The Senate

Economics Legislation Committee

Provisions of the Tax Laws Amendment (2004 Measures No. 7) Bill 2004

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CHAPTER 1

PROVISIONS OF THE TAX LAWS AMENDMENT (2004 MEASURES NO. 7) BILL 2004

Background

1.1 The Tax Laws Amendment (2004 Measures No. 7) Bill 2004 was introduced into the House of Representatives on 8 December 2004.[1] The House passed the bill on 10 February 2005.[2]

1.2 On 9 February 2005, on the recommendation of the Senate Standing Committee for the Selection of Bills (Selection of Bills Committee), the Senate referred the provisions of the bill to the Economics Legislation Committee for inquiry and report by 7 March 2005.[3]

The bill's provisions

1.3 The bill contains 11 schedules which deal with a range of matters.

1.4 The hearing of the Economics Legislation Committee focussed on the bill's provisions in Schedules 1 and 5 which the Selection of Bills Committee cited as warranting further investigation,[4] and were the only Schedules on which the Committee received submissions.[5]

1.5 Schedule 1 of the bill provides for an entrepreneurs' tax offset of up to 25 per cent on income tax liabilities attributable to business income where the business has an annual turnover between $50 000 and $75 000. The proposed offset is intended to assist very small businesses in the simplified taxation system. Issues raised in the supporting documents attached to the Selection of Bills Committee's report were:

(a) whether Schedule 1 measures pose a threat to the tax base by opening significant tax avoidance opportunities;

(b) whether Schedule 1 measures create an incentive for a taxpayer to split income between different taxation entities (e.g. a company or partnership);

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1 The Hon. Mal Brough MP, *House Hansard*, 8 December 2004, p. 3.

2 The Hon. Mal Brough MP, *House Hansard*, 10 February 2005, p. 40.

3 Senator Julian McGauran, *Senate Hansard*, 9 February 2005, p. 62.

4 Selection of Bills Committee, *Report No. 1 of 2005*, 9 February 2005, p. 62.

5 With the exception of *Submission* 1 (William Buck (SA) Pty Ltd) which queried the commencement date for Schedule 7.

(c) whether the grouping rules for the simplified tax system are sufficient to prevent tax avoidance given that they are designed to operate from a much higher threshold; and

(d) whether the measures in Schedule 1 are appropriately targeted to entrepreneurial activity.

1.6 Schedule 5 of the bill provides for a tax incentive for petroleum exploration in 'designated frontier areas'. Exploration expenditure, within certain limitations, will be uplifted to 150 per cent, with this amount being deductible for the purposes of petroleum resource rent tax. One issue identified by the Selection of Bills Committee was the cost and effectiveness of the proposed tax concessions in encouraging petroleum exploration in remote offshore areas.

Conduct of the inquiry

1.7 The Committee advertised the inquiry nationally on 16 February 2005 and invited the Department of the Treasury, the Department of Industry, Tourism & Resources and several private organisations identified as having an interest in the matters raised by the bill to make submissions to the inquiry.

1.8 The Committee received four submissions. These are listed in Appendix 1.

1.9 The Committee held a public hearing at Parliament House in Adelaide on Tuesday, 1 March 2005. Witnesses who presented evidence at this hearing are listed in Appendix 2.

1.10 The Hansard of the Committee's hearing, copies of all submissions and information provided on request to the Committee are tabled with this report. These documents, plus the Committee's report, are also available on the Committee's web site at http://www.aph.gov.au/senate/committee/economics_ctte/tlab_7/index.htm.

1.11 The Committee thanks those who participated in this inquiry.

CHAPTER 2

SCHEDULE 1—ENTREPRENEURS' TAX OFFSET

Introduction

2.1 In his 2004 election policy statement, *Promoting an Enterprise Culture*, the Prime Minister announced that a re-elected Coalition Government would introduce tax incentives to encourage the development of an 'entrepreneurial spirit' within the small business sector—particularly among those businesses operating from home.[1]

2.2 Schedule 1 of the bill is intended to deliver on this election promise by allowing a maximum 25 per cent "entrepreneurs' tax offset" (ETO) on the income tax liability of small businesses in certain circumstances.

2.3 The first threshold for eligibility is that the small business qualifies for, and has elected to be in, the simplified tax system (STS).[2]

2.4 Where a small business in the STS has an annual turnover of $50 000 or less, the full 25 per cent ETO will apply. Where annual turnover exceeds $50 000 but is less than $75 000, the ETO will phase out for every $1 over $50 000.

2.5 To encourage more businesses to opt into the STS, Schedule 2 of the bill introduces changes that will allow STS taxpayers to calculate their taxable income by either the cash basis method or accruals system—whichever is more appropriate for their circumstances. At present, the cash basis method is mandatory for STS taxpayers.

2.6 The new measures in Schedules 1 and 2 will apply to assessments for the first income year starting on 1 July 2005 and subsequent income years.

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1 *Promoting an Enterprise Culture*, p. 4.

2 The STS was introduced by the *The New Business Tax System (Simplified Tax System) Act 2001* to apply to income years commencing after 30 June 2001. Its purpose was to reduce compliance costs of eligible small business taxpayers. The STS allows for the application of a simplified depreciation system and simplified treatment of trading stock. The ATO advises in its publication, '*Simplified tax system—overview*', that the practical effect of these features is that eligible businesses do not have to account for trading stock each year or maintain separate depreciation schedules for each asset. STS taxpayers must use a cash-based accounting system (although Schedule 2 of the bill proposes to allow for cash or accruals accounting systems.) See http://www.ato.gov.au/print.asp?doc=/content/19925.htm for ATO publication.

Schedule 1 in more detail

Who qualifies for the ETO?

2.7 As indicated above, a taxpayer must first be an STS taxpayer for the year in question before eligibility for the ETO can be considered. Reduced to its simplest terms, Schedule 1 of the bill provides that the ETO is available to an STS taxpayer that is:

(a) an individual or a company;

(b) a partner of a partnership; or

(c) a trustee or beneficiary of a trust (depending on who is liable for tax on the trust income).

2.8 An STS taxpayer for the year who fulfils the criteria in paragraph 2.7 above must also:

(a) have an 'STS group turnover' for the year of less than $75 000; and

(b) have a 'net STS income' for the year.

2.9 For a partner in a partnership, the partner's assessable income for the year must include a share of the partnership's net STS income.[3] For a beneficiary of a trust, the assessable income for the year must include a share of the trust's net STS income.[4] In the case of trustees, they must be liable to be assessed under sections 98, 99 or 99A of the *Income Tax Assessment Act 1936* on a share of the trust's net STS income.[5]

2.10 Before looking at the formulae for the ETO, the Committee will examine in more detail the following terms which set the basic criteria for eligibility:

(a) STS taxpayer;

(b) STS group turnover; and

(c) net STS income.

What is an 'STS taxpayer'?

2.11 Section 328-365 of the *Income Tax Assessment Act 1997* (ITAA 1997) provides that an entity is eligible to be an STS taxpayer for an income year if:

(a) it carries on a business during the year;

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3 Proposed paragraph 61-510(1)(e).

4 Proposed paragraph 61-520(1)(e).

5 Proposed paragraph 61-515(1)(e).

(b) the 'STS average turnover'[6] of the business and related businesses for the year is less than $1 million net of GST credits; and

(c) the business and related businesses have depreciable assets with values totalling less than $3 million at the end of the year.

2.12 Under the ITAA 1997, an entity may calculate its 'STS average turnover' by averaging its STS group turnovers for any three of the preceding four years, disregarding a year when group turnover was unusually high. Should the STS average turnover exceed allowable limits using the retrospective test, the entity may take into account the actual turnover for the current year plus a reasonable estimate of turnover for the next two years. If the entity has only carried on a business for part of the current year, again, a reasonable estimate of STS group turnover may be used.

'STS group turnover'

2.13 Calculations of 'STS average turnover' must take into account 'STS group turnover' which is defined in the ITAA 1997 as the total value of the business supplies made during the year by the entity and by the entities it is grouped with. The definition does not include the value of business supplies made between the entity and the grouped entities or among the grouped entities themselves.[7]

2.14 Section 328-380 provides that an entity should be grouped with another where:

(a) either entity controls the other;[8]

(b) both entities are controlled by the same third entity; or

(c) the entities are STS affiliates[9] of the other.

2.15 The inclusion of grouped entities in the calculation is an anti-avoidance measure intended to prevent a taxpayer from structuring one business as several

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6 Section 328-370. See also TR 2002/11, *Income tax: Simplified Tax System eligibility—STS average turnover*, 26 June 2002.

7 The value of business supplies is defined in section 960-345 of the ITAA 1997 as being the values of all taxable supplies (excluding GST and receipts from asset sales, interest, dividends and rental not in the ordinary course of carrying on the business).

8 Section 328-380 ITAA 1997 defines 'control' in the context of the STS grouping rules. In an overview of the STS, the ATO says that "In broad terms, you control another taxpayer in an income year if you and/or your STS affiliates: are entitled to at least 40% of any income or capital of the other taxpayer in that year; or if the other taxpayer is a company, have the right to exercise at least 40% of the voting power in the company. See TR 2002/6, *Income tax: Simplified Tax System eligibility—grouping rules (STS affiliate, control of non-fixed trusts)*, 13 March 2002. This ruling provides guidance on the application of the non-fixed trust control rule and the definition of 'STS affiliate'."

9 Under section 328-365 ITAA 1997, an 'STS affiliate' is an entity that could reasonably be expected to act in accordance with the taxpayer's wishes or in concert with the taxpayer in relation to the taxpayer's business. See also TR 2002/6.

smaller units so as to qualify for STS benefits. Nonetheless, a taxpayer may be eligible for more than one ETO where the businesses involved are not grouped entities, as the following excerpt from the Explanatory Memorandum makes clear:

> A taxpayer may be eligible for more than one tax offset. For example, if a taxpayer is a sole trader who has elected into the STS and that taxpayer is also a partner in a partnership that has also elected into the STS, the taxpayer may be entitled to a tax offset in respect of their income as a sole trader and also in respect of their share of the STS income from the partnership…However, if the sole trader and the partnership are grouped entities, the amount of STS group turnover is relevant to determining eligibility for an offset.[10]

'Net STS income'[11]

2.16 The 'net STS income' is the 'STS annual turnover' less deductions attributable to the turnover. The 'STS annual turnover' is the value of the business supplies made by the entity less 'supplies that constitute an insurance recovery or the principal component of a loan'.[12]

2.17 The Explanatory Memorandum further comments on the meaning of STS annual turnover that:

> The turnover of a business reflects the ordinary activities of carrying on that business, such as the sale of goods and the provision of services, and also includes interest received on amounts deposited in business banking accounts. The turnover does not include items such as dividends, rental income where the rental activities do not form an ordinary part of the business or amounts resulting from realisation of an investment.[13]

Calculation of the ETO

2.18 Having discussed the eligibility criteria for the ETO, namely, that the taxpayer must be an STS taxpayer for the year with an STS group turnover of less than $75 000 and a net STS income, it is proposed to look at the formulae for calculating the ETO.

2.19 Proposed sections 61-505 to 61-520 set out the ETO formulae. The sections provide working examples of ETO calculations for an individual or company; partner in a partnership; trustee of a trust and beneficiary of a trust.

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10 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, pp. 15-16, para. 1.12.

11 Proposed section 61-525.

12 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, p. 17, para. 1.16.

13 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, p. 17, para. 1.19.

2.20 There are two basic formulae—one for the ETO where STS group turnover is $50 000 or less for the year, and the other where it exceeds $50 000 but is less than $75 000.

ETO—STS group turnover of $50 000 or less

2.21 To calculate the ETO where the STS group turnover is $50 000 or less:

- multiply 25 per cent of the income tax liability for the year (excluding any tax offsets) by the 'STS percentage' which is calculated by dividing the net STS income by the taxable income and multiplying it by 100.

ETO—STS group turnover of less than $75 000 but over $50 000

2.22 To arrive at the ETO for group turnover exceeding $50 000 but less than $75 000, start with the basic formula above and multiply it by the 'STS phase-out fraction'.

2.23 The STS phase-out fraction is calculated by dividing by $25 000, the difference between $75 000 and the taxpayer's STS group turnover for the year.[14]

Matters of interest—overview

2.24 As indicated in chapter 1 of this report, supporting documents attached to the Selection of Bills Committee's report raised the following matters in relation to Schedule 1:

(a) whether Schedule 1 measures pose a threat to the tax base by opening significant tax avoidance opportunities;

(b) whether Schedule 1 measures create an incentive for a taxpayer to split income between different taxation entities (e.g. a company or partnership);

(c) whether the grouping rules for the simplified tax system are sufficient to prevent tax avoidance given that they are designed to operate from a much higher threshold; and

(d) whether the measures in Schedule 1 are appropriately targeted to entrepreneurial activity.

2.25 In the course of its hearing on 1 March 2005, the Committee heard evidence from the Department of the Treasury (Treasury) and Australian Tax Office (ATO) about these and related matters.

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14 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, pp. 20-21, para. 1.25.

Grouping rules and tax avoidance

2.26 The Committee questioned officers from Treasury and the ATO about the effectiveness of the STS grouping provisions as an anti-avoidance measure.

2.27 Both Treasury and the ATO expressed confidence in the grouping provisions and added that business splitting as a tax-avoidance measure was not without its drawbacks. On these points, Mr Mark O'Connor, Treasury, told the Committee that:

> The grouping rules attached to the simplified tax system are very robust; they have been working for the simplified tax system since 2001. To our knowledge—and, I understand, the knowledge of the ATO—there have been no concerns with them. There is a very strong and robust link there to what is referred to as an STS affiliate, which is that basically anyone who is related to you could act under your direction or control and also be held to be acting in concert with you. It is a very wide application of a grouping provision. We do not anticipate this measure giving rise to people seeking to split businesses—and I think that was also referred to in the explanatory memoranda. We do not see that, by splitting their businesses, they would be able to overcome the grouping provisions. There are other circumstances that would give rise to people not wishing to split businesses, such as the cost. In the *Hansard* of the debate in the House of Representatives, I noticed there was concern about the cost of getting accounting advice. The cost of restructuring a business from, say, a sole trader to a corporate or a trust is fairly significant, seeking legal and accountancy fees.
>
> We also see other blockers to restructuring a business, such as the incurrence of potential stamp duty on transfer of assets and potential triggering of capital gains tax provisions when assets are moved from one entity to another. Given that (1) you have the integrity of the grouping measures and (2) there are outside forces and market forces, such as the cost of setting up a company or a trust and the ongoing compliance costs associated with that, we did not think there was a large compliance risk in this measure…[15]

2.28 As far as enforcing compliance with the grouping rules was concerned, Mr Mark Konza of the ATO said that the department had not rated the avoidance risk as 'significantly high' but was looking at a range of computerised tests to identify possible instances of non-compliance. He added that with first returns for ETO taxpayers not due until the 2006 financial year, this allowed the ATO 'some little time' to design a compliance program.[16]

Conclusions and recommendations—grouping rules

2.29 The Committee is reassured by evidence from Treasury and the ATO that the grouping rules are an effective anti-avoidance measure. Given the time available to

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15 *Proof Committee Hansard*, 1 March 2005, pp. E2-3.

16 *Proof Committee Hansard*, 1 March 2005, p. E3.

the ATO to design a compliance program, the Committee accepts that enforcement should not be a problem.

2.30 The Committee also appreciates that incentives to qualify for STS benefits and ultimately, the ETO, through business splitting may be dampened by the costs entailed.

2.31 For these reasons, the Committee does not consider that the measures to be introduced by Schedule 1 will provide new opportunities for tax avoidance.

The rationale for the ETO

2.32 As mentioned earlier, the ETO is intended to deliver on the government's 2004 election promise to foster an 'entrepreneurial spirit' in the small business sector.

2.33 Certainly, the Coalition's proposed package of reforms for small businesses[17] was well received by the Council of Small Business Organisations of Australia Ltd (COSBOA) which saw it as 'a significant step in the right direction for start-up small businesses'.[18]

2.34 In his second reading speech for the bill, the Minister for Revenue and Assistant Treasurer, the Hon. Mal Brough MP, said of Schedule 1 that it 'provides an incentive for the growth of very small, micro and home-based businesses' and, later, that 'allowing these small businesses in their micro phases to be able to hang on to more of their income gives them capital and greater incentive to be innovative and, therefore, to be able to grow and to build their businesses'.[19]

The ETO—costs and benefits

2.35 The Regulation Impact Statement (RIS) included with the Explanatory Memorandum for the ETO estimates that 'more than 300 000 small and home-based businesses will be able to benefit from the 25 per cent tax offset'.[20]

2.36 While the ATO's estimated total administrative costs of $7.3 million for Schedule 1 from 2004-05 to 2007-08 are relatively small, the estimated cost to the revenue for this period is $790 million.[21]

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17 *Promoting an Enterprise Culture*, The Howard Government Election 2004 Policy Statement. The package of reforms for small business included proposals for the ETO; introduction of optional cash or accrual accounting methods for STS taxpayers; a reduction in the tax adjustment period from four to two years for STS businesses and the establishment of a Regulation Reduction Incentive Fund.

18 Council of Small Business Organisations of Australia Ltd, Media Release, *Big benefits for Micro Business!*, 26 September 2004.

19 *House Hansard*, 10 February 2005, p. 37.

20 RIS, Explanatory Memorandum, p. 32, para. 1.50.

21 RIS, Explanatory Memorandum, p. 34, paras. 1.60-1.61, p. 34.

2.37 In this context, the Committee sought additional information about the proposed beneficiaries of the ETO; whether the scheme was appropriately targeted and whether on a costs/benefit analysis, it should proceed.

Entrepreneurial activity and the ETO target group

2.38 The RIS states the policy objective for the ETO thus:

> The objectives of this measure are to provide encouragement for enterprising Australians in the early days of a small business, in particular to provide a greater benefit to businesses with greater productivity, and to provide incentive for the growth of small business especially the very small, micro and home-based businesses which are in the STS.[22]

2.39 While the RIS estimated that more than 300 000 small businesses could benefit from the ETO, the Committee was unable to find data to support this estimate. Mr Mark O'Connor, Treasury, indicated at the start of the Committee's hearing that Treasury and the ATO were presently compiling figures on 'STS take-up and those sorts of things'.[23] This information was supplied in a letter to the Committee dated 4 March 2005, in which Schedule 1 is estimated to attract 440 000 taxpayers into the STS and provide benefits to 540 000 small businesses.[24]

2.40 Another matter of interest to the Committee was whether the ETO was appropriately targeted. While Treasury and ATO officers confirmed that businesses offering, for example, cleaning or grass cutting services might qualify for the ETO, they could not provide evidence of a need to stimulate growth in this area in response to a shortage of supply.[25]

2.41 The Committee canvassed the idea that where there was a shortage of businesses offering certain goods or services, these might be a more appropriate target for tax incentives. On this point, the Committee asked the ATO for an estimate of the number of businesses offering services in a trade such as plumbing or bricklaying, for example, which would fall within the qualifying annual turnover threshold for the ETO.

2.42 This information is in Appendix 4 and indicates that for bricklayers and carpenters, just under one-third of sole traders have a turnover of $50 000 or less. With plumbers, the figure for sole traders is roughly one-quarter.

2.43 Another matter of interest when looking at the ETO's targeted beneficiaries is the method of calculating the ETO. It appears to the Committee that basing the ETO

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22 RIS, Explanatory Memorandum, p. 30, para. 1.41.

23 *Proof Committee Hansard*, 1 March 2005, p. E1.

24 A copy of this letter is in Appendix 3.

25 *Proof Committee Hansard*, 1 March 2005, p. E7.

on a taxpayer's net income has the effect that a business with high operating expenses will qualify for a lower ETO than a business with lower operating expenses.

2.44 While superficially, operating costs might be an indication of business efficiency thereby justifying higher tax offsets to low-cost as opposed to high-cost businesses, this fails to take into account that some businesses of necessity have higher operating costs than others. A consultancy business providing specialised advice and report-writing services, for example, is more likely to incur lower operating costs than, say, a landscaping business.

Practicality of the provisions

2.45 The Committee heard evidence that predicating ETO eligibility on STS taxpayer status could entail a level of complexity and expense that might deter participation by some of the intended beneficiaries.

2.46 The Ralph Review referred to studies[26] showing that tax compliance costs for small businesses were disproportionately high and commented that:

> Labour time spent on taxation activities by owners, employees and helpers is the most significant component of tax compliance costs. There are substantial opportunity costs associated with this, as time spent on compliance reduces the time available to invest in business growth.[27]

2.47 Anecdotal evidence from professional sources suggests that small business has largely kept away from the STS because it is seen as too complex and too costly to comply with.[28] Certainly, ATO figures for the 2002 tax year show that only 14 per cent of eligible businesses opted into the STS.[29]

2.48 Having said this, the Committee is encouraged that Schedule 2 of the bill will remove one significant impediment to taxpayer participation in the STS by permitting

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26 The studies cited were Evans C, Ritchie K, Tran-Nam B and Walpole M (1996), *Costs of taxpayer compliance—Final Report*, Revenue Analysis Branch of the ATO, Canberra, pp. 9-67, and Evans C, Ritchie K, Tran-Nam B and Walpole M (1997), *A report into taxpayer costs of compliance*, Commonwealth of Australia, Canberra, p. 51.

27 *Review of Business Taxation*, Final Report—Section 17: Small Business Initiatives. Accessed at http://www.rbt.treasury.gov.au/publications/paper4/part6/section17.htm on 28 February 2005.

28 'Advisers call for simpler simplified tax', *Australian Financial Review,* 18 February 2003, p. 49. This article canvasses the views of William Buck Accountants; BDO Kendalls; Hayes Knight; and CPA Australia.

29 ATPF Issues Log, A27—Simplified Tax System take-up rate. Accessed on 2 March 2005 at http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/39983.htm&page=249&H22_1.

accrual-based accounting.[30] The extent to which this concession will reduce the compliance cost burden can only be a matter of conjecture but it will at least obviate the need for some businesses to keep accounts based on both cash and accrual methods.

2.49 In a recent study by Michael Dirkis, Tax Director, Taxation Institute of Australia, and Brett Bondfield, Lecturer, Faculty of Law, University of Technology Sydney, the authors refer to the low take-up rate of STS and attribute it in part to the 'convoluted' nature of the provisions and accompanying tax rulings.[31] The authors state, for example, that:

> Conceptually, STS is a potentially concessional tax system that sits on top of and has to interact with the rest of the tax laws. Surely having an add on system that delivers concessional treatment of some tax items…is not inherently simple…
>
> ….STS eligibility is set out in s328-365 and contains 11 terms that themselves have a definition, which illustrates that the basic proposition that eligibility to STS is a simple three point test is misleading. Those three points are tightly defined and potentially complex in their operation so much so that the ATO has issued…two TRs…[32]

2.50 At the Committee's public hearing, the ATO told the Committee that it was looking at ways to simplify the paperwork and calculations—and thus reduce costs—for taxpayers assessing their ETO eligibility. In this regard, Mr Brett Peterson told the Committee that:

> Where we have taxpayers with just one eligible stream of STS income we will ask them to let us know the amount of their STS income. On the strength of that we will be looking to calculate the size of their offsets. So we will take the manual calculation out of the process for taxpayers to the extent we can. For taxpayers who may have multiple offsets available to them, rather than multiply the number of labels on the form our approach will be to provide a third label whereby a taxpayer can—probably using a calculation product we will provide or will be provided through software providers—calculate and add a single figure to the label, claiming the offset from multiple STS entitlements.[33]

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30 Criticisms of the STS are discussed in 'Advisers call for simpler simplified tax'*, Australian Financial Review,* 18 February 2003, p. 49; 'Small business shuns STS use', *Australian Financial Review*, 10 June 2003, p. 59; 'Tax cut at micro end of town'*, Australian*, 27 September 2004, p. 8.

31 *The RBT ANTS Bite: Small Business the First Casualty*, (2004) 19 Australian Tax Reform, p. 148.

32 *The RBT ANTS Bite: Small Business the First Casualty*, (2004) 19 Australian Tax Reform, p. 148.

33 *Proof Committee Hansard*, 1 March 2005, p. E3.

2.51 The Committee welcomes the ATO's moves and considers that this should go some way towards reducing compliance costs. Nonetheless, the Committee is concerned that the costs entailed in establishing and monitoring STS eligibility (on which ETO eligibility depends) may still be prohibitive for some taxpayers.

Conclusions and recommendations—utility of the ETO

2.52 The Committee believes that, conceptually, the ETO has merit as a means of encouraging entrepreneurial activity and—where it already exists—nurturing it.

2.53 The Committee appreciates the arguments for narrowing the application of Schedule 1 to businesses where there is untapped demand. However, it seems to the Committee that limiting the ETO to certain groups will deprive many worthy businesses of the chance to grow and also to create a demand where one does not exist at the moment.

2.54 The Committee believes that the bill should be passed without alteration to Schedule 1. However, as with any initiative such as this, the Government should closely monitor the uptake of the ETO and its impact on small business. The Government should also investigate, as part of its monitoring exercise, whether compliance costs involved in the ETO meet acceptable levels.

CHAPTER 3

SCHEDULE 5 – INCENTIVES FOR PETROLEUM EXPLORATION IN FRONTIER AREAS

Outline of Schedule 5

3.1 Schedule 5 of the bill, if passed, will amend the *Petroleum Resource Rent Tax Assessment Act 1987*, introducing provisions intended to encourage exploration for new petroleum (oil and gas) reserves in Australia's remote offshore areas. This measure was announced by the Treasurer and the Minister for Industry, Tourism and Resources, the Hon. Ian Macfarlane MP, on 11 May 2004.

3.2 The stated policy objective of the measure is 'to encourage petroleum exploration in Australia's remote offshore areas in order to discover a new petroleum province'.[1]

3.3 The measure allows the Minister responsible for the *Petroleum (Submerged Lands) Act 1967* to allocate up to 20 per cent of the annual offshore petroleum acreage release areas as 'designated frontier areas'. Persons conducting exploration in these designated areas will be able to claim 150 per cent of the costs associated with their exploration expenditure (currently 100 per cent) for the purposes of determining the amount of Petroleum Resources Rent Tax (PRRT) payable. The incentive is limited to new exploration only—it will not apply to activities associated with evaluating or delineating previous discoveries.

3.4 The cost to the revenue of this measure is expected to be $17 million over the period from 2004-05 to 2007-08.[2]

3.5 The Explanatory Memorandum for the bill notes that these amendments are being introduced in the context of concerns about Australia's declining oil reserves raised by the oil industry and by the House of Representatives Standing Committee on Industry and Resources' 2003 report, *Exploring: Australia's future*.

3.6 The Explanatory Memorandum further notes that while Australia has some 40 offshore basins that display petroleum potential, many remain unexplored, often because they are in deep water and far from existing infrastructure, making them difficult and expensive to explore. The amendments are intended to encourage exploration in these remote areas.

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1 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, p. 79.

2 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, p. 83.

3.7 These exploration incentives are being introduced at a time when Australia's domestic reserves of oil are dwindling rapidly, increasing dependence on imports; and a low level of exploration for oil and gas is being undertaken, resulting in few new discoveries being made to replace reserves that are being run down.

Petroleum resource rent tax

3.8 The amendments proposed by the Government provide a measure of relief from PRRT, increasing (or 'uplifting') the amount that may be claimed in respect of exploration expenditure in the designated frontier areas from 100 per cent to 150 per cent.

3.9 The following section gives an abbreviated overview of the operation of the PRRT. The material is drawn from the ATO and ITR web sites.

3.10 PRRT was originally designed to ensure that the Australian community receives an appropriate share of the large returns that can follow the development of rich petroleum deposits, while providing companies with adequate rewards in return for the risks they accept in undertaking offshore exploration and development. It commenced on 1 July 1987.

3.11 This tax applies to all petroleum projects in offshore areas (or Commonwealth Adjacent Areas) under the *Petroleum (Submerged Lands) Act 1967,* other than production licences derived from the North West Shelf exploration permits WA-P-1 and WA-P-28. The latter are subject to the excise and royalty regime. The 'adjacent areas' extend three nautical miles from the territorial sea baselines to the outer limits of the continental shelf, other than areas covered by production licences granted on or before 1 July 1984 and permit areas that those production licences were drawn from. Other exemptions include permits in the Joint Petroleum Development Area (JPDA) with East Timor.[3]

3.12 PRRT is assessed on a project basis and is levied on the taxable profits of a petroleum project at a rate of 40 per cent. A ‘project’ consists of facilities in the project title area, and any facilities outside that area necessary for the production and initial storage of marketable petroleum commodities.[4]

3.13 'Taxable profit' is the project’s income after all project and ‘other’ exploration expenditures, including a compounded amount for carried forward expenditures, have been deducted from all assessable receipts. PRRT payments are deductible for company tax purposes, currently at a rate of 100 per cent. Eligible expenditures include exploration and all project development and operating expenditures.

3 From ATO Website: www.ato.gov.au

4 From ITR Website: www.itr.gov.au

Closing-down expenditures, including offshore platform removal and environmental restoration, are also deductible in the year in which they are incurred.[5]

3.14 With the exception of a number of items, exploration expenditure incurred in areas covered by the PRRT is deductible against all projects held by that person subject to compliance with anti-avoidance provisions. In the case of a company in a company group, the expenditure will be deductible against all projects held by the group. This ensures that the pattern of exploration is not affected by taxation arrangements.[6]

3.15 Expenditures that are not deductible include financing costs, private override royalty payments, income tax, goods and services tax, fringe benefits tax, cash bidding payments and certain indirect administrative costs.[7]

3.16 In 2002-03, PRRT collections were approximately $1.72 billion. The majority of this revenue came from the production of petroleum products in Bass Strait. [8]

Rising imports and declining reserves

3.17 Australia both imports and exports oil. Most domestically produced oil is light, and is not suitable for many applications, for example bituminous products and lubricants. Imports exceed exports by a substantial margin. In 2003-04, 23 649 million litres were imported and 17 660 million litres were exported. This margin is expected to widen, such that the proportion of imported oil in primary consumption will rise from 37 per cent in 1998-99 to 52 per cent in 2019-20.[9] This change results from a combination of increasing domestic demand and declining domestic reserves.

3.18 Australia has substantial natural gas reserves but limited and declining oil reserves. Australian gas reserves represent about 2.2 per cent of the world's total, but oil reserves account for only 0.4 per cent of global reserves.[10] Nonetheless, Australia has enjoyed a high level of self sufficiency in oil and gas for the last three decades. However, the rate of new discoveries of oil and gas has lagged behind rising domestic demand and we are increasingly dependent on imported oil.

3.19 Increasing dependence on imported oil has the potential to place further pressure on Australia's trade balance. Representing the Australian Petroleum Production & Exploration Association Limited (APPEA), Mr Barry Jones commented

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5 From ITR Website: www.itr.gov.au

6 From ITR Website: www.itr.gov.au

7 From ITR Website: www.itr.gov.au

8 From ITR Website: www.itr.gov.au

9 Derived from Parliamentary Library Bills Digest No.111 for 2004-05.

10 Submission by Geoscience Australia to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 29.

that if current oil prices persist and the government's best supply forecast is met, imported oil would add 'about $30 billion a year to the national export bill by 2015'.[11]

3.20 The quantity of domestic crude oil reserves is subject to constant amendment, as new discoveries are made and existing stocks are drawn down. According to Geoscience Australia, reserves peaked in 1994, declined by 19 per cent by the year 2000, and are continuing to decline. Australia's current reserves of crude oil totalled 819 million barrels, with a further 671 million barrels of condensate[12] as at 1 January 2003, equivalent to about 5 years of consumption at current rates.[13]

3.21 There are also further known reserves that may be exploited in the future but which are currently regarded as non-commercial. About three-quarters (1 407 million barrels of a total of 1 859 million barrels) of these non-commercial reserves are in the form of condensate, and so require markets to be found for the associated gas before being exploited.[14]

3.22 Production declines as reserves diminish. Geoscience Australia expects production to decline by 40-50 per cent in the medium term and then to decline steadily even further.[15]

Declining exploration activity

3.23 Exploring for oil and gas is expensive. This is particularly so in the offshore frontier areas off Australia's coast, because drilling activity is carried out in very deep water. Estimates vary. Geoscience Australia costs a single offshore exploration in the region of $8-10 million.[16] APPEA advised that the cost of a deepwater exploratory well may exceed $50 million.[17]

3.24 Australia is also considered a risky place to explore. Success rates are low compared to other countries. In a submission to the House of Representatives Standing Committee Inquiry into Resources Exploration Impediments, ExxonMobil cited a study conducted by international oil and gas consultants, Wood Mackenzie, which rated the world's top oil and gas producing regions:

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11 *Proof Committee Hansard*, 1 March 2005, p. E12.

12 Condensate is a term used to describe hydrocarbons that exist as a gas in a gas field and which are separated out from the accompanying gases to form a liquid during production.

13 *Submission* 2, APPEA, p. 2.

14 Submission by Geoscience Australia to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 26.

15 Submission by Geoscience Australia to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 31.

16 Submission by Geoscience Australia to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 33.

17 *Proof Committee Hansard*, 1 March 2005, p. E12.

> The study found that offshore Australia ranked 46th in the world in exploration drilling success, with a commercial success rate of a little over 6%. This compares with other locations such as Malaysia with a commercial success rate above 50% and Angola with over 40%.[18]

3.25 Nonetheless, substantial sums of money are being spent on exploration for oil and gas in this country. In 2002-04, explorers spent a total of $995 million—$191.3 million for on-shore exploration and $803.7 million for offshore exploration. The amount spent fluctuates from year to year, the total spent in 2002-03 representing a 14.7 per cent increase over that spent in 1998-99.[19]

3.26 However, the overall trend for the last two decades has been for levels of exploration to decline, particularly when the number of wells drilled and quantity of seismic surveys carried out are considered.

3.27 In 2002, 88 wells were drilled, and 91 in 2003, a much lower level of activity than the peak of 267 wells drilled in 1985.[20] According to APPEA, the quantity of seismic survey work undertaken has also fallen dramatically since the peaks of the early 1990s.[21]

Prospects for future exploration

3.28 While exploration has declined, there appears nonetheless to be further exploration potential for new petroleum resources. Geoscience Australia notes that of the 40 Australian offshore basins, about half remain unexplored. The organisation notes that if Australia is to maximize the opportunity to maintain an indigenous liquid hydrocarbon supply, there is a need to extend the area in which Australian exploration occurs. However, the organisation sounds a note of caution, warning that the chance of finding large crude oil fields is limited.[22]

3.29 The measure introduced by the Government recognises the need to extend exploration into previously unexplored areas. The Government has indicated that when specifying designated frontier areas, the relevant minister 'is likely to favour those areas which are at least 100 kilometres from a commercialised oil discovery and not adjacent to an area designated in the previous year's acreage release.'[23]

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18 Submission by ExxonMobil to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 3.

19 Australian Bureau of Statistics, Mineral and Petroleum Exploration Australia, 1301.0 – 2005.

20 From Geoscience Australian website, www.ga.gov.au/oceans/projects/q4_2003_apeda.jsp

21 *Submission* 2, APPEA, p. 4.

22 Submission by Geoscience Australia to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 31.

23 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, p. 74.

3.30 The APPEA representative appeared somewhat pessimistic about whether the gap between supply and demand would be closed by further exploration:

> I do not see exploration as closing the emerging demand-supply gap in this country. We will still have to do energy sufficiency measures, we will still have to look at demand-side management and we will still have to look at alternative fuels. To deal with that issue requires a suite of measures, of which more exploration is only one.[24]

Environmental impacts

3.31 During the second reading debate in the House of Representatives, the Member for Hunter, Mr Joel Fitzgibbon, indicated that while the Opposition would not oppose the schedule and recognised the need for further exploration, environmental considerations required closer examination by the committee.[25]These considerations appeared to be based on anxieties about possible drilling activity on the Barrier Reef and in the Sydney Basin.

3.32 Mr Barry Jones of APPEA sought to refute these concerns. He told the Committee in evidence that 'we have absolutely no interest of any kind in exploring the Great Barrier Reef World Heritage area'.[26] He emphasised that exploration in areas around the reef posed no threat:

> The way the rules work in this country is that if the oil was found in an area where the currents - meaning moving water – and temperature conditions would lead to a drift potentially at any time into the Barrier Reef World Heritage area, the development would not be allowed.[27]

3.33 APPEA also advised that it was more likely for gas to be discovered than oil, as Australia was 'gas prone'. Australian oils are also very light, similar to kerosene, and evaporate readily, unlike those portrayed in catastrophic oil spills in the northern hemisphere. Any risk to the reef or other areas is therefore low.

3.34 There was no evidence before the Committee to suggest—nor is there any reason to believe—that the bill would affect the Great Barrier Reef World Heritage Area or otherwise have any adverse environmental impact.

Effectiveness of the measure

3.35 As noted previously, Australia is regarded as a risky exploration proposition, particularly in relation to oil, the prospects for finding a commercial oil field being low. Further, there is global competition for the exploration dollar.

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24 *Proof Committee Hansard*, 1 March 2005, p. E12.

25 *House Hansard*, 10 February 2005, p. 36.

26 *Proof Committee Hansard*, 1 March 2005, p. E11.

27 *Proof Committee Hansard*, 1 March 2005, p. E17.

3.36 Political, social and economic stability do weigh in Australia's favour when decisions are made about whether to invest in exploration, but it is clear that the fiscal environment (i.e: the taxation of profits) is a central issue. In *Exploring: Australia's future,* the House of Representatives Standing Committee on Industry and Resources noted that submissions and evidence had repeatedly identified taxation as 'one of the primary factors that affected the economic quality of petroleum development'. A number of major submissions to that committee rated Australia as unattractive for investment.[28]

3.37 APPEA supported the proposed measure as a step in the right direction:

> We need to recognize that exploration is a high risk business…The proposed PRRT change recognizes this risk, particularly in deep water. It recognizes that there are public benefits to be gained if exploration is successful and that market forces alone will not drive that investment.[29]

3.38 However, APPEA echoed the concerns raised in the House of Representatives inquiry about the competition for capital, noting that other countries had already altered their fiscal regimes to make them more competitive:

> I think we also need to recognize that there will be strong competition for exploration capital globally over the next decade… The world out there is a highly competitive market. Other countries such as Norway, the UK, the USA and New Zealand have already adjusted their fiscal systems to maintain their international investment competitiveness. In our view, Australia should do the same. This measure is one step along the way.[30]

3.39 The projected cost of this incentive is modest, about $17 million. This amount contrasts markedly with the sums spent by the industry every year on exploration. (see for example paragraph 3.25). The Committee sought information about whether the measure would have an effect on exploration activity.

3.40 When asked whether the measure would result in any new wells being drilled, Mr Barry Jones of APPEA was cautious. His view was that if there were no bids on any of the frontier licence areas in the first or second round, then 'you have an answer to your question'.[31] However, he noted that there were two possible kinds of benefits that might result: a commercial benefit, if a discovery is made; and a knowledge benefit:

> Every piece of seismic survey that we run adds to the public knowledge of what is available in that area…At present, nothing is happening in those areas, or very limited is occurring. The number of bids you get, the amount

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28 Para 3.87, p. 40.

29 *Proof Committee Hansard*, 1 March 2005, p. E12.

30 *Proof Committee Hansard*, 1 March 2005, p. E13.

31 *Proof Committee Hansard*, 1 March 2005, p. E13.

> of seismic activity and eventually whether a discovery is made will all be indicators.[32]

3.41 Committee members questioned Treasury officers about whether other incentives for encouraging exploration had been considered, for example, exempting offshore greenfield discoveries in designated areas from PRRT. The officers responded that this was a policy issue, and would not be drawn on what advice had been provided to the Government.

3.42 Officers did, however, advise that the Ministerial Council on Mineral and Petroleum Resources has recently requested a study into the fiscal competitiveness of the environment that the resources sector faces. Officers advised that the study would examine the fiscal regimes applying to energy resources across Australia and whether these are impediments to attracting investment. The study is to report to the Ministerial Council in September, but it will be a decision for the Council as to whether the report is published.

A level playing field?

3.43 Renewable Energy Generators of Australia Limited (REGA), while acknowledging the need for further petroleum exploration, did not appear to support the measure. REGA's argument was that targeting funds to the petroleum industry in this way skewed the allocation of capital towards the petroleum industry. Representing REGA, Mr Simon Maher contended that:

> The impact, therefore, of providing a 150 per cent deduction in relation to exploration expenditure makes it more likely that capital will be allocated to the provision of a fossil fuel future for Australia and therefore less likely that capital will be available for renewable energy research and development…It is at the margin where economic decisions are made. The move being contemplated provides encouragement to fossil fuels but leaves a competing set of technologies behind.[33]

3.44 Mr Maher did not appear to be aware of the relatively modest size of the proposal, conceding that the $17 million allocated was not a substantial incentive within the renewable sector either. However, he maintained that the principle stood and that the effect, while marginal, would still be to change capital allocation incentives[34].

3.45 In this vein, the Committee explored the issue of whether there should be a uniform approach to taxation across the entire energy sector, including renewables. The Committee noted that coal resources are not subject to similar taxes. There are

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32 *Proof Committee Hansard*, 1 March 2005, p. E18.

33 *Proof Committee Hansard*, 1 March 2005, p. E20.

34 *Proof Committee Hansard*, 1 March 2005, pp. E21-2.

obstacles to such a system, for example the Commonwealth has only offshore jurisdiction in this area, which is why PRRT does not apply to onshore oil and gas.

3.46 Mr Jones of APPEA considered a uniform approach to be a reasonable proposition:

> In my view, it is a perfectly valid economic argument to consider the nature of resource taxation across this country and consider having a level playing field across all energy resources...
>
> If the decision is that there should be some sort of resource use tax—which is the case, both for mining and petroleum—and if this resource tax is based on the grounds that these are public resources, community resources, being used by industry for a commercial reason and a public benefit, then I have two views: it should be a level playing field for everyone—and that does not exist, even within the fossil fuels sector—and it should cover everyone. [35]

3.47 In supporting the concept of a level playing field within the resource sector, Mr Jones went on to say that even within the petroleum sector, APPEA did not consider that PRRT worked optimally:

> I do not believe that it in fact treats risk within the petroleum sector in a consistent way. So I do not believe there is a level playing field within it.[36]

3.48 When questioned about whether the renewables sector should pay a resource rent tax, Mr Maher of REGA acknowledged that there currently was no level playing field, but other factors had to be considered:

> It depends what you contemplate as being the various issues of the relative sectors' impact on the economy. For example, the renewable sector certainly does not pay a resource rent tax. But on the other hand, the argument would be that it does not contribute to the same range of negative externalities that some other sectors of the economy do—in this case, fossil fuel. There is no level playing field, but I guess you take my point: certainly we accept that we do not get resource rent tax but neither do we provide detrimental impacts in certain aspects.[37]

3.49 The Committee attempted to pursue this issue further with representatives of the Treasury and the Department of Industry, Tourism and Resources. Officers would not be drawn beyond observing that the whole issue of energy taxation is one where there are competing interests and views, and that the government has dealt with these, insofar as it is currently disposed to deal with them, in the energy white paper.

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35 *Proof Committee Hansard*, 1 March 2005, p. E19.

36 *Proof Committee Hansard*, 1 March 2005, p. E19.

37 *Proof Committee Hansard*, 1 March 2005, p. E20.

Conclusions and recommendations

3.50 The Committee notes concerns about Australia's increasing dependence on imported oil and the level of international competition that exists for exploration funding. This is an important issue, which is under active consideration by government through the Ministerial Council on Mineral and Petroleum Resources' study of the fiscal competitiveness of the environment that the resources sector faces.

3.51 What this study will address has yet to be determined. The Committee is of the view that there is a persuasive case for considering the differential taxation treatment within sectors of the industry as well as factors that affect international competitiveness. Given that taxes applicable to the resources sector are cross-jurisdictional (i.e: the states having jurisdiction over land-based resources industries), the vehicle of a ministerial council study provides an appropriate means of addressing these issues. The Committee suggests that the Ministerial Council consider including these issues within the study.

3.52 On the basis of the evidence presented to it, the Committee does not consider that passage of the schedule will, in any way, heighten risks to the environment. Arguments to that effect are unsustainable, and the schedule should not be opposed on those grounds.

3.53 The Committee notes that the measure in this bill is relatively modest. However, it should not be viewed in isolation. It is actually part of a suite of initiatives, current and future, that are required to address the issue of Australia's future energy supplies. In particular, the Government's white paper, *Securing Australia's energy future*, provides a comprehensive of the Government's initiatives in this area. These include significant support for renewable energy programs.

Recommendation 1

3.54 The Committee recommends that the Government institute a public inquiry into the impact of differential tax regimes in the resources sector, in particular with a view to identifying and removing any anomalies arising from differential tax treatment within the sector.

CHAPTER 4

OTHER PROVISIONS OF THE BILL

Introduction

4.1 Altogether, the provisions in the bill are contained in 11 schedules. The provisions of Schedules 1 and 2 and 5 have been discussed in earlier chapters. The provisions of the remaining schedules deal with the following matters:

- Schedule 3: Employee share schemes
- Schedule 4: FBT exemption thresholds for long service leave awards
- Schedule 6: Consolidation regime—providing greater flexibility
- Schedule 7: STS roll-over relief for depreciating assets
- Schedule 8: Family trust elections and interposed entity elections
- Schedule 9: Non-commercial loans
- Schedule 10: Technical corrections and amendments
- Schedule 11: Minor amendment to the refundable film tax offset

Submissions received

4.2 In the only submission[1] regarding Schedule 7, an objection was made that the starting date for the amendments was proposed to be 'the income year following the income year in which this Act receives the Royal Assent'.[2]

4.3 The submission argued that the starting date for the Schedule 7 amendments should be 1 July 2001, to accord with 'Senator Coonan's press release of 4/3/03 (CO13/03)' that, among other things:

> Roll-over relief amendments will be effective from the start date of the STS, 1 July 2001, so eligible taxpayers can elect to enter the STS in their 2001/02 tax return.[3]

4.4 The submission said further that:

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1 *Submission* 1 (William Buck (SA) Pty Ltd).

2 Item 20 of Schedule 7.

3 Press Release CO13/03—Minister for Revenue and the Assistant Treasurer, Roll-over Relief for Simplified Tax System Partnerships, 4 March 2003. At http://assistant.treasurer.gov.au/atr/content/pressreleases/2003/013.asp?pf=1 accessed on 22 February 2005.

> …as a result of the press release…many taxpayers would have (a) entered STS on the basis that the rollover would be available to them and (b) those already in STS would have applied the rollover.[4]

4.5 Senator Coonan's statement concerned roll-over relief amendments introduced by the *Tax Laws Amendment Act (No. 2) 2004* (TLAA2)—not the proposed amendments in the Tax Laws Amendment (2004 Measures No. 7) Bill 2004. The following excerpt from the Explanatory Memorandum for the TLAA2 puts this beyond doubt:

> ***Proposal announced:*** This measure was announced in the Minister for Revenue and Assistant Treasurer's Press Release C13/03 of 4 March 2003.[5]

4.6 The Committee has received no evidence to suggest that 1 July 2001 was promoted by the government as the commencement date for the Schedule 7 amendments. Furthermore, the Committee has heard no compelling arguments for substitution of the proposed commencement date with another date. In the circumstances, the Committee has no objection to the proposed amendments.[6]

Conclusions and recommendations

4.7 The Committee can see no reason why the provisions of the bill should not be passed.

Recommendation 2

4.8 The Committee recommends that the Tax Laws Amendment (2004 Measures No. 7) Bill 2004 be passed without amendment.

Senator George Brandis
Chair

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4 *Submission* 1 (William Buck (SA) Pty Ltd).

5 Taxation Laws Amendment Bill (No. 2) 2004 (Previous citation: Taxation Laws Amendment Bill (No. 9) 2003), Revised Explanatory Memorandum, The Parliament of the Commonwealth of Australia, p. 8.

6 At the Committee's hearing on 1 March 2005, the Department of the Treasury confirmed the Committee's conclusions about the starting date for the ETO. See Mr Mark O'Connor, *Proof Committee Hansard*, 1 March 2005, pp. E3-E4.

Senate Economics Legislation Committee
Taxation Laws Amendment (2004 Measures No.7) Bill 2004
Australian Democrats Minority Report

Schedule 1 – The 25 per cent Entrepreneurs' Tax Offset

The Australian Democrats are opposed to Schedule 1. It is bad policy that should be roundly condemned.

There is no evidence whatsoever that Australian micro and small business lack sufficient entrepreneurial spirit or that their numbers have been held back by a lack of entrepreneurial spirit[1]. In fact the reverse is the case.

There is a shortage of workers in a number of trades, for example, plumbers, bricklayers, boilermakers and carpenters. No evidence was provided that the Entrepreneurs' Tax Offset would encourage workers into these areas, particularly due to the limitation of a $75 000 turnover. Evidence provided to the Committee by the Australian Taxation Office indicated that less than a third of plumbers, bricklayers and carpenters would meet the $75 000 turnover limitation.

This is an untargeted measure that will apply equally to all classes of micro and small business, whether the goods and services they provide are in excess or short supply. Why is this incentive not just targeted at micro and small business areas that are in short supply?

The answer is that it is not an incentive at all, it is a political gift.

There is no evidence that it will further encourage entrepreneurial activity, although prima facie, it will make businesses that fall within the threshold more profitable.

This measure creates yet another class of rent seekers. The Coalition's entire income tax strategy seems to consist of parcelling out income tax concessions to targeted constituencies in an apparent attempt to secure their vote.

This may be in the Coalition's political self-interest but it is not in the national interest.

Fortunately some Coalition backbenchers are starting to rebel against such blatant political pork-barrelling, but their backbench campaign for structural income tax reform is unlikely to extend to crossing the floor on issues like these.

Changes to the Income Tax Act such as this only serve to further complicate an already excessively complicated income tax system.

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[1] Refer Committee Hansard Page 7

The legislation may be only 9 pages long but could only be followed by an accountant with a good understanding of taxation law, and is likely to result in additional compliance costs. No estimation has been made of the compliance costs for taxpayers or for the Taxation Office.

All of this serves to again emphasise that what is needed is major structural reform. Tinkering at the edges won't do. The income tax system must be simplified and tax concessions that feed rent seekers and create inequities done away with. Simplifying the system and broadening the income tax base would free up money for genuine tax cuts.

Certainty and equity in income taxation are vital. Certainty and equity should be delivered by a three-part plan phased in over a number of years in order to ensure affordability - in this order with these objectives in mind: a $20 000 tax-free threshold; indexation to end bracket creep; and possibly, a $120 000 top rate threshold.

At the very least, the income tax system needs to accept that it is entirely inappropriate to tax income below $12 500, which is the estimated minimum subsistence income.

In the meantime the priority is to keep addressing the needs of low income workers, increasing their disposable income and living standards, reducing their cripplingly high effective tax rates, and moving poorer Australians from welfare to work.

The best single way to do this is by raising the tax-free threshold, which has a side benefit of flowing on to all Australian taxpayers, not just a favoured few.

I will be recommending to the Democrats that this bill's complicated, unnecessary and unfair tax cut for a selectively limited group should be shared by all taxpayers.

The evidence presented to the Committee demonstrated that the Entrepreneurs' Tax Offset in this Schedule 1 is unduly complicated. Further, neither the Treasury nor Taxation Office representatives could demonstrate any measurable economic or social benefit from the proposal.

Our preference is to redirect the $400 million a year Treasury-estimated cost of this proposal to increase the tax-free threshold from $6 000 to $6 260.

At an estimated cost of $398 million a year, this would provide Australia’s nearly 9 million taxpayers with a $44.20 a year tax cut or around 85 cents a week.

The 2003 budget tax cuts were referred to as the ‘sandwich and milkshake’ tax cuts; our redirection of this unnecessary, ill conceived proposal will provide all Australians with a ‘freddo frog’ tax cut.

We are also concerned by the possible tax avoidance opportunities as the legislation makes it clear that a taxpayer may claim more than one tax offset. Arguably, a relatively well-off taxpayer could restructure their affairs so that they run a diverse

range of businesses, each with turnover under $75 000, and claim an Entrepreneurs' Tax Offset on each.

Alternatively, the legislation provides yet more encouragement for genuine employees to try and contrive to avoid the PAYG system. Why could anyone think that would be in the national interest?

Questioning from Senator Watson also demonstrated that there could be a comparative price advantage available to businesses that could utilise the Tax Offset. Generally, we would prefer a level playing field in all aspects of business.

It has often been stated that the three elements of an ideal tax system are efficiency, simplicity and equity. In our opinion, the Entrepreneurs' Tax Offset meets none of these criteria and, arguably, makes all three worse.

The Australian Democrats will be opposing the Entrepreneurs' Tax Offset contained in Schedule 1 of the Tax Laws Amendment (2004 Measures No.7) Bill 2004 and introducing an amendment to provide an income tax cut for all Australian taxpayers.

Schedule 5 – Petroleum Exploration Incentive

In view of the nature of the multi-billion energy industry, when I first saw the estimated cost of this incentive of $17 million, I assumed it would be only of minor benefit to the oil and gas prospecting industry. The evidence was to the contrary[2], however it must be considered that little of the discussion explored the degree to which Australia's long term greenhouse mitigation costs may increase as a result of the initial $17 million investment in fossil fuel exploration.

In contrast the Renewable Energy Generators of Australia Ltd thought the $17 million too small an incentive for them, which also took me by surprise. [3]

The Australian Democrats have a history of supporting prospecting and research and development measures. We opposed the Governments cost-cutting in this area, and later data has proved us right.[4]

We do not oppose Schedule 5 that allows a 150 per cent uplift to certain exploration expenditure conducted in the first term of an exploration permit in a designated frontier area.

As evidence suggests that this incentive will benefit prospecting for gas as well as other fossil fuels, there is potential for increased use of this less damaging energy source.[5]

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[2] Refer Committee Hansard page 18

[3] Refer Committee Hansard page 21

[4] Refer Committee Hansard page 17

[5] Refer Committee Hansard Page 17

I for one would like to see much more gas found, however the Australian Democrats have also vigorously advocated limitations on exploration close to environmentally sensitive sites such as the Great Barrier Reef World Heritage Area. The Democrats remain of the firm belief that areas such as the Reef whose tourism income may be permanently and irreversibly damaged by large-scale petroleum exploration should be closed to petroleum exploration and extraction.

Natural gas is the major alternative to very harmful coal. The more natural gas Australia can find, use in Australia, and export, to reduce the use of coal in Australia and other countries (particularly our large regional neighbours), the better.

While gas is preferable to coal and to oil we must remember that it is also a finite resource and also contributes significantly to CO2 and global warming levels. Therefore we should talk about it as a transition fuel, not a joyous opportunity to use with abandon.

What is necessary as a balancing item is that this Government, that has had a minimalist approach to encouraging renewable energy, matches this incentive for the oil and gas industry with the same amount of $17 million for renewable energy.

Senator Andrew Murray
Australian Democrats Taxation Spokesperson and
Senator for Western Australia

APPENDIX 1

SUBMISSIONS RECEIVED

Submission Number	Submitter
1	William Buck (SA) Pty Ltd
2	Australian Petroleum Production & Exploration Association Limited (APPEA)
3	Renewable Energy Generators Australia Limited (REGA)
4	Total Environment Centre

APPENDIX 2

PUBLIC HEARINGS AND WITNESSES

Tuesday, 1 March 2005, Adelaide

ANDERSON, Mr John, Manager, Indirect Tax Division
Department of the Treasury

COLMER, Mr Patrick, General Manager, Indirect Tax Division
Department of the Treasury

JONES, Mr Barry, Executive Director
Australian Petroleum Production and Exploration Association Limited

KONZA, Mr Mark, Deputy Commissioner, Small Business
Australian Taxation Office

LIVINGSTON, Mr Peter, Manager, Resources Taxation Section
Department of Industry, Tourism and Resources

MAHER, Mr Simon, Director, Renewable Energy Generators of Australia Limited

MULLEN, Mr Noel, Commercial Director
Australian Petroleum Production and Exploration Association Limited

O'CONNOR, Mr Mark, Principal Adviser, Individuals and Exempt Tax Division
Department of the Treasury

PETERSON, Mr Brett, Assistant Commissioner, Small Business
Australian Taxation Office

ROLLINGS, Mr Jonathan, Manager, Small Business Unit, Business Tax Division
Department of the Treasury

Australian Government

The Treasury

APPENDIX 3

4 March, 2005

Mr Peter Hallahan
Committee Secretary
Senate Economics Committee
Department of the Senate
Parliament House
Canberra ACT 2600

Dear Sir

TAX LAWS AMENDMENT (2004 MEASURES NO.7) BILL 2004

I refer to the Senate inquiry into the abovementioned bill which was held on 1 March 2005. During the course of the inquiry a number of questions were taken on notice. In response to those questions, I now provide the following responses:

Senator Stephens

Q 1. How many taxpayers are estimated to be in the STS system after these measures (in schedule one) are introduced?

Answer It is estimated that the population of STS taxpayers after the commencement of these measures will be approximately 860,000.

Q 2. How many extra taxpayers are expected to join the STS system as a result of schedule one measures?

Answer It is estimated that the measures in schedule one will attract a further 440,000 taxpayers into the STS system.

Q 3. Is this increment to the STS tax base from schedule one measures included in the costings of the expansion of the STS in schedule two?

Answer Yes, the accruals impact for entities taking up the STS was factored in to the costings for schedule two.

Q 4. What is the average cost to the revenue per new STS taxpayer under schedule one measures, schedule two measures or schedules one and two?

Answer As the accruals impact for entities taking up the STS as a result of the schedule one measure was considered to be minor the average cost to the revenue of schedule one measure is estimated to be $700.

Q 5. What is the average estimated taxable income of STS taxpayers who are expected to receive the offset?

Answer The average estimated taxable income of taxpayers who are expected to benefit from the offset is expected to be approximately $18,000.

Q 6. What is the average estimated taxable income of STS taxpayers?

Answer The average estimated taxable income of STS taxpayers is approximately $25,000.

Senator Brandis

Q 1. What is Treasury's estimate of the number of small businesses that will benefit from these provisions?

Answer On the basis of 2002-03 income tax return data, it is estimated that 540,000 small businesses will benefit from the provisions contained in schedule one.

Senator Watson

Q 1 What is the offset worth for a taxpayer with $35,000 purely of business income compared to a person with $35,000 purely of salary and wages?

Answer Assuming the taxpayer's turnover is less than $50,000 (ie. is not in the shade-out range) a taxpayer with $35,000 of net STS income would have an initial tax liability of $6,672. The 25% offset would be $1,668 leaving a final liability (not including medicare levy) of $5004. These figures are based on the 2005-06 rates of tax applicable to resident individual taxpayers.

A taxpayer earning income purely from salary or wages is not an entrepreneur.

I trust the above responses will be of assistance to the Committee.

Yours sincerely

Mark O'Connor
Principal Adviser
Individuals and Exempt Tax Division

APPENDIX 4

From: Peterson, Brett [mailto:Brett.Peterson@ato.gov.au]
Sent: Friday, 4 March 2005 5:36 PM
To: Hallahan, Peter (SEN); Meredith, Bronwyn (SEN)
Cc: Konza, Mark

Subject: Hearing 1 March 2005 - Senate Economics Legislation Committee

Mr Hallahan/Ms Meredith

Attached is the data I advised I would seek to provide for the committee. We have extracted information covering bricklayers, carpenters and plumbers.
Please let me know if there are any concerns. I can be reached on telephone 02 6216 1185.

Brett Peterson
Assistant Commissioner
Small Business

Bricklayers (ANZSIC 42220)	**Total Population**	**Turnover $1 to $50000**	**Turnover $50001 to $75000**
Sole traders	22,699	8,090	1,738
Partnerships	4,925	1,348	889
Trusts	715	119	76
Companies	1,677	305	141
Total	29,916	9,862	2,844

Sole traders			
Partnerships	55,487	19,357	6,212
Trusts	7,750	2,242	1,567
Companies	1,416	287	200
Total	4,853	962	635
	69,506	22,848	8,614

Plumbers (ANZSIC 42310)			
Sole traders			
Partnerships	21,657	5,726	2,155
Trusts	6,120	1,254	841
Companies	2,279	288	165
Total	5,936	759	417
	35,992	8,027	3,578

Data extracted from the Business Market Table using 2003 and 2004 latest return lodged. Based on specific ANZSIC code provided by the taxpayer, and total business income returned. Note that any of these taxpayers may also have other sources of income.

Bricklayers Carpenters Plumbers