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The Federal Budget 2013-2014: Comedy or Tragedy?

As potentially the final act plays out in Treasurer Wayne Swan's Federal Budget performances, it is perhaps fitting to ask the question – was this long drama a comedy or a tragedy?

Tonight's budget was a safety first affair, largely being a renouncement of previous big announcements designed to reassure the patrons before they prepare to leave the theatre. There is nothing in this budget to give a strong indication that the box office will not close on 14 September when the Federal

The Budget confirms the announced significant deteriorations in the fiscal outlook. Deteriorating commodity prices, diminished company tax revenues, disturbingly low carbon tax and mining tax revenues. The inability of the Treasurer to reliably estimate short term forward revenue over past months definitely presents as a comedy.

But in my view, this is a tragic budget. This Government, in its possible final act, has decided to attack large corporates and foreign investors in ways that achieve modest revenue gains, but which clearly present the message to the world that Australia is indifferent and ungrateful to inbound foreign capital investors, or to corporate innovation and research and development by large corporates.

R&D concessions are scrapped for businesses with turnover of more than $20 billion. Thin capitalisation thresholds are potentially reduced from a debt equity ratio of 3:1 to 1.5:1. Outbound corporate investors will lose a tax deduction for interest on borrowings against some foreign investments that produce tax exempt dividends (still ultimately fully taxed to shareholders). We will apply a non-final 10% of face value withholding tax when foreigners sell commercial real estate, mining assets (or residential real estate with a value of more than $2.5 million). Ultimately, we will require all entities with a turnover of more than $20 million to pay tax instalments monthly, creating a permanent cash drain even on smaller businesses.

The announced superannuation reforms are simply ill considered, riddled with potential injustices and inconsistencies which demonstrate a lack of proper due diligence and a tendency to announce measures without fully assessing potential impacts. Expect a red tape boom as compliance costs soar across all these measures that, by their nature, must be complex.

Small to medium business gets just about nothing (again!). Exceptions are the quarterly refund of R&D tax credits to small enterprises – a welcome cash flow reprieve – and the removal of the thin capitalisation rules where debt deductions are less than $2 million.

The big picture measures have already been announced – the Gonski Education Reforms, the modest "Industry and Innovation" package, DisabilityCare Australia (funded by an increase in the Medicare levy from 1.5% to 2% from 1 July 2014). Reannouncements of big infrastructure projects mainly already in the budget (again). There is nothing to capture the imagination of businesses (large, small or international) and set up the environment for the next economic boom. This budget represents an opportunity missed and simply sets up this Government and its people to tread water until voters express themselves at our looming election. But most tragic of all, many of these budget measures may never see the light of day in Parliament.

INDIVIDUALS & FAMILIES

Increase in the Medicare levy

From 1 July 2014, the Medicare levy will increase from 1.5% to 2%. This increase in the levy will fund DisabilityCare Australia.

2012/13 Medicare levy low income thresholds

The Medicare levy low income threshold for the 2012/13 income tax year will increase to $20,542 for individuals and $32,279 for pensioners eligible for the Seniors and Pensioners Tax Offset.

The Medicare levy low income threshold for families for the 2012/13 income tax year will increase to $33,693, and the additional family threshold for each dependant child or student will increase to $3,094.

Net Medical expenses tax offset to be phased out

For those taxpayers who claim the NME tax offset in the 2012/13 income year they will continue to be eligible for the offset in the 2013/14 income tax year if they have out of pocket medical expenses above the relevant thresholds.

The relevant threshold for people with adjusted taxable incomes above $84,000 ($168,000 for couples) is $5,000 in out of pocket expenses and the rate of reimbursement is 10%. For those taxpayers who claim the NME tax offset in the 2013/14 income year they will continue to be eligible for the tax offset in the 2014/15 income year.

Income tax cuts deferred

Income tax cuts that had already been legislated (by way of increasing the tax free threshold) and that were due to commence on 1 July 2015 will be deferred indefinitely.

Replacing the Baby Bonus with new family payment arrangements

Family Tax Benefit Part A (FTB Part A) payments will be increased by $2,000, to be paid in the year following the birth of a first child, and $1,000 for a second and subsequent child. The additional FTB Part A will be paid as an initial payment of $500, with the remainder to be paid in seven fortnightly instalments.

As a result of these reforms the Baby Bonus will be abolished.

HECS-HELP discount and voluntary HELP repayment bonus discounts will end

From 1 January 2014, the following discounts relating to the Higher Education Loan Program will be removed:

- The 10% discount available to students electing to pay their student contribution upfront, and
- The 5% bonus on voluntary payments made to the Tax Office of $500 or more.

Work related self education expenses

From 1 July 2014, a taxpayer will only be able to claim a maximum deduction of $2,000 for work related self education expenses.

Eligible work related self education expenses include costs incurred on a course of study or other educational activity such as a conference or workshop, and include tuition fees, registration fees, textbooks, professional and trade journals, travel and accommodation expenses and computer expenses, where these expenses are incurred in the production of the taxpayer's current assessable income.

Introduction of CGT Withholding Tax Regime for Non-resident Taxpayers

From 1 July 2016, where a foreign resident disposes of taxable Australian property, the purchaser will be required to withhold and remit to the Tax Office 10% of the proceeds from the sale. This measure will apply to commercial property and residential property with a value over $2.5million.

CORPORATES AND BUSINESS

The dramatic fall in the health of the budget has meant that for the business community the budget delivers only bad news. This bad news comes in the form of bringing forward the timing of tax payments irrespective of the cash flow and administrative problems this may cause, or the tightening of other provisions such as the thin capitalisation provisions for international businesses.

In a business environment that is probably best described a fragile, let's hope the budget doesn't further hamper an already difficult environment.

Monthly PAYG Tax Instalments

Changes to the PAYG tax instalment system to be introduced by government will result in all large entities paying monthly tax instalments to the government. These changes will be an administrative nightmare and result in cashflow management issues for the entities affected.

The entities caught and timing of the changes have been summarised in the table below:

Entity Affected	Date Monthly Instalments Begin
Companies with turnover greater than $1b.	1 January 2014
Companies with turnover greater than $100m.	1 January 2015
Companies with turnover greater than $20m and all other entities with greater than $1b turnover.	1 January 2016
All other entities with turnover greater than $20m.	1 January 2017

As shown in the table above these changes are far reaching in the number of taxpayers that will be impacted.

Foreign Non-Portfolio Equity Interests

Presently, the receipt of dividends from a non-portfolio investment of greater than 10% in a foreign company are treated as exempt from tax. These rules are going to be tweaked by the government to ensure they operate as intended.

This will include ensuring that the exemption flows through a trust or partnership correctly.

Interest Expenses Relating to Foreign Exempt Income

The government has announced that it will be amending the legislation to prevent an interest deduction being claimed with respect to the derivation of certain foreign exempt income.

Changes to Mining Concessions

The generous tax concession available to the mining industry are being tightened to exclude acquired mining rights and information from those assets that can be claimed as an immediate deduction as part of the cost of assets first used for exploration. Affected assets will need to be depreciated over the shorter of their effective life or 15 years.

Only original costs of issue from government and genuine new exploration expenditure will qualify for outright deduction.

This does not apply to rights and information acquired from a government authority. These changes will apply from budget night.

Thin Capitalisation

As was expected by many advisers, the government has made the decision to tighten the thin capitalisation rules that apply to foreign companies that have operations in Australia and Australian companies that have operations overseas.

The government has increased the de minimis threshold from $250,000 to $2 million. This means that taxpayers with total interest expense below $2 million are not subject to the thin capitalisation rules. The rules broadly apply to disallow interest deductions where a taxpayer has more than $3 of debt to every $1 of equity. Interest deductions are reduced on proportionate basis.

The budget has proposed that this ratio be reduced to $1.50 of debt for every $1 of equity. This is a significant blow to both Australian companies that are looking to expand offshore and to international companies looking to invest in Australia.

For foreign multinational companies this is a significant change that makes Australia a less appealing place to carry on business. When the boards of these large foreign companies sit down to determine where to invest their capital, this is one extra reason to choose a country other than Australia.

The government has noted that these changes will apply to financial years beginning on or after 1 July 2014. These changes are significant and therefore it will be crucial to closely monitor the details of how these changes will be implemented and the drafting of the legislation surrounding these changes.

Other Changes Impacting Corporate Taxpayers

Other changes to note include the following:

- Removal of dividend washing opportunities exploited by some taxpayers. This enables some sophisticated investors to claim franking credits twice by selling shares ex-dividend and re-purchasing other shares that carry a right to dividends.
- R&D benefits have been scrapped for corporate groups that have greater than $20b turnover.
- The changes previously announced by the government in the 2009/2010 budget with respect to the CFC and FIF provisions have been put on hold until the OECD has finished a review of international profit shifting. This announcement means that businesses with international operations face a longer period of uncertainty.
- The Venture Capital regime will be amended to encourage ‘angel’ investors. This will be achieved through lowering the minimum invested capital requirement from $10m to $5m.
- Various amendments are to be made to the tax consolidation provisions, to prevent taxpayers from obtaining unintended benefits, such as double deductions through shifting assets between groups and deducting liabilities twice.

CHARITIES AND NOT FOR PROFIT ENTITIES

Definition of Charity

A statutory definition will be applied to the term charity from 1 January 2014, rather than the reliance that is currently placed on common law principles. The statutory definition will however preserve these principles.

Not For Profit Tax Concession Changes

Planned changes to the tax concession that apply to commercial activities that are carried on by not for profit entities are to be delayed. These changes will commence from either 1 July 2014 or 1 July 2015 depending on when the activities commenced.

These changes will broadly mean that income tax concessions will not always be available for unrelated commercial activities carried on by not for profit groups. The availability of income tax concessions will only be available where the unrelated commercial activity profits are not directed back to the organisations altruistic purpose.

FBT, GST and DGR benefits will also not be available in relation to the unrelated commercial activities.

These changes could be far reaching for the not for profit sector and should therefore be considered in detail for clients that operate in this sector. This issue is further hampered by uncertainty surrounding what these provisions will actually entail when legislated.

SUPERANNUATION

Increase in concessional contributions cap

A temporary cap of $35,000 (up from $25,000) will apply from 1 July 2013 for individuals aged 60 and over. The increased cap will apply for individuals aged 50 and over from 1 July 2014.

The government will index the general cap of $25,000 that applies to everyone else from the 2015 financial year onwards. The increase in the cap to $35,000 will apply as follows:

Start Date	Age Requirement
From 1 July 2013	60 and over
From 1 July 2014	50 and over
From 1 July 2018	No age requirement

Example

Tony's birthday is 12 May 1954. He is 59 years old on 30 June 2013. For the 2013-14 financial year, Tony's concessional contributions cap is $35,000, and his non-concessional contributions cap is $150,000 (where the general concessional contributions cap is $25,000).

Removal of $500,000 superannuation balance test

As a result of the above-proposed increase in the concessional contributions cap, the previously announced concessional contribution limit of $50,000 for individuals with superannuation balances below $500,000 will be removed.

Taxation of earnings on superannuation assets supporting income streams

From 1 July 2014, future earnings (such as dividends and interest) on assets supporting income streams will be tax free up to $100,000 a year (to be indexed in $10,000 increments), and the balance of earnings will be taxed at 15%.

Under the current law, all superannuation earnings on assets supporting superannuation pensions and annuities are tax-free.

The change to the taxation of superannuation funds in pension phase will undoubtedly punish good investment performance. For example, the Government announcement points out that "assuming a conservative estimated rate of return of 5%, earnings of $100,000 would be derived from individuals with around $2 million in superannuation". However, if a superannuation fund earns 10%, then it will be subject to tax for assets that are at the $1 million level.

Special transitional rules for capital gains

- Special arrangements will apply for capital gains on assets purchased before 1 July 2014:
- For assets that were purchased before 5 April 2013, the reform will only apply to capital gains that accrue after 1 July 2024;
- For assets that are purchased from 5 April 2013 to 30 June 2014, individuals will have the choice of applying the reform to the entire capital gain, or only that part that accrues after 1 July 2014; and
- For assets that are purchased from 1 July 2014, the reform will apply to the entire capital gain.
- The government is yet to release draft legislation with respect to this measure but the flow-on impact, if legislated, is likely to impact other areas. For example, if after 1 July 2014 you buy a capital asset in your superannuation fund, sit on it for 10 years, and then realise a $1 million gain to fund your pension as a one-off.

Without further clarification from the government, it might be that averaging will apply to the capital gain, that is, $100,000 gain each year that the asset was held, thereby limiting tax exposure. Alternatively, $900,000 of the capital gain could potentially be taxed at a higher tax rate.

Tax relief for excess contributions

Many innocent people have been subject to a punitive rate of tax if they accidentally exceed their concessional contributions threshold. Individuals are taxed at 46.5% even if their personal tax rate is lower, where they have exceeded the cap. Moreover, if the excessive contribution was accidental, it has not been possible to withdraw the excess contribution and correct the error.

Pleasingly from 1 July 2013, it will be possible to withdraw the excessive contributions, be taxed at your ordinary rate with an interest charge on the benefit of a tax timing difference that arises because of the different tax payment dates of the superannuation fund.

Changes to government co-contributions

The government has introduced legislation to halve the co-contribution to $500 for eligible taxpayers.

The superannuation co-contribution matches eligible (after-tax) personal superannuation contributions made to a superannuation fund up to the maximum amount of $500. However, the government has recognised that this benefit is not as popular with the targeted group – lower income earners.

Increase in Superannuation Guarantee

The Superannuation Guarantee rate is gradually increasing from the current 9% to 12% by 1 July 2019 in 0.25% increments each financial year. From 1 July 2013, employer will be required to contribute 9.25% to superannuation.

The government has also increased the maximum age limit to 75 for when employers are required to make superannuation guarantee contributions for employees. Previously, employers were not required to make superannuation contributions on behalf of employees over the age of 70.

INNOVATION AND RESEARCH

While not specifically a budget measure, one of the key developments in 2013 was the announcement of the 1 billion dollar "Industry and Innovation Statement" in February 2013. Financials of this package were re-announced in the budget. There are some beneficial elements which apply from 1 July 2013 in this package.

Research and Development

Following the announced changes, there are now three tiers of research and development support:

- A 45% refundable tax offset for those businesses with an aggregated assessable income turnover of less than $20 million.
- A non-refundable 40% tax offset which is available for businesses with turnover between $20 million and $20 billion.
- Access to the ordinary dollar for dollar tax deduction rules, capital allowance rules and blackhole expenditure rules for large businesses that have a turnover of more than $20 billion.
- Essentially, the message is that research and development incentives are not for the top end of town.

For businesses that are not yet cash flow positive and that have a turnover of less than $20 million, an important improvement in the refundable tax offset system is the ability to opt in for a quarterly refund from 1 July 2013. The refund for each quarter will be physically paid 28 days after quarter end. In theory, this means that the first payment of a quarterly refund would be 28 October (i.e. after the next Federal election).

Taxpayers can either choose to adopt a "safe harbour" instalment credit based on last years R&D claim. Alternatively, a reasonable assessment can be made. There are two key requirements in order to get the quarterly credit. The first is that the taxpayer must have a reasonable expectation of qualifying for the credit in this years income tax return. The second is that the taxpayer must have complied with all its obligations for the last five years and it must be reasonable to expect it will continue to comply. The ATO has a discretion to waive certain types of non-compliance.

Australian Industry Participation Authority

A non-revenue measure which has been announced by the government is that businesses that plan to initiate projects with a cost of greater than $500 million will be required to create an Australian Industry Participation Plan in the early stages of project planning to outline opportunities for local industry to participate in the project. The Australian Industry Participation Authority will then coordinate with industry to improve supply of local production, creating local jobs.

Projects which have a value of more than $2 billion will be required to "embed" Australian Industry Participation Officers.

Innovation Precincts

The government also announced plans to create up to 10 "innovation precincts". The first two precincts have been announced in the manufacturing and food industries with hubs based around Melbourne. Participation in the precinct also opens access to a $50 million Industry Collaboration Fund which is aimed at getting different businesses aligned around common technology and process solutions required to drive that particular industry segment forward.

Venture Australia

An additional $350 million has been made available for new "Infrastructure Investment Funds". In summary, approved managed fund operators will have the opportunity to place strategic investments in applicant businesses from this fund subject to the investment rules specified by government.

Enterprise Connect and Enterprise Solutions

The enterprise connect program has been expanded to include additional industry categories of professional services, information and communication technologies, and transport and logistics. This gives qualifying businesses the opportunity to work with a business coach to develop an appropriate business plan and is to apply for grant funding from the government to implement recommendations that are specified in that business plan. This can release $20,000 or in some cases more for businesses to address improvements to systems and processes.

Additionally, the government intends to proceed with a program to assist growing businesses to develop their capabilities to meet the standards for supply required by government.

Finally, qualifying businesses will gain access to “Gold” Executive Training (Growth Opportunities Leadership Development). This is a new executive training program aimed at building the next generation of leaders in future industry employers.

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