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LAWYERS

Preparing for a Labor Government

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Winter is coming. An election is imminent. A blitzkrieg of negative advertisements about Labor's tax policy is almost certain to bombard us.

The Labor tax policy has been announced (or confirmed) by drip feed over the last 18 months. Is there more to come? What questions remain unanswered? What can be done to prepare for the introduction of these policies?

As a lot of the detail about the policy proposals still remain in press release format or in media responses, there is still some uncertainty about what will be implemented (leaving aside the challenge of whether Labor will in fact be elected as the bookmakers now predict, and whether Labor will attract sufficient senators to vote in favour of their proposals "as is" or if a compromise will need to be found a la exempting food from GST).

Lifting the top marginal rate

The marginal rate will increase from 45% to 47%. After adding the Medicare levy this is an effective tax rate of 49% on earnings over $180,000 per annum.

Franking credits

Probably the most controversial of the changes proposed by Labor is to deny refunds of franking credits to individuals and superannuation funds. This measure is squarely targeted at self-funded retirees and self-managed superannuation funds. Charities and not-for-profits are expressly excluded, as are pensioners and SMFs which had a member in receipt of a means-tested government pension as at 28 March 2018. Although the policy will apply to APRA regulated funds, minimal impact is expected because they rarely receive refunds.

An unsettled question: If a taxpayer is entitled to a refund as a consequence of over-payment of instalments under the PAYGW system and the refund arises because of a component directly attributable to franking credits, will the refund be denied? In other words, will the refund be said to be for franking credits or overpayment of PAYGW?

A similar problem will arise with the interaction of this rule and the proposed new framework for taxation of trusts. What will happen where the share of a beneficiary to trust income includes franking credits, upon application of those credits, entitle the beneficiary to an effective tax rate of less than 30%? One suspects the intention is that the refund cannot be claimed.

I also wonder whether part of the design, or an unintended consequence of this policy, is to discourage micro businesses. In other words, a business which has incorporated but only earns less than $90,000 a year will need to employ its principal in order for the principal to access tax-free thresholds. This is because the franking credits on dividends paid to the shareholder have no utility (or reduced utility) if the shareholder's marginal tax rate is less than the applicable company tax rate. It has long been a goal of the trade union movement to fight the practice of individual contractors incorporating in order to assist employers to avoid employment law obligations and incidental on-costs. This measure, together with the new framework for trusts, will also reduce the effectiveness of income splitting.

The mainstream media are already publishing tables of public companies that are said to have large amounts of franking credits and retained earnings with a view to shareholders imposing pressure upon them to implement capital management strategy before the election. It is likely that a number of tenders for selective buy-backs will be announced by public companies before the result of the election is known.

Negative gearing

If Labor win the election, then from a "date to be announced" investors will not be allowed to use net investment losses on existing properties to offset salary and wage income. This policy has been promoted to "help level the playing field for first home buyers competing with investors" and "help put the Australian dream of home ownership back within the reach of middle and working class families".

New real property investments will be expressly excluded from this policy.

While the headlines about the policy are expressly directed to the property market and in particular the residential property market, it is not immediately obvious from announcements to date that gearing losses will be quarantined to the actual investment acquired using proceeds of loans borrowed to make that acquisition (and generate those particular losses).

In other words, key unanswered questions include:

- Will the losses be quarantined from salary and wages income only?
- Will the losses be quarantined to the particular investment?
- Can a taxpayer offset a loss on a property investment against income from share investments?
- Can passive investment losses be offset against business or partnership profits?
- If new residential property is exempt, how will this be defined? Will the definition link to the GST definition?
- Will the policy still be implemented if the housing market continues to slump?

From a commercial perspective taxpayers will need to be mindful of the effect of their investment on the secondary market and this may adversely affect their ability to obtain finance in order to acquire real property investments.

The policies will not apply retrospectively. Presumably this means that refinancing a grandfathered asset will still permit a taxpayer to offset the loss against other income sources. On that basis, the rules should not apply to unit trusts which were fully capitalised before the transition date.

Capital gains tax

The ALP intends, from a date to be announced, to halve the capital gains tax discount for individuals. In other words, the discount presently for assets held for more 12 months is 50%. The discount will be reduced to 25% making an effective tax rate for someone on the maximum marginal rate of 37%.

Grandfathering will apply. The 50% discount continues for assets acquired before the critical date.

The publicity surrounding this proposal purports that small business assets will be exempt. In political speak what does this mean?

- Does it mean that active assets for the purposes of the small business CGT concessions can continue to access a 50% general discount?
- Does it mean that the general small business CGT discounts in Division 152 are not affected (and in particular the 50% reduction) but that the general discount of 25% will apply to small business assets?
- Will there be some other definition of small business asset?

Superannuation funds remain unaffected and will continue to receive a one-third CGT discount.

There has been no discussion as to whether the holding period to qualify for a CGT discount will change.

A new framework for taxation of trusts

Labor has eschewed entity taxation.

Instead, Labor will introduce a standard minimum 30% tax rate for discretionary trusts to distributions to beneficiaries over 18, anticipated to commence from 1 July 2019.

There will be some exemptions such as for people with disability "to ensure people suffering genuine hardship are not affected". The Commissioner will be given discretionary powers to manage this. Question whether there will be categories of beneficiaries to whom the 30% floor will not apply and the Commissioner's discretion is to add to those classes or if the Commissioner needs to apply that discretion before any person (including people with disability) may apply standard progressive income scale rates for trust distribution income.

Special disability trusts, deceased estates (presumably included testamentary trusts) and fixed trusts, "farm trusts" and charitable trusts will not be affected. Question what level of farming activity will need to be undertaken by a trust to qualify as a "farm trust". Will it be a similar test to the non-commercial losses (which seems unnecessary to the extent that a trust with losses will not have income to which these provisions will apply)? Will it simply be a dominant purpose test equivalent to land tax primary production exemptions.

How will this arrangement work with streaming?

Will the franking credits in relation to dividends paid on shares owned by a discretionary trust continue to flow through to beneficiaries which may mean that their effective tax rate is below 30%. Will they be denied a credit or refund, as applicable, if the rate is below 30%?

If for example franked distributions are paid where the franking rate is 27 cents, does it mean that a beneficiary will need to pay a top-up of 30 cents even if that beneficiary's rate would ordinarily be below 30 cents?

Also question whether as a matter of fairness the ALP will permit businesses operating through a discretionary trust to restructure without a tax penalty… or where passive investment assets are held through a discretionary trust where there might be a rollover opportunity. One suspects the answer is no.

Cap on deduction for tax affairs management at $3,000

According to Mr Shorten's 2017 budget reply speech a number of Australians earning more than $1 million paid no tax because they used "clever tax lawyers" and the deductions paid to their "accountants" averaged over $1 million. I do not have any information to doubt the veracity of the claims in that budget reply speech.

This policy is said to apply expressly to individuals, self-managed superannuation funds, trusts and partnerships. Question whether there will be an exception for small business.

In one respect tax has always been regarded as a private obligation and therefore arguably the costs of managing that private obligation should also be non-deductible. However, denying deductions for tax matters advice which can be complex may simply have the effect of discouraging the community from engaging with seeking advice about their proper tax position. It is clear that Labor are only concerned about a very, very small minority of taxpayers.

Australian investment guarantee

There will be a 20% instant asset write-off for capital expenditure not exceeding $20,000 subject to certain eligibility criteria. At present the only announced test is that the claimant must have a turnover of less than $10 million. The Coalition have recently proposed a $25,000 cap for a similar measure.

No more overseas holidays

Labor proposes to deny deductions for travel to known tax havens.

Presumably this rule will apply irrespective of whether the purpose of travel is for legitimate commercial reasons, such as negotiating the export of products.

They will also include mandatory shareholder reporting of tax haven exposure requiring companies to disclose to shareholders as a "material tax risk" if a company is doing business in a tax haven.

Will the law refer list to the OECD list of Unco-operative Tax Havens or will a separate list be published in the Act or from time to time by the Commissioner?

General Comments

There remain a number of unanswered questions. Hopefully the detail will be properly debated and subject to a more expansive consultation than seems to be the case to date.

In the long run it is good for the Australian community to have a fresh perspective and new initiatives that will hopefully lead to a vibrant healthy debate about our tax system. However, it will be counter-productive to antagonise and politicise tax professionals, the overwhelming majority of whom try to make the system work.