Potential impact of Federal and State stimulus packages on future tax policy in Australia

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Introduction

In this newsletter, we look at the financial impact of Federal and State Government stimulus measures that have been introduced as at 21 April 2020 and consider how the COVID-19 crisis is likely to influence Australia's tax policy over the coming years.

The 2020-21 Federal Budget has been delayed by the Government until October 6 which will allow sufficient time to consider the effectiveness of shutting down major parts of the economy and the financial impacts which will inevitably lead to a review of our tax policies over the medium term to allow us to eventually make inroads to paying off Government debt without stifling a recovery.

In the past two weeks, Prime Minister Scott Morrison, Treasurer Josh Frydenberg and Finance Minister Matthias Cormann have been grilled in the media about how COVID-19 will impact our economy and what that will mean for Australia's future tax system.

"All I know is that the hit the Australian economy is taking is the biggest we have seen since the Great Depression," Mr Morrison told Melbourne's 3AW radio. "The GFC was an entree compared to what this is, this is on a whole other level. On the economy we have some really bad news coming our way ... this thing is going to hit like a truck."

The Reserve Bank of Australia and Treasury have warned the government's current economic policy framework was inadequate for the task ahead, with Mr Morrison last week leaving open the option of breaking election promises if need be.

Our clients will be interested to know how any potential changes to tax policy could affect them.

Below, we have set out our thoughts on some of the potential tax changes that the Government could consider to support the economy and guide us towards a period of economic recovery and what such potential changes to tax policy could mean for our clients. In particular, whether such changes may necessitate different thinking around tax planning.

1. Financial impact of Government stimulus measures

Since the COVID-19 pandemic, our State and Federal Governments have been decisive in implementing the largest economic stimulus packages that Australia has ever seen.

Westpac's chief economist Bill Evans has reported "Prospects are now for a deep recession in 2020, with output to contract in the March quarter, –0.7 per cent, June, –8.5 per cent, and September quarter, –0.6 per cent."

The International Monetary Fund forecasts the local economy to shrink 6.7 per cent this year, the biggest contraction since the Great Depression in 1931. It also forecasts the global economy to shrink by 3 per cent in 2020.

Leading independent economist Saul Eslake has said the Federal Government had so far committed more than $200 billion in stimulus packages, the State Governments have coughed up close to $50 billion, and all have missed out on at least $100 billion in taxes because of the crippling disruption to business and trade. Mr Eslake also states that given almost all of the relief measures have a shelf life of six months, extending the support beyond two quarters would cost federal and state governments at least $500 billion.

With the RBA and Treasury warning the Government that its current economic policy framework was inadequate for the task ahead and Mr Morrison hinting at breaking election promises "if need be", we are clearly going to see a number of significant changes to government policy around its source and composition of revenue.

Treasurer Josh Frydenberg reiterated last week that the Liberal Party are the party of "lower taxes". In recent media statements, the Prime Minister has flagged possible tax breaks for big business, deregulation and wide-scale industrial relations reform as part of the government's attempts to lift the nation out of the economic black hole caused by the global coronavirus pandemic.

It is important to note that the Government wants to allow the economy to stabilise and recover before implementing any policy changes that could hamper any positive gains.

2. The use of Modern Monetary Theory ("MMT") to buy us time

How does the Government fund "lower taxes" at a time when its debt is skyrocketing? The answer in the short term may lie in the use of Modern Monetary Theory ("MMT").

MMT has already been initiated by the Reserve Bank of Australia (RBA) which has resulted in it buying Government Bonds in a low interest rate environment. By buying government bonds from banks and pension funds the RBA is increasing that supply of money — effectively pumping cash into the economy. When banks have more money, they can lend more readily to businesses and consumers, which in turn leads to greater spending, and ultimately more economic activity.

For example, in March, the Government took out a 12-year loan at an interest rate of 0.8185%, denominated in Australian dollars. If inflation exceeds the rate of interest on the Government bonds over the longer term, the Government will effectively be paying less than it originally borrowed to pay off the debt (in real dollar terms). This is an example of how the Government could substantially increase its issuance of Government bonds at an interest rate below the long term average rate of inflation to fund its commitments. However, it should be noted that the RBA printing money and buying Government bonds can have an adverse effect on our exchange rate as a result of flooding the market with new cash. It also has the potential to be problematic where a significant flow of these funds goes to imported goods, resulting in a net outflow of funds from Australia.

During the Global Financial Crisis, the US Federal Reserve used MMT (also referred to as quantitative easing) to capitalise companies like Fannie Mae and Freddie Mac, its largest and most vulnerable mortgage lenders to help the US out of the credit crunch. If the Australian Government uses its funds from the sale of bonds on infrastructure spending, or to capitalise our banks for example, it could ensure that the funds are directed predominantly towards domestic use. In the case of bank capitalisation, it could even generate a return on its investment in excess of its cost of funds.

At some point, the borrowings will need to be repaid and this will undoubtedly lead to an overhaul of our tax system. However, the use of MMT could buy the Government time to assess the economic impacts of COVID-19 and allow it to ponder which changes could be implemented to the tax system over the medium and longer term to ensure that business and economic growth continue to prosper, which will lead to higher tax revenue.

3. The Hot Topics

Hot Topic No 1 - Will the Government introduce a COVID-19 levy?

How has the Government previously handled significant costs from major economic events?

We have seen the introduction of "temporary levies" in the past to pay for economic disasters such as:

- A Temporary Flood and Cyclone Reconstruction Levy ("flood levy") was Introduced from 1 July 2011 to assist affected communities recover from natural disasters. The levy applied for one year and applied to income earners in excess of $50,000, with the highest levies being $250 + 1% on all income over $100,000.

- A Temporary Budget Repair Levy was introduced in the 2014-15 Federal Budget and imposed an additional 2% tax on taxable income in excess of $180,000. It applied to

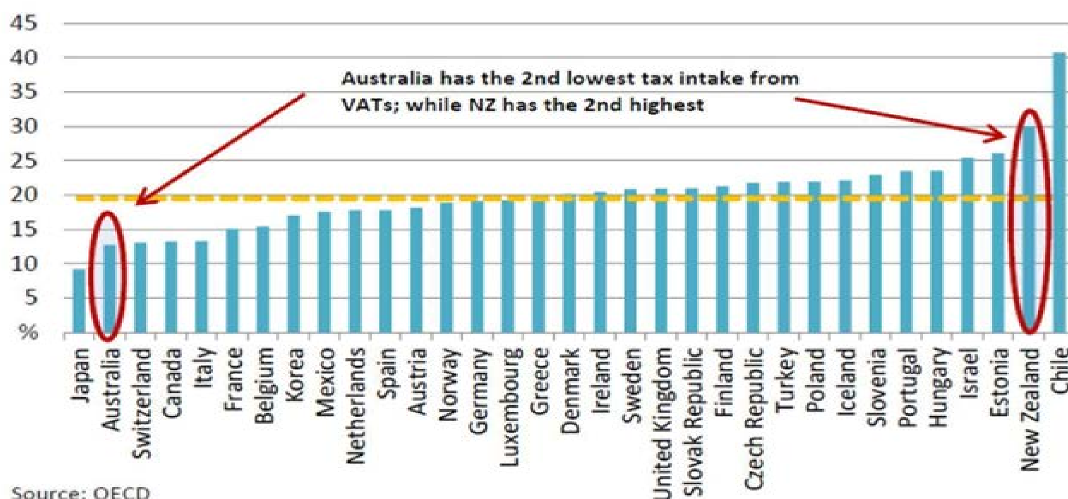
both resident and non-resident individuals from 1 July 2014 and applied to the 30 June 2015, 2016 and 2017 income years. In his 2014 Federal Budget speech, then Treasurer Joe Hockey commented: "Tonight we are asking higher income earners to help repair the Budget. From 1 July this year and for just three years, we are asking higher income earners to pay a Temporary Budget Repair Levy."

While previous Governments have implemented temporary levies to generate additional revenue from previous economic disasters, the Prime Minister last week ruled out the introduction of a COVID levy. As a result, this appears to be off the table in the short term.

It should be noted however, that the Labor party proposed a top marginal rate of 49% for all income earners over $180,000 in its 2019 Federal election campaign, so a 2% levy would likely be pushed by them in its budget reply speech later this year which would be consistent with its approach to taxing the "top end of town".

Hot Topic No 2 - GST in review … How do we compare to other countries in the OECD?

One possible mechanism to replace the lost revenue to the states over the longer term could be in the form of an increase to the rate of GST or a broadening of the base upon which it is levied. On a global scale, a 10% consumption tax is very low as a percentage of total tax revenue when compared to other advanced economies, as indicated below.



When questioned about the possibility of raising the rate of GST, Mr Frydenberg has stated that he had "no plans to increase the GST" to help pay for the massive cost of the COVID-19 crisis. However, there was no mention of whether the base upon which it is levied could be broadened.

Prior to stepping down as Chairman of NAB, Ken Henry urged political and business leaders to revisit the "politically difficult" issue of raising and broadening the GST to remedy Australia's "too low" tax take, while decrying governments' reluctance to act on challenging issues because they were seen as "too hard". He warned that without tax reform Australia risked losing the capacity to fund its infrastructure and health, education and welfare systems - saying that "if you lose the capacity to finance government on a sustainable basis then government fails".

A recent parliamentary review identified that GST comprises approximately 16% of the total revenue collected by the Australian Government and is only levied on 47% of Australian goods and services. Not only is the GST rate low on an international comparison, the base upon which it is levied is also narrow.

There would need to be significant cooperation between the major political parties, Independent MPs and senators and also negotiation with State Governments, for any significant changes to the GST to pass. There would also need to be generous compensation to the most vulnerable groups, such as age pensioners and low income earners to ensure that they did not become worse off as a result of any changes. This could be achieved in the form of income tax relief for low income earners and an uplift in the age pension for example.

Blaze Acumen comment regarding possible changes to GST

While Australia's rate of GST is low compared to its OECD counterparts, we have one of the highest rates of personal and property taxation in the world. If there was to be a broadening of the base upon which GST is levied or an increase to the headline rate of 10%, any additional revenue could be directed to support our economic recovery in the short term rather than the repayment of debt. We would encourage the Government to put potential changes to the GST back on the table and have a public debate about it at the appropriate time.

In addition, in our view, there needs to be significant focus on removing taxes that are an impediment to economic growth. A prime example of this is payroll tax.

In responding to the COVID-19 pandemic, the State Governments made immediate moves to support small business in the form of payroll tax relief as outlined in our Client Alert No 61. See: https://blazeacumen.com.au/no-61-covid-19-update-response-from-the-state-governments/

While the level of relief differed from state to state, the common theme was to support employers by reducing or eliminating a tax imposed on businesses as a result of employing staff.

Treasurer Josh Frydenberg has openly stated that payroll tax "is a disincentive to employ people". Now may finally be the time for businesses to be offered significant payroll tax relief as an ongoing measure to support the employment of staff to allow our economy to thrive once again.

Payroll tax forms a low revenue base in a period of high unemployment and an ageing population. However, GST provides a more generous revenue base to the states to continue supporting businesses.

Hot Topic No 3 - Are we in for a major overhaul to state taxes?

The recent collaboration between Federal and State leaders through national cabinet meetings to tackle COVID-19 could be the opportunity to finally break through reluctance to reform the revenue imbalance between the states and the Commonwealth.

Late last week, Victorian Treasurer Tim Pallas called out state financing as a key part of broader economic reforms that will be necessary to resuscitate the economy. Mr Pallas stated: "We will be reforming the way the economy operates, make no mistake about that. We have to do it, the future demands it. The way the states derive income needs to be reformed."

The NSW Government is also looking to reform stamp duty as part of a major federal financial review commissioned last year by NSW Treasurer Dominic Perrottet. "Reform will be a key

pillar of the NSW Government's economic recovery strategy, which is already being developed by NSW Treasury," Mr Perrottet said.

NSW has estimated the gap between revenue and expenditure will grow to 3.4 per cent of gross state product by 2056, equivalent to $20.6 billion or a fifth of revenues.

A 2017 NSW Treasury report estimated stamp duty abolition would lead to a 25 per cent increase in property transfers creating the equivalent of an extra 70,000 homes. Stamp duty is about a quarter of both states' revenues.

While details have not publicly emerged yet regarding the other states, if the national cabinet can take a collegiate approach towards revenue distribution and harmonisation of taxes, this may open an opportunity to substantially reduce or eliminate payroll tax to small businesses as well as significantly reforming stamp duty and land tax.

Hot Topic No 4 – Broken election promises … where will the focus likely be?

We need only consider the debate between Labor and the Coalition in the lead up to the 2019 Federal Election regarding Australia's tax system for a list of changes that could resurface, including:

- **Refundable franking credits.** Labor was strongly opposed to the ongoing refund of franking credits to Australian shareholders. In his media release in November 2018, shadow treasurer Chris Bowen said "Australia is the only country in the world which provides a refund for corporate tax paid to shareholders if they don't pay income tax. It's a $5 billion a year anomaly that must be fixed in the interest of budget responsibility." The Labor Party later softened its approach by exempting certain groups such as pension recipients, charities and low income earners after significant backlash regarding its initial policy;

- **A 30% minimum tax rate on discretionary trust distributions to adult beneficiaries.** Changes to the taxation of income distributions from trusts was strongly advocated by the Labor Party in its 2019 election campaign. As tax advisors, we have seen a very aggressive approach by the ATO regarding the use of trusts by the high net wealth sector. Unfortunately, trusts are often seen by the ATO as a mechanism to minimise or avoid paying tax rather than a genuine vehicle for asset protection and to protect and manage investments for current and future generations. It would not be surprising to see the debate about the use of trusts re-emerge by the shadow treasurer in a budget reply speech later this year;

- **A reduction in the Capital Gains Tax discount from 50% to 25%** on assets held for at least 12 months? While this was Labor's policy going into the 2019 Federal election, the current climate could see the 50% CGT discount being phased out altogether. The Government could even introduce a "use it or lose it" measure to tempt taxpayers to reset their CGT cost base to market value by electing for there to be a deemed disposal if the 50% discount is to be removed. A decision to pay less tax sooner rather than more tax later could generate significant tax revenue for the Government, particularly from the high net wealth sector. Prior to the introduction of the 50% CGT discount in 1999, Australia used an indexed based system to tax capital gains.

- **A Restriction on lowering company tax rates for large companies and multinationals.** Just before Malcolm Turnbull was dumped as Prime Minister, the Coalition, facing a hostile Senate, abandoned its plan to cut the corporate tax rate to 25 per cent for all companies by 2026-27. Instead, it secured a lower rate for businesses with turnovers capped at $50 million a year. The drop in the tax rate to 25

per cent was then fast tracked to occur in 2021-22. It is now unlikely that a corporate tax cut to large companies and multinationals will be revisited in the 2020-21 Federal Budget.

The timeline for reduction in company tax rates is as follows:

Income year	Aggregated turnover threshold	Tax rate for base rate entities under the threshold	Tax rate for all other companies
2017–18	$25m	27.5%	30.0%
2018–19 to 2019–20	$50m	27.5%	30.0%
2020–21	$50m	26.0%	30.0%
2021–22	$50m	25.0%	30.0%

Hot Topic No 5 – The Henry Tax Review and possible topics for reconsideration

The Australia's Future Tax System Review, informally known as the Henry Tax Review was intended to guide tax system reforms over the next 10 to 20 years. The Henry Tax Review which was commissioned by the Rudd Government in 2008 and published in 2010 identified 125 taxes in Australia, of which 90% of the country's revenue was generated from 10 of them.

While only a handful of the 138 recommendations were adopted by the Rudd / Gillard / Rudd Government, a number of the recommendations could resurface in a period of post economic recovery.

Whilst many of the recommendations from the Henry Tax Review would be unpopular with voters, the present economic environment could necessitate revisiting some of them which included:

- Imposing land tax on the family home;
- Reducing CGT discount;
- Applying a discount to negative gearing deductions;
- Removing benefits of dividend imputation (as mentioned above);
- Introducing a bequests tax; and
- Abolishing luxury car tax (we no longer have a car manufacturing industry).

If we see a focus on land tax by State Governments to fund a reduction or removal of payroll tax and / or major reform regarding stamp duty, then land tax on the family home could be a major change to the source of revenue for them.

We expect that changes to the CGT discount concession will again resurface, notwithstanding that Mr Morrison would be breaking an election promise if changes were made to this concession. However, the COVID-19 crisis has brought about conditions seen once in a hundred years and one would think that promises made pre election have little standing in the current environment, particularly if conditions worsen.

If changes are made to the base upon which state and federal taxes are levied, this would also be an opportune time to revisit many of the 125 taxes identified in the Henry Tax Review that are a drag on economic recovery. We have too many layers of tax causing a burden on businesses to comply with a complex framework instead of getting on with business.

Blaze Acumen comment

We expect the Government to pause on any increase to taxation to ensure that the economy is given the right opportunity to first recover, and then return to growth. The use of modern monetary theory while interest rates are incredibly low will support this approach.

The Treasurer has stated that an increase to the rate of GST was not on the table and the Prime Minister has all but ruled out the imposition of a COVID-19 levy. However, the RBA and Treasury have both warned the Government that its current economic policy framework was inadequate for the task ahead. As a result, we expect to see major reform to State and Federal taxes, along with a host of broken election promises. This could include increases to the GST rate or a levy, particularly if current assumptions are not met and even more drastic measures are called for.

The Government will likely implement recommendations made by the Board of Taxation and Treasury regarding changes to Division 7A integrity Measures. Changes to the integrity measures would likely include "pre 16 December 2009" unpaid beneficiary entitlements being required to be put on a commercial footing with minimum annual repayments being required to be made. In addition, the maximum period for a complying loan may be reduced from 25 years (for a secured loan) to 10 years, forcing loans to be repaid sooner either by physical repayment or by declaration of dividends.

Any changes to dividend imputation should protect our most vulnerable groups such as low income earners and pensioners by carving out specific groups. It should also be noted that a reduction in company tax rates does not necessarily mean lower taxes for all Australians. For many of our clients, the use of corporate beneficiaries to manage annual tax obligations has resulted in deferring tax that may otherwise have been payable sooner. However, lower company taxes can mean higher taxes to shareholders as a result of changes to imputation credits attached to dividends, also known as "franking". Consider the following example using franking rates of 30%, 27.5% and 25%:

	30% franking credits	27.5% franking credits	25% franking credits
Dividend received (Cash)	$70,000	$70,000	$70,000
Imputation Credit	$30,000	$26,552	$23,333
Gross taxable income to shareholder	$100,000	$96,552	$93,333
Tax at 47% (assume maximum rate)	$47,000	$45,379	$43,866
Less imputation Credit	-$30,000	-$26,552	-$23,333
Balance of tax payable	$17,000	$18,827	$20,533

As indicated in the above example, as the rate of company tax decreases, so does the rate of franking credits attached to dividends, resulting in higher tax payable by shareholders. The additional tax payable by a shareholder with a 25% franking credit is in fact 20.8% higher than a shareholder with a 30% franking credit attached to their dividend.

Higher top up tax in the future may mean that taxpayers that have companies with significant historical retained earnings may need to make some difficult decisions in regard to repaying company loans and beneficiary entitlements sooner than intended. If repayments are not able to be made in cash, they may want to lock in lower overall taxes by bringing forward dividend declarations that were otherwise intended to be deferred for many years.

In our opinion, superannuation has been tinkered with enough and should be left alone. Significant changes were made in 2017 which reduced the tax benefits enjoyed by high net wealth clients. However, the threshold at which Division 293 tax arises (an additional 15% on concessional superannuation contributions) could be lowered from $250,000 to $200,000 as was Labor's proposal in the lead up to the 2019 Federal Election.

The comments expressed in this opinion piece represent the consensus view of the Partners at Blaze Acumen and incorporate public statements made to date in regard to tax policy by both sides of politics at state and federal level, along with public statements issued by the Reserve Bank and Treasury. The views and comments do not lend support to any particular political view or preference and are intended to focus on the most relevant issues affecting our clients. They are in no way intended to be inclusive of all industries and sectors.

Your Blaze Acumen advisor would welcome the opportunity to engage with you regarding how any of the measures raised in this article may impact you, your business and your family group.