

BUDGET UPDATE

2010/2011 Federal Budget

COMMENTARY

The Treasurer handed down his third budget and was, no doubt, able to reflect that twelve months is a long time in politics and is also a long time in terms of the state of the economy.

The headline statistics illustrate an improving economy, with the forecast deficit for 2010/11 at \$40.8 billion being \$16.3 billion less than the forecast from last year's budget.

Mr Swan has forecast a return to budget surplus by 2013 which is three years ahead of schedule. Real GDP growth of 3.25% has been forecast for 2010/11 with 4% forecast for 2011/12. The anticipated unemployment rate is 5.3% over the next twelve months and 4.75% in 2011/12.

From a tax perspective, this year's budget is probably most noticeable for the lack of tax nasties than it is for announcing any significant tax measures. The key tax measures had previously been announced, at least in concept, in the Government's response to the Henry Report issued last week.

The key elements from a personal income tax point of view are the promised tax cuts from 1 July 2010, the introduction of a standard dollar limit deduction for personal tax returns and the introduction of a 50% discount on the first \$1,000 of interest income starting from 1 July 2011.

Overall, there is very little in the Budget for the average business. Apart from the resources super profits tax, the key measure for business is the reduction in the corporate tax rate from 30% to 28%. However, it is worth bearing in mind that this does not phase in until the 2013 financial year for small businesses and 2014 for other businesses.

The Government did announce several changes arising from the Johnson Report. These are designed to establish Australia as a financial services hub and are directed towards eliminating interest withholding tax and changing the rules to managed investment schemes to encourage international investment.

In terms of expenditure matters, the Government has gone to great lengths to be regarded as fiscally responsible and Wayne Swan said that this was not a big spending budget. The key expenditure measures relate to health, the development of infrastructure and renewable energy. The Government has committed \$2.2 billion to various health initiatives, \$6.52 billion to a Renewable Energy Future Fund and \$1 billion to rail infrastructure. This latter amount is in addition to amounts to be allocated to infrastructure from the resources super profit tax.

The Government's commitment to tax reform is still in question. We have already commented on the lack of response to most of the Henry recommendations. The Government has now announced it will provide \$65M over four years to Treasury to develop and implement the Government's response to the Henry recommendations. Many of us thought this had already occurred.

BUSINESS TAXATION

Tax Consolidation

The Budget Papers contain 4 technical tax consolidation measures. These are:

- The announced start dates of various measures in the Treasurer's press release of 13 May 2008 will be modified to ensure that no consolidated group is disadvantaged.
- Non-membership equity interests issued by an entity that joins or leaves a consolidated group will be taken into account under the tax cost setting rules with effect from 10 February 2010 with the option to apply the measure from 1 July 2002. Broadly, non-membership equity interests are interests that are neither membership interests for tax consolidation purposes nor liabilities for accounting purposes, e.g. convertible notes.
- Amendments to the rules relating to the calculation and collection of income tax liabilities from

consolidated groups and multiple entry consolidated ('MEC') groups. These include an amendment to ensure that an entity in a tax sharing agreement can leave a consolidated group or MEC group clear from any further liability. In most cases, these measures will simply confirm existing practice.

- A number of other technical deficiencies have been addressed. These include simplifying the approach to making various consolidation choices and, in particular, ensuring that a choice to form a consolidated group remains effective despite a defect in the notice to advise the Commissioner of Taxation of the choice.

Most of these measures have previously been addressed by the Tax Laws Amendment (2010 Measures No. 1) Bill, which is currently before the Senate.

Look-through CGT treatment for earnout arrangements

Earnout arrangements are often included as part of business or asset sales and acquisitions, whereby the agreed sale/purchase price varies depending on the future performance of the business. Since 17 October 2007 when the ATO issued a Draft Ruling in relation to the CGT treatment of earnout entitlements and obligations there has been uncertainty about the correct CGT treatment.

Broadly, earnout rights are treated as separate CGT assets, a treatment which can result in anomalous outcomes for taxpayers where the actual payments under the earnout right differ from the amounts estimated at the time of the sale agreement. For example, because the earnout right of the vendor of a business is not an active asset, any gain made (because the amount received is greater than originally estimated) would not qualify for small business CGT relief. On the purchaser side, the earnout obligation may not qualify as part of the cost base of the acquired assets.

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The Government announced in the Budget that payments under a "qualifying earnout arrangement" will be treated as relating to the underlying business assets. This treatment should result in equitable CGT outcomes for both buyers and sellers party to earnout agreements. The new rules will apply from the date of Royal Assent, with transitional provisions available in certain cases from 17 October 2007.

Extension of CGT demerger relief for certain demerger groups

The purpose of the demerger relief provisions is to disregard capital gains and losses which arise on certain group restructures where the economic ownership of the restructured group remains the same.

The current rules prevent groups from accessing rollover relief where either a corporation sole (a corporation consisting of one natural person only and that person's successors to that position e.g. such as a bishop or Minister) or complying superannuation entity is the head entity of the restructured group.

The Government will amend the CGT demerger provisions to remove this defect in the law by allowing another entity in the restructured group to be the head entity. This will be achieved through excluding the corporation sole or complying superannuation entity from being a member of the restructured group.

This measure is intended to make it possible for a wider range of business restructures to result by expanding the scope of entities that can benefit from the demerger rollover relief.

The measure will apply to CGT events happening after 7.30pm on 11 May 2010. The Government has released a consultation paper on proposed amendments.

ATO compliance program

The Government will provide an additional \$108 million over 4 years to the ATO to assist with data matching programs aimed

at small businesses operating in the cash economy.

Broaden access to Capital Gains Tax rollovers

The Government has announced that it will introduce changes to the CGT rollover provisions to make it easier for Australian investors to access a rollover when they have received new interests in an entity as a result of a restructure in circumstances where there are also foreign equity investors. These restructures often involve the issue of equity to an agent or nominee on behalf of the foreign investors.

Currently, in order to meet the requirements of such rollovers ownership proportions of all equity owners in the old entity must be maintained in the new entity. This requirement cannot be satisfied in respect of foreign investors if the new interests are issued to an agent or nominee as described above.

The proposed changes will aim to disregard those interests to determine whether ownership proportions have been maintained and will apply to CGT events which happen after 7.30pm on 11 May 2010.

Tax Running Balance Account Provisions

The Government aims to simplify, improve and enhance the flexibility of the running balance accounts and provide for interest to be paid to taxpayers where overpayments arise because of an amended franking deficit tax assessment.

The detail of these amendments is not yet known and will be decided by public consultation.

Australia as a financial services centre

As part of its commitment to position Australia as a leading financial services centre, the Government established the Australian Financial Centre Forum in September 2008. On 15 January 2010, the Forum's Report (the Johnson Report)

was released and contained 19 recommendations.

The Government's response provides in principle support or direct support to all but one of the 19 recommendations. The Government has already acted to phase down interest withholding tax paid by Australian financial institutions (refer detail below).

Some of the other recommendations that the Government supports include:

- The introduction of an investment manager regime to ensure that non-residents investing in offshore assets will not face further Australian tax on their investments when using Australian intermediaries;
- Providing tax flow through treatment for a broader range of investment vehicles;
- The establishment of a task force to monitor progress on implementation of those tax recommendations in the Johnson Report that are accepted by the Government;
- Regulatory changes aimed at avoiding unnecessary regulation and reducing regulatory requirements;
- Development of an Asian regional funds passport where regional governments and agencies work together to develop a commonly agreed set of licensing agreements, investment restrictions and administration mechanisms; and
- The establishment of a task force of a senior financial sector representatives to continue its work in promoting Australia as a financial centre for the region and facilitate industry input into the design of a range of proposals.

There will be ongoing and further consultation on each of the supported recommendations.

Film Tax Offsets

The Government announced the following changes to the eligibility requirements for film tax offsets effective from 1 July 2010:

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- the removal of the current 70% QAPE requirement for productions valued between \$15 million and \$50 million; and
- the Post, Digital and Visual Effects Production threshold reduced from \$5 million to \$500,000.

Interest Withholding Tax Phase-down for Financial Institutions

In a move to raise cheaper and additional debt capital for the Australian retail debt capital market, Interest Withholding Tax ("IWT") rates payable by financial institutions on most offshore borrowings will be phased down as follows:

	Australian subsidiaries of offshore parents	Australian branches of offshore head offices
Up to 2012/13 year	Up to 10%	Up to 5%
2013/14 year	7.5%	2.5%
2014/15 year	5%	0%
2015/16 year & future years	Possibly 0% (subject to Government fiscal objectives)	0%

An integrity measure will be introduced to ensure the IWT rate phase down will not apply to interest paid to non-residents on retail deposits held in Australia, hence limiting the phase down to wholesale markets.

PHILANTHROPY

The Government announced a welcome extension of the deductible gift recipient (DGR) regime to volunteer fire brigades and other volunteer based and state recognised emergency services entities, as well as to all state government bodies that coordinate volunteer fire brigades and state emergency services. This will mean that donations to such organisations will become tax deductible. This change will take effect from the date of Royal Assent of the relevant legislation.

In addition, the Government announced that effective 1 July 2011, Public Ancillary Funds will be subject to a new regulatory regime focussing on the establishment and maintenance of such funds. The new regime will establish legislative guidelines and provide the Commissioner the power to impose penalties on fund trustees where there are breaches of the guidelines.

SUPERANNUATION & RETIREMENT INCOMES

Some minor changes to superannuation and retirement incomes were announced. These included:

- permanently reducing the co-contribution matching rate to 100% (formerly 150% but reduced last year to 100% as a savings measure);
- allowing the Commissioner to exercise discretion for the purposes of excess contributions tax before an assessment is issued;
- reviewing whether deductions should be available to superannuation funds providing benefits to a member against a terminal medical condition;
- introducing technical corrections to allow deductions for contributions made for former employees or where contributions are transferred to a successor fund.

Giving the Commissioner discretion before an excess contributions tax assessment issues is welcome assuming the Commissioner is more readily willing to exercise this power.

PERSONAL TAXATION

Personal tax rates – no change to already scheduled tax cuts

The Government did not make any changes to the currently legislated tax rates for 2010-11

The legislated current and 2010-11 personal tax rates and thresholds for resident individuals (excluding the 1.5% Medicare levy) are set out in the following table:

Current Taxable income \$	Rate (%)	From 1 July 2010 Taxable income \$	Rate (%)
0 – 6,000	0	0 - 6,000	0
6,001 – 35,000	15	6,001 - 37,000	15
35,001 – 80,000	30	37,001 - 80,000	30
80,001 – 180,000	38	80,001 - 180,000	37
180,001+	45	180,001+	45

From 1 July 2010 the low income tax offset will increase from \$1,350 to \$1,500 thereby increasing the effective tax-free threshold to \$16,000 for people earning \$30,000 or less. This increase has also effectively increased the Div 6AA tax-free threshold for "unearned income" of an eligible minor to \$3,333, up from \$3,000 in 2009-10.

Other personal income tax changes include:

- Senior Australian Tax Offset regulations to be amended to ensure rebate calculated correctly (now factors in the low income tax offset)
- Medical expenses rebate threshold to be raised to \$2,000 from 1 July 2010 with adjustments for CPI each year thereafter
- Relaxation of the First Home Saver Account rules concerning saving transfers
- Increase in the Medicare levy threshold for taxpayers that are eligible for the Senior Australian Tax Offset.

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Standard deduction for work-related expenses and the cost of managing tax affairs

The Government will provide individuals with an optional standard deduction that will be phased in over two years. From 1 July 2012, individuals will be entitled to claim a standard deduction of \$500 for work-related expenses and the cost of managing tax affairs. From 1 July 2013, the standard deduction will increase to \$1,000. The Government announced that this measure is a key step towards a "tick and flick" system of pre-filled tax returns.

A standard tax deduction for work related expenditure was recommended by the Henry Tax Review. It is noted that the Review also recommended a general tightening of rules for eligible work related expense deductions. The government has not suggested adopting such a recommendation.

Family Tax Benefit (FTB)

The Government will put in place more flexible arrangements for FTB recipients who do not lodge tax returns.

The participation requirements to remain eligible for FTB Part A will be further strengthened.

Child Care Rebate (CCR)

The cap for the CCR will be reduced to \$7,500 per child, with indexation of the cap paused for four years.

War Widows Pension

War Widows (or Widowers) will no longer be eligible for the Pension if they enter a de facto relationship following the death of their veteran partner.

50% discount for interest income

From 1 July 2011, the Government will provide individuals with a 50% tax discount for the first \$1,000 of interest

earned. The discount will be available for interest income earned directly (eg. deposits held in banks) and indirectly (eg. through a trust).

It is noted that this measure is in response to the Henry Tax Review recommendation to provide a 40% tax discount on interest income.

Medicare Levy – thresholds increased

The Medicare levy low-income thresholds have been increased from 1 July 2010 as follows:

- Singles – from \$17,794 to \$18,488
- Families – from \$30,025 to \$31,196
- Pensioners (below Age Pension age) – from \$25,299 to \$27,697

Social Security measures

A number of social security measures were announced in the Budget, importantly the Government will make some changes to the eligibility criteria and allowable uses for Special Disability Trusts. The changes are designed to make them more accessible and increase uptake (applicable from 1 January 2011). The definition of a beneficiary will be expanded to include people with a disability who can work up to seven hours per week (excluding work in an Australian Disability Enterprise) and the allowable uses for the trust will be expanded to include all medical expenses, including membership costs of private health funds, maintenance expenses of Special Disability Trust property and discretionary spending of up to \$10,000 per year.

GST

Additional GST compliance funding for the ATO

The Government will provide \$337.5 million to the ATO over 4 years to fund additional activities that target fraudulent GST refunds, under-reporting of GST

liabilities, non-lodgement of GST returns and non-payment of GST debts.

This compliance funding is expected to generate an additional \$2.7 billion of revenue over 4 years through increased taxpayer compliance with the GST law.

The ATO has increased its targeted GST compliance activities in recent years. The additional funding announced in the Budget will result in a significant number of GST registered businesses being targeted for ATO GST reviews and audits over the next few years. All GST registered entities would be well advised to ensure that their GST affairs are in order before the ATO comes knocking. In addition to the unexpected GST cost, any underpayments of GST can also result in expensive penalty and interest charges, which can impact cash flow and profitability.

Changes to the financial supplies rules

The Government has announced changes to the financial supply rules that are designed to reduce compliance and administrative costs for small business. The key changes include:

- Increasing the Financial Acquisitions Threshold from \$50,000 to \$150,000;
- Treating all elements of a hire purchase transaction as a taxable supply;
- Allowing taxpayers that account for GST on a cash basis to claim input tax credits for hire purchase acquisitions on the same basis as non-cash GST taxpayers;
- Expanding the range of expenses that qualify for reduced input tax credits to include -
 - Acquisitions related to supplies of life insurance by super funds to members;
 - Lenders mortgage re-insurance;
 - Transactional fraud monitoring services;

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- Protecting the revenue base by preventing trustee and responsible entity service acquisitions from being used to claim credits for all acquisitions.

While these changes are welcome, the financial acquisitions threshold is also exceeded where a taxpayer's financial acquisitions exceed 10% of all acquisitions. This threshold is more likely to impact small businesses and it would have been preferable for this threshold to have also been increased.

Unfortunately, these compliance reduction measures will not take effect until 1 July 2012.

Restructure of the margin scheme rules

The Government has released the findings of a Treasury review of the operation of the margin scheme.

The property industry had identified a number of concerns with the margin scheme and had suggested that they could be addressed through further amendments to the existing legislation.

However, the view of the Government is that additional rules within the existing legislative framework would be likely to increase complexity and would add significant additional revenue costs.

Instead the Government has agreed to clarify the existing law by restructuring the margin scheme provisions to give prominence to the main principles, with the exceptions set out separately and to insert objects clauses for key provisions. This is not expected to be a complete replacement of the existing provisions with a set of principles, which was an

option that was not supported in any of the submissions to Treasury.

GST and cross-border transactions

The Government has accepted all of the recommendations made by the Board of Taxation following its review of cross-border transactions. The GST legislation will be amended with effect from 1 July 2012 to reduce the number of non-residents who are unnecessarily drawn into the Australian GST system. The amendments will:

- Limit the 'connected with Australia' provisions in their application to non-residents;
- Expand the circumstances where a resident entity will have a reverse charge GST liability when dealing with a non-resident;
- Extend the GST-free rules for cross-border supplies; and
- Remove the need for some non-residents to register for GST.

GST exemption for taxes, fees and charges

The Government will amend the current mechanism for exempting from GST Australian taxes, fees and charges imposed by Government agencies.

Currently, in order for taxes, fees and charges to be exempt from GST, they must specifically be included in a determination issued by the Treasurer. From 1 July 2011, this will be replaced by a principles-based approach. A detailed list of exempt taxes, fees and charges will no longer be

produced. Rather, a broad set of principles in the legislation will determine which taxes, fees and charges are exempt.

The aim of this is to increase certainty for taxpayers and Government agencies in relation to the GST treatment of new taxes, fees and charges. In our view, the opposite is likely to occur and the adoption of a broad set of principles is likely to result in costly disputes between taxpayers and the ATO around how the principles should be interpreted.

Deferred start date for changes recommended by Board of Taxation

The start date for the implementation of the following recommendations made by the Board of Taxation following its review of GST administration has been deferred for 12 months, to 1 July 2011:

- adopting the income tax self assessment regime for indirect taxes;
- reforming the rules that govern change of use adjustments;
- allowing adjustments for pre-registration acquisitions;
- clarifying the treatment of tax law partnerships;
- simplifying the GST grouping membership interest rules and allowing grouping of non-operating holding companies; and
- introducing a reverse charge regime for supplies of going concerns and farmland.

FURTHER INFORMATION

Please ask your regular Johnston Rorke tax contact for further details on the issues raised in this Tax Bulletin.

JR Acknowledges the assistance of our national affiliates, Pitcher Partners, with the production of this Tax Bulletin.

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