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The Australian Tax Planning Playbook: Volume 1

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Abstract

Has income tax become voluntary in Australia? It appears that for some, nil or very low tax bills are a very real prospect. Those with flexibility over how they earn income can use a range of legal means of 'tax arbitrage' to pay a lower marginal tax rate. Those highly motivated to achieve the lowest possible tax bill can structure their financial affairs so as to stream income through a mix of companies, trusts, property assets, superannuation funds and adult family members over time. This paper presents some of the simpler strategies that are part of the 'Tax Planning Playbook'. In doing so, it shows how tax planning is available to people across the income distribution. It is not surprising that taxpayers make use of the opportunities available to them and respond to the incentives they face. However, a system that encourages tax planning is an affront to the commonly-held core principles of good tax design of fairness, efficiency and simplicity. It also raises questions about the longer-term sustainability of Australia's tax system. Addressing tax planning requires a wholesale rethink about the design and role of income in Australia's tax system.

JEL Codes: H23, H24, H26
Keywords: Tax minimization; tax system design; fairness

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Introduction

Australia relies heavily on the direct taxation of income to raise government revenue. According to the 2019-20 Mid-Year Economic and Fiscal Outlook, the federal government is expected to raise 17 per cent of Australia's GDP from individual and company taxes in 2019-20 (Frydenberg and Cormann 2019b). A point made in major Australian tax reviews, as well as in a range of publications from international institutions such the IMF and OECD, is that Australia's strong reliance on income taxes for revenue-raising makes us an outlier among the international community. Based on the latest available internationally comparable data (excluding social security taxes), in 2017 Australia raised around 59 per cent of total tax revenue from taxes on income and profits (OECD2019a). The corresponding average among OECD countries was 33.2 per cent (OECD 2019b).

In this paper, we show how Australian income taxes are being raised in a manner that is overly complicated, unfair and inefficient. As a result, a significant segment of Australia's revenue-raising is inconsistent with the core, broadly-accepted principles of good tax design.

Australian policymaking circles long ago succumbed to the philosophy that some Australians could be treated as special in the eyes of the tax system. Now many Australians can receive privileged tax treatment simply by operating in specific ways in the economy. And some people have copious, legal, opportunities that they can combine to reduce their income tax bills. The use of such opportunities is the domestic version of tax base erosion and profit shifting (BEPS), the well-discussed corporate strategy for reducing corporate tax owed.

We present a basic Tax Planning Playbook: a guide to some of the simpler tax approaches and structures that are available. Even these simplistic 'plays' reveal that tax planning can be beneficial to a wide range of Australians. It is also lucrative. In some cases and for some 'taxpayers', income tax can become temporary or even voluntary in nature. At the same time, other Australians, such as sole-earning wage and salary earners, are comparatively 'punished'. They pay higher tax rates and shoulder a disproportionate share of the taxpaying burden. This outcome violates basic tax design principles of horizontal and vertical equity.

We conclude by highlighting how restoring a sense of fairness into the Australian tax system is a significant task that will take coordinated policymaking action.

THE BASICS OF TAX PLANNING

Important definitions: tax arbitrage, tax planning and Australia's hybrid income tax

In this paper we make frequent use of three reasonably obscure terms so we will define them here.

Tax arbitrage refers to people assuming a different legal form in order to receive a lower marginal tax rate in an economic transaction. It can be thought of as a specific form of arbitrage; the general concept that concerns the simultaneous buying and selling of an asset (or store of value) in order to take advantage of different prices for the same asset. Tax arbitrage hinges on two features. First, a tax administrator deems a range of taxpaying entities as legitimate ways to engage in the economy. Second, those taxpaying entities pay different tax rates on a marginal dollar of income.

The Australian Taxation Office recognizes a variety of types of taxpaying entity, which we will call *tax vehicles*. The most popular tax vehicles are as an individual, a trust, a partnership, a company and a superannuation (super) fund.[1]

Tax planning refers to strategies to arrange one's financial affairs to keep tax to a minimum (ATO 2020a). Taxpayers that control how they receive income have two primary incentives to plan. Shifting income from a high-taxing to low-taxing structure delivers an immediate tax saving. Deferring a nominal tax liability into the future increases the tax saving as long as inflation is positive. The tax saving is even larger if deferral means the income attracts a lower tax rate in the future than it does in the present.

It is important to stress that tax planning is entirely permissible under Australian law.[2] It is a common feature of most tax systems around the world. People have every right to arrange their financial affairs effectively. Tax is a material consideration to people's financial affairs. Tax professionals typically provide advice that falls within existing laws. And in general, Australians will celebrate any sense of special treatment that means we get a 'leg up' over our own tax bill.

Moreover, Kerry Packer became a public hero when he stated in 1991 that "of course I am minimizing my tax and if anybody in this country doesn't minimize their tax they want their head's read" (Peatling 2015). This quote is frequently invoked in Australian public discourse and often held up as an example to be emulated. In can be argued that tax planning has become something of a revealed societal preference; one embedded into the spirit through which those in society engage.

Also valuable is a definition of income. Based on the broadly-accepted Schanz-Haig-Simons[3] definition of income, Australia's income tax system is a 'hybrid' between the two 'pure' tax approaches that governments can adopt of 'comprehensive' or 'schedular' taxation[4]. Australia's particular interpretation sees most forms of personal income (wages, salaries, interest, dividends and rent) taxed under a global regime at full progressive rates. Corporate income and some capital gains are taxed under the same global regime, but at flat rates. Some capital income receives discounted tax treatment under the global regime, while other capital income (linked to retirement savings) is taxed under its own schedule.

The resulting spectrum of marginal tax rates, as at the current 2019-20 financial year, is shown in Chart 1.

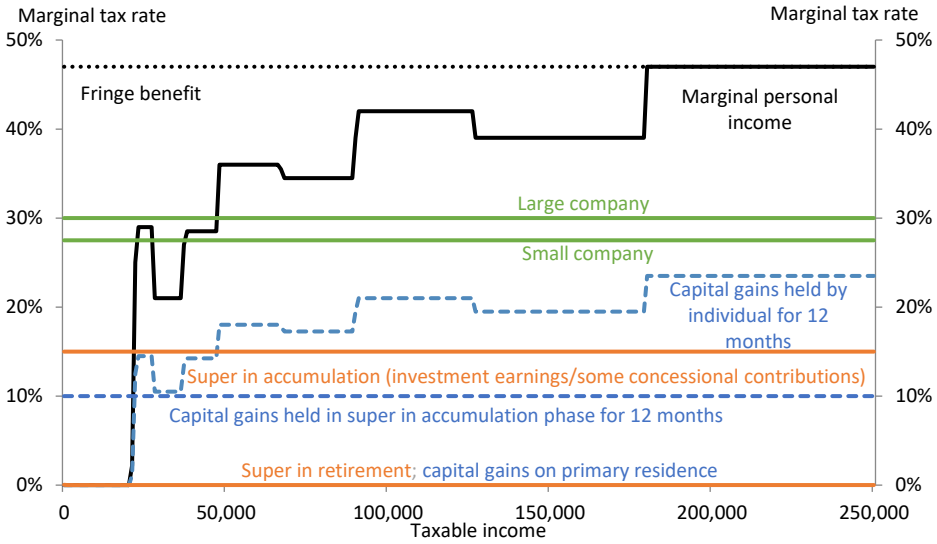
[1] There are others but we will just focus on these main forms. Note that tax is just one reason to operate through a trust, a partnership, a company or a super fund.

[2] Lawful tax planning should be distinguished from tax evasion actions such as deliberately underreporting income or sham contracting, where people try to exploit tax and super systems in ways that are not lawful.

[3] The comprehensive measure of income advocated for by Schanz (1896) and developed by Haig (1921) and Simons (1938) is generally considered by economists to be the best measure of wellbeing. That said, income tax benchmarks typically depart from a 'pure' Schanz-Haig-Simons definition in important places. It is common, for example, to evaluate tax expenditures by defining a progressive personal income tax schedule on a nominal, realisation basis as the structural 'base' feature of the Australian tax system (e.g. Treasury 2020). But there is nothing, at least in theory, that would suggest that this should be some everlasting configuration. Indeed, progressive 'universal' income taxation is only a relatively recent (post-World War 2) development. For our purposes it would be unwise to restrict thinking about what tax design might be publicly acceptable to only our current lived experience.

[4] A comprehensive global income tax sees all income aggregated and taxed under one rate schedule. In contrast, a schedular system sees different income types taxed under different schedules.

Chart 1. Marginal income tax rates for first $200,000 of income in 2019-20.



Notes: marginal personal income tax rates include the medicare levy, the low income tax offset (LITO) and the low and middle income tax offset (LMITO). The large company tax rate only takes effect once a company turns over $50m. Capital gains tax is represented as a dash lined, reflecting that it is a derived calculation of an implied tax rate that applies to a discounted nominal gain during the year in which an asset is sold. However, in practice, the capital gains tax discount is applied to the *gains*, which are either halved (capital gains on ordinary income) or discounted by 33 per cent (capital gains on super in the accumulation phase) for assets that are sold and have been held for 12 months or longer. Then full marginal rates apply to that gain. Source: Australian Taxation Office.

Different ways to interpret the current design of the hybrid Australian income tax

Chart 1 shows that Australia's income tax system is complex. In 2019-20, Australian taxpayers face marginal tax rates that range from 0 to 47 per cent. The precise rate depends on how much income the taxpayer receives, and whether its designation is as personal income, corporate income, super, capital gain, or fringe benefit. For example, someone's $100,001-th dollar in 2019-20 attracts a marginal tax rate of: 47 per cent if a taxable fringe benefit; 39 per cent if taxable personal income; 27.5 per cent tax rate if earned by a small business; 19.5 per cent tax rate if an individual realised as a capital gain on an asset they held for more than 12 months; 15 per cent tax rate if it was the ordinary income of a super fund outside the retirement phase, and 0 per cent if the income was a capital gain earned on the primary residence, or income of a super fund during the retirement phase.

Little wonder the majority of Australian taxpayers – 71 per cent in the 2016-17 income year (ATO 2019) – choose to turn to a tax agent to process their tax affairs rather than engage directly with the complexity themselves.

Putting the in-your-face complexity to one side, what to make of the tax rates depends on the perspective of the viewer. For example, one perspective – which we call the *policymaker's perspective* – is that each separate tax rate is a design feature of the tax system. Each tax rate has been individually justified on particular economic and/or social grounds. One example is choosing to tax capital at a lower rate than 'ordinary' personal income (e.g. Sorenson 2006). Another is to make small businesses subject to the lower tax rate than large businesses (Swoboda 2015). Yet another is creating a tax-free threshold for the first $18,200 of income individuals earn each year (Bradbury and Swan 2012). A further example is exempting from tax all of the income earned as capital gains (or losses) on the main residence (Treasury 2020). A final example is exempting earning through super through the retirement phase, to encourage Australians to purse this particular form of saving (Nielson 2007).

Like any complex system, some features will be underpinned by a more robust rationale than others. But overall, the shape of Australia's tax system reflects the kind of uneasy compromises that policymakers have to constantly grapple with in attempting to deliver a system that Australians accept. Understanding objectives, incentives and trade-offs is critical in order to understand the policy implications of tax planning. We will deal with these in more detail below.

Before we do that, it's worth considering another perspective – which we call the *tax planner's perspective* – which approaches tax as a 'minimization' problem. For the aspiring tax planner, Chart 1 reveals that some forms of income result in lower annual tax bills than others. The tax planner's challenge is to divide her total income among available tax schedules in a way that gets her to the lowest total tax bill. By doing so, the tax planner also pays the lowest *average* rate of tax for that year. She can then turn her attention to thinking beyond herself (by minimising the taxes paid by her household) and by thinking beyond a single income year.

Chart 2 highlights the stylised system-wide implications of such tax planning behaviour within a hybrid system. For most points along the income distribution, personal taxes attract the highest rate[5]. This means that a taxpayer subject to *only* the personal income tax schedule, such as a full-time wage earner with no financial assets, faces the marginal tax rate curve MTR_{PIT} and average personal tax rate curve ATR_{PIT}. A taxpayer might instead have the option to pay lower corporate, super or capital gains taxes. If so, they still face MTR_{PIT}, but can realise a lower average tax schedule (lines in red in Chart 2).

The tax planner's average tax rate curve could take a range of different shapes. $ATR_{HYBRID1}$ would be the result if the tax savings achieved through planning were a fixed proportion of the average personal income tax rate. As the slope of *average* tax curve is up for all income, the income tax system would remain progressive. However, in a system with planning, tax progressivity is not guaranteed. $ATR_{HYBRID2}$ shows what happens if tax savings from planning increase result in the taxpayer paying a flat marginal rate. It is conceptually straightforward to imagine a situation where someone achieves a flat average tax rate after a certain income level. $ATR_{HYBRID3}$ would reflect a situation where a high income earner is able to commit more money and a greater share of their income in order to achieve a lower tax rate than those on low incomes. It's the sort of scenario brought to mind when considering the tax rates paid by US billionaire Warren Buffett and his secretary Debbie Bosanek (McArdle 2012).

[5] Some examples: tax capital at a lower tax rate than 'ordinary' personal income (Sorensen 2006). A taxpayer's main residence is exempt from capital gains tax. A 50 per cent reduction applies to capital gains made by an individual (or trustee) on assets held for more than 12 months, and a 33 per cent reduction applies to capital gains made by a super fund on assets held for more than 12 months. In addition, small businesses can be eligible for cascading capital gains tax concessions that range from 50 to 100 per cent.

Chart 2. Stylised average and marginal tax rates

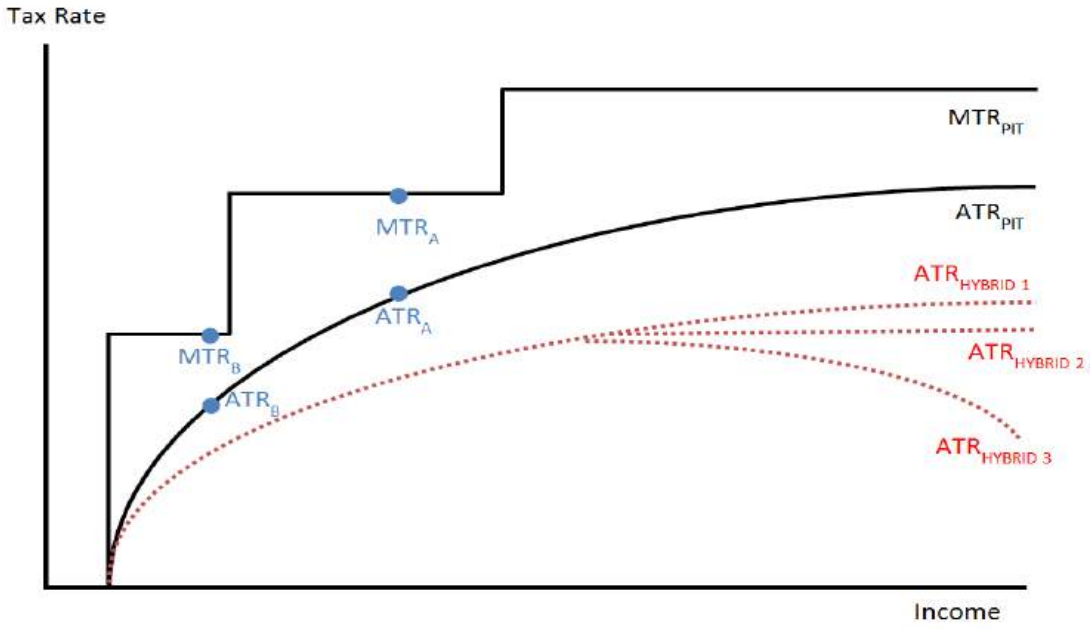


Chart 2 depicts the incentives to tax plan that also exist for those looking to operate at the household, rather than individual, level. The basic maths of ever-higher marginal tax rate tiers is: once people get past the tax-free threshold, two (adult) people earning an equivalent amount of collective income as a sole-earner will pay a lower amount of tax. It is hard to view in the stylised chart, so the box below puts some 'real world' numbers around the incentives. A single-income couple where the breadwinner earns $80,000 in 2019-20 has an $8,363 incentive to find a way to split their income equally and so be treated in the same way as a 'dual-earning' couple.

The generalised principle is that the combined incentives – to lower the amount of income recognized along the personal income tax schedule, and/or adopt an alternative tax schedule with a lower marginal rate – are present each year. Tax savings are the result of exploiting tax rate differentials over time.

The incentives of a progressive personal income taxation system

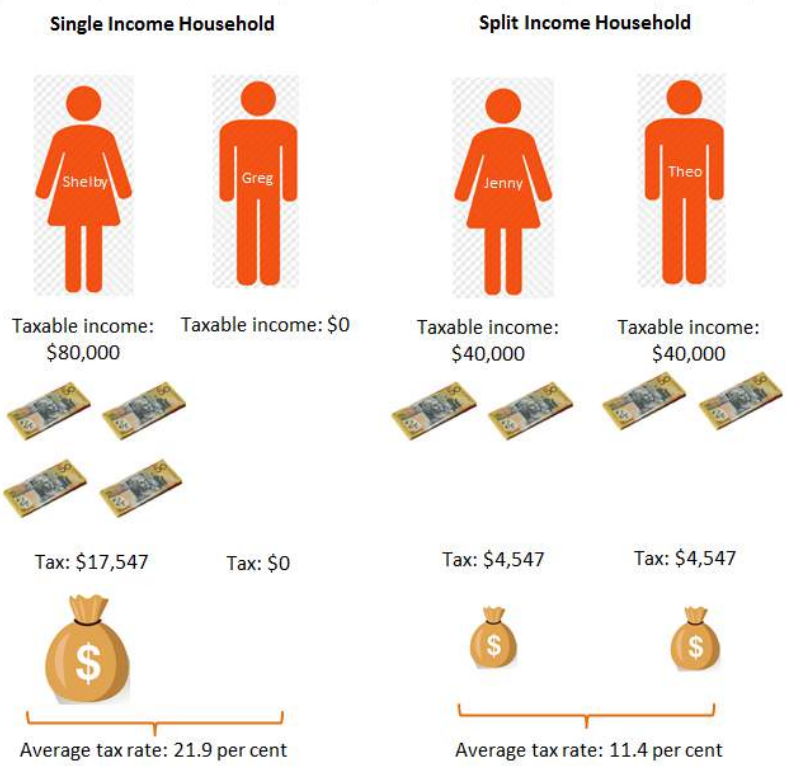
Two couples, Shelby and Greg and Jenny and Theo, each earn $80,000 in taxable income in the 2019-20 financial year.

Shelby and Greg derive their income from an $80,000 salary that Shelby receives from an employer. They cannot split the income for tax purposes. Based on currently legislated marginal personal income tax rates Shelby's income tax bill is $17,457, at an average tax rate of 21.9 per cent.

Jenny and Theo derive their income from a business they jointly control. Only Jenny works in 2019-20 and generates $80,000 in taxable income from this. Jenny and Theo are able to flexibly direct this income. They decide to split equally such that each is 'paid' $40,000. They would each pay $4,547 in personal income tax on this income. Jenny and Theo's household tax bill is $9,094, at an average tax rate of 11.4 per cent.

Another way to think about this is their combined tax bill on $80,000 of income is equivalent of a sole-earner on a salary of around $54,000. By way of contrast, if Shelby, Greg, Jenny and Theo were instead charged a 16.5 per cent flat tax that applied to their first dollar of income, both couples would pay $13,200 and would not have any incentive to split their income.

While a key consideration is that both couples are relying on income derived by one spouse's exertions, the same principles would apply if Jenny and Theo instead worked half of a full time equivalent load each (an admittedly unusual arrangement within the Australian labour market). However, if Jenny and Theo were instead both working full time and collectively earned $80,000, the difference in tax bill between the couples would represent the unpriced home production of Greg.



Note: Calculations for these examples are stylised. Unless otherwise specified, they are based on headline personal, corporate and/or super tax rates and thresholds only, without offsets, deductions or levies such as the Medicare levy or low-income tax offset.

THE BASIC TAX PLANNING PLAYBOOK

How can people take advantage of these opportunities? Below we cover off on some of the main 'channels of arbitrage'. Specifically, we provide five illustrative cameo-style examples of the types of financial arrangements that are of interest to the vast majority of Australian adults at some point in their lives. The cameos combine the use of pre-tax wages, property assets, trusts, companies, super funds and small businesses. The arrangements featured range from the simple and widespread to 'active' structures that stream and defer income across multiple tax vehicles over time.

The 'plays' are well understood within the tax advice industry, and the advice behind them is pretty easy to access. This playbook serves as a basic introduction to the types of arrangements available. We also suggest possible extensions that would achieve more tax-advantaged outcomes. That said, we do not deal with the types of bespoke 'best of breed' tax arrangements that aggressively combine income splitting and tax deferral in sophisticated ways (such as through the arbitrage of international tax regimes).

Common and widespread: salary packaging, and the primary residence

Something many Australians are aware of (even if only vaguely) is that it is possible to reduce taxable income via salary sacrifice. Also known as salary packaging, 'salary sacrifice' is an arrangement that workers can enter into with their employers which allows them to use pre-tax salary to purchase certain goods or services (through a third party) that they would normally use after-tax income to pay for. For many Australian households, this means that they can purchase

items that are important to their lifestyle, in a way that lowers tax. The potential tax savings increase with a greater the (effective) marginal personal tax rate.

The precise opportunities an employee can access depend on what their employer provides[6]. It can include cars and associated running costs, financial loans, health insurance, childcare, electronic devices such as laptops and phones, and contributions to super. On these types of purchases, Play 1 illustrates how salary sacrifice can deliver a sizeable annual tax benefit. Note that the overall benefit an individual will receive is influenced by the terms and fees that the lease company or employer might impose in return for the opportunity.

Play 1: Changing your taxable income through salary packaging

Three single individuals, Bruce, David and Andrea, all work full-time for a large Australian Public Service agency that offers a range of salary sacrificing options. All earn a salary of $100,000 in 2019-20, and receive a 15.4 per cent compulsory contribution into their super funds from their employer. They all plan to take out a loan for a new car, spend $52,000 after-tax to maintain their lifestyle, and save the rest.

Bruce, 35, likes a simple life. He doesn't understand how salary sacrifice arrangements work and isn't interested in finding out. He resents compulsory super and is happy outsourcing his (very simple) tax return to an agent. He maintains his lifestyle (including car) using after-tax money. Bruce's tax agent tells him that his total tax bill on $100,000 taxable income and $15,400 compulsory super is $26,801 at an average tax rate of 23.2 per cent.

David, 43, has been thinking about his retirement. After a little research, he decides to salary sacrifice into super. He negotiates with his agency to continue to pay super on his $100,000 salary while he salary sacrifices $9,600. This brings his total super contribution to $25,000. Otherwise, David funds the same after-tax lifestyle as Bruce. David's total income tax bill on $90,400 taxable income and $25,000 total super is $24,695 at an average tax rate of 21.4 per cent. By taking advantage of one salary sacrifice opportunity, David pays $2,112 less in income tax than Bruce.

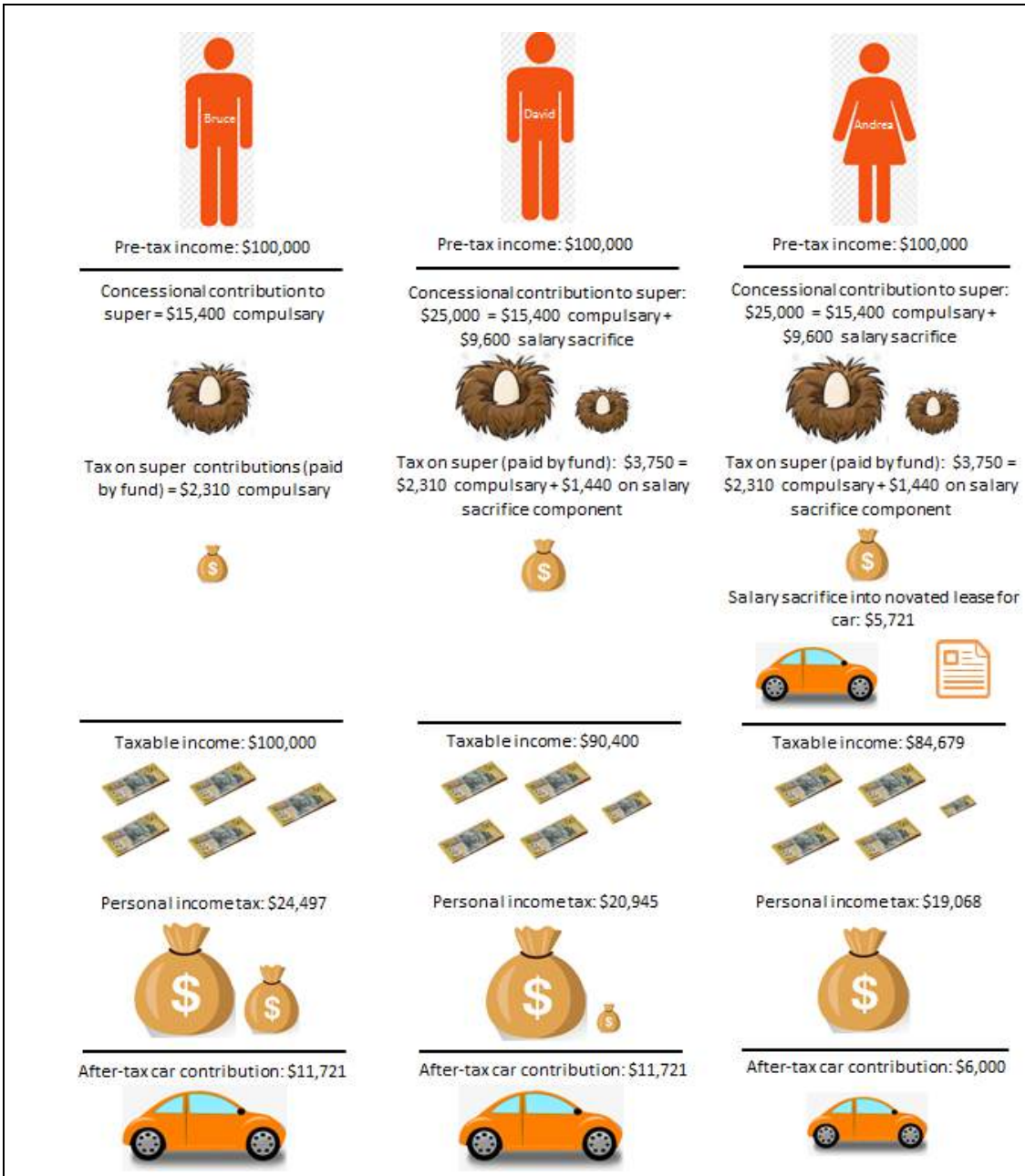
Andrea, 28, is highly motivated to lower her tax bill. Like David, she salary sacrifices $9,600 into super. Andrea also takes advantage of a novated lease arrangement[7] in which a third-party financer buys the car and leases it to Andrea. Andrea funds a lifestyle equivalent to David and Bruce. Andrea's total income tax bill on $84,679 taxable income and $25,000 total super is $22,818 at an effective tax rate of 20.8 per cent. By taking advantage of two salary sacrifice opportunities, Andrea pays $3,989 less in income tax than Bruce.

A comparison of what the different approaches adopted by Bruce, David and Andrea imply for their personal income, consumption, savings and tax rate is included below.

Name	Personal income		Consumption	After-tax savings		Average tax rate
	Salary	Taxable income		In super	Total	
Bruce	$100,000	$100,000	$52,000 + car loan	$13,090	$24,811	23.2%
David	$100,000	$90,400	$52,000 + car loan	$21,250	$26,984	21.4%
Andrea	$100,000	$84,679	$52,000 + car loan	$21,250	$28,861	20.8%

[6] Large organisations are more likely to provide access to salary sacrifice arrangements than small businesses. And the employer is generally liable to pay fringe benefits tax on what is provided.

[7] Novated leasing is a three-way arrangement between a salaried employee; an employer and a finance company. In this arrangement, the employee is responsible for the payments. The financier buys the vehicle and leases it to you. The employer agrees to take the payments from your salary (as a 'salary sacrifice') before income tax is paid. Often the employee will do this in return for a fee that takes at least a part of the gains, and potentially a significant share of them.



Notes: Calculations for these examples are stylised. Unless otherwise specified, they are based on headline personal, corporate and/or super tax rates and thresholds only without offsets, deductions or levies such as the Medicare levy or low-income tax offset.

This is a basic scenario for illustrative purposes. We've assumed that financing terms available to Bruce, David and Andrea are the same. We also haven't included 'bells and whistles' that would increase the attractiveness of salary packaging. For example: packaging the maintenance of the car (such as fuel, service costs) into the arrangement; the lease company claiming the GST and employee purchasing the car ex-GST; or the employee selling the leased car at a profit in the future. We also acknowledge that tax is only one consideration when contemplating salary sacrifice arrangements. For example, a leasing arrangement might reduce a worker's ability to swap employers. Similarly, super savings are 'locked in' in important respects relative to savings outside super.

While the tax saved from salary sacrifice is sizeable, wages and salaries are difficult to use for many tax planning arrangements. This is because such income, typically earned from an individual's physical exertion, is difficult to allocate among various people for tax purposes. Income derived from dividends, interest, rent and other forms of investment is more flexibly able to be managed. It thus offers significant potential for large tax savings.

The most prominent form of investment in Australia is housing. Some 67 per cent of Australian households own (or their bank owns) a house in 2016 (AIHW 2019). For many Australians, the family home is the main asset that they own in their life. Housing assets also represent a significant proportion of overall Australian wealth. Capital gains on the primary residence are fully exempt from income tax, unless the primary residence has been rented to generate a financial return more than 6 years, in which case the marginal gains beyond 6 years of rental are subjected to a 50 per cent capital gains tax discount. The capital gain tax exemptions that apply to the primary residence are among the most broadly enjoyed tax effective arrangements in Australia.

These exemptions are exceedingly generous for those fortunate enough to experience them. Play 2 shows how a couple that jointly own a family home that experienced a $1.7 million capital gain over 21 years, and was deployed as a financial asset for just under half of this time, can incur just a 0.9 per cent average tax rate on the overall capital gain when sold.

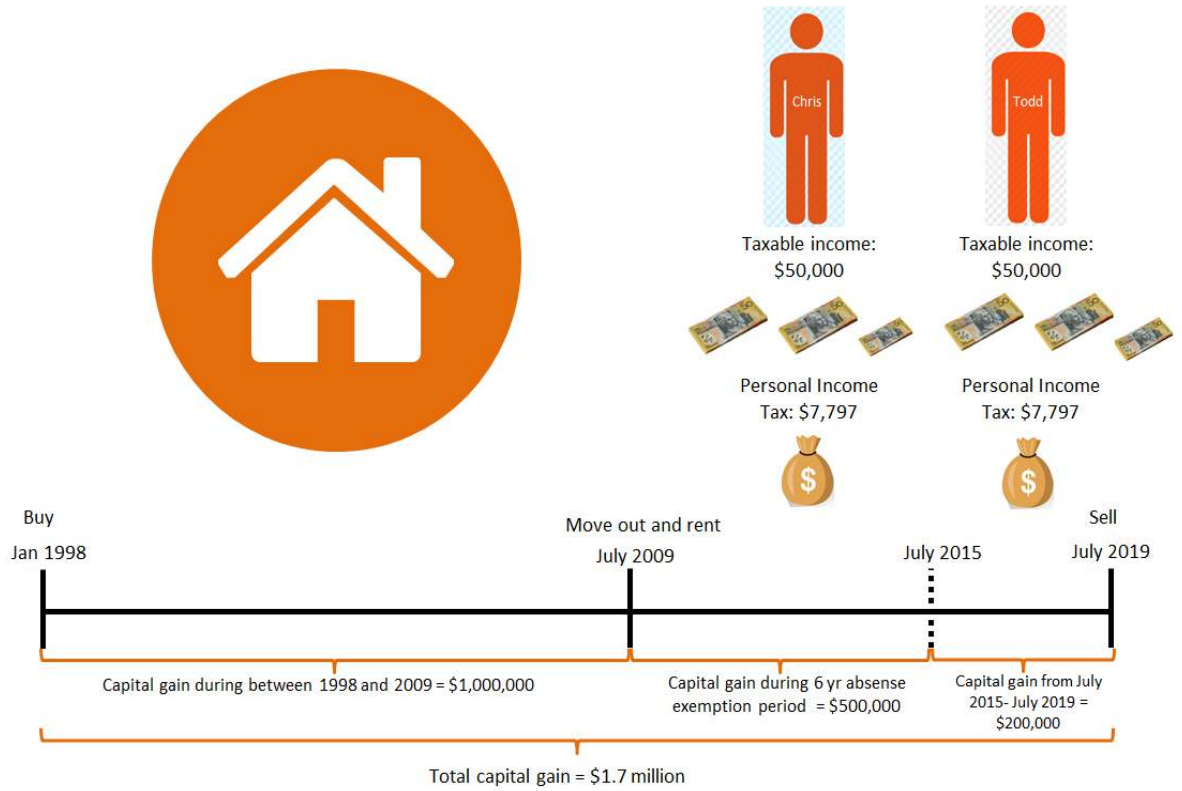
Capital assets such as housing provide an ancillary benefit that tax planners also value greatly. They provide the flexibility to choose the year in which to incur a tax bill. A tax liability on a capital asset is only incurred when an asset is realised, or sold, rather than when the value accrues (and the economic activity occurs). For example, a house bought in 2010 and sold in 2017 may experience an increase in economic value in each year for eight years. However, under Australian tax law, the capital gain is only incurred with the asset's sale in 2017. This means that not only are capital gains eligible for discounted tax treatment, the capital owner has complete discretion on when (or if) to realise the gain (or loss) and incur a tax liability.

Play 2. Why some can afford avocado on rye: (Not) paying tax on capital gains on the primary residence

Chris and Todd, both 47, contributed equally when they bought a house in Melbourne in 1998 for $300,000. This serves as their primary residence for the 21 years between July 1998 and July 2019. They live in the property for the first 11 years from 1998-2009. In July 2009, Chris and Todd accept job offers relocating them to Sydney for 10 years. They live in a rental while in Sydney. At the same time they rent out their Melbourne house to produce a (neutrally geared) financial return. Then, in July 2019, they embrace a 'sea change' lifestyle. After selling the Melbourne house for $2 million, they buy a $1.5 million apartment in the South Coast of NSW.

In calculating their tax bill, Chris and Todd take advantage of three capital gains tax discounts and exemptions. First, as primary residence, the capital gain for the 11 years that Chris and Todd lived in the house is tax-exempt. Second, thanks to the six-year absence exemption, the first six years of rental are exempt from tax. Chris and Todd therefore only pay tax on the final four years, which is estimated to see a capital gain of $200,000. Third, this gain is eligible for the 50 per cent capital gains discount as the asset has been held for longer than a year. The taxable gain is just $100,000 over the life of the property. And Chris and Todd each realise $50,000 of this gain.

Provided the capital gain this is their only personal income in 2019-20, Chris and Todd each pay $7,797 in personal income tax. Their combined $15,594 tax bill works out to be 0.9 per cent of the $1.7 million lifetime capital gain, or 2.2 per cent on the $700,000 gain since July 2009.



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To put this into context, if Chris or Todd individually realised $1.7 million in wage and salary income, they would pay $738,097 in tax at an average tax rate of 43.5 per cent. If they instead realised a $1.7 million in capital gain from jointly owned shares – $425,000 in taxable income each after applying the 50 per cent capital gains tax discount – they would pay $164,347 each in tax at an average rate of 38.7 per cent.

There are more tax-advantaged alternatives too. For example, if Chris and Todd lived in the property the entire time they owned it, there would be no capital gains tax implications. If they never sold the house and instead gifted it as part of their estate, their children may escape tax. And, if Chris and Todd were instead retirees aged over 65, they could contribute up to $300,000 post-tax income from the sale of the house into super. The tax free 'downsizer' contribution would get around many integrity measures governing super, such as non-concessional contribution caps.

The basics of advanced tax structuring: the streaming and tax deferral benefits of a bucket company and a trust

Using a combination of entities provides taxpayers more flexibility to control when and how they receive income for tax purposes. Play 3 depicts a simple setup involving a couple, a discretionary trust and a 'bucket' company[8] over a two-year horizon.

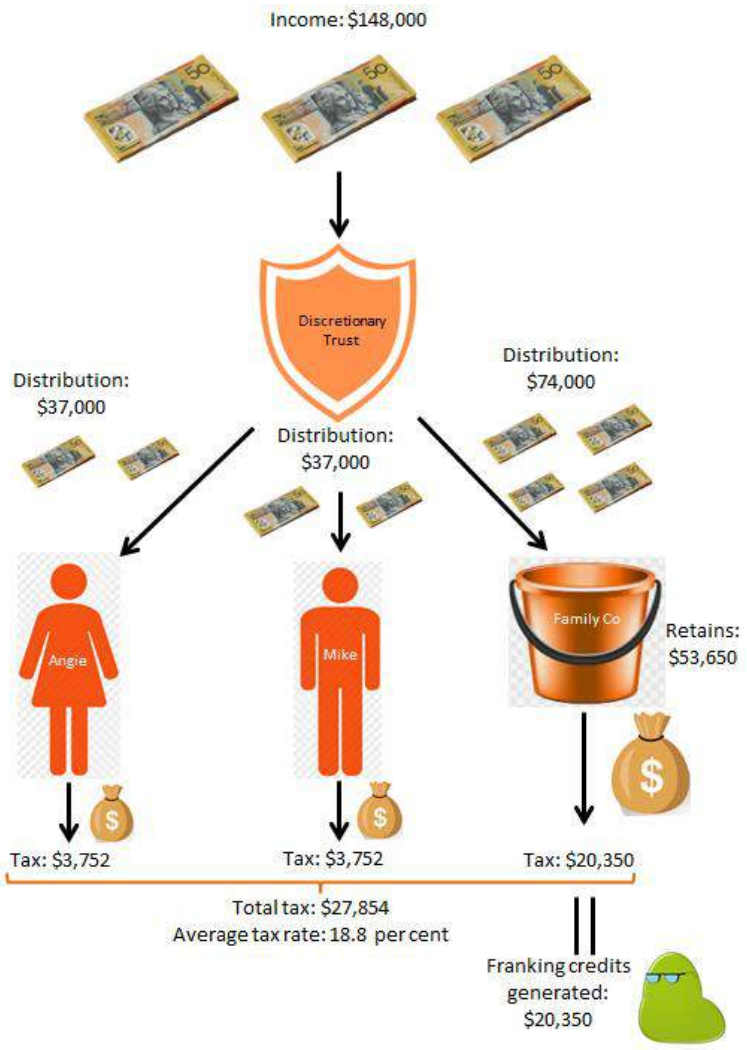
Play 3 Part 1 shows the arrangements in the first year.

[8] A bucket company is a commonly-used term to describe a passive private company set up to be a beneficiary of a trust. The 'bucket' element refers to the company sitting below the trust and being used to pour money into it to reduce tax.

Play 3. Part 1.Basic tax structuring using a bucket company and a trust. Year 1 – 2019-20

Mike and Angie are both aged 32. They have worked out that they can maintain their current lifestyle on $66,000 after tax per year. Mike operates a consulting practice that provides digital transformation analysis and advice to large Australian firms. He is also trustee of a family trust, which is paid the taxable profit of $148,000 in 2019-20 that the consulting practice generates. The trust has three beneficiaries: Mike, Angie and Family Co., a small 'bucket' company that Mike controls. Family Co. is dedicated to managing an investment portfolio and its investment strategy is to only hold cash.

As trustee of the trust, Mike determines that the trust will distribute all $148,000 of its net income to the three beneficiaries: $37,000 to each of Mike and Angie and the remaining $74,000 to Family Co. (If it didn't, the trust would have to pay the highest marginal tax rate of 47 per cent on retained earnings).



Note: Calculations for these examples are stylised. Unless otherwise specified, they are based on headline personal, corporate and/or super tax rates and thresholds only without offsets, deductions or levies such as the Medicare levy or low-income tax offset.

Under trust taxation rules, Mike, Angie and Family Co are assessed on the proportion of trust income that they are 'presently entitled' to. In this case, present entitlement is equal to the income received. Mike and Angie each pay tax at their marginal personal income tax rates on their income. Family Co. pays tax on the $74,000 in profit it receives at the 27.5 per cent small business tax rate. Plus, as an Australian resident corporation, it generates a $20,350 franking credit balance - which it considers an asset. The company holds on to the after-tax profits of $53,650 as 'retained earnings' as well as the $20,350 in franking credits.

In total, on $148,000 of income in 2019-20, the structure pays $27,854 in tax at an average tax rate of 18.8 per cent. To put this into context, if Mike instead earned $148,000 as a salary, he would receive a tax bill of $42,257 ($14,403 more than the structure) at an average tax rate of 30.4 per cent.

There are three essential steps in the process:

- The couple operates a consulting business. Payments to the business are paid into a discretionary trust which the couple controls.
- The trust distributes enough income to the individuals such that they can meet their desired standard of living, and the rest to the company.
- The company holds its profits as 'retained earnings'. It pays corporate tax on the profits and generates franking credits (an asset) on this corporate tax.

The immediate gains from setting up a structure are lucrative. $14,403 in first year tax savings come from paying the small business tax rate rather than the marginal personal tax rate and streaming income across two adult family members. But it is the second year of the hypothetical arrangement that shows the full power of a trust and bucket company structure to deliver low *lifetime* tax rates. And it highlights the (unintended) role that Australia's refundable dividend imputation system plays as a tax planning vehicle.

When Australian businesses distribute taxed profits (at a rate of 27.5 per cent for small businesses or 30 per cent for large businesses) to their shareholders, they have the ability to pass on or 'impute' the tax by allocating imputation credits to (Australian resident) shareholders. This is called 'franking' the distribution, and imputation credits are commonly known as franking credits. Franking credits can be used be as tax offsets against marginal tax rates, providing a refundable credit against the tax the recipient would need to pay.

Franking credits are designed to prevent a situation where profits are taxed twice: once when earned by a business and a second time when the business distributes a dividend to a shareholder. A number of countries, including Canada and New Zealand, have 'one-tier' systems in place that are designed to ensure that company profits are taxed only once (Martin 2019). That said, Australia is unique among the OECD in permitting refundable franking credits.

Importantly, the role that franking credits play in the Australian tax system has gradually changed since its introduction in 1987. A policy designed to avoid double taxation makes it possible to engineer a zero-tax outcome. The key is to think of franking credits as a 'tax bank' in exploiting tax rate differentials. The tax bank involves a deposit and withdrawal stage. The deposit stage stems from the incentive individual taxpayers face to 'cap' their marginal tax rate at the corporate rate of 27.5 or 30 per cent rate, which is cheaper than a top marginal tax rate of 47 per cent (including Medicare Levy). And in the process, it costs nothing for the company to generate a franking credit.

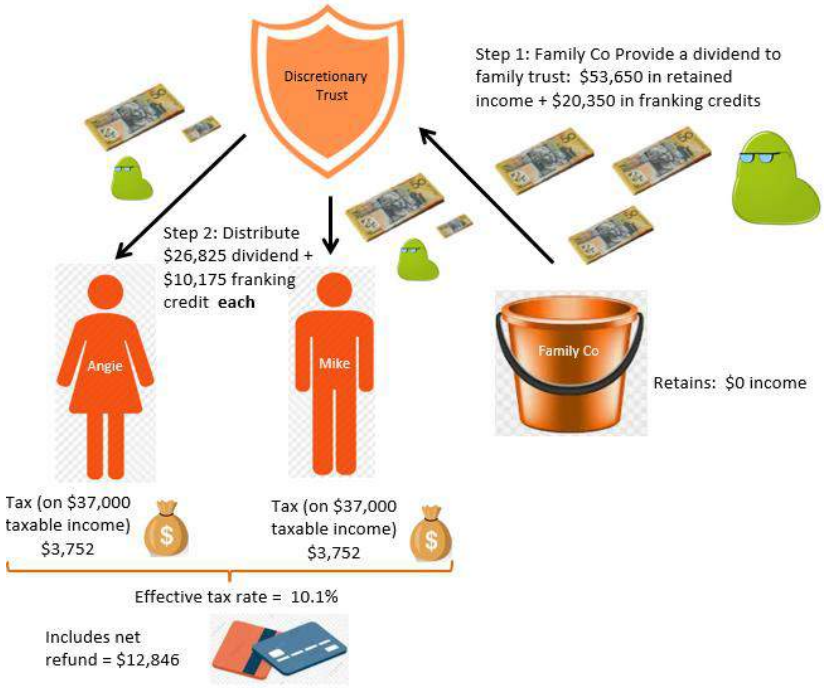
The withdrawal stage occurs during the subsequent distribution of the franked dividend to a shareholder. If the shareholder receiving the dividend is a personal income taxpayer or super fund and the income part of a tax-free threshold, they can fully 'withdraw' from government the company tax paid. When company tax is paid by one part of a tax structure and then fully refunded to another, then no net tax is received by government on the economic activity performed by the structure. This behaviour is explored further as part of Play 4 below.

It's worth acknowledging that the conceptual issue is not with refundable dividend imputation itself. Franked dividends do not *need* to play the tax bank role. Rather, it's the different tax treatment of companies, super and personal income. If there were no differential between marginal corporate and marginal personal tax rates, and no tax discount for super, then there would be no incentive to use franking credits in tax arbitrage. The generalised principle is that single taxation at the individual level is conceptually robust when part of a properly designed comprehensive income tax system. But this principle does not hold water in a complex hybrid system.

Play 3. Part 2. Basics tax structuring using a bucket company and a trust. Year 2 – 2020-21

In 2020-21, Mike has looked closely at his finances and decided that he and Angie can fund their $66,000 annual lifestyle without him working this year. He determines that Family Co. will provide a dividend worth all of its retained earnings ($53,650 and franking credit balance of $20,350) to the family trust. As trustee of the family trust, Mike determines that he and Angie are each entitled to half of the dividend and half of the franking credits– $26,825 and $10,175 respectively. Family Co. (despite being a beneficiary) receives no distribution from the trust this year.

Mike and Angie each pay tax on their $37,000 in taxable income at their marginal personal income tax rates. They claim $20,350 collectively in franking credits (which represents tax that has already been paid by their company to the ATO on their behalf) against $7,504 in income tax. The couple has arrived in tax refund city. On $74,000 of realised income, they pay $7,500 in income tax and receive a refund on their dividends of $12,846. Their effective average tax rate falls to 10.1 per cent in year two.



Note: Calculations for these examples are stylised. Unless otherwise specified, they are based on headline personal, corporate and/or super tax rates and thresholds only without offsets, deductions or levies such as the Medicare levy or low-income tax offset.

Mike and Angie have been able to fund the same after-tax lifestyle as in year 1, without having to work. In nominal terms, the total tax paid is $15,008 (four payments of $3,752) at an average tax rate of 10.1 per cent. By taking advantage of income splitting, the refundable imputation system, and a trust and bucket company structure, Mike and Angie pay $27,249 less in tax compared to a single income salary of $148,000.

The basic logic of bucket companies and trusts extends to more complex arrangements involving more income and extra family members. Play 4 shows how the same framework functions for a family of four adults with a combined taxable income of $500,000. The structure displayed in Play 4 reduces an effective tax rate of 25.2 per cent in the first year to just 6 per cent over the full life of the scheme.

What's more, by staying entirely within the tax free thresholds available for personal taxpayers and in super, it shows how a wealthy retired couple can finance a generous $140,000 post-tax lifestyle - of which $42,000 is tax refund – at a *negative* effective tax rate in the second year of the scheme. Over the course of approximately 10 years of this structure, the couple would be refunded the entire tax bill paid by their company in one year of the arrangement. They have found a way to convert their company tax into a temporary, interest-free loan to government.

Play 4. Fun for the whole (wealthy) family: streaming across multiple adult family members using a bucket company and a trust

Year 1 – 2019-20

Senior executive Claire, 57, her (stay-at-home, professionally unsuccessful artist) husband Owen, 58 and their two adult children, Josh 23 and Eliz, 22, live in the city centre of Perth and close to the university that both Jill and James attend. Both James and Jill are in the final year of their studies (as recipients of tax-free scholarships).

The family is both income- and asset-rich. Claire earns $500,000 annually as a high-profile director for several large companies in the commodities sector. Her fees are paid into a discretionary trust. They also fully own their family home, worth $3 million (purchased for $1.5 million), which serves as the household's primary residence. Claire and Owen have focused their savings on two accounts in a healthy self-managed super fund holding assets totalling $2.6 million, accumulated as a result of years of voluntary salary-sacrificed contributions made when both worked. The fund invests in a share portfolio that delivers franked dividends worth 4 per cent annually. Their current living expenses total approximately $180,000 annually, which finances a comfortable lifestyle and allows them to financially support Jill and James' university studies. This support means that Jill and James are able to focus full-time on their studies and don't work – they can fund their lifestyles using their scholarships combined with living at home – and are looking forward to the prospect of no debt once they graduate because of their parent's financial support.

Claire has employed a tax adviser to establish a bucket company and trust structure that is similar in style to Play 3 but that takes advantage of distributing to four adult family members. Because the family is streaming significantly more income through the structure, her bucket company is generating a substantial balance of franking credits. On the $320,000 in profit that Bucket Co. realises, it retains $232,000 in earnings, pays $88,000 in corporate tax (at the 27.5 per cent small business tax rate) and generates $88,000 in franking credits. Instead of holding retained earnings as cash, the earnings retained in the bucket company are invested in a low-risk managed fund that (after costs) delivers returns of 3 per cent annually.

Year 2 – 2020-21

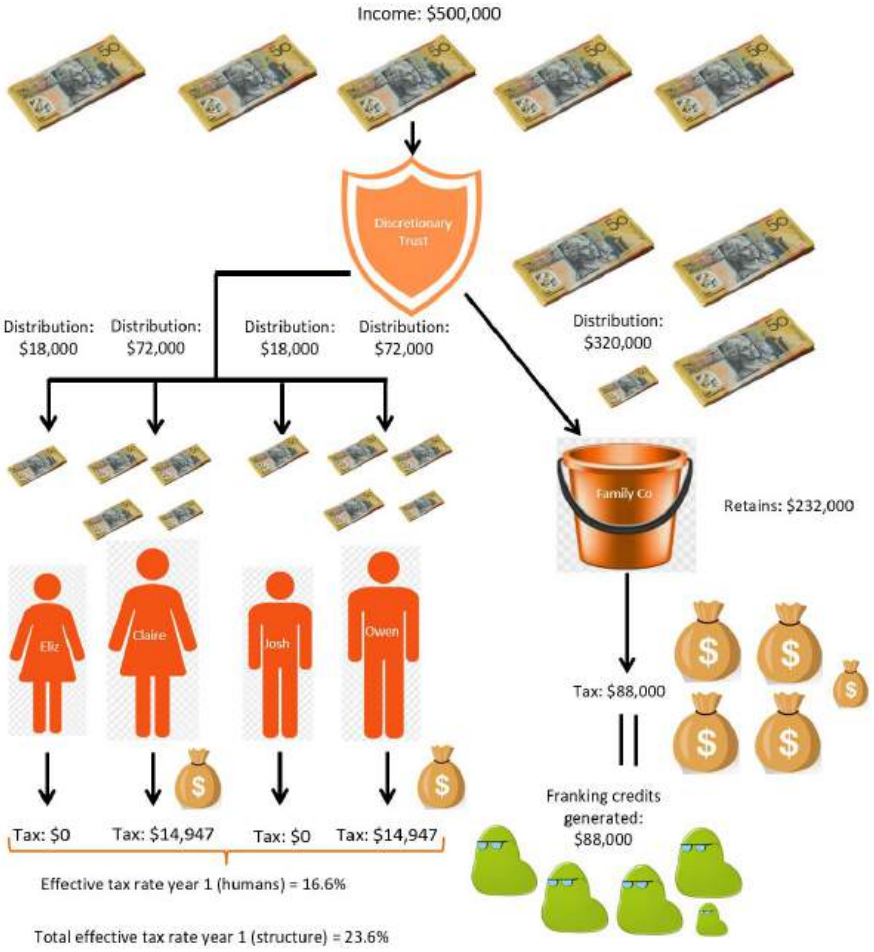
Moving forward to 2020-21. Eliz and Josh have completed their studies, entered the workforce and moved out of home. Claire retires, having reached her super preservation age – the age at which she is able to retire and gain access to her super. Owen and Claire take advantage of the fact that income earned in super in the retirement phase accrues no income tax and determine that their super assets will distribute to them $103,600 of franked dividends this year (based on a withdrawal rate of 4 per cent). Claire and Owen decide to fund a lifestyle of $140,000 annually at minimal tax. So Claire determines that $18,200 should be distributed to each of Claire and Owen in 2020-21.

As a result of this arrangement Owen and Claire pay no income tax on their $140,000 of total income in 2020-21. Claire and Owen instead face an effective tax rate of -27.5 per cent on their personal income in 2020-21. Because they are using franking credits against all income realised through the structure, and this income is all within tax-free thresholds, the company income tax previously paid by the bucket company is being gradually refunded. This is also true for the tax paid by the Australian companies that the super fund has invested in. In total their structure allows them to receive a combined net refund of $41,090; $10,010 outside of super and $31,080 from their super (based on the fund receiving fully franked dividends paid at a 30 per cent tax rate).

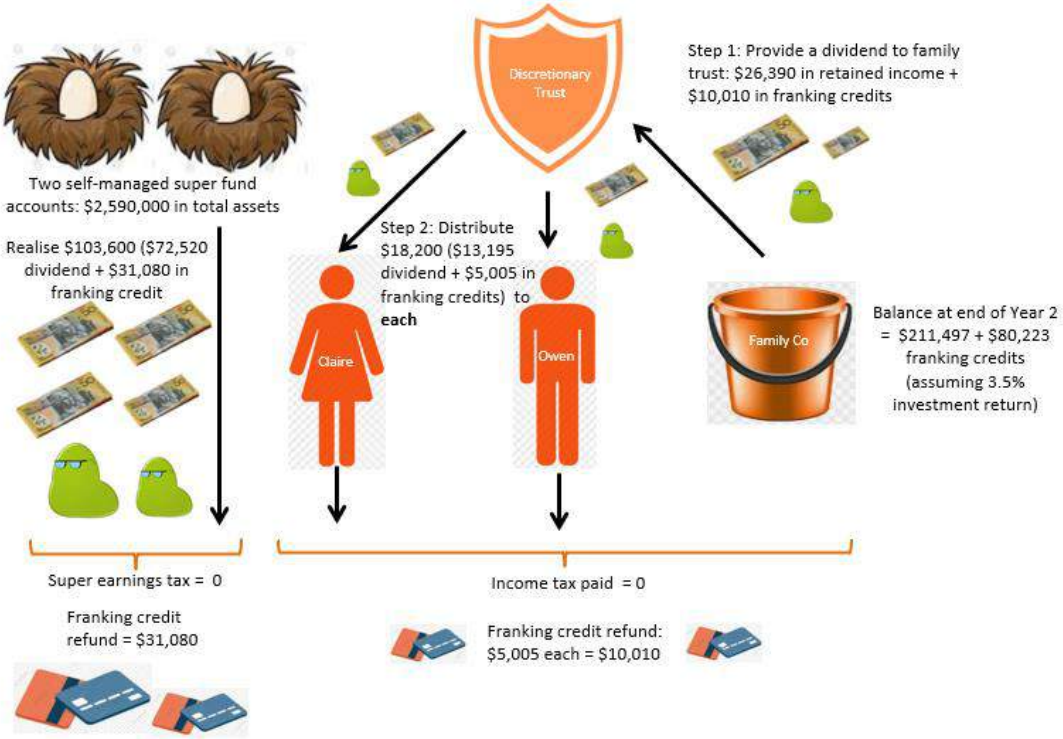
Based on assumed returns of 3.5 per cent on the bucket company's investments, it will take approximately 10 years of realising income in this way before Owen and Claire fully exhaust the bucket company's capacity to deliver dividends and franking credits. Once exhausted, <u>all</u> of the lifetime company tax paid by the bucket company would be refunded.

This means that the lifetime effective tax rate of the structure and more than $500,000 in income earned in 2020-21 (and used to generate additional income) is 6 per cent – the $29,894 in personal income tax paid in Year 1. The tax saving compared to someone who earns and pays personal income tax on $500,000 of income is $168,203. The lifetime effective tax rate that applies to Owen and Claire is even lower if considering the income streams generated through their super fund as well.

Year 1 – 2019-20



Year 2 – 2020-21 (and approximately 9 further years)



Note: Calculations for these examples are stylised. Unless otherwise specified, they are based on headline personal, corporate and/or super tax rates and thresholds only without offsets, deductions or levies such as the Medicare levy or low-income tax offset.

More aggressive tax planning: using a small business and a self-managed super fund

Given their tax-advantaged status, it is unsurprising that super funds are another common vehicle for tax planning. They are particularly attractive for older Australians, as age can be a criterion for access to particular opportunities (such as particular small business exemptions that interact with superannuation). In addition, as a rule-of-thumb, the closer one is to retirement, the less patience they require before they can access retirement benefits. Self-managed super provides significant amounts of autonomy.

Sophisticated tax structures combine super funds with entities such as small businesses and trusts. Play 5 shows one such arrangement involving a specific type of trust - a 'non-geared unit trust' and two types of opportunity: extinguishing accrued capital gains and artificially increasing tax deductions.

Drawing funds from a self-managed super fund to buy the small business premises is an 'on paper' transaction. The business gains $1 million in cash but sells a $1 million asset (the business premises) to do so. The super fund loses $1 million in cash but gains the $1 million asset. The owners of the business and super fund are the same people. Their overall financial situation hasn't changed. But because they engage in the transaction, they can disregard $500,000 in capital gain.

Play 5 also shows how an 'active' tax planner can generate a second, ongoing tax reduction. The super fund now leases the 'newly acquired' business premises back to the small business. Say the two parties (business and super fund) were to 'agree' to commercial terms of say, 10 per cent on the $1 million asset annually. The business therefore generates $100,000 of 'new' annual tax deductions. Realising half the income through the progressive personal income tax schedule lowers the annual personal income tax bills of the couple by more than two-thirds.

This is possible because of the peculiarities of non-geared unit trusts. There are certain rules that govern how to make use of a non-geared unit trust. But their presence allows tax structures to get around certain 'arms length' super integrity rules designed to ensure that the types of transactions depicted in Play 5 do not generally take place. For this reason, the arrangement outlined in Play 5 can considered a more aggressive form of tax planning. The opportunity also arises from a couple making clever use of a sizeable balance in their super fund. It would not be available if, say, all of the couple's assets were instead tied up in the small business.

Play 5. Golden years: more aggressive planning involving a small business and a super fund

Dom and Lisa, age 68 and 65, jointly and equally own a small company they created in 2000, which turns over $400,000 and generates $200,000 in deductions annually. They purchased their business premises for $300,000; it is now worth $1,000,000. Dom and Lisa have been saving actively for retirement and have accumulated $1,200,000 in a self-managed super fund. They split the $200,000 of business profit equally, such that they each pay $24,497 in personal income tax on $100,000 of income at an average tax rate of 24.5 per cent. They feel like their total tax bill is $48,994 is significantly more than their peers.

Dom and Lisa approach a well-recommended tax adviser for advice on the best way to structure their tax affairs. They have three stipulations. First, they keep running the business to supplement their income during retirement. Second, they reduce the amount of tax that they pay. Third, they both need to be able to understand the arrangement.

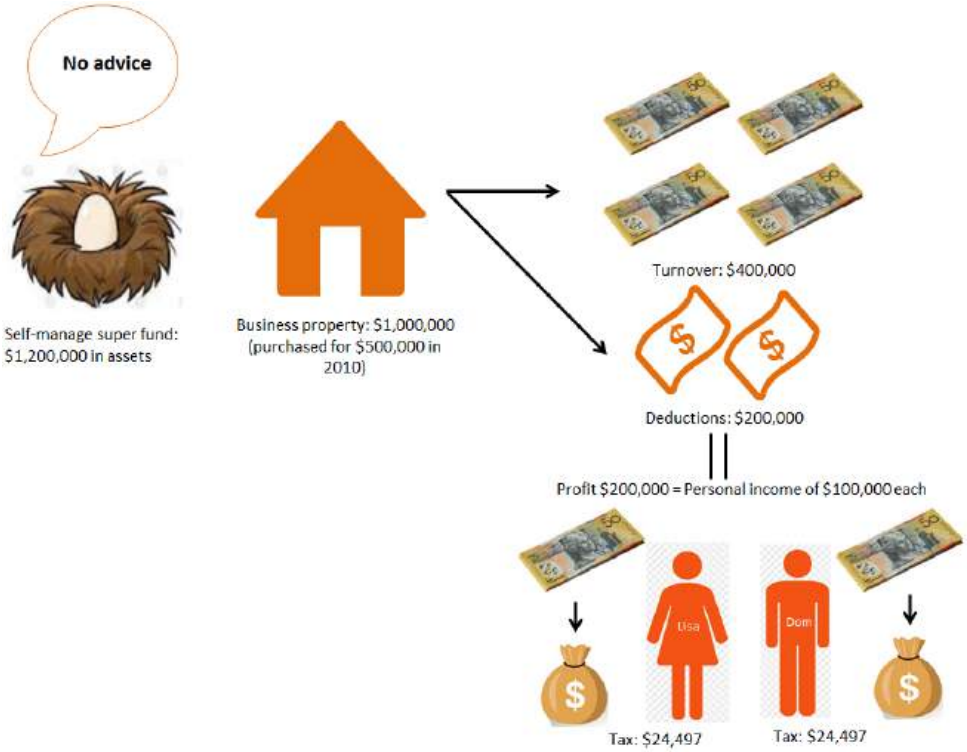
The tax adviser smiles. She suggests that they improve their tax outcome in two ways: by rolling over the capital asset of the business into the super fund in a way that extinguishes the capital gains tax liability, and by increasing their deductions that their business can claim. Both actions require a change in legal form only; the business activity is the same as before and Dom and Lisa's lifestyle is unaffected.

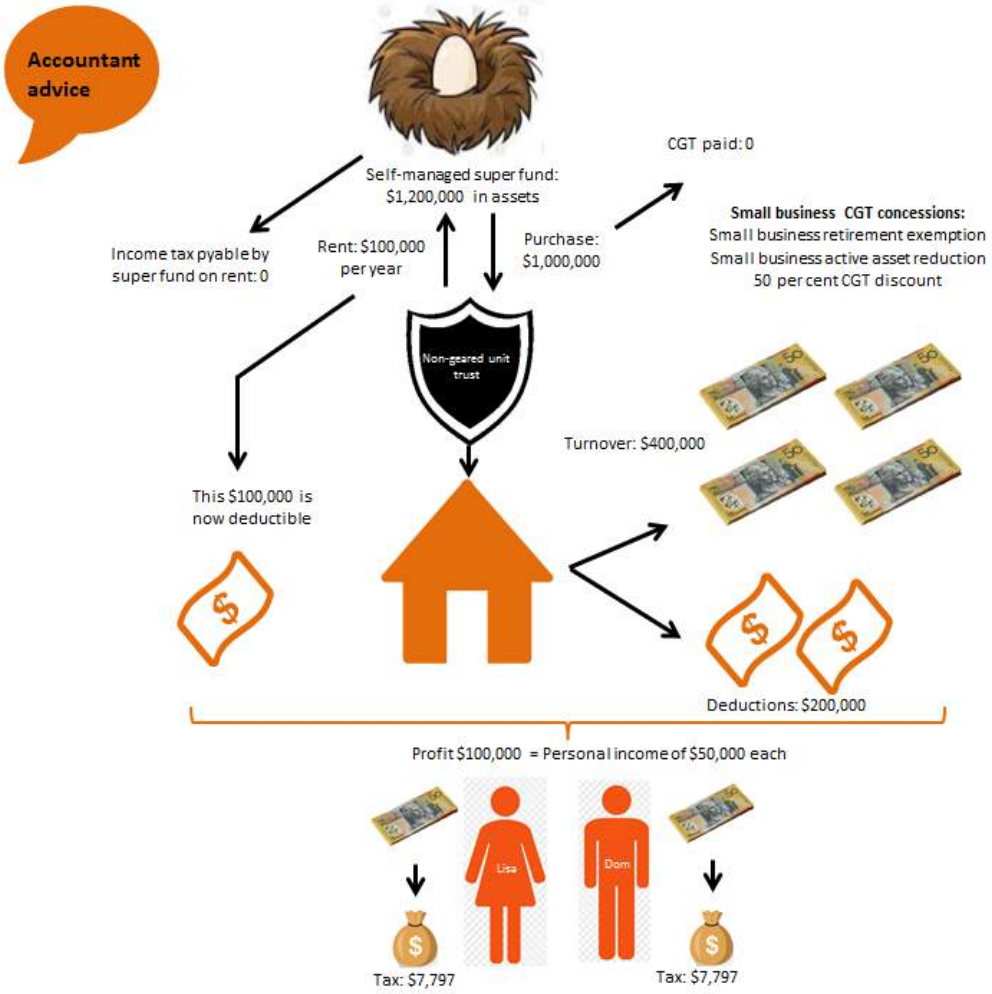
The first step is for the self-managed super fund to purchase the business premises for its market value of $1 million. This is only a change in form of assets – the super fund becomes $1 million poorer in cash but gains a $1 million asset. At the same time, the small business gains $1 million of cash but loses a $1 million asset. As small business owners, Dom and Lisa are eligible for a number of generous capital gains tax concessions. One is the small business retirement exemption, which means that as Dom and Lisa are over 55, capital gains of up to $500,000 per person (over their lifetimes) are tax free (ATO 2020c). The $500,000 in capital gain that has accrued here is well within the maximum allowed.

Step 2 is for the self-managed super fund to start leasing the business premises to the company, at a charge of $100,000 in annual rent. This requires careful structuring in order to get around self-managed super integrity provisions, such as in-house asset tests. In this case, because the asset in question is real estate with no borrowings secured on the title of the property, the adviser suggests a non-geared unit trust, a popular structure for self-managed super fund (and managed investment fund) investments (Butler 2015). Dom is made the trustee of the unit trust and the self-managed super fund is the only beneficiary. The business deductions increase from $300,000 to $400,000, lowering company profits by $100,000, and the rental income that the super fund (in retirement phase) receives is tax free.

The advice reduces their tax liability to $15,594 annually, at an average tax rate of 7.8 per cent. Dom and Lisa can now finance an after-tax lifestyle of just under $185,000 rather than $150,000. They have also been saved from paying $500,000 of future capital gain, upon which they would have been responsible for as much as $58,750 each (half of the gain is $250,000 if split equally and gains taxed at 47 per cent.

The tax adviser also suggests that, in the future, Dom and Lisa might be interested in more aggressive variants of this structure that would see all assets of the business structured and leased to an operating company or trust, and potentially making greater use of the super fund assets through limited-recourse borrowing agreements. She suggests that their use of legal incentives all depends on how motivated Dom and Lisa are to reduce their tax bills.





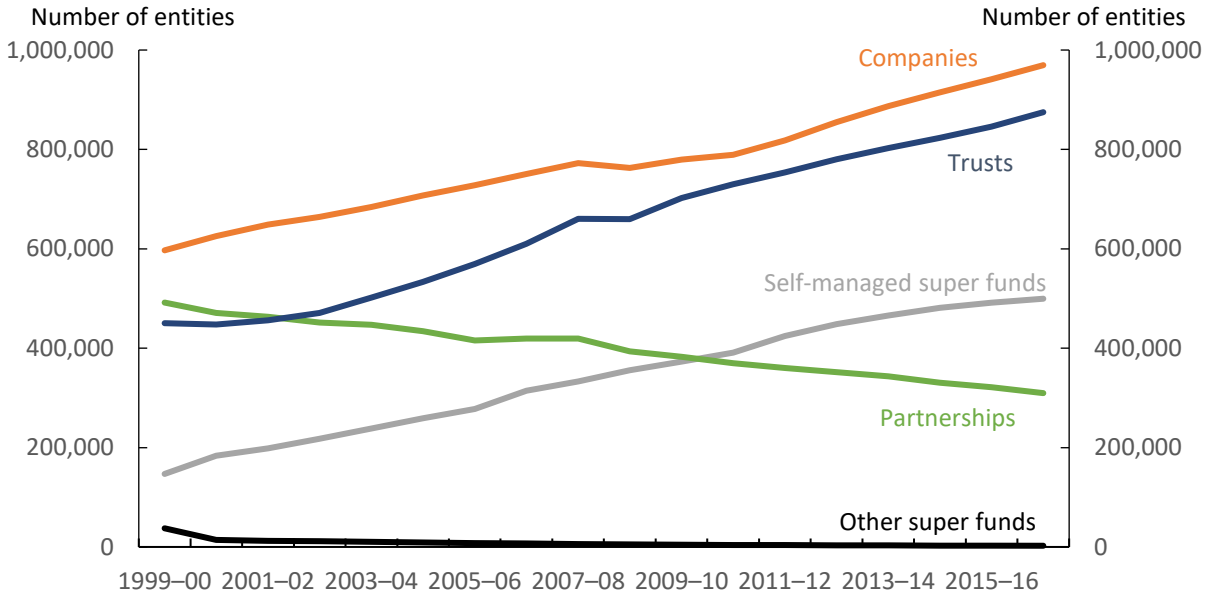
Note: Calculations for these examples are stylised. Unless otherwise specified, they are based on headline personal, corporate and/or super tax rates and thresholds only without offsets, deductions or levies such as the Medicare levy or low-income tax offset.

As an aside, Plays 4 and 5 reveal a further, important feature of Australia's tax system. The presence of deductions, offsets and transfer payments through the welfare system accentuate the differences between (effective) marginal and average tax rates that different individuals face. They also add to the options available to tax planners. That said, the conceptual framework for analyzing their effect are the same as for tax arbitrage opportunities. We therefore do not intend to discuss deductions, offsets and the interaction between tax and transfer systems further in this paper.

DO PEOPLE ACTUALLY RESPOND TO TAX PLANNING INCENTIVES?

Taxpayers are increasingly engaging with different tax vehicles. The most obvious trend since the turn of the century has been the growth in the number of trusts and self-managed super funds (Chart 3). Since 1999-2000, the number of trusts have close to doubled from approximately 450,000 to 875,000, and the number of self-managed super funds has more than tripled, from approximately 150,000 to 500,000. This compares with a one-third increase in individual tax filers (from 10.1 million to 13.9 million) and two-thirds increase in companies (from 600,000 to 970,000). Part of the growth in trusts and self-managed super funds is coming from the declining interest in partnerships, which are generally more restrictive than trusts.

Chart 3. Number of companies, trusts, super funds and partnerships in Australia



Source: 2016-17 Taxation Statistics, Snapshot Table 6.

In addition, there is a relatively extensive academic literature (which is also growing as administrative taxation data becomes more accessible) pointing to taxpayers' propensity to respond to tax incentives. Academic empirical studies - including international studies such as Feldstein (1999), Saez (2010) and Kleven (2016) as well as Australian-focussed studies such as Breunig and Johnson (2016) - observe that the bigger the difference in marginal rates, the greater the tendency for taxpayers to structure their affairs. In addition, there is a higher propensity to respond to incentives from those who derive their income in more flexible forms.

Some estimates have been produced about the tax revenue at stake as a result of specific strategies. For example, in 2019 at team of RMIT researchers identified a number of sophisticated strategies using discretionary trusts, which they estimated to shelter as much as $1.2 billion in tax annually (de Silva et al. 2019).

However, as yet, comprehensive Australia-wide evidence on the extent of tax planning – evidence that combines the number of entities with the total value of tax at stake – is something of a blind spot for research. This is partly due to the challenges in assessing how much tax planning is occurring. The income that tax authorities observe (and audit) is what has occurred after a significant amount of tax planning action has taken place. The strong assumptions required to arrive at a counterfactual amount of taxable income someone 'should otherwise be earning' before they tax plan suggests that such exercises would quickly become assumption and values driven.

Even if a counterfactual could be robustly determined, measurement would be a challenge. Those embarking on tax planning activities tend to prefer to keep their arrangements private. One of the features of trusts, in particular, has been their anonymity and secrecy and propensity to be combined in very complex ways. As a result, getting a complete picture on the amount of income that is directed through trusts, and especially complex structures, remains notoriously difficult. Building on this evidence base is one of the more compelling and pressing areas that warrants further analysis.

TAX PLANNING AND THE PRINCIPLES OF GOOD TAX DESIGN

Individuals benefiting from particular tax planning outcomes are likely to view these as a great development that should be retained. However, tax planning is problematic for the Australian tax system in a number of important respects.

Less fair

First, a strong argument can be made that tax planning reduces the fairness of the tax system.

As a range of authors (such as Konow (2003) and Davis et al. (2019)) have argued, notions of fairness are subjective, nebulous and contested. They are based on morals and ethics, with arguments drawn from a number of competing theories and philosophies of distributive justice[9]. They are heavily context dependent; for example, they are influenced by where 'you' are (the tax rate that applies to 'your' income) relative to someone else. And there is no single viewpoint as to what is fair. Fairness requires value judgements.

In addition, as Davis et al. (2019) notes, the seminal 1975 Asprey review of Australia's tax system discussed two key concepts which are important for tax planning: 'the benefit principle' which loosely generalises to taxation being the price of engaging with civilised society, and the 'capacity to pay principle' which can be generalised as an individual's ability to pay tax increasing as his or her income (or assets) increase. These two rationales have received widespread political and community support within Australia over an extended period of time. As part of the capacity to pay principle, the Asprey review discussed the two key concepts of vertical and horizontal equity:

> *"As a quality of a tax or a tax system everyone demands fairness, or equity (the terms will be used interchangeably). But, in tax matters as in law and ethics, it is an ideal exceedingly difficult to define and harder still to measure. It is customary to distinguish the two dimensions of 'horizontal' and 'vertical' equity: the notions that it is fair that persons in the same situation should be equally treated, and those in different situations differently treated, with those more favourably placed being required to pay more."*

The fundamental ideas that vertical and horizontal equity embody - that those in similar positions are treated similarly, and those more favourably placed required to pay more - are crucial to public acceptance of the Australian 'self-assessment' system, which relies on people voluntarily reporting and complying with their tax obligations.

Tax planning works to undermine horizontal equity. Australians earning similar amounts of income from similar activities do not pay similar amounts of tax, with the size of discrepancy based on whether (or how much) they structure their affairs. The discrepancy becomes more pronounced for particular types of income. For example, those with more discretionary income have a greater capacity to plan.

In undermining horizontal equity, tax planning undermines vertical equity. If people in the same position are not treated the same, it is impossible to trust that those on higher incomes are actually paying more. To put it another way, a system that is notionally progressive in shape, may not be progressive in practice.

The discrepancy between people's capacity to pay and their tax paid becomes more acute when considering that those on higher incomes are likely to have more income to devote to planning, and

[9] As Davis et al. (2019) point out, equality of opportunity, libertarianism, utiliatarianism, Rawlsianism, and the capabilities approach would all produce different definitions of fairness.

a stronger motivation to avoid higher (including the top) marginal personal tax rate. The consideration becomes even more stark when considering the cumulative benefits that accrue from planning over many years, and in setting up affairs through trusts that ultimately benefit future generations within a single family.

Consider the distributional consequences of the different tax rates paid in Play 4. Should policymakers place more weight on the average tax rate of 25.2 per cent the structure pays after year 1, the 16.6 per cent tax rate that the couple pays after year 1, the negative 27.5 per cent tax rate the couple pays in year 2, or the 6 per cent effective tax rate over the life of the structure? Important nuance can be missed by comparing just the tax rates that people face in any given yearly 'snapshot'. It raises serious questions about the robustness of current annual distributional analysis of tax outcomes, and points to an urgent need to develop genuine, lifetime (or at a minimum longer-term) tax analysis capacity.

Less efficient

Second, tax planning makes it much more difficult to determine if the tax system is operating in an efficient manner.

Consider again Chart 2, which depicted a number of different average tax rate schedules that are possible in a hybrid tax system where a schedule of statutory marginal personal tax rates is generally higher than the marginal tax rates that apply to other designations of income.

A system with higher marginal tax rates and lower average tax rates will typically generate inefficiencies that are known as 'excess burden' (e.g. as defined in Fullerton and Henderson 1987). The greater the gap between marginal and average tax rates, the greater the excess burden. Further rules-of-thumb are a) that marginal tax rates create distortions in individual decision-making, while average tax rates (multiplied by the number of taxpayers) underpin calculations of the aggregate revenue collected by government, and b) that the higher the marginal tax rate, the greater the 'deadweight loss' inefficiency.

Tax planning can increase the gap between marginal and average tax rates for both tax planners and those not tax planning. To make up for the revenue foregone from tax planners, the government needs to impose higher marginal tax rates on those who don't tax plan if it is to raise the same amount of revenue from income taxes.

The calculation for tax planners is a little more complicated. In general, to the extent that tax planning is genuinely influenced by a marginal dollar, tax planners have lowered their effective marginal tax rate as a result of their planning. As these taxpayers have effected a lower transfer from themselves to government, it can be considered an efficiency gain. That said, our speculation is that tax planners generally make decisions based on their overall financial position. This means that a significant part of decision-making regarding tax planning is based on the 'extensive margin' (the decision to exploit available arbitrage opportunities and achieve the maximum total tax savings associated from these opportunities) rather than on the 'intensive margin' (responding to the incremental tax saving associated with a marginal dollar). The less responsive tax planners are to marginal incentives, the more muted the expected efficiency gains. And it is worth bearing in mind that at the economy-wide level, tax planners are engaging an industry whose presence diverts societal resources away from more productive enterprise.

In sum, the efficiency calculation is a balance between the unambiguous efficiency losses for those who don't tax plan, weighed against the balance of efficiency gain and efficiency loss for those who

do tax plan. In a country with 13.9 million personal income tax filers, compared with 970,000 companies, 875,000 trusts and 500,000 self-managed super funds, our judgement call is that the balance probably falls on the 'less efficient' side, even without adding in the time costs of unproductive activity.

More complex

Third, tax planning is both a feature of and a driver of a complex tax system. As the 2015 Tax White Paper acknowledged, Australia's tax system is complex:

> *"the complexity of the Australian tax system [which largely reflects the historical foundations of the tax system and the way the changes have been implemented in the past] reduces integrity and transparency, and imposes unnecessary compliance costs on taxpayers, as well as other costs on the Australian economy."*

To plan, taxpayers can turn to dedicated arrangements which can be technical and require specialist expertise to understand and enact. There is a financial cost both to set up and to maintain such arrangements. Further, the more complex their affairs and the more income at stake, the greater risk to taxpayers if the structure were to run afoul of tax authorities. The resulting 'compliance' activities impose a financial and emotional toll, and often divert the taxpayer's focus from other aspects of their life. As a result, taxpayers entering into structures typically turn to the tax advice industry, and are at least partly motivated to outsource as much risk as possible to a professional tax planner.

The different tax rates, vehicles, and variety of opportunities also add up to a tax code that is a nightmare to administer. The system requires constant adjustment. And the tax administrator has finite resources and has to prioritise its compliance efforts. If one objective of the administrator is to deliver the taxpayer value-for-money – that is, to prioritise compliance activities onto the areas that deliver the greatest revenue 'gains' to government – then there may also be a tension in deciding on what types of tax compliance activities to prioritise. For example, do you 'go after' the arbitrage behaviour of a small number of high income earners, who have engaged advisors, established sophisticated arrangements and have a strong capacity to challenge you, or do you instead focus on small revenue gains across a large population, such as common low-value deductions?

Less sustainable

Tax planning also offers over-time headaches for tax policy. Chart 4 depicts the kind of stylised 'cost-benefit' choices that tax administrators and policymakers are likely to face. The tax system originally moves along a trajectory where income tax revenue is at (or close to) what would be expected if people were all paying at their marginal personal tax rates. But over time, as some of the population lower their average tax rates, a wedge opens up between the (theoretically) full collection level and actual collections.

The growth in this wedge will not be a 'linear' progression. The wedge can, in general, be anticipated to cumulatively increase over time, as new tax planning opportunities are discovered and tax advisers overcome the fixed costs from developing necessary expertise and road-testing the advice. However, once a robust opportunity is developed, the marginal costs of marketing the advice and otherwise increasing the number who can access it are likely to be low.

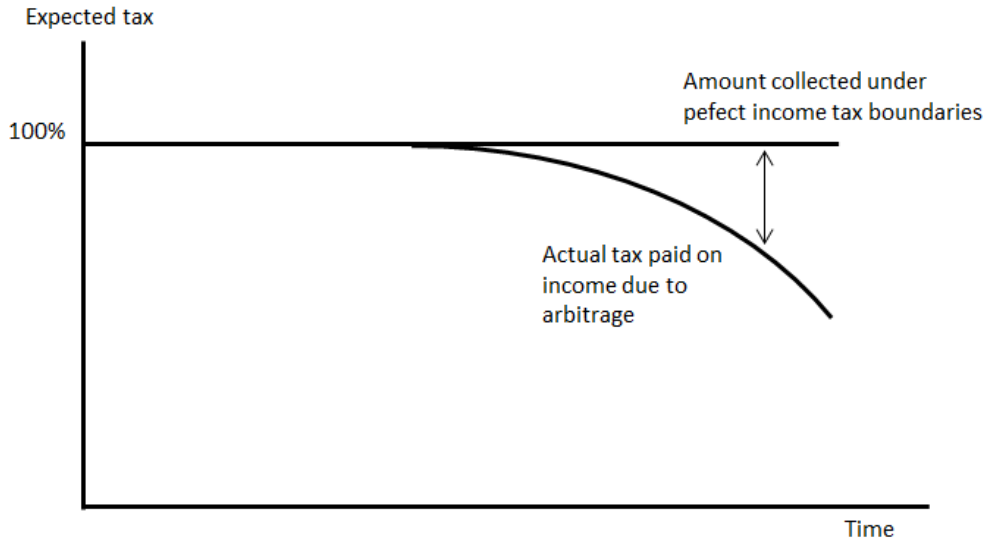
The increasing revenue leakage over time has a number of consequences. First, more real-world time and economic resources are progressively spent on new forms of planning, and a niche industry

forms around the opportunities. And, once there is sufficient take-up, tax administrators attempt to stem the leakage leading to increased compliance burdens and regulatory action.

But policy settings also often take time to 'catch up'. The tax planning opportunity is only likely to arrive on the policymaking radar once ‘revenue leakage’ reaches a sufficient level, at which point there will be pressure on governments to fix the hole through a policy change. If the policy response is such that the opportunity is closed off entirely, then the revenue collections might return to the original collection level. However, the Australian experience in recent decades has been a tendency to amend existing laws to clarify precisely what planning behaviour is deemed acceptable (‘exhibit A’ of this behaviour is Division 7A of the *Income Tax Assessment Act 1936*), or to create new laws that increase the system’s overall complexity.

Equally importantly, there is a risk that taxpayers that are not benefiting will lose faith in the system and find ways to avoid paying taxes themselves. This might, at some point, include increased action in the informal economy. The risk grows as the number of opportunities for tax minimisation across the economy proliferates.

Chart 4. The cumulative cost of tax planning



It’s worth acknowledging that while this is a vulnerability, the dam walls have not (yet) burst. Australia continues to reliably collect large sums of money from direct taxation – the 2019-20 MYEFO estimates that $231 billion will be collected in 2018-19 from individuals and other withholding taxes (Frydenberg and Cormann 2019b). But, as Davis et al (2019) revealed, this tax has in recent decades become increasingly concentrated among a narrower band of top-earners. In 2016-17, Australia collected 45 per cent of personal income tax revenues annually from approximately 1 million top-earning taxpayers earning at least $125,000 annually and paying an average tax rate of 35 per cent of their income in tax. The composition of the top decile of taxpayers changes over time, but the membership shares a common incentive to lower their marginal tax rates. So there are reasons to be alert to the risk that the revenue base erodes. In particular, should the trajectory of revenue collections proceed in the stylised manner depicted in Chart 4, it is reasonable to anticipate that there will be some future point at which revenue collections erode.

WHERE TO GO FROM HERE?

Based on the 'problem identification' that some people are taking advantage of differentials in tax rates to dramatically lower their tax bills, and this is happening in a manner that varies substantially across the economy, policymakers could take one of four generic courses of action:

- *Do nothing.* Persist with the current hybrid income tax approach. Either implicitly or explicitly drop horizontal equity as a fundamental principle guiding the design of the tax system. And accept that public acceptance of the tax system will continue to be questioned.

- *Give everyone access to a 'no income tax' outcome.* Instead of taxing income, move the taxation base entirely over to an expenditure tax base, perhaps combined with an estate tax designed to ensure the integrity of the consumption tax regime (and reduce any tax-induced incentive to set up a dynasty structure that generates tax returns over generations). This would be an extreme shift given the current tax mix.

- *Close the incentives to arbitrage*. The general principle would be to directly address the incentives to arbitrage by closing (or significantly reducing) the gap between marginal personal tax rates and the corporate, super and capital gains rates on an enduring basis.

  This kind of approach raises a number of important (complex) tax system design questions. For example, should a government pursue a logically 'pure' comprehensive income tax approach that could lead to a 'one page tax code' with a single, low, flat tax rate that applies to all income (regardless of source) economy-wide? What are the over-time distributional consequences of the reduced apparent 'annual' progressivity associated with a flatter personal income tax schedule and can these be addressed through a more active role for redistribution through the welfare system and/or a higher rate of tax on savings? What are the economic consequences of a system where capital income does not receive discounted tax treatment relative to labour income? How should the impacts on the tax advice industry of a simpler tax code be managed?

- *Close the opportunities to arbitrage.* The general principle would be regulating additional constraints around the use of common vehicles that 'work across' different income types, and considering the prohibition of tax vehicles entirely if more narrow solutions are not pragmatic.

  This kind of approach also raises a complex set of tax system design questions. For example, should a government pursue a logically 'pure' schedular tax approach with more regulation to create multiple distinct and separate forms of income? How many forms of income should be accepted – for example, a dual income basis (labour and capital), or with additional unique definitions for passive savings (including for people's retirements)? Can a schedular tax approach survive on a realisation basis, or will an accruals taxation need to be introduced? And how to manage refundable dividend imputation and the flow-through tax treatment of trusts – if these are to be abolished, how to prevent the double-taxation of income sources? And how much confidence can we have that law designers can craft rigorous boundaries around income definitions that are effective and enduring?

The types of questions canvassed here go deep into the basic design of tax. Accordingly, they have, in the (relatively) recent past, been within the remit of major tax reviews in the spirit of the *Review*

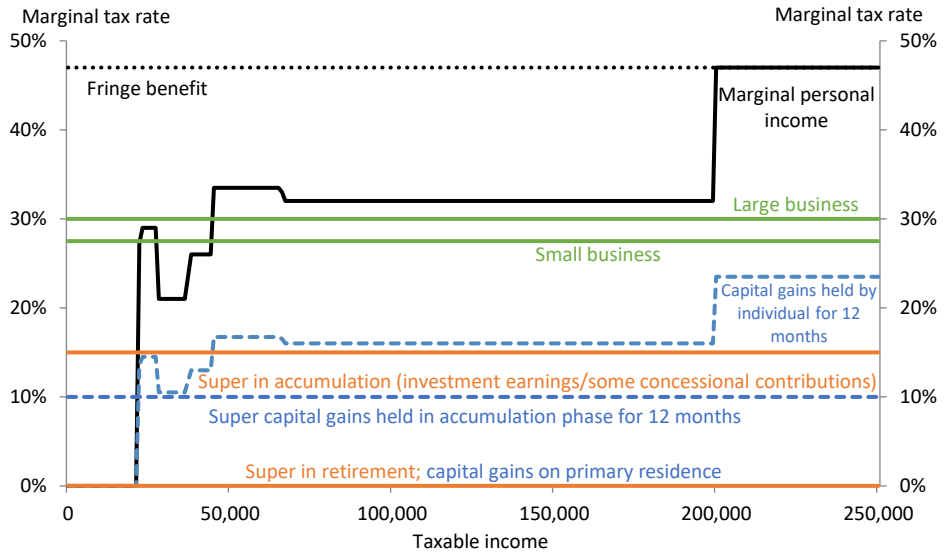
of Australia's Future Tax System (Australian Treasury 2009) and *Tax by Design*, the final report from the Mirrlees Review in the United Kingdom (Mirrlees et al. 2011). This paper does not aspire to be a 'solutions' paper in the spirit of such weighty reports. We won't advocate for a particular form of the Australian tax mix here. Instead, we advocate for an informed public policy conversation in Australia around which approach to taxation is most appropriate.

We also point out an important consideration: that while incremental, piecemeal changes to specific sources of tax can lead to positive improvement, adequately addressing tax planning requires 'big bang' comprehensive reform that is implemented simultaneously across multiple sources of tax.

Consider the impact of one of the most consequential tax changes (in terms of revenue cost) in the past decade - the 7 year tax personal income tax plan - on marginal tax rates and arbitrage incentives. Compare Chart 5, which depicts the tax rates that are legislated to be in place in 2024-25 with Chart 1, which depicts the tax rates that are currently in place in 2019-20.

On the face of it, reducing marginal personal income tax rates from as high as 47 per cent to 30 per cent (excluding the Medicare Levy) for those earning less than $200,000 in a year (estimated in the 2019-20 Budget to cover up to 94 per cent of the taxpaying population (Frydenberg and Cormann 2019a)) will reduce the discrepancy between marginal personal and corporate tax rates and thereby reduce the initial incentive for salaried employees to set up and operate as a business. However, tax planners will still have incentives to use franking credits to generate tax refunds, particularly those in the top tax bracket. Moreover, tax planners can be expected to shift their attention to other opportunities from 2024-25 onwards. For example, there will be a more prominent incentive to earn income through 'passive' capital gains rather than through 'active' corporate profit making, wage and salary earning.

Chart 5. Marginal tax rates and thresholds expected in 2024-25



Notes: marginal personal income tax rates include the medicare levy and the low income tax offset (LITO) legislated as at January 2020. The large company tax rate only takes effect once a company turns over $50m. Capital gains tax is represented as a dash lined, reflecting that it is a derived calculation of an implied tax rate that applies to a discounted nominal gain during the year in which an asset is sold. However, in practice, the capital gains tax discount is applied to the *gains*, which are either halved (capital gains on ordinary income) or discounted by 33 per cent (capital gains on super in the accumulation phase) for assets that are sold and have been held for 12 months or longer. Then full marginal rates apply to that gain. Source: Australian Taxation Office.

Conclusion

This paper has presented a number of common and relatively simple tax planning arrangements. These should be considered the tip of the proverbial iceberg of what is available in the Australian tax system. In publicising these examples, we recognize that we might be helping erode tax revenue by leading to more people seeking out more tax planning opportunities. However these arrangements are common enough that we are confident we are not revealing any trade secrets.

We publish these examples with three goals in mind.

First, their existence makes for a compelling argument to reform Australia's hybrid income tax system. Some Australians have access to a wide range of tax planning opportunities and can engineer very low tax bills. Other Australians have access to limited planning opportunities. Yet other Australians have access to no opportunities. As a result, it is becoming increasingly unlikely that people in similar positions are paying similar amounts of tax. It is also impossible to determine if people who have a greater capacity to pay tax actually pay more tax. Therefore, on two crucial and commonly accepted metrics of fairness, the Australia income tax system is objectively unfair. The myriad of choices and options available to taxpayers mean that it is also more complex and less efficient than it should be.

What would be ideal, now, is a level-headed public debate about the relative merits of moving towards a tax system with less incentive to arbitrage – this would require reducing the gap between tax rates on personal, business and savings income – or perhaps accepting the complications that come from a number of different definitions of income, and pursuing reforms that place robust boundaries around them. Such a discussion would need to take place in the wider context of the tax and transfer system, as changes to the transfer system would be required to maintain the desired level of progressivity of the system.

Second, they reveal that the current empirical evidence base around tax planning is sadly lacking. Current distributional analysis of tax burdens generally compares people's taxes in any given (annual) snapshot, which can provide a fundamentally misleading picture about someone's true over-time tax burden. The only solution to this dilemma is to build the evidence base by investing in our collective capacity to undertake genuine lifetime distributional analysis.

Third, we want to make an appeal to society to acknowledge that income tax should not be voluntary or temporary in nature. And for that to happen, Australian society needs to buy in to the notion that we collectively can't afford for specific groups of people to be treated as special in the eyes of the tax system.

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