuation fund holdings of Australian equities account for around one quarter of the market capitalisation of the Australian Stock Exchange.

As a result superannuation funds feature prominently in the list of payers of capital gains tax**. In 1996-97 (the latest year for which detailed taxation statistics are available) superannuation funds had capital gains of $3,870 million, just over 40 per cent of the total capital gains reported**. Additional capital gains relating to superannuation would also form part of the taxable income of life insurance companies, which are included in the aggregate company taxation statistics.

Superannuation funds with a trust structure paid just over 27 per cent of total taxes collected on capital gains. This lower percentage than their share of capital gains reflects the fact the superannuation funds pay tax on their earnings at a flat rate of 15 per cent as part of the overall taxation of retirement savings through superannuation.

While only around 7 per cent of individual taxpayers and 5 per cent of companies paid capital gains tax, around 25 per cent of superannuation funds did, with 54 per cent of funds with taxable income exceeding $1 million paying capital gains tax. The bulk of capital gains at the individual level come from shares and trust distributions. Superannuation funds, particularly the larger ones, have capital gains across a range of assets.

Clearly any changes to the structure of capital gains taxation would have a significant if not disproportionate impact on the operations of superannuation funds.

Review of Business Taxation consideration of capital gains tax options

The Review has indicated its intention to assess the main design features of the capital gains tax and to consider reforms that would make it more acceptable, while not compromising its overall contribution to the integrity of the taxation system. This intention is subject to the Terms of Reference of the Review which require it to examine the scope for capping the rate of tax applying to capital gains for individuals at 30 per cent, and extending the CGT rollover provisions to scrip-for-scrip transactions. The Review is also required to take into account the need to achieve overall revenue neutrality in respect of any such changes.

The treatment of capital gains taxation in the Discussion Paper is not without ambiguities. The Paper acknowledges that capital gains taxation in Australian is relatively harsh by world standards and notes the Government's request for examination of options to reduce the burden of the CGT. However, the discussion in the Paper appears to treat with some suspicion any departure from full taxation of nominal gains as being inconsistent with the comprehensive income tax base favoured by the Review.

For instance, at paragraphs 11.3 and 11.4 it is noted that most countries tax capital gains more favourably than ordinary income in order to encourage savings and investment, and that other countries tend to provide more generous tax treatment than does Australia. While the remainder of Chapter 11 examines arguments for capital gains tax relief, and a range of possible options for capital gains tax relief at the individual level, the general attitude seems to be that taxing capital gains at a lower rate than other income leads to administrative and compliance complexity and could reduce the integrity of the income tax system (paragraph 11.31).

Nevertheless, the strategy for reform is stated by the Paper to be to achieve a balance between encouragement of investment and attracting capital in a more vibrant capital market, on the one hand, and collecting an appropriate contribution to revenue on the other. The cost to revenue is seen as an important constraint, with removing indexation and averaging suggested as an acceptable trade-off for other reductions in the burden of CGT. It is stated that if alternative CGT proposals cost more than the revenue available from abolition of indexation and averaging, then there will be implications for the scope to reduce other taxes or alternative revenue sources will be needed.

However, the Paper does not explain how changes which affect the structure of the capital gains tax but do not decrease the revenue from CGT would reduce the burden of the CGT. As well, no mention is made of the implications of changes such as removal of CGT indexation which might generate more revenue than would be foregone by other changes to the CGT regime. Neither is there mention of the implications of CGT changes which increase the obligations of companies and superannuation funds in order to provide CGT relief at the individual level**. ASFA suggests that all of these issues would need to be thought through carefully before any consideration could be given to changes to indexation and other provisions.**

Discussion Paper proposals for CGT modifications

In contrast to the very flat description of possible options for CGT relief at the individual level, Chapter 12 of the Paper asserts that indexation, averaging and quarantining of loss aspects of the current CGT regime are complex, inequitable and distortive.

Indexation

The main “evils” attributed to indexation are that Australia is one of the few countries that indexes capital gains, and if the possibility of reducing capital gains is left aside, removal of indexation would minimise the incentive to classify income as capital gain so as to benefit from indexation. The first leg of these arguments is not compelling, and sits oddly with the public position of successive Australian Governments that indexation is an intrinsic feature of the capital gains tax system in Australia. As well, the Commonwealth Treasury in successive Tax Expenditure Statements has considered that indexation of capital is part of the benchmark for our income tax system rather than a departure from an acceptable benchmark.

The other inconsistency in the argument in Discussion Paper is that the main reason that removal of indexation is proposed is to provide revenue so as to finance a reduction in the rate of tax paid by individuals on capital gains. If this objective were achieved there would in fact be increased incentives to transform income into capital gains, given that the rate cut would apply to capital gains achieved over a relatively short period as well as gains over a longer period. Currently, to benefit from indexation requires an asset to be held for a relatively long period, which reduces the scope for tax planning.

Applying a concessional rate of income tax at the individual level to relatively short term capital gains is relatively expensive in revenue terms. $823 million was collected in CGT from individuals in 1996-97, with nearly all of this amount projected to be lost from tax revenue if certain changes are made to the treatment of CGT and individuals. For instance, a 30%, 25%, 12% CGT regime for individuals is projected to involve a revenue cost rising from $350 million to $650 million a year. Scrip-for-scrip rollover relief is projected to cost a further initial $100 million, with a cost of $50 million in subsequent years.

These figures suggest that the options proposed would provide extremely concessional treatment for capital gains received by individuals and/or that reducing the CGT rate for relatively recently acquired assets would lead to individuals transforming income into capital gains.

The other difficulty with the removal of indexation for all taxpayers and its replacement with a rate cut for individuals would be that outcomes would be inequitable and distorting across categories of taxpayers. For instance, superannuation funds would pay more CGT with no offsetting benefit. The Discussion Paper estimates that removal of indexation would generate around $500 million in revenue annually. Given that superannuation funds pay about one-quarter of total CGT, this suggests that removal of indexation would take an additional $125 million annually in taxes from funds.

Superannuation funds paid about $500 million in taxes on income other than contributions in 1996-97 after allowance for deductions and imputation credits. A $125 million increase in taxes on earnings flowing from removal of indexation would be a substantial increase in superannuation fund tax liabilities.

Another difficulty with the arguments in the Discussion Paper is that there is an implication that a revenue neutral proposal on capital gains will somehow make the capital gains tax less onerous. However, the reality is that a revenue neutral proposal will simply shift the burden between various taxpayers.

Shifting the burden between categories of CGT payers can give rise to inequities. For instance, the bulk of Australian workers have the largest part of the financial wealth outside of residential housing in superannuation. **Over 8 million Australians are members of superannuation funds and most of these benefit from the indexation of CGT provisions. To tax capital gains of superannuation funds more would in effect lead to higher taxes for the bulk of the Australian workforce. To use that revenue to reduce CGT liabilities of individuals would redistribute to the relatively well off in Australian society.** In 1996-97 there were under 600,000 individuals with taxable capital gains, with many of these individuals wealthy in asset terms at least.

If it is considered that the indexation provisions impose an excessive record keeping burden on individuals it would be open to the Review to recommend that indexation for individual taxpayers be replaced by a cut in the CGT rate for individuals. Current arrangements could continue to apply to funds and companies, given that these entities will be required to maintain records in any event.

Distortions and inefficiencies in the availability of capital could also arise through removing indexation from the CGT regime. For instance, superannuation funds provide around half of the venture capital raised in Australia, and are substantial investors in infrastructure projects. **Removal of indexation would lead to less investment by superannuation funds in such projects, which typically have a long investment horizon with a substantial proportion of the return coming from an increase in the capital value.**

In regard to scrip-for-scrip rollover relief, this is not a high priority for superannuation funds as their liquidity generally is such that payment of any CGT obligation is not a major constraint, and there are problems with equity between fund members who leave the fund at different times if CGT obligations are accrued indefinitely.

The Review should note that scrip-for-scrip relief would allow individuals with pre CGT shares to maintain the CGT-free status of their shares even after a takeover. The equity arguments for such treatment are not compelling, especially if the consequence was that more revenue would have to be raised from individuals and entities subject to the CGT on all of their asset holdings.

Averaging

As indicated in the Discussion Paper there is evidence that averaging provisions are abused by some individuals. No such abuses occur in the case of superannuation funds because they pay tax at a flat rate and averaging provisions are not relevant.

While some averaging may be appropriate for individuals given the "lumpiness" of many capital gains, ASFA supports modifications to the provisions to avoid abuse and the extension of averaging beyond what is required to provide for a reasonable level of smoothing of taxation on capital gains. The revenue gain of around $150 million a year could be used for improvements to arrangements applying to individuals paying CGT or more generally in regard to individuals if this were considered appropriate.

Taxation treatment of capital losses

ASFA acknowledges that there are grounds for better integrating capital losses into the CGT regime. However, given that potential easing of current arrangements could give rise to avoidance problems, reforms in this area are not considered to be of high priority. ASFA also would not support the removal of indexation as an appropriate trade-off for an easing in the restrictions of the treatment of capital losses.

The carry-back of losses against past capital gains on all assets would be very expensive with revenue loss of over $400 million a year. While it is arguable that the current quarantining of capital losses may be a source of some bias against risk taking, changing the treatment of past losses will in no way influence the investment decisions made in the past that led to those losses. Any argument for changed treatment of past losses based on equity considerations is also tenuous given that past investments were made with full knowledge of CGT provisions, and any change now would provide a windfall for those who incurred losses.