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Labor's Tax Policies – What Next for Business Tax?

Elections are, quite understandably, fought on issues that will grab the voters' imagination, and so far as tax is concerned, that usually means personal tax matters will receive the most attention – income tax cuts, child care tax rebates, education tax rebates and so on. Labor's business tax proposals might not have captured the headlines but there is some important material that clients will need to factor into their forward planning and dealings with the new Labor Government. This Tax Brief principally examines the implications for business of Labor's tax policies, with a few details included on some of the personal tax and superannuation changes.

Labor's various tax announcements prior to and throughout the election campaign were not assembled into a single policy document and span a period of several months. We have gathered together various announcements and statements in speeches to give an overview of what we may expect to see in tax legislation over the next three years. The material is sourced from the ALP official website www.alp.org.au and from the Treasury election costings website www.electioncostings.gov.au.

1. Business tax proposals

1.1 *Financial services*

Important changes are likely to come in for the funds management industry as part of Labor's policy "to make Australia the financial services hub of Asia."

Some of this detail had been announced well before the election campaign started. In a speech by Shadow Treasurer Wayne Swan on 3 April 2007 and in Kevin Rudd's speech in reply to the Budget in May, Labor committed itself to a 15% flat final withholding tax on distributions of income made by fund managers from 1 July 2008. (The new measure will not apply to dividends, interest and royalties to which the current withholding tax would continue to apply). Property trusts will be the group mainly affected by this proposal.

In order to make the withholding tax a final tax, Labor proposes abolishing the requirement for foreign investors in Australian managed funds to lodge a tax return where their income is subject to withholding.

Costings were obtained in relation to some but not all of the proposals as some of them require further investigation. Labor costed this measure at \$75m in the first year and \$15m per year thereafter, partly on the basis that interest deductions would no longer be available to non-resident investors. Treasury had a slightly smaller cost in the first year of \$70m but \$100m or greater thereafter. The difference largely arises because the Australian

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Taxation Office (the “ATO”) informed Treasury that non-resident investors do not actually file tax returns and claim interest deductions at the moment, whereas Labor was counting on cost savings from the denial of interest deductions to investors. It will be interesting to see how “fiscal conservatism” fits into the final delivery of this policy.

1.2 Property industry

A related change is proposed for the property industry.

Adopting a flat rate of withholding tax within a trust framework will not deal with all the international issues confronting the managed funds industry, so, in addition to the promised 15% tax rate, shadow Assistant Treasurer Chris Bowen proposed on 3 August 2007 that the Board of Taxation should undertake a review of a general tax regime for the funds management industry, including the potential for a specific tax regime for REITs (Real Estate Investment Trusts).

Part of the difficulty with the current trust regime is that income is usually viewed as retaining its character as it flows through trusts so that different tax treaty articles are relevant to different parts of the income. The major difference between the current trust regime for managed funds and a REIT type regime is that under the latter the entity is a company for tax purposes but is not taxed provided it meets specific conditions. Distributions are treated as dividends and this simplifies the application of tax treaties and international tax rules generally. The OECD recently released a draft paper on the tax treaty treatment of REITs which is largely built around the corporate model. (Indeed, it proposes that for treaty purposes, Australian type property trusts would be treated as companies and their distributions as dividends even though they are not companies under domestic tax law.)

As such a change would take some time, in the short term the Government would ask Treasury to advise on the more immediate reform of Division 6C of the *Income Tax Assessment Act 1936* (Cth) which currently determines the limits of activities that can be undertaken by property trusts if they are to maintain their taxation treatment as trusts. In particular, options to be examined will include:

- harmonising the definition of a trading trust with international practice, allowing a trust to receive up to 25% of its income from non-eligible sources, without being taxed as a company;
- overhauling the definition of eligible investment business to make it responsive to current business practices; and
- abolishing or substantially curtailing the application of the control test to public trading trusts. (The control test has already been relaxed in recent legislation which permits a listed trust to be placed on top of current listed stapled entities without failing the control test.)

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1.3 Tax incentives for investment in affordable housing

One element in Labor's strategy to address housing affordability was the announcement of a "Rental Tax Incentive" to encourage the building of new accommodation for rent to low and middle income households. Labor expects that superannuation funds will be interested in this incentive.

The tax incentive is in the form of a tax offset of \$6,000 per annum for up to 10 years for each new dwelling constructed. It appears to be the case that the incentive is to be made available to investors who commission the construction of, or acquire, newly constructed dwellings, although another part of the policy refers to the incentive being made available to investors who "provide the finance for construction of affordable rental accommodation projects."

It appears, in addition, that the tax incentive will not be automatically available for developments that meet the requirements – the policy says, "the Rental Tax Incentive will be allocated through a competitive process."

It is a requirement of the incentive that the developer will rent the accommodation to households that meet an income test, and the owner must charge rent which is at least 20% below the market rate for the area. The policy contains the additional hurdle that the Rental Tax Incentive will only be allocated through States that agree to provide direct or in-kind financial support of at least \$2,000 per dwelling per year for ten years.

Labor has promised to consult the housing and finance sectors as it elaborates the detail of the policy. The policy does not provide details of the commencement for this proposal – for example, whether it will apply only to dwellings where construction commences after a particular date, construction is completed after a certain date, dwellings acquired and put to use after a certain date, or finance provided after a certain date.

1.4 R&D

Labor's policy statement, *Innovation Future for Australian Industry*, proposed a review of the current 125% R&D tax concession, including the 175% Premium Concession.

Labor has said its review will "consider the role of the R&D tax concession scheme in promoting R&D and innovation" and in particular address some key concerns such as better targeting to encourage sustained growth in R&D activity, greater spillover benefits, providing an incentive for multinationals to undertake their R&D in Australia, and re-designing the incentive so that it is accessible to small companies.

1.5 Tax credit for water infrastructure

Labor's policy statement, the *National Urban Water and Desalination Plan*, included a proposal for a 10% tax offset for the cost of qualifying investments in urban water infrastructure – most obviously rain-water harvesting schemes or desalination plants.

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Access to the tax offset will not be automatic – applications will be solicited by the Government until June 2009, and then assessed by Infrastructure Australia. The implication is that the tax offset will be available only to successful applications. The total amount of tax offset under this scheme is capped at \$1 billion.

2. Personal tax issues

2.1 Personal income tax rate scale

The Labor party's proposed personal income tax rates were the subject of much comment during the campaign. In summary:

- Labor announced that it would implement the tax cuts announced by the Coalition in the 2007-08 Budget which have already been enacted, but are not due to start until 1 July 2008.
- In addition, Labor would adopt with one exception the proposed tax rates and income thresholds which the Coalition parties had announced earlier in the election campaign.
- The exception was that Labor would not reduce the top personal rate of 45% down to 43% and then to 42% as the Coalition had proposed. (The difference was to be used to fund the education expenses tax rebate.)
- Labor's "aspiration" would be to have just 3 tax rates from the start of the 2013-14 year of income – that is, the expected year for the election due after the next election!

The proposed personal income tax rates will be:

Current 2007-08		2008-09		2009-10		2010-11		Aspiration 2013-14	
Income (\$)	Rate (%)	Income (\$)	Rate (%)	Income (\$)	Rate (%)	Income (\$)	Rate (%)	Income (\$)	Rate (%)
0 – 6,000	0	0 – 6,000	0	0 – 6,000	0	0 – 6,000	0	0 – 6,000	0
6,001 – 30,000	15	6,001 – 34,000	15	6,001 – 35,000	15	6,001 – 37,000	15	6,001 – 37,000	15
30,001 – 75,000	30	34,001 – 80,00	30	35,001 – 80,000	30	37,001 – 80,000	30	37,001 – 180,000	30
75,001 – 150,000	40	80,001 – 180,000	40	80,001 – 180,000	38	80,001 – 180,000	37		
150,001 +	45	180,001 +	45	180,001 +	45	180,001 +	45	180,001 +	40

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In addition, Labor has promised tax rebates for child care, some education costs and increasing the low income tax offset and the Senior Australians Tax Offset.

The rate for the fringe benefits tax will remain unchanged at 45%.

2.2 First home saver accounts

Other personal tax announcements may have direct significance for business. There are clearly opportunities for fund managers and financial institutions to develop new products that will implement some of the personal tax announcements such as the first home saver accounts.

A second element in Labor's strategy to address housing affordability was the announcement of a First Home Saver account to help people save for their first home. The model is a low tax saving product similar to the superannuation system. It is expected that these accounts will be offered by private sector financial institutions, including superannuation funds.

The accounts can be established by (or for) a person aged over 18 who complies with the eligibility criteria for the First Home Owners Grant. Contributors may deposit up to \$10,000 per annum into an account, up to a maximum balance of \$50,000. The account will have a minimum term of 4 years. Withdrawals from the accounts can only be made to purchase an eligible first home, subject to special concessions in cases of hardship. The First Home Owners Grant will remain unchanged.

The tax features of the proposed accounts are:

- Contributions up to \$5,000 per annum will be taxed at 15%, rather than the depositor's ordinary tax rate.
- In addition, a further \$5,000 per annum may be contributed from after-tax income, either by the depositor or a third party.
- Interest on the account will be taxed at a maximum of 15%.
- Withdrawals from the account to purchase a first home will be tax-free. Amounts not used to purchase an eligible first home may be taxed to claw back the benefit of the concession.

Again, the policy does not provide details of the commencement for this proposal.

3. Superannuation

3.1 Offshore investments by Australian superannuation funds

In 2003 the Board of Taxation recommended that imputation credits be given in respect of foreign income distributed by Australian companies at an assumed 20% foreign corporate tax rate as a means of addressing the tax barrier that the imputation system creates for offshore investment by

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Australian multinationals. The 2003 Budget rejected this proposal “at this time” but Australian companies have kept pushing on the issue.

In his speech of 3 April 2007 discussing funds management issues, Wayne Swan re-visited this issue in respect of superannuation funds. He said:

Another example, and of greater significance to domestic superannuation funds, is the tax treatment of foreign source income. An impediment to further growing domestic superannuation and its outreach into the global economy is the lack of foreign source income imputation credits. As superannuation funds continue to diversify their portfolios by investing in international equities and other financial instruments, they are increasingly being exposed to double taxation of earnings. A foreign source income tax credit paid at a lower rate than the domestic imputation credit could help address the bias, allowing funds to further enmesh in the global economy consistent with their long term risk and return objectives, while simultaneously improving real returns to fund members.

He said he had not reached a final conclusion on the issue but he was willing to listen to industry views.

It seems clear that Labor accepts superannuation funds face a potential double taxation of earnings if they invest in international equities. As a consequence, we may see some type of foreign tax credit for resident superannuation funds (perhaps set at a lower rate than the domestic 30% imputation credit) to help address this issue.

3.2 Other superannuation measures

Labor has made a number of other minor announcements about the superannuation system:

- it will ensure that the current 9% superannuation guarantee contribution is based on pre-salary-sacrifice salary and wages;
- it will continue the current superannuation co-contribution scheme and will consider expanding it, either through lifting the \$1,500 cap or relaxing the means test; and
- it will attempt to address the problem of lost superannuation accounts by the automatic consolidation of inactive accounts based on the contributor's tax file number.

4. Tax administration

Labor announced two proposals in relation to tax administration:

- more resources will be made available to the ATO for tax compliance, including in relation to large companies; and
- Labor will abolish the office of the Inspector General of Taxation. This has been Labor policy since the office was first created by the former Government.

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5. Tax policy development – the Board of Taxation continues

The Board of Taxation was created as a result of the Review of Business Taxation in 1999 and has played an important part in tax policy development, acting as a bridge between business and government. The ALP has implicitly confirmed that the Board will continue under the new Government by referring some of its announcements to the Board for further development.

We assume this also means the Board of Taxation will continue with its current enquiries which include such important matters as the reform of the anti-tax deferral regimes for foreign source income and off-market share buybacks – on which nothing was said during the election campaign.

6. The unfinished agenda

Finally, it is worth noting some of the important matters that fell into abeyance with the calling of the election. Given that many might best be described as “tax housekeeping,” it is not clear that the Labor party will have an obvious position with respect to them, but there is certainly a long list of unfinished business left by the previous Government.

At the time that the election was called two tax Bills were before Parliament, both of which have now lapsed:

- the Tax Laws Amendment (2007 Measures No 6) Bill 2007. This Bill contained a disparate collection of modest tax measures; and
- the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007. This Bill will enact the last stage of the project on the taxation of financial arrangements (“TOFA”). It is not expected that this election would derail a project that has already withstood federal elections in 1993, 1996, 1998, 2001 and 2004. The TOFA reforms were originally announced by a Labor Government in 1992.

Other Bills on customs and superannuation were before the Senate and have also lapsed.

The list of announcements made by the previous Government that did not even make it into Bill form is far longer. A few highlights are: proposed modifications to tax cost setting for consolidated groups after a roll-over, measures to facilitate the re-organisation of consolidated and MEC groups, changes to the method of determining ownership for the purposes of the corporate loss rules, changes to unlimited periods for issuing amended assessments and the role of discretions in the self-assessment system, changes to the treatment of rights issues, a new regulatory regime for tax advisers and a multitude of changes to the GST.

Of particular concern to business taxpayers are the announcements by the former Government in relation earlier stages of the TOFA reforms including:

- numerous amendments to the foreign exchange tax regime, many to be backdated to 1 July 2003;

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- the deductibility of interest on Upper Tier 2 subordinated notes issued by banks, with effect from 1 July 2001; and
- clarification that “solvency clauses” will not preclude the classification as debt of certain term subordinated debt instruments.

Finally, the abolition of the office of Inspector General will obviously curtail the projects being undertaken or proposed by his office.

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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.

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