

"SOME IMPACTS OF THE  
HOWARD GOVERNMENT'S TAX REFORM  
PACKAGE UPON THE AUSTRALIAN  
PROPERTY INDUSTRY"

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## **1 Introduction**

### **1.1 Tax Reform is Ongoing in Australia**

Pressure for tax reform has long been a feature of the Australian political process (Groenewegen, 1979). In 1983, the Hawke Labor Government mounted a Tax Reform Summit, which first considered but then discarded a Goods and Services Tax (GST). In 1993, the electorate declined to endorse a more radical program incorporating a GST (Fightback! 1991).

But, in the intervening period, Australia adopted such wide-ranging tax reforms as a capital gains tax, a company share dividend imputation system, a fringe benefits tax and wider taxation of superannuation, and sharply reduced the company tax rate. Overall, although each reform has its imperfections, these measures have enhanced the equity and efficiency of the taxation system (in line with hallmarks suggested by Asprey, 1973 *et al*). Nevertheless, in Australia, marginal income tax rates remain the highest in the Asia Pacific region and the indirect system consists of no fewer than seven differential rates, applied to a wide variety of goods but not

services.

## **1.2 The Howard Government's 1998 Proposals**

Prior to the 1998 election, the Howard-led Liberal-National Party Government presented to the electorate a manifesto comprising a radical set of tax reform proposals. The proposals included substantial reductions in personal income tax rates, the introduction of a GST at a rate of 10 per cent effective from 1 July 2000 and promises to eliminate a range of other taxes and duties.

In the event, the Howard Government was returned to office, albeit with a greatly reduced majority. It has claimed a mandate to implement its reform proposals and introduced the GST legislation into Parliament on 2 December 1998.

Select Committee L report on the GST by 19 April 1999. However, some of the minor parties and Independents, which hold the balance of power in the Senate, are also claiming a mandate to seek amendments to the GST. Accordingly, the final legislation form of the Tax Reform package remains uncertain.

### **1.3 Purposes of Paper**

The purposes of this paper are:

- a) to briefly canvass the key elements of the Government's tax reform package;
- b) to identify and assess a range of impacts of the package measures upon the property industry in Australia; and
- c) to broadly assess the wider economic impacts of the package, with special reference to property markets.

## **2 The Howard Government's 1998 Proposals: A Summary**

### **2.1 Principles**

On 13 August 1997, the Prime Minister, Mr Howard, announced five principles on which the subsequent taxation reform program would be based. These were:

- a) that there should be no increase in the overall tax burden;
- b) that any new taxation system should involve major reductions in personal income tax, with special regard to the taxation of families;
- c) a broadly-based indirect tax to replace some or all of the existing indirect taxes;
- d) appropriate compensation for those deserving of special consideration; and
- e) that reform of Commonwealth-State financial relations must be addressed (Tax ...Reform 1 998, p 12).

## 2.2 Key Measures of Reform

### a) Personal Income Tax Cuts

Personal income tax cuts totalling over \$13 billion per annum will be implemented from 1 July 2000. The cuts involve approximately 95 per cent of all taxpayers, and are substantial - as is evident from a study of Table 1.

TABLE 1

EXISTING AND PROPOSED INCOME TAX RATES: AUSTRALIA

1999 and 2000

Existing Rates		Proposed from 1 July 2000	
Taxable Income	Tax Rates	Taxable Income	Tax Rates

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\$to\$	%	\$to\$	%
0-5,400	NIL	0-6,000	NIL
5401 -20,700	20	6,001 -20,000	17
20,701 -38,000	34	20,001-50,000	30
38,001 -50,000	43	50,001-75,000	40
50,000+	47	75,001+	47

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*Source: The New Tax System: The GST- How It Works (1998), p1*

**b) Indirect Tax Reform**

A GST at the rate of 10 per cent will be introduced from 1 July 2000 on a wide range of goods and services, including food, clothing and books. Any request for a change to the GST rate would need to be made to the Commonwealth by all State Governments. It would need to be endorsed by the Commonwealth Government of the day, and relevant legislation passed by both Houses of Parliament.

**c) GST Credits, GST-Free Activities etc.**

- Registered persons will be able to claim input tax credits for the GST paid on purchases of business inputs.
- GST-free activities include:
  - exports of goods and services, but not tourism related services;
  - international air and sea travel, and domestic air travel, purchased overseas by non-residents;
  - virtually all health, education and childcare services;

- charitable activities;
- religious services; and
- taxes and charges levied at all levels of government, including local government rates and water and sewerage rates and charges.

**d) Abolition of Existing Indirect Taxes**

- The GST will replace the following indirect taxes: the wholesale sales tax, and in consultation with the States, the following types of taxes:
  - financial institutions duty;
  - debits tax;
  - conveyancing duties on business property;
  - stamp duty on credit arrangements, instalment purchase arrangements and rental hiring agreements;
  - stamp duties on leases;
  - stamp duties on mortgages, bonds, debentures and other loan securities;
  - stamp duties on cheques, bills of exchange and promisory notes;
  - bed taxes.

These proposals will be beneficial for the small business sector (The New Tax System: The GST - How It Works (1998), pS)

**e) Changes to Commonwealth-State Financial Relations**

- These are far reaching. From 1 July 2000, the Commonwealth will provide the States with all revenue from the GST, conditional upon the States abolishing "inefficient" taxes, such as the financial institutions duty, the debits tax and



various stamp and conveyancing duties, and not re-introducing them.

- Financial Assistance Grants will be abolished.
- The States will take over (from the Commonwealth) the payment of general purpose assistance grants to local government (Tax Reform, 1998).

**f) Business Measures**

- Consultations will take place with the business sector on the extent of reform of the business investment base, the prospect of further Capital Gains Tax (CGT) relief and the prospect of moving towards a 30 per cent company tax rate.
- Trusts will be taxed similarly to companies, with excess imputation credits to be refunded.
- Provisional tax will be abolished and replaced by a new pay-as-you-go system.
- More generous CGT rollover relief and retirement exemptions will be extended to small business and will include certain land and buildings integral to a business when their assets are owned separately.
- Simpler tax administration for business will operate with a single quarterly tax statement and payment for most businesses.
- The taxation of life insurance companies will fundamentally change. From 1 July 2000, growth on insurance and friendly society bonds will be taxed at the investor's marginal tax rate, regardless of how long the bonds have been held.

- The superannuation pension fund income tax of 15 per cent will be extended to that part of the fund income which relates to the payment of pensions (currently tax exempt).

**g) Pensions and Benefits**

- The maximum social security and veterans (age and service) pensions will be lifted by 4.0 per cent.
- The income test free areas applied to social security, veterans and student income support payments will be increased by 2.5 per cent. In addition, the income test for pensions will be eased by reducing the taper from 50 per cent to 40 per cent.
- A one-off untaxed Aged Pension Savings Bonus of up to \$1000 per person will be available to retired people over 60, subject to an income test.
- The Pensioner and Aged Person's Tax Rebate will be increase by \$250 per singles and \$175 per person for couples.

**h) Other Measures**

- A First Home Owners Scheme will be introduced to offset the net impact of the GST on the price of new homes (construction costs only and excluding land). It will provide those eligible with a lump sum payment of \$7,000 from 1 July 2000.
- Excises on petrol and diesel to be reduced at the time of GST's introduction so that pump prices need not rise.
- Provisional tax will be abolished.
- Cash refunds of excess imputation credits paid in respect of dividends and other relevant income will be made.
- The Government will consider capping the CGT at 30 per cent.
- Other measures include a Wine Equalisation Tax, a '*per stzck*'

excise on cigarettes, a retail tax of 25 per cent on luxury cars (above a GST-inclusive \$60,000 threshold) and a 30 per cent tax rebate/benefit for the cost of private health insurance.



### **3 Likely Impacts on the Property Industry**

Industry reaction to the reform measures has generally been favourable. The GST has been welcomed (Property Council Backs a GST, 1998). The proposals to eliminate a raft of inefficient State taxes have been supported (Abolished: Commercial Stamp Duty, 1998). Proposals to increase pensions and benefits will increase affordability of rental accommodation. Some industry criticism has been levelled at the targeting of the First Home Owners Scheme, the likely growth in "*informal work*" and the taxation of listed property trusts on a company tax basis.

The major impacts upon the property industry will emerge from the imposition of the GST on property-related activities, changes in the tax rates of industry participants and the abolition of selected State taxes. The following general effects are expected, although the final outcomes will depend on the content of the final legislation, and the influences and interactions of other industry drivers.

#### **3.1 Likely Impacts on Land Transactions**

a) Only land sold by registered persons will be subject to a GST. Hence, land for commercial development is likely to be subject to a GST (KPMG, 1998).

b) However, "*residential land*" (yet to be defined) will be treated as second-hand goods. So, if land is sold by a developer or other registered business, it will only be subject to GST on the margin or value added by the business and not on the full sale price.

c) Land sold by private individuals will not be taxable.

d) The sale of an existing family home will not be taxable (as distinct from the construction of a family house - see 3.2 below).

### **3.2 Likely Impacts on Construction Costs**

a) The costs of all construction, including new homes and repairs and renovations will be subject to the GST.

b) The GST will add between around \$5,000 and \$10,000 to the construction of a new home (Housing Industry Association, 1998). To offset this additional cost burden, the

Government has proposed assistance from 1 July 2000 of \$7,000 through the First Home Owners Scheme to qualifying persons, viz., Australian citizens and permanent residents who are buying or building their first home in Australia.

c) The construction and sale of new homes will be subject to the GST, possibly even where the new home is part of a retirement complex.

d) Activities associated with construction of commercial buildings appear likely to be taxed under the GST. These include

- extraction of raw materials, e.g. lime, sand and iron ore;
- processing of raw materials into building products, eg. bricks, steel and glass;
- manufacture of building components and services, e.g. lifts, air conditioning and telecommunications services; and
- the building process itself (KPMG, 1998, p7).

e) The sale and delivery of the completed building to the market, i.e. services provided by estate agents, solicitors and marketers, will be subject to the GST.

f) In the value added chain, full credit should be available for input tax paid.

### **3.3 Likely Impacts on Sales of Buildings**

a) The sale of commercial buildings will be fully taxable under the GST.

b) Residential buildings (apart from the family home) will be

treated like second-hand goods.

c) It would appear that the standard GST will apply to all property transactions irrespective of the trading structure or vehicle employed, e.g. whether freehold title, strata title, time share arrangements, property trusts or unitisation (KPMG, 1998, p6).

d) The sale of property trust units is likely to be treated as a financial arrangement under a GST, and thus input-taxed.

e) Where stamp duty is payable on residential property transactions, the stamp duty taxbase is expected to be grossed up on the GST inclusive price (KPMG, 1998, p6).

### **3.4 Likely Impacts on Rentals**

a) Commercial rent will be fully taxable under a GST. Commercial businesses will be able to claim input tax credits in regard to property maintenance, repairs, etc. (Tax Reform Package, 1998).

b) Residential rents will not be subject to a GST and no input tax credits may be gained. That is, a landlord cannot claim credits for GST paid on maintenance or other operating costs (Tax Reform Package, 1998).

c) Hotel and other short-term accommodation tariffs and rents apparently will be taxable. Accordingly, tax paid on inputs should be recoverable by owners. Nevertheless, the imposition of a GST on tourist accommodation and other services is of concern to the tourist industry, which is lobbying for relief. It should be pointed out that in New South Wales, the GST will replace the State-imposed bed tax, which is one of the State taxes to be removed in exchange for the GST receipts being directed to the States .



d) It would appear that where a landlord provides both residential and commercial accommodation, there is a need for attribution and/or apportionment of input taxes

between these activities.

e) Leases of car park spaces, sporting areas, conference and convention centres and storage facilities would appear to be GST taxable supplies.

f) Body corporate fees will be subject to GST. Accordingly, input tax credits on relevant expenditure may be claimed.

### **3.5 Likely Impacts on Government Services**

a) All three levels of the non-commercial activities of Government in Australia, viz. Federal, State and Local Government, will be GST-free. These are most Government services

b) The Tax Reform Package includes land tax and stamp duties as examples of taxes and charges which will not be subject to a GST. Local Government rates will not be subject to the GST.

c) The GST will not apply where Governments supply services free of charge.

d) However, the commercial activities of Governments of all levels will be taxable. All levels of Government will be able to claim input tax credits in regard to these activities.

### **3.6 Transitional Arrangements**

The general principle is that GST will apply to all goods delivered and services performed after the start date, viz., 1 July 2000 (Tax Reform Package, 1998). Hence, where a GST is applicable, only sale transactions occurring after this date and lease payments attributable to a period after this date will be subject to the GST.

It is not yet clear how various normally taxable transactions which straddle the implementation date will be treated, e.g. rentals payable in advance, lease premiums, leases with rent free periods, contracts extending past 1 July 2000 and construction and maintenance contracts covering periods before and after the implementation date.

It is emphasised that the parties to any contract which is entered into before mid-2000 should consider the impact of a GST. For construction and similar contracts extending beyond 1 July 2000, a valuation may need to be obtained as at the GST implementation date. This will be used to ascertain the part of

the contract which will not be subject to a GST, while the remaining part will be taxed. Full input tax credits will be available for any GST paid on construction inputs purchased after the implementation date.

The rebate scheme will apply where businesses hold inventories or trading stock, but not capital assets at 1 July 2000. Businesses will be allowed a credit equal to the wholesale sales tax (WST) paid on their stocks, to be offset against their GST liability.



### **3.7 Property Investment and Negative Gearing**

On balance, the impacts of the tax package on property investment are likely to be positive. Because of the income tax cuts, more individuals will be able to afford to enter into property and other investments, albeit financed by borrowing. That is, more negative gearing schemes are likely. The likely capping of the capital gains tax rate at 30 per cent will also encourage property investment.

However, for persons with taxable incomes below \$75,000, the benefits of the tax saving through negative gearing will be less, because of the lower income tax rates. Overall, the above positive incentive effects are expected to outweigh this reduced benefit. Hence, some increase in property investment is expected.

### **3.8 Impact on Trusts Including Listed Property Trusts**

The tax reform package envisages that trusts will be taxed as companies, probably at 30 per cent. This is likely to increase the costs of operating a trust as tax will need to be paid quarterly. Industry criticism has been levelled at the impact of this proposal on listed property trusts.

However, under the new system, all distributions will be franked and therefore will carry imputation credits. Further, the tax reform documents say that *"trusts ... (can) ... continue to realise the benefits of income splitting among beneficiaries."* With the threshold for the top marginal tax rate increasing to \$75,000, it is likely that new income splitting opportunities will arise (Your Money and the GST, p16).

On balance, it would appear that discretionary trusts and listed property trusts, with their flexibility and relatively low tax rate (30 per cent), along with the protection provided by the trust structure, could become even more widespread.

### **3.9 Unresolved**

Many issues remain unresolved. In particular, it is not yet clear:

- how construction contract retention monies will be treated (KPMG, 1998. p14);
- how advance rental payments for leases straddling 1 July 2000 will be treated;
- how insolvency and bad debts will be treated;
- how imported services will be treated; and
- whether residential land includes existing buildings attached to the land.

### **4 Will the Government's Tax Package be Implemented? And Will it Achieve its Claimed Benefits?**

The answers to these questions are that one must wait and see. However, several points and reservations to the outcomes claimed in the Government's package are expressed:

- a) The Federal Government may not have the Budget surplus it originally foreshadowed with which to fund the personal tax cuts. The surplus projections were predicated on annual growth of 3.5 per cent over the next two years. This could now be lower because of the

deepening of the Asian economic and financial crises and the flow-on effects of the recent economic upheaval in Russia and Latin America.

b) The political process to implement the GST has yet to be played out. Although the Howard Government has claimed a mandate to proceed with its tax package, following its re-election, the other political parties do not see it that way. It is highly probable that several key provisions of the package may be negotiated away, e.g. the tax on food, if the Government is to gain passage of its legislative package through the Senate.

c) Some of the price effects are dubious. The claimed addition of only 1.9 per cent to the CPI in the second year of the GST has been challenged by a number of observers. It is also likely that financial institutions, such as banks, which are unable to pass on the GST on their inputs, will lift bank charges. Moreover, official estimates of the effects of the GST on services, which have not been taxed in Australia before, are necessarily "*guesstimates*" (Clark, 1998, p 18).

d) The economic outworkings of the package may not be fully realised. For example, some people may spend their tax cuts, rather than save (most of) them. Moreover, if their spending is directed to overseas travel or imports, the tax cuts could flow through to a worsening of the current account deficit as well as lower national saving.

The liability for the GST will accrue irrespective of the trading vehicle or structure adopted. The GST will not apply to most Government services or taxes.

Transitional issues will need to be carefully examined by participants, especially where contracts straddle the proposed implementation date of the GST, viz., 1 July 2000. A range of unresolved issues remain. The housing industry is concerned about the targeting of the First Home Owners Scheme and the potential growth in informal work, while the imposition of a type of company tax on listed property trusts has attracted industry attention. But overall, the property industry has welcomed the package.

Because it lacks a majority in the Senate, and following the appointment of the Senate Select Committee on tax reform, the Howard's Government tax package is expected to be adopted in a modified form, with the emerging benefits likely to be lower than has been announced. Property transactions could be affected initially through expected price rises consequent upon the imposition of a GST, but the market is expected to benefit from the abolition of a range of State taxes and charges. In the longer term, some existing behavioural patterns are expected to change, which will flow through to industry activity including variations in the supply of and demand for building stock. New equilibria will be reached as the property industry adjusts to the tax reform package along with other influences upon activity, including global and domestic economic conditions and supply and demand imbalances of property stock.



Moreover, the cut in marginal tax rates may not provide enough incentive to encourage people to work harder, but may help them to indulge a preference for more leisure (Clark, 1998, p18). Again time will tell.

## **5 Summary and Conclusion**

The pre-election tax package announced by the Federal Government, if implemented, is

expected to enhance the overall equity of the taxation system as well as encouraging, at the margin, personal saving, investment and economic growth, along with stimulating moderate additional inflation effects. The efficiency of the tax system will be enhanced and simplified through the proposed abolition of a bevy of State taxes.

However, some of the Government's claims, whilst likely to be achieved in part, appear optimistic. In particular, the growth, saving and employment effects are likely to be lower than envisaged and the inflationary and current account deficit impacts a little higher.

Impacts on property markets are also uncertain. The GST will add to the cost of home construction, which has been recognised by the Government through its enhanced assistance to initial buyers through the First Home Owners Scheme. In the main, developers and other owners will pay GST on a range of activities associated with the construction and management of commercial buildings, but will be able to claim input tax credits. The final burden will be borne by the consumer.

Commercial rentals, along with hotel and other tourist accommodation, will be taxable under a GST, while residential rents will not. Accordingly, businesses will be able to claim input tax credits on

repairs etc. while a landlord will not. The tourist industry and other special interest and lobby groups are seeking more favourable treatment.

Leaseholds and body corporate fees will be subject to the GST. Only registered persons can sell land subject to a GST - the sale of land by private individuals and the sale of an existing family home will not be taxable. However, the sale of land for commercial development is likely to fall within the GST net, as will the sale of commercial buildings.

Property investment is expected to increase a little, with a significant proportion financed by negative gearing.

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