

THE HENRY REVIEW: WHAT IT MEANS TO YOU AND YOUR BUSINESS

Introduction

On 2 May 2010 the long anticipated “root and branch” review of the Australian taxation system as well as the Government’s initial response to the recommendations made in the Henry Review was finally released to the public.

Based on the Government response, its commitment to genuine tax reform must be questioned.

In short, the Henry Review, provided to the Government on 23 December 2009, comprises of approximately 1,300 pages and makes 138 recommendations. The stated brief was to strengthen Australian fiscal policy to deal with socio-economic challenges faced by Australians in the 21st century.

Disappointingly, the Government’s response, entitled “Stronger, Fairer, Simpler: A Tax Plan for our Future” adopted only a handful of these recommendations, definitively ruled out around 20 and is largely silent on the remainder.

The limited response:

1. proposes certain changes in the short to near term (principally in the next 3-5 years), the most significant of which is a Resource Super Profits Tax;
2. specifies certain recommendations that have been rejected (including abolition of the CGT discount); and
3. leaves the great majority of the Henry Review open and unresolved with the possibility of some further commentary “in the coming months”.

The Government has stated that its response announced today – a bit more than 4 months after it received the Henry Review - “are the first steps in a 10 year agenda”.

We can expect measured responses from the Government in the coming months dealing with recommendations about making tax time simpler for everyday Australians and improving incentives to save. Other recommendations will be discussed in the coming years.

What are the recommendations contained in the Henry Review?

The Henry Review recommendations are divided into 7 categories.

Briefly, the categories are as follows:

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3. Land and resource taxes
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5. Enhancing social and market outcomes
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What is the Government's initial response to the recommendations?

The Government's initial response to the Henry Review contains a handful of recommendations that it is willing to adopt, and a list of rejected recommendations, but no discussion on the merits of each proposal.

DETAILED ANALYSIS

Phased Reduction of the Company Tax Rate

The government has recommended a phased reduction of the company tax rate. It is proposed that small businesses get the reduction in the 2012/13 income year whilst other companies will have a later start date (see table below).

	Small Business Company	Other Companies
Current	30%	30%
2012/2013	28%	30%
2013/2014	28%	29%
2014/2015	28%	28%

The government has not outlined any details as to implementation. For example transitional measures will be required to recognise the impact on franking credits following a move from a 30% to a 28% taxation and credit regime.

The company tax rate reduction falls short of the 25% tax rate proposed by the Henry Review. It should assist to achieve the stated goals of increased investment and international competitiveness. However we query whether this modest rate reduction does enough on either of these two counts.

While the Henry Review flagged a rethink on Australia's company income tax system, the government has put to rest any fears about removing the imputation system.

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Resource Super Profits Tax

Concerned that taxes imposed on the resources industry are failing to keep pace with “super profits” derived from the exploitation of natural resources, the government will introduce a new 40% “Resource Super Profits Tax” (RSPT) from 1 July 2012.

The Government’s response to the Henry Review states that resource royalties have reduced from an average 34% of “super profits” over the first half of the decade, to less than 14% in 2008/09.

The Henry Review considers that the imposition of royalties by state governments and indigenous landowners distorts investment decisions because they are based on production volumes rather than on the actual profits on extraction. Conversely, the RSPT will be levied on the realised value of resource deposits, measured as the difference between the revenues generated from resource extraction and associated costs including an allowance for capital expenditure.

The RSPT will apply to all legal entities directly involved in exploiting Australia’s non-renewable resources except for those projects already covered by the Petroleum Resource Rent Tax (“PRRT”). Projects currently covered by the PRRT will be allowed to opt in to the RSPT; these arrangements will be subject to consultation.

The timing of the taxing point for the RSPT is still to be determined and will be the subject of consultation although the Henry Review notes that a practical approach would be to set it at the point that a saleable commodity exists.

It is important to note that entities subject to RSPT will still be subject to income tax on their exploration and production activities. The refund paid by the Government to the entity to reimburse the royalty charges levied by the states or territories will be assessable and the RSPT will be deductible for income tax purposes.

State Infrastructure Fund

Infrastructure funding is to become a permanent feature of the State and Commonwealth budgets with some of the proceeds from the proposed RSPT directed into a State Infrastructure Fund. The initial contribution in 2012/13 has been stated to be \$700m with the contribution in 2013/14 forecast to be \$735m. The amount in the Fund will be paid to the States annually.

While the Fund will support investment by the States in nation building infrastructure generally, the resource-rich States are to receive relatively more of the Fund to support investment in the infrastructure necessary for the development of the resource industry.

The final details for the infrastructure fund will be negotiated with the States.

Resource Exploration Refundable Tax Rebate

Exploration expenditure incurred and carried out in Australia on or after 1 July 2011 will provide a refundable tax offset at the prevailing company tax rate.

The tax offset will be available to all companies and is expected to benefit 4,300 companies in the resources sector. Eligible exploration expenditure will:

- ❖ include an immediate write off in respect of depreciating assets that are first used for exploration; and

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- ❖ be expanded to include expenditure incurred in exploring for geothermal energy.

The refundable nature of the tax offset is a significant improvement on the current regime as it will enable companies with tax losses access to cash tax refunds. This aspect is designed to encourage more direct investment into the Australian resources industry.

Recommendations for Small Business

Early start to 28% corporate tax rate for small business companies

'Small business' companies will enjoy an early start to proposed company tax rate reductions. From 1 July 2012, a tax rate of 28% will be applied to companies which meet the definition of a small business entity. Broadly speaking, that is an entity which carries on a business and has an aggregated annual turnover of less than \$2 million.

Small Business Capital Allowance Rules

Small business entities are currently permitted to immediately write off the cost of assets with a value of less than \$1,000. Where they do so, they are required to allocate assets having effective lives of less than 25 years to a "general small business pool" and assets having effective lives of more than 25 years to a "long life small business pool". The depreciation rates applied to the general pool and the long life pool are 30% and 5% respectively.

The Government has announced that it will adopt the recommendations by allowing small business to immediately write-off assets costing less than \$5,000 (instead of \$10,000 as recommended by the Henry Review) and to pool all other depreciating assets in a pool subject to an annual depreciation rate of 30% from 1 July 2012, as recommended.

Recommendations for Superannuation and Retirement Incomes

The Government and the Henry Review both agree that superannuation should continue to receive preferential tax treatment compared to other forms of savings bar the family home. This is clear from the recommendations of the Review and also the response announced today by Government. In terms of the exact means of achieving preferential treatment for super however, the parties appear to still be some distance apart.

The Government's response falls short of the main thrust of the recommendations made by the Review. In particular the Government has not announced increases in superannuation taxes for those on higher incomes as many had feared. However it is also worth noting that at this time the Government has not ruled out changes of this nature at some point in the future.

Government announces superannuation changes

The Government announced a number of changes impacting on existing superannuation arrangements:

- ❖ The rate of employer compulsory superannuation contributions will increase from 9% to 12%. The rate will increase to 9.25% in 2013/14 and 9.5% in 2014/15 and 0.5% each year thereafter, reaching 12% in the 2019/20 year;
- ❖ The Government will contribute up to \$500 to the superannuation account of people with taxable income of less than \$37,000. This contribution will be calculated as 15% of the individual's concessional contributions. The measure starts from 1 July 2012 with the first payments made in the 2013/14 year;

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- ❖ People over 50 years of age with superannuation balances below \$500,000 will continue to be able to make up to \$50,000 concessional contributions per year after 1 July 2012, when the current transitional arrangement is scheduled to end;
- ❖ From 1 July 2013 compulsory employer contributions will be payable for employees up to age 75. Currently compulsory contributions are not required for employees over 70 years of age.

The Government's superannuation changes differ from the Henry Review's recommendations in a number of ways:

- ❖ Henry recommended compulsory employer contributions be retained at 9%, while the Government intends to increase the rate from 9% to 12%;
- ❖ Henry recommended the removal of the existing co-contribution (in relation to non-concessional contributions) and the spouse tax offset while the Government has indicated that they will add another co-contribution scheme on top of the existing one;
- ❖ The Government will require employers to make compulsory contributions for employees up to age 75 while Henry does not mention such a change;
- ❖ Henry recommends that the current contribution caps be retained into the future (the \$50,000 cap for 50+ year olds was to stop in two years time) while the Government added the requirement that their superannuation balance is less than \$500,000.

RECOMMENDATIONS REJECTED

The government has announced that, in the interests of providing some certainty, it will not implement the whole or part of 27 of the 138 recommendations. These include

- ❖ Changes to CGT including
 - Removal of the grandfathering of pre-CGT assets
 - Reduction of the CGT discount
- ❖ Removal of negative gearing
- ❖ Changes to the dividend imputation system
- ❖ The possible introduction of an estate tax
- ❖ Superannuation retirement incomes
 - Aligning the preservation age for access to superannuation (65) with the age pension eligibility age (67),
 - The Government offering an annuity product to allow people to purchase a lifetime income stream.
- ❖ Changes that harm the not-for-profit sector – for example:
 - Increasing the threshold for deductible gifts from \$2

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- Reconfiguring the existing FBT concessions
- New tax arrangements for trading activities
- ❖ The rate and base of the GST will not be changed.
- ❖ Changes to family assistance and pensioner support
 - Indexation of payments and income test parameters
 - Requiring parents to return to work once their youngest child turns 4
 - Including the family home in means tests
 - Means testing of single parent supplements
- ❖ Extending the fuel tax to all fuels used in road transport and indexing that tax
- ❖ Abolition of the luxury car tax
- ❖ Changes to the alcohol tax regime
- ❖ The family home will not be included within the land tax base

The government have also indicated that they will not be implementing a proposed savings income discount. The savings income discount proposal would have seen 60% of net interest income, net rental income/loss and capital gains included in taxable income.

HENRY RECOMMENDATIONS NEITHER ADOPTED NOR REJECTED

Disappointingly, of the 138 recommendations made, 114 have neither been adopted nor rejected by the Government. No doubt this will lead to considerable speculation and debate in the lead up to the Federal Budget on 11 May 2010 and the Federal Election scheduled for later this year.

KEY RECOMMENDATIONS NEITHER ADOPTED NOR REJECTED INCLUDE:

Superannuation funds

- ❖ The current 15% contributions tax would be abolished
- ❖ Employer superannuation contributions would be treated as the employees income and taxed in the employees hands at marginal rates
- ❖ Individuals would be eligible for a flat tax offset, in the order of 20%, on contributions up to the existing annual caps on contributions
- ❖ The annual cap on contributions eligible for the tax offset for over 50's would remain at double the rate of the standard cap (currently the increased cap is due to end on 30 June 2012)

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- ❖ The annual contribution caps would be indexed
- ❖ The Government co-contribution and spouse tax offset would be abolished
- ❖ Compulsory employer contributions would not reduce eligibility for income support or family assistance payments
- ❖ The rate of tax on superannuation fund earnings and capital gains reduced to 7.5%
- ❖ The 7.5% tax rate would apply on earnings derived from assets held to pay pensions (earnings on pension assets is currently exempt from tax)
- ❖ Recommendations not compelling individuals to use some or all of their retirement savings to purchase lifetime income streams

Tax Losses

- ❖ Companies should be allowed to carry back a revenue loss to offset it against the prior year's taxable income.

International Tax

- ❖ Removal of interest withholding tax on interest paid by Australian financial institutions to non-residents and seek zero interest withholding tax rates in Australia's future double tax treaties
- ❖ Australian managed funds should have greater certainty that conduit income will not be subject to Australian tax
- ❖ Increased harmonisation of business income tax arrangements between Australia and New Zealand should be considered

Small Business CGT concessions

- ❖ Removal of two of the four small business capital gains tax concessions together with implementation of some favourable modifications
- ❖ Increasing the \$2 million annual turnover threshold to \$5 million, to ensure that a wider range of small businesses are eligible for the various small business tax concessions

Capital allowances

- ❖ To permit immediate write-off of low-value assets for all taxpayers
- ❖ Reviewing agricultural and statutory effective life caps and other concessional write-off provisions

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Personal income tax

- ❖ A high tax-free threshold with a constant marginal rate should be introduced
- ❖ An expansion of scope of the personal services income regime

Trusts & Closely-held companies

- ❖ Updating the current trust rules to reduce complexity and uncertainty
- ❖ A flow-through entity regime for closely held companies and fixed trusts should not be adopted for now

Property developers

- ❖ Infrastructure or developer charges should be reviewed to ensure they appropriately price infrastructure provided in housing developments

Not-for-profit organisations

NFP organisations that receive income tax or GST concessions should retain them including income tax concessions for commercial activities.

Fringe Benefits Tax ('FBT')

As was widely anticipated the Henry Review made various recommendations in relation to FBT. The key recommendation was that fringe benefits that are easily valued and readily traceable to a particular employee should be removed from FBT and assessed as income in the hands of the relevant employee. Benefits that do not fall within this category or are merely incidental to employment would remain to be taxed to employers.

Further recommendations of the Review included

- ❖ The replacement of the current four rates for valuing car benefits under the statutory formula method with a single rate of 20%
- ❖ Removal of the FBT concessions for not for profit organisations
- ❖ Removal of the FBT exemption for child care facilities
- ❖ A review of all current FBT exemptions

Payroll Tax ('PRT')

The Henry Review recommended that PRT be abolished and replaced by a more broad based value added tax. The Government has not commented on this recommendation, which in any event would require consensus by the various State Governments.

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Road transport taxes

- ❖ A road congestion tax should apply to all registered vehicles using congested roads
- ❖ The development of mass-distance-location pricing for heavy vehicles (road-wear charges) should be accelerated

State and Other taxes

- ❖ All specific taxes on insurance products, including the fire services levy, should be abolished
- ❖ Stamp duties and payroll tax should eventually be abolished
- ❖ Land tax should be levied on a broad base with a tax free threshold for low-value land
- ❖ Government should undertake a review of user charges and minor taxes against the principles set out in the review

Closer scrutiny of the Australian Taxation Office

A board should be established to advise the Commissioner on the general organisation and management of the ATO. The government would appoint members to the board.

CONCLUSION

Disappointing to say the least, the Australian public have eagerly awaited the public release of the Henry Review for more than 4 months since it was originally released to the Government.

With this review, the Government appears to have put too many recommendations in the too hard basket.

Given the critical need to create “a tax structure that will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century ...” and to ensure that significant effort has not been wasted, Australia urgently needs its Government to provide a robust statement of their intentions and processes in relation to the Henry Review.

FURTHER INFORMATION

Please ask your regular Johnston Rorke tax contact for further details on the issues raised in this Tax Bulletin.

JR Acknowledges the assistance of our national affiliates, Pitcher Partners, with the production of this Tax Bulletin.

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