Australian Government

The Treasury

Regulation Impact Statement: Changes to the Wine Equalisation Tax Rebate

November 2016

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BACKGROUND

CONTEXT

The wine industry is an important contributor to the Australian economy, employing around 30,000 people directly and many more indirectly. Over 2,400 wineries and approximately 5,900 independent wine grape businesses operate in Australia, comprising mostly small operations located in rural and regional areas in all States and the Australian Capital Territory, but predominantly in South Australia, New South Wales and Victoria.

The wine equalisation tax (WET) came into effect in 1999 alongside the GST, replacing wholesale sales tax (WST). The rate of WET (29 per cent) was designed so that it would be equivalent to the WST rate of 41 per cent once GST was included.

The WET rebate was introduced in 2004 to provide wine producers a rebate of 29 per cent of the wholesale value of eligible domestic sales. The rebate cap was set at $290,000, later increased to $500,000 in 2006. The rebate was originally intended to support small wine producers in rural and regional Australia by offsetting their WET liabilities.

Prior to 2004, wine producers had access to a maximum rebate of $42,000 for cellar door and mail order sales under the Australian Government Cellar Door Rebate scheme.

Since the introduction of the WET rebate, two rebate specific integrity measures have been introduced, the associated producers provision and the earlier producer rebates provision.

The associated producers provision was introduced in 2004 and provides that if two or more producers are associated (where they act under the direction or control of one another), they can only claim the maximum rebate of $500,000 for a financial year as a group.

The earlier producer rebates provision was introduced in 2012 to ensure the rebate could not be claimed more than once on a single quantity of wine. The provision requires that, where a producer blends or further manufactures wine using wine bought from another producer, they must reduce the amount of rebate they claim by any earlier rebates the other producer is entitled to claim (whether or not the previous entitlement was actually claimed).

However, both measures have proved insufficient, as detailed below in Section 1.

In the 2016-17 Budget, the Government announced that it would reduce the WET rebate cap and introduce eligibility criteria to return the rebate to its original intent of supporting small wineries including in regional Australia. An interim RIS was prepared prior to the Budget decision.

Current operation of the WET and WET rebate

WET

All sales of wine in Australia attract the WET, which is applied at the rate of 29 per cent of the final wholesale price on domestic sales of both Australian and imported wine. In 2015-16 the WET accounted for $853 million in Commonwealth revenue.

As wine may be bought and sold many times throughout the production process, the WET is usually applied on the last wholesale sale of wine. The last wholesale sale of wine is typically to a retailer, such as a bottle shop, hotel or restaurant.

Producers are able to defer the payment of WET through a process called quoting. In general, quoting occurs when a GST registered purchaser of wine quotes their Australian Business Number to a supplier of wine, which allows a particular supply or sale of wine to be exempt from the WET. Quoting is also used to exempt WET in other circumstances, such as where the purchaser will export the wine.

WET Rebate

The WET rebate entitles all individual wine producers, regardless of business size, to a rebate of 29 per cent of the wholesale value of eligible domestic sales up to a maximum rebate of $500,000 each financial year. The maximum rebate amount also applies to a group of associated producers. The vast majority of claimants are small and medium size business. Roughly 3,000 producers claimed the WET rebate in 2014-15. Of these, 9 out of 10 producers claim less than $350,000 worth of rebate.

To be eligible for the WET rebate, an entity must be a producer of wine. The term producer is defined quite broadly under the current provisions to include entities that are registered or required to be registered for GST, and:

- Have manufactured wine; or
- Provided their produce to a contract winemaker to make wine on their behalf; or
- Have subjected purchased wine to a process of manufacture. This includes blending a distinct finished wine from two or more different wines and further manufacturing raw or unfinished wine (including stabilising, fining, filtering, secondary fermentation, maturation and racking to clarify the wine by removing unwanted solids).

In order to be eligible for the rebate, an entity must also be liable to pay WET on the wine or would have been liable to pay WET on the wine had the purchaser of wine not quoted for the sale of the wine.

New Zealand wine producers are also able to receive a rebate of 29 per cent of the approved selling price of wine in Australia. This is in accordance with Australia’s obligations under the Australia-New Zealand Closer Economic Relations Trade Agreement 1983.

1. THE PROBLEM

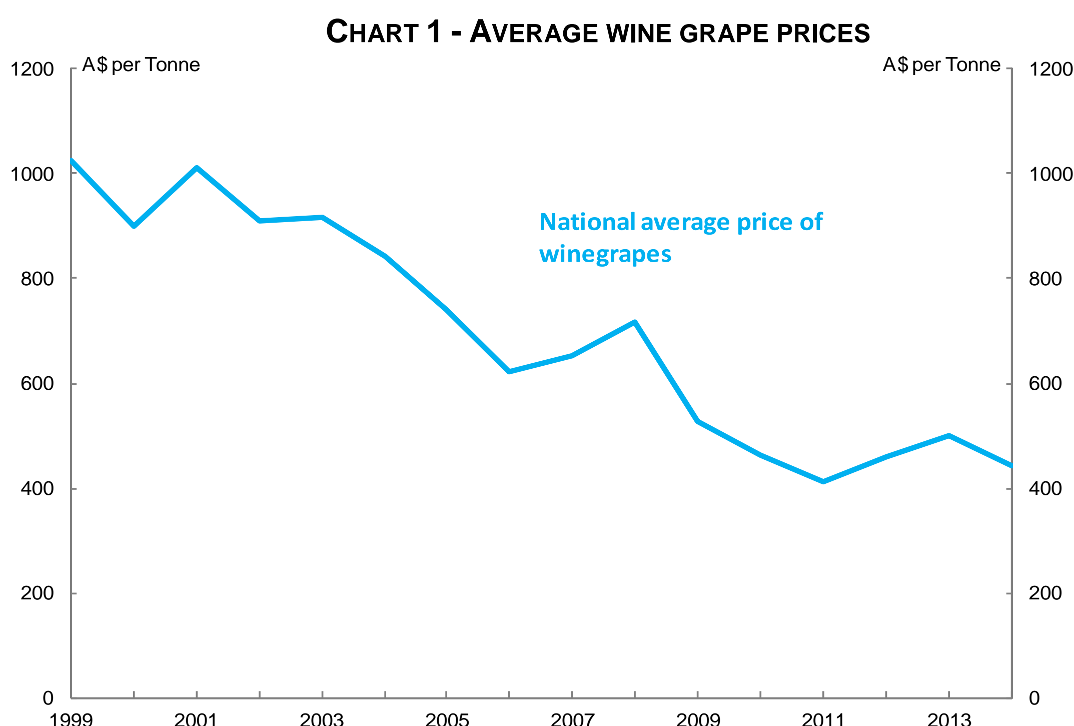
Reform of the WET rebate would better target the rebate, consistent with the original policy intent, and improve its integrity. The Government is seeking to address several integrity issues that have been identified with the rebate in its current form. The broad eligibility criteria and level of rebate currently in place has allowed unintended recipients to access the rebate and altered the behaviour of wine producers. This has contributed to economic distortions in the Australian wine market. These problems are examined in detail below.

1.1 MARKET DISTORTIONS

The WET rebate has distorted production in the wine industry, contributing to the increased supply of wine and wine grapes, and preventing necessary adjustments that would improve the long term strength of the industry. In 2014-15 tax expenditure on the rebate was $315 million against total gross WET payable of $1.1 billion. The total value of domestic wine sales was 2.7 billion[1].

The wine industry has faced a significant decline in prices since 1999 when the WET was introduced (Chart 1). Falling prices have put pressure on winemakers by reducing profits and threatening the economic viability of many producers.

CHART 1 - AVERAGE WINE GRAPE PRICES

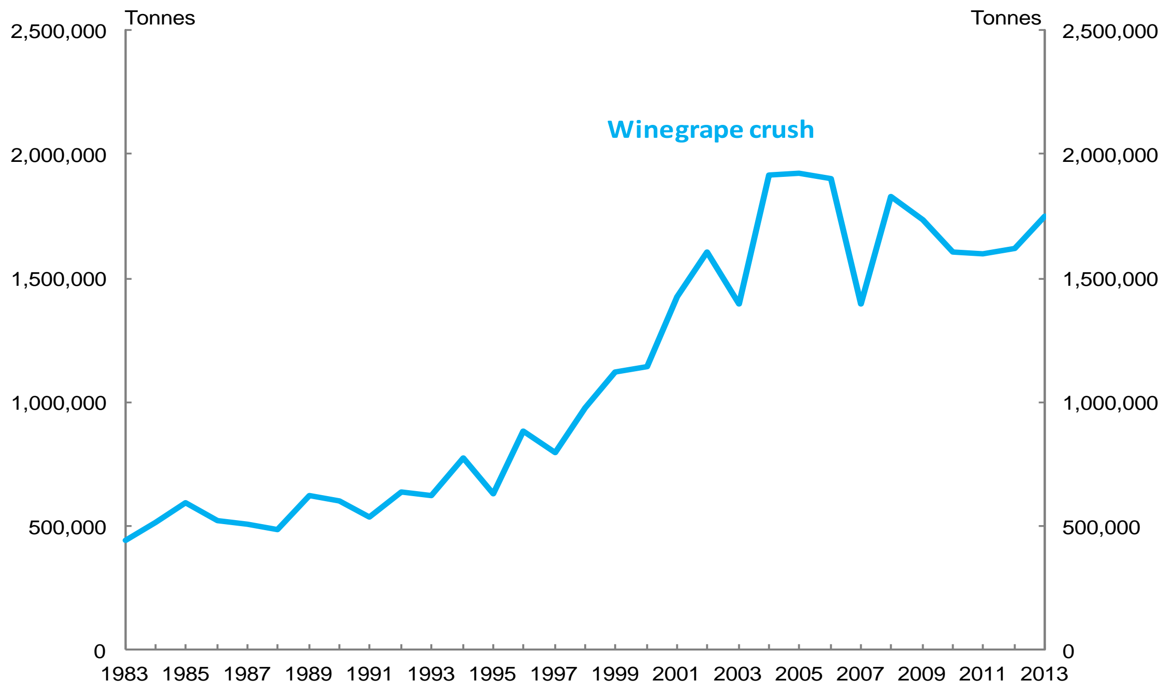


Source: Australian Grape and Wine Authority, Annual Price Dispersion Reports and Anderson K (2015) *Growth and Cycles in Australia's Wine Industry – A statistical compendium, 1843-2013*, University of Adelaide Press.

[1] Wine Australia website

In an efficient market supply is expected to decrease in response to falling prices as producers decrease production or, in some cases, exit the market. Instead, production (grape crush) has stayed approximately steady since 2006 (Chart 2).

CHART 2 - WINE GRAPE CRUSH



Evidence provided to the 2016 Senate Inquiry into the Australian grape and wine industry suggests a supply-demand imbalance in the wine industry has existed since at least 2005-2006[2]. Since 2009 this imbalance has been further exacerbated by a variety of factors, including an increase in the value of the Australian dollar, falling international demand, and competition with new low cost producers. By 2009, Australia was producing 20–40 million cases a year more wine than it was selling[3].

The WET rebate contributes to the additional supply problem outlined above by allowing uneconomic producers to remain in the industry, dis-incentivising consolidation to improve profitability and encouraging the production of bulk wine. The precise magnitude of the WET rebate's contribution to the supply problem is difficult to estimate due to the complexity and number of factors involved. However, Treasury's qualitative assessment of its impact suggests it is significant. This view was supported by a number of large industry stakeholders, both through submissions to the Senate inquiry on the Australian grape and wine industry and through numerous consultations conducted by Treasury. For example, the Riverina Wine Grape Marketing Board expressed a view that 'the WET rebate is subsidising cheap wine in the market' and that 'once we get

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[2] Senate Inquiry into the Australian grape and wine industry, Senate Rural and Regional Affairs and Transport References Committee, February 2016, pg.6
[3] Ibid. pg.6

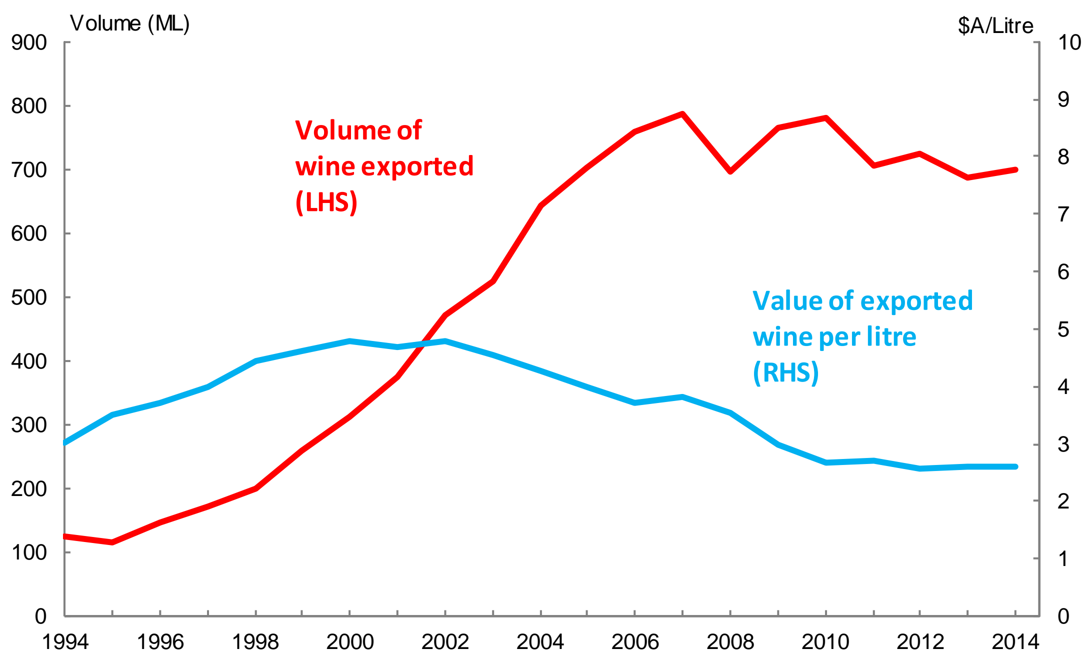
that subsidy out of the way, wine should return to its correct value[4].' Treasury Wine Estates also told the senate committee that current 'wine tax arrangements actively distort the market, preventing necessary restructuring and sustaining structural oversupply'[5].

Encouraging the production of bulk wine

The high level of the WET rebate encourages producers to turn what would otherwise be uncommercial grapes into bulk wine for the purpose of claiming the rebate. This bulk wine competes with branded products, in both the domestic and export markets, lowering the price producers receive.

The majority of industry stakeholders have expressed the view that the Australian industry is best served by focusing on the premium wine market and cultivating a reputation for quality. Some stakeholders take the view that the additional supply of bulk wine at low prices in overseas markets has harmed the international brand image of Australian wine. Chart 3 shows that the value of exported wine has fallen as volume has increased.

Chart 3 - Wine exports – Volume and value per litre



Source: Wine Australia, December 2014, *Wine Export Approval Report*. Accessed through Winetitles (2015) *Australian and New Zealand Wine Industry.*

[4] Ibid pg. 21
[5] Ibid pg. 20

PREVENTING THE EXIT OF UNECONOMIC PRODUCERS

Evidence provided to the Senate Inquiry estimated that a large segment of wine producers were operating below the cost of production. The Inquiry outlined that by 2014, an estimated 84 per cent of producers were not covering their variable costs, up from 77 per cent in 2016. The Wine Federation of Australia estimated that up to 70 per cent of Australian wine grape production may be uneconomic[7]. Without access to the rebate some of these businesses would exit the industry, reducing supply and creating a more sustainable environment for the producers remaining in the market. The WET rebate counteracts this market correction by allowing otherwise uneconomic producers to remain viable.

DISCOURAGING INDUSTRY CONSOLIDATION

In some cases consolidation of wine businesses could increase profitability by lowering costs and providing useful synergies. The rebate discourages this behaviour as consolidation can significantly reduce access to the rebate. If for instance two entities were claiming the maximum allowable rebate under the cap, the new consolidated entity would lose access to $500,000 worth of rebate. While the rebate is intended to benefit small producers it also needs to support small businesses to grow, increase their efficiency and make prudent business decisions without distortion from the WET rebate. In aggregate, the current level of the cap is resulting in a less profitable, less efficient industry than would otherwise be the case. The WET rebate cap could be lowered to reduce this distortion while still benefiting small producers given around nine out of ten wine producers currently claim less than $350,000 in rebate.

1.2 INTEGRITY ISSUES

The broad eligibility of the rebate and high cap of $500,000 incentivises producers to enter into structures to improperly access the rebate beyond its original policy intent. Eligibility for the rebate, as currently defined, includes grape growers who contract out the winemaking process, entities that blend wines, producers of bulk and unbranded wine and 'speculators' who trade in wine to access the rebate. A number of these structures and unintended consequences are detailed below.

GROWERS BECOMING 'PRODUCERS' TO CLAIM THE REBATE

Industry stakeholders have indicated there has been a trend of wineries purchasing bulk wine from grape growers instead of purchasing grapes to make wine. This effectively enables wine grape growers to become wine producers and entitles them to claim the WET rebate on the wine sold to the winery. The winery is then able to purchase the wine at a subsidised, rebate inclusive price.

[6] Senate Inquiry into the Australian grape and wine industry, Senate Rural and Regional Affairs and Transport References Committee, February 2016, pg.7
[7] Ibid.

This transfers the benefit of the rebate to large producers at the end of the supply chain (such as large wine producers and major retailers) rather than grape growers or small wine producers, contrary to the policy intent of the rebate.

Blending and further manufacture

Producers can claim more than one rebate on a given parcel of wine through blending and further manufacture. To do so, producers undertake blending or further manufacture of wine, often by creating business arrangements involving additional interposed entities, solely so that the rebate can be claimed multiple times on the same wine. These arrangements can be structured to circumvent changes in the law in 2012 that were intended to prevent multiple rebate claims on the same wine.[8]

Producers accessing multiple rebates

Large producers can break down their winemaking business into multiple entities to circumvent the $500,000 cap and obtain access to multiple rebates.

An associated producers provision was introduced in 2004 to combat this behaviour. However, wine producers are still able to structure their affairs so they are not captured by the provision and the current rules are complex and time consuming in their application. The current law stipulates that an association can only be determined at year end, thereby making real-time compliance action difficult.

'Speculators'

'Speculators' is a term used by some stakeholders to describe those producers that enter the wine industry for the sole purpose of accessing the rebate. They have no involvement in the winemaking process and they do not have investment in the wine industry.

Wine Exports benefiting from the rebate

The WET rebate is intended to be paid only on wine for domestic sale, since exported wine is not subject to the WET. However, current rules allow producers to make WET declarations based on the intent of where the wine will be sold. This allows some producers to purchase wine slated for domestic sale and redirect it for export while still claiming the rebate.

Does not target small producers as intended

The WET rebate was intended to assist small wine producers. However, the cap limit has been set well above the level that most producers claim, principally benefiting large producers. While all producers can claim the rebate less than 1 out of 10 producers claim above $350,000. Producers claiming over $350,000 worth of rebate represent over 50 per cent of the value of all claims.

[8] Changes were made by the Tax Laws Amendment (2012 Measures No. 5) Act 2012.

2. THE CASE FOR GOVERNMENT ACTION

The objective of the WET rebate is to benefit small wine producers who are making a genuine investment in the wine industry, many of whom are in rural and regional Australia. Small wine makers are important sources of economic activity and employment in their regions. They are less well equipped to manage the risks of external factors such as climate and disease compared to larger winemakers, which are able to utilise a diverse range of locations. The WET rebate assists small wine makers and delivers benefits to their communities.

However, as detailed above, the rebate has led to business structuring to maximise rebate claims and has contributed to increasing the supply of wine and wine grapes, exacerbating challenging market conditions. Reform of the WET rebate would improve its integrity and better target the rebate, consistent with the original policy intent.

3. POLICY OPTIONS

3.1. SUMMARY OF THE RECOMMENDED OPTIONS

In light of consultation with the wine industry the following options were considered to achieve the Government's objectives:

- Option 1: No change (current system): Under this option, no action would be taken by the Government and the existing legislation would continue.
- Option 2: Reduce the WET rebate cap to $350,000 on 1 July 2018 and tighten eligibility criteria. The eligibility criteria would cover packaging, branding and ownership requirements. Additional integrity measures would also be given to the ATO to monitor and enforce compliance.
- Option 3: Reduce the rebate cap to $290,000 by 1 July 2018 and tighten eligibility criteria. The eligibility criteria would cover packaging and branding requirements, as in Option 2. An additional asset test would apply requiring producers to own or have long term lease of a winery in order to be eligible for the rebate. Additional integrity measures would also be given to the ATO to monitor and enforce compliance.

3.2. DETAILED DISCUSSION OF THE OPTIONS

Option 1: No change

This option involves no new actions by the Government and relies on the existing law. Consequently, it would introduce no new impacts on businesses, community organisations or individuals. At the same time, it would not address the issues identified in Section 1: *The Problem*.

Option 2 (proposed): Reduce the rebate cap and tighten eligibility criteria using an ownership test

This option involves introducing new eligibility criteria which would amend the definition of an 'eligible producer' and 'rebatable wine'.

The definition of rebatable wine would be amended to require wine be packaged in a container not exceeding 5 litres in a form fit for retail sale. Wine would also have to be branded with a wine producer's registered trademark. Licenced trademarks would be excluded and common law trademarks would be allowed only by exception. There was strong support among stakeholders for these changes.

The definition of eligible producer would also be changed to include the requirement that 85 per cent of the rebatable wine must have been owned throughout the wine making process. This requirement would demonstrate that producers have a long term investment in the industry and the products they sell. The 85 per cent rule would allow wine producers to blend a modest amount of wine into their products from other sources. This allows producers some flexibility to deal with poor harvests or other issues with their grape supply. This definition was largely supported by industry, though some stakeholders suggested a lower percentage requirement, such as 75 per cent.

The tightened eligibility criteria would be introduced 1 July 2018. This will minimise compliance costs by allowing time for wine producers to adjust their production to meet the new requirements.

Additional integrity measures would also be implemented to allow the ATO to monitor and enforce compliance. The first measure would better link the WET rebate payment with the payment of WET liability. Current rules allow producers to make WET declarations based on the intent of where the wine will be sold by the purchaser. This allows entities to purchase wine, indicate they intend to sell it domestically to allow the producer to claim the rebate, but then redirect it. This includes redirecting the wine for export (where no WET is paid) or blending the wine to claim the rebate again on the same parcel of wine. The updated rules would require purchasers to pay the WET on their next dealing of the wine in order for producers to claim the rebate. This would ensure the rebate on is only paid when a WET payment is made to the ATO by either the producer or another entity their wine has been sold to.

The second measure would improve the associated producer provision. The current provision aims to prevent entities artificially splitting themselves to claim multiple rebates. It is designed such that if two or more producers are associated (they act under the direction or control of one another), they can only claim the maximum rebate of $500,000 for a financial year as a group. The current law stipulates that an association can only be determined at year end, thereby making real-time compliance action difficult. The update would allow the ATO to monitor and enforce this law in real time. Stakeholders were supportive of additional measures that would give the ATO greater power to monitor and enforce the integrity of the rebate.

To better target assistance to small producers, the WET rebate cap would be reduced to $350,000 from 1 July 2018. Stakeholders were spilt on the merits of a cap reduction, with some suggesting the rebate provides important support to winemakers and their communities. However, a number of producers were also strongly in favour of reducing the cap to reduce the market distortions it causes. Less than 1 out of 10 producers claim above the $350,000 threshold, meaning the cap reduction would largely not affect the small wine producers who are the intended recipients of the rebate.

Option 3 (Budget announcement): Reduce the rebate cap and tighten eligibility criteria using an asset ownership test

The WET rebate cap would be reduced to $350,000 from 1 July 2017, followed by a reduction to $290,000 from 1 July 2018. This would be a larger reduction than option 2 and would occur sooner. The earlier timing of the cap reduction would give stakeholders less time to adjust to the lower cap.

Option 3 would adopt the packaging and branding requirements of option 2 but would introduce an alternative definition of eligible producer, requiring producers to own specified assets in order to access the rebate.

This option would require producers to own or have a long term lease on a winery to access the rebate. The intent of this approach is to ensure that producers accessing the rebate have a stake in the wine industry and have made an investment which benefits their community and region.

Stakeholders and pointed to a number of problems with this approach. The first is the existence of a variety of production models in the industry. Many producers, for example, contract out the production of grapes to a winemaking facility. New entrants to the industry generally do not possess physical assets but were acknowledged as an important source of innovation in the industry. An assets test would unfairly exclude some producers who have a legitimate stake in the industry.

A further problem would be incentivising overcapitalisation by producers. If an assets test was introduced there would be an incentive for producers to invest in physical assets where that may not otherwise be beneficial to their business. Driving producers to invest in more capital would be against an industry trend to specialise and maximise efficiency.

The final problem with an assets test is definition and enforcement. It would be difficult to fairly define a ‘winery’’. Monitoring and enforcing an assets test would also be time consuming and difficult for the ATO. These problems would apply equally to other asset tests, such as requiring producers to own a vineyard or cellar door.

As in option 2, the same associated producer measure would be implemented to allow the ATO to better monitor and enforce compliance.

4. IMPACT ANALYSIS

The proposed changes to the rebate seek to restore it to its original intent to support small wine makers in regional areas.

The changes would better target the rebate to small wine producers many of whom are in rural and regional Australia and improve efficiency for wine grape and wine markets in the long run, strengthening the prospects of the wine industry.

Community organisations and individuals are unlikely to be significantly affected by these reforms.

4.1 IMPACT ON INDUSTRY

OPTION 2

Reducing the cap and strengthening eligibility criteria would reduce market distortions in the wine industry.

As discussed in section 2, the WET rebate contributes to increasing supply in the Australian wine market by encouraging the production of bulk wine, and allowing uneconomic producers to remain in the market.

With a reduction in the cap, producers will reach the point where marginal production does not benefit from the rebate at lower volumes. Where this marginal production becomes unprofitable without the rebate, producers will reduce their volumes. In particular, this change would make the production of bulk wine less attractive.

The result would be a lower, more sustainable level of supply for the industry. The reduction of bulk wine volumes would also benefit the market for premium wine and the industry's aspiration of maintaining and further developing a reputation for quality in international markets.

A cap reduction would reduce the dis-incentive against entities consolidating, as the loss of access to the cap is less valuable. This is expected to improve the efficiency of the industry in the long term.

The cap reduction would also deliver increased revenue to the budget.

Both lowering the cap and introducing tightened eligibility criteria will make the rebate less attractive for contrived arrangements and artificial structuring. In particular, it will reduce practices aimed at claiming the rebate multiple times and will ensure the rebate is better targeted to its intended recipients. The new eligibility criteria are designed to directly combat the integrity issues identified in section 2.

Under the new eligibility criteria producers would need to own their grapes throughout the winemaking process. Bulk growers would no longer be able to access the rebate unless they produce their own appropriately packaged and branded wine. This would prevent arrangements where the benefits of the rebate is transferred from small producers to large producers that benefit from the rebate through lower prices on their bulk wine purchases.

Multiple rebate claims on the same wine would be reduced both through the new eligibility criteria and the new measure to better link the WET rebate payment with the payment of WET liability. These changes would target the rebate to legitimate producers and reduce the incentive to produce bulk wine.

Under the new eligibility criteria, package size would be limited to 5 litres, which would make the physical process of buying wine, blending it and repackaging more expensive. As producers would also have to own the wine throughout the process, blending wines purchased from other producers would not qualify a producer to receive the rebate. Further, under the measure to better link the WET rebate payment with the payment of WET liability, the rebate would only be paid when a WET payment is made to the ATO by either the producer or another entity their wine has been sold to. If

a producer attempted to blend wine and re-sell it to claim the rebate the ATO would have visibility of the transitions and be able to penalise any improper claims.

The new measure to better link the WET rebate payment with the payment of WET liability would help prevent claims being made on wine which is eventually exported. Under the new rule, if an entity attempted to purchase wine from a producer that has claimed the rebate and exports the wine without notifying the producer the purchaser will incur a penalty from the ATO. If the producer is correctly notified they would lose access to the rebate, preventing WET rebate claims on exported wine.

Eligibility requirements would stop 'speculators' accessing the rebate and better target it to its intended recipients. The requirement to own the wine throughout the winemaking process increases the time between a 'speculator's' initial investment and their return, preventing transactions to quickly buy and sell wine to access the rebate. This will ensure that producers who access the rebate have substantial investment in the winemaking industry.

Lowering the cap would better target the rebate to smaller wineries as originally intended. Smaller wineries would be unaffected by the reduction in the cap as around nine out of ten WET refund claimants claim less than $350,000.

The reduction in the cap may have a small negative economic impact on non-premium producing wine regions. For example, modelling by Anderson of moving to a $150,000 cap found small, short run decreases in GDP and employment in affected regions[9]. Some wine producers would be expected to downsize their production or exit the market.

The changes to the eligibility criteria would have a low compliance cost impact. There would be no additional reporting requirements for the requirement to own 85 per cent of rebatable wine through the winemaking process. The 85 per cent figure aligns with the current reporting requirements for the label integrity program. Under this program, wine producers already keep records (e.g. weighbridge documents, grape crush data, purchase and processing invoices and agreements) to establish their ownership of 85 per cent of the grapes used in their production.

There is expected to be a low compliance cost impact associated with education and learning as wine producers would need to be informed of the changes. This is expected to be relatively straightforward and potentially part of the routine existing update processes. The new eligibility criteria would apply from 1 July 2018. This would minimise compliance costs by allowing time for wine producers to meet the new requirements.

There is expected to be a low compliance cost impact related to evaluation and planning. Taxpayers may undertake evaluation and planning to better understand the implications of this change on their business activities (consideration may be given to production decisions in light of the grandfathering provisions).

[9] K. Anderson and G. Wittwer, *Australia's Wine Equalisation Tax (WET): Impacts of Reforming its Rebate Scheme*, September 2015.

There is expected to be a low ongoing compliance cost associated with the requirement for purchasers to notify producers if the WET will not be paid on their next dealing of the purchased wine.

The aggregate compliance cost impact over ten years is estimated to be $1,350,000. This is $135,000 per year over 10 years. For all reporting periods, the Treasury portfolio has reported net compliance cost reductions and there is no reason why the portfolio will not continue to deliver on its red tape reduction targets this year, in line with the Government's regulatory reform agenda.

Table 1: Regulatory burden estimate

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$ .135	-	-	$.135

OPTION 3

Some of components of option 3 are the same as option 2, including the packaging and branding requirements and the associated producer provision. For these components the impact on industry would be the same as option 2, described above. This section will analyse the impact of lowering the cap to $290,000 and using an assets test to determine eligible producers in addition to those impacts.

As described in option 2 a reduction in the size of the cap would result would be a lower, more sustainable level of supply for the industry. As the cap reduction is larger it would be expected to reduce supply by a larger magnitude and deliver greater revenue savings than option 2. Smaller wineries would be unaffected by the reduction in the cap as around nine out of ten WET refund claimants claim less than $290,000.

The earlier timing of the cap reduction under Option 3 would give less time for producers to adapt to the change.

Under the eligibility criteria of option 3 producers would be required to own or lease a winery. This would result in a number of small wine producers losing access to the rebate as many producers contract out the production of grapes to a winemaking facility. It would also discourage new entrants to the industry by creating a high barrier to entry due to the requirement to purchase or lease expensive physical assets. This would reduce an important source of innovation and growth in the industry.

The requirement to own or lease a winery would also incentivise overcapitalisation by producers. If an assets test was introduced there would be an incentive for producers to invest in physical assets where that may not otherwise be beneficial to their business. Driving producers to invest in more capital would reduce specialisation, efficiency and drive lower return on investment in the sector.

As with option 2 there is expected to be a low compliance cost impact associated with education and learning as wine producers would need to be informed of the changes. This is expected to be relatively straightforward and potentially part of the routine existing update processes.

There is expected to be a low compliance cost impact related to evaluation and planning, although this cost is higher than option 2 given the larger decrease in the cap. Taxpayers may undertake evaluation and planning to better understand the implications of this change on their business activities. There would be no changes to ongoing compliance cost.

The aggregate compliance cost impact over ten years is estimated to be $300,000. This is $30,000 per year over 10 years.

Table 2: Regulatory burden estimate

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$ 0.03	-	-	$0.03

5. CONSULTATION

The Government has undertaken extensive consultation on the WET rebate including two formal public consultation processes led by Treasury, ongoing targeted consultation, and significant Ministerial engagement.

On 21 August 2015, the Government released the WET Rebate Discussion Paper for public consultation and announced the formation of the WET Rebate Consultative Group to consider submissions and provide advice to Government on possible options for reform.

Submissions to the discussion paper generally agreed that changes needed to be made to the rebate to ensure it was properly targeted. Opinions on the change to the cap were mixed; some stakeholder submitted that the rebate should be significantly reduced and eventually phased out, while others advocated retaining the current $500,000 cap and tightening the eligibility criteria.

The Consultative Group included the Winemakers' Federation of Australia (WFA) and a number of WFA members. The group agreed that the current use of the rebate has led to unsustainable outcomes in the industry and reform of the rebate is warranted to return the rebate to its original policy intent.

The Consultative Group's key recommendations were:

- Leave the cap unchanged at $500,000.
- Amend definitions of 'producer' and 'eligible wine' to better target the rebate.
- Introduce specific anti-avoidance provisions into the WET act.
- Provide transitional assistance to the industry.

The Government released an implementation paper on the eligibility criteria announced in the 2016-17 Budget, on 2 September 2016 to invite views from industry. Submissions to the paper formally closed on 7 October 2016. This consultation process was focused on implementing the eligibility criteria announced in the Budget.

In-person consultation sessions to discuss the changes to the rebate were also held from 20 September to 29 September 2016. The sessions were held in Melbourne, Hobart, Sydney, Perth and Adelaide.

While a wide range of views were expressed by stakeholder there were several broader themes. In general:

- The industry agreed there is a problem with artificial structuring and the integrity of the system and wants the rebate to return to its original policy intent of supporting small wine producers.
- The industry agreed there should be changes to the eligibility criteria and that bulk and unbranded wine should not have access to the rebate.
- The industry supported the Government's decision to limit the rebate to packaged, branded wine for domestic sale.
- The industry preferred an alternative definition of 'eligible producers' from what was announced in the Budget. Rather than requiring producers to own or lease a winery they suggested an alternative test which would require a producer to own the grapes throughout the winemaking process.
- Views on the cap reduction were mixed. Medium size producers that would be affected by the cap reduction did not support the reduction. Several large stakeholders support the cap reduction, as they consider changing the eligibility criteria by itself will not stop artificial structuring to access the rebate.

The Rural and Regional Affairs and Transport Reference Committee also conducted an inquiry into the Australian grape and wine industry. The report was released on February 2016. The inquiry recommended that the WET rebate be phased out over five years and replaced with a grant to cellar door operators.

Consultation was undertaken with industry on the draft legislation to assist with the implementation of the measure.

The draft legislation was released for exposure from 5 April to 28 April 2017. 17 submissions were received. Several discussions were held with the Winemakers' Federation of Australia to discuss the technical implementation issues.

The technical changes made to the legislation following consultation included:

- amending the 85 per cent ownership test by excluding certain products (e.g. additives and fortifying spirit) from the 15 per cent allowance.

- changing the timing of when the ownership of source product test is met from immediately after crushing to before crushing.
- amending the trademark requirements to allow trademarks owned by an associated producer of the entity claiming the rebate, and by expanding the types of trademarks that would meet the test.
- amending the application provision to provide appropriate transition periods for wine and fortified wine sourced from the 2017 and previous vintages, and existing fortified wine stored in tanks and barrels.

6. CONCLUSION

Three options were considered in the context of reforms to WET rebate. These were:

- Option 1: maintaining the status quo;
- Option 2: Reduce the rebate cap and tighten eligibility criteria using an ownership test; and
- Option 3: Reduce the rebate cap and tighten eligibility criteria using an asset ownership test

Option 1, maintaining the status quo would have no net benefit, and would leave unresolved a number of issues caused by the current scheme. Issues with the current scheme include market distortions and supply issues, artificial structuring, and that that the scheme is poorly targeted to its intended recipients. Rather than benefiting small wine producers in regional Australia as originally intended the rebate often benefits large producers and producers without real investment in the Australian wine industry. Reform is needed to return the WET to its original policy intent to support small wine producers in regional areas. Supporting these producers will continue to deliver economic benefits to their local regions.

Two options were considered to reform the rebate: Option 2 and Option 3. Both options seek to address the two main problems outlined in section 2: market distortion and integrity issues.

Both reform options include changes to eligibility criteria which would combat artificial business structuring and better target the rebate to its intended recipients. Option 3 uses an asset test to determine eligibility while Option 2 uses a wine ownership test. The eligibility criteria in option 2 is assessed as having a higher net benefit because it better targets the rebate to small wine producers in regional Australia, while still reducing artificial structuring and market distortions. The assets test in Option 3 would incentivise businesses to purchase physical assets, resulting in overcapitalisation, while also excluding legitimate producers. It would create a barrier to entry for producers looking to enter the market, depriving the industry of new sources of growth and innovation. Finally, it would be far more difficult to monitor and enforce compared to Option 2.

Both options would lower the rebate cap, reducing the incentive to engage in artificial structuring, while also reducing market distortions and improving the long term health of the Australian wine industry. The cap reduction in both cases is accessed as having a significant net benefit. Without a

cap reduction the rebate would be less targeted to smaller producers and there would remain a significant incentive for entities to find new ways to game the system, even with the new eligibility criteria. A cap reduction would address the market distortions that have led to supply problems in the wine and grape market as it reduces the incentive to supply otherwise uncommercial grapes and encourages greater efficiency.

Option 2 would lower the cap to $350,000 by 1 July 2018, while Option 3 would lower it to $350,000 on 1 July 2017, followed by a further reduction to $290,000 on 1 July 2018. The earlier timing of the reduction under Option 3 would give less time for producers to adapt to the change. Option 2 provides a greater transition period for industry.

Both options include improvements to ATO integrity measures. These integrity measures would stop erosions of revenue to producers which are acting contrary to the intent of the rebate. Option 2 includes an additional integrity measure which would better link the WET rebate to the payment of the WET liability. As Option 2 includes this additional measure it would more effectively protect government revenue and improve the integrity of the system.

The option with the highest net benefit is one which applies the eligibility criteria in Option 2 combined with a significant cap reduction.

7. Implementation and evaluation

Legislation is required to implement the proposed reduction in the cap and to implement the new eligibility criteria.

The ATO would be responsible for administering the tax rules. The ATO will monitor compliance and will advise Treasury if any problems are identified so remedial action, if appropriate, can be considered.