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Tax in Agriculture

A collaborative research project for the agricultural sector

by Boyce Chartered Accountants and Su McCluskey

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October 2016

RIRDC Publication No 16/019
RIRDC Project No 010394

ISBN 978-1-74254-865-4
ISSN 1440-6845

Tax in Agriculture
Publication No. 16/019
Project No. 010394

Researcher Contact Details

Name: Jonathan Forrest
Address: Boyce Chartered Accountants

PO Box 56, COOMA NSW 2630

Phone: 02 6452 3344
Fax: 02 6452 4060
Email: jforrest@boyceca.com

In submitting this report, the researcher has agreed to RIRDC publishing this material in its edited form.

RIRDC Contact Details

Rural Industries Research and Development Corporation
Building 007
Boorooma Street
Charles Sturt University
Wagga Wagga NSW 2650

C/o Charles Sturt University
Locked Bag 588
Wagga Wagga NSW 2678

Email: rirdc@rirdc.gov.au.
Web: http://www.rirdc.gov.au

Electronically published by RIRDC in 2016
Print-on-demand by Union Offset Printing, Canberra at www.rirdc.gov.au
or phone 1300 634 313

Foreword

This report identifies a number of areas of the tax system that currently facilitate positive productivity and sustainability outcomes for farmers and regional communities, along with those measures that may be impeding the sector. It aims to provide a resource for the agricultural sector to draw on to enable it to proactively engage in the tax reform debate, both now and into the future.

For almost 25 years, Australians have enjoyed a standard of living that is the envy of the world, underpinned by strong economic growth. However, periodic reviews are necessary to ensure that Australia's tax system continues to underpin future prosperity.

The benefits of an efficient tax system will be felt by all Australians with flow through improvements to our health and education systems, our infrastructure and other services, representing a rich investment in future generations.

Australian farmers and the rural and regional communities in which they live rely on an efficient and equitable tax system that underpins economic growth and regional sustainability. Previous tranches of tax reform, such as that undertaken in the late 1990s, left Australian agriculture stronger and more resilient.

The Australian Government, through the Agricultural Competitiveness White Paper identifies as one of its priorites, the need for a fairer go for farm businesses, to keep families on the farm as the cornerstone of agriculture, by creating a stronger business environment with better regulation, healthier market competition, more competitive supply chains and an improved tax system.

The scoping study and project underpinning this report were jointly funded by the Australian Egg Corporation Limited, Australian Pork Limited, Dairy Australia, Grain Growers Limited, Horticulture Innovation Australia Limited, Meat and Livestock Australia, the National Farmers' Federation and Rural Industries Research and Development Corporation. The project represents an important cross-sectoral approach by rural research and development corporations and industry to explore policy issues of national significance and mutual interest.

This report was first drafted in February 2016 and has been updated to include consideration of the Federal Budget announcements from May 2016, noting that the first tranche of draft legislation for superannuation reforms announced in the Budget was released 7 September 2016.

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John Harvey
Managing Director
Rural Industries Research and Development Corporation

About the Authors

Boyce Chartered Accountants is an industry leading professional services firm with five offices in the major New South Wales (NSW) regional centres of Cooma, Dubbo, Goulburn, Moree and Wagga Wagga. While our offices are located in NSW, we have clients in all states/territories and therefore have relevant experience in all jurisdictions.

We have specialist knowledge of business and agriculture in each of the major sectors, including exposure to cotton growing and ginning, broad-acre dryland and irrigated cropping, grain marketing and pool operations, grazing, dairy, viticulture, water rights, orchards, poultry, and forestry.

Due to our regional presence and many years of experience working with large-scale agribusinesses, we are acutely aware of agricultural issues and associated risks. By specialising we truly understand the areas of agriculture that our clients pursue.

Today the Boyce team consists of more than 110 professionals across our five strategically located offices led by 13 directors and four associate directors. We are proud to have a number of highly proficient, talented professionals as part of the Boyce team who have developed specialist areas of knowledge and expertise; capability that is not normally available outside of the top-tier metro firms.

Our specialists operate with a brief to remain up to date with all legislative and statutory changes to ensure the advice we give is opportune and insightful, and delivers commercially practical outcomes.

Our growth has largely been due to the distinctive Boyce philosophy and approach that defines how our services are delivered, how our staff are recruited and developed, and how we strive each day to assist our clients to maximise their wealth potential.

A number of our senior team have been involved with previous policy-setting projects and government consultative committees in relation to tax and GST issues, exceptional circumstances funding, farm debt mediation, etc. The firm was also engaged with a research project prior to the implementation of GST to determine the financial impacts for various rural industries.

Su McCluskey has a strong background in agricultural and regional taxation and economic policy and development. Su was the Director of Taxation at the National Farmers' Federation during the introduction of the new tax system in the early 2000's.

Su has also held the role of CEO of the Regional Australia Institute and the Council of Rural Research and Development Corporations, the Executive Director of the Office of Best Practice Regulation and has held senior positions with the Business Council of Australia and the Australian Taxation Office.

Su is currently the Chairman of Energy Renaissance and a Director of Australian Unity, the Foundation for Young Australians and the Royal National Capital Agricultural Society. Su is a member of the Ministerial Advisory Council on Skilled Migration and was a member of the Harper Review of Competition Policy and the Regional Telecommunications Independent Review Committee.

Su's professional qualifications include a Fellow Certified Practising Accountant (FCPA), Bachelor of Commerce (University of Canberra) and Member Australian Institute of Company Directors (MAICD). Su was named the Westpac/Australian Financial Review Regional Woman of Influence in 2013 and received the Women in Agribusiness award in 2014 for outstanding contribution to policy development.

Acknowledgments

The authors would like to acknowledge the input of the following in participating in workshops and providing insights:

- ABARES;
- AgForce;
- Australian Bankers Association;
- Australian Lot Feeders Association;
- Australian Dairy Farmers;
- Australian Egg Corporation Limited;
- Australian Pork Limited;
- Cattle Council of Australia;
- Dairy Australia;
- Department of Agriculture and Water Resources
- GrainGrowers Limited;
- Horticulture Innovation Australia Limited;
- National Farmers' Federation;
- NSW Farmers Association;
- Rural Industries Research and Development Corporation;
- Sheepmeat Council;
- The Australian Treasury; and
- Victorian Farmers Federation.

Abbreviations

ABARES – Australian Bureau of Agricultural and Resource Economics and Sciences

ABC – Australian Broadcasting Commission

ABN – Australian Business Number

ABS – Australian Bureau of Statistics

ACC – Australian Competition and Consumer Commission

ACOSS – Australian Council of Social Service

ADI – Authorised deposit-taking institution

ASEAN – Association of South East Asian Nations

ATO – Australian Taxation Office

CPI – Consumer price index

FBT – Fringe benefits tax

FIRB – Foreign Investment Review Board

FMD – Farm Management Deposit

FTA – Free trade agreement

FTC – Fuel tax credits

GDP – Gross domestic product

GFC – Global financial crisis

GST – Goods and services tax

ITAA – Income Tax Assessment Act

LCT – Luxury car tax

MIS – Managed investment scheme

NATSEM – National Centre for Social and Economic Modelling

NAV – Net asset value

NFF – National Farmers Federation

NSW RAA – New South Wales Rural Assistance Authority

OECD – Organisation for Economic Cooperation and Development

QRAA – Queensland Rural Assistance Authority

R&D – Research and development

RDC – Research and development corporation

RE – Responsible entity

RIRDC – Rural Industries Research and Development Corporation

SBE – Small business entity

SG – Superannuation guarantee

SGC – Superannuation guarantee charge

TFN – Tax file number

TPP – Trans Pacific Partnership Agreement

WET – Wine equalisation tax

Contents

Executive Summary

The Australian agricultural sector is a strong contributor to the economy and plays a vital role in the social, economic and environmental sustainability of the nation[1]. There are approximately 123,265 farm businesses in Australia, 99 per cent of which are Australian owned[2]. Australian farmers produce 93 per cent of Australia's daily domestic food supply[3].

The agricultural sector, at the farm gate, contributes two per cent to Australia's gross domestic product (GDP)[4]. The gross value of Australian farm production in 2013-14 was $51 billion, an increase of six per cent from 2012-13[5]. In the same year, Australia's farm exports earned the country $41 billion, which is around 60 per cent of what farmers grow and produce[6]. Australian farmers are an essential part of the economy's fabric, contributing to the sustainability of rural and regional communities, as well as the broader economy.

Agriculture has always played an important role in the prosperity of Australia and continues to play a pivotal role in building the country's wealth. This is why agriculture is considered one of the five pillars of the Australian economy. A strong agricultural sector contributes to a strong economy, which means more jobs, more exports, higher incomes and better services to the community.

Australia's continued economic wellbeing depends on all levels of government facilitating an environment that drives economic growth and ensures current living standards can continue or improve, while also protecting the prosperity of future generations[7].

A good tax system raises the revenue needed to finance the provision of government services and activities without imposing unnecessary costs on the economy. Tax reform is about improving the tax system as a whole and is not just about raising revenue. While expenditure constraints are acknowledged, tax reform should be based on longer term economic efficiency.

The community expects governments to maintain a strong and sustainable social safety net. However, with an ageing population, in the absence of tax reform, significant pressure would be placed on the health system and social welfare expenditure.

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[1] National Farmers' Federation 2015, Annual Review 2014-15, http://walshmedia.realviewtechnologies.com/default.aspx?iid=132735&startpage=page0000005#folio=4

[2] Australian Bureau of Statistics 2015, 7121.0 - Agricultural Commodities, Australia, 2013-14, http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/7121.02013-14?OpenDocument

[3] Keogh, M 2009, Australia's response to world food security concerns, http://webcache.googleusercontent.com/search?q=cache:pbmSDu5PL1gJ:www.farminstitute.org.au/LiteratureRetrieve.aspx%3FID%3D47785+&cd=1&hl=en&ct=clnk&gl=au

[4] Australian Government 2014, Agricultural Commodities Statistics 2014, http://data.daff.gov.au/data/warehouse/agcstd9abcc002/agcstd9abcc0022014/ACS_2014_1.0.0.pdf

[5] Australian Bureau of Statistics 2016, 7503.0 - Value of Agricultural Commodities Produced, Australia, 2014-15, http://www.abs.gov.au/ausstats/abs@.nsf/PrimaryMainFeatures/7503.0

[6] Australian Government 2014, Agricultural Commodities Statistics 2014, http://data.daff.gov.au/data/warehouse/agcstd9abcc002/agcstd9abcc0022014/ACS_2014_1.0.0.pdf

[7] National Farmers' Federation, *Annual Review 2014-15*, National Farmers' Federation Ltd and Walsh Media

Australians have largely benefited from the strong economic growth that came from implementing major reform measures, such as the introduction of the new tax system in 2000, including the GST. Putting in place reform measures now can lead to a better future for ourselves, our children, and future generations to come.

Therefore, it is critical that Australian agriculture can proactively engage in policy debates that will support the competitiveness of the sector as a whole. Comprehensive tax reform has been identified as a way of underwriting productivity and economic growth, while also ensuring fiscal stability[8].

The agricultural sector is seeking to participate in the current taxation debate to enable it to advocate on issues specific to agriculture and play a significant role in achieving constructive solutions for farmers and Australia's regions more broadly.

The report has been framed in terms of the desirable outcomes for the agricultural sector and how Australia's tax system helps or hinders the sector in achieving these outcomes. The desirable outcomes include increased productivity and profitability, regional development, improved risk mitigation, innovation and effective succession planning.

The report highlights those areas of the tax system that facilitate achieving these outcomes, providing a case for their retention, as well as identifying areas where barriers exist and possible alternative approaches could be considered.

The areas identified in this report that may benefit from consideration of alternative options include measures impacting on investment and risk mitigation, as well as state and territory taxes. Consideration has also been given to the taxation of temporary residents, the goods and services tax (GST), and the taxation impacts on business structures, succession planning and superannuation. Measures aimed at addressing environmental issues and transport, tax zone rebates and fringe benefits tax (FBT) are also included. Further, consideration has been given to the impact of announcements made in the 2016 Federal Budget as they pertain to these areas.

This report and its scoping study were funded by a collaboration of research and industry organisations in the agricultural sector and includes the following:

- Australian Egg Corporation Limited;
- Australian Pork Limited;
- Dairy Australia;
- GrainGrowers Limited;
- Horticulture Innovation Australia Limited;
- Meat and Livestock Australia;
- National Farmers' Federation; and
- Rural Industries Research and Development Corporation.

These organisations have made a commitment to undertake a comprehensive piece of work on taxation that will provide an evidence-based resource for the broader agricultural sector in the years to come.

Investment

[8] National Farmers' Federation, *Annual Review 2014-15*, National Farmers' Federation Ltd and Walsh Media

Investment in agriculture includes potential investment from new participants to the industry, avenues of accessing possible financing, and existing participants expanding their investment. Investment in the industry is necessary to ensure the long-term sustainability of rural industries and communities.

Australia's tax system should support the attraction of investment and improved productivity in the sector, while at the same time carefully balancing this with protecting the national interest and maintaining the integrity of the tax system.

The 2016/17 Federal Budget proposes to reduce the tax rate for small businesses with a turnover of less than $10 million to 27.5 per cent (already reduced from 30% to 28.5% in the 2016 year). This measure and the proposal to decrease the tax rate on all companies to 25 per cent over ten years will make Australia more competitive compared with the company tax rate of other countries.

Measures that facilitate industry investment

The recent changes to depreciation and capital write-offs saw the introduction of additional measures for primary producers, including to enable them to better prepare for drought conditions and to immediately deduct expenditure on fencing and water facilities. The measures support sustainability in the longer term and recognise the vagaries of the industry.

For those not eligible to be a small business entity (SBE), there are current low value pool arrangements to enable items costing between $100 and $1,000 to be depreciated at 37.5 per cent. To further support investment in agriculture, consideration could be given to increasing this threshold from $1,000 to $5,000. This reduces the administrative burden for businesses and only impacts on the timing of allowable deductions.

Measures that impede industry investment

The non-commercial loss rules have discouraged investment in agriculture relative to other investments, such as property, where negative gearing provisions apply. Consideration could be given to revising the non-commercial loss rules to ensure that they are better targeted and the provisions expanded to cover both business and investment activities, including negative gearing. This will reduce the distortions in the marketplace which currently provide a disincentive to investing in agricultural businesses.

In relation to Managed Investment Schemes (MIS), pooled arrangements are an effective means to raise investment funds for both agricultural and non-agricultural businesses. However, common enterprise schemes have been used by agribusiness as a mechanism primarily to reduce tax rather than encourage investment. As an option to address this, the tax treatment of these common enterprise schemes could be revised to confirm these investors are not able to claim tax deductions relating to expenditure in these schemes. Any changes could allow some form of grandfathering protection to existing investors.

In relation to foreign investors, the transfer pricing rules require that market evidence be provided to support the true market price of items transferred between related parties that involve a foreign jurisdiction. Consideration could be given to setting a threshold, below which the transfer pricing provisions do not apply, or at least only apply in a minimal simplified format. For consistency, setting a $2 million threshold equal to the thin capitalisation rules would appear appropriate. This would simplify the reporting requirements, including the suggestion that third party market value evidence could adequately support adopted prices.

It is important to ensure Australia's corporate tax rate is internationally competitive. Consideration could be given to reducing this rate over a period of time. A target rate of 22 per cent would be consistent with other countries in the region and would increase Australia's appeal as a place to invest and do business.

State/territory taxes and duties

Australian state and territory governments apply taxes and duties to a range of transactions, products and activities. The structure and design of these often varies between jurisdictions and adds complexity to the affairs of businesses operating in multiple jurisdictions. Despite differences in application, the tax base across the states and territories is substantially similar, with stamp duty, land taxes and payroll tax, (including local government rates) contributing around three quarters of total state tax revenue.

Measures that support agricultural efficiency, productivity and sustainability

The current land tax exemptions for primary production businesses support agricultural profitability and should ideally be made consistent across all jurisdictions. Any extension to land tax to include agricultural land would have a severe adverse impact on farmers' net income.

Measures that impede agricultural efficiency, productivity and sustainability

Stamp duty on the transfer of land can lead to inefficient economic decisions and impacts the agricultural sector's productivity, as it discourages moving capital that could potentially be invested in more productive locations and assets. As such, there is a strong view by the agricultural sector that, in accordance with the 1999 Intergovernmental Agreement, stamp duty should be removed, particularly on all non-residential property conveyances. This would remove a major cost to farmers on the transfer of land.

Consideration could also be given to extending the inter-generational stamp duty concession for rural land to companies or trusts that are essentially controlled by a family group. This is extremely important for primary production businesses and will better facilitate the inter-generational transfer of the land, removing the current disincentive for younger generations to take over land ownership in a structure that best meets their needs.

Inconsistencies in payroll tax across jurisdictions create an unnecessary administrative burden for primary producers and other small businesses. Consistent payroll tax arrangements across all jurisdictions would be simpler and more cost-effective to comply with for businesses that operate across state and territory borders.

Risk mitigation

Measures that support improved risk mitigation

Australian farmers are increasingly required to manage risk in their businesses and generally have extremely variable incomes compared to business owners in other industries. Some of the risks in agriculture include variations in weather, with drought, floods and fire, and environmental issues with pests and diseases. The existing measures of primary production averaging and tax treatment of abnormal receipts provide strategies to enable farmers to address the risk of the fluctuating nature of primary production income.

For the above reasons, the recommendation from the Agricultural Competitiveness White Paper for taxpayers to be able to opt back into primary production averaging after 10 years is likely to further support positive risk management outcomes for the sector.

Measures that impede risk mitigation

Farm Management Deposits (FMDs) enable farmers to set aside pre-tax income in a high income year and withdraw in a low income year. While the FMD scheme is a highly valued risk management tool for primary producers, there are elements of the scheme that may be limiting its value for some groups in the agricultural sector.

Consideration could be given to allowing FMDs to be held at the entity level rather than only at the individual level, enabling eligibility to be extended to companies and trusts. This better aligns the FMD at the business level. Integrity measures will be required to prevent manipulation between entity structures.

In relation to the unexpected cessation of a primary producer due to ill health or death, the FMD must be withdrawn in full in that tax year. This can result in excessive taxation liability, thus impairing prior tax planning. Consideration could be given to the FMD being brought back into the business over a two or three year period, or the additional income taxed at average rates.

There are further concerns in relation to the interaction with the non-commercial loss rules when an FMD is withdrawn. In these circumstances it would seem appropriate to clarify the withdrawn funds as being income from the business activity from which the deposit was originally sourced without further restriction.

Temporary residents

Many agricultural industries are dependent on itinerant workers to provide the labour inputs required to operate their business and it is often difficult to attract workers to these industries. It is important to continue to be able to attract itinerant workers, a large proportion of whom are foreign nationals on temporary working visas.

Measures that impede agricultural efficiency, productivity and sustainability

It is already difficult to attract workers to agriculture and many that make up the itinerant workforce for farm businesses are working holiday makers from overseas, including backpackers. Changes proposed in the 2015 Budget to increase the tax on all temporary residents to 32.5 per cent on each and every dollar are now unlikely to proceed. This would have resulted in reduced backpacker tourism and agricultural losses, as well as the loss of income for the temporary worker and as a consequence, less money that these workers spend in our regional communities. The commentary in the 2015/16 Federal Budget is over-simplified in terms of how the residency tests are currently applied, specifically focusing on the 183-day test, but not acknowledging that the Double Taxation Agreement (DTA) for the country of origin needs to be considered. Technically, a lot of existing backpackers would be treated as non-residents, even though in practice they are treating themselves as residents if they are in Australia for more than 183 days.

For simplicity and consistency, all non-residents could be taxed at a rate of 19 per cent up to a threshold of $37,000 with the 32.5 per cent rate applying on income up to $80,000. The most recent proposed changes are to tax working holiday makers at 19 per cent from their first dollar earned.

Consideration could also be given to allowing Superannuation Guarantee (SG) for temporary residents to be paid directly to the Australian Taxation Office (ATO), to simplify compliance for farm businesses.

Goods and services tax (GST)

Measures that impede agricultural efficiency, productivity and sustainability

GST reform should focus on ways to simplify the system and reduce the compliance burden imposed upon businesses. Consideration could be given to the following changes to remove some of the complexities that exist within the current system:

- Assess turnover against the GST registration threshold annually rather than monthly;
- Ensure the thresholds are regularly reviewed so that they remain appropriate and balance the compliance burden with the revenue raised;
- Revise grouping rules to allow entities with the same ultimate ownership to be grouped regardless of the type of entity that is the ultimate owner; and
- Revise the 60 day shipping requirement so that the supplier is not required to recover the GST if goods are not ultimately exported within 60 days, and allow look-through treatment for associated costs incurred by an agent when determining whether exports are GST-free.

Exemptions significantly increase the complexity of the GST and introduce distortions by changing the relative prices of goods and services. They are also available to all households, regardless of their income level. This potentially makes GST exemptions less effective and more costly than other means of targeting assistance to lower-income households.

Broadening the GST base to include items such as fresh food, health and education could be considered to make the system more durable in the long term. For the purposes of this report, it is relevant for the agricultural sector to engage in a debate around broadening the GST base, including to fresh food. This debate should not be undertaken in the context of solely revenue raising but on the grounds of simplicity, efficiency, durability and equity of the taxation system in the longer term.

Should consideration be given to changes to the GST, low income earners and welfare recipients – for example the bottom 20 per cent - should be compensated. This underpins the basic premise of taxation that it is levied to ensure that essential services can be provided to all, as well as providing a safety net for the under-privileged.

Additional revenue raised could be directed to better meeting the needs of all Australians, including farmers and rural communities, through investment in regional development, the health system, infrastructure, telecommunications, and education.

Business structures

All business tax payers have to choose a business structure when they commence, and significant time is spent on choosing the most appropriate structure. Taxation implications are a significant factor in the choice of business structures in Australia.

Measures that support agricultural efficiency, productivity and sustainability

While consideration has been given to the establishment of a specific small business company model, such as the US S-Corporation, such a structure is not seen to provide any significant benefits, particularly with the introduction of the small business entity (SBE) in recent years. The existing package of SBE tax measures provides a necessary boost to small businesses whose scale puts them at a competitive disadvantage. They also help to simplify the obligations of small business and minimise compliance costs.

Measures that impede agricultural efficiency, productivity and sustainability

To avoid additional complexity for those small businesses that operate at, or around the current $2 million qualifying threshold, consideration could be given to increasing the threshold. An alternative option would be to introduce a system of average or phased rates and thresholds rather than the current 'cliff face' approach. The proposal in the 2016 Budget to increase this threshold to $10 million will ensure the concessions and associated efficiency benefits enjoyed by SBEs are captured by a larger number of small farm businesses.

Further for SBEs, following the ceasing of the $20,000 immediate write-off provisions in 2017, consideration could be given to setting the immediate deduction threshold at $5,000 for all asset purchases. The remaining cost of the asset can then be added to the pool and depreciated under existing rules. This would prevent the distortion that can arise from choosing to invest in multiple low cost assets rather than in higher cost, more productive assets.

There are a number of other changes that can be considered to simplify the system to deliver efficiency and productivity benefits to primary producers.

From a practical perspective, some owner farmers working in their company may not claim on their workers compensation policy due to the likely added cost of increased premiums after the claim. Providing these owners with the option to opt-out of workers compensation would allow them to either accept the risk or obtain their own personal insurances.

Currently, capital losses can be accessed and utilised easily by a trust to reduce future capital gains, whereas there are many complex tests that a trust has to go through to claim losses on revenue account. For consistency, capital losses could be subject to the trust loss rules in the same fashion as revenue losses.

To allow family businesses to access more streamlined rules, consideration could be given to allowing companies to make a 'Family Company' election based on similar criteria and similar consequences as a trust making a 'Family Trust' election.

To allow the consistent treatment across jurisdictions relating to the maximum life of a trust, the states and territories could repeal the current 80 year life span periods on trusts, allowing them to have an indefinite life.

Further, consideration could be given to taxing returns from companies equally if distributed during the life of the company, as they are upon ultimate liquidation. This would address current inconsistencies, in particular in relation to profits from capital gains and small business exempt amounts.

Succession planning

A common concern raised by farmers when first considering succession planning is in relation to the likely tax liability associated with unwinding existing tax structures to better suit the incoming generation and current tax framework.

Measures that impede effective succession planning

To better facilitate the timely intergenerational transfer of the family business, consideration could be given to CGT rollover relief being available for the transfer of assets within a wholly owned family group. The aim is to essentially provide CGT relief during the life of a taxpayer that would currently be available on death.

Further, consideration could be given to allowing the intergenerational change in ownership of stock and plant without the need for a 25 per cent continuing ownership interest. This would remove an administrative and structural difficulty associated with the current system.

Superannuation

Superannuation is considered to be the primary savings vehicle for allowing individuals to provide income for their retirement, avoiding or reducing the need to draw on the aged pension. It should not be seen as a wealth creation vehicle.

Measures that support effective retirement planning

The simplicity of the superannuation system introduced in 2006 and the tax free withdrawal of income streams for those over 60 years of age are consistent with the objectives of supporting farmers and the general community to save income for their retirement.

Measures that impede effective retirement planning

Superannuation is not currently paid for employees where earnings are less than $450 per month and this amount has not changed since 1992. Adjusting this threshold for the consumer price index (CPI), which would make the threshold around $800, would reduce the administrative burden on employers who need to track and pay small amounts of superannuation. Employees would still have an incentive to contribute to superannuation through other mechanisms within the system.

Consideration could be given to introducing a tax of 7.5 per cent on fund earnings in pension phase. Currently, earnings in a superannuation fund attract 15 per cent tax during accumulation phase, but once the individual reaches pension phase, the earnings attract no tax at all. Putting in place a modest amount of tax on all earnings in pension phase would be a fair outcome and no grandfathering would be required, noting that this impacts only on the growth in the fund, not on the amount contributed.

The proposal in the 2016 Budget to limit the amount that can be tranfered to tax-free retirement phase accounts to $1.6 million and limit annual non-concessional contributions to $100,000 will achieve a similar objective of a fair outcome. However, the proposal to lower the annual concessional contributions cap to $25,000 is not considered necessary if the cap on tax-free concessions is set at $1.6 million. The lower annual concessional cap and lifetime non-concessional cap could disadvantage those taxpayers who are not in a financial position to contribute as much to superannuation at an earlier age (eg due to other financial commitments, lower wage levels, etc).

The 10 per cent rule is discriminatory, provides a disincentive to earn income and adds unnecessary complication to the contributions rules. It also has the greatest impact on low income earners or those with only a small portion of employment income during the year, affecting many farmers and their families. To enable farmers to contribute to superannuation, even if they have off-farm work, consideration could be given to removing the 10 per cent rule, allowing all taxpayers to make personal superannuation contributions up to the contribution limits, regardless of their source of income. This will enable farmers and their families to contribute more of their earnings to superannuation, allowing them to provide additional savings for their eventual retirement. The 2016 Budget proposal (included in the draft legislation released 7 September 2016) to end the 10% rule for tax-deductible superannuation contributions should help address these issues.

For similar reasons, the ability to contribute small business capital gains or proceeds to superannuation without any age or work limits attached could also be considered. Once the asset has been determined as being an active asset to meet the small business CGT concessions, there could be the ability to place the funds into superannuation. The 2016 Budget proposal (included in the draft legislation released 7 September 2016) to remove contributions restrictions for people aged 65-75 should similarly remove disincentives and assist with effective retirement planning.

An anti-detriment payment is an additional lump sum amount that may be paid to an eligible dependent when a lump sum death benefit is paid. However, the rules are complex and inequitable. The use of anti-detriment payments can be at the expense of setting up income streams for dependents, which would generally be a better outcome. The 2016 Budget proposal to end the anti-detriment payments will remove this impediment to more effective retirement and succession planning by primary producers.

Environmental issues

Environmental impacts of land use are among Australia's most significant environmental challenges. Major problems include the loss of biodiversity, pollution of water resources, soil erosion, salinity and soil acidity.

Measures that support environmental management

The current Landcare and Water Facility provisions are important to assist primary producers to address environmental challenges by incentivising actions to address and prevent environmental problems and reduce the cost burden to farmers for actions that potentially deliver broader public benefits.

Transport and vehicle-related taxes

Measures that support agricultural efficiency, productivity and sustainability

Fuel tax credits are widely supported in the agricultural industry due to the fact that the fuel is not being used on roads and hence the applicable excise is therefore not contributing to the development and maintenance of the road network. Continuing to educate farmers on the mechanics of the fuel tax credit scheme, the eligibility requirements and the methodology of claiming would help ensure the sector derives the maximum benefit from this scheme.

Measures that impede agricultural efficiency, productivity and sustainability

A car is an essential business asset. The arbitrary application of a luxury tax and cost limit to cars and not other assets is inequitable and adds unnecessary cost and complexity to taxpayers' affairs. The modestly set thresholds also mean that a number of cars that would not typically be considered 'luxury' vehicles are currently subject to these measures, and include vehicles commonly used by primary producers in their business, such as four-wheel-drive vehicles.

The Henry Review recommendation that luxury car tax should be abolished would remove a distortion in the marketplace and deliver benefits to the sector as the tax falls disproportionately on those with requirements for more expensive vehicles.

Tax zone rebates

Tax zone rebates were introduced in 1945 to compensate recipients for the disadvantages of living in remote areas including distance, climate and the higher cost of living. The rebate amounts have remained unchanged since 1993 and the boundaries have remained broadly unchanged since 1956.

Measures that no longer support agricultural efficiency, productivity and sustainability

The current tax zone rebate system is outdated and no longer meets the original policy intent of compensating recipients for the disadvantage of living in remote areas. The tax zone rebate system could be reviewed and, as part of this review, the rebate could be realigned to the original policy intent of compensating recipients for the disadvantages of living in remote areas. This would likely result in a reduction of areas that fall within the rebate zone and an increase in the rebate in line with CPI.

Alternatively, consideration could be given to removing the rebate and redirecting the revenue to a fund that can better target regional economic development. This could include providing incentives for professionals to move to remote areas or providing regional business incentives.

Fringe benefits tax (FBT)

Employers in regional and remote towns and communities often struggle to attract or retain qualified and experienced workers. To help overcome this, consideration could be given to allowing employees located in remote areas to be able to access an FBT exemption up to a $17,000 cap per annum, where employers pay school fees on behalf of their employees. This could apply where the remote area is 40 kilometres or more from a secondary school.

Further, the remote area concessions could be reviewed to determine if they remain relevant and fit for purpose.

Other issues

Water in-situ

Certain assets such as standing crops, trees and crop stools are treated as trading stock for income tax purposes and on that basis, the cost of acquiring them is tax deductible when they are sold.

In relation to water in situ and similar consumable type items, the value of that water at the time of farm sale is not considered to be deductible.

For consistency, consideration could be given to amending the trading stock provisions to ensure a tax deduction is allowed upon purchase of land for items and products, including water in-situ, that were purchased with the land.

Passive versus active investment

Under the current and rather complex Australian taxation system there are many specific provisions that result in differences in the levels of taxation applied both to different structures and different types of income. There are a number of disparities arising in the tax treatment of active versus passive investment under tax law, including the inconsistent treatment under the non-commercial loss provisions mentioned previously.

To provide further consistency in the tax treatment of passive and active assets, limits could be placed on the amount of gains that are exempted or reduced under the CGT provisions. For example, the main residence exemption could be subject to a cap on the amount an individual can disregard during their lifetime.

Wine equalisation tax (WET)

The current WET system recognises the production risks associated with the variations in agricultural production, with the original policy intent of the rebate being to assist smaller regionally based winery businesses in the domestic market and recognise the annual risks associated with production.

Consideration could be given to removing the rebate for unbranded and bulk wine to ensure the policy intent remains. Consideration could also be given to denying the rebate for New Zealand producers, recognising that due consideration needs to be given to the implications for Australia's international trade obligations. The proposal in the 2016 Budget to restrict the rebate to packaged and branded wine is consistent with restoring the original policy intent, noting that the details are to be determined through further industry consultation.

Taxation options for consideration to improve productivity, efficiency and sustainability outcomes for the agriculture sector

The table below provides a summary of options for taxation reforms identified for consideration in this report that largely simplify the tax system and reduce compliance costs, leading to increased productivity and profitability and supporting investment and the longer term sustainability of the industry.

Measures that currently support agricultural productivity and sustainability are also contained in this table.

Area of impact/taxation	Options for consideration	Purpose
Investment	Retain recent changes to depreciation and capital write-off provisions.	Supports longer term sustainability of the industry leading to higher economic contribution.
	Increase the low value pool threshold for those with turnovers in excess of $2 million from $1,000 to $5,000.	Supports investment in agriculture and reduces administrative burden.
	Update the transfer pricing rules to enable taxpayers the option of using readily available third party market value evidence.	Ensures simplicity.
	Disallow common enterprise types of Managed Investment Schemes from claiming tax deductions.	Ensures integrity in the tax system.
State and territory taxes	Extend the inter-generational stamp duty concession for rural land to companies or trusts that are essentially controlled by a family group.	Encourages younger people to remain in agriculture by removing the disincentive for younger generations to own assets through their chosen structure.
	Retain current land tax exemptions for primary production businesses and make consistent across all jurisdictions.	Ensures consistency and continued profitability.
Risk mitigation	Retain primary production averaging and current treatment of abnormal receipts.	Ensures better risk management resulting in higher profitability.
	Enable taxpayers to opt back into primary production averaging after 10 years.	Ensures better risk management resulting in higher profitability.

Temporary residents	Tax all non-residents at a rate of 19 per cent up to a threshold of $37,000 with the 32.5 per cent rate applying on income up to $80,000.	Provides for simplicity and consistency.
GST	Assess turnover against the GST registration threshold annually rather than monthly.	Increased simplification leads to increased productivity and profitability.
	Revise grouping rules to allow entities with the same ultimate ownership to be grouped.	Increased simplification leads to increased productivity and profitability.
	Revise the 60 day shipping requirement so that the supplier is not required to recover the GST if goods are not ultimately exported within 60 days and allow look-through treatment for associated costs incurred by an agent when determining whether exports are GST-free.	Increased simplification leads to increased productivity and profitability.
Business structures	Retain current small business entity measures.	Increased simplification leads to increased productivity and profitability.
	Subject capital losses to the trust loss rules in the same way as revenue losses.	Provides for simplicity, consistency and integrity.
	Allow family businesses to make a ‘Family Company’ election similar to a trust making a ‘Family Trust’ election.	Provides for simplicity and consistency.
Succession planning	Allow the intergenerational change in ownership of stock and plant without the need for a 25 per cent continuing ownership interest.	Facilitates the intergenerational transfer of the family business leading to the longer term sustainability of the industry.

Superannuation	Retain the simplicity of the superannuation system including that the withdrawal of income streams remain tax free for those over 60 years of age.	Ensures simplicity of the system.
	Adjust the $450 per month superannuation threshold for CPI.	Reduces administrative burden.
	Introduce a tax of 7.5 per cent on fund earnings in pension phase with no grandfathering.	Ensures equity and the longer term sustainability of the superannuation system.
	Remove the 10 per cent rule, allowing all taxpayers to make personal superannuation contributions up to the contribution limits, regardless of their source of income.	Encourages savings for retirement reducing the draw on the public purse.
	Remove anti-detriment payments.	Improved integrity in the tax system.
Environment	Retain the current Landcare and Water Facility provisions.	Ensures the longer term sustainability of the industry.
Transport	Retain fuel tax credits.	Recognises the policy intent of the measure.
Water-in-situ	Allow a deduction for items and products, including water in-situ, that were purchased with the land.	Ensures consistency.

More complex taxation options for further consideration that may improve productivity, efficiency and sustainability outcomes for the agriculture sector

There are a number of options for taxation reforms discussed in this report that could inform further debate and consideration. While these reforms have been identified with the aim of improving the tax system more broadly, they are either more complex, there are a number of options to address the problem, or they require negotiation with the states and territories. Further discussion is encouraged to fully explore the policy mechanisms that will best address the issue identified. In some cases, more detailed analysis and modelling may need to be undertaken.

The table below provides a summary of the more complex options included in this report for further debate.

Area of impact/taxation	Options for consideration	Purpose
Investment	Revise and expand the non-commercial loss rules to be better targeted and provide consistent treatment of investment.	Removes the disincentive to invest in agricultural businesses and removes distortions in the marketplace.
	In relation to foreign investors, set a threshold below which the transfer pricing provisions do not apply, or only apply in a minimal simplified format.	Ensures simplicity and consistency.
	Reduce the corporate tax rate over a period of time, to a target rate of 22 per cent.	Provides for international competitiveness.
State and territory taxes	Remove stamp duty on all non-residential property.	Removes inefficient economic decisions that discourage the movement of capital.
	Provide consistency across jurisdictions for payroll tax.	Ensures simplicity which underpins productivity and profitability.
Risk mitigation	Allow FMDs to be held at the entity level rather than only at the individual level.	Aligns tax measures at business level leading to increased profitability.
	Enable an FMD to be brought to account over a 2 or 3 year period, or the additional income taxed at average rates, upon the unexpected cessation of a primary producer.	Provides for greater consistency in treatment after a taxpayer passes away.

	Review the interaction between the FMD and non-commercial loss rules.	Provides for greater consistency in the system.
Temporary residents	Allow SG for temporary residents to be paid directly to the ATO.	Provides for simplicity leading to increased profitability.
GST	Broaden the GST base, including to fresh food.	Provides for increased simplicity, efficiency, durability and equity.
	Ensure the GST thresholds are regularly reviewed.	Provides for simplicity.
Business structures	Increase the SBE threshold, or alternatively, introduce a system of average or phased rates.	Provides for simplicity.
	Following the ceasing of the $20,000 immediate write-off provisions in 2017, the immediate deduction threshold could be set at $5,000 for all asset purchases.	Provides for simplicity and removes distortions in capital allocation.
	Enable business owners to opt-out of workers compensation allowing them to either accept the risk or obtain their own personal insurances.	Removes distortions.
	Enable the states and territories to repeal perpetuity periods on trusts allowing them to have an indefinite life.	Provides for consistency.
	Tax returns from companies equally if distributed during the life of the company, as they are upon ultimate liquidation.	Provides for consistency.
Succession planning	CGT rollover relief could be available for the transfer of assets within a wholly owned family group.	Facilitates the intergenerational transfer of the family business leading to the longer term sustainability of the industry.
Superannuation	Enable the contribution of small business capital gains or proceeds to superannuation without any age or work limits attached.	Encourages savings for retirement reducing the draw on the public purse.

Transport	Abolish the Luxury Car Tax.	Removes a distortion in the marketplace.
Tax zone rebate	Review the tax zone rebate system to remove the rebate and redirect the revenue to a fund that can better target regional economic development. Alternatively, better align the rebate to the original policy intent of compensating recipients for the disadvantages of living in remote areas.	Removes a distortion in the marketplace.
FBT	Allow employees located in remote areas to be able to access an FBT exemption up to a $17,000 cap per annum, where employers pay school fees on behalf of their employees.	Enables employers in remote regions to better source labour leading to increased productivity.
	Review remote area concessions to determine if they remain relevant and fit for purpose.	Ensures durability and efficiency.
Passive versus active income	Limit the main residence CGT exemption.	Removes distortions in the marketplace.
WET	Remove the WET rebate for unbranded and bulk wine.	To ensure the original policy intent is retained.
	Consideration could also be given to denying the rebate for New Zealand producers.	To ensure the original policy intent is retained.

Introduction

Australians have largely benefited from the strong economic growth that came from implementing major reform measures, such as the introduction of the new tax system in 2000, including the GST. But environments are ever changing and this means that reform needs to be ongoing or we run the risk of stagnating. Putting in place reform measures now can lead to a better future for ourselves, our children, and future generations to come.

A good tax system raises the revenue needed to finance the provision of government services and activities without imposing unnecessary costs on the economy. Tax reform is about improving the tax system as a whole and is not just about raising revenue.

In the current context the Australian Government is spending around $40 billion more than it receives in revenue each year and in order to provide the services that we all rely upon – roads, hospitals, schools – that shortfall is being funded through increasing debt, which brings the added expenditure of interest payments[9].

The two available options are to cut government expenditure or to raise taxes and both bring with them considerable vested interest and political debate. If we are to continue to live in a vibrant and sustainable economy and wish to ensure that our children and future generations will not be worse off, we have to consider both these options in a robust way.

The Australian Government's discussion paper on tax reform provides a comprehensive overview of the challenges our tax system faces from a changing world[10].

In addition, there are trade-offs that need to be considered when trying to balance simplicity and equity. Tax reform should not be viewed through the lens of simply attempting to balance the budget. While expenditure constraints are acknowledged, tax reform should be based on longer term economic efficiency.

The findings from both the Commission of Audit and the Intergenerational Report confirm that we have an immediate tax issue in Australia – the tax system in its current form is simply incapable of raising the revenue required to fund the public services Australians want and expect in the future[11].

We therefore need to have a competitive tax system that raises the revenue required to fund public services while at the same time supporting the most vulnerable and needy within our society.

This requires the implementation of an effective tax system as well as a focus on appropriately targeted government spending. The states and territories raise a significant proportion of their tax revenue from some of the least efficient taxes in our system. The least efficient taxes undermine Australia's living standards, reduce productivity and incomes by discouraging investment and workforce participation, or by directing investment and resources to less valued activities[12].

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[9] Keogh, Mick, GST on fresh food may be a lesser evil, Australian Farm Institute, January 2015, http://www.farminstitute.org.au/ag-forum/gst-on-food-may-be-a-lesser-evil

[10] Australian Government 2015, Re:think – Tax Discussion Paper, http://bettertax.gov.au/files/2015/03/TWP_combined-online.pdf

[11] Corporate Tax Association 2015, Submission to Re:Think Tax Discussion Paper

[12] Local Government Association of South Australia 2013, Submission to the South Australian Parliament's Economic and Finance Committee, http://www.lga.sa.gov.au/page.aspx?u=2970&c=28202

The community expects governments to maintain a strong and sustainable social safety net. However with an ageing population, in the absence of tax reform, significant pressure would be placed on the health system and social welfare expenditure.

The overall framework of the tax and transfers system rests on the broad principle that levels of taxation should reflect ability to pay and that support should be provided when needed. While the lower socio-economic groups should be compensated, the balance of the revenue raised should be invested in the longer term sustainability and viability of our people, specifically in our health and regional wellbeing.

Reform of the tax system is essential to enable this to happen.

Objectives

The overall objective of the project is to develop a shared understanding between key agricultural groups, of the tax reform issues facing the agricultural sector that industry and governments should be focusing on in relation to tax reform.

This report has been framed in terms of the desirable outcomes for the agricultural sector and how Australia's regulatory environment, specifically the tax system, helps or hinders the sector in achieving these outcomes. Desirable outcomes include increased productivity and profitability, regional development, risk mitigation, innovation and succession planning. The aim has been to highlight those areas of the tax system that facilitate achieving these outcomes, providing a case for their retention as well as pinpointing areas where barriers exist and identifying possible alternative approaches.

Participating stakeholders have been engaged during the process with two workshops to provide input into the process and feedback on the report.

Methodology

Initially a selection of submissions to the Australian Government's White Paper process were reviewed. Those selected were the submissions that specifically focused on the agricultural sector. The key issues were summarised and presented to an initial workshop with stakeholders in December 2015 to confirm the key areas of focus and scope of the project.

The second phase of the project and preparation of this report has included broader research on each of the topics. While not in the scope of the project to complete primary research, the authors have completed research of other work such as the Henry Review of Taxation as well as statistical information from ABS and ABARES to assist in building the evidence. The authors have also used their experience and knowledge as tax professionals to develop suggestions of alternatives to the existing system. The focus has been on developing alternatives consistent with the objectives of the report, but also with a priority of practical application.

The third and final stage of the project has incorporated proposals announced in the 2016 Federal Budget that were relevant to the key issues identified in the report.

Chapters

1. Investment in the industry – Broadly and at the individual farm level

1.1 Background and current position

When referring to investment in the agricultural sector, investment is considered from a wide variety of sources and perspectives. It includes potential investment from new participants to the industry such as farmers, institutional investors including superannuation funds, international investors, and even ordinary Australians who are looking to make a passive investment in the industry. It also extends to avenues of accessing possible financing and existing participants expanding their investment, such as a farmer looking at acquiring a neighbouring property or infrastructure such as new plant and equipment to increase their existing productivity.

When considering investment in the industry it is about ensuring the long-term sustainability of the industry.

In terms of attracting investment to the agricultural sector, Dominic McCormick stated "The case for agriculture exposure in investment portfolios remains convincing. The middle class growth in emerging economies and the associated increased protein consumption is one of the major positive factors as is the declining supply of readily available arable land per person. Locally, the recently announced Free Trade Agreement with China and other Asian countries provides a further boost with tariffs for a range of agricultural commodities reduced over time. Over the very long-term agriculture in many countries has offered attractive pre-tax returns and strong diversification benefits showing little correlation with equities and bonds. However, the general perception from an investment perspective is that the operating profitability from many agriculture businesses is poor, is quite volatile and is subject to a range of uncontrollable factors such as commodity prices and weather. Hence, significant/consistent land price increases are required (but by no means certain) to make overall acceptable returns"[13].

While the industry itself has strong prospects and many appealing aspects, to date there is little equity investment in the industry held outside of direct participation.

"Agriculture makes up 53 per cent of Australia's land mass or 406 million hectares (ABS 2015b). There are 115,000 businesses that cite agriculture as their primary activity and a further 13,900 as their secondary activity (ABS 2014a). Of the total number of agricultural businesses in Australia 99 per cent are fully Australian owned (ABS 2013a). Around 97 per cent of farms are classified as small businesses—having annual turnover of less than $2 million (ABS 2013b). International markets perform a significant role with around 65 per cent of Australian agricultural production exported (ABARES 2015b). In 2013–14 farm exports were worth $41.2 billion (ABARES 2015a). Australia exports agricultural products to more than 100 countries. By value, our top three agricultural export destinations in 2013–14 were China ($9 billion), Japan ($3.5 billion) and the United States ($3 billion) (ABARES 2015a). By region, Australia exported agricultural products worth around

[13] McCormick, D 2015, 'Exploring agriculture Investment' *Money Management,* 30 January 2015, http://www.moneymanagement.com.au/expert-analysis/editorial/exploring-agriculture-investment

$17 billion to North Asia, around $8 billion to South-East Asia, and over $3 billion each to the Middle East, the Americas and Europe (ABARES 2014)"[14].

It would therefore appear that there is a clear opportunity to gain investment from passive investors through some form of business structure, but to date take up has been low. As shown under the topic titled 'Managed investment schemes', while attempts have been made in relation to this prospect, the focus on tax benefits rather than making a sound investment decision has skewed the results and perceptions in the industry. Further, while there have been attempts at more traditional investment models, the market has tended not to view them favourably. For instance, when Prime Ag was listed it did not take long for the share price to drop to around 50 per cent of its net asset value (NAV) suggesting the market viewed the relatively low cash returns as a more significant factor in investment decisions than longer term growth, supporting the notion that share markets in general have a shorter term focus.

There are also suggestions that certain agricultural practices can create potential social impediments to investing in agriculture, particularly as a passive investment (e.g. mulesing, battery hens, etc.).

In terms of direct investment, the Agricultural Competitiveness White Paper[15] stated "With the average broadacre farm worth around $4 million (ABARES 2015c), opportunities for young people (outside family succession) and new industry entrants to independently own and operate properties are increasingly scarce."

This highlights the significant capital hurdle that needs to be reached to enter into the industry and the need for ongoing sources of investment to not only be profitable in the long term but also sustainable.

It is therefore unsurprising that foreign investment is becoming more prevalent in this sector. It was stated in the Agricultural Competitiveness White Paper "Foreign investors will also play a critical role. Foreign investment can benefit farmers in several ways. Inwards and outwards investment can help our farmers to specialise and become better integrated with a global agricultural market that is increasingly characterised by global and regional supply chains. Foreign investment can also help farmers harness the capital needed to adopt new technologies, which is vital to improving incomes. But as with all foreign investment, foreign investment in agriculture must be delivered in ways that are in Australia's interests."

While there are significant opportunities to attract investment to the sector it is certainly not without its challenges.

In terms of the tax systems, while governments are supportive of attracting investment and improving productivity in the sector, it does need to carefully balance this with protecting the national interest and maintaining the integrity of the tax system, while also ensuring fairness to the Australian public as a whole.

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[14] Australian Government 2015, Agricultural Competitiveness White Paper, http://agwhitepaper.agriculture.gov.au/SiteCollectionDocuments/ag-competitiveness-white-paper.pdf

[15] Australian Government 2015, Agricultural Competitiveness White Paper, http://agwhitepaper.agriculture.gov.au/SiteCollectionDocuments/ag-competitiveness-white-paper.pdf

There are currently a number of provisions in the income tax legislation that encourage direct investment in agriculture and agricultural assets. Depreciation rates are typically generous, particularly for small primary producers. The current position can be broken down into three main sections, being:

1. General depreciation allowances;
2. Simplified depreciation for small business entities (SBEs); and
3. Depreciation and other capital write-offs specific to primary producers.

1.1.1 General Depreciation allowances

There was an increase in the accelerated depreciation calculation methodology on 10 May 2006 from 150 per cent/effective life to 200 per cent/effective life. This significantly increased the available depreciation claims, for example the depreciation rate for a tractor went from 22.5 per cent to 30 per cent based on a $6^{2/3}$ years effective life (TR 2015/2[16]).

Immediate write-offs are limited to items costing less than $100, while items between $100 and $1,000 can be allocated to a low value pool which is depreciated at 37.5 per cent (or 18.75 per cent in the first year). All new eligible assets under $1,000 must be allocated to the pool if one has been established, while existing eligible assets that fall below $1,000 written down value and have been depreciated under the diminishing value method are able to be allocated to the pool.

1.1.2 Simplified depreciation for SBEs

Simplified depreciation rules applying to small business (<$2 million turnover - <$10 million announced in the 2016/17 Federal Budget) are generous considering the rate is 15 per cent in the first year and 30 per cent thereafter. Further, there are immediate write-offs for assets costing less than $20,000 post 12 May 2015 until 30 June 2017 (from 1 July 2017 the immediate write off threshold is set to return to $1,000). All eligible assets must be included in the pool.

1.1.3 Depreciation and other capital write-offs specific to primary producers

12 May 2015 saw the introduction of additional measures for primary producers. One of the reasons for these measures was to better prepare primary producers for drought conditions (including more effective grazing management, hence the inclusion of more accelerated rates for fencing deductions).

1. Landcare – immediate deduction on expenses related to Landcare operations.
2. Water improvements immediately deductible – previously over three years.
3. Fencing (not portable yards) immediately deductible – previously effective life of 30 years (6.67 per cent diminishing value).
4. Fodder storage assets deductible over three years – a steel grain silo effective life was 30 years (6.67 per cent diminishing value) previously.

[16] Australia Taxation Office 2015, Taxation Ruling - TR 2015/2, https://www.ato.gov.au/law/view/document?docid=%22TXR%2FTR20152%2FNAT%2FATO%2F00001%22

5. Horticultural plants and grape vines – can claim the cost of acquiring and planting the seeds and specific direct expenses related to establishing the plants on a more accelerated basis than the general effective life of the plant (note, clearing land is not included but ploughing and developing soil composition is). Previously grape vines could be written off over four years – now they are treated like other horticultural plants.

1.1.4 Foreign Investment

There are a number of perceived risks posed to the Australian national interest as a result of significant foreign investment in Australian land, and as a consequence foreigners are required to obtain approval from the Foreign Investment Review Board (FIRB) for proposed acquisitions of agricultural land where the cumulative value of Australian agricultural land owned by the foreign person (including the proposed acquisition) exceeds $15 million.

Foreign persons are also required to be approved by the FIRB when taking a direct interest of $55 million or more in an agribusiness regardless of its total value. Under the terms of Australia's free trade agreements, investors from the United States of America, New Zealand, Chile, Singapore and Thailand are subject to higher thresholds before approval is required. Application fees to obtain approval from the FIRB range from $5,000 to $100,000.

In addition to this, from 29 February 2016 all foreigners who hold an interest in agricultural land in Australia must register that interest on the Agricultural Land Register. The first data from this Register was released in September 2016 and showed that more than 85 per cent of all agricultural land is owned by Australians. While one in seven hectares of agricultural land was foreign-owned, most of this was leasehold. Of the total 384.6 million hectares of agricultural land on the Register, 52.1 million, or 13.6 per cent, was owned offshore. UK investors own the most agricultural land - 7.2 per cent out of the total of 13.6 per cent - with the US coming in second with 2 per cent of the total. Chinese investors own the fifth largest amount, or 0.4 per cent of the total land that is foreign-owned[17]. It may be useful for the value (not just area) of the land to be captured in the report compared with the value of other rural land, however we acknowledge that this data would not be easy to include as it is not readily available and continuously changes based upon infrastructure improvements and the like.

Foreign investment poses a number of tax related challenges. For example, there are a number of international jurisdictions with tax rates that are significantly lower than Australia, creating an incentive for taxpayers to prefer profits to be taxed outside of Australia, and a number of disparities in the tax treatment of various income sources of non-residents, creating arbitrage benefits in structuring decisions.

For instance, at present where a non-resident is paid amounts of interest income, they are generally subject to a 10 per cent final withholding tax in Australia (a measure that was introduced to encourage foreign investors to lend funds to Australians). Unfranked dividends however, are generally subject to a final withholding tax of 15 per cent in Australia and franked dividends are not taxed further in Australia, but non-residents are not entitled to a refund of excess imputation credits.

To limit unintended tax leakage as a result of these opportunities there are a number of complex measures currently in place including:

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[17] Australian Government*, Register of Foreign Ownership of Agricultural Land, Report of registrations as at 30 June 2016,* Australian Taxation Office, September 2016

1. Transfer pricing provisions. While too complex to provide a complete overview of their operation in this paper, the broad intention behind these provisions is to ensure that value that has been created in Australia is taxed in Australia.

   For example, if an Australian company were to sell a module of cotton to a foreign parent entity located in a lower tax jurisdiction who then sells that module in the home country, it has an incentive to sell the module to its parent entity for as low a price as possible thereby removing income from Australia (a higher tax jurisdiction) to a foreign jurisdiction. Note that this does not impact on the value generated to the group as a whole on the sale of the module itself (only to the amount of tax and the country where the tax is paid).

   To reduce this risk, the transfer pricing provisions operate to ensure that such transactions occur at market value and require that market evidence is obtained to support the true market price of items that are transferred between related parties and involve a foreign jurisdiction.

   If this evidence is not documented before the relevant tax return is lodged, the ATO is able to insert its own assessment of market value to the affected transactions and impose penalties as if no reasonably arguable position were held when the return was lodged.

   At present there are no thresholds as to when this documentation is required and the amount of information that is required is proving expensive to obtain.

2. Thin capitalisation provisions. These rules were enacted to prevent multinational enterprises shifting profits out of Australia by funding their Australian operations with high levels of debt and relatively little equity in order to reduce their Australian taxable income.

   They achieve this purpose by limiting deductions for interest expense and borrowing costs (debt deductions) where debt-to-equity gearing ratios exceed prescribed debt limits. If Australian operations have debt above the maximum allowed threshold, debt deductions will be disallowed.

   There are a number of different debt limits for calculating the maximum debt allowed including the 'safe harbour' limit, 'arm's-length' limit and the 'worldwide gearing' limit. These debt limits vary depending on the kind of entity. Entities can choose the debt limit to use. Consideration of which debt limit to use will depend on which one gives the highest deduction and which one is easiest to apply.

   These provisions only apply once total debt deductions exceed $2 million.

   For inward investing non-Authorised Deposit-taking (non-ADI) foreign entities with Australian investments, the maximum amount of debt will generally be the greater amount determined under:

   - The safe harbour debt test - the amount of debt used to finance the Australian investments will be treated as being excessive when it is greater than that permitted by the safe harbour gearing limit of 1.5:1; and

   - The arm's length debt test - the amount is determined by conducting an analysis of the entitys' activities and funding to determine a notional amount that represents what would reasonably be expected to have been the entity's maximum arm's length debt funding of its Australian business during the period.

   In effect, while these rules do not alter the fact that a final 10 per cent withholding is applied on interest paid to non-residents, they do prevent the company from claiming a tax deduction on these excessive interest payments, applying an effective 40 per cent tax rate to the interest.

A further impediment to investing in primary production land is the potential levying of land tax. Currently most states and territories provide a blanket exemption from land tax to primary production land, except for Queensland which does generally provide this exemption, except when the land is held by foreign owners.

1.1.5 Free Trade Agreements and investment in agriculture

Free Trade Agreements (FTAs) aim to promote stronger trade and commercial ties between participating countries and open up opportunities for Australian exporters and investors to expand their business into key markets. They are particularly beneficial when they seek to remove barriers in highly protected markets or gain a foothold in potential or expanding markets. They can also facilitate investment in Australia by lowering barriers for investment.

Australia has FTAs in force with China, Japan, Korea, New Zealand, Singapore, Thailand, United States of America, Chile, the Association of South East Asian Nations (ASEAN) (with New Zealand) and Malaysia. Negotiations currently in place include India, Indonesia and the Trans-Pacific Partnership Agreement (TPP).[18]

With the China FTA coming into force in December 2015, potentially significant investment can be made in Australia. For example, just one investment fund is expected to invest as much as $3 billion into the Australia agricultural sector aiming to create a supply chain stretching from Australian cattle stations to Chinese supermarkets[19].

Australia needs investment and has a clean green product to sell however, appropriate management of investments is necessary and greater access cannot be taken for granted. While caps that limit foreign investment levels have been lifted, this will not mean free access to the market and a number of restrictions have been included in agreements that may create future hurdles for investment in Australia by foreign companies.

Investment also needs to be placed in context. For example, while Chinese investment in Australia has increased from $3 billion to approximately $32 billion over the past decade, this still only represents 1.3 per cent of total foreign investment in Australia, primarily in the resources sector, although this is expected to grow into agribusiness, property and services[20].

Although China is Australia's biggest trade partner, Chinese investment can raise controversy, particularly investment in agricultural land and foreign direct investment by state-owned businesses. Under the China FTA, the Australian government will be able to screen investment proposals by private investors from China in agricultural land valued from $15 million and agribusiness from $53 million. Investment proposals from Chinese state-owned enterprises will continue to be screened regardless of value. This is consistent with FTAs with Korea and Japan.

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[18] Department of Agriculture and Water Resources 2015, Free Trade agreements (FTAs), http://www.agriculture.gov.au/market-access-trade/fta

[19] Welch, D 2015, 'China free trade agreement expected to tip billions into Australian farms, dairy industry to be popular with investors , *ABC News*, 1 September 2015, http://www.abc.net.au/news/2015-09-01/china-fta-deal-tipped-to-transform-australian-farming-sector/6741560

[20] Rowland n.d., Challenges prevail for unprepared investors in free trade environment, http://www.rowland.com.au/challenges-prevail-for-unprepared-investors-in-free-trade-environment/

While the focus on FTAs has provided greater clarity around the rules for foreign investment, it has also heightened public interest. Therefore, good community engagement and communication will be essential to address perceptions and enable a flow of investment dollars into Australian agriculture.

1.2 Issues associated with current position

A key to attracting passive investors to the sector as provided in the Agricultural Competitiveness White Paper is for "Australian farm businesses to demonstrate value and provide investable products that allow external investment"[21].

To assist in demonstrating value it is vital that these businesses become more profitable from their operations than has historically been the trend and to reduce the reliance on increasing land prices.

The Tax Discussion paper provided "Higher performing farms tend to invest more (Figure 5). For the three years ending 2011–12, the top 25 per cent of broadacre and dairy farms accounted for 64 per cent of the net capital additions on farms, compared to two per cent for the bottom 25 per cent (ABARES 2013)." and "Investing on-farm is essential to improve sustainability and drive growth"[22].

Increasing investment in agricultural operations is therefore critical to their long term sustainability.

It should come as no surprise that the higher performing farms tend to invest more due to the way the current investment measures are predicated. Tax legislation incentives are heavily weighted towards accelerated depreciation concessions across all industries as a whole but this is accentuated for primary producers. These incentives are however, only beneficial if there is assessable income to offset the deductions and generally they have no immediate benefit in overcoming the high start-up costs associated with newcomers investing in the industry.

In terms of research and development, less than 2 per cent of the $614 million research and development tax offset recognised in the 2010-11 year was attributable to agriculture, forestry and fishing. Furthermore public expenditure on research and development (R&D) in agriculture, which grew at an average of 6.5 per cent a year between 1953 and 1980, has since grown at only 0.6 per cent a year' according to an ABARES report published in 2011[23]. The Government largely recognises that small producers cannot gain the economic return from individual R&D investment and thus provides funding to rural R&D corporations directly to achieve desired levels of innovation. 2014-15 saw a boost of $100 million over four years in competitive grants on top of the $250 million provided annually[24].

It is essential that individuals who choose to invest in the sector are not at a comparative disadvantage as opposed to investments in other assets. As discussed under the topic heading "Non-commercial losses" the existing non-commercial loss rules and particularly the existence of the $250,000 other income test, makes investing in business less attractive than, for example, investing in a negatively geared investment property.

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[21] Australian Government 2015, Agricultural Competitiveness White Paper, http://agwhitepaper.agriculture.gov.au/SiteCollectionDocuments/ag-competitiveness-white-paper.pdf

[22] Australian Government 2015, Re:think – Tax Discussion Paper, http://bettertax.gov.au/files/2015/03/TWP_combined-online.pdf

[23] Moir, B and Morris. P 2011, 'Global food security: facts, issues and implications', ABARES Science and Economic Insights, Issue 1 – 2011.

[24] Department of Agriculture and Water Resources 2015, Research and Innovation, http://www.agriculture.gov.au/ag-farm-food/innovation

While it is necessary to maintain safeguards to prevent tax revenue leakage there does need to be a measure of balance. In relation to transfer pricing, where there are significant costs in producing transfer pricing documentation but little risk of tax leakage, this is an unnecessary safeguard. For example, there is at times clear evidence of the market value of a transaction. Where this is the case, there is no benefit or mischief involved in simply allowing that source as being sufficient evidence. For instance, commodities are traded on active markets on a regular basis with often daily prices being listed. It would be appropriate to allow business the choice of using these prices as proof of market value.

Further, many of the international tax issues and the need for complex safeguards are as a result of relative arbitrage benefits in where or how profits are taxed. It was stated in the Tax Discussion Paper "Lowering our corporate tax rate would also reduce the underlying incentive for companies to engage in profit shifting, debt loading and tax avoidance"[25].

The Tax Discussion Paper also more broadly provided "Corporate tax rates that are increasingly uncompetitive will make it harder for Australia to continue to attract necessary investment. Ongoing investment in Australia is one of the key drivers of labour productivity and growth. Furthermore, high corporate tax rates increase the incentives for companies to engage in tax planning, such as profit shifting."

The Tax Discussion paper also stated "Reducing Australia's corporate tax rate would increase Australia's appeal as a place to do business. It would encourage higher levels of investment in Australia and lead to capital deepening, which promotes growth in productivity, innovation, employment and wages. In the near term, lower taxes would provide an increased incentive for non-residents to invest in Australia. In the long run, increased investment would benefit all Australians"[26].

Australia's company tax rate is becoming increasingly uncompetitive and tax is one important factor influencing decisions to invest in Australia. The statutory corporate tax rate of 30 per cent competes with an average of 22 per cent in Asia and 25 per cent across the Organisation for Economic Co-operation and Development (OECD).[27]

The trend to further lower company tax rates abroad is leaving Australia behind, exacerbating the already large costs of lost investment opportunities. The United Kingdom (UK) has recently announced its company tax rate will fall to 18 per cent by 2020. Australia is now in the position of having one of the highest corporate tax rates in the OECD.

A recent report by PwC estimates the growth dividend from a 25 per cent corporate tax rate would generate $24 billion in income tax revenue by 2024-25, with net income tax receipts estimated to be $10 billion higher by the middle of the decade. PwC's modelling assumes phasing in over five years.[28]

Modelling by KPMG for the Financial Services Council proposed cutting company tax to 22 per cent.[29]

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[25] Australian Government 2015, Re:think – Tax Discussion Paper, http://bettertax.gov.au/files/2015/03/TWP_combined-online.pdf

[26] Australian Government 2015, Re:think – Tax Discussion Paper, http://bettertax.gov.au/files/2015/03/TWP_combined-online.pdf

[27] KPMG 2016, http://www.fsc.org.au/downloads/file/ResearchReportsFile/GST.pdf, http://www.fsc.org.au/downloads/file/ResearchReportsFile/GST.pdf

[28] Greber, J 2015, 'A 25pc company tax rate pays its way within five years, says PwC', *Australian Financial Review*, 23 November 2015, http://www.afr.com/news/policy/tax/a-25pc-company-tax-rate-pays-its-way-within-five-years-says-pwc-20151123-gl5qet

The small business company tax rate has been reduced from 30 per cent to 28.5 per cent for income years commencing on, or after 1 July 2015 (noting the proposed reduction to 27.5% from the 2016-17 income year announced in the 2016-17 Federal Budget). The corporate tax rate will remain at 30 per cent for all other companies that are not small business entities, subject to whether or not changes announced in the 2016/17 Federal Budget are legislated. A reduction to 25% over 10 years has been proposed, with staggered annual aggregated turnover thresholds, gradually extending the eligibility from companies with annual aggregated turnover less than $10 million to all companies (from 2024-25).[30] See details below:

Proposed changes to business tax rates in the 2016 Federal Budget

From 1 July 2016, businesses with annual turnover less than $10 million will have a company tax rate of 27.5 per cent. The company tax rate will be progressively lowered to 25 per cent by 2026-27 for all companies.

A range of concessions (with the exception of the Small Business CGT concessions) already available to small businesses with turnover less than $2 million will be extended to all businesses with turnover less than $10 million from 1 July 2016.

The tax discount will be increased to 8 per cent (from 5 per cent) for unincorporated businesses with annual turnover less than $5 million, capped at $1,000. This discount will be further increased in phases to reach 16 per cent by 2026-27.

To ensure international competitiveness, there is strong evidence to support a reduction in the company tax rate for all companies, to be phased in over a set period, with a target rate of 22 per cent. See above paragraph regarding the proposed company tax rate changes announced in the 2016/17 Federal Budget.

Stamp duties remain a significant barrier of entry into the sector especially under the traditional model including land ownership. These duties generally represent a significant up front barrier of entry into the sector.

1.3 Areas for consideration

The low value depreciation pool threshold could be increased immediately for those not meeting the SBE definition, from $1,000 to $5,000.

For taxpayers meeting the SBE definition, when the current $20,000 write-off provisions end in 2017 they could also revert to $5,000. This reduces the administration burden for businesses and ultimately depreciation only impacts on the timing of allowable deductions.Considering that producers are likely to invest more heavily back into their business in good years (as this is when they have the available cash resources) it appears appropriate to maintain and increase access to accelerated depreciation provisions to offset this income in these good years (particularly for some industries). This would promote even further investment rather than waiting for tax benefits to be provided in future less profitable years when investment is less likely to occur.

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[29] KPMG 2016, http://www.fsc.org.au/downloads/file/ResearchReportsFile/GST.pdf, http://www.fsc.org.au/downloads/file/ResearchReportsFile/GST.pdf

[30] Australian Government 2016, Budget Measures Budget Paper No. 2 2016-17, http:// budget.gov.au/2016-17/content/bp2/html/

Consideration could be given to options available to attract new entrants into the sector (particularly in light of the significant barrier to entry associated with average farm value) including:

- The possible introduction of start-up loans analogous to the former Farm Finance Concessional loans to help break down the barriers of entry for new entrants wanting to get into agriculture. Key criteria for entry could include being a first farm buyer with farm management experience and provision of a strong business plan consisting of projected 5 year budgets with sensitivity analysis. It is noted that some states have versions of this option in place, such as the Queensland First Start Loan Program.

- The possible introduction of stamp duty concessions for new entrants into the sector.

- The possible provision of specific tax incentives for new entrants into the sector. For instance possibly providing refundable tax offsets similar to the conservation tillage refundable tax offset for certain expenditure considering that accelerated deductions are often not advantageous in early years as often losses are incurred.

It is noted that while enticing new entrants into the sector is considered a key issue, care needs to be taken to ensure that markets are not inappropriately distorted by the levers that are utilised.

Consideration could be given to setting a threshold, below which the transfer pricing provisions do not apply or at least only apply in a minimal simplified format. For consistency, a $2 million threshold set equal to the thin capitalisation rules would appear appropriate.

The transfer pricing rules could be updated to enable taxpayers the option of using readily available third party market value evidence to support adopted prices rather than requiring more formalised documentation further reducing the documentation required under the current comparable uncontrolled price (CUP) method. Proposed changes were announced in the 2016/17 Federal Budget to align our rules more closely with OECD Guidelines, however these changes are focused on intellectual property and hard-to-value intangibles, and are unlikely to have much application for agriculture.

Continued efforts could be made to reduce the corporate tax rate to ensure it is internationally competitive, preferably with an aspirational target rate of 22 per cent.

The succession planning section of this report includes additional considerations relating to investment decisions associated with ownership changes as part of ongoing family succession plans.

1.4 Impact of alternatives considered

The agricultural industry is generally very capital intensive, therefore an increased low value pool for those with revenue in excess of $2 million would help alleviate compliance in managing unnecessarily large depreciation schedules and help remove the need to separately identify insignificant/immaterial assets. A recommendation of the Henry Review[31] was to have these assets be immediately deductible rather than enter a low value pool. A large contingent (98.82 per cent) of the agriculture, forestry and fishing businesses are classified as SBEs and thus fall under the SBE rules, resulting in little revenue impact from such an outcome.

It is noted that the proposal in the 2016 Budget to increase the SBE threshold from $2 million to $10 million will provide access to simplified and ealier write-off provisions for many more businesses.

[31] The Commonwealth of Australia 2010, Australia's Future Tax System – Report to the Treasurer, http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/AFTS_Final_Report_Part_2_Vol_1_Consolidated.pdf

An ageing workforce is a key risk for the farming industry and the promotion of youth into the sector through an implemented strategy would alleviate this. At the 2011 ABS census the average age of a farmer was 53 compared to 40 years for other occupations.

Setting a threshold for the application of the detailed transfer pricing rules will reduce the red-tape and costly administration requirements that do not provide a significant safeguard to tax revenue leakage.

Allowing readily available market price information in place of costly detailed documentation streamlines the process, provides variable supporting information of a true market price and eliminates the need for costly third party documentation to be produced, while ensuring that market rates are in fact used.

Reducing the corporate tax rate will make it more attractive for international investors to choose to invest in Australia, leading to increased growth and productivity. The proposal in the 2016 Budget to reduce the tax rate for small businesses with a turnover of less than $10 million to 27.5 per cent and the proposal to decrease the tax rate on all companies to 25 per cent over ten years will make Australia more competitive.

2. Investment in the industry – Non-commercial loss provisions

2.1 Background and current position

The non-commercial loss rules were introduced in 2000, following recommendations from the Review of Business Taxation[32]. It was stated that they were aimed at improving the integrity, fairness and equity of the tax system, by addressing the opportunity for individuals to avoid tax by carrying on unprofitable business activities and claiming deductions for losses arising from such activities against their other income.

Specifically it was stated "Many of these activities are no more than hobbies and/or lifestyle choices but even those that have business like characteristics (according to existing law) are often unlikely to ever make a profit and do not have a significant commercial purpose or character".

The restrictions associated with these rules are an impediment to certain taxpayers investing in the agricultural industry.

Under the current non-commercial loss provisions that are contained within Division 35 of ITAA1997 a business loss that an individual taxpayer incurs (either alone or as a partner in a partnership) can only be deducted against the taxpayer's other taxable income if the individual income requirement and one of the four business related tests is satisfied.

The income requirement prevents individuals from deducting business losses if their adjusted taxable income (excluding the business loss) exceeds $250,000. The business related tests require the business activity that generated the loss to:

- Derive at least $20,000 in assessable income;
- Result in a taxable profit in at least three out of the last five years;
- Use real property with a total market value of at least $500,000 in the business on a continuing basis; or
- Use other assets with a total tax value of at least $100,000 in the business on a continuing basis.

If these requirements are not satisfied the loss is quarantined to the business activity (i.e. the loss is carried forward to potentially offset income from that business activity in a later period).

When the $250,000 income requirement was introduced in the 2009-10 Federal Budget, the announcement (as contained in Budget Papers No.2)[33] provided "The new test for taxpayers with adjusted taxable income greater than $250,000 will restrict the ability of such taxpayers to claim losses for non-commercial activities that are more likely to be in the nature of lifestyle choices or hobbies".

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[32] Review of Business Taxation 1999, Item 7 Specific Equity Concerns, http://www.rbt.treasury.gov.au/

[33] Australian Government 2008, Budget 2009-10 Paper Number 2, http://www.budget.gov.au/2009-10/content/bp2/html/bp2_revenue-05.htm

This is considered to be an anomalous statement as no deductions were ever allowed when expenses are incurred for a private or domestic purpose. It therefore appears that on an objective assessment the income requirement applies to deny high income earning individuals from deducting business losses against other income regardless of the scale or nature of the business.

The Budget Paper also provided the following estimates of impact on the revenue:

Revenue ($m)

	2008-09	2009-10	2010-11	2011-12	2012-13
Australian Taxation Office	-	-	330.0	240.0	130.0

It is unclear if the estimated reducing impact on revenues is an indication that it was expected that taxpayers would exit these activities if the tax benefits were removed or if they would simply restructure their tax affairs to negate the provision.

There is a Commissioners discretion available to allow deductions from these so called non-commercial activities to be claimed against other income however, where the tests are failed, there is generally limited scope as to whether the discretion is available. In addition, the process can be quite costly in terms of professional fees for the relevant application and advice.

An exception to the quarantining rules also exist for sole traders or partners in a partnership carrying on a primary production or professional arts business with assessable income from other sources that is less than $40,000 (excluding any net capital gain).

In contrast to the non-commercial loss rules there is currently no income requirement or other set of specific rules to prevent deductibility of losses from non-business activities such as negatively geared rental properties against other income. Instead, it relies upon general rules and established case law.

For example:

- One of the positive limbs to s8-1 of ITAA1997 (the general deduction provision) requires that the outgoing be incurred for the purpose of producing assessable income. This has led case law (for example Fletcher & Ors v FC or T 91 ATC 4950) to conclude that if there is no objective expectation to profit over the life of the activity (i.e. no prospect of becoming profitable) that the deductions be apportioned to the objective purpose and generally limited to the income received.

- One of the negative limbs to s8-1 of ITAA1997 prevents deductions of expenses that are incurred of a private or domestic nature.

Further, it was stated in the Agricultural Competitiveness White Paper[34] “The non-commercial loss rules have discouraged investment in agriculture relative to other investments, such as property, where negative gearing provisions apply. It has also discouraged farmers from building up off-farm assets as a strategy for building farm resilience”.

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[34] Australian Government 2015, Agricultural Competitiveness White Paper, http://agwhitepaper.agriculture.gov.au/SiteCollectionDocuments/ag-competitiveness-white-paper.pdf

It is important to keep in mind that these rules only operate to quarantine losses from an activity and they can be applied to reduce income when the activity becomes profitable. They do not result in deductions or losses being forfeited unless profits are never generated.

2.2 Issues associated with current position

There are a number of concerning facts about these provisions as they are currently drafted which include:

1. There is a clear disconnect between the stated intent of the non-commercial loss provisions and the current operation that simply denies excess deductions from any business regardless of whether it is commercial or not once an individual's other income exceeds $250,000. Specifically whether a business is commercial or not is irrelevant where the $250,000 income test is failed.

2. The $250,000 threshold was introduced to apply to the 2009-10 and subsequent income years and has not been increased and there is no current mechanism to have it periodically assessed for appropriateness or ensure that it is at least maintained in line with inflation (meaning the effective threshold is continually being eroded).

3. There are disparities arising between taxpayers as a result of the types of activities they undertake and the source of their losses. For instance, if an individual invests their capital in a farming operation (a business) that makes a loss, then they are caught up in these rules and if they fail the tests the loss will be quarantined and not available to offset any other taxable income. If however, they choose to invest in a rental property that is simply an investment activity as opposed to a business, then these rules have no application and providing they have a prospect to profit from the investment over the life of the investment, they are able to apply the losses to offset their other income (commonly referred to as negative gearing).

4. There are also significant disparities between taxpayers that arise as a result of structure choices. Specifically these rules only apply to individuals and not to companies or trusts. As a result, if an individual receives more than $250,000 income from a share portfolio and conducts a farming business that operates at a loss they will pay tax on the full investment income and the loss from the farm will be deferred. However, if they operated the business and held the investments through a trust, the business loss would reduce the investment profit and result in lower tax paid even if distributed by the trust to the same individual.

5. Although the Commissioner has discretion to not enforce losses to be quarantined under this Division it is only available in certain situations. For instance

    a. The business activity was or will be affected in the excluded years by special circumstances outside the control of the operators of the business activity, including drought, flood, bushfire or some other natural disaster (s35-55(1)(a))

    b. Where the income requirement is failed (s35-55(1)(c)):

        I. because of its nature, it has not produced, or will not produce, assessable income greater than the deductions attributable to it; and

II. there is an objective expectation, based on evidence from independent sources (where available) that, within a period that is commercially viable for the industry concerned, the activity will produce assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsections 35-10(2) and (2C)).

This effectively means if losses are created as a result of legitimate commercial considerations that are within the control of the taxpayer, there is no discretion available. For example, if there is a normal lead time of, say four years for a farming operation to become profitable (assuming there is a normal lead time to establish the business, for instance it may take some time for a cotton farmer to establish reliable water sources and undertake laser levelling before a commercial crop can be harvested) but a particular taxpayer chooses to develop the property over say 10 years (a large scale property with one field developed each season as funding becomes available) then once the 'ordinary' four year period lapses, later losses will be quarantined irrespective of the fact that this is a genuine commercial business being operated in an efficient commercial manner.

6. Currently the ATO have taken the position that where an FMD is withdrawn, it is not considered income from the business activity from which the deposit was originally sourced unless the same business is being conducted at the time the FMD is withdrawn. This is evidenced at para 92E of TR 2001/14[35]. It is also noted that former ATO ID 2004/112[36] (now withdrawn as it is stated to be no longer current) previously provided that the funds from the withdrawal also needed to be reinvested back into the business. While this requirement was not restated in revised TR 2001/14, suggesting the ATO may no longer hold this view, in practice the ATO have since its withdrawal continued to ask how the funds are used in a review situation adding to the current uncertainty on the official position. Even stating that the same business needs to be conducted at the time of withdrawal seems unnecessary and contradictory to the intention of the rules. For instance, if a taxpayer ceases primary production activities and the deposit is automatically treated as being withdrawn 120 days after cessation (when no business activity is being conducted) the current position suggests that the withdrawal will not be considered income from the relevant primary production activity. This would mean the FMD withdrawn will itself be counted as income in the $250,000 other income cap. If this income cap, including the FMD withdrawal, exceeds $250,000 it would result in the FMD withdrawn amount being taxable and any business loss being quarantined simply because it was withdrawn after the business ceased rather than immediately prior to cessation.

7. From a practical perspective, under the current position it can often be difficult to determine if an activity amounts to a business or not. Although each case depends on its own particular facts, the courts have indicated that the following eight indicators are relevant:

- Whether the activity has a significant commercial purpose or character;
- Whether the taxpayer has more than just an intention to engage in business;
- Whether the taxpayer has a purpose of profit and a prospect of profit;
- Whether there is repetition and regularity of the activity;

[35] Australian Taxation Office 2014, Taxation Ruling - TR 2001/14, https://www.ato.gov.au/law/view/document?Docid=TXR/TR200114/NAT/ATO/00001

[36] Australian Taxation Office 2004, Taxation Ruling - TR 2004/112, http://law.ato.gov.au/atolaw/view.htm?docid=%22AID%2FAID2004112%2F00001%22

• Whether the activity is of the same kind and carried on in a similar manner to that of the ordinary trade in that line of business;

• Whether the activity is planned, organised and carried on in a businesslike manner such that it is directed at making a profit;

• The size, scale and permanency of the activity; and

• Whether the activity is better described as a hobby, a farm of recreation or a sporting activity.

While all factors are considered, there are often both positive and negative factors requiring consideration and a subjective weighting needs to be applied to determine, on balance, if the activity amounts to a business.

8. Under the current criteria specified in the non-commercial loss rules, the tests do not necessarily reflect if a legitimate commercial business is in fact being conducted. For instance if land is owned in close proximity to a capital city it is not uncommon for the land to be worth more than the current $500,000 threshold enabling one of the tests to be satisfied and losses not be quarantined even if the size of the operation may be small.

2.3 Areas for consideration

Firstly it is important to consider the purpose and intent of these provisions. It seems apparent that:

1. The $250,000 income threshold is designed to prevent the wealthy from offsetting business losses from their other income regardless of whether the activity is commercial; and

2. The remaining four business-related tests are designed to provide additional clarity over when an activity is considered to amount to a commercial business activity.

Consideraton could be given to the following:

1. The business related tests be modified to more accurately reflect if a commercial activity is in fact being conducted to ensure that the rules are better targeted. It is considered that the income and profit tests remain appropriate but that the two asset tests should be removed.

2. The $20,000 income threshold was set in the year 2000 and has not been indexed or modified since. It could be reset to current values and indexed going forward to remain appropriate.

3. If the business related tests are modified as suggested, then there is no need to continue to retain the $250,000 other income threshold.

To ensure that the markets are not distorted and that a tax benefit is not available to non-business activities, the non-commercial loss rules could be extended to apply equally to other investment activities, including negative gearing.

2.4 Impact of alternatives considered

Under this approach, integrity measures will be retained but will become better targeted to meet the actual intent of the provision. In addition, this will eliminate imbalances in the tax system that arise from structure or investment decisions and promote taxpayers to conduct their affairs and make their decisions from a more commercial and less tax driven position.

This provides a freer market and encourages greater investment in the industry leading to the ultimate goal of increased productivity. Greater productivity leads to greater profitability of businesses and therefore tax revenue.

2.5 Case study

Individual A receives $300,000 per annum from a share portfolio and purchased a 10,000 hectare cotton farm in northern NSW that is being developed over a five year period, due to limited bank financing being available and the commercial availability of contractors and equipment to perform the development. Initial investment in the farm is $6 million with an annual development budget of $1 million and 20 per cent of the property is to be developed each year.

Cotton crops are expected to generate $1 million of sales revenue annually from each 20 per cent developed area. It is anticipated that annual operating expenses will be approximately $750,000 per 20 per cent area and tax concessions under subdivision 40-G provide an entitlement to claim the $1m development costs in full each year.

As a consequence the following results are expected to be achieved from the farming operation.

	Year 1	Year 2	Year 3	Year 4	Year 5
Trading income	$1,000,000	$2,000,000	$3,000,000	$4,000,000	$5,000,000
General deductions	$750,000	$1,500,000	$2,250,000	$3,000,000	$3,750,000
Capital deductions	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Taxable income/(loss)	($750,000)	($500,000)	($250,000)	$0	$250,000

Under the non-commercial loss rules Individual A will pay tax on the $300,000 investment income throughout the five year period and the losses from the business will be quarantined and carried forward. If the taxpayer had instead invested through a trust and conducted the farming business through the same trust (or simply distributed the investment income to another trust that conducted the farming business where both trust had made a family trust election specifying the same test individual), the income from the investments would have been offset by the loss from the business.

Alternately, if Individual A purchased the property but leased it to a company or trust who conducted the business then it would be treated as an investment property and any losses from negative gearing could be offset against the investment income. (Note there is a practical issue in whether the trading entity or land owner incurs the development costs, as only the farmer is entitled to the capital deduction. However, if the farmer conducts the development, it is the land-owners land that increases in value.)

3. Investment in the industry – Managed investment schemes

3.1 Background and current position

There are two very distinct styles of managed investment schemes (MIS) - that being pooled schemes and common enterprise schemes. It is the second of these that are known as tax effective MIS.

Pooled schemes involve contributions by scheme members being pooled and becoming scheme property, for use in scheme investments or otherwise to operate the scheme. Schemes of this type are typically established as trust-based investment arrangements, with scheme members playing no active role in the affairs of the scheme. Examples of pooled trusts include listed property trusts that are often stapled to shares.

Common enterprise schemes involve the use of member contributions in a common enterprise that constitutes the scheme, without those contributions being pooled. In these forms of entrepreneurial arrangements, a distinction must be drawn between scheme property and property owned by individual scheme members that is used in the operation of the scheme. Schemes of this type are typically established as contract-based arrangements, with scheme members playing an active entrepreneurial role to some degree, at least in theory[37].

However, for the second group "for taxation or other reasons, various agribusiness common enterprise schemes were structured so that scheme members ('growers') operated their agribusiness investment in their own right, entering into agreements with the responsible entity ('RE') or external parties to perform the cultivation and management activities associated with the member's enterprise"[38].

Growers participated in the project by subscribing for lots and paying a fee per lot. Generally, all fees paid were structured so that they were 100 per cent tax deductible. Yet if a farmer had set up a timber or almond growing operation themself, their deductions would have been far more limited.

If scheme members did not pay their annual fees by a certain date, generally their rights would be forfeited – quite often back to the RE or manager of the scheme. It is notable that not only were so called 'growers' not involved in running these businesses, but these Schemes were not obliged to hold meetings of members [39].

During the global financial crisis (GFC) there were some major collapses and many of the MIS were distressed and wound up soon after. For example, Timbercorp went into administration on 23 April 2009 and it had 33 MIS registered with the Australian Securities and Investment Commission (ASIC) at that time. Due to the collapse of a number of MIS in recent years, class actions have been commenced against a number of schemes for various reasons.

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[37] The Australian Federal Government Corporations and Markets Advisory Committee 2014, The Establishment and Operation of Managed Investment Schemes - Discussion Paper http://www.camac.gov.au/camac/camac.nsf/byheadline/pdfdiscussion+papers_1/$file/mis_dp_march2014.pdf

[38] The Australian Federal Government Corporations and Markets Advisory Committee 2014, The Establishment and Operation of Managed Investment Schemes - Discussion Paper http://www.camac.gov.au/camac/camac.nsf/byheadline/pdfdiscussion+papers_1/$file/mis_dp_march2014.pdf

[39] National Farmers' Federation 2001, Taxation Zones and the City-Country Divide

Approximately 700 ATO product rulings were issued between 1998 and 2010. During that time, there were a number of government reviews of these products, along with a High Court test case relating to a non-forestry MIS. The introduction of the product ruling system in 1998 strengthened the position of these tax effective schemes that were then able to be marketed with ATO approval. MIS sales reached $1 billion per annum at their peak[40].

In 2007, the ATO issued a tax ruling (TR 2007/08) which confirmed that investments in registered agricultural managed investment schemes which began on or after 1 July 2008, would be considered a capital cost of the investment and would not be tax deductible. This was contrary to the position held prior to 1 July 2008, where these costs were considered to be an outgoing in the normal course of running a business. As a result of amendments to the Income Tax Assessment Act 1997 (Cth), this tax ruling did not apply to registered forestry managed investment schemes as long as certain conditions were met.

The industry body, Agricultural Investment Managers Australia, and the Commissioner of Taxation, agreed to hold a test case in order to determine clarity for non-forestry schemes. The Federal Court decision was unanimous and confirmed the outgoings were tax deductible. The Court held that on the facts of the case, each individual investor was in fact carrying on a business and accordingly expenses incurred in running the business were tax deductible. By the time the ATO ruling was withdrawn the GFC had begun and entities associated with companies such as Timbercorp, Great Southern and Willmott Forests were placed into administration.

On 25 June 2014, the Senate referred an inquiry into the structure and development of forestry managed investment schemes to the Senate Economics References Committee for inquiry and report by 27 October 2014. After a number of extensions were granted, this Committee released its report on 11 March 2016. It includes 24 recommendations that primarily focus on the regulation of advisors and promotors. In recommendation 21, the Committee notes that neither the ATO nor Treasury have undertaken a comprehensive review of tax incentives for MIS and whether they had unintended consequences, such as diverting funds away from more productive enterprises; inflating up front expenses; or encouraging poorly-researched management decisions (planting in unsuitable locations). The Committee recommended that Treasury commission a review to better inform the policy around providing tax concessions for agribusiness MIS[41].

Today there are few tax effective MIS left and certainly few open for subscription. Some survived and are now generating returns for their growers however, this is more the exception rather than the rule. Tropical Forestry Services (TFS) have a macadamia offering and we understand there are other small schemes in this form of horticulture, however it is difficult to gather statistics.

Those tax effective MIS still existing tend to be more structured along gearing into investments with providers such as Macquarie or IOOF.

3.2 Issues associated with current position

The common enterprise scheme tax effective agricultural MIS were primarily taken up by investors wanting to reduce their tax. The expansion of the non-commercial loss rules which would seek to deny these deductions, were introduced in the 2010 financial year. This further compounded towards the demise of these schemes.

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[40] Bryant, D, 2010, 'The danger of managed investment schemes' *Money Management Magazine,* 15 June 2010.

[41] The Senate Economics References Committee March 2016, Agribusiness managed investment schemes, Bitter harvest

These investors were deemed to be 'growers' in their own right despite having no effective control over the operations they invested in. The tax effectiveness was based on large upfront payments to the promoters whose self-interest was then always to get the next scheme up and running to obtain more fees.

As the growers were deemed to be in business it was those investors who sought and received an Australian Business Number (ABN) – some registered for GST, but most were not successful as they did not meet the required turnover test. The schemes had no ABN, no Tax File Number (TFN) and subsequently little accountability through the ATO except through the product rulings given. The only watchdog left to consider these schemes was ASIC, who had been monitoring them closely for many years prior to most collapsing.

While these schemes did, in some cases, bring economic prosperity to areas that had previously suffered under drought, in the main it caused division among many living in rural communities. It caused a value shift away from grazing and farming values towards inflated prices being paid, particularly for forestry plantations. An episode of Landline[42] aired on 25 February 2007 quoted Senator Bill Heffernan as saying: "The facts are that MIS are the greatest rort that's confronted Australia in a long while, and there are going to be a lot of people in the long run getting burnt". This was three years prior to the demise of most schemes. In that same program Prue Adams interviewed John Jeffreys of Delegate Station, a historic grazing property in southern NSW with a family known to be outstanding operators: "The expansion of the industry hasn't been due to the profitability of the enterprise…..the last two auctions locally went to plantation expansion and on both occasions the losing bidder has been a young farmer like myself looking to expand the enterprise who have got existing profitable businesses and replacing that with an enterprise that at best would be questionable on its profitability long term".

3.3 Areas for consideration

It should be acknowledged that there is no suggestion that changes be made to pooled MIS, which are an effective means of raising investment funds and are essentially on a level playing field with companies.

However, in regard to common enterprise schemes, it would be appropriate to consider legislative change to confirm these investors are not carrying on a business, or an enterprise, should not be entitled to an ABN and therefore will not be able to claim tax deductions relating to expenditure in these schemes. Any changes could allow some form of grandfathering protection to existing investors.

3.4 Impact of alternatives considered

This will have very little impact as there are few schemes now on offer. Any changes could allow some form of grandfathering protection to those investors in investments that are still open.

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[42] *Landline*, television broadcast, Australian Broadcasting Corporation, 25 February 2007, Interviews conducted by Prue Adams.

4. State and territory taxes and duties

4.1 Background and current position

Australian state and territory governments apply taxes and duties to a range of transactions, products and activities. The structure and design of these often varies between jurisdictions and this adds complexity to the affairs of businesses operating in multiple jurisdictions. Despite differences in application, the tax base across the states/territories is substantially similar, with stamp duty, land taxes (including local government rates) and payroll tax contributing around three quarters of total state tax revenue[43].

4.1.1 Stamp duty

Stamp duty is a tax applied to certain transactions and documents. Stamp duty on the transfer of property is a major source of revenue to all state and territory governments[44] and is typically levied at a progressive rate as the value of property increases. Limited exemptions are available, such as those for the intergenerational transfer of rural land and first home buyer's purchases of new residential property.

In conjunction with the GST replacing Wholesale Sales Tax from 1 July 2000, the states and territories of Australia, along with the Commonwealth Government, signed the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations[45]. The first objective of this agreement was to eliminate a number of taxes that were impeding economic activity. Stamp duty on non-residential property conveyances was the final tax that was to be abolished under the Intergovernmental Agreement, however the states and territories have only agreed in part to this by committing to the removal of stamp duty on non-real non-residential property[46] (e.g. transfer of shares in a company or goodwill of a business). In NSW, the abolition of stamp duty on non-real non-residential property has been deferred multiple times and is currently scheduled to occur on 1 July 2016.

4.1.2 Land tax

Land tax is an annual tax imposed by all state and territory governments (other than the Northern Territory) once the total unimproved value of land exceeds the relevant jurisdiction's tax free threshold. Exemptions are generally available for principal residences and primary production land. Land tax is the second form of annual tax imposed on land holders who are also subject to shire council rates.

The laws between states and territories are comparable, but there are some variations.

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[43] Australia's Future Tax System n.d., State Taxes, http://taxreview.treasury.gov.au/content/Paper.aspx?doc=html/publications/papers/report/section_2-05.htm

[44] Australia's Future Tax System n.d., State Taxes, http://taxreview.treasury.gov.au/content/Paper.aspx?doc=html/publications/papers/report/section_2-05.htm

[45] Intergovernmental Agreement on the Reform of Commonwealth –State Financial Relations, June 1999.

[46] Australian Government 2007, Appendix E: Timetable for the Abolition of State Taxes, http://www.budget.gov.au/2007-08/bp3/html/bp3_main-12.htm

In NSW, land that is zoned rural land is exempt if the dominant use of the land is for primary production.

Land that is not zoned rural must demonstrate that the dominant use of the land is for the business of primary production, and:

- Primary production has a significant commercial purpose or character;
- That the size or scale of the activities are large enough to be considered a business, not just a hobby; and
- The activities are carried on with the intention of making a profit, regardless of whether or not a profit is made.

The primary production land tax exemption does not apply in Queensland for foreign owners.

The Henry Review[47] recommended the land tax base be broadened to include all land. While agricultural land would not be exempt, the suggestion included a low rate threshold on a value per square metre basis, meaning that most agricultural land would not face a land tax liability.

4.1.3 Payroll tax

Payroll tax is applied in each state and territory on amounts above the tax free threshold. The various rates and thresholds are as follows:

State/territory	**Rate**	**Annual threshold**
Australian Capital Territory	6.85 per cent	$1.85m
New South Wales	5.45 per cent	$0.75m
Victoria	4.85 per cent	$0.55m
Queensland	4.75 per cent	$1.10m
South Australia	4.95 per cent	$0.60m
Western Australia	5.50 per cent	$0.80m
Tasmania	6.10 per cent	$1.25m
Northern Territory	5.50 per cent	$1.50m

Following the harmonisation of payroll tax administration in 2007, calculations only differ slightly between jurisdictions with thresholds reduced by the proportion of total wages paid in other states. Queensland and the Northern Territory apply a deduction amount that reduces the tax free threshold by $1 for every $4 above the basic threshold. Various exemptions are available in each jurisdiction for certain categories of employer (e.g. charities) and certain categories of wages (e.g. trainee wages).

[47] The Commonwealth of Australia 2010, Australia's Future Tax System – Report to the Treasurer, http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/AFTS_Final_Report_Part_2_Vol_1_Consolidated.pdf

4.2 Issues associated with current position

4.2.1 Stamp duty

In terms of stamp duties this can be a considerable cost, considering the rate on land and business transfers in NSW is 5.5 per cent over $1 million. Further as the subsequent purchaser also needs to pay duty, this impost does not add to the value of the asset and can often mean it takes some years before values increase sufficiently in order for the owner to recover their cost of the asset in a sale, let alone make a profit. This conceptually can lead to taxpayers retaining assets that would otherwise have been sold, merely to try and recover their original investment which potentially can distort the market.

The Henry Review identified stamp duty on property conveyances as an inefficient tax. It is inefficient and volatile as a revenue source because it can be avoided by simply not taking part in dutiable transactions. It also leads to inefficient economic decision making as it discourages moving capital that could potentially be invested in more productive locations and assets[48].

When dutiable property is also a taxable supply for GST purposes, stamp duty is calculated on the total GST inclusive price of the property. This results in the purchaser paying tax on a tax as the GST component increases the stamp duty payable.

For example in NSW, the stamp duty payable on rural land that costs $1 million is $40,490. If the sale of this land is subject to GST (i.e. it is not GST free because it has not been used in a farming business for the five years immediately prior to sale) the dutiable value will be $1.1 million and the stamp duty payable increases to $45,990. This additional $5,500 is a tax (stamp duty) on a tax (GST) which is a form of double taxation.

The stamp duty exemption that exists for intergenerational transfers of rural land is extremely important to primary production businesses in Australia. These businesses are often passed through generations within farming families. The stamp duty expense that would arise, but for this exemption, would create an undesirable disincentive to younger generations, who have the knowledge and experience to run their family farm productively and efficiently, from taking over the business.

State and territory based stamp duty exemptions apply to certain inter-generational transfers of rural land assets, however these can be limiting. For example, in NSW, (and other states and territories), the land needs to be transferred to individuals (including joint and common tenancy arrangements), leaving no option (without the cost of stamp duty) to consider structures such as trusts or companies for asset protection and other reasons. In 2002, the NSW system extended the definition of family members and that has been a welcome addition.

It is suggested that the existing stamp duty exemption should continue, with extension to other legal structures for ownership that are beneficially owned by the defined family group and have anti-avoidance provisions to levy duty on subsequent transfers of interests in these entities.

Currently in Queensland the intergenerational transfer exemption only applies when land used for primary production is gifted to the next generation for no consideration[49]. The requirement for this transfer to be for no consideration is damaging to the retiring generation for whom the family farm

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[48] Australia's Future Tax System n.d., Chapter c: Land and Resources Taxes, http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_c2-3.htm

[49] Queensland Government 2016, Family Business Concessions, http://www.qld.gov.au/housing/buying-owning-home/family-business-concession/

typically represents their most significant asset, but the investment made in this asset over the course of their working life cannot be accessed in retirement. Despite there being no cash exchanged, the market value of the land being transferred will still be deemed to be the capital proceeds for CGT purposes. This can result in CGT being payable with no cash available to fund the liability, if the capital proceeds exceed the cost base of the asset and the gain cannot be exempted under the small business CGT provisions.

4.2.2 Land tax

Australian property owners are potentially subject to three different taxes on land - stamp duty, land tax and council rates. As a result, taxes on property make up around 9 per cent of taxation in Australia which is almost double the OECD average of 5 per cent[50]. Land is the most significant asset in a primary production business and as a result, this comparatively high rate of tax on land holders falls heavily upon the agricultural industry and reduces international competitiveness.

An extension of land tax to include agricultural land would have a severe impact on farmers' income. Income from farming is volatile and is impacted during drought and natural disasters in terms of the revenue that can be generated from the land. An additional land tax cost would reduce profitability as farmers do not have the ability to pass on the additional cost to consumers. Additionally, farm businesses are generally always 'land rich' as this is the prime business asset from which production flows.

Although the Henry Review included a suggestion that there be a threshold to effectively exempt low value land (i.e. most agricultural land), consideration would be needed on the impact of agricultural land held in or near future development areas.

If the land is valued at its highest and best use, the agricultural land may be valued for the purposes of residential or commercial development (including mining), even though that might not be feasible in the near future.

A recent article by Fairfax economics journalist Sarah Irvine[51] suggested that a broad based land tax would be an efficient way to raise tax. Ms Irvine also suggested that any unpaid land tax could be accumulated and deducted from a person's estate (death duties).

Mick Keogh responded in a comment on The Farm Institute website[52] that the return of so called death duties would see a return to a situation where families who inherited the family farm were also forced to take on large debt to fund the death duties.

It is also noted that the primary production land tax exemption does not apply in Queensland for foreign owners. The imposition of land tax on foreign owners would impact on their investment decisions with foreign owners having to factor this additional cost into their decision.

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[50] Australian Government 2015, Re:think – Tax Discussion Paper, http://bettertax.gov.au/files/2015/03/TWP_combined-online.pdf

[51] Irvine, J 2016, 'How to hit the rich where it really hurts', *Sydney Morning Herald,* February 12, 2016 http://www.smh.com.au/comment/how-to-hit-the-rich-where-it-really-hurts-20160211-gmr7c8.html

[52] Keogh, M 2016, Danger lurking for the agriculture sector in tax debate Australian Farm Institute, February 15 2016, http://www.farminstitute.org.au/ag-forum/danger-lurking-for-the-agriculture-sector-in-tax-debate

4.2.3 Payroll tax

In the short-run, the burden of payroll tax is borne by employers[53] and this provides an immediate disincentive to businesses taking on new employees. This disincentive is emphasised for employers that are approaching or just above the relevant state and territory threshold where the additional cost of payroll tax compliance is comparatively more significant.

Administration of payroll tax obligations is particularly complex for employers operating in multiple states and territories. Different rules apply in certain jurisdictions in relation to the grouping of related businesses, the determination of which state and territory the employment relates to, the definition of wages in each state and territory, and what activities are eligible for an exemption. This complexity creates considerable compliance risk and administration cost to affected businesses.

4.3 Areas for consideration

4.3.1 Stamp duty

Ideally stamp duty on business transactions (including insurance policies) should be abolished in all states and territories (it never applied in Victoria, was abolished in the ACT from 1 July 2006, was abolished in Tasmania from 1 July 2008, was abolished in South Australia from 18 June 2015, was to be abolished in the Northern Territory from 1 July 2009 but this has been deferred indefinitely, was to be abolished in Western Australia from 1 July 2010 but this has been deferred indefinitely, was to be abolished in NSW from 1 July 2011 but has been deferred until 1 July 2016 and remains in Queensland with no scheduled end date).

In situations where abolition was not agreed to in the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations[54], such a change may require some form of compensation to the states and territories to replace such a significant reduction in their revenue. Alternatively, the system could be entirely redesigned to effectively remove the purchase duty and replace it with a form of the previous vendor duty that is applied only on sale and only on the gain that was derived on holding the property.

The inter-generational stamp duty concession for rural land could be broadened, such that the acquisition can be made by a trust or company controlled by members of the family group.

This would involve extending the inter-generational stamp duty concession for rural land to trusts or companies (essentially controlled by a family group) as the transferors, where the underlying ownership may not be beneficially held. For example, a company with shares owned by a discretionary trust would not qualify under the existing rules (in NSW at least – s274(3) of Duties Act 1997 No 123). This would not be broadening the intent of the exemptions, but allowing them to apply to different structures operated by family groups. There may be a need for an anti-avoidance provision to reinstate the duty if interests in this entity are subsequently disposed of.

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[53] Australia's Future Tax System n.d., Chapter D: Taxing Consumption, http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_d3-1.htm

[54] Council of Australian Governments 1999, Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, https://www.coag.gov.au/node/75

Recommendations 51-54 of the Henry Review suggested that the inefficiencies of stamp duty be addressed by replacing stamp duty with a broad based land tax[55]. It is agreed that stamp duty should be abolished, particularly all non-residential property conveyances in accordance with the Intergovernmental Agreement. However, any alternative land based tax needs to be designed carefully to ensure that it does not increase the tax burden upon primary production land owners.

4.3.2 Land tax

Land is the principal asset employed in farming businesses, but as it is the least mobile factor of production, this makes land simpler and more efficient to tax than capital and to a lesser extent, labour. In order to maintain equality across the tax system it is necessary to provide protections within legislation to businesses and industries such as agriculture, that are reliant upon land, so that they are not disadvantaged and forced to contribute a disproportionate share of total tax collections.

The current exemptions for primary production businesses could be refined, and it would be useful to pursue consistency across the jurisdictions (e.g. remove the imposition of land tax in Queensland for foreign-owners).

While it is recognised that a broad-based land tax system would be an efficient method to raise additional taxes, the imposition of land tax on agricultural land would have a severe impact on farmer's profitability.

The Henry Review recommendation that a broad-based land tax be applied with a minimum value threshold set on a per-square-metre basis would impact on primary production land on the fringes of urban areas. The value could increase above the threshold even before it became feasible for the land to be used for more intensive development.

Should the Henry Review's recommendation be considered, the preferred approach would be the continuation of the current exemptions for land used in primary production businesses. Alternatively, the land value threshold could be set at a level sufficiently high enough to exempt most, if not all, primary production land. In addition, the setting of the relevant threshold could be indexed to the average increase in primary production land values.

For land on urban fringes still used in primary production, consideration could be given to using a five or 10 year average land value to ensure no sudden increase in land value would result in some primary production land being subject to the additional cost that would put their business at risk before it is feasible for more intensive development.

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[55] Australia's Future Tax System n.d., Chapter C Land and Resources Tax, http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_c2-4.htm

4.3.3 Payroll tax

Payroll tax reform needs to result in a consistent system across all jurisdictions and the steps to harmonise payroll tax legislation should be completed. The legislation should be simple to comply with for businesses that operate across state and territory borders. This would include consistency of rates and thresholds, making administration less complicated for those with employees across multiple jurisdictions.

The chosen threshold and rate should consider those currently in existence, recognising that this will involve negotiation between states and territories and the Australian Government, in terms of the impact on revenue and any other changes being made to the broader tax system at the time.

Consideration could also be given to phased thresholds, for example a certain rate at threshold entry and a higher rate(s) once a higher threshold(s) is reached.

4.4 Impact of alternatives considered

Extending the concession for the transfer of rural land to trusts and companies would provide greater flexibility for succession planning and result in ownership being in the best-suited entity for those concerned, taking into account asset protection particularly.

Abolishing stamp duty on property conveyances would reduce state and territory government revenue significantly unless an alternative tax is implemented. Primary production land owners generally hold land for comparatively long time periods which results in stamp duty liabilities occurring less frequently. A replacement land tax (if ever imposed) must contain provisions to exempt low average value land (determined on a per square meter basis) to ensure there is no additional tax burden placed on primary producers.

Moving to harmonised legislation for the payroll tax system would reduce compliance, complexity, and costs for businesses that are currently taxed under multiple state and territory regimes.

4.5 Case studies

4.5.1 Stamp duty

XYZ Pty Limited owns rural land (acquired before the introduction of CGT) in NSW, and XYZ Pty Limited also conducts the farm business on that land. Shares in the Company are held by XYZ Discretionary Trust. The beneficiaries of that trust are Fred and Sally (brother and sister). Fred and Sally have been advised that a company structure is not the most tax effective structure for holding capital assets appreciating in value due to unfavourable CGT treatment (i.e. no application of CGT discounting). Fred and Sally would therefore like to have the ownership of the property transferred from the company to themselves as tenants in common. They also feel that this would provide a more flexible structure for future succession arrangements with their children (as the farm may be sub-divided for the two families). Because the person (Fred and/or Sally) directing the transferor (company) is a shareholder that is not beneficially entitled to the shares, they are not able to claim the stamp duty exemption.

4.5.2 Land tax

Angus Murphy is a fourth generation dairy farmer on the South Coast of NSW just five minutes from the beach and 90 minutes from Sydney. Due to the low farm gate milk prices, it has been difficult to make a good return for the risk and effort, however the fertile soils and good milk production has meant the Murphy's have maintained a successful farming operation, started by Angus' great grandfather in the mid 1900's.

In recent years, there has been an increase in residential development closer to the beach and one of the neighbouring farms was subdivided into five-acre lifestyle blocks. However, more than half remain unsold.

Angus has been talking to a local real estate agent regarding the future use of the farm, but the expert view is that it could be 10 to 20 years before the population will increase to the point where further development of the farming land would be feasible.

As a result of the land values in the neighbouring subdivision, Angus was recently notified that his land had increased in value to above a level where land tax would be imposed if the Henry Review recommendation was implemented. The additional cost to the business would place at risk the family farm. For example, a farm with land worth $2 million in NSW would attract land tax of $24,388 per annum and this would be in addition to other costs of land ownership, including council rates, stamp duty on purchase, and local land services rates. Further, if Angus and his family decided to sell, developers would need to take into account this cost in their investment decision, given it could take 10 to 20 years before it was feasible to develop.

5 Risk mitigation

5.1 Background and current position

Australian farmers are increasingly required to manage risk in their businesses. Some risks in agriculture include variations in weather with drought, floods and fire; variations in market prices with little or no control over the input costs or the prices they receive for their produce, and environmental issues and pests and disease. As a result of these risks, farming businesses have extremely variable incomes compared to business owners in other industries[56].

In order to prepare for and manage these risks, the tax system currently provides a number of risk mitigation strategies for farmers, including primary production averaging, treatment of abnormal receipts and farm management deposits. This is particularly relevant in years where income is brought forward due to the impact of disaster. These strategies are summarised below.

5.1.1 Primary production averaging

The primary production averaging system enables individual tax payers with primary production income to level out the rate of tax payable based on their average income up to a maximum of the last five years (including the year of assessment). The current system only applies to individuals; either as a sole trader, individual partners in a partnership or individual beneficiaries of a trust. It is designed so that eligible taxpayers do not pay more tax over a number of years compared with taxpayers on comparable but steady incomes. Primary production averaging addresses the risk of the fluctuating nature of primary production income.

When average income is *less* than the basic taxable income, the taxpayer receives a non-refundable averaging offset, and when the average income is *more* than the basic taxable income, the taxpayer must pay extra income tax (referred to as complementary tax). Taxpayers enter the system when their basic taxable income exceeds that of the previous tax year (commencing with a two-year average).

Under the current system, taxpayers can opt-out, however the choice is irrevocable, i.e. they are subsequently not eligible to re-enter the system. The Agricultural Competitiveness White Paper has recommended that the law should be amended to allow taxpayers to opt back in after 10 years[57].

Income tax averaging is also available for artists and special professionals and in the Henry Review[58] it was recommended that averaging arrangements for primary producers and special professionals be retained.

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[56] Australian Government 2015, Agricultural Competitiveness White Paper, http://agwhitepaper.agriculture.gov.au/SiteCollectionDocuments/ag-competitiveness-white-paper.pdf

[57] Australian Government 2015, Agricultural Competitiveness White Paper, http://agwhitepaper.agriculture.gov.au/SiteCollectionDocuments/ag-competitiveness-white-paper.pdf

[58] The Commonwealth of Australia 2010, Australia's Future Tax System – Report to the Treasurer, http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/AFTS_Final_Report_Part_2_Vol_1_Consolidated.pdf

5.1.2 Treatment of abnormal receipts

Various measures are in place to allow for abnormal receipts associated with certain impacts affecting the sector. Without these measures, when farmers are forced to dispose of their produce due to certain weather events or impact by disease, it could result in a year of high income followed by a year of little or no income. The additional tax cost in the first year can have a severe impact on farmers' cash flow, particularly when they need to restock in order to maintain the viability of their business going forward. These measures include:

- *Double wool clips* – an election can be made to defer the profit on the sale of the clip from an advanced shearing (early shearing caused by drought, fire or flood) to the next year. Ordinarily, the second clip would not have been assessed until the following year if not for the disaster. By deferring the profit until the second year, this measure seeks to match the timing of the imposition of the tax to when the business would have ordinarily received the income (but for the disaster).

- *Insurance recoveries for livestock losses or loss of trees due to fire* – an election can be made to spread the payout over five years for tax purposes.

- *Profit from forced disposal or death of livestock* (from compulsory acquisition, destruction from fire, drought or flood, stock compulsorily destroyed under law for control of a disease, or they die from such a disease) – there are two alternative treatments that can be applied:

    - Electing to spread profit earned from forced disposal or death over a period of five years; or

    - Electing to defer profit and apply it to reduce the cost of replacement livestock (in the disposal year or any of the next five tax years).

The following table demonstrates the calculation of tax payable for a woolgrower who, as a result of drought, was forced into a second shearing during the income tax year. By applying the treatment of abnormal receipt provisions, the woolgrower is able to defer the profit from the second wool clip into the next year when the income would have normally been received if not for the drought.

The tax payable using the abnormal receipt measures is compared to the tax payable if the measures were not used – with and without primary production averaging.

The abnormal receipt measures result in tax payable over the two years which would be equal to the tax payable for individuals in business not exposed to the same risks as primary producers, who receive more steady income.

Without abnormal receipt measures

	YEAR 1	YEAR 2	TOTAL
Taxable income before 2nd shearing	80,000	30,000	110,000
Wool - 2nd shearing	60,000	-	60,000
Expenses of 2nd shearing	(10,000)	-	(10,000)
	130,000	30,000	160,000
Tax payable (ignoring PP averaging)	38,647	2,842	41,489

With abnormal receipt measures

	YEAR 1	YEAR 2	TOTAL
Taxable income before 2nd shearing	80,000	30,000	110,000
Wool - 2nd shearing	60,000	-	60,000
Expenses of 2nd shearing	(10,000)	-	(10,000)
Deferral of profit from 2nd shearing	(50,000)	50,000	-
	80,000	80,000	160,000
Tax payable (ignoring PP averaging)	19,147	19,147	38,294
Difference	(19,500)	16,305	(3,195)

Without abnormal receipt measures, With PP averaging

	YEAR 1	YEAR 2	TOTAL
Taxable income before 2nd shearing	80,000	30,000	110,000
Wool - 2nd shearing	60,000	-	60,000
Expenses of 2nd shearing	(10,000)	-	(10,000)
	130,000	30,000	160,000
Tax payable (with PP averaging)	33,290	7,180	40,470
Difference	14,143	(11,967)	2,176

Average table			
Year -3	80,000		
Year -2	80,000	80,000	
Year -1	80,000	80,000	
Year 0	80,000	80,000	
Year 1	130,000	130,000	
Year 2		30,000	
Average income	90,000	80,000	
Average rate	23.61%	21.93%	

5.1.3 Farm Management Deposits

FMDs are a measure designed to assist primary producers to deal more effectively with fluctuations in cash flows. Pre-tax income is set aside in the year of deposit, which provides a tax deduction. The amount is then assessable when drawn in future years. There are a number of eligibility criteria, including the following:

- Non-primary production income must be less than $100,000 in the financial year that the deposit is made;
- The deposit must be held for a minimum of 12 months, unless certain criteria are met for early access;
- The current cap for maximum FMDs held is $400,000; and
- FMDs are currently only eligible for individual tax payers.

5.2 Issues associated with current position

Primary production averaging, FMDs and the treatment of abnormal receipt provisions allow eligible taxpayers to smooth out the variability of income for tax purposes, as well as manage the tax implications of receipts as a result of extreme weather events. These measures are all helpful to avoid paying tax at a higher marginal rate in a year where income has been brought forward as a result of a disaster, however they do not have the same impact in managing cash flows during low income years where the farmer is recovering from the disaster event.

There are a number of practical and equity issues associated with FMDs only being available to individuals. As stated in the background section, FMDs are intended to assist primary producers with the variations in cash flow of their business – it therefore makes sense that the deposits are held by the business entity so that all funds are directly controlled by the entity and available to it upon withdrawal, rather than being held by the underlying individuals.

A further issue, as previously identified, is that once taxpayers have opted out of primary production averaging, they are then not eligible to re-enter the system.

5.3 Areas for consideration

The existing measures of primary production averaging and tax treatment of abnormal receipts should be retained.

The recommendation to allow taxpayers to opt back into primary production averaging after 10 years is supported.

The following changes to the FMD Scheme are commencing on 1 July 2016:

- Increasing the maximum amount that can be held in FMDs by a primary producer to $800,000;
- Allowing primary producers experiencing severe drought conditions to withdraw an amount that has been held in an FMD for less than 12 months, without affecting the income tax treatment of the FMD in the earlier income year; and

- Allowing amounts held in an FMD to offset a loan or other debt (i.e. as a result of the arrangement a lower amount of interest is charged on the loan than would otherwise be the case) relating to the FMD owner's primary production business.

In addition to the measures outlined above, the following can be considered:

- *FMDs available at the entity level, rather than individual level*. For example, money invested in an FMD in the name of a partnership would be deducted from the assessable income of the partnership before profit is distributed to partners. Assessable income from withdrawal of an FMD would then be added to the partnership income before profit is distributed to partners. As part of this proposal, eligibility could be extended to companies and trusts. Some integrity measures may be required to prevent manipulation of entity structures that may artificially increase the effective maximum deposit limit. Thought would also need to be given to the threshold applying to entities as opposed to individuals however, such challenges should not prohibit tax reform and an entity-based system being put in place.

  One of the purposes of the FMD measures was to allow cash generated in a good season to be set aside to ensure cash is available to fund operations in less favourable times. The way the system currently works for a partnership means that an individual partner must draw money (or take a loan) from the partnership to invest in an FMD, but then there must be agreement (partnership agreement and/or loan documentation) for that money to be paid back to the partnership upon its withdrawal if the funds are going to be *available to the business entity for their intended purpose* (i.e. to fund the businesses in leaner years). This same problem occurs for beneficiaries of trusts. Most related party businesses do not have this degree of governance in place and therefore rely upon partners and beneficiaries 'doing the right thing'.

  This same problem occurs for beneficiaries of trusts. While it may be argued that trusts have to distribute all of their income to beneficiaries, in practice beneficiaries often maintain an unpaid beneficiary entitlement so that funds can be re-invested by the business.

  Companies operating in the sector have the same variability in income as an individual operating the same business. While a flat tax rate avoids the problems of paying tax at higher marginal rates during more profitable years, the cash flow impacts (including higher PAYG instalments) associated with income volatility are of the same significance as any other entity. It seems inequitable that FMDs are not available to this type of structure.

  If significant changes are made in terms of whether the partners/beneficiaries versus the partnership/trust are eligible to utilise the FMD provisions, it would be important to ensure that existing deposits are grandfathered and transitional provisions implemented.

- There is an issue with FMD withdrawals and how they impact the non-commercial loss rules under Division 35 of ITAA1997. Currently the ATO have taken the position that the same business must be conducted at the time of withdrawal as when the deposit was made, and there is some confusion over how the funds need to be used, for the withdrawn funds to be considered income from the activity in which the funds were originally sourced and some anomalies with the current interpretation (refer to point 6 on page 19 for additional explanation). The result is that the FMD withdrawn may itself count towards the $250,000 other income cap. If this income cap, including the FMD withdrawal, exceeds $250,000 it would result in the FMD withdrawn amount being taxable and any business loss being quarantined.

- A further consideration may be to allow FMDs that remain on deposit upon retirement or cessation of the relevant primary production business, to be contributed to superannuation under a separate form of concessional contribution cap. It is often the case that due to the variability of cash flow and capital intensive nature of agriculture, that business assets form a significant part of a primary producers retirement planning. Integrity measures could be introduced to ensure that no unintended advantage be provided. For instance, the FMD contribution cap may be limited to the sum of the individuals previous 10 years personal concessional contribution caps less amounts of concessional contributions actually made during that period.

- A further issue arises in relation to unexpected cessation as a primary producer (for example due to ill health) and death, whereby any FMDs must be withdrawn in full in that tax year. This can result in excessive taxation liability at higher marginal tax rates, thus impairing the tax planning in prior years when the FMDs were deposited. An option would be for FMDs to be brought back over a three year period (including through the estate of a deceased), or alternatively the additional income taxed at average rates. To be clear, this would be an optional measure that could be utilised so that there were no impediments to cases where the executors wish to wind up the deceased estate in a shorter timeframe.

5.4 Impact of alternatives considered

Maintaining the existing measures for risk mitigation provide primary producers with greater certainty.

Extending FMD eligibility to other entity types would provide greater equity between different types of taxpayer, and having FMDs held by the business entity (rather than associated individuals) would also assist primary producers to more simply manage the flow of funds in and out of FMDs.

While it is acknowledged that there may be some complexity and added integrity measures required for FMDs held at an entity level, this should not prevent consideration of reforms that can improve the overall system.

6. Temporary residents

6.1 Background and current position

Many agricultural industries are dependent on itinerant workers to provide the labour inputs required to operate their business. Historically, this dependence has been pronounced in the horticultural industry for harvest, but it is also becoming more evident in broadacre cropping, livestock and the irrigated cropping industries, where all major operations are relying on itinerant labour. It is difficult to attract casual workers to these industries at peak labour times and the void has been filled by temporary residents with working visas.

It is critically important for these businesses to continue to be able to attract itinerant workers, a large proportion of whom are foreign nationals on temporary working visas. The proposed higher income tax rate for backpackers and the superannuation guarantee (SG) for itinerant workers are significant issues for the sector, particularly for those in the horticultural sector.

Working holiday makers, including backpackers, are an important source of economic revenue, generating more than $3.5 billion for the Australian economy each year. Roughly 40,000 working holiday-makers work on farms each year, and without them, the agricultural sector would face severe labour shortages.

Working holiday makers earn around $15,000 while in Australia and it is estimated that on average, they spend $14,910.77 each year while here. [59]

If working holiday makers are in Australia for more than 183 days they *may* be treated as residents for tax purposes[60], with the ability to claim the tax free threshold of $18,200, low income tax offset (LITO) and a 19 per cent tax rate on income from $18,200 to $37,000. It is noted that as residents, they would pay the Medicare Levy. Whether or not these taxpayers are classified as residents will depend on the details of the Double Taxation Agreement (DTA) relevant to their country of origin. Technically, most working holiday-makers are likely to be treated as non-residents, however in practice it would seem that most have been relying on the 183 day rule to be treated as residents (resulting in more favourable tax treatment).[61]

6.1.1 Introduction of new tax rates

In the 2015-2016 Federal Budget, the Government proposed to treat most people who are temporarily in Australia for a working holiday as non-residents for tax purposes, regardless of how long they are here, from 1 July 2016[62]. Following consultation with industry, in September 2016 the Government announced that it would instead tax working holiday makers at 19 per cent from their first dollar earned.

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[59] National Farmers' Federation, Backpacker tax: 32.5% increase is too high.

[61] Stephen Lawrence and Dale Boccabella,, Backpacker tax: if it were never broke, why try to fix it?, The Conversation, 20 May 2016, http://theconversation.com/bnackpacker-tax-if-it-were-never-broke-why-try-to-fix-it-59582

[62] Treasurer of the Commonwealth of Australia 2015, Budget 2015 – 16, http://www.budget.gov.au/2015-16/content/bp2/download/BP2_consolidated.pdf

Current resident and non-resident rates are shown below.

Residents income tax rates 2015-16		Non-residents income tax rates 2014-15	
$0 to $18,200	Nil tax payable	Up to $80,000	$32.5 per cent for each dollar
$18,201 to $37,000	19c for each $1 over $18,200	$80,001 to $180,000	$26,000 + 37 per cent of the part over $80,000
$37,001 to $80,000	$3,572 + 32.5c for each $1 over $37,000	$180,001 and over	$63,000 + 47 per cent of the part over $180,000
***Note: Non-residents are not required to pay the Medicare levy**			

6.1.2 SG for temporary residents

Currently temporary residents have the same superannuation guarantee (SG) rules applied to them while working in Australia as other workers, i.e. if they are earning over $450 per month, their employer must pay 9.5 per cent superannuation on their behalf.

Temporary residents are currently able to claim their superannuation after permanently departing Australia by applying for a Departing Australia Superannuation Payment (DASP) from their superannuation fund. The DASP is the value of (after contribution tax) superannuation minus DASP tax which is levied at 35 per cent for the taxed element of a benefit and 45 per cent for an untaxed element (plus Budget Repair Levy).

6.2 Issues associated with current position

6.2.1 Introduction of new tax rates

If the treatment of temporary working holiday-makers as non-residents had been enforced, it is likely that there would have been a decrease in the amount of temporary residents on working holidays. A survey of 1,434 backpackers found that 52 per cent of those surveyed would not stay working in Australia after 1 July 2016[63]. As the average temporary resident on a working holiday only works in order to spend, the tax revenue will be withdrawn from the economy. There is also likely to be a shortage of labour for primary producers at critical times.

‘An increase in the new tax rate would raise an estimated $540 million in tax revenue over three years, this would not compare to the economic impact this would have on the reduced backpacker tourism and associated agricultural losses.’[64]

The 32.5 per cent tax is much higher than the backpacker tax in other countries. Currently New Zealand taxes backpackers at a rate of 10.5 per cent, and Canada at a rate of 15 per cent. The introduction of this high tax rate would make Australia very uncompetitive in comparison.

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[63] National Farmers’ Federation, Backpacker tax: 32.5% increase is too high.

[64] Armstrong, C 2016, ‘Scrap backpacker tax’, *The Land,* 4 February 2016.

6.2.2 SG for temporary residents

The SG legislation puts the onus of superannuation contributions onto the employer. This obligation remains even if the employee refuses to give the employer relevant information, such as the details of their superannuation fund. For full time employees, this is relatively straight forward as it is provided once and applies then for the life of employment. For itinerant employees who are only entitled to a small amount of superannuation (it could be as little as $42.75) and who may have already determined that they will not claim the superannuation on departure, they may not provide this information to their employer. There is no liability here for the employee, only for the employer. Importantly, if an employee does not provide the details of their superannuation fund to their employer, the employer becomes liable for the superannuation guarantee charge (SGC), which includes the SG shortfall amounts plus interest and an administration fee.

If a temporary resident is employed and only works for a short period of time and earns (say) $1,052 in one calendar month, the employer would have to remit $100.00 for superannuation guarantee. There is a considerable amount of paperwork involved for the employer to contribute this small amount to superannuation.

If a temporary resident does decide to claim back their superannuation on departure, they can lose up to $54.95 out of the $100 that was contributed to superannuation by their employer (15 per cent contributions tax and 47 per cent untaxed DASP Tax). Further, there is significant paperwork in this claim-back process.

This volume of paperwork and the effective tax rate of 54.95 per cent goes a long way to explaining the high level of unclaimed superannuation.

As of December 31 2015, there was $579 million worth of unclaimed superannuation from former Australian temporary residents, which is 3.5 per cent of total unclaimed superannuation of $16.44 billion. [65]

It is claimed that up to 70 per cent of temporary resident workers do not claim their superannuation entitlements when they depart Australia permanently.[66] It can be difficult to obtain data on temporary workers. Requiring those non-residents on works permits to obtain tax file numbers (TFN) may be a way to gather data in the future.

6.3 Areas for consideration

An important consideration with any change is that there is equity between workers, such that working holiday-makers are not receiving a significant tax advantage compared with full-time Australian residents and vice versa. While outside of the scope of this report, it is also important that working holiday-makers are offered similar levels of protection as Australian workers in terms of their work conditions and coverage under the Fair Work Act.

6.3.1 Introduction of new tax rates

The Government has now announced that working holiday makers will be taxed at 19 per cent from their first dollar earned instead of the proposed 32.5 per cent tax. More broadly, a new tax bracket of

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[65] https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/Super-accounts-data/Super-accounts-data-overview/?page=1#Lost_and_ATO_held_super

[66] Goldsmith, David, Backpackers drop a bundle worth $540m, The Australian, March 12 2015.

19 per cent for all temporary residents could be considered for income from $1 to $37,000. From $37,001 to $80,000 the tax rate could be 32.5 per cent.

Consideration could also be given to allowing temporary residents to be taxed as residents but that they only be entitled to a pro-rata tax free threshold depending on how much of the financial year they work. Currently temporary residents who are treated as residents for income tax purposes, are allowed the full tax free threshold in any one financial year, even though they may only work a few months and earn very little. If the tax free threshold was pro-rated, the temporary resident would only be entitled to the tax free threshold for the period of time they were working. For example, if they worked for 6 months in any one year, they would only be allowed 50 per cent ($9,100) of the tax free threshold instead of the full $18,200.

6.3.2 SG for temporary residents

Superannuation guarantee for all backpackers and temporary residents could be paid directly to the ATO to simplify compliance for both the employer and the employee. The ATO would have to hold these funds in accordance with general superannuation requirements, possibly through the existing 'Superannuation Holding Account' system.

Separate rules would be required for temporary residents to meet a condition of release at the time of departing Australia, giving them immediate access to the amount that had been set aside as superannuation during their time working here (following a similar process of claiming back GST). A process of tracking unclaimed amounts and determining what happens with unclaimed superannuation after a certain time period needs to be determined.

Consideration could be given to the tax applied at the point of withdrawal, given that the current system effectively results in a maximum 54.95 per cent tax rate on the balance when withdrawn. This issue may provide support for a single tax rate with no SG, specifically for temporary residents.

An alternative that has been suggested is that the Government retains all of the superannuation and reinvests it in programs that support youth employment programs and job creation in rural and regional Australia. Given that most of the superannuation for temporary residents is forfeited anyway, this could be a more targeted used of the revenue.

It is noted that should the $450 superannuation threshold be increased, as suggested under the Superannuation section of this report, this would reduce the number of itinerant workers that would be caught in the system, reducing the compliance burden on employers and addressing any perceived inequity between residents and non-residents working side by side.

6.4 Impact of alternative considerations

The introduction of the additional 19 per cent tax bracket for non-residents would have revenue implications. This loss in tax revenue - the difference between the 32.5 per cent tax as announced and the suggested 19 per cent tax - would be recovered by the economic benefits of backpacker tourism and availability of casual labour for agricultural businesses.

If the superannuation guarantee was paid directly to the ATO it would reduce the overall compliance burden considerably. The temporary resident would not have to provide superannuation details to the employer, thus removing the liability of having to pay SGC if the employee has not provided the superannuation details (which, as previously discussed, is problematic and common). The temporary resident would also be getting paid equally to other workers and if they were to leave the country, it would be much easier for the temporary resident to complete the required forms to receive their superannuation on departure.

If the superannuation was to be retained, there would be an increase in revenue which would partially offset the counter of the 19 per cent tax rate as opposed to the 32.5 per cent proposed.

6.5 Case study

Currently if a temporary resident (resident for tax purposes) works and earns $1,000 plus $95 in superannuation (assuming it is withdrawn on departure), the result is;

Gross Amount	**Tax**	**NET**
$1,000 (Wage)		$1,000
$95 (Superannuation)		$95
	15 per cent contributions tax	-14.25
	38 per cent DASP	-30.69
Net to temporary resident		$1,050.06

Under the proposed 32.5 per cent tax rate, a temporary resident (resident for tax purposes) works and earns $1,000 plus $95 in superannuation (assuming it is withdrawn on departure), the result will be;

Gross Amount	**Tax**	**NET**
$1,000 (Wage)		$1,000
Tax	32.5 per cent	-$325
$95 (Superannuation)		$95
	15 per cent contributions tax	-14.25
	38 per cent DASP	-30.69
Net to temporary resident		$725.06

Under the proposal whereby the tax rate is 19 per cent and superannuation is forfeit to the ATO, a temporary resident (resident for tax purposes) works and earns $1,000 plus $95 in superannuation (assuming it is withdrawn on departure), the result will be;

Gross Amount	**Tax**	**NET**
$1,000 (Wage)		$1,000
Tax	19.0 per cent	-$190
$95 (Superannuation)		$95
	15 per cent contributions tax	-14.25
	38 per cent DASP	-30.69
Forfeit		-50.06
Net to temporary resident		$810.00

7 Goods and services tax (GST)

7.1 Background and current position

The GST is Australia's primary tax on consumption and applies at a rate of 10 per cent to a broad range of goods and services. Australia's GST rate is one of the lowest among developed countries and is around half of the average rate among OECD countries[67].

One of the key advantages of the GST is that it applies at a uniform rate to a broad range of goods and services. By taxing most goods and services in the same way and at the same rate, the GST reduces the complexity and distortions that arise when things are taxed differently. However, exemptions to the GST detract from this. Exemptions significantly increase the complexity of the GST and introduce distortions by changing the relative prices of goods and services. They are also available to all households, regardless of their income level. This potentially makes GST exemptions less effective and more costly than other means of targeting assistance to lower-income households.

The main exemptions currently provided relate to:

- Child care
- Education
- Exports
- Food
- Health and medical services
- Religious services
- Certain farm and business sales
- Water, sewerage and drainage
- Financial transactions
- Life insurance
- Residential rent
- The sale of most residential premises

7.2 Issues associated with current position

At both the Australian Government and state/territory government levels, expenditure is growing and will continue to grow, while at the same time revenue is falling. The ongoing debate around changes to the GST involves changes to the rate as well as broadening the base.

7.2.1 Increasing the rate

Australia's GST rate is one of the lowest among developed countries and is around half of the average rate among OECD countries. Further, the GST raised $55 billion in 2014-15 which was around 12 per cent of total revenue and far below the average of 20 per cent for all OECD countries. Australia's GST revenue as a share of gross domestic product (GDP) was half of the OECD average in 2012.

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[67] Australian Government 2015, Re:think – Tax Discussion Paper, http://bettertax.gov.au/files/2015/03/TWP_combined-online.pdf

Consequently, Australia relies far more on other taxes to raise revenue than most other OECD countries[68].

However, as an efficient tax, the GST has less of an adverse impact on the incentives to work, save and invest than income taxes. In fact, New Zealand's increases in 1989 to 12.5 per cent and in 2010 to 15 per cent only produced short-term rises in inflation[69].

Increasing the rate from 10 to 15 percent could potentially raise around $27 billion. Concerns about increases in prices could be addressed through providing compensation to low income earners and welfare recipients, however compensation should not be considered necessary for everyone. In fact, the benefits of increasing the GST would be felt by all Australians if the additional revenue raised was focussed on putting in place more long term sustainable measures to secure a healthier and more sustainable Australia, including those who live in rural and regional areas. A well-designed GST package that increases the rate to 15 per cent could lead to a tax and welfare system more progressive than at present. Higher welfare payments and targeted tax cuts would make low and middle-income households on average better off[70].

7.2.2 Broadening the base

Around 47 per cent of Australia's national consumption is subject to GST and it is levied by the Australian Government on behalf of the states and territories, with all of the money raised by the GST (except for certain penalties) returned to them, with the states and territories paying an administration charge. Therefore, over half of consumption is excluded, which is a little less than the OECD average of 55 per cent and much lower than New Zealand where at 96 per cent, almost all goods and services are subject to GST. In addition to this, GST does not apply to supplies made by those not required to be registered for GST (i.e. those businesses below the GST threshold).

Most of the categories of consumption not subject to GST are 'GST-free' – mainly fresh food, health, and education, but also include childcare, water, sewerage and drainage services as well as some business to business transactions, such as the sale of farm land or where the going concern exemption is available (these business to business transactions have no net GST effect once associated input tax credits are claimed).

There is a strong argument for broadening the base of the GST to include food, health and education on the basis of simplicity, efficiency, durability and equity. When the GST was introduced, health and education were made GST-free because of the significant public sector provision of these goods and services and concerns that applying the GST to them would put private providers at a competitive disadvantage. However, given the Government has agreed to consider opening up the delivery of health and other human services to the private sector, this may well cease to be such an issue[71].

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[68] Australian Government 2015, Re:think – Tax Discussion Paper, http://bettertax.gov.au/files/2015/03/TWP_combined-online.pdf

[69] http://www.news.com.au/finance/economy/australia-economy/australia-could-learn-from-new-sealands-lesson-in-the-gst/news-story/8304609520069b8b50

[70] Daley, J and Wood, D 2015, 'A GST reform package', *Grattan Institute*, December 2015, http://grattan.edu.au/wp-content/uploads/2015/12/834-GST-Reform-Package.pdf

[71] The Australian Government the Treasury, Australian Government response to the Competition Policy Review, November 2015.

Modelling suggests that applying the GST to basic foods would raise $7.2 billion in 2017-18 while health would bring in an additional $6.4 billion[72].

The area of a GST on food has a specific application to Australian agriculture and is therefore considered in more detail.

7.2.3 GST on fresh food

Australian farmers were supportive of the introduction of a broad-based GST at its inception. However many items, including fresh food, were made GST-free as part of negotiations with the Australian Democrats in 1999 to secure passage of the GST legislation through the Senate. Consequently, this has resulted in a more complex and costly GST system for farmers and there are sound arguments to remove the exemption on fresh food on the grounds of simplicity, efficiency, durability and equity, if the worse-off are compensated.

Most farmers are already in the GST system and many face the complexity of producing mixed supplies, i.e. some goods that include GST and others that do not. This introduces an added cost to their business. Farmers that produce live animals, plants and seeds already charge GST on their produce as these items are not considered to be food as you cannot eat them yet.

7.2.4 Simplicity and reduced compliance costs

The GST on food is very complex. Food can be taxable or GST-free and requires correct classification. The GST status of a food product can be affected by the way it is marketed and packaged and where it is sold. There have been numerous disputes about whether a particular food item, for example an Italian ciabatta, was subject to GST or not[73].

For those in the supply chain who are selling food, the complexity of mixed supplies and having to separately track all items, even with simple rules, is time consuming and increases compliance costs significantly. For farmers who produce both taxable and GST-free items, for example a mixed farming enterprise with cattle and citrus, there is the complexity of providing goods that are both subject to GST and GST-free.

For retailers the complexity continues. For those further along in the agricultural supply chain, these exceptions and anomalies increase the compliance burden and therefore the cost of doing business.

Subjecting food to GST will reduce complexity, compliance costs, and overall administrative burden on farmers, business, and government. The New Zealand experience shows that businesses with GST exemptions have compliance costs five per cent higher than businesses with fully taxable goods and this impact can be severe for small business[74]. Reducing these costs will enable farmers to redirect their efforts to increasing their productivity and profitability.

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[72] Daley, J and Wood, D 2015, 'A GST reform package', *Grattan Institute*, December 2015, http://grattan.edu.au/wp-content/uploads/2015/12/834-GST-Reform-Package.pdf

[73] Lansell House Pty Ltd and Perfek Pty Ltd v. Commissioner of Taxation, Federal Court 2011

[74] Kenny, Paul, The Goods and Services Tax and Food, Flinders University, School of Commerce Research Paper Series: 00-22

The distinction between GST-free and input taxed supplies adds further complexity to the system. Both have no GST in the price, the difference being that suppliers are able to claim input tax credits on acquisitions made in the course of making a GST-free supply but not on acquisitions made in the course of making an input taxed supply. Financial supplies, residential rent and the supply of residential premises are all input taxed supplies and enterprises that make these supplies, along with GST-free and/or taxable supplies, face the added compliance burden of determining which acquisitions are made in relation to the input taxed supplies and are therefore not a creditable acquisition.

The interaction between buyers and sellers who are registered for GST with other buyers and sellers who are not registered for GST (either because they are below the registration threshold or they are not carrying on an enterprise) creates market distortions. If a buyer is not eligible to claim input tax credits, they will have a preference to purchase goods and services from suppliers who are not registered for GST because, all other things being equal, the price of these supplies will be comparatively lower than supplies that are subject to GST. In the case of dutiable transactions such as the sale of commercial property, the fact that stamp duty applies to the GST inclusive price means that even if a buyer is registered for GST and can claim back the input tax credits included in the price, they will still have a preference to buy from a supplier who is not registered for GST as this will reduce the stamp duty payable.

7.2.5 Impact on demand for fresh food

It has been claimed that placing a GST on fresh food will reduce the demand and result in lower returns for farmers. There have also been claims that prices could rise more than the GST and therefore have a bigger impact on consumer demand. Further, concerns have been expressed about the power of the retailers and the extent to which costs may need to be absorbed by farmers.

Farmers generally are part of the GST system with many farmers, for example, cattle, sheep, pig, and grain producers selling produce that is already subject to GST. It is primarily only the horticulture industry that currently sells their produce GST-free that would have these goods subject to GST should the exemption be removed. Note that while the sale of milk at the retail level is GST free, the supply of unprocessed milk or 'raw' milk by dairy farmers is subject to GST.

However, it is unlikely that the impost of the GST will have a significant impact on consumption patterns or demand. Notably, a study commissioned by the Rural Industries Research and Development Corporation (RIRDC) found that the demand for bread and fresh vegetables was shown to have a low responsiveness to price changes.[75] The demand for milk was found to be unresponsive to price variations, and dairy products and fresh fruits were found to have a unit elastic demand. Importantly, expenditure elasticity estimates suggest that milk, bread, fresh vegetables, and fresh fruits are expenditure-inelastic, meaning that they are necessary items in the shopping lists at the lowest levels of expenditure.

While the demand for beef and veal, mutton and lamb, poultry and pork, were all shown to be characterised by comparatively responsive demand in the long run, it was also found that in Australia demand for different meat types is taste-driven, rather than price-driven, with generally insignificant cross-price elasticities across the meat categories.

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[75] Ulubasoglu, M, Mallick, D, Wadud, M, Hone , P, Haszler, H 2011, 'How Price Affects the Demand for Food in Australia: Australian Domestic Demand Elasticities for Rural Marketing and Policy', *Rural Industries Research and Development Corporation*, https://rirdc.infoservices.com.au/downloads/11-062

What this research demonstrates is that the demand for food is unlikely to be impacted significantly by the introduction of a GST on fresh food. Providing compensation to low income earners and welfare recipients will address the impact on both demand and consumption where it will be felt most.

With respect to potential price exploitation of consumers, the Australian Competition and Consumer Commission (ACCC) could be asked to monitor prices at the introduction of a GST on fresh food as they did when the GST was first introduced in 2000, where they had special transitional powers to take action against businesses that adjusted prices that were inconsistent with the changes in the tax rates. It is suggested that better inflation outcomes can be expected where there is some active oversight of repricing in response to tax changes[76].

In relation to the interaction between retailers and suppliers, it is noted that the Food and Grocery Code of Conduct has been in place since mid-2015 and governs certain conduct by grocery retailers and wholesalers in their dealings with suppliers. While this is a voluntary code, the major retailers are signatories to this Code with the ACCC responsible for enforcing the Code. It is also noted that the ACCC now has a specific Agriculture Commissioner who could provide oversight of this.

Notwithstanding this, it is acknowledged that there are some farmers who will remain concerned about the extent to which they may have to absorb the increase in prices due to a GST.

7.2.6 Health impacts

Health groups have raised concern that imposing a GST on food will lead to increases in diabetes, obesity and heart disease[77]. While demand is not expected to reduce, particularly if those on lower incomes are compensated, it should be noted that price is only one factor in influencing behavioural change. Encouraging Australians to eat fresh fruits and vegetables is critical to the long term health of the nation. Broad education programs, school programs to encourage healthy eating from an early age and ensuring that fresh foods can be made available to all Australians, including those in rural and remote Australia and other preventative health measures, are all key factors in assisting with obesity reduction and chronic disease. Quarantining a portion of the revenue raised to fund preventative health measures focussing on healthy eating will result in favourable outcomes on the health of Australians without placing an additional burden on the health system.

Recent research compiled by Colmar Brunton for Ausveg suggested that offering convenient, ready-to-eat formats for vegetables or ensuring consumers know about quick and simple ways to prepare produce, may be key factors in helping Australians make better diet choices[78].

Similarities can be seen with the approach to tobacco. While taxes on cigarettes have increased significantly over the past decades, price has been one factor in a suite of measures to reduce the number of Australians smoking, including health campaigns, quit programs, banning smoking in public places, such as workplaces and restaurants, and health warnings.

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[76] Australian Competition and Consumer Commission, GST final report, ACCC oversight of pricing responses to the introduction of the new tax system, January 2003.

[77] Australian Heart Foundation 2015, GST of fresh foods will only make the problem worse, http://heartfoundation.org.au/news/gst-on-fresh-foods-will-only-make-the-problem-worse

[78] Brunton, C 2015, ‘Project Harvest Monthly Tracker Report’, *Horticulture Innovation Australia*, 30 November 2015, http://ausveg.com.au/email-resources/project-harvest/wave-30/Wave30-FullReport.pdf

7.2.7 *Impact on the poor*

Imposing GST on food can be considered a regressive taxation measure that would have a greater impact on lower-income groups in terms of the percentage tax rate on their level of earnings. However, recent OECD research[79] found that this is not necessarily the case in relation to the absolute value of the tax paid[80]. The OECD found that high income groups purchased more expensive food, and in many cases obtain much more benefit in dollar value terms from exempting food than do lower income groups.

The OECD research also identified that exempting food from consumption taxes is a very blunt measure, and that there are many better targeted options available to help lower-income groups. Further, if we were to consider a 'wealth tax' and charge the GST only on the luxury type of foods (e.g. foie gras, wagyu beef etc.) the level of complexity would be enormous.

National Centre for Social and Economic Modelling (NATSEM) research undertaken for the Australian Council of Social Service (ACOSS) shows that removing the exemption for fresh food would result in people in the lowest 20 per cent of the income brackets paying two per cent more, people in the middle 20 per cent paying one per cent more and people in the highest 20 per cent income bracket paying 0.6 per cent more of their income[81].

Therefore, notwithstanding the OECD research, to address the regressive nature of the tax, an alternative way of approaching this inequity is to ensure that those that cannot afford to pay the GST on food are compensated. Consideration could be given to compensating only the lowest income quintile, or bottom 20 per cent of people. This avoids the issue that most of the GST collected is returned by way of compensation leaving those that can afford to pay the GST, including those who choose to eat luxury items, to be taxed.

Many food items already have GST in the price now. For example, many packaged, processed, and ready to eat foods, therefore the additional cost per household for those that can afford it will be minimal, yet the benefits that will be received in terms of better health care, will benefit everyone.

By compensating low income earners, this removes the regressive nature of the tax for those most in need.

7.2.8 *Targeting better outcomes*

Using a portion of the revenue raised from a GST on food towards compensation for low income earners and welfare recipients, would be a better targeted approach.

Setting aside a further portion of the revenue for health, focussing on preventive health and healthier eating would also be a more targeted approach.

For the agricultural sector, ensuring that the third of the population who live and work in rural and regional Australia have access to adequate infrastructure, including adequate health, education and telecommunications services, is critical. Quarantining revenue to establish a fund for regional

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[79] , Secretary General of the OECD,'Consumption tax trends 2014', OECD Publishing (ISBN 978-92-64-22393-6) http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/consumption-tax-trends-2014_ctt-2014-en#page54

[80] Keogh, M 2015, 'GST on fresh food may be a lesser evil', *Australian Farm Institute*, 20 January 2015, http://www.farminstitute.org.au/ag-forum/gst-on-food-may-be-a-lesser-evil

[81] http://www.acoss.org.au/media_release/using-a-higher-gst-to-pay-for-income-tax-cuts-is-a-recipe-for-more-inequality-with-higher-income-earners-the-winners/

Australia along these lines would be an investment in the future of their children and the future generations of farmers and their communities. In this context, a GST on food would provide a rich return on investment.

7.2.9 Other GST issues

When the GST was introduced, the Commonwealth Government and all of the state and territory governments signed the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations. This agreement included a schedule for the abolition of ten inefficient state/territory taxes that were to be replaced by the GST. Stamp-duty on non-residential property conveyances (i.e. commercial property, business goodwill, shares in a company, etc.) was one of the duties that were to be eliminated however, the states have since only agreed to the removal of duty on non-real non-residential property conveyances. As such, real commercial property such as agricultural land is still subject to stamp duty. An increase in the rate and broadening of the base of the GST would provide additional revenue to compensate for the removal of these duties as originally intended by the Intergovernmental Agreement.

An enterprise must register for GST as soon as their GST turnover exceeds, or is projected to exceed $75,000 ($150,000 for non-profit organisations). The requirement to evaluate projected turnover (which must be done on a monthly basis) against these thresholds is an unnecessary complexity within the system that imposes administration costs and compliance risk to businesses. At these turnover levels, affected businesses are of such a small scale that they often lack the resources to comply with, or the knowledge to be aware of, such a detailed part of the law. Simply evaluating GST turnover on an annual basis (e.g. at year-end or tax return lodgment date when a business owner meets their tax advisor) would significantly reduce this cost and risk to businesses, with minimal revenue risk to the Government given the small scale of those affected.

The GST grouping rules contain anomalies whereby an entity may be excluded from being part of a GST group simply due to its type (e.g. company, trust, partnership, individual), without regard to the ultimate ownership of that entity. For example, two companies can only be part of the same GST group if one has at least a 90 per cent stake in the other, or a third company has at least a 90 per cent stake in both (in which case the third company would also be part of the group). This means that there must always be a holding company and subsidiary company relationship for multiple companies to be part of the same GST group. If two companies are at least 90 per cent owned by a non-corporate entity rather than a company, this relationship does not exist and only one of the companies can be grouped with the non-corporate owner. This is a consequence of how the GST Act defines a 90 per cent owned group, which unnecessarily complicates structuring decisions simply due to the wording of the law.

GST-free exports are a particularly complex area of GST law due to the various conditions that must be satisfied in order to attain GST-free status. For goods to be GST-free exports, they must be shipped within 60 days of the earlier of receiving payment or issuing an invoice. Shipping delays that are out of the local supplier's control can result in this 60 day limit being exceeded, with the GST liability typically falling on the supplier, who is not necessarily in a position to pass the cost on to the buyer after already issuing an invoice or receiving payment. International buyers can purchase goods through a local agent without compromising the GST-free status of those goods, however the law stipulates that the associated costs (such as freight to the dock) are only GST-free if they are incurred by the international purchaser directly rather than through an agent. In essence, the more exemptions that exist, the more complex the legislation becomes, and consequently the greater the number of inequities and nuances that exist, reducing fairness to taxpayers overall.

7.3 Areas for consideration

There are simplicity, efficiency, durability and equity arguments to both raise the rate of the GST and broaden the base and these should be considered as part of the broader debate on tax reform. Broadening the base would be most efficient however, raising the rate would raise the most revenue.

Broadening the base to include fresh food, health and education could make the system more durable in the long term. Applying a GST to fresh food could be considered first, with a GST applying to health and education as more of these services are opened up to greater choice and competition.

In terms of policy outcomes associated with any change to increasing the rate/broadening the base of GST, low income earners and welfare recipients – the bottom 20 per cent - should be compensated. The remaining revenue could be directed to the health system and consideration could be given to establishing a future fund for Australia's regions, ensuring that the contribution of Australian farmers and the communities in which they live can provide the economic growth prospects for Australia as a nation. Such a fund could invest in regional infrastructure, telecommunications, health, and education and would ensure the future viability and sustainability of Australia's regions.

GST reform should also focus on ways to simplify the system and reduce the compliance burden imposed upon businesses. The following changes could be considered to remove some of the complexities that exist within the current system:

- Assess turnover against the GST registration threshold annually rather than monthly;
- Ensure the thresholds are regularly reviewed so that they remain appropriate and balance the compliance burden with the revenue raised;
- Re-write the grouping rules to allow entities with the same ultimate ownership to be grouped regardless of the type of entity that is the ultimate owner; and
- Revise the 60 day shipping requirement so that the supplier is not required to recover the GST is goods are not ultimately exported within 60 days (this could be achieved in a similar way to how GST is collected on imports) and allowing look-through treatment for associated costs incurred by an agent when determining whether exports are GST-free.

The 2016/17 Federal Budget included a proposed change to the small business turnover threshold (from $2 million to $10 million), providing the option for taxpayers under the $10 million threshold to account for GST on a cash basis and pay GST instalments as calculated by the ATO.

7.4 Impact of alternatives considered

The Parliamentary Budget Office (PBO) has modelled a number of scenarios for the 2017-18 year[82]. This modelling shows that applying a 10 per cent GST to basic food would raise an extra $7.2 billion or $4.8 billion after compensation. Increasing the GST to 15 per cent and applying it to basic food would raise $42.7 billion or $31.4 billion after compensation. Increasing the GST to 15 per cent and applying it to basic food, health, medical care, education, child care, water, and sewerage would raise an extra $65.8 billion or $49.3 billion after compensation.

[82] Parliament of Australia 2015, Goods and Services Tax - Distributional analysis and indicative reform scenarios, Commonwealth of Australia, Report no. 05/2015

Note, the PBO has modelled compensation being provided to the bottom 40 per cent of households by disposable income. Therefore, expected revenue would be higher if compensation was paid to the bottom 20 per cent of households rather than the bottom 40 per cent.

It is unclear whether or not any advantage will be derived with the simpler GST reporting announced in the 2016/17 Federal Budget (ie paying instalments as calculated by the ATO) due to taxpayers already having systems and processes in place to report and pay GST on an ongoing basis. However some taxpayers may prefer to report on a cash basis rather than accrual basis in terms of simplified reporting obligations.

8. Business structures

8.1 Background and current position

8.1.1 General choice of structure

All business tax payers need to choose a business structure under which to operate and spend significant amounts of time working through this process.

Because they impose economic costs, all tax systems distort economic decisions. From its simplest, this could be the impact that income tax has on the spending habits of an individual. Although more complex, tax is obviously a major factor in the decision-making process of choosing a structure to operate a business.

There is no doubt that tax is distorting the choice of business structure in Australia, and in most cases, this is largely unnecessary.

Major factors that influence choice of structure are:

- Income Tax;
- Capital Gains Tax (CGT);
- Asset protection and risk mitigation;
- Cost of administration;
- Commercial considerations (for example, flexibility, ability to obtain finance, dealing with customers etc.);
- Succession or other exit strategies and options; and
- Other imposts (such as workers compensation).

In many cases, these factors are initially considered in isolation, which then presents a challenge for advisers who need to weigh up what is more important for their client, as a good outcome for one client will invariably lead to a suboptimal outcome for another. It is therefore a consideration that needs to be undertaken on an individual basis with the adage 'the best structure for a client is one that has the least downside', holding true.

Ideally, businesses seek to access the best aspects of each of the factors above in determining their choice of structure.

The various types of structures, and the benefits and drawbacks of each are outlined in Appendix 1.

The Australian system of taxation of business structures can be contrasted with the system in the United States of America where a company has the ability to opt out of being taxed as a company. In the situation where this option is chosen, income and expenditure flows through to the individual shareholders of the company, effectively taxing those shareholders rather than the company. An overview of the US S-Corporation system is included below.

US S-Corporations

Given the evolution of complex structures, a new, single structure which contains the benefits of existing structures without the complexity may be useful in Australia.

One option that has been proposed is the adoption of the 'S-Corporation' as it is applied in the US. An S-Corporation is a corporation which has elected to have a set of special tax rules applied to it.

S-Corporations can pass corporate income, losses, deductions and credit through to shareholders for tax purposes. The corporation itself is not taxed, as all taxation is undertaken at the individual income level. Shareholders report the flow-through of income and losses on their personal tax returns and are assessed for tax purposes at their individual income tax rates.

S-Corporations offer the benefits of reduced establishment cost and complexity, limited liability (which follows from a corporate structure), and tax treatment similar to a partnership, including for losses. However, the tax treatment is not as favourable as a discretionary trust, as there is only limited ability to choose which taxpayer is liable for tax on the profits of an S-Corporation.

S-Corporation shareholders may claim deductions for losses incurred by the corporation but there are a number of overlapping limitations to the use of S-Corporation losses.

Shareholders must satisfy a series of requirements, including:

- Basis rules — which limit the use of losses to each shareholder's level of investment in the corporation and loans the shareholder has made to the business;

- At-risk limitation — which limits the use of losses to the amount the shareholder stands to lose from their investments or loans to the company;

- Passive activity loss limitation — provides that shareholders who do not have a regular, continual and substantial engagement with the company may only deduct losses from the S-Corporation against income from other passive investments; and

- Hobby-loss rules which quarantine deductions where a business is not carried on for profit.

Source: US Small Business Administration

While, in isolation, an S-Corporation style entity may be an attractive option for some small businesses, introducing such an entity in Australia without otherwise reducing the complexity of the tax system may have mixed impacts on the overall compliance burden for small businesses. This is because businesses will need additional time and professional advice to determine whether such an entity would be better overall than the existing suite of complex structures.

Given that the SBE was introduced in more recent years, while the concept of a US S-Corporation type of entity may appear appealing, it is more likely to sit beside the existing entity structures and therefore add even more complexity to the tax system. While the flow-through benefits are attractive, many agricultural enterprises adopt a combination of entities to ensure both flow-through of income and losses and asset protection are retained. Further, the ATO has previously considered the 'look through taxation' of entities as an anti-avoidance measure in relation to Personal Services Income.

It is therefore suggested that the introduction of a US S-Corporation style of entity into the Australian tax system would provide little added benefits to small business.

8.1.2 Tax treatment of different structures

Currently there are certain tax treatments that are only available to, or are only effective for, certain tax structures. These include the following:

- The research and development (R&D) offset is only available for companies.
- Farm management deposits (FMDs) are only available at the individual level (this includes individuals who are beneficiaries of a trust or individuals who are partners in a partnership, but FMDs are not allowed at the partnership or trust entity level).
- Generally working owners in a company or trust structure are employed to work in the business and are therefore required to make employer sponsored superannuation contributions. This subjects them to the 10 per cent rule before being eligible to make personal superannuation contributions (i.e. if income from employment sources exceeds 10 per cent of total income they are ineligible to make personal concessional contributions). In addition to this, owners working for the company or trust are required to be included on the workers compensation insurance policy, adding approximately 10 per cent to the cost of those wages. Typically owners will not claim on their own workers compensation policy due to the added cost of increased premiums (due to the ‘experience factor’) after a claim.
- Companies do not have access to the 50 per cent general CGT discount, while individuals and trusts do. Superannuation funds receive a $33^{1/3}$ per cent general CGT discount.
- The non-commercial loss provisions only apply to individuals (including individuals who are partners in a partnership).
- Trusts have no tests to claim capital losses.
- Companies have a very strict 'same business test' rules if they fail the continuity of ownership test. There is no ability to make an election to be a ‘family company’ to apply streamlined loss recoupment rules, such as those available to family trusts.
- In some states and territories, trusts continue to have a maximum life (referred to as the perpetuity period). In NSW and the ACT this maximum life is set at a fixed 80 years. In Victoria, Queensland, the Northern Territory, Tasmania and Western Australia the law permits a choice between a fixed 80 year period or a traditional perpetuity period (essentially being 21 years after the conclusion of a ‘then existing’ life). In South Australia however, this concept has been removed and trusts can continue for an indefinite period.
- Companies have limited liability, as do special purpose trusts with a corporate trustee, but other structures do not.
- It is relatively simple to draw capital from a non-fixed trust tax free however to access capital from a company is much more difficult. Various steps are generally set out for doing so in the Corporations Act and these amounts are often taxed as dividends if paid out during the life of the company but are often treated as returns of capital (similar to the proceeds on the sale of shares) if distributed during a formal liquidation.

8.2 Issues associated with current position

8.2.1 General choice of structure

The main issue with the current position is that the factors of income tax and CGT usually have priority when assessing structure choice. Even if the tax aspects did not have that priority, a taxpayer should not be locked into a sub-optimal outcome for tax and CGT just because they place a higher priority on (say) cost of administration or asset protection.

There is no doubt that the difference in methods of taxing income and capital gains in companies is having an impact on structure choice and, more importantly from a cost point of view, the number of structures chosen (and hence the added issue of complexity).

Overall the differences in the tax system as they apply to different entity types are having a distortionary effect on the way businesses are structured and are creating inequities between taxpayers. Reducing these differences would appear desirable.

It is noted that even when reform projects have been undertaken (such as the Modernising the Taxation of Trust Income – Options for Reform project that was announced to be conducted on 16 December 2010) they have not resulted in any real changes to the current tax system, underlining the challenge of trying to balance simplicity with equity.

8.2.2 Tax treatment of different structures

FMDs are not available at the entity level, which creates a disparity between the business (the borrower) and the individual making the deposit. As FMDs are available to the beneficiary of a trust, a situation is created whereby the FMD offsets the trust distribution in good times, whereas the FMD withdrawal is assessable in the individuals' hands, and the loss from the business is trapped in the trust in times of low income. FMDs held by beneficiaries of trusts can also cause problems in relation to the non-commercial loss rules and $250,000 other income test.

It would seem inequitable that FMDs are not available to a primary producer operating in a company structure. Practically it would simplify many of the issues associated with FMDs if they were held at the entity level, rather than by individuals. Further discussion on FMDs is included in the risk management section of this report

R&D tax provisions can only be accessed by companies. Further, results of the R&D must, in most cases, be 'owned' by the entity that carries on the R&D. In respect of 'red tape', when a business has to incorporate another entity (company) to access the concession, this stifles access to the concessions and, in turn stifles R&D in agriculture. Less than 2 per cent of the $614 million research and development tax offset recognised in the 2010-11 year was attributable to agriculture, forestry and fishing. Furthermore, 'public expenditure on R&D in agriculture which grew at an average of 6.5 per cent a year between 1953 and 1980, has since grown at only 0.6 per cent a year' according to an Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) report published in 2011[83].

The Government largely recognises that small producers cannot gain the economic return from individual R&D investment and thus provides funding to rural research and development corporations directly to achieve desired levels of innovation. This is by way of matching dollars to the agricultural

[83] Moir, B and Morris. P 2011 'Global food security: facts, issues and implications', ABARES Science and Economic Insights, Issue 1 – 2011.

levies raised by industry. 2014-15 saw a boost of $100 million over four years in competitive grants on top of the $250 million the Government provides annually[84].

8.3 Areas for consideration

8.3.1 General choice of structure

Where owners of the business are also employees (i.e. in the case of companies and trusts), it is proposed that there be an opt-out election for workers compensation in respect of those owners. This would allow the business owners to accept the risk or obtain their own personal insurances.

8.3.2 Tax treatment of different structures

It is suggested that consideration be given to FMDs being allowed to be held at the entity level rather than individual level (see Risk Mitigation section).

Capital losses could be subject to the trust loss rules in the same fashion as revenue losses. Currently capital losses can be accessed and utilised easily by a trust to reduce future capital gains, whereas there are many complex tests that a trust has to go through to claim losses on revenue account. It is not clear why one loss should be able to be easily accessed while another loss is subject to stricter integrity measures.

Companies could be allowed to make a 'Family Company' election based on similar criteria and similar consequences as a trust making a 'Family Trust' election. Currently a trust that has made a Family Trust election can claim revenue losses relatively easily. On the other hand, a company must either pass the 'Continuity of Ownership Test', or, if it can be proven that the company fails this, the 'Same Business Test' to enable the company to claim revenue losses. Practically, a 'Family Trust' can claim losses easily whereas a company cannot.

The states and territories should consider removing perpetuity periods (i.e. 80 year life span) on trusts allowing them to have an indefinite life.

The superannuation 10 per cent rule could be removed allowing all taxpayers to make personal concession superannuation contributions up to the contribution limits regardless of their source of income. It is noted that this has been proposed in the 2016 Budget (and included in the draft legislation in September 2016). If this change is implemented all individuals up to age 75 will be able to claim a tax deduction for personal superannuation contributions regardless of their employment circumstances. This provides more equal treatment for taxpayers regardless of their choice in business structure or additional employment.

Returns from companies could be taxed equally if distributed during the life of the company as they are upon ultimate liquidation. There are some amounts that will always be on income account if paid out as dividends during the life of the company and are on capital account (i.e. form part of the return of capital) if paid out on liquidation. Profits from pre-CGT capital gains and small business exempt amounts are good examples. Further, where a company uses the indexation method of calculating a capital gain, there is obviously no tax on the indexation amount in the life of the company, whereas on liquidation, this amount is assessable income (as a dividend) to the shareholders.

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[84] Australian Government Department of Agriculture and Water Resources 2015, Research and innovation, http://www.agriculture.gov.au/ag-farm-food/innovation

8.4 Impact of alternatives considered

The main impact of the proposed changes is that there will be a significant reduction in red tape.

Overall, removing differences in the tax treatment of different structures will enable business to determine the most appropriate structure for their business needs without as many tax factors distorting the decisions and improving fairness in the system overall.

8.5 Case study

Mr A is looking to buy a farm and run it with his wife. He is concerned with asset protection, having some first-hand issues in the past. The turnover of the business will be under $2 million. Estimated taxable income will be $160,000 per annum.

The lowest cost option is to own the land and run the business in an equal partnership.

The most advantageous income tax result would be to operate the business in an equal partnership. This would result in tax payable of $35,094 versus company tax of $48,000. However, if the company subsequently paid a franked dividend, the refund of imputation credits could get the family back to the same net tax position. The unfavourable cash flow and red tape outcomes associated with this approach, when contrasted with a partnership however make it unwieldly.

If a partnership is chosen, there would be no workers compensation on living expenses and superannuation contributions.

Mr A chooses a company to operate the business and a partnership for him and his wife to own the asset. The company was chosen for asset protection purposes.

Mr and Mrs A pay more tax on income (at least until dividends are paid and profits are flushed through to the ultimate owners).

Mr and Mrs A now need two entities - the company to operate the business and the partnership to own the land. This requires two sets of ABNs, GST registration, GST grouping, financial statements and tax returns.

Mr A and his wife now have the added burden of becoming employees of the company, with the administrative and financial burdens of workers compensation (at around eight to11 per cent) and SG (currently 9.5 per cent). Further, SG contributions must be made quarterly, whereas where family members are in effect making contributions for themselves, it may make more sense to make contributions less often (i.e. once a year in June) which a sole trader or partner of a partnership can do.

In terms of superannuation, Mr and Mrs A can now only make employer concessional superannuation contributions through the company, and as superannuation is counted as wages, they lose 10 per cent in workers compensation costs.

As Mr and Mrs A own the company and are the employees, it should be noted that for workers compensation purposes, there is no insured benefit for Mr A and his wife. Practically, if Mr and Mrs A were to make a claim under workers compensation, any payout to the employee would be charged back to the employer over a period of time in increased premiums. As a result, typically most owner-managers will not claim on their own workers compensation insurance policy.

If Mr and Mrs A are eligible for SBE CGT exemptions, they may decide to buy the asset in a company. If asset protection was important, a second company would be required for the operations, leading to complexity.

9. Small business entities (SBE)

9.1 Background and current position

The concept of the SBE was introduced in the 2008 income year. At a very broad level an SBE is a sole trader, partnership, company or trust that has an aggregated turnover of less than $2 million. If a business meets the general aggregated turnover threshold rule, they can be entitled to concessions on income tax, FBT, CGT and other concessions (some of the concessions have further eligibility criteria).

If you do not qualify as a small business in an income year, you may still be eligible for the CGT small business concessions if you have net assets of $6 million or less. Practically, the regime is a range of special concessions for 'small business'. The concessions are intended to assist small businesses in funding business expansion, improve their competitiveness with larger businesses and assist with providing for retirement of small business owners.

As part of the 2015 Federal Budget, the Government announced the 'Growing jobs and small business package'. The most significant tax measures contained in this package were the 1.5 per cent company tax rate reduction, five per cent tax offset for unincorporated entities and an increase in the immediate depreciable asset deduction threshold from $1,000 to $20,000. All of these measures are restricted to SBEs as defined by the Income Tax Assessment Act 1997 (ITAA 1997).

In addition to this, the 2015 Federal Budget included accelerated depreciation provisions for primary producers designed to encourage investment in drought preparedness. Originally planned to commence from 1 July 2016 but subsequently brought forward to apply from 7:30pm AEST 12 May 2015 (Budget night), primary producers can claim an immediate deduction for the cost of water facilities that were previously deductible over three income years, an immediate deduction for the cost of fencing assets (except stock yards) and a deduction over three years for the cost of fodder storage assets.

The 2016 Federal Budget has proposed to increase the SBE turnover threshold from $2 million to $10 million, increasing access to a number of tax concessions for many more businesses. As part of the 2016 Budget it was also proposed to extend the unincorporated small business tax discount to businesses with an annual turnover of $5 million (up from $2 million) and increase the discount to 8 per cent, with the discount to be increased in phases over the next decade, to 16 per cent. The proposed $10 million threshold WILL NOT extend to the Small Business Capital Gains Tax concessions – the $2 million turnover and $6 million net asset thresholds will still apply.

9.2 Issues associated with current position

As the turnover threshold of $2 million for an SBE is not indexed and neither is the net asset threshold of $6 million, the cut-off that was considered relevant when the legislation was first introduced becomes more and more irrelevant.

The turnover concept ignores different business models - high and low gross profit margins. For example, a business with a turnover of $2 million and a profit of $1.6 million is an SBE, whereas a business with a turnover of $10 million and a profit of $100,000 is not.

In essence, businesses with high turnover and low profit margins are discriminated against (it is noted that there is a special rule regarding retail fuel sales remedying this problem but this does not address the issue for other industries). Possibly the purest form of measurement here is profit, although it may be open to greater manipulation compared with the current turnover test.

The cut-off for an SBE is a ‘cliff face’. For the sake of $1 or more in net assets or turnover, there can be a significant difference in tax payable, hence resulting in inequities. For example, one primary producer and his wife have a $10 million capital gain and $1.9 million turnover. They access the 50 per cent discount, the 50 per cent active asset, the $500,000 retirement exemption or CGT rollover, and potentially pay no tax on the gain. A similar business owner with $2.1 million of turnover would pay (assuming top rate of tax of 45 cents in 2016 and ignoring levies) $2,250,000.

While it is important to retain a threshold, some of the inequities created by the current thresholds could be addressed.

Further, the net asset test currently applicable only for CGT exemptions creates some confusion. This will be further confused if the 2016/17 Federal Budget changes to the turnover threshold for other small business tests is not extended to the CGT concessions.

The small business and primary production changes contained in the 2015 Federal Budget were received positively by the public[85] and supported by the Federal Opposition[86]. 96 per cent of businesses in Australia are small businesses[87] and the tax relief provided by these measures, at a time when business confidence[88] and economic growth[89] was lagging, was considered necessary and timely by many observers.

Following the announcement that accelerated depreciation for primary producers would be brought forward to also apply from Budget night, businesses reported surging sales as taxpayers sought to increase capital expenditure prior to 30 June in order to claim deductions under the new measures in the 2015 income year. Alan Hood, director of Cooma Rural Supplies, commented to ABC news that there had been a 10-15 per cent increase in sales in June, while Anthony Fitzgerald, a sales representative for Gallagher, estimated that the animal management system developer had experienced a 30-40 per cent increase in sales since the budget was handed down[90].

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[85] The Parliament of The Commonwealth Of Australia 2015, Tax Laws Amendment (Small Business Measures No.2) Bill 2015, http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r5466_ems_1a477986-36c2-41e2-ba77-d263aff4b67b/upload_pdf/502815.pdf;fileType=application%2Fpdf

[86] Labour Government 2015, Budget Reply Speech 2015, http://www.alp.org.au/budget_reply_speech

[87] Australian Government 2015, Budget 2015: Growing Jobs and Small Business, http://www.budget.gov.au/2015-16/content/glossy/sml_bus/download/Growing_Jobs_and_Small_Business.pdf

[88] National Australia Bank 2015, NAB Monthly Business Survey – April 2015, http://business.nab.com.au/nab-monthly-business-survey-april-2015-10774/

[89] Westpac Banking Corporation 2015, The Australian Economy June 2015, https://businessfocus.westpacgroup.com.au/blog/2015/june/10/the-australian-economy-june-2015/

[90] Clarke, M 2015, ‘Rural communities reaping benefits from Government budget tax breaks’, *ANC News,* 23 June 2015, http://www.abc.net.au/news/2015-06-23/budget-tax-breaks-boon-for-farmers-rural-communities/6564968

Although the increase in the immediate deduction threshold was welcomed by small businesses, there is concern that it incentivises purchases of lower cost and less productive assets. Unlike the $5,000 motor vehicle deduction that was in place between 1 July 2012 and 31 December 2013 which allowed small businesses to immediately deduct the first $5,000 of any motor vehicle purchase,[91] the immediate deduction threshold only applies to assets that cost less than $20,000. This may distort decision making as the timing benefit encourages businesses to purchase multiple low cost assets rather than investing in a higher cost, potentially more productive asset.

For example, an SBE that purchases five assets for $15,000 each can claim a tax deduction of $75,000 in the first year. If those funds were used to purchase a single $75,000 asset the first year tax deduction that can be claimed is only $11,250. For a company paying tax at the 28.5 per cent SBE corporate tax rate, this equates to an initial cash flow benefit of $18,169. Immediately deducting an asset rather than depreciating it provides taxpayers with a timing benefit, however temporal discounting can cause this to encourage sub-optimal business decisions, particularly when assets with a cost below the immediate deduction threshold are substituted for more productive assets with a cost greater than the threshold.

The $20,000 immediate deduction threshold is scheduled to revert back to $1,000 from 1 July 2017[92]. This may also encourage unproductive investment in assets costing between $1,000 and $20,000 as the deadline approaches and fear of missing out motivates uneconomic decision making.

The effect of inflation on business turnover has not been provided for since the small business turnover threshold was increased from $1 million to $2 million from 1 July 2007. $2 million in December 2007 is equivalent to $2.4 million in December 2015 however, the aggregated turnover test throughout those nine income years has been held at $2 million.

9.3 Areas for consideration

The existing package of SBE tax measures provides a necessary boost to small businesses whose scale puts them at a competitive disadvantage. These also help to simplify the record-keeping obligations of small business, minimise compliance costs, and should be maintained.

9.3.1 SBE definition

In terms of the SBE thresholds, the thresholds should be indexed or reviewed on a regular basis (for instance every three years) to ensure they remain appropriate. This would include an initial increase to bring the thresholds up to what they should be had CPI increases been applied from the start.

Recommendation 30 from the Henry Review that the SBE income threshold be increased from $2 million to $5 million is supported for its simplicity. This would address some of the concerns with the current system. Under this proposal, a maximum cap on net assets of $12 million could be provided as an added integrity measure (rather than the existing choice of turnover or net assets).

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[91] Parliament of Australia 2011, Budget 2011-12: Small business car tax write-off, http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/BudgetReview201112/CarTax

[92] Parliament of Australia 2015, Tax Laws Amendment (Small Business Measures No.2) Bill 2015, http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r5466_ems_1a477986-36c2-41e2-ba77-d263aff4b67b/upload_pdf/502815.pdf;fileType=application%2Fpdf

The proposal in the 2016/17 Federal Budget to increase the SBE threshold from $2 million to $10 million will see more primary production businesses benefit from access to additional concessions, however this does not assist with the Small Business CGT thresholds that have not changed since those measures were introduced in 2007/08.

In the absence of this (ie if the change is not legislated), to fully address the cliff face concerns, consideration could be given to a three year average of turnover or profit or in line with the indexing of thresholds.

In terms of the turnover and the suggested profit thresholds, a single year is often not representative of the true size of the business. Invariably many businesses may experience isolated events that result in losses arising, or have the ability to change their circumstances which results in distortions over certain periods of income, for instance a cotton farmer selling cotton through a pool versus directly.

As a result, it would seem that something similar to the three year average of turnover or profit as provided under the former *Simplified Tax System (STS)* would provide a better representation of the true size of the business. It should be emphasised that this is different to the three tests that currently apply to determining $2 million turnover (i.e. likely or actual current year, or prior year).

Further, an entity should be able to be classified as a small business entity either on turnover, taxable income or net assets for **all** SBE concessions, with these thresholds subject to indexation. Consideration could be given to a new baseline/initial thresholds of $2.4 million turnover, $7.2 million net assets and $240,000 of taxable income (these allow for the CPI increase since the thresholds were originally introduced).

To address the concerns regarding 'cliff face' thresholds, a second tier of thresholds could apply to CGT, whereby 50 per cent of those concessions would be allowed where turnover was between $2.4 million and $3 million, or net assets between $7.2 million and $9 million, or taxable income between $240,000 and $300,000.

Note, for the non-monetary concessions such as the 'SBE stock take concession', the upper limits would apply in terms of determining eligibility (rather than the $10 million proposed in the 2016/17 Federal Budget).

The consistency of definitions across the tax system would also be a significant benefit in relation to reduced complexity and reduced red tape.

9.3.2 Immediate asset write-off

The immediate deduction threshold for asset purchases could be increased permanently and applied to the first $5,000 of ALL asset purchases (to be consistent with the recommendation under 'Investment in the Industry'). The remaining cost of the asset is then added to the pool and depreciated under existing rules. This will continue to provide a simpler method of tax deductibility for the lower cost items without distorting economic decisions. It is acknowledged that should the proposal to increase the SBE threshold to $10 million be implemented, many more businesses will have access to simplified and increased tax concessions.

9.4 Impact of alternatives considered

The phase out changes would result in greater fairness and opportunity for businesses that fall outside of the current thresholds.

The suggestion of considering three year average turnover or taxable income would also reduce the likelihood of the thresholds being manipulated in order to meet the tests.

10. Succession planning

10.1 Background and current position

Australian Bureau of Statistics (ABS) released a report in 2012 for Australian Social Trends[93]. The report included the following findings:

- In 2011, the median age of farmers was 53 years, compared with 40 years for people in other occupations.

- In 2011, almost a quarter (23 per cent) of farmers were aged 65 years or over, compared with just 3 per cent in other occupations.

- The median age of farmers increased by nine years between 1981 and 2011. The proportion of farmers aged 55 years and over increased from 26 per cent to 47 per cent, while the proportion of farmers aged less than 35 years fell from 28 per cent to just 13 per cent.

- In 2011 there were 93,300 farming families. 90 per cent of farms are family owned.

- More than half (56 per cent) of Australia's farmers were self-employed owner managers.

These statistics support the general view in the industry that succession is a very important issue to be addressed now and into the future.

Primary producers recognise that they should face the challenges of succession planning early. Anecdotally, farm businesses are more inclined to thrive financially if management control is passed onto the next generation while the owner is aged in their 30's rather than in their 40's or 50's. This is because risk profiles typically change as people get older (i.e. become more conservative); younger farmers embrace new and more efficient technologies; and there can be higher energy levels of the younger generation. If this is undertaken well, the exiting generation can still be involved to provide support and guidance. Ultimately this should result in more viable farm businesses in the long term.

A common concern raised by farmers when considering succession planning is in relation to the likely tax liability associated with unwinding existing tax structures to better suit the incoming generation.

Family owned and operated farm businesses are unique in comparison with many other businesses because of the cross-over between family life and the farm business – as well as all of this being at the one physical location. This leads to many family farm businesses (and hence the assets that they control) continuing from one generation to the next.

This characteristic is not unique to Australia. It is acknowledged that these issues are also not exclusive to the agricultural industry and that any ongoing family business would have to face similar issues. What is different for agriculture is the capital-intensive nature of the industry, generally leading to tax considerations with greater quantum, and therefore potentially having a major impact on the future viability of the business.

Given the timing of introduction of CGT in 1985, many businesses are facing a change from pre-CGT status with farm land to post-CGT status; with a significant amount of value associated with these assets. Any farm land acquired since the introduction of CGT is already subject to CGT.

CGT is not the only tax consideration. There are other considerations, as follows:

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[93] 4102.0 Australian Social Trends – Dec 2012, Australian Bureau of Statistics

- Retained profits in companies – it is typical for farmers to re-invest profits into the business, leaving a corporate structure with retained profits subject to tax at individual marginal tax rates if the structure is to be unwound as part of a succession plan (often the case where the next generation do not choose to trade together).

- Unrealised profits on livestock because of the lower tax values for natural increase.

- Lower written down value of plant and equipment for tax purposes compared with current replacement value, and hence unrealised profit to be considered for disposal/transfer.

- FMDs becoming assessable at the time of ceasing to be a primary producer, or dying.

- Superannuation rules and how they impact the retiring farmer (see superannuation section of this report).

- Stamp duty is also a potential significant cost in transferring agricultural assets to the next generation. (See 'State taxes' section of this report for further detail).

10.2 Issues associated with current position

10.2.1 Capital gains

Due to the relatively capital intensive nature of farm businesses, capital gains are usually the most important tax considerations for succession planning. CGT assets passed through an estate are not subject to CGT until the beneficiary sells the asset. Family groups who meet the SBE definition for the small business CGT concessions generally have flexibility when it comes to capital gains and therefore how this can fit in with succession plans. Those who are not eligible face the potential of a significant tax liability, or they will resist changing their business structure and most appropriate succession plan (including the passing of management control) to further push out the CGT liability (as CGT is not necessarily triggered from assets passing to the next generation after someone dies). This results in a sub-optimal outcome as far as succession planning is concerned, however the intention of passing the assets onto the next generation is no different to choosing to pass the assets through an estate (no CGT triggered) or for those eligible for small business CGT concessions.

The small business CGT concessions involve 'cliff face' thresholds with no phase outs. If a taxpayer has under $2 million in turnover or under $6 million in net assets they are eligible (assuming all other criteria are met), but as soon as these thresholds are exceeded (even by small amounts) they cannot apply the concessions. While the two-test approach of turnover or assets provides alternatives for businesses with different attributes (e.g. high turnover-low margin businesses potentially still being eligible under the net asset test), the lack of any phase-out remains a concern.

We note that a further issue with the CGT small business provisions is that parents leasing land to the next generation as part of succession transition may lose active asset status, which can limit planning opportunities.

10.2.2 Entity structure and unrealised/retained profits

Families will not always choose to retain the same business structure as that used by their parents, and in many cases it is sensible to unwind the structure during the succession process as different family members become involved, and thought is being given to future generations as much as the current generation.

10.2.3 Farm management deposits (FMD)

If the retiring generation hold FMDs at the time of retirement they will be taxable in that year. Likewise if a family member dies, FMDs will be assessable in the final tax return of the deceased. Taxpayers can plan around retirement, but obviously not as well for death. See further detail regarding FMDs the 'Risk management' section of this report.

10.3 Areas for consideration

10.3.1 CGT

Tax relief should apply in the form of a CGT rollover (i.e. tax liability being passed from one generation to the next, but not triggering disposal/realisation of profits until a disposal to a third party occurs) for the transfer of assets within a wholly owned family group. This tax relief should apply to all family businesses, not just those in the agricultural sector, otherwise this would create significant inequity in the tax system. The aim is essentially to provide CGT relief during the life of a taxpayer that would currently be available on death.

Consideration should be given to the CGT small business concessions having phase out thresholds to fix the current problem of 'cliff face' thresholds (this recommendation is elaborated on further under the 'Small business entities' section of this report). Consideration should also be given to including a three year average for turnover as used to apply under the 'Simplified Tax System' (STS) rules.

10.3.2 Transfer of livestock and plant at tax values

Consideration should be given to allowing inter-generational transfers without the need for a 25 per cent continuing ownership interest for livestock and a continuing ownership interest for plant. This would avoid the need for the retiring generation to continue in business for a period of time before the assets can be passed to the next generation in their entirety, which adds an unnecessary step in the succession planning process.

10.3.3 Superannuation

As highlighted at the start of this section, the ageing farmer population is well known. Older farmers have not necessarily invested in retirement savings due to competing cash flow demands over the years and the pressures during periods of drought, low commodity prices, and for many, the declining terms of trade in agriculture and the need to increase scale. The age-based limits for superannuation contributions limit the ability for retiring farmers to invest adequate amounts in superannuation for their retirement. From a policy perspective, incentives are important in terms of enabling self-funded retirees to save so they do not need to rely on the public system as much during their retirement.

Consideration should be given to removing the work test beyond age 65 (as also suggested under the age based contribution limits section in this report) to open up superannuation planning for older business owners. Integrity measures would have to be considered in terms of how these proposed changes would integrate with the superannuation measures associated with the small business CGT concessions. It is noted that the 2016 Budget proposed removing the work test and applying the same contribution acceptance rules for all individuals aged up to 75. This proposal allows those taxpayers with a later start with superannuation contributions to receive the tax benefits and still have the opportunity to be self-funded in retirement and take pressure off the public system.

10.3.4 Other issues

The 'State taxes' section of this report refers to inter-generational stamp duty concessions.

The 'Business structures' section of this report refers to a 'family company' election (similar to a 'family trust' election).

10.4 Impact of alternatives considered

10.4.1 CGT

Having a phase out of the thresholds relating to the small business CGT concessions would provide greater fairness in the system and less likelihood of manipulation.

Rollover relief for transfer of business assets among family members would create a timing issue, but not a permanent tax difference. It would encourage family businesses to succeed over multiple generations without the concern of CGT liabilities being triggered. This would also create some equality between passing assets to family members during a taxpayer's lifetime compared with doing the same through their estate.

10.4.2 Transfer of livestock and plant/equipment at tax values

Allowing the transfer of livestock and plant and equipment without 25 per cent continuity of ownership test would remove an administrative and structural difficulty associated with the current system.

10.4.3 Superannuation

Allowing business owners to increase their superannuation contributions later in life allows them to be self-funded in retirement. Employees have the security of knowing that their employer is setting aside the SG as a minimum for their long-term retirement. Business owners take a lot more risks and have to deal with variability in profit and cash flow such that for many years they may not be in a financial position to fund superannuation contributions for themselves.

11. Superannuation

11.1 Background and current position

Superannuation is considered to be the key savings vehicle for allowing individuals to provide for their retirement. The system is now underpinned by SG contributions from employment earnings. Saving in superannuation should have the key element of providing for retirement. Superannuation is the second largest savings vehicle, behind the family home and makes up 22 per cent of all assets held by Australian households[94].

The superannuation system was overhauled by the Howard government in the 2006 year with the introduction of Tax Laws Amendment (simplified superannuation) Bill 2006[95]. The fundamental changes included the abolition of the reasonable benefits limits, while at the same time capping contributions that could be made to superannuation. At that time, annual contribution caps were introduced of $50,000 concessional and $150,000 non concessional (with the ability to use a bring forward rule for non concessional contributions up to $450,000). Earnings within pension phase from that time had no tax applied and pensions/income streams taken from superannuation for those over 60 were exempt from income tax. The policy intent of ‘Simpler Super’ was to improve retirement incomes and increase incentives to work and save. It was also designed to reduce the administrative burden of the system and make it simpler to understand; an intent well achieved.

The simplification of the system at that time, along with the introduction of very generous concessions has subsequently led to strong growth in the sector and in total savings. To demonstrate the relative growth, in 1989 there was $119 billion in superannuation rising to $148 billion in 1992 at the time SG was introduced at 3 per cent. When the Howard Government introduced the ‘Simpler Super’ provisions in 2006 there was already $912 billion in superannuation. At June 2015, total superannuation assets were $2 trillion and are predicted to grow to $9 trillion by 2040[96].

In 1993 the World Bank endorsed Australia’s three pillar system for the provision of retirement income as world’s best practice. The three pillar system refers to the Age Pension, compulsory savings through SG and voluntary superannuation saving[97].

In 2010 both the Cooper and Henry reviews were focussing on superannuation, with the impact on policy along with the relationship to income tax.

The 2016 Federal Budget made a number of proposed changes to the superannuation system to more closely target tax concessions. See the list at 11.1.3 regarding the proposed changes, with these elements considered in further detail throughout this Chapter.

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[94] Australian Government 2016, Objective of Superannuation – Discussion Paper, http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2016/Objective%20of%20superannuationannuation/Key%20Documents/PDF/objective_superannuation_DP.ashx

[95] The Tax Laws Amendment (Simplified Superannuation) Bill 2006 Explanatory Memorandum, http://www.alp.org.au/fairer_superannuation_plan

[96] Australian Government 2016, Objective of Superannuation – Discussion Paper, http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2016/Objective%20of%20superannuationannuation/Key%20Documents/PDF/objective_superannuation_DP.ashx

[97] Parliament of Australia 2010, Chronology of superannuation and retirement income in Australia, http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/BN/0910/ChronSuperannuationannuation

11.1.1 The current system

A very brief summary of key current rules includes:

- Superannuation fund balances in accumulation phase (i.e. the period where members are contributing to their superannuation) have their taxable incomes taxed at 15 per cent with capital gains attracting a 1/3 concession to bring the effective CGT rate to 10 per cent. Franking and foreign tax credits can be claimed and offset not only against income but also concessional contributions.

- Superannuation fund balances in pension phase (i.e. the period where members are drawing on their superannuation) pay no tax on their income – neither on ordinary income or capital gains. Franking tax credits can be claimed and in a 100 per cent pension fund, will generally result in a tax refund of franking credits being paid to the fund for the benefit of the members in pension phase. Foreign tax credits are generally denied to those in pension phase.

- Contribution caps: Concessional (tax deduction claimed) $30,000 for those under 50 and $35,000 for those over; Non concessional (no tax deduction claimed) $180,000 per year or $540,000 over three years (only available to those under 65 for the three year bring forward rule).

- Small business CGT concessions can link with superannuation contributions including the retirement exemption that has a life time limit of $500,000 and the 15 year asset exemption which requires a sale of an active business asset for those over 55 and retiring from business with a total CGT cap of currently $1.395 million. The $500,000 small business CGT retirement exemption amount can be contributed under either the superannuation CGT cap or as part of the non-concessional contributions cap at the discretion of the member.

- Special rules are in place regarding excess contributions. These complex rules were until recently largely unfair and recent changes have improved the integrity and fairness of the system.

- Contributions tax of 15 per cent is applied to all concessional contributions made. Additional contributions tax is applied for those with incomes greater than $300,000.

- If you are aged over 18 and are paid $450 (before tax) a month, employers must pay 9.5 per cent of the ordinary time earnings of their employees into a complying superannuation funds or retirement savings account. The $450 a month has remained unchanged since 1992 and has not taken inflation into account. In line with the Reserve Bank of Australia's (RBA) inflation calculator an amount valued at $450 in 1992 would be worth $809 in 2015.

- Rebates of the contributions tax are available to low income contributors and this is known as low income superannuation contribution (LISC). The maximum amount is $500 and it is available to those on incomes of less than $37,000.

- Age based limits are in place that require a work test to be met after age 65 to continue contribution eligibility. After age 75, only SG contributions can be made.

11.1.2 Proposed changes

On 9 March 2016, the Minister for Small Business and Assistant Treasurer, the Hon Kelly O'Dwyer MP, released a discussion paper entitled "The objective of superannuation" for public consultation. The desire is to enshrine in legislation a guide to policy makers, regulators, industry and the community about superannuation's fundamental purpose. The press releases surrounding the discussion paper confirm the Federal Government's view that superannuation should not be a vehicle for wealth accumulation and succession planning. At a gathering of the Association of Superannuation Funds in Australia in Melbourne on 9 March 2016, Ms O'Dwyer indicated "No one has a right to a superannuation tax concession. It is a gift that the government should only provide when it makes sense… The government accepts the financial system inquiry's recommendation that the objective of the superannuation system is to provide for retirement and to substitute or supplement the age pension"[98].

The points raised in the discussion paper (see table below) include standard of living in retirement, adequacy, fiscal sustainability and increasing of national savings. The last issue is noted as no longer being as strong a motivation however, it is worth noting that prior to the introduction of SG, we were not known to be a nation that would save and this has fundamentally changed, primarily due to the superannuation system.

Subsidiary objective	**Why the objective is important**
Facilitate consumption smoothing over the course of an individual's life	Superannuation is a vehicle for individuals to fund consumption in retirement largely from working life income. The system should facilitate consumption smoothing while providing choice and flexibility to meet individual needs and preferences.
Help people manage financial risks in retirement	Risk management is important as retirees generally have limited opportunities to replenish losses. The retirement income system should help individuals manage longevity risk, investment risk and inflation risk. Products with risk pooling would help people to manage longevity risk efficiently.
Be fully funded from savings	A fully funded system, as opposed to an unfunded system, is important for sustainability and stability. The system is designed to be predominantly funded by savings from working life income and investment earnings, where superannuation fund members in general have claims on all assets in the fund.
Be invested in the best interests of superannuation fund members	Superannuation funds are managed for the sole benefit of members, which means the investment focus should be on maximising risk-adjusted returns, net of fees and taxes, over the lifetime of a member. This results in auxiliary benefits to the economy by creating a pool of savings to fund long-term investment.
Alleviate fiscal pressures on government from the retirement income system	Government's total contribution to the retirement income system, through both the Age Pension and

[98] Rose, S 2016, 'Kelly O'Dwyer says superannuation isn't for wealth accumulation or bequests', *Financial Review,* 9 March 2016, http://www.afr.com/personal-finance/kelly-odwyer-says-superannuation-isnt-for-wealth-accumulation-or-bequests-20160309-gneg3m

	superannuation tax concessions, needs to be sustainable and targeted. Higher private provisioning for retirement should reduce the burden on public finances.
Be simple and efficient, and provide safeguards	The system should achieve its objectives at the minimum cost to individuals and taxpayers. Complexity is less appropriate for a compulsory system, as it tends to add to costs and to favour sophisticated and well-informed investors. Given the compulsory nature of SG contributions, the system needs prudential oversight and should provide good outcomes in both the accumulation and retirement phases for disengaged fund members.

Source: Financial System Inquiry Final Report

Issue	**Points to consider**
Retirement income *or* standard of living in retirement	While retirement income will provide resources to help a person meet their costs of living in retirement, standard of living is broader as it includes the use of both income and assets. Both also clarify that superannuation is meant to help fund a person's retirement, it is not for unlimited wealth accumulation or bequests.
Adequacy	While adequacy provides a sense of targeting superannuation and is consistent with fiscal sustainability, there is no consensus of what adequacy means. While the OECD defines it through the use of replacement rates, implying people have different levels of adequate retirement incomes according to their wages, others may conceive of a single level of income applicable to all.
Fiscal sustainability	The superannuation system should also be fiscally sustainable - through reducing reliance on the Age Pension and providing tax concessions that are targeted. While the objective of the system is to improve retirement incomes, balancing the need for fiscal sustainability may mean there is a limit to the support that can be given.
Increasing national saving	While this was an important motivation for establishment of the superannuation system, as perceptions and the economy have evolved the need for prominence in the objective may have reduced.

Source: Financial System Inquiry Final Report

11.1.3 2016/17 Federal Budget proposed changes

The objective for superannuation to provide income in retirement to substitute or supplement the Age Pension will be enshrined in law (included in the September 2016 draft legislation).

The proposed reforms to superannuation include[99]:

- the introduction of a $1.6 million cap on the amount that can be transferred to tax-free pension balance;
- a 30 per cent tax on concessional contributions for those earning over $250,000 per annum;
- a lower $25,000 annual concessional contributions cap;
- the reduction of non-concessional caps to an annual amount of $100,000 rather than $180,000 and a balance cap of $1.6 million in relation to any further non-concessional contributions;
- allowing unused concessional caps to be carried forward by individuals with superannuation balances of $500,000 or less, to enable 'catch up' superannuation contributions;
- removing impediments to allow eligible rollover funds to proactively reunite amounts they hold with active accounts of the fund member;
- removing the tax exemption on earnings of assets supporting Transition to Retirement income; and
- the following measures which have been included in draft legislation released 7 September 2016:
    - allowing all Australians under the age of 75 to claim a tax deduction for personal contributions to an eligible superannuation fund, up to the concessional cap (through removal of the 10% rule);
    - extending the eligibility for individuals to claim a tax offset for contributions to allow contributions made to their low income spouses' superannuation; and
    - lifting restrictions on contributions to superannuation that apply to Australians aged 65 to 74 and instead apply the same contribution acceptance rules for all individuals up to age 75 (through amendment of the SIS Regulations).

11.2 Issues associated with current position

There is current concern over the relative benefits given to high income earners and the inequity that results. While these taxpayers can reduce their rate of tax by up to 34 per cent by contributing to superannuation, this applies up to a maximum of $35,000 a year where personal income is between $180,000 and $300,000 and the person is over 50 – therefore, for most people the tax saving achieved is a lot less than the maximum possible of $11,200. This also assumes they would pay their marginal tax rate on the money no longer contributed to superannuation which is not necessarily correct, as a large proportion of the contributions are compulsory through the SG system. The Murray report showed that the share of superannuation tax concessions by income decile was higher with higher personal income, but so is the share of personal tax. It is any difference in proportion which is relevant, not the raw amounts[100].

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[99] Australian Government 2016, Budget Measures Budget Paper No. 2 2016-17, http:// budget.gov.au/2016-17/content/bp2/html/

[100] The Australian Government the Treasury, Financial System Inquiry Final Report, November 2014.

11.2.1 $450/month threshold

There is an administrative burden on employers in terms of tracking the $450 per month threshold and paying small amounts of superannuation for anyone earning income around that level (i.e. $450 of wages = $42.75 SG at 9.5 per cent).

11.2.2 Generosity of the system in pension phase

For those in pension phase the 2006 changes were very generous:

- No tax on pensions/income streams taken from age 60.
- No tax payable within the fund on pension balances.
- Excess franking credits in pension phase are refunded to the fund.

The 2006 changes promoted a new era of simplicity and this should be retained however, the system for many is now very generous and many in pension phase note they are now not paying their 'fair share'. The generosity has led to a desire to transfer wealth to superannuation so that in retirement/pension phase the income is tax free.

The Labor Party's 'fairer super plan' proposes to tax at 15 per cent incomes earned on pension balances above $75,000 a year. There are, however difficulties in measuring income from balances of individuals in pension phase, particularly when some pensions come from unfunded sources (such as Commonwealth pensions) and a person has more than one superannuation balance.

The proposal in the 2016 Budget (and since refined) to introduce a $1.6 million cap on balances in pension phase will limit the total amount that an individual can transfer into tax-free retirement phase accounts and therefore limits the generosity identified above.

If there is an overall limit on the amount that can be treated as tax-free in pension phase, then it should not matter how this money is contributed and superannuation contributions should continue to be encouraged. Retention of the annual cap on concessional contributions of $35,000 to superannuation would provide a greater incentive to save for retirement than cutting the cap to $25,000. Further, the proposed $100,000 annual cap for non-concessional contributions is considered unnecessary and can prevent an older farmer from being able to increase their superannuation balance to better provide for their retirement.

It is unclear at this point how the $1.6 million cap will work and whether or not it ignores the possibility of any investment losses that might occur after the cap has been reached and the taxpayer not having the ability to top up their balance through non-concessional contributions.

It is considered that if the $1.6 million cap is implemented, then there should be active encouragement, through both annual contributions and lump sum contributions, for people to reach this cap throughout their lifetime to reduce the burden placed on the Age Pension.

11.2.3 Contribution changes announced in the 2016/17 Federal Budget

The additional proposal in the Budget proposes to reduce the annual concessional contributions cap from $35,000 to $25,000. The lower annual concessional cap, coupled with the lifetime non-concessional cap, could disadvantage those taxpayers who are not in a financial position to contribute as much to superannuation at an earlier age. Practically, taxpayer income levels change over time and it is unlikely in the first 10 years of work that agricultural employees (with relatively lower incomes) would be contributing much more than $5,000 to $10,000 per annum. There is therefore likely to be greater reliance on the higher concessional caps later in working life. Taxpayers also tend to have less disposable income available to salary sacrifice additional superannuation contributions while they are raising a family, paying off a mortgage, or establishing/growing a business (in the case of those who are self-employed).

The concept proposed in the Budget of catch-up contributions (ie concessional caps carried forward on a rolling basis for a period of five consecutive years) has a positive outcome for the above circumstances. This measure is also positive for those taxpayers who may have been out of the workforce or experienced reduced earning capacity (eg illness, raising children, etc) for a period of time.

11.2.4 Age based contribution limits

After age 65 a work test must be met in order to contribute to superannuation. The test requires the individual to be gainfully employed for at least 40 hours in a period of, at most, 30 consecutive days in the financial year. Gainful employment includes self-employment.

From age 65, the bring forward rule enabling non-concessional contributions up to $450,000 is no longer available.

From age 75, only SG contributions may be made.

The ability to make use of the small business concessions is limited for those over 65. Between the age of 65 and 75 it is possible for the capital gain relating to small business concessions to be placed into superannuation tax free, however the work test must still be met. Over 75 years, regardless of the work test, the small business capital gains cannot be contributed into superannuation.

The restrictions on the small business contributions is acutely felt in agriculture where many farmers retire much later than in other occupations. In many cases, the capital tied up in the farm is considered to be the source of retirement wealth and therefore retirement income, making it difficult to access the concessions after these ages.

For example, Ted suffers a health event and he ceases working on the farm at age 66. He leases the farm for the next three years and finally decides to sell the farm. He would like to place the capital gain into superannuation. The farm meets all the conditions of being an active asset for the small business CGT concessions to apply. As Ted is over 55 he does not have to place the proceeds into superannuation to apply the retirement exemption, however he would like to in order to boost his superannuation savings. Ted has owned the farm for over 15 years and the sale is in connection with retirement, so if he could make use of the concessions, a cap of $1.395 million would apply. Ted has put little into superannuation over the years due to the need to keep the funds within the farm. As Ted has not been well enough to meet the work test he will be unable to contribute to superannuation. Similarly, if Ted were over 75, regardless of his ability to meet the work test he would not be able to contribute to superannuation.

The 2016/17 Federal Budget recommendation is for the removal of the work test and this has been included in the September 2016 draft legislation. This change provides an opportunity for taxpayers to continue building up their superannuation balance and be less reliant upon the Age Pension.

11.2.5 Anti-detriment payments

An anti-detriment payment is an additional lump sum amount that may be paid to an eligible dependent when a lump sum death benefit is paid. The payment represents a refund of the 15 per cent contributions tax that has been paid by the deceased member over their lifetime.

The rules surrounding this are complex, however if they can be applied they generally result in a benefit to the remaining members of the fund that appears too generous. The amount of the anti-detriment payment is considered to be a tax deduction to the fund and often results in the fund having tax losses that can be carried forward to offset against future income and contributions tax.

Not all funds are able to make use of the rules as there must be sufficient funds available to make the payment. The funds must be separate from the member's superannuation interest. They can be sourced from a reserve or from proceeds of an insurance policy.

Anti-detriments must be paid out of the fund, such that if there is a desire to keep money in the fund for income streams for dependents, it may not be possible to pay out the anti-detriment amounts.

11.3 Areas for consideration

11.3.1 $450/month threshold

It is suggested the $450 per month threshold be adjusted for CPI that would have applied since the threshold was introduced in 1992, and adjusted on an ongoing basis (in line with the review timing of other superannuation caps). This would make the threshold $800 (rounded to the nearest $100).

11.3.2 Pension phase taxation

The simplicity of the system introduced in 2006 should be retained and the withdrawal of income streams should remain tax free for those over 60.

However, a modest rate of tax could be considered on the income generated from pension balances. Currently the rates in accumulation phase are 15 per cent (and 10 per cent capital gains for those allowed the discount). A suggestion may be to apply a tax to income generated in pension phase of half the rate applicable to that in accumulation phase – thereby allowing a tax rate of 7.5 per cent (and 5 per cent capital gains).

To be clear, this is about applying tax to the earnings generated from balances held in pension phase, not tax on the contributions or pension withdrawal itself. While such a proposal has been floated in the media there is some discussion of grandfathering current arrangements.

An alternative floated is to deny franking credits, however as franking credits were introduced in 1986 to prevent double taxation any return to a loss of franking credits would be penal and would represent a reversion to a form of double taxation. For example, for a fund fully invested in shares generating franked dividends (presume other income offsets fund expenses) the effective rate in accumulation is 15 per cent yet the franked dividends represent tax being paid at 30 per cent. Where the fund is in pension phase with a tax rate of zero, the fund would effectively lose the franking credits from any franked dividends – equivalent to them paying 30 per cent tax. Denial of franking credits would have a significant negative impact on the Australian share market and investors and is therefore not supported.

As mentioned in section 11.2.2, the proposal in the 2016 Budget to introduce a $1.6 million cap on pension balances is considered an appropriate limit to the total amount that an individual can transfer into tax-free retirement phase accounts.. However, the additional proposals in the Budget to reduce the annual concessional contributions cap from $35,000 to $25,000 and to introduce a $100,000 annual cap for non-concessional contributions could disadvantage those taxpayers who are not in a financial position to contribute as much to superannuation at an earlier age..

It is considered that if the $1.6 million cap is implemented, then there should be active encouragement, through both annual contributions and lump sum contributions, for people to reach this cap throughout their lifetime to reduce the burden placed on the Age Pension.

11.3.3 Age based contribution limits

Consideration could be given to removing any age or work limits from the ability to contribute small business capital gains or proceeds (dependent on which concession is applied). Once the asset has been determined as being an active asset to meet the small business CGT concessions then there should be the ability to place the funds into superannuation.

The arbitrary change of rules at 75 is discriminatory against those who choose to continue working – this is particularly prevalent in agriculture where farmers will generally just slow down rather than cease working. The work test should not only apply between 65 and 75 but for anyone over age 65 (hence removing the age 75 barrier). See further recommendations in the ‘Succession planning’ section of this report.

The general rules regarding the work test are considered fair.

It is noted that the 2016 Budget has proposed to remove the restrictions in relation to minimum work requirements, the bring-forward of non-concessional contributions and contributions for spouses aged under 75 years. The proposal is to apply the same contribution acceptance rules for all individuals up to age 75.

11.3.4 Anti-detriment payments

Consideration could be given to abolishing anti-detriment payments. This is a complex area and the policy intent is no longer clear. The concessions are unduly generous and the use of anti-detriment payments can be at the expense of setting up income streams for dependents, which would generally be a better policy outcome.The 2016 Budget proposed to remove the anti-detriment provision.

11.3.5 Division 293 and $300k threshold

Division 293 is the additional 15 per cent tax on contributions where income exceeds $300,000. This is effectively a tax on more wealthy individual taxpayers, and concern would be raised should this threshold be reduced. It is noted that the 2016 Budget proposed to reduce this threshold to $250,000.

11.4 Impact of alternatives considered

11.4.1 Pension phase taxation

Greater equity in the superannuation system could be achieved by introducing a tax on fund income in pension phase. Significant revenue will also result, which could be used to help fund the services and infrastructure essential to Australians. It is noted that the proposed changes in the 2016/17 Federal Budget with the $1.6 million cap on tax free pension accounts would be a positive step in this direction. The important step in drafting the legislation is that integrity measures are included and that the system is not overly complicated, including the calculations for defined benefit pensions.

The merits of grandfathering of old arrangements should be carefully evaluated. For example, the introduction of a low tax would not dramatically impact those on pensions, however it will have a large impact on tax revenue receipts.

12. Superannuation – Maximum earnings as an employee (the 10 per cent rule)

12.1 Background and current position

The 10 per cent rule is one of the conditions to claim a tax deduction for a personal superannuation contribution. An individual will pass the 10 per cent test for an income year, if less than 10 per cent of their total assessable income plus reportable fringe benefits plus reportable superannuation contributions for the year is attributable to employment activity.

The test is currently included in s290-160 of the 1997 ITAA but was previously part of the 1936 ITAA in s82AAS and s82AAT. Thornton's case[101] in 1995 confirmed failure of the 10 per cent test meant that further personal concessional contributions (at that time simply known as superannuation deductions) could not be claimed. When 'Simpler Super' was introduced in 2007 it did not highlight the 10 per cent rule other than to say it was to stay.

From 1 July 2009, reportable superannuation was included in the definition of assessable income. This was put in place as an integrity measure to stop salary sacrifice circumventing the rules, which should have rendered the 10 per cent rule redundant, but this was not considered in the process.

Originally the 10 per cent rule was in place at a time when tax deductions for superannuation contributions were limited to age based limits of down to $9,000 per year. The self-employed could claim $3,000 plus 75 per cent of further contributions up to their age based limit, while employers claimed every dollar contributed up to the age based limit. The 'Simpler Super' legislative changes in 2007 recognised this was discrimination and removed the limits, however nothing was done to consider the implications and fairness of the 10 per cent rule.

12.2 Issues associated with current position

The 10 per cent rule continues to be discriminatory and is an old rule from the early 1990s that was associated with superannuation in a different form and policy intent of the time. It adds unnecessary complication to the contribution rules.

This rule has the greatest impact on low income earners or those with only a small portion of employment income during the year. It can be a disincentive to earn income which is contrary to the policy intent of 'Simpler Super'.

For example, Annie is a joint partner on her farm with her husband Bruce. Annie would like to contribute to the family's financial situation and so she takes on a one day per week part time job at the local school as a teacher's aide. She receives $8,000 of wages and SG is paid by the Department of Education on her wages. The farm has had a reasonable year and as their children have left home they would both like to contribute to superannuation to top up for all the years when their children's' education costs took greater priority. The farm has generated a profit of $100,000 of which Annie has a share of $50,000. Bruce and Annie both wish to contribute $20,000 to superannuation and claim a tax deduction. Annie has no other income. Annie's total assessable income is $58,000 and as her employment income of $8,000 exceeds 10 per cent of her total assessable income she is unable to place further monies into superannuation and claim a tax deduction. Her employer would have contributed $760 into superannuation for her benefit. Bruce can claim his contribution as a tax

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[101] *Thornton* v *FC of T* 97 ATC 2117

deduction as he has no employment income. While Annie may have been able to salary sacrifice additional superannuation up to her total salary this would still mean at most $8,760 was contributed to superannuation, therefore it remains unequitable in terms of the maximum allowable contribution. Further, it would have meant she would have had to make a decision much earlier (at a time when she may not have known there would be any cash available from the business operation to fund a contribution).

Clearly this example is discriminatory and does not meet the needs and objectives of the 2006 amendments[102] where the policy intent was to improve retirement incomes and increase incentives to work and save. The 10 per cent level is arbitrary, having no relationship to sufficiency or income level.

Further anomalies include individuals with a multiple number of small employment jobs where none meet the SG level for contribution yet collectively they form more than 10 per cent of assessable income. Again the individual is denied the right to claim a tax deduction for superannuation contributions made[103].

Difficulties arise when someone has employment income only for a short time in the year. For example, Matt is employed for three years and leaves his employment in August to go out on his own as a self-employed plumber. At the end of the year Matt would like to place some monies into superannuation and claim a tax deduction. He is potentially denied the ability to do this unless he passes the 10 per cent rule. Similarly, someone who is self-employed and has been making regular contributions to superannuation during the year may be denied the deduction if, towards the end of the year, they take up an offer of employment that means the 10 per cent rule is breached.

Salary sacrifice can sometimes be used to overcome the rule however, the employer must be willing to enter into an arrangement and this is not always the case. Additionally the overall income from employment may be less than the contribution caps and so may not solve the issue of discrimination.

It is notable that a 2006 House of Representatives Committee (Standing Committee on Economics, Finance and Public Administration, headed by the Hon Bruce Baird MP) recommended the removal of the 10 per cent rule.

As the calculation is made on an annual basis, which can only be determined after 30 June and contributions must be received by a superannuation fund before 30 June, people who may fail the test must contribute regardless, in the hope that they will pass the test and be able to claim a tax deduction.

12.3 Areas for consideration

The 10 per cent rule could be removed and all parties treated without discrimination to allow individuals to claim effectively through their applicable age based contribution caps. This will assist both individuals and employees to not only increase their savings, but to diminish the red tape and issues associated with managing salary sacrifice arrangements.

It is noted that the 2016 Budget proposes removing the 10% rule for tax-deductible superannuation contributions. This has been included in the September 2016 draft legislation. The Budget proposal to expand spouse contributions should also positively assist with retirement planning.

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[102] Australian Government 2006, Tax Laws Amendment (Simplified Superannuation) Bill 2006, https://www.legislation.gov.au/Details/C2006B00226

[103] *Edmonds-Wilson* v *FC of T* 98 ATC 2276

12.4 Impact of alternatives considered

There will be a revenue impact of increasing the ability for these individuals to claim a tax deduction for additional superannuation contributions. Superannuation contributions tax paid by funds would increase. However, it removes discrimination and provides greater equity to encourage savings for retirement.

Such a change would reduce red tape for self-employed people and remove unexpected consequences for individuals who are unaware of the rules until they are denied tax deductions.

The changes would better fit with the policy intent enshrined in the 'Simpler Super' legislation.

13. Environmental issues and land degradation

13.1 Background and current position

Environmental impacts of land use are among Australia's most significant environmental challenges. Major problems include the loss of biodiversity, pollution of water resources, soil erosion, salinity, and soil acidity[104]. Land and water resources are essential to every primary production business. These assets are also an extremely important factor in the long term sustainability of these businesses. Some of the issues of land degradation and water deficiency are associated with climate factors and events (e.g. long term drought) outside of the taxpayers' direct control.

Under current legislation an eligible taxpayer, who carries on a business of primary production on any land in Australia or, who carries on a business other than one of mining or quarrying, for the purpose of gaining or producing assessable income from the use of any rural land in Australia, can claim an immediate deduction for capital expenditure incurred on a Landcare operation on land in Australia. A Landcare operation is one of the following operations:

a) Erecting a fence to separate different land classes on the land in accordance with an approved management plan for the land; or

b) Erecting a fence on the land primarily and principally for the purpose of excluding animals from an area affected by land degradation:

   i) to prevent or limit extension or worsening of land degradation in the area; and

   ii) to help reclaim the area; or

NOTE: *The May 2015 introduction of accelerated depreciation (immediate deductibility) for fencing has added further options for fencing deductibility*

c) constructing a levee or a similar improvement on the land; or

d) constructing drainage works on the land primarily and principally for the purpose of controlling salinity or assisting in drainage control; or

e) an operation primarily and principally for the purpose of:

   i) eradicating or exterminating from the land animals that are pests; or

   ii) eradicating, exterminating or destroying plant growth detrimental to the land; or

   iii) preventing or fighting land degradation (except by erecting fences on the land); or

f) a repair of a capital nature, or an alteration, addition or extension, to an asset described in paragraph (a), (b), (c) or (d) or an extension of an operation described in paragraph (e); or

g) constructing a structural improvement, or a repair of a capital nature, or an alteration, addition or extension, to a structural improvement, that is reasonably incidental to an asset described in paragraph (c) or (d).

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104 Australia State of the Environment 2006, Independent report to the Australian Government Minister for the Environment and Heritage, http://www.environment.gov.au/system/files/resources/b0832197-9ef7-4f72-8c0b-2b726d08fa26/files/soe-2006-report.pdf

In addition to Landcare expenditure, there are specific provisions associated with expenditure on water facilities that are primarily and principally for the purpose of conserving or conveying water for use in primary production businesses. This includes capital repairs and structural improvements to water facilities. Before the May 2015 changes this expenditure was generally claimed over a three year period, however from 12 May 2015 taxpayers can deduct the whole amount in the year in which they incurred the expenditure.

Energy continues to be a major cost for primary producers. Agriculture is the fourth most energy intensive industry in Australia, behind manufacturing, transport and mining[105]. Remoteness (distance from source) has a big impact on the cost of energy for farmers[106].

There are currently tax concession, loans and reduced interest loans in place for farmers to implement technology to reduce energy costs. For example, the Queensland Government, through QRAA have a Sustainability Loan, the NSW Rural Assistance Authority has the Farm Innovation Fund, while the Clean Energy Finance Corporation provides loan at reduced interest rates.

The NSW Farm Innovation Fund provides low interest loans of amounts per project of $250,000 and a maximum of $500,000 to be borrowed at once. These loans can be used towards the costs of carrying out permanent capital works that will have a significant beneficial impact on the land, long term profitability and address adverse seasonal conditions, such as drought preparedness, environment, farm infrastructure and natural resources. Currently there are available funds of $250 million with $53 million worth of loans approved.

In addition, the accelerated small business write offs and the current depreciation regime are also applicable to energy-related capital works.

13.2 Issues associated with current position

The current position provides tax deductions for the eligible taxpayer, but does not necessarily encourage producers to focus on long-term environmental sustainability.

The current Landcare and water facility legislation have been successfully and legitimately utilised by farmers primarily with a view to increase production more efficiently.

However, tax concessions are not always the best means of targeting the degradation problems that cause the largest public costs[107]. While tax concessions are being used for Landcare development by those producers who can afford it, for those farmers who are not in a taxable situation, there are limited ways to access funds to improve their land. The general provisions of deductibility of expenses being necessarily incurred in carrying out a business (except those which are capital in nature) will generally preclude the ability to claim deductions for work associated with environmental improvements. The Landcare and water facility provisions are therefore important in creating this nexus through specific legislation.

The rules in place to access (for example) the RAA Farm Innovation Fund are not onerous. The $5M off farm asset test and the ability to provide security over land make sense. Similarly, QRAA's Sustainability Loan requires security over land and that 'non-enterprise assets is no more than that needed for prudent risk management'.

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[105] Australian Bureau of Statistics, 4604.0 Energy Account Australia

[106] Sustainable Transport Coalition WA, Submission 13, p1

13.3 Areas for consideration

The current tax concessions encourage producers to develop their land and should be retained. The current tax concessions should remain as producers are utilising these concessions to develop their land and water facilities, however, consideration could be given to making available grants for those producers who cannot afford the cost of development. An example of such a grant is the Healthy Head Waters program.

In terms of alternate energy sources and conversions, the current measures should be retained.

13.4 Impact of alternatives considered

Enabling access to both tax deductions and grants for environmentally sustainable development would provide greater equity to those primary producers who may not otherwise be in a financial position to conduct this work on their properties.

13.5 Case study

Bob and Jude complete a Property Management Plan with the assistance of their local Landcare coordinator. They have identified $40,000 of fencing and earthmoving work that is required to protect some wetland areas, fence stock out of some erosion areas and plant these areas out with native vegetation. They complete an application for $20,000 (with the balance to be funded themselves), two-thirds of which is paid upfront and one-third paid upon successful completion of the project.

14. Transport and vehicle-related taxes

14.1 Background and current position

14.1.1 Fuel tax credits (FTC)

Tax on fuel was introduced in the early 1900s as customs and excise duties on transport fuels to fund the development and maintenance of Australia's road networks. This was extended to diesel in the 1950s. FTC provide certain businesses and business activities with a credit for the fuel excise tax (currently the main rate is 39.2c/L) that is included in the price of fuel used in machinery, plant, equipment and heavy vehicles (13.06 c/L is currently the main rate for heavy vehicles travelling on public roads). The underlying purpose of FTC when they were introduced was to reimburse off-road users for the excise being levied to fund development and maintenance of Australia's road networks. Some fuels and activities are not eligible, including fuel used in light vehicles of 4.5T GVM or less, travelling on public roads. For businesses with mixed usage (type of vehicle, on/off road, etc.) additional administration is required to determine eligibility for FTC.

The fuel scheme commenced on 1 July 2006 and replaced the Energy Grants Credits Scheme (both schemes provided means to claim back excise for eligible users). The new scheme expanded the eligibility to include agriculture, fishing, forestry and other activities. On 1 July 2008, the eligibility criteria of the Scheme were further expanded to include additional activities, and significantly, to include petrol as a fuel that could be claimed under the Scheme[108].

Participation and cost has grown significantly since the expanded eligibility criteria (32 per cent increase in claims from 2006/07 to 2013/14 and a 27 per cent increase in participants in the same period).

The scheme is designed to be easy to administer with the majority of claimants being able to claim through their business activity statements (BAS).

From 2006 to 2014 the agriculture, forestry and fishing industry generated the most number of claims however, was ranked third behind the mining and transport, postal and warehousing industries in total amount claimed. Of total FTC claimed, 12 per cent relates to the agricultural sector which also makes up 44 per cent of total claims in the 2013/14 year[109].

The total number of claims in the agriculture, forestry and fishing industry for the 2013/14 year was 305,320.

14.1.2 Luxury car tax

Luxury car tax (LCT) came into effect on 1 July 2000 as one of the measures accompanying the introduction of the GST. LCT was designed to ensure luxury cars that were subject to Wholesale Sales

[109] Australia's Future Tax System n.d., Chapter E: Enhancing Social and Market Outcomes, [110] A New Tax System 1999, Luxury Car Tax Bill 1999, Explanatory Memorandum Background 1.22 http://www5.austlii.edu.au/au/legis/cth/bill_em/antsctb1999383/memo1.html

Tax (WST) at the higher rate of 45 per cent above the luxury car threshold, would fall in price in the same proportion to cars just below the threshold as a result of the GST replacing WST[110].

Upon introduction, LCT was applied at a rate of 25 per cent to the value of a vehicle above the LCT threshold, which was $55,134 for the year ended 30 June 2001. From 13 May 2008 the LCT rate increased to its current level of 33 per cent, and the threshold indexed to the all groups CPI factor so that it was no longer aligned with the car limit. The threshold for the year ending 30 June 2016 is $63,184 ($75,375 for fuel efficient vehicles).

Primary producers and tourism operators are eligible for a refund of 8/33 of LCT paid, up to a maximum of $3,000, for four-wheel drive or all-wheel drive vehicles meeting certain requirements that are used in carrying on a business. Primary producers are limited to a refund on one vehicle per year but there is no limit on the number of vehicles acquired by tourism operators. It should be noted that certain commercial vehicles are exempt from LCT. These include vehicles that are not designed for the principal purpose of carrying passengers, for example a single cab farm utility.

In 2008 a Senate Committee[111] came to the following conclusions:

- The original 1986 wholesale sales tax appears to have been a protectionist measure, designed to increase the price of European imports, while the 2000 LCT was introduced to ensure the introduction of the GST did not result in a sudden reduction in the price of luxury vehicles, apparently because this might erode support for GST.

- The number of four-wheel drives and SUVs attracting LCT has risen from less than 100 vehicles in 1979 to 38,000 in 2007.

- The question to ask is why vehicles should be singled out as luxury items and have further tax imposed on them?

- Almost 70 per cent of cars that were subject to LCT were not cars of 'millionaires', as they were sold for less than $75,000.

- Tax avoidance also occurs as a specific LCT threshold encourages cars to be priced at just below the threshold limit in order to increase sales. Alternatively buyers forgo optional extras and get the cars fitted with after-market products.

- In 1979 only 2 per cent of new vehicles were captured within the LCT threshold. However, this percentage rose to 4.5 per cent in 1986 and to 12 per cent in 2007.

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[110] A New Tax System 1999, Luxury Car Tax Bill 1999, Explanatory Memorandum Background 1.22
http://www5.austlii.edu.au/au/legis/cth/bill_em/antsctb1999383/memo1.html

[111] The Parliament of Australia 2008, Tax Laws Amendment (Luxury Car Tax) Bill 2008,
http://www.aph.gov.au/parliamentary_business/committees/senate/economics/Completed%20inquiries/2008-10/tlab_luxurycars_08/report/index

14.1.3 Car Limit

The car limit is a threshold that limits the depreciable cost and input tax credits that can be claimed for cars. The threshold is indexed to the motor vehicle purchase sub-group of the CPI and is set at $57,466 for the year ending 30 June 2016. A car is defined as a motor vehicle (except a motor cycle or similar vehicle) designed to carry a load of less than 1 tonne and fewer than 9 passengers[112].

14.2 Issues associated with current position

14.2.1 Fuel tax credits

By claiming FTC through the BAS, complexity and red tape is removed and is more efficient than having a system that allows eligible users to not get charged excise upon purchase. Integrity of the system is maintained through easily accessible information on how to and how much to claim through online calculators. There is also a specialist ATO team to administer FTC. Random audits and trend analysis on claims also help identify incorrect claims[113].

FTC are widely supported in the agricultural industry due to the inherent nature of the tax. Essentially, due to there being no connection between the fuel purchased and the intended use of the tax (to maintain public roads) it is critical in maintaining the industries international competitiveness to have a rebate in place[114]. It is essential that the agricultural industry continues to access the credit recognising that the fuel is not being used on roads and hence the applicable excise is therefore not contributing to the development and maintenance of the road network. It is not a concession or subsidy to the industry as was recently expressed by the media[115].

14.2.2 Luxury car tax

LCT was identified by the Henry Review as an ineffective tool to redistribute income as it imposes a greater tax burden on those with a preference for expensive cars without regard to the purchaser's level of income or wealth – people with the same economic means will pay different amounts of tax depending on their tastes[116]. The Henry Review also made recommendations to the Australian Government to abolish the LCT and to replace vehicle registration taxes with more efficient road user charges, further suggesting that the current fuel excise should be phased out and that transport-specific taxes should only be imposed where they improve social or market outcomes. The Government has also said that it will investigate the benefits, costs and potential next steps of options to introduce cost-

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[112] The Commonwealth of Australia 1997, Income Tax Assessment Act 1997 s995.1 http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1997240/s995.1.html

[113] Australian National Audit Office 2011, Fuel tax credits scheme, http://www.anao.gov.au/~/media/Uploads/Audit%20Reports/2010%2011/201011%20Audit%20Report%20No%2049.PDF

[114] Grain Growers Limited 2015, Submission in Response to the Re:think – Tax Discussion Paper, http://bettertax.gov.au/files/2015/06/Grain_Growers_Limited.pdf

[115] Arup, T 2015 'Paris UN Climate Conference 2015: Australia rejects fossil fuel pledge', *Sydney Morning Herald*, 1 December 2015 http://www.smh.com.au/environment/un-climate-conference/paris-un-climate-conference-2015-australia-rejects-fossil-fuel-pledge-20151130-glbw4s.html

[116] The Commonwealth of Australia n.d., Australia's Future Tax System, http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_e8-2.htm

reflective road pricing for all vehicles in response to the Harper Review[117]. Similarly, the car limit imposes a penalty on businesses using relatively expensive cars as they cannot claim a full input tax credit or depreciation deduction in relation to their purchase.

A car is an essential requirement in almost any business, even more so in agriculture where multiple vehicles and relatively more expensive four-wheel drives are a necessity, due to on-farm usage, accessing certain roads during wet conditions, etc. The increased tax burden imposed by both LCT and the car limit for a business asset as fundamental as a car is inequitable as it penalises businesses that cannot exercise the same level of discretion as other businesses or private consumers when evaluating their vehicle requirements.

The highest rate of sales tax of 45 per cent, applicable only to luxury cars, was established in August 1993 by the Sales Tax (Customs) (Deficit Reduction) Bill 1993[118]. As evidenced by the name, this was one of a number of budget repair measures introduced by the then Labor government to increase revenue.

When LCT commenced from July 2000, the explanatory memorandum accompanying the legislation stated that the Government did not believe it would be appropriate for the price of luxury cars subject to the highest rate of sales tax to fall dramatically as a result of the GST replacing WST[119]. This policy objective to maintain the status quo in terms of the relative prices of vehicles above and below the luxury car threshold was the only rationale provided for the implementation of LCT and has resulted in an inefficient tax[120] continuing for over 22 years after its first incarnation was effected to reduce the budget deficit.

Various other luxury goods such as jewellery, watches, and fur clothing were taxed at the second highest sales tax rate of 32 per cent[121]. Unlike motor vehicles that are an essential asset to agricultural (and most other) businesses, the Government did not consider it inappropriate for these goods to fall in price dramatically in comparison to other consumer goods upon introduction of the GST. As such, LCT is now the only luxury tax on a specific good or service in Australia[122].

In the 15 years since its introduction, the LCT threshold has increased by $8,050 (14.60 per cent). Over the same period the car limit has increased by $2,332 (5.23 per cent). Despite these thresholds being indexed to the all goods and motor vehicles CPI indexation factors respectively, the adjustments made to CPI for quality improvements mean that there has been a degree of bracket creep over time. Price increases attributable to improved safety and performance features would not contribute to increases in either threshold, however these do push up the actual price paid for cars.

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[117] The Australian Government the Treasury, Australian Government response to the Competition Policy Review, November 2015

[118] The Parliament of Australia 1993, Sales Tax (Customs) (Deficit Reduction) Bill 1993, http://www.austlii.edu.au/au/legis/cth/bill_em/strb1993332/memo_1.pdf

[119] The Parliament of The Commonwealth of Australia 1999, A New Tax System (Luxury Car Tax) Bill 1999, Explanatory Memorandum, http://www5.austlii.edu.au/au/legis/cth/bill_em/antsctb1999383/memo1.html

[120] The Commonwealth of Australia n.d., Australia's Future Tax System, http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_e8-2.htm

[121] Australian Bureau of Statistics 1998, Economic Indicators June 1998, http://www.abs.gov.au/ausstats/abs@.nsf/90a12181d877a6a6ca2568b5007b861c/aed4428c69c7e6d4ca256fd80078d6e5!OpenDocument

[122] Australian Government 2015, Re:think Tax Discussion Paper, http://bettertax.gov.au/files/2015/03/TWP_combined-online.pdf

In 2016 a number of four-wheel drives, family cars and vans that would not typically be considered luxury cars exceed the LCT threshold and car limit, such as the Nissan Patrol[123] and Toyota Prado[124]. The volume of Toyota vehicles sold that exceed the LCT threshold has resulted in the total Luxury Car Tax paid by Toyota buyers being similar to, or exceeding that of traditional luxury brands such as BMW, Audi, and Mercedes-Benz[125].

In addition, the LCT is applied to the GST inclusive amount which results in tax being levied on top of another tax (i.e. 1/11th of what LCT is being paid on is actually the GST).

14.3 Areas for consideration

14.3.1 Fuel tax credits

The education, promotion and advertising of the FTC scheme, including the eligibility requirements and the methodology of claiming should be continued. Data-mining ABN information of those in the agricultural industry from tax returns against BAS information to determine the rate of uptake in FTC could allow for targeted information to ensure FTC are being claimed (or at least analyse the uptake rate).

Further, there would be benefit in well-advertised regional seminars providing information on grants, rebates and other incentives (such as the R&D tax incentive) that are available in relation to energy efficiency and promoting innovation in this area.

Should consideration be given to a cost-reflective user pays system, it will be important to ensure that the same exemptions that currently apply to fuel are adopted under the new regime.

14.3.2 LCT and depreciation cost limits

A car is an essential business asset. The arbitrary application of a luxury tax and cost limit to cars and not other assets is inequitable and adds unnecessary cost and complexity to taxpayers' affairs. The modestly set thresholds also mean that a number of cars that would not typically be considered 'luxury' vehicles are currently subject to these measures.

It is acknowledged that any moves towards the development of a cost-reflective road pricing system will necessarily need to consider other taxes and levies that apply to vehicles, including the LCT.

As such, recommendation 80 from the Henry Review that LCT should be abolished is supported. The tax falls disproportionately on those with preferences or requirements for relatively expensive vehicles. It was implemented as a deficit reduction measure and is ineffective in achieving the economic objective of income redistribution.

Given the history of the LCT and its relationship with the higher WST threshold being a protectionist measure for the Australian car industry, it makes even more sense for LCT to be abolished given the demise of Australian car manufacturing.

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[123] Nissan 2016, Patrol, http://www.nissan.com.au/Cars-Vehicles/Patrol/Range-and-Pricing

[124] Toyota 2016, Prado, http://www3.toyota.com.au/prado/prices

[125] Dowling, J 2015, 'Toyota buyers pay more in Luxury Car Tax than those of Audi, BMW and Mercedes-Benz cars', *news.com.au,* 29 August, http://www.news.com.au/national/toyota-buyers-pay-more-in-luxury-car-tax-than-those-of-audi-bmw-and-mercedes-benz-cars/story-e6frfkp9-1227504163246.

The car limit on depreciation and input tax credit claims could be reviewed such that it is more consistent with what would be considered a 'luxury car' in this day and age. In the same way as LCT, this measure discriminates against certain taxpayers and is overly complicated in its application.

If it is not removed then it should at least only apply to the GST exclusive value of vehicles so that it is not resulting in double taxation for the GST component.

14.4 Impact of alternatives considered

The revenue loss that would result from the removal of LCT and the car limit could be addressed by making adjustments to the rates and thresholds of the existing income tax system. This along with the transfer system has been found to be a far more effective form of income redistribution than taxing specific goods and services differently[126].

[126] The Commonwealth of Australia n.d., Australia's Future Tax System, http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_e8-2.htm

15. Tax zone rebates

15.1 Background and current position

Tax zone rebates were introduced in 1945 to compensate recipients for the disadvantages of living in remote areas, including distance, climate and the higher cost of living.

- Two designated Zones, Zone A and Zone B (see map below), as well as 'special areas' (particularly isolated areas).

- Base rebate per year - $338 Zone A, $57 Zone B and $1,173 in the special areas, as well as a 20 per cent loading Zone B and 50 per cent loading for Zone A and special areas for dependents.

- In 1997-98, 191,733 taxpayers claimed zone rebates totalling $200 million which is an average claim of $407 per taxpayer. Tax revenue foregone was $180 million; this is less than the $200 million claimed above as not all claims are successful[127].

- Section 78A of the ITAA 1936 – must reside or work in a specified remote area for more than 182 days in an income year.

- From 1 July 2015 fly-in-fly-out (FIFO) workers are excluded, i.e. your normal residence must be within a prescribed area (zone).

Source: NATMAP NMP/84/002.24

15.2 Issues associated with current position

- The rebate amounts have remained unchanged since 1993. The effects of inflation have rendered the dollar amounts of rebates ineffective in meeting the disadvantages of living in the remote areas. At today's rates Zones A & B would need to be $1,335 and $221 respectively and the special rate would need to be $2,576, to offset the rate of inflation.

- "The boundaries have remained broadly unchanged since 1956" (Australia's future tax system – Report to the Treasurer Part 2 Volume 1[128]). The criteria for the zones were latitude, rainfall, distance from centre of population, density of population, predominant industries, access to rail and road service and the cost of food and groceries.

- Three of Queensland's regional northern coastal cities each have a population exceeding 60,000; Cairns (population 120,000); Townsville (population 171,000); and Mackay (population 91,000). They are all situated in the present Zone B, have high growth rates, and a combined population of 291,800. This represents about 165,000 taxpayers, more than half the estimated taxpayers entitled to a Zone B rebate[129].

- Zone B provides an average individual taxpayer with a rebate of $57 per year, and an average family taxpayer, with an employed spouse and two dependent children, with a rebate of approximately $208 per year. These individual payments are relatively insignificant to individual taxpayers. However, the total payment to 165,000 Zone B taxpayers who reside in the above large cities represents an annual cost to Commonwealth revenue of about $25 million.[130]

- The tax zone rebates are currently for individuals who live in the remote parts of Australia. The way they are currently structured does not encourage or create incentives for individuals or business' to relocate or open business in these remote areas.

- Attracting professionals (particularly doctors and others in the health care sector) to remote and rural locations continues to be a challenge.

15.3 Areas for consideration

Tax zone rebates should be reviewed, with the aim to better focus on the original policy intent or to remove the rebate and redirect revenue to regional economic development..

Alternative 1 – Better target the rebate

The rebate amount could be increased to an amount in line with CPI that would be more closely aligned with the original policy intent of the tax zone rebate when it was introduced in 1945, i.e. to compensate recipients for the disadvantages of living in remote areas.

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[127] Department of the Parliamentary Library 2000, History of the Zone Rebate, http://apo.org.au/files/Resource/01rn26.pdf

[128] Commonwealth of Australia, 2009, Australia's Future Tax System – Report to the Treasurer, http://taxreview.treasury.gov.au/content/downloads/final_report_part_1/00_afts_final_report_consolidated.pdf

[129] Fullarton, AR 2014, Are you still here, Mr Haase? A Study of Australia's Tax Rebates for Residents In Isolated Areas, http://www.austlii.edu.au/au/journals/JlATaxTA/2014/3.html

[130] Fullarton, AR 2014, Are you still here, Mr Haase? A Study of Australia's Tax Rebates for Residents In Isolated Areas, http://www.austlii.edu.au/au/journals/JlATaxTA/2014/3.html

If the rebate continues, present zoning is likely to stay the same, but centres with populations greater than a certain level (say 25,000) could be removed from the zoning.

Alternative 2 – Repeal and focus on regional economic development

Alternatively, removal of the rebate could be considered with the funds used to better target regional economic development, particularly for more remote locations in re-defined zones (i.e. excluding some of the larger population centres of the existing zones).

Consideration could be given to incentives for professionals to stay/move to remote areas through, for example, relief of HELP debts for residents in remote areas and further relief for new residents who move to an area with a HELP debt, enticing movement of professionals to these areas.

Consideration could also be given to regional business incentives to encourage development. For example:

- Federal, state and local governments could assist in the establishment of infrastructure, which would reduce the risk of business' setting up in regional areas as they do not have to pay 100 per cent of the major set up costs involved.

- Strategic and sustained investment in infrastructure to improve productive linkages in communities – transport infrastructure, telecommunications and other utilities, environmental infrastructure, and social infrastructure such as education and skills development, particularly in areas which will improve efficiency and competitiveness[131].

The ICAA/LGSA report proposes to give tax benefits to companies investing in administratively selected enterprise zones[132].

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[131] Australian Chamber of Commerce and Industry 2001, Enterprise Zones and Regional Development, http://web.archive.org/web/20080722072337/http://www.acci.asn.au/text_files/review/r77.pdf

[132] National Farmers' Federation 2001, Taxation Zones and the City-Country Divide

15.4 Impact of alternatives considered

Increasing the amount of the rebate to be aligned with CPI would cost the Government tax revenue, although the rebate would now be providing the benefit for what the Tax Zone Rebate was introduced for.

- With the repeal of the rebate there would be tax savings due to none being eligible for the rebate, which would have saved the Government $180 million in the 1997-1998 tax year. The total cost of HELP offset will be negligible because only a small percentage of Australia's population live in remote areas and therefore there would only be a small number of these taxpayers that would have currently incurred HELP debts. In a proposal put forward in the Fullarton–Winfield submission 2003, it was stated that graduates in remote areas receive greater remuneration than in the city, thus taxed at higher marginal rates. The loss of the HELP tax offset would be recouped with higher tax revenue as the graduates are reaching the higher marginal tax rate quicker than their city counterparts[133].

- If professionals moved to remote areas it would encourage development of facilities and increased services to support these regional communities, hence improving long term prosperity and tax revenue.

[133] Fullarton, AR 2014, Are you still here, Mr Haase? A Study of Australia's Tax Rebates for Residents In Isolated Areas, http://www.austlii.edu.au/au/journals/JlATaxTA/2014/3.html

16. Incentives for increased education of children of agricultural employees

16.1 Background and current position

Employers in regional and remote towns and communities often struggle to attract or retain qualified and experienced workers. The attraction and retention of skilled and professional staff to a community is critical if it is to remain vibrant and self-sufficient, and hence able to sustain itself into the future. The under-provision of services and infrastructure is a hallmark of non-metropolitan Australia and its lack both pushes people out of communities and turns people off going there for any length of time[134].

Residents in regional and remote areas are at a disadvantage when accessing basic services such as health and education. Subsequently, many employers struggle to attract or retain suitably qualified workers with adequate experience for the required positions. In addition, it is not always easy for the employed farm worker's spouse to find good paying work due to the remote locality of properties they are working on, hence reducing the financial capacity to pay for schooling.

Remote and non-remote areas are similar in that both increasingly need external skilled workforces to fill vacant jobs and career opportunities. The most significant difference between remote and non-remote service provisions is that the supply of essential services in non-remote areas has sustained growth of sufficient size, whereas in remote areas, the supply of essential services is inadequate due to a variety of factors. These include the wide dispersal of a relatively small population over large areas, the unevenness of jobs and labour force numbers and a diversity of service needs, ranging from chronic Aboriginal health conditions, education for all ages, policing and housing[135].

For employees that choose to remain working in rural areas that have school aged children, access to education for them is a critical issue. Parents are often left with little choice; they either move back to a city with access to quality schools, or send their children to boarding schools at a significant cost. Farm business owners, like employed agricultural workers, face similar issues and often send their children to boarding school.

Allowing employees located in rural and remote locations to salary package their children's school fees may enhance opportunities for employers to attract and retain workers who have families with school aged children. Considering that these services are generally not available in these areas, providing a tax benefit not only encourages people to remain in these areas but also improves overall fairness allowing all children to access government funded or subsidised education.

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[134] McKenzie, H F 2007, Attracting and retaining skilled and professional staff in remote locations, Dessert Knowledge CRC, http://www.nintione.com.au/resource/DKCRC-Report-21-Staff-Attraction-and-Retention.pdf

[135] McKenzie, H F 2007, Attracting and retaining skilled and professional staff in remote locations, Dessert Knowledge CRC, http://www.nintione.com.au/resource/DKCRC-Report-21-Staff-Attraction-and-Retention.pdf

16.2 Issues associated with current position

There are currently no direct tax concessions available for educating children of employees in rural and remote locations and often there are no schools within an accessible distance.

FBT was introduced in 1986 to tax employers on the provision of non-cash benefits that an employer provides in respect to employment (including the payment of employee's children school fees). This FBT structure is designed to tax the employer at a rate equivalent to the highest marginal tax rate if that benefit had been paid to the employee in salary or wages. It was originally introduced to prevent high income earners from salary packaging benefits such as motor vehicles, school fees and holidays to reduce their tax.

While income tax rates for individual tax payers are dependent on their level of income, FBT is applied at the equivalent of the highest marginal tax rate. Therefore, it is usually more beneficial for an employee to take their employment package in the form of a salary rather than other benefits.

There are currently exemptions available for Public Benevolent Institutions and Public and Not-For-Profit Hospitals and concessions for registered charities that would allow them to provide their employees with non-cash fringe benefits, such as school fees, without having to pay FBT up to a specified maximum limit. These concessions are provided to such employees to enable those employers who would otherwise not have the capability to compete with for-profit businesses, to attract and retain staff.

There are no such concessions available for employees located in rural and remote areas – employees who arguably have a need in terms of trying to compete with their metropolitan counterparts.

16.3 Areas for consideration

Employees of Public Benevolent Institutions have a $30,000 FBT exemption cap and employees of Public and Not-For-Profit Hospitals have a $17,000 FBT exemption cap (set to increase to $31,177 and $17,667 for the 2017 FBT year due to the budget repair levy).

Registered charities may be eligible for a rebate equal to 48 per cent (in the 2015 year) of the gross FBT payable, subject to a capping threshold of $30,000 (set to change to 49 per cent and $31,177 for 2016 & 2017 FBT years and 47 per cent and $30,000 for the 2018 FBT year onwards), to compensate them for the loss of benefit of a tax deduction for the Fringe Benefits Tax paid.

The exemption caps and 48 per cent rebate enable employees of eligible organisations to access concessional treatment of fringe benefits to salary package non-cash items such as school fees.

These caps allow those employers to attract and retain staff, who would otherwise struggle to compete with private enterprise to pay market value salary.

Section 58Z of the FBT Act currently exempts remote area housing benefits from FBT. There is also concessional treatment of the provision of a housing assistance, residential fuel and holiday travel for employees in a remote area.

Consideration could be given to providing employees located in remote areas with up to a $17,000 exemption per child per annum (i.e. linked to the current caps for hospital employees), where employers pay school fees on behalf of their employees. This would require an additional definition relating to 'remote' areas to ensure that it is appropriately target and not abused. This could be 40 kilometre or more from a secondary school. If standard remote area definitions were to be used this would capture locations where there are already a number of secondary school alternatives. In addition to this, the employee must live in a remote area as otherwise defined for FBT purposes.

16.4 Impact of alternatives considered

By allowing employees located in remote areas to salary package their children's school fees, it will provide significant benefits including:

- Assisting employers located in remote areas to attract and retain high quality workers;
- Encouraging regional employment and development;
- Improving access to quality education for children in remote areas; and
- Enhancing educational outcomes for students including the increased likelihood of continuing on to tertiary education and obtaining higher qualifications. This may in turn lead to a cyclic effect whereby these children contribute more successfully as employees in rural communities.

16.5 Case study

A farm located 100 kilometres west of Walgett struggles to attract and retain a manager for the mixed farming operation. The last manager left shortly before his eldest child started secondary school, transferring to a farm near Tamworth to access better quality education. The school in the local community is a primary school and finishes at year six. The closest high-school is 100 kilometres away. The cost to send a child to a modest boarding school can cost up to $20,000 per year.

For a farm manager earning $80,000 per annum, the before tax cost to send a child to boarding school would be $29,630 (i.e. $20,000 / (1- 32.5 per cent)). This cost is beyond what is reasonable for the average wage earner to spend on the education of one child.

If the farm manager was able to salary package the boarding school fees, up to $17,000 would be paid out of the pre-tax salary, a savings of $5,525 compared to the existing treatment.

If remote area concessions were available to salary package school fees, it may allow the remotely located farm to retain employees more readily.

17. Fringe benefits tax (FBT) and remote area concessions

17.1 Background and current position

The FBT remote area concessions were introduced in order to attract individuals to work in remote areas. It was suggested that various items such as the construction costs of houses were higher in remote areas and with lower levels of public amenities and other facilities there was a need for incentives to be provided to attract workers to these areas.

In order for these concessions to apply you must be working in a remote area. An area is considered remote for FBT purposes if one of the following classifications apply:

Classification 1

The location is:

- **not** in Zone A or Zone B for income tax purposes; and
- at least 40 kilometre from a urban centre that in the 1981Census had a population of **14,000** or more; and
- at least 100 kilometres from an urban centre that in the 1981 Census had a population of 130,000 or more.

Classification 2

The location is:

- in Zone A or Zone B for income tax purposes; and
- at least 40 k kilometres from an urban centre that in the 1981 Census had a population of **28,000**; and
- at least 100 kilometres from an urban centre that in the 1981 Census had a population 130 000.

Classification 3

An area is also classified remote if:

- the employer is one of the <u>certain regional employers</u> listed below; and
- the employer is providing a housing benefit; and
- the location is at least 100 kilometres from an urban centre that in the 1981 Census had a population of 130,000 or more.

Certain regional employers

- a public hospital
- a hospital carried on by a non-profit society or a non-profit association
- a government body where the duties of employment are exclusively performed in, or in connection with, a public hospital or a non-profit hospital
- a charitable institution
- an employer who provides public ambulance services or services that support those services where the employee is predominantly involved in connection with the provision of those services
- a government body where the employee's duties are performed in a police service.

The specific remote area concessions are (references are to the Fringe Benefits Tax Assessment Act 1986 (FBTAA)):

- Remote area housing – Full FBT exemption - section 58ZC
- Meals for primary production employees – Full FBT exemption - section 58ZD
- Residential fuel reductions – Subject to a 50 per cent reduction in taxable value - section 59
- Remote area housing loans – Subject to a 50 per cent reduction in taxable value - subsection 60(1)
- Remote area housing loan interest – Subject to a 50 per cent reduction in taxable value - subsection 60(2)
- Remote area rent – Subject to a 50 per cent reduction in taxable value - subsection 60(2A)
- Remote area residential property benefits – Subject to a 50 per cent reduction in taxable value - subsection 60(3)
- Remote area residential property expense payment benefits – Subject to a 50 per cent reduction in taxable value - subsection 60(4)
- Remote area residential property option fees – Subject to a 50 per cent reduction in taxable value - subsection 60(5)
- Remote area residential property repurchase consideration – Subject to a 50 per cent reduction in taxable value - subsection 60(6)
- Remote area holiday transport – Subject to certain limits subject to a 50 per cent reduction in taxable value - sections 60A and 61

Each of these exemptions or concessions have their own set of conditions that need to be satisfied in order to access them and these conditions range from four to 10 separate requirements, meaning there are a significant number of complexities and compliance costs involved in administering this system.

The findings of Australia's future tax system – Report to the Treasurer[136] showed "Fringe benefit valuation and apportionment methodologies impose unnecessary compliance costs on employers and have embedded high levels of concessionality in the FBT system. Most of the existing FBT concessions and exemptions have a historical basis that is no longer relevant. This has eroded the FBT tax base." Therefore, at recommendation nine it provided "All fringe benefits tax (FBT) exemptions should be reviewed to determine their continuing appropriateness. To improve simplicity, consideration should also be given to excluding fringe benefits from tax where the costs of compliance outweigh equity and tax integrity considerations".

While FBT was generally raised in the recent Tax Discussion Paper, the remote area concessions themselves were not mentioned.

17.2 Issues associated with current position

Empirically it is evident that any incentives such as the remote area FBT concessions that effectively provide employees a higher after tax benefit at a lower cost to employers will make it easier for employers to attract employees to these areas. However, there is a lack of evidence in the form of formal studies to provide specific evidence in terms of the impact that these concessions are having in remote areas.

It is clear that most of these concessions were introduced in 1986 with the introduction of FBT and subsequently expanded to all employers in remote areas (initially most concessions were only

[136] The Commonwealth of Australia 2010, Australia's Future Tax System – Report to the Treasurer, http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/AFTS_Final_Report_Part_2_Vol_1_Consolidated.pdf

available to the primary production industry). However, many of the concepts including the definition of remote area rely on 1981 census data or tax zones that were defined in 1945 and the boundaries have remained broadly unchanged since 1956[137] meaning it is difficult to determine in fact how relevant they remain today. See further discussions in the 'Tax zone rebates' section of this report.

While it can be suggested that these concessions make it comparably cheaper for employees to live in remote areas and for employers to attract quality employees at a lower cost than would otherwise be possible, we need to consider the impact that this is having on the remote areas themselves. For instance if an employee can purchase a house in a remote area and effectively have only half of the purchase cost needing to be paid for in after tax dollars with the other half in pre-tax dollars in a competitive market, it would suggest that it possibly inflates housing prices in these areas in the long term. Over time, it is conceivable that the benefit of these concessions have been eroded and that there is a conceivable preference that people in remote areas would prefer to be employees than business operators (unless they are employees of their own business structures), interfering with free market economics.

Additionally, while fringe benefits are provided to employees, it is the employer that pays the FBT and the rate applied is the highest marginal tax rate regardless of the marginal tax rate applied to employees. To ensure individuals entitlements and benefits are calculated appropriately the individual employees must record their 'reportable fringe benefits' and provisions exist in other tax and welfare provisions to ensure they are factored into the relevant calculations (such as the non-commercial loss adjusted taxable income $250,000 test).

17.3 Areas for consideration

The remote area concessions were introduced in order to attract individuals to work in remote areas and they were considered fair and reasonable because various items, such as the construction costs of houses, were higher in remote areas and these areas had lower levels of public amenities. These concessions have largely been in place since 1986, and should be reviewed to determine if they remain relevant.

The recommendation in *The findings of Australia's future tax system – Report to the Treasurer* that it would seem appropriate that these measures need to be reviewed in detail to determine if they remain relevant and suitable for purpose is supported.

Subject to the findings of such a review, consideration could be given to removing benefits provided in the form of remote area residential property option fees and remote area residential property repurchase consideration from the FBT system. Instead these mounts could be treated as proceeds on the sale of the premises to enable them to be taxed under the CGT regime and only taxed concessionally under the main residence exemption if eligible for that concession.

Consideration could also be given to better targeting the provisions by defining a remote area to only include those where the incentives are in fact required (considering issues such as public amenities, transportation, housing costs etc.).

Consideration could also be given to removing the 50 per cent reduction in taxable value of remote area residential property expense payment benefits, If the employment position has the degree of permanence to attract employees to purchase a house, it is suggested that the area is not unattractive for the employee to want to move to the location, therefore the property market should be allowed to

[137] The Commonwealth of Australia 2010, Australia's Future Tax System – Report to the Treasurer, http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/AFTS_Final_Report_Part_2_Vol_1_Consolidated.pdf

set appropriate housing prices for all and not make houses comparatively cheaper for some employees putting other at a competitive disadvantage.

On the face of it, an optimal system would remove the burden of FBT in general from the employer and reallocate it to the employee simply as taxable income, thereby reducing the adjustments required to other specific provisions of the tax legislation (e.g. tax rebates) and ensuring that these benefits are taxed at the employees appropriate marginal tax rate. If taxed at marginal tax rates rather than the highest marginal tax rate, it would seem there is a reduced benefit or need for the 50 per cent reductions in taxable value of the majority of these benefits to attract suitable employees. If employees are subject to the highest marginal tax rate, there is a reduced need for the taxpayer to subsidise their costs. In fact, if fringe benefits were taxed at an employee's marginal tax rate then all of the 50 per cent reduction concessions could be removed.

17.4 Impact of alternatives considered

Reviewing the concessions will ensure that they operate to achieve the purported intent; identifying any inefficiencies and enabling improved productivity and allocation of labour resources.

Re-allocating the house sale concessions to sale proceeds and enabling possible concessions under the main residence exemption better aligns the treatment with other taxpayers who simply sell a house and significantly simplifies their operation. These arrangements are, after all, structured as the employer purchasing the employees house.

Removing the concession in relation to house purchase is expected to enable the market to normalise and determine appropriate housing prices that are available to all residents (including business owners that are not employees).

Moving the burden of FBT from employers to employees will ensure that the appropriate marginal tax rates are applied and reduce the need for other income and rebate provisions requiring special adjustments to taxable income to be performed.

17.5 Case study

Employee A relocates to a remote area mining community and purchases a house for $250,000. When the house is purchased, the employee enters into an eligible options agreement to sell the property back to the employer for the employees purchase price plus $10,000 pa and receives a $10,000 option fee under the agreement.

In four years time the option is exercised and the employer purchases the house for $290,000 when the market value is now $200,000 but the guideline price is $290,000.

Under the current rules the $10,000 option fee and the $90,000 paid to acquire the house in excess of the market value up to the guideline price are treated as fringe benefits where the taxable value is reduced by 50 per cent (i.e. the taxable value is $50,000). These are type two benefits meaning the grossed up taxable value is $94,340 and the FBT payable is $46,226.60.

If treated as sale proceeds on the house the taxable capital gain would be the $100,000. If the main residence exemption is available in full there would be no tax payable and if not, then the general discount would apply and the employee would have a taxable capital gain of $50,000 taxable at their marginal tax rate.

18. Water in-situ (when purchased with a property)

18.1 Background and current position

When a farm is sold, there are usually many different assets being sold. This includes land, fixtures, livestock, and crops growing on that land. In many circumstances, there are also some consumable type items that are associated with the sale.

In relation to these consumable type items, the ATO is of the view[138] that water stored in a dam (to be used within 12 months to irrigate crops) is an inseparable part of the land, meaning if the land is a capital asset, the water being part of that asset is also a capital asset. Further, the ATO believes that any similar consumable such as fuel in a large underground storage, would also be an inseparable part of land. It is of the view that fuel in 200 litre drums which rest on the ground is separate to the land. It is uncertain how the ATO would view items such as unspread fertiliser stored in bulk piles.

18.2 Issues associated with current position

To say that water in storage or fuel in an underground tank are part of land at the time of purchasing a farm is highly inconsistent when compared with the tax treatment of items purchased on normal trading terms.

Water can be purchased and pumped from a river by farmers to irrigate their crops. This is a consumable and is tax deductible, subject to a few rules such as those outlined in IT333 relating to consumable stores. When this same water is in situ on a farm that is purchased, the result is unclear, but the ATO suggest in ATO ID 2013/49 and private ruling 1012520599280) that it is not tax deductible.

The ATO argues that as water forms part of land it is only possible to trigger a capital gain or loss once a CGT event has been triggered. If it could be proven that there has been a reduction in the value of the land as a result of the evaporation or consumption, there is the prospect of arguing that this portion of water no longer forms part of the land asset. This may allow this portion of the cost base to be treated as capital expenditure and generate an effective deduction under the horticultural plant provisions.

However, practical difficulties arise in identifying the specific water that had been utilised (e.g., if you continue to harvest water into the dam or it rains) and that there has been a reduction in the value of the land.

In addition to the inconsistent treatment noted above, there are also practical difficulties in applying the ATO’s current position as well as uncertainty in relation to the correct treatment of this issue.

18.3 Areas for consideration

A standing crop is not trading stock. It becomes trading stock when it is severed from the land.

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[138] Australian Taxation Office 2016, Income Tax - Physical water purchased on acquisition of a primary production business, http://law.ato.gov.au/atolaw/view.htm?docid=%22AID%2FAID201349%2F00001%22

Section 70-85 ensures that certain assets (standing crops, trees and crop stools) are treated as trading stock for income tax purposes and on that basis the cost of acquiring same is tax deductible when they are sold.

In relation to water in situ and similar consumable type items (e.g. fuel in bulk storage), while it has an economic cost and while that cost will be inherent in a crop when it is severed, the value of that water at the time of farm sale cannot be said to be a crop, a tree or a crop stool.

It would be relatively simple to add a fourth subsection to section 70-85 to bring 'costs in establishing the above' into the trading stock provisions. This would ensure a tax deduction for items and products purchased with land similar to purchasing those items and products on a normal business basis.

If there is a concern that these assets may remain on hand for more than one tax period, integrity measures could be developed to ensure that these assets remain to be treated as trading stock after acquisition and therefore no effective ultimate deduction is available until the consumables have been utilised.

18.4 Impact of alternatives considered

To ensure tax equity between consumables purchased with a farm and those purchased in the ordinary course of business.

18.5 Case study

Farmer A buys the farm next door.

At the time of settlement, there is 1,000 mega litres of water in a farm dam and 20,000 litres of fuel in an underground storage. Farmer A uses that water to water crops and fuel in general to grow crops which he subsequently harvests and sells.

This proposed change in legislation would ensure that the value of the fuel and the value of the water would be treated in the same way as trading stock.

Under the current tax rules no deduction would be available upon acquisition of these assets and the most likely scenario is that the associated cost would be included in the cost base of the property with no tax benefit arising until the property is sold once more.

19. Passive versus active investment

19.1 Background and current position

Under the current and rather complex Australian taxation system there are many specific provisions and at times nuances in the law that result in differences in the levels of taxation applied, both to different structures and different types of income. This has largely arisen as the taxation laws have been developed over a long period of time (legislation continually being added to as different issues and concerns of the time are addressed). Consequently, the tax system in some cases has developed to intentionally redistribute wealth or encourage particular activities at the expense of others. Occasionally these discrepancies have been unintentional as some considerations may have been overlooked when a specific issue was addressed.

A passive investment is essentially an investment that requires limited day-to-day management. For example, a rental property, that is often managed by an agent and requires little attention from the property owner. An active investment on the other hand requires extensive day-to-day management and generally amounts to a business activity. For example, the purchase of farm land for the purpose of direct farming.

It was provided in the Tax Discussion Paper[139]:

> "Australian households save primarily through home ownership (43 per cent of total household assets), superannuation (15 per cent of total household assets), and other property, including investment property (15 per cent of total household assets). Other popular vehicles for savings include shares, bank accounts and debt instruments, as well as trusts and company structures."

Following is a brief summary of the main disparities arising in the tax treatment of active versus passive investment:

- Non-commercial business losses. As previously outlined under the topic heading 'Non-commercial losses', there are specific provisions in place to prevent an individual from claiming losses from business activities against their other income if their other income exceeds $250,000 or if they do not pass one of the other four specific requirements. Losses from passive investments or losses to other entity types are not subject to these specific rules (e.g. negative gearing losses on investment properties). Instead they are subject to general tax principles and these losses are generally available to offset other income unless there is no objective expectation to profit over the life of the activity (i.e. no prospect of becoming profitable).

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[139] Australian Government 2015, Re:think – Tax Discussion Paper, http://bettertax.gov.au/files/2015/03/04_Savings.pdf

- CGT general discount. A 50 per cent discount is available to individuals and trusts and a $33^1/_3$ discount to complying superannuation funds on capital assets that have been held for greater than 12 months. This is not available on revenue type assets. For example, a parcel of BHP shares that is held by an individual investor for 12 months would qualify for the discount and would be considered a passive investment. However, a parcel of BHP shares acquired by an individual share trader (someone who buys and sells shares with the intention of generating a profit on the trades) would hold these shares as trading stock (a revenue type asset) and would be considered to be carrying on a business in relation to the holding as an active investment and not be entitled to the discount regardless of how long the shares were actually held. This discount is not available to companies.

- CGT main residence exemption. Under existing taxation rules in Australia, individual taxpayers are exempt from paying CGT on their main residence. There are also rules that mean that once a dwelling is established as an individual taxpayer's main residence that the exemption continues once they vacate the property. This can continue indefinitely if the property does not become income producing or continues for up to six years if it does become income producing. There is no limit on the amount of gain that can be disregarded. An individual can only have one elected main residence at any time, including allowing for periods of absence.

- Small business CGT provisions. These provisions are available to small business taxpayers, essentially those with net assets below $6 million or turnover below $2 million. The definition itself and issues associated with this definition are discussed further under the topic heading 'Small business entities'. Once classified as a small business entity, taxpayers can look to apply the 50 per cent active asset reduction on the capital gain.

- Stamp duties. State/territory based charges, and specifically stamp duties, also apply differently to business and passive assets. This is covered in greater detail under the section ''State and territory taxes' but for instance in NSW, duties continue to be levied at ad valorem rates on land and business assets (such as goodwill and intellectual property) and on unlisted marketable securities at the rate of 0.6 per cent.

- The distinction between active and passive investment can at times be difficult to determine and even be manipulated. This has been highlighted separately under the topic heading 'Managed investment schemes'.

It was stated in Australia's future tax system – Report to the Treasurer (The Henry Review[140]) that:

> "Different tax treatment can have an effect on the form in which savings are held. More favourable tax treatments for some assets may lead households to engage with a different risk-return profile than they otherwise would. An OECD literature review concluded that low-income individuals may respond to tax incentives with new saving. High-income individuals are more likely to divert savings to more tax-preferred savings, likely resulting in some change in the risk-return profile of their savings portfolios. The Financial System Inquiry found that, to the extent that tax distortions direct savings to less productive investment opportunities, a more neutral tax treatment would likely increase productivity." and

[140] The Commonwealth of Australia 2010, Australia's Future Tax System – Report to the Treasurer, http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/AFTS_Final_Report_Part_2_Vol_1_Consolidated.pdf

"It is important to note that, although taxes may affect the allocation of savings, they are unlikely to affect significantly the overall level of investment in the economy."

"Currently, around 70 per cent of individual investors in rental properties are in a net loss position. This figure has increased from 58 per cent in 2000–01 (see Chart A1–21). The increase largely reflects increases in interest deductions, reflecting rising levels of gearing rather than higher interest costs. Rental deduction claims have also increased relative to gross rent."

"Households held around $700 billion of residential investment property assets in 2005–06 (ABS 2007). This represented around 14 per cent of total household assets, a proportion that has increased over the last decade."

19.2 Issues associated with current position

While it is known from the empirical data that differences in the taxation treatment of various assets will result in distortions to a taxpayer's preferred investment mix, the real question is whether or not these distortions are desirable or whether additional distortions or incentives are required.

One point that needs to be carefully understood is that the distinction between an active and a passive investment can at times simply be a matter of perspective. For example, if an individual taxpayer owns a farm and operates a business on that farm then the farm itself is an active investment to the individual taxpayer. If however, the same individual owns the farm but leases the farm to a related trust that conducts the farming business, then from the individual taxpayers perspective they own a passive investment that in reality is a rental property (and as a result any rental loss derived by that individual on the farm would not be subject to the non-commercial loss rules). Consequently the type of asset is not definitive in determining its tax treatment.

In terms of CGT provisions, the main residence exemption appears to be highly favourable to individual taxpayers in areas experiencing high rates of property growth and high valued properties (generally those in major cities). There is no cap on the quantum of the gain that can be disregarded and no minimum period that a taxpayer must physically reside in the dwelling.

The small business CGT provisions, while very favourable, have a higher hurdle to access. Firstly you must be a small business taxpayer and the asset must be an active asset for a minimum of either half the ownership period or seven and a half years. To be completely exempt the asset must be owned by the taxpayer for at least 15 years (noting if the turnover test is passed conceptually there is no limit on the amount of gains that could be exempted under this concession). If the asset is not owned for 15 years then there are some limits on the amount of the gain that can be free from tax (e.g. the $500,000 lifetime limit under the retirement exemption). If the thresholds are exceeded then these provisions are not available at all.

It should also be noted that the Henry Review[141] provided recommendations to allow more favourable tax treatment towards passive investments. Recommendation 14 suggested a 40 per cent savings income discount to individuals for non-business income including net interest income and net residential rental income, while recommendation 17 suggested that the small business 50 per cent active asset reduction and 15 year exemption should be removed.

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[141] Australian Taxation Office 2004, Taxation Ruling - TR 2004/112, http://law.ato.gov.au/atolaw/view.htm?docid=%22AID%2FAID2004112%2F00001%22

19.3 Areas for consideration

In terms of CGT, limits could be placed on the amount of gains that can be reduced under the main residence exemption. Specifically, consideration could be given to placing a life time cap on the main residence exemption rather than exempting all gains in full. This is also covered in the 'Small business entity' section of this report.

19.4 Impact of alternatives considered

Changes in CGT limits could maintain reasonable benefits to taxpayers when investing in capital assets, thereby, encouraging investment over consumption, while removing tax biases from the investment mix decision. This will allow investment decisions to be based on commercial considerations and returns, rather than taxation impediments, thereby creating a freer market and more efficient allocation of resources.

20. Wine equalisation tax and rebate

20.1 Background and current position

Wine production is a major agricultural industry in Australia, employing around 30,000 people directly, and many more indirectly[142].

Over 2,400 wineries and approximately 5,900 independent wine grape businesses operate in Australia, comprising mostly small operations located in all states and the Australian Capital Territory, but predominantly in South Australia, New South Wales and Victoria. Of these wineries, approximately 70 per cent crush less than 100 tonnes of grapes[143].

20.1.1 Wine Equalisation Tax

The Wine Equalisation Tax (WET) was a result of the introduction of the GST (i.e. replacing tax on wine (41 per cent) under the wholesale sales tax system) [144]. The WET was introduced as part of the GST tax reform package with the intent of equalising the amount of tax on wine, in particular cask wine, with that which existed under the wholesale sales tax system[145].

Generally, those making wine, importing wine into Australia or selling it by wholesale have to account for WET.

WET is a tax of 29 per cent of the wholesale value of wine (not alcohol content as it is for other beverages). It is only payable if you are registered or required to be registered for GST.

WET is designed to be paid on the last wholesale sale of wine, which is usually between the wholesaler and retailer. It may apply in other circumstances such as cellar door sales or tastings where there has not been a wholesale sale. WET is also payable on imports of wine (whether or not you are registered for GST).

WET is a form of excise (in a similar way to tobacco and other alcoholic products) essentially driven by the social policy objective associated with responsible alcohol consumption.

20.1.2 WET Rebate

The stated intent of the WET rebate is to benefit small wine producers in rural and regional Australia. The explanatory material to the Bill to establish the WET rebate stated that a majority of wine producers would be able to fully offset their WET liability by accessing the WET rebate. In particular,

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[142] Winemakers' Federation of Australia 2014, Wine tax unchanged in tough budget - 2014-05-13, http://www.wfa.org.au/information/noticeboard/wine-tax-unchanged-in-tough-budget/

[143] Winetitles 2015, Australian and New Zealand Wine Industry and Department of Agriculture

[144] Australian Government 1998, Tax reform: Not a New Tax, a New Tax System, http://archive.treasury.gov.au/contentitem.asp?ContentID=167

[145] Australian Government 2015, Re:think – Tax Discussion Paper, http://bettertax.gov.au/files/2015/03/04_Savings.pdf

small wine producers in rural and regional Australia would benefit by having their WET liability reduced or offset entirely[146].

Wine producers may be entitled to a credit (rebate) of the WET amount paid on a wine dealing, or the amount of WET that would have been paid had the buyer not quoted their ABN, up to a maximum of $500,000 each financial year (equivalent to $1.7 million of sales). The rebate was introduced in 1999 to replace the previous cellar door rebate (under the wholesale sales tax system), and in 2004 was extended to cover all domestic sales (rather than just cellar door). The reasoning provided by the Treasurer at the time was that it was designed to support small producers with domestic sales.

If the buyer quotes their ABN, the seller can claim the producer rebate only if the buyer has declared that they do not intend to make a GST-free supply of the wine.

To be a producer you must do one of the following:

- Manufacture the wine from grapes, other fruit, vegetables or honey you produce or purchase;
- Provide the grapes, other fruit, vegetables or honey to a contract winemaker to be made into wine on your behalf; or
- Subject your wine to a process of manufacture – for example, manufacturing finished wine from raw wine, or blending wines to make a commercially distinct wine (but you must reduce your claim by any earlier producer rebates).

You are **not** a producer if, for example, you simply purchase bulk wine and bottle it for sale.

New Zealand winemakers can claim the wine producer rebate if they:

- Produce the wine in New Zealand;
- Register successfully with New Zealand Inland Revenue;
- Show that the wine is exported to Australia; and
- Show that WET was paid on the sale of the wine.

The New Zealand rebate only applies where the wine is ultimately sold in Australia. To fulfil this requirement, a New Zealand producer does not actually have to sell the wine in Australia. It is usually an Australian entity such as a wholesaler or distributor that makes the sale in Australia.

The New Zealand scheme came into effect from 1 July 2005, and is in accordance with Australia's obligations under the *Australia-New Zealand Closer Economic Relations Trade Agreement 1983*.[147]

In May 2015, the Treasury prepared a discussion paper examining the WET rebate. A consultative group has been formed to consider submissions and provide advice to Government on options for reform. The findings are yet to be reported.

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146 Parliament of Australia 2004, Tax Laws Amendment (Wine Producer Rebate and Other Measures) Bill 2004, http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r2085

20.2 Issues associated with current position

The rebate was designed to support small winemakers however, there are concerns that the rebate is not only being claimed by bigger winemakers, but also multiple times with refunds increasing each year since the scheme was introduced, from $119 million to more than $300 million. There are also claims that the system is being abused, with contracting out of the manufacturing process simply to claim the rebate and claiming more than one rebate for the same parcel of wine by blending and remanufacturing in the name of different entities.

As the Australian National Audit Office (ANAO) noted in its 2011 report, the operating conditions in the industry have created a difficult environment for the administration of the WET rebate by the ATO[148]. A number of schemes have arisen in recent years for the purpose of improperly accessing the rebate. Wholesalers and retailers are also incentivised to minimise the amount of WET paid and maximise WET rebate claims. Some of these arrangements are within the law but have the potential to erode revenue, contrary to the original intent of the law.

There seems to be a growing trend in the wine industry for some wineries to purchase bulk wine from grape growers instead of purchasing grapes to make wine. This effectively enables wine grape growers to become wine producers and entitles them to claim the WET rebate on the wine sold to the winery. The WET rebate is then factored into the processing fee charged by wineries to produce the wine or into a lower price charged to the winery for the finished wine. This can provide a means for wineries to gain access to wine that is financially subsidised by multiple rebates[149].

Virtual wine producers are entities that claim the WET rebate despite having no involvement in the winemaking process (they do not own or lease vineyards and do not have plant or equipment or a cellar door). To claim the rebate, virtual producers acquire grapes and/or wine and contract out the manufacturing or blending process.

Some of these entities may exist for the sole purpose of claiming the WET rebate. Generally these entities are not legally related to the entity that benefits from the additional WET rebate claims, making these arrangements difficult to detect[150].

Overall, there is concern that the WET rebate is driving behaviour that is in effect exacerbating challenges for the domestic wine industry, in particular by encouraging the production of bulk wine which in turn encourages businesses structuring to obtain the rebate[151].

The Winemakers' Federation of Australia (WFA) has put forward an option to restrict eligibility for the WET rebate by excluding bulk, unpackaged and unbranded wine. Under the WFA's model, eligibility for these products would be phased out by 25 per cent each year over four years and would have the effect of directing the WET rebate to wine businesses with an investment in regional Australia and that produce branded wine products.

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[148] Australian National Audit Office 2010, Administration of the Wine Equalisation Tax, http://www.anao.gov.au/~/media/Uploads/Documents/2010%202011_audit_report_no20.pdf

[149] The Australian Government 2015, Wine equalisation tax rebate, http://treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2015/Wine%20Equalisation%20Tax%20Rebate/Key%20Documents/PDF/WET_Rebate_Discussion_Paper_2015.ashx

[150] The Australian Government 2015, Wine equalisation tax rebate, http://treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2015/Wine%20Equalisation%20Tax%20Rebate/Key%20Documents/PDF/WET_Rebate_Discussion_Paper_2015.ashx

[151] The Australian Government 2015, Wine equalisation tax rebate, http://treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2015/Wine%20Equalisation%20Tax%20Rebate/Key%20Documents/PDF/WET_Rebate_Discussion_Paper_2015.ashx

The WFA's proposal would mean that entities that sell bulk wine as part of their current commercial practice would no longer be eligible for the rebate.

There is also concern that access to the rebate gives New Zealand winemakers a commercial advantage. However, adjusting the New Zealand producer rebate could have implications for Australia's international trade obligations, including under the *Australia and New Zealand Closer Economic Relations Trade Agreement 1983*. Australia's international trade law obligations provide that like imported products should be treated in the same way as domestic products under Australian taxation law.

The Australian wine industry is taxed at high rates compared with countries that Australia competes with, and the lower tax relative to beer and spirits is consistent with the approach in competitor countries as well.

It is also important to note that WET is not the only tax paid by the wine industry. It is also potentially paying payroll and property taxes (including state and local government), GST, and income tax.

There are suggestions that an alternative may be to move to a volumetric tax (i.e. based upon alcohol content). However, such a system would disproportionately affect those who consume alcohol responsibly, while having a detrimental impact on the Australian wine industry. Further, expensive wine (tending to be consumed by those on higher incomes) would be relatively cheaper and cheaper wine (tending to be consumed by those on lower incomes) would be relatively more expensive. This would therefore make it a regressive tax where the lower the income, the higher proportion of income that is paid in tax.[152] The excise-based system based upon alcohol content, would also be difficult to administer and regulate due to alcohol volume fluctuating from one wine variety to the next and also variations from season to season.

20.3 Areas for consideration

Consideration should be given to retaining the current WET system, with the removal of the WET rebate for unbranded and bulk wine. As an industry with very close links to agriculture (i.e. value-add to grape production) the WET system recognises the production risks associated with the variations in agricultural production (i.e. volume and quality affected by annual variations in climate, disease risks, etc.). The quality and volume of the end product for a winery is very much linked to the raw product of grapes and this varies annually.

The WFA position to remove the rebate on unbranded and bulk wine is supported. This is on the basis that the original policy intent of the rebate was to replace the cellar door rebate and assist smaller regionally based winery businesses in the domestic market and recognise the annual risks associated with production, etc. Such a change would also remove some of the current market distortion between the unbranded/bulk wine compared with its counterparts.

[152] Accolade Wines 2015, Re:think – Better Tax, Better Australia – Submission, http://bettertax.gov.au/files/2015/06/Accolade_Wines.pdf

Thought should also be given to denying the rebate for New Zealand producers, recognising that due consideration needs to be given to the implications for Australia's international trade obligations.

The proposal in the 2016 Budget to restrict the rebate to packaged and branded wine is consistent with restoring the original policy intent of the rebate. It is noted that consultation will be undertaken to settle final details on the tightened eligibility criteria, with an Implementation Paper being released for comment in September 2016.[153]

[153] The Commonwealth of Australia, Improving the integrity of the wine equalisation tax rebate and growing exports, Budget 2016, Tax Fact Sheet 10

Appendices

Appendix 1

Tax Structures Comparison Summary Table

	Sole Trader	Partnership	Company	Fixed Trust	Non-fixed Trust
Establishment documents	None	Partnership agreement	Constitution	Trust deed	Trust deed
Who controls	Individual	Partnership agreement	Directors/ Shareholders	Trustee/Unitholders	Trustee/Appointer
Stamp duty	None	None	None	Depends on state	Depends on state
Perpetual existence	Terminates on death	Terminates on death or bankruptcy of partner	Yes	Must vest within certain period - usually 80 years	Must vest within certain period - usually 80 years
Limited liability	No	No	Yes	Can be if trustee a company	Can be if trustee a company
Complexity	Simple	Simple	Complex	Complex	Complex
Governing Law	No specific act	Partnership Act	Corporations Law	Trustee Act	Trustee Act
Reporting to public	No	No	Yes if public, no if private	No	No
Tax rate	Individual tax rates	Individual tax rates	Company tax rate	Various rates if retained in trust or taxed to beneficiary	Various rates if retained in trust or taxed to beneficiary
Basis of tax accounting	Cash or accruals - what ever is most appropriate to type of business	Cash or accruals - what ever is most appropriate to type of business	Accruals generally. Can be cash if was STS at 1/7/05. (No cash provisions for income tax in SBE legislation)	Accruals generally. Can be cash if was STS at 1/7/05. (No cash provisions for income tax in SBE legislation)	Accruals generally. Can be cash if was STS at 1/7/05. (No cash provisions for income tax in SBE legislation)
Distribution of losses	Individual can use	Partners can use	Trapped in company	Trapped in trust	Trapped in trust
Carry forward of losses	No restrictions	No restrictions	Continuity of ownership and same business test restrictions	Compliance with trust loss laws	Compliance with trust loss laws
Transfer of losses	No	No	Yes to group companies - can only transfer if consolidated (from 1 July 2004)	Generally no. Is possible in some specific circumstances when in a consolidated group.	Generally no. Is possible in some specific circumstances when in a consolidated group.
Income splitting	No	Limited by S.94 ITAA 1936 and PSI rules	Salaries or dividends, but note PSI rules	Salaries or distributions but note PSI rules	Salaries or distributions but note PSI rules
Streaming of income	No	No	No	No	Yes
Loans to principals	N/A	No	Division 7A ITAA 1936	Yes, unless corporate unitholder with unpaid present entitlement	Yes, unless corporate beneficiary with unpaid present entitlement
Interest deduction on return of capital	N/A	Generally Yes TR 95/25	Generally Yes TR 95/25	Generally Yes TR 2005/12	Generally Yes TR 2005/12
Return of tax free capital - CGT?	N/A	N/A	SS.44,47(1A) ITAA 1936 S. 104-135	S.104-70	Should be as per TD 97/15
Subdivision 149-B Change in majority underlying ownership	N/A	N/A	Can apply	Can apply	Should not apply to discretionary trust unless a new family added - refer IT2340
S.104-230 - CGT event K6 Pre CGT shares or units	N/A	N/A	Can apply	Can apply	Not apply to discretionary trust
S.100A ITAA 1936 Reimbursement agreements	N/A	N/A	N/A	Can apply	Can apply
Excessive payment to principal or relative	N/A	S.65 ITAA 1936	S.109R ITAA 1936	N/A	N/A
50% CGT discount	Yes	Yes	No	Yes	Yes
Significant individual test	N/A	N/A	Applies	Applies	Applies
Can principal be employed	No	No	Yes	Yes	Yes
Superannuation contributions	Self employed	Self employed	Employer sponsored	Employer sponsored	Employer sponsored
Who registers for GST	Individuals	Partnership	Company	Trust	Trust
Where is tax assessed	Individual	Partners	Company	Beneficiary (or trustee)	Beneficiary (or trustee)
Do principals have fixed interest	Yes	Generally, Yes. But can be modified by partner's salaries.	Generally, Yes. But can have non fixed interests to certain classes of shareholders (i.e. preference shares)	Yes	No
Regulatory body	N/A	N/A	ASIC	N/A	N/A
Flexibility	Inflexible	Some flexibility	Some flexibility	Inflexible	Flexible
Trustee Beneficiary Statement rules	N/A	N/A	N/A	Apply	Apply

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RIRDC Publication No 16/019

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This project was conducted in partnership with: