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2014-15 Australian Federal Budget

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Short term pain shared by government, business and households is necessary to repair our record deficit, and it's now time for long term planning and reform.

The 2014-15 Budget has shown that fiscal repair is a priority for this Government, given the growth in Australia government debt. PwC analysis showed that if no change was made in this Budget, our federal and state debt would almost exceed our gross domestic product in 25 years.

Some of the key measures in this Budget:

- Introduction of a 2 per cent Temporary Budget Repair Levy for high income earners from 1 July 2014.
- A cut to the company tax rate of 1.5 per cent from 1 July 2015.
- Temporary increase to the Fringe Benefits Tax rate to 49 per cent from 1 April 2015.
- Reduction to the rates of the Research and Development tax offsets from 1 July 2014.
- Resumption of indexation of fuel excise from 1 August 2014.
- Rephasing of the superannuation guarantee rate rise.
- Increase to the pension age to 70 by 2035.
- An additional $11.6 billion infrastructure growth package, expected to catalyse additional infrastructure investment in excess of $125 billion through to 2020.

The continuing weakness in Australia's economy, as we transition to the post resources boom environment, has reinforced the need to get the Budget on a more sustainable footing without stifling economic growth. While this Budget seems to bring spending growth under control and invests in new productive infrastructure, the next step is to transform the fragmented and inefficient revenue streams through major tax reform.

To fund Australia's future, we need comprehensive tax reform to underpin economic growth, support our most vulnerable and deliver secure budgets at all levels of government. The Budget takes some steps toward this, but we now need to engage the community in an active conversation about tax reform with everything on the table.

Personal tax

In a speech last month, the Treasurer indicated that 'the task of getting the Budget back on track is a national priority and will require every sector of the community to make a contribution'.

In tonight's Federal Budget, the Government has sought to ensure that outcome by calling upon high-income earners to share the burden of reducing the country's debt with the introduction of a Temporary Budget Repair Levy, while at the same time paring back some of the health and social benefits provided to those on lower incomes.

Personal income tax accounts for the largest proportion of total tax revenue in Australia, however, the number of individual taxpayers who will suffer the increased tax burden with the new Temporary Budget Repair Levy is not so great. Having said that, it is worth reiterating that there are other tax measures to come into effect on 1 July 2014 which will affect the majority of individual taxpayers, including the increase in the Medicare levy and potential savings due to the proposed repeal of the carbon tax.

As a reminder, due to the proposed repeal of the carbon tax, the Prime Minister has previously stated 'the average households would be $550 a year better off [as a consequence of businesses passing on the benefits to the individuals]'. However, the introduction of a Temporary Budget Repair Levy from 1 July 2014 will likely absorb any savings for high-income earners, at least for the next three years.

The Government's next challenge will be to pass the proposed measures through Parliament so they can be enacted before the applicable commencement dates.

What are the tax rates from 1 July 2014?

New Temporary Budget Repair Levy

The Government ended the speculation and announced the introduction of a Temporary Budget Repair Levy of two per cent on individuals' taxable income exceeding $180,000. If the measures are legislated, the Temporary Budget Repair Levy will apply from 1 July 2014 through to 30 June 2017 and is expected to raise around $3 billion.

The introduction of the Temporary Budget Repair Levy means that individuals with taxable income exceeding $180,000, and who are liable to the Medicare levy surcharge because they do not have adequate private patient hospital insurance, will be subject to a top rate of tax of 50.5 per cent on income exceeding $180,000 as follows:

Type of tax/levy	Rate (%)
Income tax	45
Temporary Budget Repair Levy	2
Medicare levy	2
Medicare levy surcharge	1.5
Total	**50.5**

This now makes the differential between the corporate tax rate (proposed to reduce to 28.5 per cent from 1 July 2015) and the top marginal personal tax rate much greater. The Fringe Benefits Tax (FBT) rate will also increase from 47 per cent to 49 per cent from 1 April 2015 to 31 March 2017 to align with the total top rate of tax for high income earners (disregarding the Medicare levy surcharge). Tax rate differentials may bring about changes in behaviour and affect taxpayer decisions concerning when, where and how to invest, work, and retire.

High income earners may wish to discuss their current remuneration and fringe benefits package with their employers, and cross check their current health insurance coverage, in order to manage their net disposable income.

Income tax

In spite of the introduction of a Temporary Budget Repair Levy, there will be no changes to the personal income tax rates. The current legislated tax rates (see the table below) are expected to continue until at least 2015-16.

Taxable income threshold range ($)	2014-15 marginal income tax rate (%)
0 – 18,200	0
18,201 – 37,000	19
37,001 – 80,000	32.5
80,001 - 180,000	37
180,001 +	45

Personal tax

The following table sets out the amount of income tax and Temporary Budget Repair Levy payable on a range of taxable income amounts of a resident individual, ignoring the Medicare levy and surcharge, the Low Income Tax Offset and any other tax offset entitlements.

Taxable income ($)	2014-15 tax payable ($)	Temporary Budget Repair Levy ($)	Total ($)
37,000	3,572	0	3,572
50,000	7,797	0	7,797
75,000	15,922	0	15,922
100,000	24,947	0	24,947
150,000	43,447	0	43,447
180,000	54,547	0	54,547
200,000	63,547	400	63,947
300,000	108,547	2,400	110,947
400,000	153,547	4,400	157,947

Medicare

With the National Insurance Disability Scheme (NDIS) reforms already legislated, the Medicare levy will increase from 1.5 per cent to 2 per cent from 1 July 2014. The funds raised by the additional levy are proposed to be directed to fund the NDIS.

The increased Medicare levy also has consequential implications for other taxes which are based on the top individual marginal tax rate plus Medicare levy. For instance, the rate of FBT has already increased from 46.5 per cent to 47 per cent with effect from 1 April 2014 to 31 March 2015.

For the 2013-14 year, the Medicare levy low-income threshold for families has been indexed from the 2012-13 amounts of $33,693 to $34,367. The additional amount of threshold for each dependent child or student will be increased to $3,156. The thresholds for individuals and pensioners will remain unchanged given they have already been increased by more than the growth in the Consumer Price Index (CPI), that is $20,542 and $32,279 respectively.

Non-residents

For the 2014-15 year, a flat rate of 32.5 per cent will apply to all taxable income of non-residents up to $80,000. For taxable income exceeding $80,000, the marginal tax rates for non-residents are the same as those for resident individuals noted above. Non-residents are also expected to bear the burden of the Temporary Budget Repair Levy.

Private health insurance and Medicare levy surcharge

Although there was no change made to the Private Health Insurance Rebate and the Medicare levy surcharge in tonight's Budget, it is worth noting the changes that automatically apply to the relevant thresholds for the forthcoming tax year. The Private Health Insurance Rebate entitlements and Medicare levy surcharge applicable to those individuals who do not have the appropriate health insurance hospital cover from 1 July 2014 to 31 March 2015 are as follows:

		Full entitlement	Tier 1	Tier 2	Tier 3
Taxable income	Singles	$90,000 or less	$90,001 - $105,000	$105,001 - $140,000	> $140,000
	Families	$180,000 or less	$180,001 - $210,000	$210,001 - $280,000	> $280,000
Rebate	Aged under 65 years	29.040%	19.360%	9.680%	0%
	Aged 65-69 years	33.880%	24.200%	14.520%	0%
	Aged 70 or over	38.720%	29.040%	19.360%	0%
Medicare levy surcharge	All ages	0.0%	1.0%	1.25%	1.5%

Note: The rebate percentage is adjusted annually from 1 April, while the taxable income thresholds are indexed annually from 1 July.

Although the majority of Australians arrange their own health insurance coverage, it is common for individuals on assignment to Australia to have their health insurance policy arranged by their employer. Where an inbound assignee is liable to the Medicare levy (eg by virtue of being from a Reciprocal Health Care Agreement country), it is important that he or she has the correct health insurance in order to limit exposure to the Medicare levy surcharge.

Personal tax

Easing tax compliance for individuals

In a positive move, in the lead up to the Federal Budget the Government announced the '*MyTax*' initiative, to apply from 1 July 2014, which aims to reduce the compliance costs and time needed to prepare and lodge income tax returns by millions of individuals with relatively simple tax affairs (ie those with salary, interest income, dividend income and deductions etc).

The key features of *MyTax* will be:

- Automatic transfer of information from third parties such as banks and employers to support the initiative of prefilling tax returns.
- Enabling individuals to review and lodge their return on their laptop, smartphone or tablet.

Unfortunately, those individuals with more sophisticated tax affairs (eg individuals with businesses, foreign income, capital gains or rental income) will not be able to avail themselves of *MyTax*.

Moves are also afoot to further improve compliance following the Government's announcement last year to proceed with last year's Federal Budget measure designed to enhance the information reported to the Australian Taxation Office (ATO) by a range of third parties through the introduction of new reporting regimes applicable to sales of real property, shares, units, and Government grants. These measures will be deferred to 1 July 2016.

Welfare benefits

There is a strong theme in this Budget of paring back welfare and it is important to consider these changes in the context of employment and retirement plans and arrangements.

The Government has proposed a range of reforms to Family Tax Benefits (FTB), the majority of which will limit the availability of these benefits. In particular, the Government proposes to reduce the primary earner income limit for the FTB Part B from $150,000 per annum to $100,000 per annum from 1 July 2015.

Mature aged workers

From 1 July 2014, the Mature Age Worker Tax Offset will be abolished. The Government has announced the savings will be redirected to the Government's expanded seniors employment incentive payment called 'Restart' so as to support mature age job seekers re-entering the workforce.

As part of 'Restart', from 1 July 2014 a payment of up to $10,000 will be available to employers who hire a job seeker aged 50 years or over who has been receiving income support for at least six months. Note the payment is made to the employer and not the employee, placing the incentive to hire an aged worker on the employer. Given the average life expectancy of our population is increasing, the Government has expressed an interest in looking into longer term structural changes to superannuation to make the system more sustainable.

Dependent Spouse Tax Offset

The Government will abolish the Dependent Spouse Tax Offset for all taxpayers from 1 July 2014.

Tax receipts for individuals

The Government has honoured its election commitment to introduce 'tax receipts', announcing that from 1 July 2014, the Australian Taxation Office will issue personalised and itemised tax receipts to individual taxpayers that show in dollar terms how much of a person's tax bill was spent on each budget area, and the level of gross government debt with a breakdown per person.

Corporate tax

Company tax rate cut to offset Paid Parental Leave Levy

The Government has reconfirmed its commitment to a reduction in the corporate tax rate in this year's Federal Budget. However, the benefit of any rate reduction for many companies will be offset by the Government's previously proposed Paid Parental Leave (PPL) Levy.

The company tax rate will be reduced from its current rate of 30 per cent to 28.5 per cent with effect from income years beginning on or after 1 July 2015 and apply to all companies.

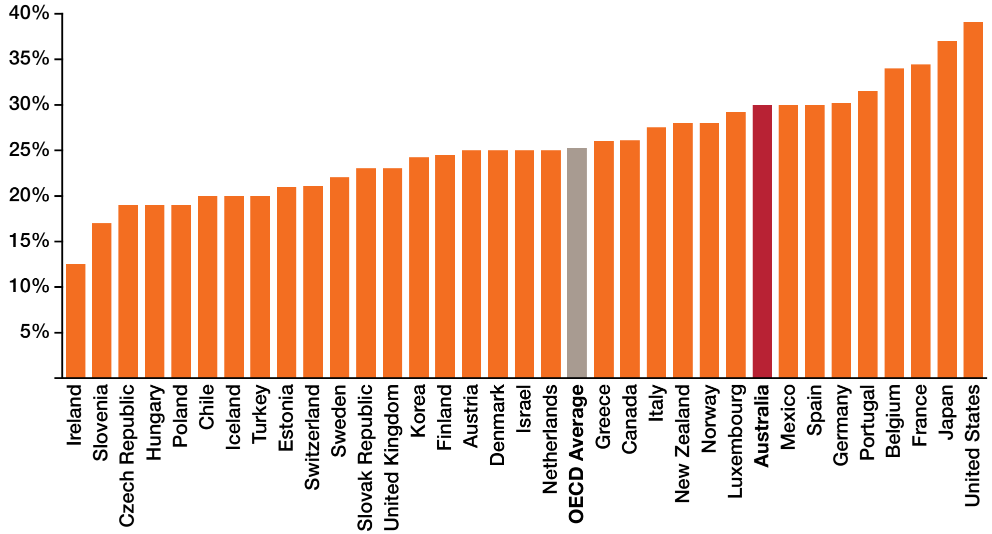
The reduction to the corporate tax rate should benefit many corporate businesses across all sectors, but in particular those smaller companies who will benefit from a much needed cash flow boost to support business activity and growth.

However, for a company with taxable income in excess of $5 million, any expected benefits from the rate cut will be largely offset by the imposition of the PPL Levy at the rate of a 1.5 per cent, to be imposed on the taxable income that exceeds $5 million. Effectively, for those companies subject to the PPL Levy, the total company tax take will remain close to 30 per cent. The following table illustrates the effective overall tax burden from 1 July 2015, assuming the PPL Levy is applied as proposed in the Coalition's election policies:

Taxable income ($)	Income Tax – 28.5% ($)	PPL Levy – 1.5% ($)	Effective overall tax burden (%)
5,000,000	1,425,000	Nil	28.5
10,000,000	2,850,000	75,000	29.25
15,000,000	4,275,000	150,000	29.5
20,000,000	5,700,000	225,000	29.625

Although the proposed reduction in the headline company tax rate is a step in the right direction to make Australia's corporate tax rate more competitive, it fails to bring the tax rate in line with the OECD average (see table below) and the aspirations of Australia's Future Tax System Review (the 'Henry Review') to have a corporate tax rate of 25 per cent. Whilst businesses should welcome this move in the right direction, there is clearly more work to be done to truly increase the level of business investment in Australia.

Corporate income tax rates in the OECD



Source: The Organisation for Economic Co-operation and Development (OECD) – http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCaptial

The change to the company tax rate and the imposition of the PPL Levy will have a number of consequential issues which need to be understood and managed once the finer details are known, including:

- impact on the company's ability to frank dividends (also noting that the payment of the PPL Levy will most likely not generate franking credits)
- impact on the after-tax return on dividends paid to shareholders after 30 June 2015
- tax effect accounting implications
- tax consolidated groups will need to manage the payment of the PPL Levy and consider its impact on any tax sharing/funding arrangements
- managing PAYG instalment obligations that take into account the rate change particularly during the first year of application.

Private business

As confirmed in the Budget, private companies will have a lower corporate tax rate of 28.5 per cent from 1 July 2015. This should provide much needed cash flow respite to support business activity and growth. However, with the planned introduction of the 1.5 per cent Paid Parental Leave (PPL) Levy from 1 July 2015, which is expected to be payable by a company whose taxable income is in excess of $5 million, the benefit of this corporate tax rate reduction will be eroded.

The Government will also introduce a three year temporary levy – the Temporary Budget Repair Levy – on high income earners from 1 July 2014 until 30 June 2017. The Temporary Budget Repair Levy will apply at a rate of two per cent on an individual's taxable income in excess of $180,000 per annum.

In order to prevent high income earners from salary sacrificing and therefore avoiding the Temporary Budget Repair Levy, the Government has also announced that the Fringe Benefits Tax rate will be increased from 47 per cent to 49 per cent, albeit nine months later from 1 April 2015 and until 31 March 2017.

There is a series of interesting mismatches between the start dates of these initiatives which will inevitably lead to tax rate arbitrage consequences which may encourage employees to assess their salary sacrificing arrangements in the short term.

These initiatives will further increase the differential between the top marginal rate for individuals and the corporate tax rate. This will provide more even more incentive for private businesses to accumulate profits which are subject to the corporate tax rate.

Taxpayers should monitor the details of the new rules and whether any changes will encourage shareholders to access company profits prior to the start of these arrangements.

The reintroduction of fuel excise indexation is a negative as it will increase the cost of doing business.

The Government confirmed its election commitment to establish a Small Business and Family Enterprise Ombudsman and has committed $8 million of funds over four years for this office. The new Ombudsman will be a Commonwealth-wide advocate for smaller enterprises, a single entry point agency for small business to access Australian Government small business programmes and support, contribute to making Australian Government laws and regulations more small business friendly and act as a 'concierge' for dispute resolution.

It is also important to remember that the faster write-off for small business depreciating assets (no longer available post 1 January 2014) and the loss carry-back offset measures (basically a one-year initiative for 2013 only) will be repealed as a result of the Government's election commitment to repeal the Minerals Resources Rent Tax.

Current tax reform affecting the private business sector includes the current reviews being conducted by the Board of Taxation in relation to 'Division 7A' deemed dividends and Small Business tax issues, together with the Parliamentary Joint Committee's Family Business Inquiry and the Government's review of employee share schemes for start-up companies and their employees. We eagerly await the outcome of these reviews and encourage a systematic review of the Australian tax system.

Superannuation and retirement

The Government has not proposed significant change to the superannuation system in this year's Federal Budget. The Government had previously stated it would not make adverse unexpected changes to superannuation in its first term and so the lack of significant change is not surprising.

It is pleasing to see the Government resisted the temptation to change superannuation again in order to achieve short term gain. There has been constant and increasing pressure from industry and the community to provide a degree of certainty after continuous tweaking and greater complexity over many years. Confidence in the system is crucial for the Australian public if they are to be incentivised to save for their own retirement.

Superannuation should be considered as an integral part of comprehensive tax reform that can build a sustainable system to support the ageing population. Greater stability and a higher degree of consultation with industry and transparency prior to change is required to restore greater confidence in the system.

It is pleasing to see the increase in superannuation contribution caps although we still need much greater incentives for making contributions throughout a person's life with more meaningful increases in contribution caps. We also need an ability to accumulate greater levels of superannuation at a time in life when there is higher disposable income available to do so and it is disappointing to see the delay of superannuation guarantee increases.

It is particularly pleasing to see a fairer approach to excess contributions tax.

Any future change will need to ensure superannuation remains the most tax effective environment for many taxpayers to provide for income in their retirement. The combination of tax concessions applying to contributions and investment earnings, and the environment created while a superannuation pension is paid will need to continue to provide individuals with the ability to accumulate wealth in a significantly lower tax environment, compared with other alternatives. The core element of choice needs to be maintained so taxpayers determine the appropriate type superannuation fund including self-managed funds (SMSFs), industry, retail, employer, wholesale etc.

Contribution caps

A significant development from 1 July 2014 is the indexation of contribution caps. Regular indexation of the caps was legislated seven years ago back in 2007, however it has been frozen in recent years. It is pleasing the Government did not seek to again halt the increase in the caps.

Year	Concessional contribution cap			Non-concessional contribution cap	
	Age under 50 years	Age 50 to under 60 years	60 years and over	Standard	3 year bring forward
2012-13	$25,000	$25,000	$25,000	$150,000	$450,000
2013-14	$25,000	$25,000	$35,000	$150,000	$450,000
2014-15	$30,000	$35,000	$35,000	$180,000	$540,000

Whilst we welcome the increase in contributions, the increases do not go far enough. We would like to see further and meaningful increases to both the concessional and non-concessional contribution caps for all taxpayers in order to incentivise Australians to contribute and build meaningful superannuation balances.

Individuals need to be able to make contributions at a time when they can afford it in order to save for their retirement. The low rates of concessional contributions are insufficient for Australians to build meaningful balances in order to provide appropriate levels of income in retirement.

Concessional contributions are not high enough to build meaningful balances. Incentives need to come in the form of increased tax deductibility of superannuation contributions and higher caps at an earlier age and especially at a stage when greater disposable income is available.

Withdrawal of excess non-concessional contributions

The Budget includes a policy to enable individuals who inadvertently exceed the non-concessional contribution cap to withdraw the excess amount plus associated earnings from the fund. Non-concessional contributions are those made out of post-tax income. By choosing to withdraw excess non-concessional contributions the penalty tax will not apply. The refunded earnings will be taxed at the individual's marginal rate of tax (this may be administratively complex). The Government will consult with industry to finalise the detail of the policy which is intended to apply to excess non-concessional contributions made from 1 July 2013.

We very much welcome this announcement as this tax has always represented a disproportionate penalty, with an effective tax rate of up to a 'staggering' 93 per cent applying in some cases due to the interaction with concessional contribution caps.

Recent legislation enables excess concessional contributions made on or after 1 July 2013 to be refunded in full, avoiding the flow on effect to non-concessional contribution caps. Prior to this change the maximum amount that could be refunded was $10,000 and taxpayers had to rely on Commissioner's discretion and the existence of special circumstances.

The combination of the recent measures and this new proposal makes the excess contributions tax system significantly more equitable from the current financial year.

Unfortunately those who have exceeded the caps in prior years cannot benefit from these measures and we would have liked to see this ability to withdraw excess contributions extended to previous years.

Rephasing Superannuation Guarantee

The Government will change the timetable for increasing the superannuation guarantee rate to 12 per cent. The superannuation guarantee rate will increase from 9.25 per cent to 9.5 per cent from 1 July 2014 as currently legislated. The rate will remain at 9.5 per cent until 30 June 2018 and then increase by 0.5 percentage points each year until it reaches 12 per cent.

Year ending 30 June	Previous Coalition proposal (%)	Proposal in Budget (%)
Up to 2013	9	9
2014	9.25	9.25
2015	9.25	9.5
2016	9.25	9.5
2017	9.5	9.5
2018	10	9.5
2019	10.5	10
2020	11	10.5
2021	11.5	11
2022	12	11.5
2023	12	12

Preservation age

The Budget did not contain any measures regarding the preservation age for withdrawing superannuation benefits. The recent Commission of Audit recommended increasing preservation age to 62 by 2027. In its response to the Commission's report, the Government will deal with this issue within the Financial Services Inquiry and the upcoming Tax White Paper.

In spite of the above, the Federal Budget confirmed the increase in the qualifying age for the age pension. The current rate of increase in the qualifying pension age is proposed to continue beyond age 67 so that it reaches age 70 by 1 July 2035.

Other announcements

We have seen a myriad of proposed and confirmed changes to superannuation legislation in the last twelve months, including some major reforms such as the phased increase in the superannuation guarantee rate and the Stronger Super measures. The Government has also clarified its position in relation to the measures announced by the previous Government.

The combination of low contribution caps in the last few years and the introduction of the 15 per cent surcharge from 1 July 2012 has significantly reduced the tax effectiveness of additional superannuation contributions for high income earners. Significant legislative risk, taxes on death benefits and the punitive taxes on inadvertent excess non-concessional contributions result in the need for careful planning.

Super reforms already in place

- Taxing excess concessional contributions tax and allowing refund
- Introduction of 15 per cent surcharge on concessional contributions of high income earners earning more than $300,000
- Improvements to tax outcomes for superannuation death benefits
- Increase in superannuation guarantee rate to 9.25 per cent
- Extension of compulsory superannuation contributions beyond age 70
- Various measures affecting SMSFs including registration of auditors, investment strategy requirements
- Penalties for promoters of illegal early release schemes

Super reforms impending

- SuperStream obligations for superannuation funds and employers
- Abolition of the low income superannuation contribution
- Penalty regime for SMSF trustees

Super reforms not proceeding

- Tax on income earned on pension assets above $100,000 per annum
- Formal review of limited recourse borrowing arrangements by SMSFs
- Ban off-market transfers to/from SMSFs and stricter valuation rules

International tax

Against a background of a changing global tax landscape, it is positive to see that the Government has exercised some restraint in this Budget and refrained from announcing any new major tax developments in the area of international tax, other than proposing a further tightening of the rules regarding the capital gains tax (CGT) treatment of indirect Australian real property interests. As it currently stands, the Government is still in the process of dealing with those substantial international tax amendments announced in last year's Federal Budget, which the Government subsequently confirmed it would proceed with.

This table provides an overview of these measures and their current status.

Measure	Status
Reform of the thin capitalisation regime This broadly includes the following, which will apply to income years commencing on or after 1 July 2014: • reduce the 'safe harbour' debt limit for general entities from 75 per cent to 60 per cent of adjusted Australian assets (from 3:1 to 1.5:1 on a debt to equity basis) • reduce the 'safe harbour' debt limit for non-bank financial entities from 20:1 to 15:1 on a debt to equity basis • increase the 'safe harbour' minimum capital for banks from four per cent to six per cent of the risk weighted assets of their Australian operations • reduce the 'worldwide gearing ratio' from 120 per cent to 100 per cent and make it available to qualifying inbound investors, and • increase the de minimis threshold from $250,000 to $2 million of debt deductions	Treasury released exposure draft legislation in relation to these amendments on 8 May 2014. Following a short consultation period (comments can be made until Friday 6 June 2014), the final legislation will be introduced into Parliament in the current Winter Sittings. See PwC's Tax Talk Alert which outlines key features of the draft legislation.
Amendments to the exemption for foreign dividends This includes removing the exemption for dividends paid on legal form shares that are classified as 'debt' for Australian tax purposes, and extending the exemption to non-share equity and dividends received indirectly via trusts and partnerships. This measure was originally proposed to apply to income years commencing from 1 July 2014.	Treasury released exposure draft legislation in relation to these amendments on 8 May 2014. Following a short consultation period (comments can be made until Friday 6 June 2014), the final legislation will be introduced into Parliament in the current Winter Sittings. See PwC's Tax Talk Alert which outlines key features of the draft legislation. The operative date is likely to be the subject of consultation referred to above.
Limitation on interest deductions for foreign investments Although the Government announced in November last year that it would not proceed with the former Government's plans to repeal the provisions that provided a deduction for 'debt deductions' (such as interest) incurred in relation to debt used to make investments in foreign companies that generate exempt dividends, it announced that it would instead introduce a targeted integrity rule to prevent the use of these provisions for artificial loading of debt in Australia by multinationals.	The Government announced in this year's Federal Budget that it is still seeking advice on this measure. On the basis that the originally proposed repeal of the provision was intended to apply from 1 July 2014, it is expected that the new targeted anti-avoidance measure will apply from that date.

Measure	Status
Tightening the CGT treatment of indirect Australian real property interests As originally proposed, these amendments would treat mining, quarrying and prospecting information and goodwill together with mining rights as real property for the purposes of the 'principal asset test' which is relevant in working out whether a foreign resident has an indirect Australian real property interest and thus subject to CGT on disposal of 'taxable Australian property'. In addition, amendments will also ensure that transactions within a tax consolidated or multiple entry consolidated (MEC) group are ignored for the purposes of applying that test where the effect of the transaction is to create an asset (such as a debt) that is not taxable Australian real property.	Treasury released exposure draft materials in relation to these measures in conjunction with this year's Federal Budget. In relation to the proposed changes to treat mining, quarrying and prospecting information and goodwill together with mining rights as real property for the purposes of the 'principal asset test', the exposure draft material indicates that the Government will await the conclusion of litigation currently before the Courts (Commissioner of Taxation v Resource Capital Fund III LP) that deals with valuation of such assets, so as to determine whether, and in what form, changes are needed. The Government also announced that the amendment proposed to deal with the creation of assets in a tax consolidated or MEC group will also apply more generally to transactions between entities within non-consolidated groups. This additional measure is included in the exposure draft material referred to above, and is proposed to apply to CGT events occurring after 13 May 2014. The measures that apply to transactions between members of a tax consolidated or MEC group will continue to apply retrospectively to CGT events occurring after 7:30pm (AEST) 14 May 2013. Submissions with respect to the exposure draft are required to be made by 9 June 2014. It is likely that the final legislation for these changes will be introduced into Parliament in the current Winter Sittings.
New CGT withholding regime for non-residents From 1 July 2016, a 10 per cent non-final withholding tax will apply to the disposal of taxable Australian property by non-residents, subject to a limited concession for certain low value residential property.	We would expect to see consultation on the design and practicalities of such a regime in the years to come.

The global arena

The international spotlight is firmly on international tax avoidance as a result of the Action plan of the Organisation of Economic Co-operation and Development (OECD) to combat base erosion and profit shifting (BEPS). The Action Plan, which was released on 19 July 2013 and has been endorsed by the G20, comprises 15 actions or work-streams grouped into general actions, treaty actions, permanent establishment and transfer pricing actions, and data and transparency actions. The Action Plan has a tight timeframe with all agreed actions due to be completed by December 2015, and to date we have seen substantial progress, including public consultations and the recent release of discussion drafts in relation to tax treaty abuse, hybrid mismatch arrangements, and the challenges of the digital economy.

It is positive to see that the Australian Government has heeded the warning of the OECD against taking unilateral action to further protect its tax base in this Federal Budget. However, at this stage, the outcomes and success of the BEPS project are far from certain or clear. Some are sceptical of how much will be achieved, despite the current momentum and stakeholder participation. This is principally because of doubts regarding the level of consensus which is achievable. There is a danger of inconsistencies emerging as countries push-back on proposed changes which are inconsistent with their national interests or cherry-pick from the recommendations likely to emerge from this process. There is also a danger of increased instances of double taxation and disputes with revenue authorities across the globe. Almost certainly, the BEPS project will increase uncertainty, red tape and the cost of conducting international business in the short to medium term.

From Australia's perspective, no doubt there is added pressure to be seen to 'lead the way' on BEPS as president of the G20 in 2014. Creating sound tax bases is a critical component of the G20's commitment to promote global economic resilience and growth. Last week PwC sponsored the G20 International Tax Symposium in Tokyo which was a step towards engendering cooperation across various global stakeholders to build an efficient international tax system. We should all be watching this space closely in the lead up to the final meeting of the G20 finance ministers to be held in Brisbane in November this year.

Read more about BEPS in PwC's TaxTalk Alert: 'The forces and tensions shaping BEPS' and for more information in relation to BEPS generally see PwC's BEPS website.

Indirect taxes

Fuel excise to be indexed from 1 August 2014

The Government will reintroduce indexation of excise and excise-equivalent customs duty for all fuels except aviation fuels. Indexation, which will occur biannually commencing on 1 August 2014, was previously frozen in 2001. This measure is expected to generate $2.2 billion in revenue, which is intended to be used for building new and upgrading existing road infrastructure.

The fuel tax increases will be cost neutral for fuel tax credit claimants.

Tax treatment of ethanol and biodiesel

Cost savings are also proposed in relation to the taxation of ethanol and biodiesel.

Specifically, under these measures, the *Ethanol Production Grants Programme* will cease on 30 June 2015, and fuel excise on domestically produced ethanol will be reduced to zero from 1 July 2015. From 1 July 2016 the excise rate will then be increased by 2.5 cents per litre each year for five years until it reaches 12.5 cents per litre (representing 50 per cent of the energy content equivalent rate). The excise equivalent customs duty for ethanol will be retained at 38.143 cents per litre.

From 1 July 2015, grants made under the *Cleaner Fuels Grant Scheme* will be reduced to zero as will the excise on biodiesel. The excise rate for biodiesel will then be increased from 1 July 2016 for five years until it reaches 50 per cent of the energy content equivalent tax rate. The excise equivalent customs duty for imported biodiesel will continue to be taxed at the full energy content equivalent tax rate.

Tax consolidation

Business groups can breathe a sigh of relief knowing that this year's Federal Budget contained no major amendments to the tax consolidation regime. Instead, the Government used this year's Budget to reaffirm its commitment to implement the consolidation measures announced by the former Government in last year's Budget following the release of the Board of Taxation's post-implementation reviews of the Consolidation Regime, with some minor amendments.

Consolidation changes to proceed

To recap, the five amendments that were announced last year in relation to tax consolidated groups were broadly:

- Future deductible liabilities (eg employee leave entitlements) of a joining entity will result in the head company of the joined group including a corresponding amount in its assessable income (referred to as the 'deductible liabilities' measure).
- Non-residents will not be able to buy and sell membership interests between consolidated groups to allow the same ultimate owner 'to claim double deductions' through the resetting of the tax cost of the assets of the relevant joining entity without any recognition under the non-resident capital gains tax (CGT) rules (referred to as the 'churning' measure).
- Intra-group assets will no longer be recognised for purposes of applying the 'principal asset test' in working out whether an indirect Australian real property interest held by a foreign resident is subject to CGT.
- Consolidated groups will not be able to access double deductions by shifting the value of assets between entities, ie when an encumbered asset, whose market value has been reduced due to the intra-group creation of rights over the encumbered asset, is sold by a consolidated group (referred to as the 'double deductions' measure).
- Only net gains and losses on certain intra-group liabilities and assets that are subject to the taxation of financial arrangements (TOFA) regime will be recognised for tax purposes upon exit of a member from a consolidated group (seemingly also included as a 'double deductions' measure).

In this year's Federal Budget, the Government has clarified that the start date for the double deductions, churning and deductible liabilities measures will be amended to apply to arrangements that commence on or after 14 May 2013, rather than to the exit or entry of a subsidiary that takes place on or after that date. Furthermore, the Government has announced that the deductible liabilities measure will be amended so that retirement villages' residential loan liabilities will be excluded from the measure.

The Government also announced an additional measure to be added to this package to address another concern raised by the Board of Taxation. Under this new proposed measure, accounting liabilities relating to securitised assets held by a subsidiary will be disregarded in certain situations where a subsidiary member joins or leaves a consolidated group. This change is to apply to arrangements that commence on or after 7.30pm AEST on 13 May 2014, and transitional rules will apply to arrangements commencing before this time.

Although we are yet to see legislation to give effect to these changes, it is likely that the draft legislation will be released shortly for public consultation, with the aim that final legislation will be introduced into Parliament during the current Winter Sittings.

No changes to be implemented from MEC review

The Government has announced that it will not proceed with the proposal originally announced in the 2013-14 Federal Budget to remove inconsistencies in the tax treatment for multiple entry consolidated (MEC) groups and Australian consolidated groups. The report from the tripartite review commissioned last year, released with the Budget, concluded that there was limited scope to address the inconsistencies without a broader consideration of international tax policy measures. However, the Government has indicated that Treasury will shortly commence consultation on some measures identified by the review, including an amendment to extend a modified form of the unrealised loss rules to MEC groups. Further detail on these measures is to come.

We have seen no further movement on the bulk of the recommendations coming out of the Board of Taxation's reviews since the former Government's in-principle support for most of the other 20 or so recommendations made by the Board in last year's Budget. However, in December 2013 the current Government indicated that Treasury would undertake a broader review of consolidation issues in 2015, and this review would also address the outstanding recommendations from the Board of Taxation.

Resources

Mining Interest Realignments

In last year's Federal Budget it was announced that mining rights and information acquired from a third party and first used for exploration would no longer be eligible for immediate deduction, but would instead be deducted over the shorter of 15 years or the life of the mine.

Applying this change to the realignment of interests in a common project could result in each party having an immediately assessable balancing adjustment in respect of the interest effectively disposed (based on market values), whilst obtaining a deduction for the interest acquired over the life of the relevant tenement. This is an inequitable result in a circumstance where ultimate ownership in the overall project has not changed. Take the following example:

- A Co holds 100 per cent of exploration tenement A with a market value of $20 million.
- B Co holds 100 per cent of neighbouring exploration tenement B with a market value of $20 million.
- A Co and B Co enter a joint venture agreement to share their interests and associated costs of exploration. As a result, A Co and B Co hold a 50 per cent interest in each of tenement A and B. No money is exchanged for this change in interests.
- Under the changes to the deductibility of exploration tenements acquired after 14 May 2013, each of A Co and B Co would be entitled to a deduction of $10 million over the lesser of 15 years or the life of the mine/project. However, the balancing adjustment provisions would give rise to an immediate assessment of $10 million for each of A Co and B Co in respect of the disposal of their respective interests.

This year's Federal Budget includes clarification that such realignments should result in a tax neutral outcome, thereby removing this inequity. The clarification will apply from 7:30pm on 14 May 2013 (ie the date of the original announcement of the change to the treatment of exploration rights). Roll-over relief would be the most likely measure to achieve the tax neutral outcome, although we await further detail on this point.

Exploration Development Incentive

This year's Federal Budget confirms the introduction of the Exploration Development Incentive (EDI) from 1 July 2014, previously announced in the Coalition's Policy for Resources and Energy (September 2013). Details of the incentive were provided in a discussion paper released by Treasury on 13 March 2014.

At the core of the EDI is the ability of exploration companies to convert income tax losses arising from exploration expenditure into a refundable tax credit that can be passed on to shareholders.

Access to the EDI is proposed to be limited to Australian resident companies which are listed or have greater than 50 members. Private companies will generally not have the ability to pass exploration deductions to shareholders.

'Exploration credits' are proposed to be passed to shareholders only in respect of expenditure incurred in a year when the company is in a tax loss position. Further, no assessable income can be derived by the company from mining activities. These conditions will restrict the EDI to companies involved primarily in greenfield exploration activities.

A key issue in administering the EDI will be applying the proposed cap of $100 million over the forward estimate period to 30 June 2017 (capped at $25 million, $35 million and $40 million for the years ended 30 June 2015, 2016 and 2017 respectively). Because the cap is applied on a total cost basis, taxpayers will not be able to precisely pre-determine the extent to which their expenditure will qualify for exploration credits. This will result in significant uncertainty for investors, and will result in delays in the distribution of the credits (likely two years after the company has incurred the expenditure).

The system would likely require integrity measures similar to those applying to the imputation system (eg a 45 day holding period rule).

Enabling access to tax concessions for indirect investment in exploration has been on the wish list of the minerals and resources community for many years. Monitoring the detail of the proposals as they are developed will be important.

Further commentary is available in our April edition of PwC TaxTalk Monthly.

Research and development

Reduction to the Research and Development tax offset rates

In line with the cut to the company tax rate by 1.5 per cent to 28.5 per cent from 1 July 2015, the Government will preserve the relative value of the Research and Development (R&D) Tax Incentive by also reducing the rates of the refundable and non-refundable R&D offsets by 1.5 percentage points, effective from 1 July 2014.

This means that:

- the refundable R&D tax offset will reduce from 45 per cent to 43.5 per cent (for eligible companies with turnover less than $20 million)
- the non-refundable R&D tax offset will reduce from 40 per cent to 38.5 per cent (for eligible companies with turnover of greater than $20 million).

Importantly, the reduction in the R&D tax offset rates will occur from 1 July 2014, one year ahead of the corresponding fall in the corporate tax rate.

R&D benefit in the 2014-15 income year

There will be a small reduction in the benefit of the R&D tax offset for 12 months from 1 July 2014.

For companies eligible for the refundable R&D tax offset in the 2014-15 income year, the outcome will be:

- a reduction in R&D cash benefit from 45 per cent of eligible expenditure to 43.5 per cent (where tax is not otherwise payable)
- a reduction in the R&D benefit from 15 per cent to 13.5 per cent (where the R&D offset is applied against tax otherwise payable).

For all other companies (ie those with turnover greater than $20 million) the R&D benefit will be reduced from 10 per cent to 8.5 per cent.

R&D benefit in the 2015-16 and subsequent income years

Once the corporate tax rate decreases to 28.5 per cent from 1 July 2015, the R&D tax offset will re-align with the corporate tax rate. The overall benefit of eligible R&D activities will return to levels similar to those available before 1 July 2014.

Summary of the net benefit of the R&D tax offset (and income tax deduction equivalent)

Turnover	Current (30% tax rate)	From 1 July 2014 (30% tax rate)	From 1 July 2015 (28.5% tax rate)
<$20 million (refundable tax offset)	**15%** (150% deduction)	**13.5%** (145% deduction)	**15%** (153% deduction)
>$20 million (non-refundable tax offset)	**10%** (133% deduction)	**8.5%** (128% deduction)	**10%** (135% deduction)

Given the imminent start date of these measures, companies should assess the impact of these changes on the after tax cost of any R&D expenditure in the lead-up to the changes.

Restructure of other Industry Assistance Programs

The Government will establish the Entrepreneurs' Infrastructure Programme (EIP) to implement its new approach to industry policy. The program will focus on supporting the commercialisation of good ideas, job creation and lifting the capability of small business, the provision of market and industry information, and the facilitation of access to business management advice and skills from experienced private sector providers and researchers.

However, the new EIP will result in consolidation of many existing programs including the cessation of the following programs from 1 January 2015:

- Australian Industry Participation
- Commercialisation Australia
- Enterprise Solutions
- Innovation Investment Fund
- Industry Innovation Councils
- Enterprise Connect
- Industry Innovation Precincts
- Textile, Clothing and Footwear Small Business and Building Innovative Capability.

It is disappointing to see the loss of many of these industry assistance programs, which have supported predominantly smaller companies in commercialising their innovations over many years.

Other tax measures

Fringe Benefits Tax changes

The Government has announced that it will increase the Fringe Benefits Tax (FBT) rate from 47 per cent to 49 per cent from 1 April 2015 until 31 March 2017 to take into account the proposed two per cent Temporary Budget Repair Levy on high income earners.

This will result in a corresponding increase to the FBT gross-up rates and the FBT rebate.

The cash value of benefits received by employees of public benevolent institutions and health promotion charities, public and not-for-profit hospitals, public ambulance services and certain other tax-exempt entities will be protected by adjusting the relevant concessional caps.

Seafarer tax offset to be abolished

The Government has announced that the seafarer tax offset will be abolished from 1 July 2015, and the savings from this measure will be redirected to repair the Budget and fund policy priorities.

Start date of managed investment trust regime deferred

As expected by many involved in this sector, the Government has announced that the start date for the new tax system for managed investment trusts (MITs) will be deferred by 12 months to 1 July 2015, to allow industry and the Australian Taxation Office (ATO) additional time to implement system changes. Additionally, the Government will amend the law to allow MITs to continue to disregard the trust streaming provisions for the 2014-15 income year.

Exposure draft legislation for the proposed MIT regime is expected to be released for public consultation in June 2014.

Inspector-General of Taxation to manage tax complaints

The Government has announced that it will provide funding to transfer case management of tax complaints from the Office of the Commonwealth Ombudsman to the Inspector-General of Taxation (IGOT). The Government expects this will enhance the systematic review role of the IGOT and provide taxpayers with more specialised and focused complaint handling for tax matters.

Better targeting of not-for-profit tax concessions

In December 2013, the Government announced that it would not proceed with the former Government's measure to 'better target' not-for-profit tax concessions, but would explore simpler alternatives to address the risks to revenue. In this year's Federal Budget, the Government has indicated that it has considered alternatives to this measure and concluded that the alternatives are not required at this time.

National Rental Affordability Scheme to be discontinued

The Government has announced that the final round of the National Rental Affordability Scheme (NRAS) will not proceed and the savings from this measure will be redirected to repair the Budget and fund policy priorities.

The funding for incentives from earlier rounds that are uncontracted or not used within agreed timeframes will be returned to the Budget, however funding for tenanted NRAS properties is not affected.

First Home Saver Accounts Scheme to be discontinued

The Government will achieve significant saving by abolishing the First Home Saver Accounts scheme. New accounts opened from 7.30pm on 13 May 2014 will not be eligible for concessions, with the Government co-contribution to cease from 1 July 2014 and tax concessions and the income and asset test exemptions for government benefits associated with these accounts to cease from 1 July 2015.

ATO to bring forward staff reductions

The former Government had announced total staffing reductions for the Australian Taxation Office (ATO) of 4,700 through to 2017-18. While there will be no net increase in the total staff reductions at the ATO, the Government has indicated in this year's Federal Budget that it will bring forward the reduction in staffing of 1,600 that was due to occur in 2015-16.

Tax reform agenda

At its most basic level, tax reform is the process of changing the way taxes are collected or managed by governments. But this can mean many different things – Australian taxpayers would be familiar with tax reform in the sense of constant tinkering with the tax system to simplify and improve its operation, to lower taxes when it is politically expedient or increase taxes when government needs funding. We've had a few attempts at what is often referred to as 'comprehensive tax reform' – for example, the Ralph Review, the Henry Review, and the Business Tax Working Group – some with greater success than others, but the time is now ripe to tackle the challenge headfirst.

To wrap up PwC's coverage of this year's Federal Budget, we reflect on the tax reform pipeline.

In the lead up to last year's Federal election, the Coalition promised to kick off the next wave of comprehensive tax reform with the delivery of a White Paper on Tax Reform in its first term in Government, with the aim of taking any recommended changes to the next Federal election (likely to be held in 2016). Against this background, however, the Government currently has a large number of other key tax priorities to deliver in the short term, including repealing the Minerals Resource Rent Tax (MRRT) and the carbon pricing mechanism in the face of a potentially hostile Upper House, and the reduction of the company tax rate to 28.5 per cent and the introduction of a 1.5 per cent levy on certain large corporates to fund the proposed new Paid Parental Leave scheme.

The repeal of the MRRT, intended to take effect from 1 July 2014, will also see the loss of a number of related measures including:

- repeal of loss carry back regime with effect from the start of the 2013-14 income year
- removal of small business capital allowances concessions for depreciating assets that are first used and installed ready for use on or after 1 January 2014
- rephasing of the increase in superannuation guarantee (to reach 12 per cent by 1 July 2022, as announced in this year's Federal Budget).

Similarly, the repeal of the carbon pricing mechanism will take with it planned personal tax rate cuts and associated amendments to the low income tax offset, and the equivalent carbon price imposed through the fuel tax credit system, excise and excise equivalent customs duties and synthetic greenhouse gas levies.

Clearing the backlog

The Government undertook to 'restore integrity in the Australian tax system' in late 2013 by clearing the backlog of 92 announced but unlegislated tax and superannuation measures left behind by previous governments. During this process, it confirmed that, in addition to the measures touched on in other parts of our Budget analysis (such as amendments to thin capitalisation and tax consolidation regimes), the following measures would proceed:

- introduction of a new tax regime for Managed Investment Trusts (the Government has announced in this Federal Budget that the start date of this regime will be deferred to 1 July 2015)
- amendments to the existing Investment Manager Regime to implement the proposed third and final element of that regime
- amendments to the Taxation of Financial Arrangements (TOFA) tax hedging provision (also noting that Treasury will conduct a broader review of TOFA in the second half of 2014)
- amendments to the loss recoupment rules for companies with multiple share classes
- look through treatment for 'earn-out' arrangements
- limiting the scope of the integrity provision in the debt/equity rules
- introduce a targeted integrity measure for Offshore Banking Units
- GST reverse charge for going concerns.

Of the 92 unenacted measures, the Government also confirmed last year that it would not proceed with 55 of them, and in a welcome move, announced it will provide statutory protection for taxpayers who self-assessed on the basis of an announced measure that will no longer proceed.

Measures no longer proceeding include:

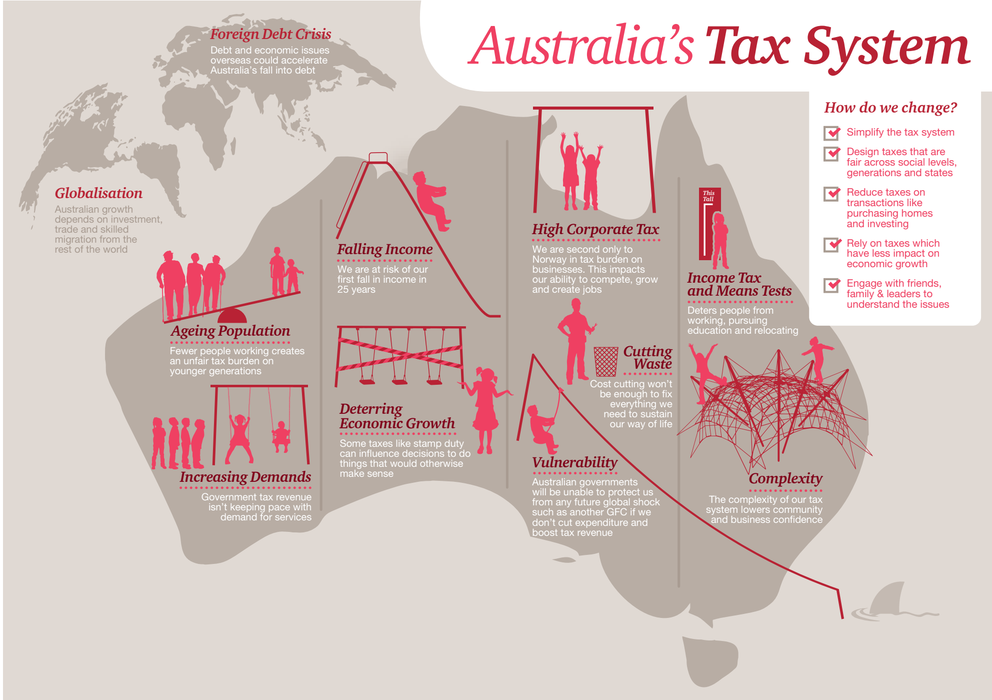
- imposing a tax on earnings on superannuation assets supporting pensions
- amendments in relation to the application of the tax consolidations provisions to demergers, and technical amendments regarding collection of tax liabilities from tax consolidated groups
- modernisation of the controlled foreign company (CFC) provisions and introduction of a foreign accumulation fund rule (reform of Australia's CFC provisions is likely to re-emerge down the track following the work of the Organisation of Economic Cooperation and Development on base erosion and profit shifting) implementation of recommendations from the Board of Taxation's 2008 report on modifying the tax treatment of off-market share buy backs.

Whilst the Government's efforts to clear the backlog are commendable, it is in some ways disappointing as some of the measures that are now 'not proceeding' represented real technical deficiencies in the law or opportunities to improve the tax system. Additionally, little progress has been made on those measures that are to proceed, despite assurances from Government that the bulk of the legislation should be passed by Parliament during 2014. As this creates ongoing sources of uncertainty for taxpayers, it is vital that the Government honour its commitment to legislate these measures without further delay.

The need for broader tax reform

Amongst all of this 'tinkering', the Government remains committed to conducting a 'white paper' process in regard to tax reform prior to the next Federal election and to take to the election tax policies to seek a mandate for implementation in the Government's second term. This process is unlikely to kick off until early 2015, and unfold over the following 18 months. This is likely to include input from other reviews currently underway or scheduled to take place, including:

- the Financial System Inquiry, whose terms of reference included the examination of the taxation of financial arrangements, products or institutions to the extent these impinge on the efficient and effective allocation of capital by the financial system, and to provide observations that could inform the Tax White Paper
- the White Paper on Reform of the Federation, which the Government committed to produce within two years of being elected. This could include discussion of the allocation of taxing rights between Federal and State and Territory governments (noting that the recent Commission of Audit suggested that State and Territory governments should have access to the personal income tax system to fund their own priorities) and the distribution of Federal Government revenues (eg revenue from the Goods and Services Tax) to the states and territories.



PwC believes there is a clear need for comprehensive tax reform – done the right way. The 'right way' means increasing those taxes that have the least effect on investment and employment, and at the same time reducing reliance on taxes that distort incentives to work, invest and transact business. It also means addressing those factors which increase the complexity of the tax system and the cost of compliance. Without comprehensive tax reform, government debt levels as a proportion of GDP will continue to rise to unsustainable levels, and Australian governments risk not being able to meet the key needs of our community and further slide into debt. You can read more about the case for comprehensive tax reform in PwC's Protecting our Prosperity series, available on PwC's Tax Reform website.

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