

## Chapter Three

### Comparative Federal Income Tax

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In 2012, I presented a paper to the Samuel Griffith Society that put forward a model in which a State-level income tax may be a feasible option to resolve vertical fiscal imbalance in Australia.<sup>1</sup>

The essence of that proposal was that the Commonwealth would vacate the personal income tax field in favour of the States reintroducing such a tax; the Commonwealth would retain the corporate income tax; and the revenue from the goods and services tax (GST) would also be retained by the Commonwealth. Jurisdiction to tax would be based on residency, hence the need for the corporate income tax to remain at the Commonwealth level, as companies may easily be located in a different jurisdiction compared with their principals.

A question that arises from this proposal<sup>2</sup> is how such a model compares with those used by other federations with a State-level income tax. That comparison forms the focus of this paper.

While there are several federations from which lessons can be drawn, for a number of reasons (comparability of development, economies, federal structure, similarity of legal system), this paper provides a brief examination of Canada, the United States and Germany. The intention is not to be especially comprehensive but, recognising that the idea of reintroducing any form of income tax at the State level in Australia is a significant departure from the fiscal system that has been in place for a substantial period of time, this paper represents something of a good starting point for what will hopefully be a serious consideration of this policy proposal.<sup>3</sup>

#### ***Canada***

An early observation that may be made about Canada is that there are a number of parallels between both the history of its federation and its federal structure when compared with Australia. Interestingly, though, at many junctures, Canada has adopted a distinctly different, if not a completely opposite, approach from that pursued in Australia, demonstrating that there is nothing either inevitable or necessary about the present Australian system.

Canada is comprised of ten provinces and three territories, with the provinces having a formal status similar to those of the States in Australia. Unlike Australia, the Canadian provinces have constitutionally enumerated powers. A further distinction from the Australian States is that the Canadian provinces enjoy a high degree of fiscal autonomy, with a high degree of control over their spending programs and access to revenue sources, including income tax.<sup>4</sup> As such, it may be noted that Canada's federation is much more inherently decentralised than Australia's, with provincial powers constitutionally protected.

Prior to the First World War, the provinces levied their own income taxes, with the Federal Government entering this realm in 1917. Between the World Wars, little co-ordination between the two levels of government occurred and, with the growth of the

Federal Government's involvement in the income tax field, gave rise to a "tax jungle" with sometimes conflicting requirements.<sup>5</sup> This was a similar situation to that which existed in Australia at the same time.<sup>6</sup>

With the onset of the Second World War, responsibility for the income tax was concentrated in the Federal Government. While a similar situation existed in Australia, it is instructive to note that the Canadian arrangement was achieved with the acquiescence of the provinces,<sup>7</sup> in contrast with the Australian position which was, ultimately, imposed on the States with the support of the High Court.<sup>8</sup>

After the conclusion of hostilities, Canada developed a system based on co-ordination between the levels of government, which, inter alia, involved the Federal Government devolving much of the income tax base to the provinces.<sup>9</sup> Again, this may be contrasted with developments in Australia, where the response to similar challenges and opportunities has been concentration of taxing power in the central government rather than decentralisation.

Another interesting point of difference with Australia is the taxing power under the Canadian Constitution. As with Australia, taxation is a power shared between both levels of government but, in Canada, this is restricted to direct taxes. Australia, while not explicitly restricting State taxing powers, has in effect done so through the High Court's constitutional jurisprudence.<sup>10</sup> It is interesting to note, though, at least for (further) comparison purposes, that the Canadian Supreme Court's interpretation of the term, "direct taxation", has been so wide as to allow the provinces to impose what are normally regarded as indirect taxes, such as consumption taxes. Arguably, this represents a judicial departure from the intentions of the framers of the Constitution, similar to Australia, but with the outcome of expanded subnational government powers, in contrast with Australia.

The centrepiece of Canadian fiscal federalism is a Tax Collection Agreements (TCA) system, first implemented in 1962 following a number of similar but failed attempts at formalising tax sharing arrangements.<sup>11</sup> In the subsequent half century, the purpose behind the TCAs has remained unchanged (a major reform was undertaken in 2001, which is discussed below), being described as "to facilitate the imposition of income taxes by provinces, while maintaining the federal interest of a harmonized national tax system."<sup>12</sup>

The essential features of the Canadian income tax system<sup>13</sup> are that the Federal Government administers and collects the income tax, the value of which is then distributed to the provinces and, in return, the provinces adopt a common tax base, maintain legislation closely aligned with that at the Federal level, and provide the Federal bureaucracy with the necessary powers to collect and administer these taxes. In respect of personal income tax, all provinces and territories except Quebec have entered into a TCA implementing this system; Quebec and Alberta are the only exceptions in respect of corporate income tax.<sup>14</sup> This is especially important for provincial autonomy. The provinces have complete control over the rates that are set.

Taxpayers benefit through simplified compliance procedures, largely illustrated through being required to prepare only a single tax return and being able to access a single audit and review process.<sup>15</sup>

The original model used for the TCA system was the "tax on tax" system, under which the provinces would impose tax as a proportion of the Federal rate.<sup>16</sup> This system provided the provinces with only limited autonomy, undermining the potential

for competitive federalism, although the provinces were able to compete in a limited fashion through the provision of tax credits.<sup>17</sup> Notwithstanding such inflexibility, this system persisted for almost 40 years.

This inflexibility did not extend to the corporate income tax, where the provinces were able to set their own rates independently of the Federal Government.

In 2001, a new series of TCAs was implemented. The major concern with the original TCAs was the inability of the provinces to determine independently the progressivity of their personal income tax scales.<sup>18</sup> In response to this matter, the new TCAs permitted the provinces to set their own personal income tax rates (a “tax on income” system) in much the same manner as that previously (and continued to be) used for the corporate income tax. While the option of using the tax on tax system remained, none of the provinces has elected to use this method.

The Canadian income tax system can be summarised as centrally administered through a series of bilateral agreements, with provinces exercising autonomy over the rates adopted. Most provinces have joined this system.

### ***United States***

In contrast with Canada, which may be characterised as a system of co-ordinated independence, the United States is characterised by maximum State autonomy.

The Federal Government has imposed an income tax since 1913, the final form of which was the outcome of a number of constitutional challenges. In contrast, there are no constitutional limits on the taxing powers of the State. At the time of writing, 43 (out of 50) States imposed a personal income tax and 47 imposed a corporate income tax. To illustrate the extreme level of decentralisation in the United States, income tax is also applied at a sub-State level, such as on residents of New York City.

The most notable feature of the income tax in the United States is the almost complete level of independence exerted. Each State (as well as the Federal Government) has its own legislation, although, in practice, most States have tended to follow the Federal model in most significant respects.

Each State has its own bureaucracy administering its income tax, with the result that many taxpayers are required to file multiple returns.<sup>19</sup>

An important element of the interaction between the two systems is that the Federal income tax allows a deduction for State income taxes to be paid. Some States permit a credit or deduction for other States’ income taxes paid, although this is not universal.

This independence, as with the international income tax system, leads to the prospect of double taxation.<sup>20</sup> Most State income tax systems use source as the basis for their jurisdiction to assess tax on income, although, again, this is not universal. For example, wages tend to be assessed based on the number of days the individual worked in that State; assessment of business income is often based on the extent to which the relevant business is conducted in that State. While the deduction/credit mechanism mentioned earlier relieves some of this double taxation, this does not occur in all cases.

As with the personal income tax, States exert a great deal of autonomy over their corporate income tax. In general, though, there is a large degree of overlap with the Federal definition of taxable income and the States tend to restrict their taxing authority to business income that is apportioned to that State as well as the non-business income of resident corporations. For instance, for income tax purposes some

States have used the principles enunciated by the Supreme Court of the United States in *Quill Corp v North Dakota*,<sup>21</sup> which held that (for sales tax purposes) a business needed to have a physical presence in that State to be liable to that States' sales tax.

Overall, the United States has a system characterised by a high (if not extreme) degree of autonomy at the subnational level. While this maximises State autonomy, it also has the effect of imposing high compliance costs on taxpayers with further legal complexity. This is mitigated to an extent through some States following a general model, but as this is not universal and is premised on unilateral action, inappropriate outcomes (such as double taxation) can and do occur.

### **Germany**

Germany is comprised of 16 länder (States), which do not exercise fiscal autonomy as such, but rather tend to share in federal level taxes, such as personal income tax, corporate income tax and value added taxes.<sup>22</sup>

The fiscal structure in Germany is very rigid, especially when compared with Australia, Canada and the United States. The German Constitution dictates the länder and the federal governments' respective shares of the total taxation revenue (separated out by type), which is then distributed amongst the länder in an explicit policy of horizontal equalisation, where tax revenue is allocated according to fiscal need.<sup>23</sup> As a result of this policy, large transfers are made from those länder with deemed high revenue capacity to those that score low on this measure. The primary basis for determining revenue capacity is taxpayer residence.

Examples of the split in categories of revenue are as follows:

Income tax on wages and assessed income tax: Federal, 42.5%; länder, 42.5%; municipal, 15%.

Capital gains tax: Federal, 50%; länder, 50%.

Corporations taxation: Federal, 50%; länder, 50%.<sup>24</sup>

Responsibility for the administration of taxes, whether in their own right or on behalf of the Federal Government, falls primarily on the länder.<sup>25</sup>

In contrast with Canada and the United States (and Australia), it may be seen that the German fiscal structure is very rigid, being constitutionally mandated. The länder have little control over rates and, whilst they are in charge of the administration of these taxes, little fiscal autonomy may be exerted in the face of these constitutional requirements and the accompanying policy of horizontal equalisation.

### **Endnotes**

1. Keith Kendall, "The Case for a State Income Tax", *Upholding the Australian Constitution*, vol 24, 2014, 125-150.
2. And, in fact, was raised by Justice Ian Callinan as the first question after this proposal was presented in 2012.
3. Since the 2013 conference, the idea of a State-level personal income tax has been raised elsewhere; see National Commission of Audit, *Towards Responsible Government – Phase One*, Commonwealth of Australia, February 2014, Chapter 6, especially 70-72.

4. Robin Boadway, “Fiscal Equalization: The Canadian Experience” in Núria Bosch and José Durán (eds), *Fiscal Federalism and Political Decentralization: Lessons from Spain, Germany and Canada*, Edward Elgar, 2008, 109, at 109.
5. Paul Berg-Dick, Michel Carreau, Deanne Field and Mireille Éthier, “Tax Coordination under the Canadian Tax System” in Bosch and Durán, above n 4, 169, at 172.
6. Kendall, above n 1.
7. Berg-Dick et al, above n 5, 172.
8. See Kendall, above n 1.
9. Boadway, above n 4, 113.
10. As noted, the Australian Constitution does not enumerate State powers. While the States are regarded as having taxation capabilities, due to the manner in which the High Court has interpreted customs and excise duties (which are restricted to the Commonwealth Government), a State-level indirect tax may be susceptible to a constitutional challenge, although this is yet to be tested; see Miranda Stewart, “Australia” in Gianluigi Bizioli and Claudio Sacchetto (eds), *Tax Aspects of Fiscal Federalism: A Comparative Analysis*, 2011, International Bureau of Fiscal Documentation, 2011, 137, 163.
11. See Berg-Dick et al, above n 5, 173.
12. Ibid, 173-4.
13. See, generally, ibid, 174-5.
14. Ontario was the most recent province to enter into a TCA in respect of its corporate income tax, which took effect from 2009; see <http://www.cra-arc.gc.ca/whtsnw/tms/ctao-eng.html>.
15. See Berg-Dick et al, above n 5, 175.
16. Ibid, 176.
17. Although the ability to compete in this manner was also limited by a series of guidelines designed to promote national harmonisation to a large extent; see ibid, 177.
18. Ibid, 178.
19. In the author’s brief stay as a student in the United States several years ago, he

was required to file one State income tax return (Illinois) and his Federal income tax return. One colleague in his mid-20s reported he was required to file three State returns in addition to his Federal return.

20. In this context, double taxation occurs where two jurisdictions attempt to assert taxing rights over the one receipt.
21. 504 US 298 (1992).
22. Thiess Buettner, “Fiscal Equalization in Germany”, in Bosch and Durán, above n 4, 137, 142.
23. *Basic Law of the Federal Republic of Germany* (German Constitution) Article 106; see also *ibid*.
24. See Alexander Ulbricht, “The Decentralization of Tax Administration in Germany: Consequences” in Bosch and Durán, above n 4, 193, 195.
25. *Ibid*, 197-8.