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Australian Federal Budget 2013/14

Last night, Treasurer Wayne Swan handed down his sixth Budget, which was characterised by a paring back of expenditure to essential services, and was delivered against a backdrop of significant erosion in Australia's tax base and unprecedented write downs in national revenue.

After two weeks of negative news for the government, in which it foreshadowed 'urgent and grave decisions', the Budget contained confirmations rather than surprises. The previously announced changes to superannuation featured heavily, shaping up to be one among many thinly veiled wealth distribution measures. As expected, the National Disability Insurance Scheme (**NDIS**) will be funded by a half of a percentage point increase in the Medicare levy from 1.5% to 2% from 1 July 2014.

In stark contrast to the 2012/13 Budget, which focused heavily on the extractive industry and sharing the wealth of the mining boom, no further mention existed of the mining tax – suggesting that the boom, in the government's eyes, is well and truly over. Also, only a brief mention was made of the elusive Budget 'surplus', with the government making a second promise to return the Budget to surplus – this time deferring the promise until 2016/2017. In light of the projected surplus of over $1bn for 2012/13 that remains unseen, taxpayers would be forgiven for wondering if the quest for a budget surplus is less elusive and more illusory.

Below is a selection of the key revenue measures that were announced in the Budget.

Increase in the Medicare levy and low-income threshold

As mentioned, the Medicare levy will increase by half a percentage point to 2% from 1 July 2014. This measure will provide funding for the government's signature NDIS, DisabilityCare Australia. The additional revenue raised will be invested in a new fund that will be applied specifically to advance the scheme.

As an associated measure, the Medicare levy low-income threshold will be increased to $33,693 from 1 July 2012. Taxpayers earning less than this threshold will not pay the levy. The threshold will increase by a further $3,094 for each additional dependent child or student.

Superannuation – no further measures announced

No further superannuation measures were announced in the Budget, though the measures previously announced on 5 April 2013 provided

a handy amount of additional taxation revenue. Readers might recall that these measures included:

- reforms to the excess contributions tax system
- introducing a higher contribution cap for taxpayers aged 60 and over
- removing the tax exemption for earnings on superannuation assets supporting pensions of $150,000 or more.

Tackling 'base erosion' – thin capitalisation changes

The thin capitalisation rules, which can restrict debt deductions for certain entities with international operations, will be amended in three ways with effect from 1 July 2014. The changes are intended to address a perceived erosion in the corporate tax base caused by debt to equity ratio of multinational businesses.

1. The 'safe harbour' limit will be changed from the current debt/asset ratio of 3:1 to a more restrictive 1.5:1. In other words, to rely on the safe harbour rule, taxpayers must have 60% or less debt to assets, compared to the current 75% debt to assets.
2. The worldwide gearing ratio for outbound investors will be reduced from the current 120% to 100%.
3. The thin capitalisation *di minimus* threshold will be increased from $250,000 to $2m. This change will mean that taxpayers need not apply the thin capitalisation rules unless they are claiming $2m or more in debt deductions.

Tackling base erosion – non-portfolio dividends and related deductions

Dividends paid to Australian resident companies from foreign companies are currently exempt from Australian tax under section 23AJ of the *Income Tax Assessment Act 1936* (Cth), provided that the Australian company holds a non-portfolio interest (broadly 10% or more) in the foreign company. The government will now implement changes to section 23AJ that were originally announced in the 2009/10 Budget. With effect from 1 July 2014, these changes will mean that the exemption will no longer apply where:

- the shares held are essentially debt instruments, such as redeemable preference shares
- the Australian company, in substance, only holds 10% or less of the foreign company.

As an associated measure, the government will repeal the provision that allows deductions for interest expenses incurred in deriving exempt dividends. Consequently, with effect from 1 July 2014, taxpayers will not be able to claim interest deductions where the funds are used to finance the acquisition of a non-portfolio interest in a foreign company.

Reforms to the charitable and not-for-profit sector

Scrapping the transitional arrangements that were to apply to the 2011/12 Budget measure, *Not-for-profit sector reforms – better targeting of not-for-profit tax concessions*, and deferring the 'small scale unrelated commercial activities' exemption will cause an increase in revenue (approximately $1m) and GST payments to the states and territories of $66m.

The government has incorporated a $250,000 small scale activities threshold in its estimates. This appears to indicate that revenue derived by not-for-profit entities from unrelated commercial activities totaling less than $250,000 per annum will continue to be exempt from income tax even after the measures are introduced.

But the previously announced transactional measures that were to apply for activities commenced prior to 10 May 2011 will now only apply until 1 July 2015. Hence it seems that all unrelated commercial activities with revenue exceeding $250,000 will be subject to tax from 1 July 2015.

The government will also delay the proposed statutory definition of 'charity' by one year, to 1 July 2014.

Foreign residents and capital gains tax

A new, non-final withholding tax of 10% will apply to the disposal by foreign residents of certain taxable Australian property.

Foreign residents are already subject to tax on any gains at their marginal rates, so it appears this measure is intended to achieve better compliance. The measure will not apply to the disposal of residential real estate valued at $2.5m or less, but it appears that all other transactions will be captured. This change will take effect from 1 July 2016.

In addition, two technical amendments will be made to the principal asset test that forms part of the foreign resident capital gains tax (**CGT**) regime. This test applies when determining whether the principal asset(s) of a particular entity are Australian real property (such as real estate or mining rights). The amendments are intended to ensure that:

- there is no duplication when the test is applied to consolidated groups

- mining, quarrying or prospecting information and goodwill are valued together with the mining rights to which they relate.

They will apply from 14 May 2013.

Refinement of the research and development (R&D) tax incentive

The R&D tax incentive will no longer be available to large companies with a turnover of more than $20bn from 1 July 2013. For companies under that threshold, the R&D tax incentive will continue to provide a 45% refundable tax offset to eligible companies with annual aggregate turnover of less than $20m and a 40% non refundable tax offset to all other eligible companies.

Enhancement of venture capital tax concessions

The government will improve access to the venture capital tax concessions applying to the Venture Capital Limited Partnership (**VCLP**) and the Early Stage Venture Capital Limited Partnership (**ESVCLP**) regimes by reducing the minimum investment capital required for entry into the ESVCLP program from $10m to $5m. The government also announced plans to phase out the Pooled Development Fund program over a number of years.

GST

Note that only businesses will be permitted to continue to use the GST instalment system if they move to a net refund position.

PAYG instalments extended to additional large entities

The requirement to make monthly Pay As You Go (**PAYG**) income tax instalments has been extended to include all large entities in the PAYG instalment system, including trusts, superannuation funds, sole traders and large investors. This measure is a step towards the objective of achieving tax neutrality as between different business structures.

The requirements will be introduced in tranches:

- corporate tax entities with a turnover of more than $1bn will still move to monthly PAYG instalments from 1 January 2014
- corporate tax entities with a turnover of $100m or more will still move to monthly PAYG instalments from 1 January 2015
- all other entities in the PAYG instalment system with a turnover of $20m or more will move to monthly PAYG instalments from 1 January 2017.

Entities (other than head companies or provisional head companies) with a turnover of less than $100m will not be required to pay PAYG instalments monthly (provided they report GST on a quarterly or annual basis).

Crackdown on trust structures

The ATO will receive $67.9m over four years to undertake compliance activity that will target tax scheme designers, promoters, individuals and businesses who participate in tax evasion using trust structures.

Closing 'loopholes' in the consolidation regime

Various amendments to the consolidation rules will be introduced in response to two Board of Taxation Reports on consolidation that were publicly released along with the Budget. The changes will apply to transactions that take place after 14 May 2013 (ie Budget night), and include the following:

- Where membership interests in a non-resident entity are transferred to a consolidated group, and the interests are not taxable Australian property, the tax cost setting rules will only apply if there is a change in the underlying beneficial ownership of the joining subsidiary.
- Any deductible liabilities of joining entities will not be taken into account twice as part of the tax cost setting process.
- For taxpayers subject to the taxation of financial arrangement rules, only net gains or losses will be taken into account when an entity exits a consolidated group.
- Consolidated groups will not be able to access double deductions by shifting the value of assets between entities.

Multiple entry consolidated groups

The government will also consult on some additional consolidation changes to apply to multiple entry consolidated groups (**MEC Groups**). It perceives that such groups can access tax advantages that other taxpayers cannot. In particular, it is concerned that:

- MEC Groups without taxable Australian property can avoid capital gains tax by selling only eligible tier 1 companies (this is because any gain will accrue to a foreign resident, and be exempt from Australian tax).
- When they acquire an entity, MEC Groups can choose whether to 'stick' or 'reset' the tax cost of the entity's assets by choosing whether the entity joins as an eligible tier 1 company, or at some other level.

The government says it will work with industry to develop ways to remove these tax advantages. But it has not put forward any specific proposal to do so. Nonetheless, any amended tax treatment will apply from 1 July 2014.

Targeting deductions that relate to exploration activity

A range of amendments will be made to the treatment of certain exploration expenditure. The changes will apply to all transactions entered into after 14 May 2013.

One change will be the provision that allows an immediate deduction for:

- the cost of depreciating assets used in exploration
- the cost of mining, quarrying and prospecting rights and information.

The immediate deduction for the cost of mining, quarrying and prospecting information will be removed, and instead this cost will need to be claimed over the life of the relevant mine, or 15 years if that life is not known.

Immediate deductions will continue to be permitted for the cost of depreciating assets, and also for the cost of mining rights obtained from a government authority.

In addition, the government will legislate to preserve the ATO's current approach to the treatment of farm-in, farm-out arrangements.

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