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GRANT THORNTON
FEDERAL BUDGET 2016 REVIEW

FOREWORD

NOT JUST ANOTHER BUDGET

Treasurer Scott Morrison's 2016-17 Budget targets growth tied to an ambitious national innovation and infrastructure plan aimed squarely at growth and jobs for the 2 July federal election.

The focus was on transitioning from a mining-led economy to a stronger, more diverse economy, with measures to set Australia on a more sustainable footing to bringing the budget back to balance.

The mix of **tax measures** announced is good news for mid-sized businesses. Progressive company tax rate reductions from 30% to 25% over the next ten years kick off with a one per cent drop for businesses with a turnover of up to $10 million and embrace mid-size businesses as the plan proceeds. This ten-year enterprise plan accompanies tax integrity measures, as well as defence spending and changes to superannuation. However, it will be hard to make headway against the current $40 billion deficit, with nominal growth projected well into the next five years.

In a welcome move, the government is promoting **growth** for mid-size businesses, with $195 million in tariff reductions to flow from the recently signed Trans Pacific Partnership agreement – good news for those looking for growth opportunities in the Asia Pacific region.

Promoting a more **diverse** workforce, the Treasurer also unveiled greater support for women re-entering the workforce, with top-ups to superannuation from spouses who stay in the workforce.

As well, the fintech sector is not forgotten, as the government moves to introduce e-invoicing, as well as a $230 million **cyber security** Strategy for Australian businesses to develop security capacity globally.

DIVE INTO THE DETAIL

In our in-depth 2016-17 review of the tax changes announced in last night's Budget, our specialists have again put together a detailed summary, with targeted commentary on corporate tax, international tax, and how the budget will impact individuals, including a look at the changes announced to superannuation.

Please contact your usual Grant Thornton advisor for further specific advice and to answer any queries that emerge from our summary of how the Budget affects you and your business.

CONTENTS

CORPORATE AND INTERNATIONAL TAX

TAX WAS A CORNERSTONE OF THE BUDGET, WITH A NUMBER OF PROPOSED TAX CUTS AND INCENTIVES ANNOUNCED, AS WELL AS A RAFT OF INTEGRITY MEASURES AIMED AT FUNDING THOSE CONCESSIONS.

Mid-size business should be pleased as this budget is a step in the right direction to recognise and support growth for this important segment. However, there's opportunity for more to be done to ensure the engine room of Australia's economy is supported to succeed. While some concessions (like the corporate tax rate reduction) will be of great benefit, the time before business can access the concessions is disappointing. Further, the extra demands of the announced integrity measures could prove more challenging to mid-size business than any other sector. Small companies are less likely to be impacted, while larger companies will have the resources to more easily deal with these extra demands.

The key measures are set out below.

CORPORATE TAX RATE REDUCTIONS

As part of its Ten Year Enterprise Tax Plan, the Government announced a program to cut company tax rates from 30 per cent to 27.5 per cent for all businesses with a turnover of up to $10 million, effective from 1 July 2016.

Following this initial company tax rate cut, there will be a gradual decrease of the company tax rate to 25 per cent by 1 July 2026.

This announcement will come as welcome relief to mid-size businesses who might have felt short-changed after missing out on the previous 1.5 per cent rate cut for small businesses. We also expect mid-size businesses to benefit from the reduced tax burden, enabling them to focus on growing and strengthening their operations. Foreign investors will also gain from this proposal, providing favourable conditions for investment into the Australian economy.

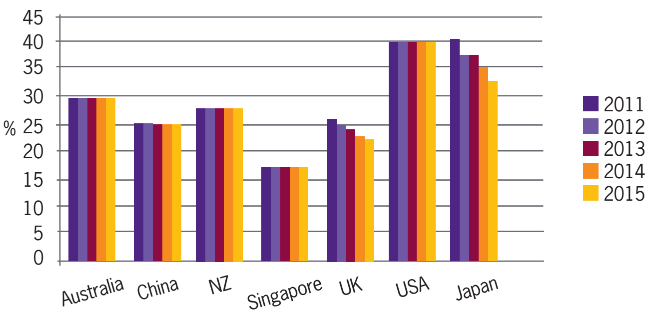
The annual aggregated turnover threshold for companies entitled to the 27.5 per cent tax rate will increase from $10 million as follows:

- $25 million in the 2017-18 income year
- $50 million in the 2018-19 income year
- $100 million in the 2019-20 income year
- $250 million in the 2020-21 income year
- $500 million in the 2021-22 income year
- $1 billion in the 2022-23 income year

As a result, all companies with a turnover of $1 billion and below should have a flat rate of 27.5 per cent by the 2023-24 income year and 25 per cent by the 2026-27 income year. These measures will introduce the first significant company tax cuts in over a decade, with the last one occurring in 2001 under the Howard government.

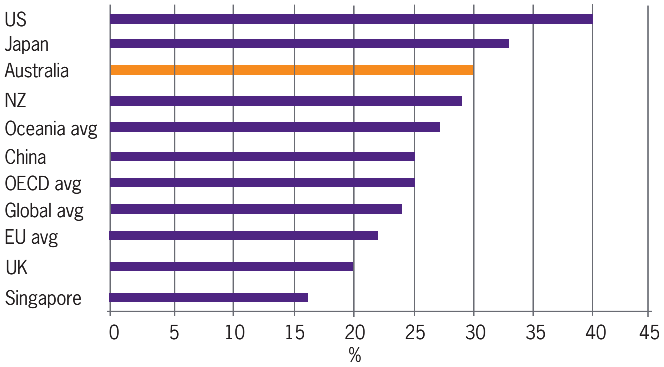
The reduction to the company tax rate follows growing concern that Australia is becoming uncompetitive in the face of the changing global landscape. As seen in the graph below, countries such as the UK and Japan have taken steps to reduce their effective company tax rates over the past five years by six and eight per cent respectively. During that same time, Australia's company tax rate has stagnated at 30 per cent.

COMPANY TAX RATES OVER FIVE YEARS



Globally, Australia also has one of the highest company tax rates, alongside the US and Japan, as illustrated in the following graph. (It is, however, important to note that Japan and the US have a much stronger global reach than Australia and are therefore better positioned to generate economic activity despite their higher-than-average corporate tax rates).

2015 GLOBAL COMPANY TAX RATES



The Treasurer made clear that Australia needs to attract more investment to drive growth in the post-mining boom with additional work required to strengthen our global economic standing.

Based on this rationale we think there needs to be more urgency on the timing of these rate cuts. Innovative mid-size businesses should have access to the 27.5 per cent rate sooner than the proposed five-year time frame, with sufficient evidence available suggesting Australia will fall behind if an immediate tax reduction is not implemented. While we support the Treasurer's plan to reduce Australian company tax rates to 27.5 per cent, and ultimately to 25 per cent as part of the government's plan, it still lags behind OECD, EU and global averages.

Following the proposed changes to the company tax rate, franking credits will be able to be distributed in line with the rate of tax paid by the company making the distribution. Companies will also need to manage their PAYG instalment obligations, particularly during their first year of change.

Notwithstanding that more needs to be done to reduce company tax rates in a shorter timeframe, we support this announcement with the expectation of growth in inbound foreign investment, strengthening of jobs in Australia and the reduction of tax burdens on growing mid-size businesses.

GOVERNMENT HAMMERS MULTINATIONALS

The government also announced measures to combat multinational companies (MNC) tax avoidance. To close the deficit loophole, the government is relying on combative actions focused on those MNCs perceived as not paying their legitimate share of taxes. However, these measures will affect all companies, particularly mid-size businesses, significantly adding to the costs of tax compliance.

As a first measure, the new ATO Tax Avoidance Taskforce will receive $680 million of additional funding and 1,000 new staff over four years, to crack down on avoidance schemes of large public and private groups and high-net-worth individuals.

Central to the budget is the new Diverted Profits Tax (DPT) which is expected to come into effect from 1 July 2017. The new tax will target MNCs with global revenues of $1 billion or more, which are found to have artificially diverted profits from Australia through transfer pricing arrangements, reducing their Australian tax liability by more than 20 per cent. The DPT is not applicable to MNCs with Australian turnover of less than $25 million, unless they have artificially booked their revenue offshore. Under the new regulations, penalties of up to 40 per cent will be imposed on the diverted profits.

Mid-size businesses which are part of a large global group will need to be wary of these provisions, as it may impact on both them and their global organisation.

In a second measure to combat tax anti-avoidance, the Government will introduce new transfer pricing rules to better align its existing transfer pricing regulatory framework to the OECD BEPS action plan. The new measures focus on pricing of commodity transactions, intragroup services and cost contribution arrangements, as well as the application of the transactional profit split method.

A key area of focus is the valuation of intangibles. A controversial aspect of the new rules will allow the ATO to use information that only comes into existence after the transfer of the intangible, to determine whether the transfer of the intangible was done at arm's length. This could lead to potential tax adjustments for intangibles already transferred.

This rule will create significant uncertainty for businesses looking to legitimately manage intangible assets or transfer intangible assets offshore.

The DPT and the new transfer pricing rules, along with the Multinational Anti-Avoidance Law (MAAL) introduced last year, are expected to raise an additional $650 million over the next the four years.

Although the measures are intended to combat opportunistic tax planning and profit shifting by MNCs, MNCs and mid-size businesses with legitimate business models will undoubtedly be impacted by having to defend their positions and endure lengthy ATO enquiries and costs. The ATO has already selected 400 companies for review under the anti-avoidance provisions announced in last year's Budget and this number will more than double with the new measures.

In particular, the MAAL provisions have impacted MNCs that have previously avoided paying GST. With the ongoing MAAL reviews, mid-size businesses that are part of a multinational group face the dilemma of reducing their profit margins to remain competitive or increasing their prices to consumers to include the new GST. This may have flow-on effects for their investment and employment decisions.

While the budget contained many positives for mid-size business, the multinational company tax avoidance announcements will be disruptive, particularly as the Government expects to raise $3.7 billion in additional revenue over the next four years with the new Tax Avoidance Taskforce.

NEW COLLECTIVE INVESTMENT VEHICLES RULES

A new tax and regulatory framework has been proposed for two new types of collective investment vehicles (CIV):

- The corporate CIV – from the income year starting on or after 1 July 2017, and
- The limited partnership CIV – from the income year starting on or after 1 July 2018

The new framework aims to allow Australian fund managers to offer investment products using vehicles commonly in use globally, thereby improving the international competitiveness of the Australian managed funds industry. The new rules should allow investors the flexibility to pool their funds, and have the funds managed by a professional funds manager via a company or a limited partnership (in addition to the current option to invest via a Managed Investment Trust (MIT)).

The new CIVs are required to satisfy similar eligibility criteria as MITs. Broadly, this requires the CIV to be widely held, and not carrying on a trading business.

TAXATION OF FINANCIAL ARRANGEMENTS

The government is proposing to reform the Taxation of Financial Arrangements (TOFA) rules which currently calculate the amount and timing of gains and losses on financial arrangements. These measures will reduce compliance costs, provide more certainty and, importantly, remove the majority of taxpayers from the scope of the TOFA rules.

While the current regime was designed for the largest taxpayers, these rules inadvertently captured a significant number of mid-size businesses with small operations in Australia. The proposed measures will therefore align with the objective previously sought when the rules were enacted.

The measure contains four key components:

- A 'closer link to accounting' which will strengthen and simplify the existing link between tax and accounting in the TOFA rules
- Simplified accruals and realisation rules that will significantly reduce the number of taxpayers subjected to the TOFA rules
- A new tax hedging regime which is easier to access, encompasses more types of risk management arrangements (including risk management of a portfolio of assets) and removes the direct link to financial accounting
- Simplified rules for the taxation of gains and losses on foreign currency to preserve the current tax outcomes but streamline the legislation

The proposed redesign of the TOFA framework is certainly a welcome measure for mid-size business, as it will remove the currently complex and burdensome regime for many.

TAX CONSOLIDATION MEASURES

The budget also introduces a number of integrity measures for the tax consolidation regime, specifically with respect to entities joining and leaving a tax consolidated group. These integrity measures are intended to address previously unintended risks, uncertainties or anomalies identified in the tax cost-setting provisions. Broadly, these should act to simplify the tax cost-setting process.

DEFERRED TAX LIABILITIES

Currently, the entry and exit tax cost-setting process in the consolidation provisions include adjustments that must be made for deferred tax liabilities. This measure proposes to remove the current adjustments in the tax cost-setting process relating to deferred tax liabilities. By doing so, it is expected that the commercial and tax outcomes will be more closely aligned, therefore removing any unintended anomalies and reducing the complexity of the tax cost-setting process.

These measures will apply to joining and leaving events from transactions that commence after the date the amending legislation is introduced in Parliament. These changes are long overdue and the reduced complexity and removal of anomalies will benefit taxpayers.

DEDUCTIBLE LIABILITIES

This integrity measure applies to prevent tax consolidated groups from obtaining a double tax benefit whenever a joining entity has 'deductible liabilities', by excluding these liabilities from the tax cost-setting process.

This measure was initially introduced in the 2013-14 budget and has been modified to remove certain inequitable consequences for taxpayers that were identified during the original consultation process and also to provide a simpler approach than the earlier 2013-14 formulation.

The starting date for these measures has been deferred from 14 May 2013 to 1 July 2016, and is a welcome change, as many taxpayers were facing uncertain outcomes given the implementation of the original measures was delayed.

SECURITISED ASSETS

Under these measures, accounting liabilities that relate to securitized assets held by a subsidiary are disregarded in certain situations where the subsidiary joins or exits a tax consolidated group.

This measure was initially announced as part of the 2014-15 budget to address the anomaly that arose in the consolidation regime due to the asymmetrical treatment of certain assets and liabilities under the tax cost setting rules in relation to securitized assets; however, it only applied to financial institutions. This has now been extended in the 2016-17 budget to apply to both financial and non-financial institutions.

The change will apply to arrangements that commence on or after 7:30pm (AEST) on 3 May 2016. Transitional rules will apply to arrangements that commence before this time.

REMOVING THE TAX BENEFIT OF HYBRID INSTRUMENTS

As part of its tax integrity measures, the Government will introduce legislation to combat hybrid mismatch arrangements. This reflects Action 2 under the OECD's Base Erosion Profit Shifting (BEPS) action plan. Similar to the Diverted Profits Tax, the Government has followed the UK which has proposed similar measures.

Hybrid mismatches arise where multinational companies take advantage of different tax rules in the various jurisdictions in which they operate. New rules will be introduced to neutralise the impact of such arrangements at a global level.

For example, an Australian subsidiary of a foreign parent company may obtain an interest deduction on funds 'borrowed' from its parent as the funds are classified as debt interests for tax purposes. However, the parent company in its jurisdiction is able to treat the funds provided as equity and therefore any return on such funds may be treated as a tax-free dividend.

The rules for hybrid mismatch arrangements are therefore likely to target transactions between related entities in multinational groups and will be an addition to the ATO's arsenal in maximising global profits that are captured for tax in Australia.

ASSET-BACKED FINANCING ARRANGEMENTS

The government has announced it will remove key tax barriers to the use of asset-backed financing arrangements, for example deferred payment and hire purchase arrangements.

The aim of these measures is to align the tax treatment of such funding to interest bearing loans. It is anticipated that these changes will make such financing options more attractive for Australian businesses looking to grow and expand, which can only assist mid-size business funding.

Further clarity is still to be provided around the proposed measures, which will not apply until 1 July 2018.

GST: LOW-VALUE IMPORT THRESHOLD TO BE ABOLISHED

The Federal Government has announced changes to the low-value import threshold for goods being imported into Australia, by extending GST to all imported goods from 1 July 2017. This measure is targeted at the surging sales of goods from overseas-based online retailers and to level the playing field for all retailers, including those mid-size businesses that are competing against foreign players not caught by Australia's GST net.

Grant Thornton believes the change will be a win for domestic retailers and will bring Australia into line with similar measures imposed by other OCED countries.

The Federal Government is expecting that overseas suppliers that have an Australian turnover of $75,000 or more will be required to register for GST to collect and remit the GST for low-value goods being supplied to Australian consumers. We expect that the practicalities of imposing and enforcing the obligation on overseas suppliers to register for GST to collect and remit the GST will be challenging.

DIVISION 7A

Welcome changes are planned for all private businesses that utilise a company in their operations regarding the operation and administration of the Division 7A rules; however, these changes will not take effect until 1 July 2018, i.e. the 2019 financial year.

The changes are intended to provide clearer rules and ease the compliance burden while ensuring the overall integrity and policy intent of the law.

Subject to the outcomes of the post-implementation review and consultation process, the Government will amend the Division 7A rules to include:

- a self-correction mechanism providing taxpayers whose arrangements have inadvertently triggered Division 7A with the opportunity to voluntarily correct their arrangements without penalty
- new safe harbour rules such as for use of assets to provide certainty and simplify compliance for taxpayers
- amended rules, with appropriate transitional arrangements, regarding complying Division 7A loans, including having a single compliant loan duration of 10 years and better aligning calculation of the minimum interest rate with commercial transactions; and
- technical amendments to improve the overall operation of Division 7A.

SUPERANNUATION

SUPERANNUATION — STILL EFFECTIVE, BUT DIMINISHING RETURNS

Stemming from the progressive reforms of the mid-1980's, Australia's superannuation system has continued to be a resounding success. A victim, in fact of its own success, with this Budget's superannuation reforms underpinned by the rationale that investors have been using the system too well.

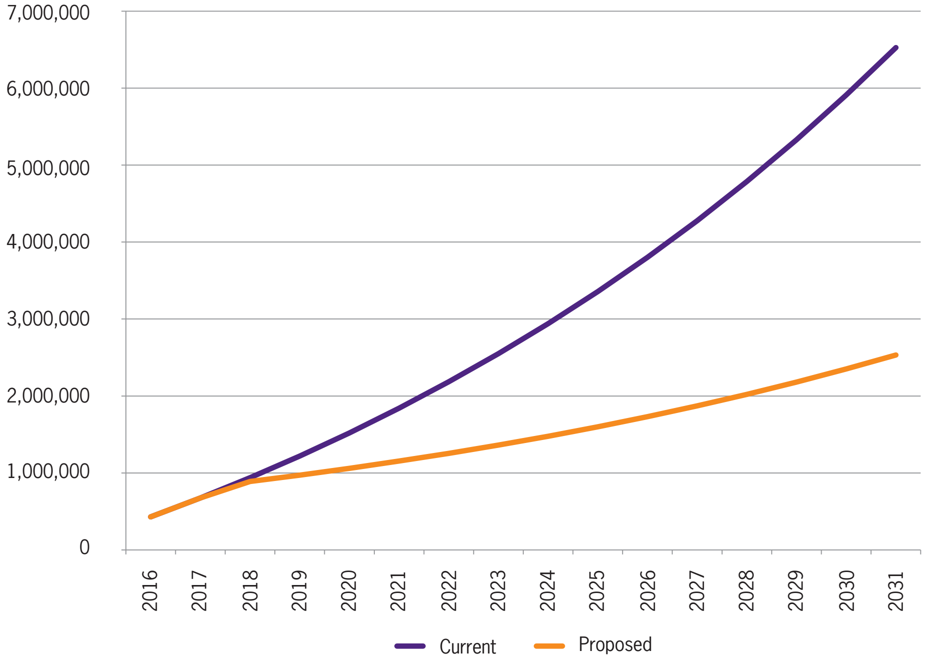
By enshrining within legislation the Objective of Superannuation "to provide income in retirement to substitute or supplement the Age Pension", The government is clearly signalling that superannuation should not be an estate planning tool.

Most of the proposed reforms, which are summarised below, will apply from 1 July 2017. Their impact is a mixed bag for mid-size business. While there are welcome measures that provide greater flexibility, there is a price for being too successful. Perhaps the biggest revenue raiser will be the need to reduce pension balances to $1.6 million per person by 1 July 2017 – inconvenient, but a reversal of a measure that was probably too generous.

A particularly harsh measure is the retrospective application of a new $500,000 lifetime cap for non-concessional contributions back to 1 July 2007. Many mid-size businesses that have had the discipline to release cash from their businesses to build separate wealth will now have to find a new home for their savings. The potential impact is illustrated by the graph that follows the table below: the new rules mean that less than 40 per cent of the current potential superannuation nest egg will be available in 15 years' time.

FEATURE	WHAT'S CHANGED?	IMPACT
CONTRIBUTIONS PHASE		
Work test	Removed from 1 July 2017	• Contribution caps to be only restriction up to age 75
Non-concessional contributions	Annual $180,000 to be replaced by $500,000 lifetime cap (indexed to average weekly ordinary time earnings, or AWOTE) from 3 May 2016 Lifetime cap to be backdated to 1 July 2007	• Restricted ability to use super as a savings and asset protection vehicle • Limited ability to repay existing super gearing facilities • Pre-3 May 16 contributions count towards cap but won't trigger an excess contribution
Concessional contributions	Cap reduced to $25,000 from 1 July 2017 (currently $30,000 or $35,000 for those over 50)	• Reduced ability to save for retirement • Reconsider salary sacrifice arrangements • $25,000 indexed to AWOTE
	Personal super contribution deductions permitted from 1 July 2017 without restriction up to age 75	• Self-employed not penalised for having part-time employment • Employees not disadvantaged if not using salary sacrifice • An extra 10 years of tax deductible contributions available without work test
	Catch-up contributions permitted for "unused cap amounts" accruing from 1 July 2017 if balance less than $500,000 (calculated on five-year rolling basis)	• Opportunity for all people, including those with interrupted work or savings patterns, to catch up with retirement savings tax effectively where they don't use their maximum caps • Salary sacrifice would be a useful tool for catch up
	Threshold for extra 15% superannuation contributions tax reduced from $300,000 to $250,000 from 1 July 2017	• Super not taxed as effectively from $225,000, so may need to reconsider salary sacrifice arrangements
	Current Low Income Superannuation Contributions to be replaced by Low Income Superannuation Tax Offset (LISTO)	• LISTO to operate similarly to current system
	Threshold raised for low income spouse super tax offset from $10,800 to $37,000 from 1 July 17	• Up to $540 offset, phasing out at income of $40,000 • Helps boost saving for low income spouse
SAVING PHASE		• Super gearing, i.e. LRBAs or Limited Recourse Borrowing Arrangements still permitted
RETIREMENT PHASE		
Transition to Retirement Pensions	Earnings no longer tax-free from 1 July 17 Election to treat withdrawals as tax-free lump sums no longer available	• Depleted earnings and growth: 15% tax with 10% CGT
Pension income streams	$1.6 million transfer balance cap for "retirement pensions" from 1 July 17 (indexed in $100,000 CPI-based increments)	• Tax-free earnings will only apply to the first $1.6 million capital plus growth • Balance can stay in super, but taxed at 15% with 10% CGT • Need to track progressive percentage use of cap • Fluctuations after initial measurement against cap will be ignored • Incentives to pursue high growth strategies in pension accounts, including allocated high risk/return investments and LRBAs
	Existing retirement pensions must reduce their retirement account balance to $1.6 million by 1 July 17	• Reduced tax exemption • Need to consider whether best to withdraw excess or leave it in super
Recycling/ recontribution strategy	$500,000 lifetime non-concessional cap restricts contributions	• Greater accumulation of wealth outside super during life • More tax on death benefits paid to next generation
ESTATE PHASE		
Anti-detriment deduction for certain lump sums	Deduction removed from 1 July 2017	• Potential reduction in benefit payouts to survivors
Pension income streams	Balances above $1.6 million will not lock in tax-free component as a percentage	• More tax on death benefits paid to next generation

ASSUMPTIONS: 50 YEAR OLD WITH A SUPER BALANCE OF $200,000 CONTRIBUTES MAXIMUM CONCESSIONAL AND NON-CONCESSIONAL CONTRIBUTIONS ANNUALLY (NCC SUBJECT TO LIFETIME LIMIT). EARNINGS AT 8% PER ANNUM.



OTHER TAX MEASURES

PERSONAL TAX RATES FROM 1 JULY 2016

Alert to the politically sensitive issue of bracket creep, the government announced last night an increase in the 32.5% personal income tax threshold from $80,000 to $87,000 from 1 July 2016. This positive measure will shield around 500,000 taxpayers from a 37% marginal tax rate and provide modest tax savings for higher income earners.

BUDGET DEFICIT LEVY NOT TO BE EXTENDED

Also noteworthy is the announcement that the two per cent budget deficit levy (tax) on incomes over $180,000 will not be extended beyond 30 June 2017, which contrasts with Labour's intention to extend the levy beyond the legislated three-year period if elected.

UNINCORPORATED BUSINESSES

To complement the company tax rate reductions, the tax offset for unincorporated small businesses (e.g. sole traders and partners in a partnership) will increase over a 10-year period from five per cent to 10.

SMALL BUSINESS TAX MEASURES

SMALL BUSINESS THRESHOLD

A welcome initiative is the increase of the small business entity threshold from $2 million to $10 million from 1 July 2016. As a result, a business with an aggregated annual turnover of less than $10 million will be able to access a number of small business tax concessions from 1 July 2016 including:

- simplified depreciation rules, including immediate tax deductibility for asset purchases costing less than $20,000 until 30 June 2017 and then less than $1,000
- simplified trading stock rules giving businesses the option to avoid an end-of-year stocktake if the value of the stock has changed by less than $5,000
- a simplified method of paying PAYG instalments (calculated by the ATO) which removes the risk of under or over-estimating PAYG instalments and the resulting penalties that may be applied
- immediate deductibility for various start-up costs (e.g. professional fees and government charges)
- a 12-month prepayment rule; and
- a more generous FBT exemption for work-related portable electronic devices (e.g. mobile phones, laptops and tablets)– note the FBT car parking exemption for small business already applies to entities with annual gross income of less than $10 million.

FROM A GST PERSPECTIVE

- The GST cash accounting threshold will be extended in line with the increase to the definition of small business from $2 million to $10 million.

- Simplified GST reporting will also be trialled from 1 July 2016 – the government estimates that between 90,000 and 100,000 businesses will benefit from this measure.

CGT CONCESSIONS

Less exciting for small family business is that small business tax changes will not affect eligibility for the small business CGT concessions, which will only remain available for businesses with annual turnover of less than $2 million or that satisfy the maximum net asset value test (and other relevant conditions such as the active asset test).

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