

## Tax Brief

3 May 2010

### The Henry Tax Review

The guessing is over – we now know what a ‘root and branch’ tax review looks like. We were also reminded that, in an election year, caution can be a very attractive option for a government.

The Government released yesterday the 3-volume final Report of the Henry Review of Australia’s Future Tax System. As expected, the Report is far-reaching, intended to shape Australia’s tax system for the first half of the 21st century. It contains 138 specific recommendations covering a broad spectrum of tax and related areas, supported by extensive analysis of relevant issues, including estimates of likely economic impacts.

The Government’s reaction to the Report, released at the same time, is less voluminous and less ambitious, proposing a staged and very selective response to the Report; and the committed changes will have deferred starts.

In this Tax Brief we examine the background to the Report, the key recommendations for Australian business which the Government has indicated it will adopt, the second term initiatives still under consideration, the recommendations rejected out of hand and the recommendations which have not been specifically addressed at this stage but which business might want to encourage the Government to revisit.

#### Summary of key announcements

**Committed.** Three key areas have been targeted for medium term action – the resources sector, superannuation and a handful of business tax issues. In summary, the key measures are –

- Mining:
  - a Resource Super Profits Tax will be introduced from 1 July 2012 at a rate of 40% on profits from the exploitation of Australian resources - part of the revenue raised will be utilised to provide the States and Territories with a new infrastructure fund;
  - a refundable Resources Exploration Rebate, providing refundable company income tax offsets for resources exploration expenditure, including expenditure on exploration for geothermal energy;

# Greenwoods & Freehills

- a range of superannuation changes, including:-
  - raising the superannuation guarantee rate from 9% to 12%;
  - raising the superannuation guarantee age limit from 70 to 75;
  - providing access to the government superannuation co-contribution to a greater range of individuals; and
  - continuing the higher cap for concessional superannuation contributions for those aged 50 and over, provided they have superannuation balances of less than \$500,000;
- two targeted business tax changes –
  - a phased reduction in the company income tax rate from the current 30% to 28% in the 2014-2015 income year (29% in the 2013-2014 income year), with small business companies benefiting from the 28% rate from the 2012-13 income year – the Government makes clear that this is dependent on the introduction of the RSPT;
  - small businesses will benefit from immediate expensing of depreciating assets valued at less than \$5,000 and will be able to depreciate all other assets (except buildings) in a single pool at a 30% rate from 1 July 2012.

**For Consideration.** The Government will then consider some of the other recommendations as part of a second term agenda, focusing principally on taxpayer compliance obligations, incentives to save, and on the administration of the tax system. Although it is not entirely clear what the Government proposes to do, the main elements of the recommendations involve a 40% discount for certain types of income from saving by individuals, measures to reduce the tax compliance burden for individuals and some changes to the governance of Australia's tax regime.

**Rejected.** The Government has also indicated those recommendations that it will **not** implement –

- it will not remove the benefits of dividend imputation;
- it will 'never' increase the rate, nor broaden the base, of the GST;
- it will not remove tax free superannuation payments for those aged 60 and over;
- it will not reduce the capital gains tax ('CGT') discount, apply a discount to negative gearing deductions or change grandfathering arrangements for CGT;
- it will not offer a government annuity product;
- it will not introduce a bequests tax;

- it will not remove the Luxury Car Tax;
- it will not make any changes to the tax system that harm the not-for-profit sector, such as removing the benefit of fringe benefits tax concessions, raising the gift deductibility threshold or changing income tax arrangements for clubs.

**The rest.** That still leaves a long list of recommendations not specifically addressed by the Government. While the Government does not wish to endorse them, it does want to encourage debate on them in the coming years. Some, which may be valuable for business, are examined below.

## 1. Background

The genesis of the *Review of Australia's Future Tax System* was a suggestion made at the 2020 Summit in April 2008. The Report of the Summit's proceedings records,

'Participants in the economic stream shared a vision of a holistic tax system that is fair, simple and efficient, minimises distortions, interacts constructively with the welfare system, and supports the global competitiveness of the economy. The taxation sub-group believed that, to achieve this vision, a comprehensive tax review is necessary.'

Unlike many of the ideas raised at the 2020 Summit, the Government took up this proposal with enthusiasm, announcing almost immediately – in the May 2008 Budget – that it was appointing a review panel with a mandate to report by the end of 2009.

The initial scope of the review appeared to focus mainly on personal income tax issues and the interaction with the social security system, but it quickly became clear that the scope of the review would expand to encompass the entire tax system, both Federal and State taxes, as well as the social security system, with only a few topics ruled out-of-bounds. A parallel project would examine the future of Australia's retirement income system. Another project examining Australia's pension system was added to the process.

During the 20-month life of the review, the panel was not idle. It published several papers – an overview paper in August 2008 [see our Tax Brief at [http://www.gf.com.au/829\\_675.htm](http://www.gf.com.au/829_675.htm)] and a consultation paper in December 2008 [see our Tax Brief at [http://www.gf.com.au/829\\_716.htm](http://www.gf.com.au/829_716.htm)]. It commissioned various papers on selected topics, published numerous fact sheets, held regional consultation meetings, delivered speeches, organised a conference with leading local and international tax academics and digested over 1,500 submissions.

Ken Henry had made it clear from the outset that he considered his task to be to develop a long-term vision, not just the kind of plan that might serve well for the next Budget, or even the next election campaign. The tone of his speeches and the panel's publications all pointed to this desire to produce a blueprint for Australia's tax system in the 21st century. So it is not surprising

that the Report reflects an extensive review of Australia's system of taxation.

Neither is it surprising that the Government did not have much appetite for such a bold agenda.

The real measure of the success of the Henry Report will be whether we see tax reforms in the next decades described as 'originally suggested in the 2010 Henry Review ...'

## **2. First stage Government responses**

### ***2.1 Resource exploration rebate***

A refundable company income tax offset will be introduced for exploration expenditure incurred on or after 1 July 2011. The offset will be at the company level (and hence, set at the prevailing company tax rate) rather than at the shareholder level.

For a single project explorer this will provide immediate cash benefits. In effect the Federal Government will co-invest with explorers. The rebate will provide a significant incentive for minerals exploration, particularly when the possibility of a refund of RSPT at the end of an unsuccessful project is taken into account (see below). Not insignificant exploration risk will shift from the private sector to Government.

The current definition of exploration expenditure will also be expanded to include expenditure incurred exploring for geothermal energy.

### ***2.2 Resource super profits tax***

#### **Overview**

A separate new Resource Super Profits Tax ('RSPT') will be introduced from 1 July 2012 at a rate of 40 per cent on 'super' profits made by entities (companies, partnerships and trusts) from the exploitation of Australia's non-renewable resources. It will apply to new and existing projects alike.

The RSPT will replace the crude oil excise. There will also be an irrevocable election to bring Petroleum Resource Rent Tax projects within the scope of the RSPT.

RSPT will be deductible and refunds will be assessable for income tax purposes.

The RSPT will operate in parallel with State and Territory royalty regimes. A refundable credit for royalties paid to State and Territory Governments will be available. In effect the State royalty regimes, although not abolished, will be subsumed by the RSPT. Resources will be taxed broadly by reference to profit rather than volume/gross value.

The Government argues that the measure is necessary because the current resource royalty arrangements provide insufficient return to the community, and do not recognise the cost of resource investment and production. The Government notes that developed countries (such as Canada, Norway and the United States) have moved towards tax systems based on taxing resource rents (or super profits). The Government argues that low margin

# Greenwoods & Freehills

projects will be more viable, even if high margin projects will be less lucrative.

## **Timeline to commencement**

The Government proposes to conduct consultations on the measure this year with a 'final design paper' late in 2010, and exposure draft legislation after further consultation by mid-2011.

## **Impact**

Contrary to some views, the Government cites modelling which suggests that under a RSPT mining investment will rise by 4.5%, jobs by 7% and production by 5.5% in the long run.

The Government suggests that no project that was profitable under the royalty system will become unprofitable because of the RSPT. Rather, it is suggested, some projects that would eventually become unviable under the royalty system may now remain viable for longer because the RSPT is a profit-based system that recognises the costs associated with resource projects.

## **Scope**

**Super profits.** 'Super profits' are, according to Government, 'net returns that exceed a satisfactory return to investors, from the extraction and sale of resources.'

For that reason, an allowance ('**RSPT allowance**') will be provided for project capital expenditure. A RSPT capital account will record undeducted capital expenditure and unutilised losses, which will be annually 'uplifted to ensure its real value is maintained over time.' The uplift rate proposed will be the 10-year Government bond rate.

The uplift will be available regardless of whether expenditure has been debt or equity funded in practice. However, actual finance costs (eg, interest) will not be deductible for RSPT purposes.

**Example.** The following example is provided in the Government materials to illustrate the operation of the RSPT.

The project commences at the start of year 1, when \$100 is spent on capital. The Government recognises capital expenditure through depreciation arrangements – allowing in this example \$60 to be claimed as depreciation in year 1 and \$40 to be claimed as depreciation in year 2.

In year 1, the project does not have any receipts. As such, the project makes a RSPT loss of \$60 in year 1. The unutilised loss, \$60, will be carried forward with undepreciated assets, \$40, to make the RSPT capital base \$100 in total.

In year 2, the project has \$150 of receipts. The project is able to utilise the depreciation deduction in year 2 (\$40) and losses carried forward from the previous year (\$60) as well as the RSPT allowance (\$6).

The investor will have assessable profit of \$44 in period 2 and pay the Government \$18 in RSPT.

# Greenwoods & Freehills

The material also suggests –

- exploration expenditure will be immediately deductible under the RSPT (and seemingly the same expenditure will qualify for the proposed resources exploration rebate);
- most other capital expenditure will be written off over time;
- qualifying expenditure can be transferred from a loss-making project to other projects within the entity or wholly owned company group - where no other profitable projects exist the RSPT losses can be carried forward; and
- carried forward RSPT expenditure can be:
  - used to offset future assessable resource super profits within the entity or wholly owned company group;
  - carried forward with an uplift for the 10 year Government bond rate (currently about 5.7% pa); or
  - refunded at the 40% rate on a 'reasonable basis' to be determined by consultation – 'such as when an entity exits the resource sector'.

The RSPT capital base will not change with changes in the ownership of the project.

The potential for RSPT expenditure refunds at the end of a project will of itself transfer significant risk from private sector to Government.

Exploration expenditure in a single project company will qualify for an initial resource exploration company income tax offset (which is refundable in cash) at the prevailing company tax rate (proposed ultimately to be 28%) and if the project fails and the company is wound up, seemingly a further 40% RSPT refund would also be available eg:

<b>Exploration expenditure</b>	<b>-100</b>
RER company income tax refund	28
RSPT refund (on wind up)	40
Company income tax on RSPT refund	-11
<b>Net cost to Company*</b>	<b>-43</b>
<b>Net cost to Government*</b>	<b>-57</b>
* Disregards uplift & financing costs	

The converse of the 40% RSPT, of course, is that it will also significantly reduce the potential upside for producers and their investors.

# Greenwoods & Freehills

## **Transitional rules**

As mentioned above the RSPT will apply to existing projects. Entities that have interests in existing projects will be given an RSPT 'starting base,' for the audited accounting values of existing project expenditure (or market value in cases where audited values do not exist) to recognise past investment (but not project value). To 'soften' the impact of the RSPT the starting base can be used at concessional rates over the first five years of its operation - to reduce the RSPT payable on that project or carried forward, but the starting base is neither deducted against income from other project interests nor refundable. The deduction rates will be 36% in year 1, 24% in year 2, 15% in years 3 and 4, and 10% in year 5.

Investment expenditure between the time of announcement and commencement of the RSPT will be given the same treatment as expenditure outlaid after commencement.

## **2.3 Company tax rate**

The company tax rate will be cut from 30% to 29% for the 2013-14 income year, and then to 28% from the 2014-15 income year.

Small businesses will benefit from an early start date, with the 28% rate applying from the 2012-13 income year.

The Government has also said that it will 'seek to cut the company tax rate further, as revenue allows.' The Henry Report itself recommended the rate be reduced to 25%, which is the current average rate for small to medium OECD countries.

## **2.4 Capital allowances – small business concessions expanded**

The existing small business capital allowance concessions will be expanded by:

- allowing depreciating assets valued at less than \$5,000 to be written-off immediately – this is an increase from the \$1,000 threshold under current law, but less than the \$10,000 threshold recommended in the Henry Report; and
- allowing any remaining depreciating assets (except buildings) that are not written-off immediately to be grouped and depreciated in a single pool at a rate of 30% (rather than the two separate pools required under current law).

Both changes will commence from 1 July 2012. The Henry Report recommended that the small business entity turnover threshold should be increased from \$2 million to \$5 million, and adjustments to the \$6 million net asset value test should be considered. The Government has not responded to these recommendations.

# Greenwoods & Freehills

Nor has the Government responded to the Henry Report's recommendation that there be greater simplification of the capital allowance regime, including allowing companies immediate write-offs for assets valued at less than \$1,000 (as small businesses can under current law), and the introduction of new depreciating asset grouping rules.

## **2.5 Superannuation and retirement savings**

### **Gradual increase in the superannuation guarantee contribution rate from 9% to 12%**

The superannuation guarantee (SG) contribution rate will be gradually increased from 9% to 12%, starting 1 July 2013 with a 0.25% increase. The indicative timeline to increase the rate is as follows:

Year	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Rate (%)	9.25	9.5	10	10.5	11	11.5	12

Many of the submissions to the Henry retirement income review had suggested that an increase to 12% was necessary to achieve adequate retirement savings, particularly for lower income earners.

### **15% contributions tax**

There is not presently a Government proposal to increase the 15% tax on concessional superannuation contributions, but equally an increase has not been ruled out and the Henry Report is open to that prospect.

### **Increase in the superannuation guarantee age limit from 70 to 75**

The current cessation of mandatory superannuation guarantee contributions at age 70 will be deferred until 75. The indicative start date is 1 July 2013. The change is intended to encourage mature workers to remain in the workforce.

### **Low income earners Government contribution**

For individuals with 'adjusted taxable income' of up to \$37,000, the Government will make a contribution of 15 cents for every \$1 of concessional contributions made, capped at a total Government contribution of \$500 (unindexed). This is intended to have the effect of eliminating the 15% contributions tax paid by the superannuation fund on contributions from low income earners.

The measure is intended to apply to concessional contributions made from 2012-13, with the first Government contributions paid in 2013-14.

Concessional contributions include both employer contributions and deducted contributions made by individuals who meet the 'self-employed' test.

# Greenwoods & Freehills

An employee earning salary of \$37,000 would receive sufficient mandatory superannuation guarantee contributions at 9% to qualify for the whole \$500 Government contribution without having to sacrifice any cash salary.

The existing Government co-contribution paid on non-concessional contributions (generally after-tax contributions), which for the 2012-13 year is scheduled to be \$1.25 per \$1, will often remain more attractive for low income employees than sacrificing additional salary into superannuation in order to access the new proposed Government contribution.

Other details of the proposal will be developed in consultation with the superannuation industry. At this stage we would not expect the proposed Government contribution to be taxed as a concessional contribution. Issues that will need to be addressed include whether the proposed Government contribution will count towards the non-concessional contributions limit and whether it will affect the existing Government co-contribution. In addition, using 'adjusted taxable income', which is an existing concept in the tax legislation, as the income test will be out of step with the standardised income test applied for other Government benefits.

For higher income earners with 'adjusted taxable income' in excess of \$37,000 the retention of the 15% tax on concessional contributions without a rebate is seen by the Government as being a sufficient concession, considering their marginal tax rates. Their marginal rate will generally be at least 30% plus Medicare Levy – from 1 July 2010, this rate commences at taxable income of \$37,000.

## **\$50,000 concessional contributions cap**

Current transitional arrangements provide a more generous \$50,000 concessional contributions cap for individuals aged 50 or over. This higher cap was due to expire on 30 June 2012. The Government has announced that the \$50,000 contributions cap will apply on a permanent basis for individuals aged 50 or over, but only for those with total superannuation balances of less than \$500,000. This proposal is intended to come into effect from 1 July 2012. It will assist those individuals approaching retirement age who are in greatest need to build their superannuation savings.

## **Tax free status of end benefits after age 60 reaffirmed**

The Government has reaffirmed that it will not be removing the tax free status of superannuation benefits paid to persons aged 60 or over.

## **3. Second stage Government responses – second term tax agenda**

While most of the detail in the Government's response is directed to its immediate agenda – resource taxation, superannuation and business tax – the Government also indicated tentative support for recommendations in three other areas: 'making tax time simpler for everyday Australians, improving incentives to save and improving the governance and transparency of the tax system.' The response was far less clear about just

# Greenwoods & Freehills

when and how it would act on these recommendations, other than to say that ‘this would represent a full second term agenda.’

With regard to savings, the Henry Report recommended providing a 40% discount to individuals for non-business related:

- net interest income;
- net residential rental income;
- capital gains (and losses); and
- interest expenses related to listed shares held by individuals as non-business investments.

It is worthwhile noting, however, that the Government indicated in its response that it would not reduce the existing CGT discount (50% for individuals). In addition, it has indicated that it will not apply a discount to negative gearing deductions, although it is not clear whether, and how, this intersects with the above recommendations in the Henry Report.

The discount for net interest income in the above recommendation has been considered as one means of encouraging increased levels of domestic funding for Australian banks and removing incentives towards negative gearing. What qualifying limitations would be placed on these accounts is not discussed in the Report.

The Report also suggests that further consideration should be given to providing a clearer line on whether gains on investments made by individuals are capital gains or ordinary income. The recommendation was limited to individuals but any ‘bright line’ test would be useful for all taxpayers, particularly managed funds and non-residents.

With regard to reducing the compliance burden for individuals, the Report examines the possibility of implementing pre-filled tax returns for the majority of individuals, and the use of standard deductions for employee expenses (such as managing tax affairs and workplace deductions). Pre-filling would involve establishing ‘client’ (ie, taxpayer) accounts including up to date information on income earned from all sources, taxes withheld and transfer payments received. It would require third parties such as employers, government agencies, financial institutions and share and property registries to provide this information to the ATO. The use of a standard deduction in lieu of claiming itemised deductions would mirror the system currently used in the USA to minimise the importance attaching to the intractable problem of employee deductions.

With regard to establishing a more transparent tax system, the Report considers giving the Board of Taxation the ability to conduct its own reviews of current tax policies, clarifying the role of the Inspector-General of Tax, establishing a board to advise the ATO on organisation and management and publicising Treasury information given to the ATO in relation to determining the purpose or object of the law and policy intent. A more detailed overview of these recommendations is in an Appendix to this Tax Brief.

## 4. A third stage?

The above short list of measures exhausts the recommendations in the Henry Report that the Government has accepted, even tentatively. The rest of the Report is consigned to an uncertain future. The Government, not wishing to give it credence, says simply that 'other recommendations in the review are not government policy.' Yet there is much in the Report that deserves a better fate. There are some recommendations which businesses might wish to pursue and press future Governments to adopt.

### 4.1 Corporate taxation

The Report recommends that the structure of the company income tax system, including the imputation system, should be retained in its current form, at least in the short to medium term. However, it is suggested that a business level expenditure tax could suit Australia in the future and is worthy of public debate, as other economies may move to such a system in coming years.

A further long-term suggestion is that companies should be allowed to carry back revenue losses to offset the taxable liability of prior years. The amount of any refund would be limited to a company's franking account balance.

### 4.2 Finance tax issues – interest withholding tax

The Henry Report recommends that:

- Australia introduce a specific exemption from interest withholding tax ('IWT') for interest paid to non-residents by financial institutions operating in Australia; and
- consideration be given to reducing the rate of IWT to zero in Australia's double tax treaties (subject to 'appropriate safeguards').

The first recommendation will be welcomed by the Australian banking industry which has been lobbying for an exemption of this nature for a number of years – similar exemptions are available in various overseas jurisdictions including the United Kingdom. The availability of this exemption (if introduced) should help Australian banks attract a greater range of deposits from overseas and accordingly allow them to reduce the funding gap between deposits held and loans made. The scope of any such exemption would, almost certainly, be limited to financial institutions – the Report recommends that it not be available to other companies, insurers or fund managers.

The Government has not responded to either of these Recommendations. It will be particularly interesting to see the Government's response to the second recommendation as this would represent a major shift in Treaty policy – it has only been in recent years that the Government has accepted the inclusion of the 'financial institution' exemption in a number of Australia's tax treaties including the US, the UK and France.

## 4.3 Taxation of trusts

**Managed funds.** The Report recommends that taxation arrangements applying to Australian managed funds should be improved to provide greater certainty that conduit income will not be subject to Australian tax. These and other issues will be considered as part of the ongoing separate review of Australian managed investment trusts.

**Closely-held trusts.** The Report also observed that it had received submissions raising concerns about the use of discretionary trusts, in particular, to split income. This concern, among others, had led the Ralph Committee in 1999 to recommend that most trusts be taxed as if companies, subject to introducing a collective investment vehicles regime which would allow them to pass through particular tax concessions to investors.

The Report alluded to this debate but ultimately did not recommend that approach. The fact that:

- a discretionary trust that is taxed as a company can still distribute income to a range of beneficiaries; and
- with the advent of refundable imputation credits, a beneficiary with a low marginal rate of tax could obtain a refund or some or all of the taxed paid at the 'company' level,

means that tax advantages would survive even if trusts were to be taxed as companies.

An alternative approach to address income splitting that was canvassed is for the settlor of a trust to be taxed on all the income of the trust when it retains control of the trust assets. While noting that such a regime exists already for foreign trusts, the Report stopped short of recommending this approach more broadly.

**Improving the tax regime for trust income.** Despite broadly accepting the current structure for the taxation of trust income, the Report made a number of recommendations for the more general reform of trust taxation. The impetus behind the recommendations was the observation that many aspects of taxation of trust income are based on general law concepts that have defied clarification over decades. These include –

- the geographical 'source' of income – the general policy of the tax laws is to enable foreign source income to pass through Australian entities to foreign investors without suffering Australian taxation. However, there is uncertainty whether income derived offshore by Australian fund managers actually has a foreign source, especially if the relevant documentation is executed, and decisions are made, in Australia. This acts as an impediment to using Australia as a funds management and investment hub and therefore limits Australia's export earnings in this area; and
- the allocation of taxation between beneficiaries and trustees. Although this area has been clarified to some degree by the High

Court decision in *Bamford*, the taxation of beneficiaries on a share of the tax law income of a trust based on their share of the 'income of the trust estate' can still result in inappropriate outcomes. For example, there remains the potential for the income beneficiaries of a trust to be taxed on capital gains even where those capital gains are distributed to another class of beneficiary.

The Report recommends that these rules be 'updated and rewritten', but does not provide any guidance on how this should proceed.

## **4.4 Superannuation**

### **Tax on superannuation contributions**

The Report recommends that the tax on superannuation contributions at the fund level be abolished. Rather, it recommends that employer contributions be treated as income in the hands of the individual and taxed at the employee's marginal rate, with a flat rate refundable tax offset. The offset would be provided on contributions up to an annual cap (indexed) of \$25,000. The rate of rebate would be set so that most taxpayers (those on a marginal tax rate of not more than the Report's recommended 'standard rate' of 35%) would not pay more than 15% tax on their contributions. The Report at least leaves open the prospect of higher contributions tax for top marginal rate taxpayers.

One can envisage a range of issues associated with this measure, not the least of which would be liquidity concerns and member funding of defined benefit arrangements.

### **Complying superannuation fund tax rate**

The Report also recommends a reduction in the complying fund tax rate from 15% to 7.5%, a recommendation which one suspects would find universal approval. However, there is a sting in the tail – a recommendation for the removal of the pension exemption at fund level.

### **Encourage the development of the longevity insurance market**

A further recommendation in the Report is that the Government support the development of a longevity insurance market by the introduction of 3 key measures –

- (1) Government-issued long term securities;
- (2) the issuance of data needed to create and maintain a longevity index;
- (3) relaxing the prescriptive superannuation legislation to foster product innovation in this regard.

## **4.5 Fringe benefits tax**

The Report posits that income from work, whether in the form of wages and salaries, fringe benefits or superannuation contributions should be taxed consistently and there should be few tax exemptions for labour income.

In light of this, the Report recommends that fringe benefits which can be readily valued and attributed to individual employees should be taxed in the employees' hands under the PAYG withholding system, instead of the FBT regime. This would represent a return to the mechanism that operated before FBT was introduced in 1986. A recommendation to wind back FBT was made by the Ralph Review in 1999 – and was ignored.

The Report suggests that other fringe benefits should be taxed to employers at the top marginal rates and the scope of fringe benefits subject to tax should be simplified.

The Report also recommends that market value should generally be the preferred method for valuing fringe benefits. Under the current FBT regime there is a myriad of formulas to determine taxable value. In addition, the current statutory formula used for valuing a car fringe benefit should be replaced with a single statutory rate of 20%, instead of four different rates, determined by reference to total kilometres travelled.

#### **4.6 Indirect taxes and transaction taxes**

Given that the Terms of Reference expressly excluded any discussion of GST, it was no surprise that indirect taxation does not feature in the recommendations accepted by the Government. Indeed, in their joint press release the Prime Minister and Treasurer re-emphasised that their Government will 'never increase the rate or broaden the base of the GST.'

While the Report includes a number of indirect / transaction taxes recommendations, the only one that seems likely to be implemented is the already announced increase to tobacco excise.

A number of other indirect tax specific recommendations await response. While there is a detailed discussion on the taxation of consumption including in relation to financial services (see below), it contains few recommendations, but will no doubt prove the basis for future discussion.

The Report does however float the idea of a 'broad-based cash flow tax' which for business could conceivably replace even the GST in time (refer further comments under 'Payroll tax' below).

#### **4.7 State taxes**

##### **Land tax and stamp duty**

The Report recommended broadening the land tax base to include the family home. More generally, it supported land tax as efficient and a more reliable source of revenue, given that land is immobile. The broadening of the land tax base would permit removing stamp duty on the purchase of real estate, both residential and commercial.

The Report recognised that a shift to a broader annual land tax would require some form of transitional arrangement, perhaps taking as long as 10 years. A long lead time would be needed so that the change would not cause major disruption to property values. It would also help address the fairness concerns, particularly for those who had recently purchased land – and so paid stamp duty – and would now be required to pay land tax, not

taken into account at the time of the purchase. The Review also recognised that some might not be able to pay land tax annually, and so deferral of the tax with an interest charge, to the time the property was sold might be required.

The Government's response rejected the introduction of land tax on the family home, but it did not respond to the other recommendations, other than to note that these are State taxes and each State Government should consider the recommendations.

## **Payroll tax**

The Report recommended that State payroll tax should be replaced with a more efficient broad-based indirect tax. Again, the Government did not address this recommendation.

The Report suggested that all business be subject to a new broad-based cash flow tax to fund the removal of payroll tax (as well as some other State taxes, such as duty on insurance contracts). The cash flow tax would also be destination based – it would exclude cash inflows for exports. The operation of such a cash flow tax would be similar in concept to the operation of GST but with fewer exemptions and would be based on actual cash flows.

The cash flow tax would include all cash inflows, other than exports and financial transactions, reduced by all cash outflows other than wages and financial transactions, in order to capture as widely as possible the value of domestic consumption. Like the GST, only business entities would be required to pay this cash flow tax. This would capture the 'real' cash flow tax base, but some form of financial services tax would also be required in order to capture the value of domestic financial transactions.

There is no mention in the Report of the likely tax rate that would be required to fund the removal of inefficient State taxes, but it seems that such a cash flow tax together with a financial services tax could operate either alongside the GST or, for business, in place of the GST.

In the absence of collective willingness by Federal and State Governments, it is difficult to see such a proposal coming to fruition. Indeed, if it were to occur, Australia would be one of the handful of places with a broad-based cash flow tax – Mexico introduced something similar in 2008 (the *Impuesto Empresarial a Tasa Unica*) and some US States (notably Michigan and California) are considering cash-flow taxes as part of their fiscal tools.

## **4.8 Road transport taxes**

The Report made eight specific recommendations relating to road transport taxes. The Report argued that the current system of taxing road use through fuel taxes and registration fees is designed to raise revenue, whereas the aim should be to deliver efficiency through less congested and better maintained roads.

The Report recommends the introduction of variable congestion pricing on major roads, particularly in congested metropolitan areas.

# Greenwoods & Freehills

The Report also recommends mass-distance-location pricing for heavy vehicles, in order to ensure that these vehicles pay for the road-wear costs that they cause. Road freight should be subject to additional charges where it is in direct competition with rail-based transport. Finally, the Report recommended that fuel taxes should be replaced over time with more efficient broad-based taxes.

## **5. What next?**

As we noted above, Ken Henry always conceived of this project as designed to generate a long-term vision for Australia's future tax system. Judged against this goal, the Government's decision to address directly only a handful of the 138 recommendations indicates little about the Report's ultimate significance.

There is much in the Report that may return, for good and ill, in the next few decades. To put it more positively, business may find it very worthwhile to trawl through the 3 volumes to find the good ideas it contains that should not be allowed to languish just because they are unappealing to the Government at the moment.

# Greenwoods & Freehills

For further information, please contact

## **Sydney**

Andrew Mills  
61 2 9225 5966  
[andrew.mills@gf.com.au](mailto:andrew.mills@gf.com.au)

James Pettigrew  
61 2 9225 5979  
[James.Pettigrew@gf.com.au](mailto:James.Pettigrew@gf.com.au)

Shayne Carter  
61 2 9225 5959  
[shayne.carter@gf.com.au](mailto:shayne.carter@gf.com.au)

Anthony Frost  
61 2 9225 5982  
[tony.frost@gf.com.au](mailto:tony.frost@gf.com.au)

Jane Michie  
61 2 9225 5915  
[jane.michie@gf.com.au](mailto:jane.michie@gf.com.au)

## **Melbourne**

Adrian O'Shannessy  
61 3 9288 1723  
[adrian.oshannessy@gf.com.au](mailto:adrian.oshannessy@gf.com.au)

Ken Spence  
61 3 9288 1451  
[Ken.Spence@gf.com.au](mailto:Ken.Spence@gf.com.au)

Richard Shaddick  
61 3 9288 1412  
[richard.shaddick@gf.com.au](mailto:richard.shaddick@gf.com.au)

Richard Buchanan  
61 3 9288 1903  
[richard.buchanan@gf.com.au](mailto:richard.buchanan@gf.com.au)

Hayden Scott  
61 3 9288 1545  
[hayden.scott@gf.com.au](mailto:hayden.scott@gf.com.au)

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Greenwoods & Freehills Pty Limited ABN 60 003 146 852  
Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia Facsimile  
(02) 9221 6516 Telephone (02) 9225 5955

Liability limited by a scheme approved under Professional Standards  
Legislation

### **Institutions, governance and administration**

A collection of recommendations in the Report propose more transparent systems and improved structures for the governance and oversight of Australia's tax system.

#### **Raising ideas for changes to the tax system**

While recognising the community can already raise ideas for changes to the tax system in a number of ways, the Report suggests opportunities for doing so should be both more transparent and accessible. The AFTS recommends that the existing Tax Issues Entry System ('**TIES**') be the non-exclusive forum for this (that is, it would not replace existing avenues of raising issues). As an aside, it is noted that the Board of Taxation is currently undertaking a separate review of the awareness and operation of TIES.

#### **Principles-based design**

The Report notes that the tax laws having been growing in complexity and that the use of tax agents in Australia to assist people meet their tax obligations is considerably higher than in other OECD countries.

As part of the recommendations the Report suggests that the government commit to a principles based approach to law design as a means of addressing the growing volume and complexity of the law and as a way of achieving interpretation that is consistent with policy objectives.

Using principles-based design has been an objective of those drafting tax laws for some time. The result has not always been apparent in the laws we have. This is as much a result of the desire for more detail and clarity on the part of the community as it is a reflection on those attempting to draft the laws. There will be a challenge in achieving this objective without considerable work on all participants in the system.

#### **Expanded role for the Board of Taxation**

The Report notes the significant role that the Board of Taxation has played to date in producing a number of reports and recommendations that have resulted in significant improvements to the tax law. In particular, the independence of the Board from both government and sectional interests is noted as adding to its strength as an independent voice.

Accordingly, the Report recommends that the Board be charged with additional role of 'circuit breaker' – to initiate its own reviews of lower order tax policy issues and identify and propose solutions for problems being experienced by taxpayers. In doing so, the Board would still be an advisory body, not a decision maker. The Report seems to state that the Board's role should not extend to areas that, inferentially, are already covered by the Inspector General of Taxation, the ANAO or the Ombudsman.

To meet the challenges of such an expanded role, the Report recommends that the government consider:

- appointing additional members if needed;
- establishing a separate, independent secretariat for the Board;
- making the Commissioner, the Secretary to the Treasury and the First Parliamentary Counsel advisers to the Board rather than members as they currently are; and
- appointing the Inspector General, the Auditor General, the Ombudsman and the Chair of the Tax Practitioners Board as advisers to the Board.

### **Improving ATO accountability**

While recognising the statutory independence of the ATO that already exists and the scrutiny to which it is already subject, the Report recommends that a management Board should be established for the ATO that would advise the Commissioner on the organisation and management of the ATO. The Report suggests that the Board not be a decision making body and not have a role in interpreting the law. The main role of such a Board would be to provide the ATO with high level strategic advice and private sector experience and expertise to enhance the ATO's performance and corporate governance. Such a suggestion is timely given the much publicised difficulties with systems implementation that the ATO is experiencing.

In addition, the Report recommends that the Joint Committee of Public Accounts of Parliament take a greater role in monitoring the ATO's response to reports from the Ombudsman and the Inspector General.

Further, the Report also recommends that the roles of Inspector General and the Ombudsman be clarified to ensure that the risk of overlap between them is minimised and that both organisations be adequately resourced to perform their functions.

### **Tax law interpretation**

The Report notes the ongoing concern that the ATO adopts pro-revenue interpretations of tax laws. The Report suggests that greater transparency about the policy objectives of tax laws would support a more purposive approach to interpretation. Such transparency would, the Report recommends, be enhanced by the publication of

- materials used by the ATO to determine policy intent; and
- information or advice provided by Treasury to assist the ATO in determining the purpose of the law.