Grant Thornton

An instinct for growth™

Federal Budget 2014-15

Budget opportunities: are we poised for growth?

In the lead up to the budget, Treasurer Joe Hockey made the focus of the Abbott government clear: **“This budget is about shaping the destiny of our nation”.**

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Introduction

Contribution from all Australians to rebuild the prosperity of our nation underpins the 2014-15 Federal Budget. Mr Hockey has balanced this "heavy lifting" with measures which hope to incentivise ongoing economic stimulus and thereby create new jobs and benefits for higher education, health and a sustainable welfare system.

Stimulus measures announced in the Budget include the deregulation of higher education and the establishment of the Medical Research Future Fund, as well as the direct linking of the fuel indexation measure to our roads building budget and the Infrastructure Growth Package.

Other announced measures which will inflict some degree of "pain" include the temporary 2% Budget deficit levy, the increase in qualifying age for the age pension, and the tightening or abolition of a range of personal tax offsets and family tax measures.

As Mr Hockey stated, our "age of entitlement" is over and it is time for us to contribute to the future of our country by paying our share.

Every Australian will be impacted in some way, either through the incentives for increased workforce participation, the tightening of our welfare system or through increases in the taxes and levies they are required to pay. Australian industry will also feel some of the pain of the planned measures as government assistance is reduced and it is required to stand on its own two feet, instead of being propped up by government aid or support.

However, there is some good news for companies, in particular mid-sized businesses who reinvest for growth, namely the reduction in the corporate tax rate to 28.5%. The widening gap between the top marginal tax rate and the corporate tax rate also presents some interesting tax planning opportunities for mid-market companies.

Although the Budget did not deliver any significant tax reform, we believe that the planned Tax Reform White Paper (which was a Coalition election promise) is the right approach for effecting change in our tax system and that any recommendations should be taken to the Australian people at the next election. We believe that, when it comes, this reform should not involve a myriad of overly complex measures but should centre around a small number of highly effective "big bang" measures.

Any meaningful tax reform needs to include changes to the base or rate of GST. An increase in the GST rate is appropriate as the incidence of tax will be on those who can afford it, the consumers. Consumption-based taxes are relatively equitable and efficient and an increase in the GST will therefore be effective in stimulating growth and investment in our economy, as well as bringing us into line with other OECD countries who have overseen increases in their consumption tax rates and bases.

Despite this, there is still great uncertainty within our tax system, with many announced changes remaining unenacted and others suffering fierce opposition in a Senate which is controlled by the opposition. These include the MRRT, the carbon tax, the company loss carry back rules and the small business capital allowance rules.

We look forward to a resolution of these issues to increase investor confidence and promote growth and prosperity in our economy.

As Mr Hockey stated, our **"age of entitlement"** is over and it is time for us to contribute to the future of our country by paying our share.

Business tax measures

Decrease in corporate tax rate and the introduction of the Paid Parental Leave Scheme

The Government confirmed that it was committed to cutting the company tax rate by 1.5 percentage points from 30% to 28.5% with effect from 1 July 2015. This coincides with the planned introduction of the Government's much hyped paid parental leave scheme.

Large companies (taxable incomes of greater than $5 million) will need to pay a 1.5% Paid Parental Leave levy from 1 July 2015, which will fully offset the drop in the corporate tax rate.

Whilst the Paid Parental Leave Levy may be viewed as an impost on large business, the "Mum and Dad" and self-managed super fund shareholders of these companies may be the real losers due to loss of the franking credits available to pass on to them. This is because it is likely that the Paid Parental Leave Levy will not result in the generation of any franking credits thereby limiting franking credits to the 28.5% corporate tax rate.

R&D changes

The Government has announced that the R&D tax offset is to be reduced by 1.5% from 1 July 2014 in line with the reduction in the corporate tax rate. However, the corporate tax rate cut actually comes a year after the reduction in the R&D tax offset rate. This measure will not be welcomed by mid-sized business and will not encourage the growth the Government seeks to achieve.

The Treasurer stated that one of the features of the budget was stability in tax policy. The reduction of the refundable R&D tax offset rate to 43.5% and the non-refundable R&D tax offset rate to 38.5% from 1 July 2014 is not an example of this. By tying this change to the corporate tax rate, the Government is trying to make it more palatable but this ignores the fact that the companies who get the most out of the R&D tax offset are not tax paying. They are the startups who are in tax losses, so this change will directly affect the cash these companies have. For those companies that are paying tax, the sting, of course, is the timing of the introduction, being one year prior to the reduction in the corporate tax rate.

Many mid-sized businesses have come to Australia in the last two years, attracted by the R&D tax incentive. Some of these companies are coming here and doing what the Government is seeking to do with its Medical Research Fund, being medical research. But this also misses the piece around encouraging the creation of jobs. There was no discussion of announcements made in the lead up to the election including review of innovation policy and looking at patent box incentives to encourage manufacturing to be undertaken in Australia.

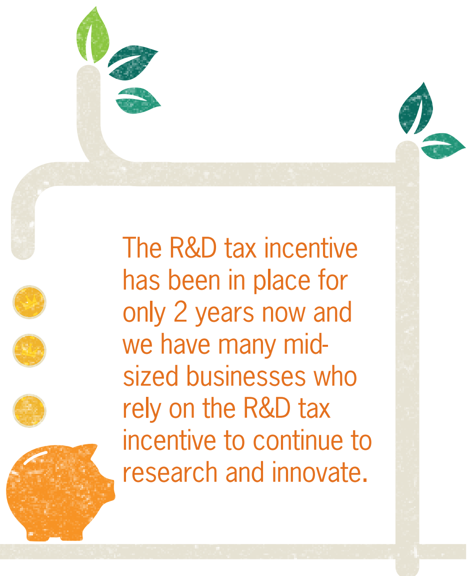
In order to have sustained growth there needs to be stability in policy. This means knowing what the position is more than one year out. The R&D tax incentive has been in place for only 2 years now and we have many mid-sized businesses who rely on the R&D tax incentive to continue to research and innovate. These changes come on the back of dismissing the policy for the payment of quarterly credits. If the amount of cash is going to be reduced, it would have been a measure of good faith to at least have access to it on a more timely basis. From an innovation perspective, what this budget has delivered is doubt - will there be further reductions going forward; are there going to be other changes to the law?

Investment in Foreign Companies

The Treasurer announced in November 2013 that it would not proceed with the former Government's proposal to repeal Section 25-90. This section allows Australian companies to claim an interest deduction on borrowed funds used to invest in overseas companies (even though the dividends ultimately received from such an investment are exempt from Australian tax). Although not repealing section 25-90, the Government indicated that it would instead target certain conduit arrangements by introducing an anti-avoidance provision.

The Budget updated this announcement in that the Government has not yet made a decision on a targeted anti-avoidance scheme (which is likely to include limiting deductions under Section 25-90 in certain circumstances) as it is still seeking advice.

At present, taxpayers can continue with their existing overseas investment structures and still obtain an interest deduction, subject to satisfying Thin Capitalisation rules. This is positive for our clients on the face of it, although certainty and clarity in tax laws is still preferred.



The R&D tax incentive has been in place for only 2 years now and we have many mid-sized businesses who rely on the R&D tax incentive to continue to research and innovate.

Fringe Benefit Tax and salary packaging changes

FBT rate

The FBT rate is to increase from 47% to 49% to align with the highest marginal tax rate inclusive of the Temporary Budget Deficit Levy of 2% (refer to Personal Tax Measures below for further details).

The new rate is to apply from 1 April 2015, 9 months after the 2% Deficit Levy starts, and drops again from 1 April 2017, 3 months prior to the Deficit Levy's end date.

Changing the FBT rate also changes the FBT gross-up rates, as follows:

	2014-15 FBT year	2015-16 FBT year	2016-17 FBT year	2017-18 FBT year
FBT rate	47%	49%	49%	47%
Type 1 gross-up	2.0802	2.1463	2.1463	2.0802
Type 2 gross-up	1.8868	1.9608	1.9608	1.8868

Salary packaging

The reason for increasing the FBT rate is: "To prevent high income earners from utilising fringe benefits to avoid the levy". But salary packaging $20,000 would only produce a saving of around $400 with this 2% differential, so high income earners are unlikely to bother.

Not-for-profit caps

In order to protect the value of fringe benefits provided in the not-for-profit sector, that otherwise diminishes with an FBT rate increase, the annual caps for concessional treatment are to be increased. Confirmation of the new caps has not yet been provided.

FBT rebate

The FBT rebate (currently 48%) is to be aligned with the FBT rate as of 1 April 2015.

Mining tax changes/announcements

The Government has announced that it will clarify the taxation treatment of realignment of interests between joint venture partners in a mining or petroleum project.

In a comment which is vague and therefore uncertain in its application the measure is said to apply only to changes within a common project (including combining neighbouring fields into one project and sharing expenditure on items such as planning, research and construction of infrastructure).

It is thought that this announcement relates to the Government's previous decision to limit the deduction for mining rights first used for exploration to the lesser of the life of the mine or 15 years rather than being immediately deductible. Some discussion has taken place on the potential application of this measure to movements in ownership in a project between joint venturers. The Budget announcement will enable the Government to consider the application of that proposal to farm in and farm out arrangements.

Tax consolidations and MEC changes

The Government has announced that the consolidation integrity package announced in the 2013-14 budget will be amended to include a new measure and to modify the effective date of others.

The new measure, which will apply to arrangements commencing on or after 13 May 2014, will clarify that accounting liabilities relating to securitised assets held by a subsidiary will be disregarded in certain situations where the subsidiary leaves a consolidated group and/or joins a consolidated group. Transitional rules will apply to arrangements that commence prior to 13 May 2014.

The following measures will be amended so that they apply to arrangements that commence on or after the date of announcement of the original measure (14 May 2013), rather than to the exit or entry of a subsidiary that takes place on or after the date of announcement.

- The double deductions measure which broadly denies access to double deductions created by value shifting between subsidiaries;
- The churning measure which prevents the tax cost setting rules from applying in circumstances where foreign residents transfer membership interests that are not subject to CGT to MEC or tax consolidated groups, unless there has been a majority change in beneficial ownership or the interests were acquired within 12 months; and
- The deductible liabilities measure which broadly applies to consolidated groups that purchase entities with deductible liabilities and aims to prevent such liabilities being taken into account twice.

Also, the deductible liabilities measure will also be modified so that retirement villages' residential loan liabilities are excluded from the measure.

The above changes target the duplication of benefits which may have been attractive to taxpayers considering corporate restructures and tax consolidation. Accordingly these measures should be considered when companies consolidate or undertake restructures.

The Government will not proceed with proposed changes to MEC groups previously announced in the 2013-14 budget. The disregarded measures were designed to ensure that MEC groups could not access tax benefits not available to tax consolidated groups.

This is welcome news as it removes the uncertainty concerning the effectiveness of MEC groups.

MITs: changes deferred

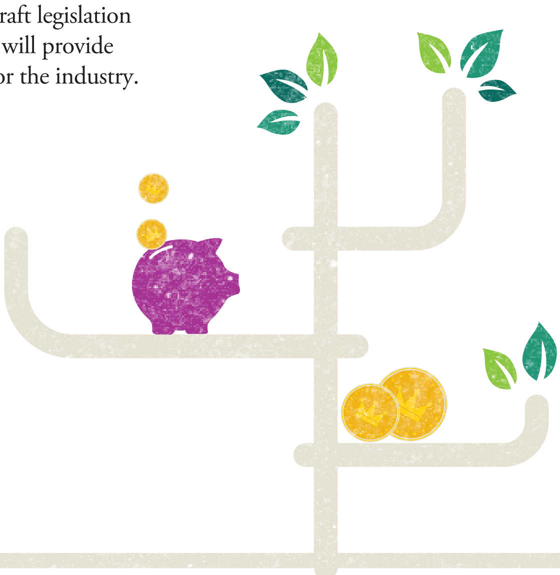
The Government has announced that it will defer the start date of the new tax regime for Managed Investment Trusts by 12 months to 1 July 2015. The new tax regime is expected to provide certainty to taxpayers and reduce compliance costs.

While it is sound for the Government to undertake consultation before implementing new legislation, the financial services industry have been waiting some time for these changes. It is hoped draft legislation will be released shortly that will provide clarification and certainty for the industry.

Employee Share Schemes

As a means to increase innovation and entrepreneurship, it was hoped that the Budget would include measures to improve the Employee Share Scheme ("ESS") rules. The most recent changes to the ESS rules have operated from 1 July 2009. These rules have been criticised – particularly by private and start-up companies who would otherwise like to use equity based remuneration – for being too complex. The rules are also considered punitive as they may crystallise a tax liability for employees well before they have any mechanism to realise such value through a share sale or listing etc.

Changes to the ESS rules in the Budget would have been warmly welcomed, particularly by our clients involved in start-up companies i.e. those operating in the technology and mining industries. Hopefully positive changes come through in the near future, as Treasury have recently indicated that they would review the existing arrangements and consult with key stakeholders.



Personal income tax measures

Income tax rates

A budget deficit levy of 2% will be imposed on high income earners with a taxable income in excess of $180,000. The deficit levy will apply for three years from 1 July 2014.

Personal income tax rates are otherwise unchanged from previous announcements, as follows:

2013-14 income year

Taxable income $	Taxable payable $
0 - 18,200	Nil
18,201 - 37,000	Nil + 19% of excess over 18,200
37,001 - 80,000	3,572 + 32.5% of excess over 37,000
80,001 - 180,000	17,547 + 37% of excess over 80,000
180,001+	54,547 + 45% of excess over $180,000

If the temporary Budget deficit levy is implemented, the rates for the year commencing 1 July 2014 would be:

2014-15 income year

Taxable income $	Taxable payable $
0 - 18,200	Nil
18,201 - 37,000	Nil + 19% of excess over 18,200
37,001 - 80,000	3,572 + 32.5% of excess over 37,000
80,001 - 180,000	17,547 + 37% of excess over 80,000
180,001+	54,547 + 47% of excess over $180,000

The rates for 2015-16 and 2016-17 would be:

2015-16 and 2016-17 income year

Taxable income $	Taxable payable $
0 - 19,400	Nil
19,401 - 37,000	Nil + 19% of excess over 19,401
37,001 - 80,000	3,344 + 33% of excess over 37,000
80,001 - 180,000	17,534 + 37% of excess over 80,000
180,001+	54,534 + 47% of excess over $180,000

Non-resident individuals

	From 1 July 2012 to 30 June 2014	From 1 July 2014 onwards
Taxable income	Tax payable	Tax payable
$0 – $80,000	32.5c for each $1	33c for each $1
$80,001 – $180,000	$26,000 + 37% for each $1 over $80,000	$26,400 + 37% for each $1 over $80,000
$180,001 and over	$63,000 + 45% for each $1 over $180,000	$63,400 + 47% for each $1 over $180,000

Medicare Levy

As announced in last year's budget, the Medicare levy will increase from 1.5% to 2% from 1 July 2014. This change was introduced to help fund DisabilityCare Australia. Combined with the proposed new budget deficit levy, the effective top marginal tax rate would become 49% from that date.

Superannuation Guarantee

The superannuation guarantee will increase to 9.5% from 1 July 2014 despite the government previously announcing that the rate would remain at 9.25%.

What does this mean for business?

The budget from an industry perspective

Energy & Resources

The Energy & Resources industry has some wins and losses from the budget announcements.

On the positive side, the Government has confirmed that it will proceed with the Exploration Development Incentive program to encourage greenfields mineral exploration. The incentive targets junior explorers by allowing investors to receive a tax credit similar to a franking credit for eligible exploration activities. The Exploration Development Incentive will be capped at $100m and the government has commenced consultation on the design of the legislation.

The budget also revealed that the government proposes to clarify the treatment of realignments of interests between joint venture partners. This proposed reform addresses uncertainty with respect to potential unintended adverse consequences due to the decision to remove the immediate deduction for mining rights acquired and first used in exploration.

The reduction of the R&D tax offsets is negative to the E & R industry particularly for exploration companies. Due to the recent down turn in the industry, exploration companies are finding it difficult to raise capital and have been using the R&D concession to assist with working capital and funding requirements.

Food & Beverage

Product innovation in the food and beverage sector will be further stifled by the announcement that the Government will reduce the R&D tax offset rate by 1.5%.

According to our recent study, Australian food and beverage companies currently spend only 1% of turnover on R&D for product innovation, which is significantly below their US counterparts who spend closer to 2%. New reforms could lead to even further reductions in spend in Australia.

Australian food and beverage companies are becoming more challenged with private labels increasingly moving onto supermarket shelves. The development of new products is one way companies can reduce reliance on private labels by opening up new opportunities for their products, and this change could lead to less innovation in an industry which looks at product innovation for export markets and new distribution channels.

Healthcare

Establishment of the Medical Research Future Fund (MRFF)- the largest medical research fund of its kind in the world - has a positive impact on the Health & Aged Care sector. This is a welcome initiative to advance leading medical research projects, attract and retain first class researchers and address impending long term health challenges. Many of these challenges include an ageing population, growing complexity in care needs, an ageing workforce, and funding reform which includes consumers bearing more for their individual cost of care.

Taking a long term view, the government will need to be mindful that savings relating to the research fund do not increase the burden on current health care providers and consumers. Research will need to be balanced between addressing current health challenges and producing much needed preventative solutions that will reduce the increasing strain on our health services over years to come.

Specific health savings from the budget include reforms to health funding and expenditure including new patient contribution towards the costs of standard GP visits, and for imaging and pathology services and a new Medicare Safety Net. The Government is also increasing co-payments for Pharmaceutical Benefits Scheme (PBS) medicines to ensure the scheme remains sustainable into the future.

State governments will also feel the pressure of federal funding saving initiatives and be left to manage the funding gap.

Life Sciences

The importance of the life sciences sector in shaping the future of Australia's economy has been emphasised in the 2014/15 Budget. Specifically, the life sciences sector has been granted a great boost by the Government's commitment to the $20 billion MRFF. The purpose of this Fund will be to provide funding for medical research over the coming decade, which is intended to place Australia at the forefront of medical research. Such a commitment should encourage and support innovation and lead to the creation of valuable intellectual property in Australia over the coming years.

The MRFF will be established with an initial capital injection of $1billion and is estimated to reach the $20 billion target capital level by 2020. The net earnings from the MRFF for a given year will be available for distribution in the following year to fund medical research priorities, with the first dividend of $20 million to be made available in 2015 increasing to around $1 billion per annum by 2022/23.

While the MRFF is welcome news for the life sciences sector, other tax reform has not been so kind. Specifically, the R&D refundable tax offsets will be reduced from 45% to 43.5% from 1 July 2014. While the Government has tried to justify this change on the basis of the change to the corporate tax rate, this ignores the fact that the majority of life sciences companies are not paying tax and are relying directly on the refundable tax offset to partly fund their research programs.

Manufacturing

Australian manufacturers' diminished capacity to invest in capital and innovation will severely impede the industry's ability to revive itself to a position as a strong contributor to Australia GDP.

Industry requires incentives that foster growth to meet the future needs of the sector. The budget released by the government however is reliant on induced private sector investment, for which programme design is yet to be finalised.

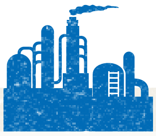
It is critical that the productive capacity and capability of the automotive sector, and manufacturing in general, is preserved. The Government should be focused on redirecting this capability rather than resigning itself to market forces.

The turnaround in manufacturing growth in advanced economies is demonstrating that GDP is positively related to growth in manufacturing. Manufacturing is essential to the long-term health of economies, as it is the engine that drives innovation.

Not for Profit

The budget provided some certainty for the NFP sector with the confirmation that there would be no change to the Exempt Income for Charities and that the rumoured changes to the Fringe Benefits Tax Concesssions did not eventuate. There has been one change to the FBT regime in that the concessional caps available to PBI/NFP's (currently $17,000 and $30,000) will be raised to offset the increase in the FBT rate.

One measure that will have a negative impact on the NFP sector is the measure to delay access to Newstart Allowance and Youth Allowance (Other) for 6 months which will put additional pressure on those within the sector who provide support services to the unemployed.



Major Projects & Infrastructure

The Government continues to focus on long term growth and Nation Building through an additional contribution of $11.6 Billion through its “Our Growth Package”. This package, which now increases the Government’s commitment to Infrastructure spending over the next decade to $50 Billion, is forecast to stimulate investment of up to an additional $125 Billion in the Sector by the end of the decade. This welcome investment will stimulate new jobs and spending, and is designed to drive an additional 1% contribution to total National output.

The additional commitment to Infrastructure is of three parts:

1) $3.7 Billion will mainly go to road projects throughout Australia
2) $2.9 Billion will be allocated towards the Western Sydney area
3) $5 Billion Asset Recycling Initiative

There is a significant opportunity forgone in this budget in its allocation of funding to rail Infrastructure. Whilst the Federal Government has allocated funding to projects such as Melbourne to Brisbane inland regional freight line it is unclear as to why State Government committed projects such as the Melbourne City to Airport Rail link have been overlooked.

Importantly an opportunity to drive Australia’s future by incentivising State Governments and the Private Sector to invest in projects such as high speed rail has not been considered. This opportunity could have had the dual benefit of both easing the burden on future Government spending on both road infrastructure and airports as well as accommodating an increasing population over a broader geographical area and therefore assisting with housing affordability.

We would further encourage the Federal Government to collaborate with the States and Private Sector in terms of assessing the Infrastructure priorities of Australia both now but more importantly for our future and in particular how to incentivise the spread of the population into regional areas through infrastructure enhancements. The Federal Government should also continue to develop its thoughts about how to enable private sector investment by the Self-Managed Superannuation Sector into these projects and thus ensuring that all Australians have the opportunity to partner with the Government in the future growth and prosperity of the Nation.

Public Sector

The budget outlined the Government’s priority to establish a “smaller, less interfering government” with a reduction of 16,500 public servants and no reduction to frontline services.

In line with the Commission of Audit, and global government reform, the market will be tested for services traditionally delivered by Government. Invariably this will result in the transfer of service delivery to the private and not for profit sectors where it is efficient to do so. The dynamic and agile nature of mid-sized businesses in Australia ensures they are well placed to apply current infrastructure and business models to the delivery of services traditionally delivered by Government. The success of changing service delivery models and transitioning to a model of mixed delivery between government and mid-market businesses is dependent on the Government allowing businesses to innovate in the delivery of services. Success will also be dependent on ensuring the regulatory burden on mid-market businesses does not erode margin to the point where it is not economical for them to continue to deliver services.

What does this mean for business?

Real Estate & Construction

The Development sector took a hit to Affordable Housing, with the announcement that the final round of the National Rental Affordability Scheme (NRAS) would not proceed. While existing incentives will continue for up to 10 years, the scheme is to be reviewed. As a result of the low take up of the First Home Saver Accounts Scheme since introduction, this will be scrapped along with the pilot scheme for seniors housing assistance. The conclusion of such programs will almost certainly cause a slowdown in the growth of this sector.

In addition, the overhaul to the Managed Investment Trust (MIT) regime that was set to commence on 1st July 2014 has been pushed back a further twelve months. Given the impact that further changes in this area could have on foreign investment into Australian real estate, a considered and consultative approach is welcomed.

Of key concern is the short term fallout from the personal tax changes in the budget that could have an impact on consumer confidence levels and the improvement we have seen in the residential housing sector of late.

Retail

The budget announcements made by the Federal Treasurer are unlikely to have a positive impact on consumer confidence. Initiatives that reduce disposable income, such as the "Budget Repair Levy" will not be welcomed by the retail sector. Overall it is a tough budget, but unlikely to have a significant negative impact on business.

The scheme for encouraging employment of 50+ year olds may mean they find jobs in retail. Many retailers would love to have more experienced and mature store staff, however quite a bit of training is required to re-skill.

Despite the shortcomings, this initiative is encouraging for small and medium businesses and could help drive continued growth in the retail sector.

Technology & Media

Australian innovators will likely continue to look offshore for commercial opportunities to realise their full potential.

Rather than providing incentives that encourage and foster innovation within Australia, there is a lost opportunity to develop our knowledge based industries and services. Instead, the industry faces cuts to key sources of assistance, including the abolition of: Commercialisation Australia, Innovation Investment Fund, Industry Innovation Precincts, Enterprise Connect and Australian Renewable Energy Agency.

The ICT sector is perfectly positioned to drive the Government's growth agenda through innovation. Yet calls from the sector to eradicate rules that stifle these companies' ability to compete on a global stage are still not being heard, including continued unfavourable tax treatment of employee share schemes. This Budget also reduces the R&D tax offset by 1.5% from 1 July 2014, sending a clear message that innovation is not a priority. As a result, companies are taking their intellectual property and commercialising it offshore where conditions are more supportive.

From a global competiveness standpoint, the budget measures are not equipping Australia to be seen as a leader in this space, often ranking behind smaller and less equipped nations. The ICT sector requires long term investment, not short term cost cutting. Strong investment in the sector is required to underpin growth throughout a modern digital economy.

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