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TAX UPDATE – SPECIAL EDITION

2011 – 2012 Federal Budget

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Introductory Comment

Earlier this evening, the Treasurer Wayne Swan handed down his fourth budget, the first under a Gillard Government.

In what many have described as a “tough love” budget, the Government has introduced a number of spending cuts and revenue measures which, taken together, aim to have the budget back in surplus by 2012- 2013. Given the current debt levels and an uncertain economy, this is an ambitious target.

We are pleased to present our summary of the taxation changes arising out of tonight's budget.

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Personal Income Tax Measures

Although previously announced, the Budget confirmed that changes will be introduced disallowing a deduction for expenses claimed in earning all Government Assistance Payments, for example youth allowances. This amendment reverses the impact of the recent High Court decision in Anstis. The Medicare Levy low income threshold will increase to \$31,789 for couples, and to \$18,839 for singles. For families, the additional amount of threshold per dependant child will be increased to \$2,919. Similar increases also apply to pensioners below Age Pension age.

The Low Income Tax Offset (LITO) will no longer be available to minors on unearned income such as interest, dividends and trust distributions. Currently, minors can effectively receive unearned income of \$3,000 tax free (after the Offset), but this will now be reduced to \$416. This change takes effect from 1 July 2011, and is expected to raise \$250 million a year.

Currently 50% of the LITO is delivered to taxpayers via their regular pay throughout the year. From 1 July 2011 this will be increased to 70% for low and middle income earners. The remaining 30 per cent of their LITO benefit will still be paid as a lump sum on assessment of their income tax returns. This adjustment will deliver up to \$300 in more timely tax relief to low and middle income earners. Individuals' total LITO entitlement in any one year will remain unchanged.

There were also a number of changes introduced to the way in which various family tax benefits can be claimed, in particular:

- » Families in hardship may be able to access in advance part of their entitlements to the family tax benefit;
- » Family Tax Benefit Part A will no longer be available in respect of children over the age of 21;
- » Indexation of Family Tax Benefit thresholds and entitlements will be "paused" until 1 July 2014.

From 1 July 2011 a temporary flood and cyclone reconstruction levy will be introduced towards the rebuilding of the flood and cyclone affected regions. The levy will be as follows:

Taxable Income	Flood and Cyclone Levy
\$50,000 or less	0%
\$50,001 - \$100,000	0.5% on taxable income above \$50,000
Over \$100,000	0.5% on taxable income between \$50,001 and \$100,000 and 1.0% on taxable income over \$100,000

Flood and Cyclone Levy

Taxpayers who are in receipt of the certain disaster recovery payments will be exempt from paying the levy. The GDP adjustment factor for the PAYG instalment calculation will be reduced to 4 percent for the 2011-12 income year (currently that rate is at 8%)

Dependent Spouse Tax Offset Being Phased Out

From 1 July 2011 taxpayers with a dependent spouse born on or after 1 July 1971 will no longer be eligible for the dependent spouse tax offset (DSTO). This means that the DSTO will be gradually phased out as the population ages.

Dependent spouses with children are not affected by this measure because they are eligible for Family Tax Benefit B rather than the DSTO. Taxpayers with an invalid or permanently disabled spouse, supporting a carer, or people who are eligible for the zone, overseas forces and overseas civilian tax offsets will not be affected by this change.

This will encourage younger dependent spouses without children to seek paid employment. This measure was a recommendation from the Australia's Future Tax System Review. The taxpayer benefited all participants in the WA grain industry not just growers. There was no 'individual' member who benefited solely by reason of their membership in the taxpayer. The constitution of the taxpayer does not allow for any profits or surplus assets to be distributed to members. Accordingly the Court upheld the taxpayer's tax exempt status

Entrepreneurs' Tax Offset Abolished

The Government will abolish the Entrepreneurs' Tax Offset (ETO), with effect from the 2012-13 income year. This offset is currently available for small businesses who have turnover of \$75,000 or less. The Government states that the offset is complex and small businesses will benefit from the range of other measures introduced in this budget.

For example Australian small businesses will be provided with an instant write-off of the first \$5,000 of any motor vehicles purchased from the 2012-13 income year.

Reforms to Car Fringe Benefit Rules

As widely anticipated, a flat statutory rate used in the calculation of the taxable value of a motor vehicle fringe benefit will be introduced. Almost \$1 billion is expected to be generated over the next 4 years from this change.

The statutory rate will be set at 20%, which is the rate currently used for cars that have travelled between 15,000 and 25,000 kilometres in a FBT year.

For cars that travel fewer kilometres, the rate decreases from 26% to 20% with immediate effect. This change means that the FBT liability will be reduced.

For those cars that travel a greater number of kilometres the statutory rate will progressively increase rising to 20% from 1 April 2014. This change will significantly increase the FBT liability in each year.

These changes apply to all cars acquired under a contract entered into after tonight.

In a smaller FBT reform measure, the exemption on fly in – fly out arrangements will be extended to cover Australian residents working in remote areas and living in employer

provided accommodation, and not just their own accommodation.

GST – Confirming the Treatment of Newly Constructed Residential Premises

The Government will amend the Goods and Services Tax (GST) law in relation to the supplies of certain new residential premises to ensure that these remain taxable supplies and thus restoring the policy intent of the law.

This issue arose out of a recent Federal Court decision (Commissioner of Taxation v Gloxinia Investments (Trustee) [2010] FCAFC 46) which found that the sale by developers of certain newly constructed residential premises to owner occupiers and investors was input taxed rather than taxable supplies. The measure will ensure that GST applies to the value added to real property by developers constructing new residential premises.

The amendments will ensure that:

- » from 3 October 2007, new residential premises constructed under development lease arrangements are treated as taxable supplies;
- » from 1 July 2000, the granting of individual strata lot leases over newly constructed residential premises is not sufficient by itself to make future supplies of the premises input taxed; and
- » from 1 July 2000, any change in property title arrangements will not result in the premises once again becoming new residential premises.

Transitional arrangements will apply to taxpayers who have applied the Federal Court's decision to arrangements entered into prior to the Government's announcement on 27 January 2011.

GST – Delaying the Start Date for Certain 2009-10 Budget Announcements

The Government will defer the 1 July 2011 start date for a number of components from the 2009-10 Budget which were to implement a number of recommendations from the Board of Taxation's review of the legal framework for the administration of GST. At the earliest the revised start date will be the first quarterly tax period after the relevant Bill introducing the measures, receives Royal Assent.

Some of the components of the 2009-10 Budget which will be affected by this deferred start date include:

- » adopting the income tax self assessment regime for indirect taxes and refreshing the period of review
- » clarifying the treatment of tax law partnerships
- » simplifying the GST grouping membership rules, including grandfathering of current membership rules
- » introducing a reverse charge for supplies of going concerns and farmland.

GST – Other Measures

» For the mortgage lending sector the Government will amend the application of the GST legislation where a mortgagee in possession or control sells the property of a corporation. This will allow mortgagees in possession or control of property of corporations to continue to report and account for their GST obligations under a single registration. These measures will take effect from 1 July 2012.

» The Government will amend the GST legislation to ensure that certain supplies made to health insurers in the course of settling health insurance claims will be GST-free with effect from 1 July 2000. This follows a Full Federal Court decision and the legislative amendment merely restores the status quo for these supplies.

» The Government will extend the current GST instalment system to allow small businesses in a net GST refund position to choose to access the GST instalments system, with an instalment amount each quarter of zero. Any refunds or liability due to the taxpayer will be reconciled in their annual GST return. The measure will come into effect when the relevant legislation receives Royal Assent.

Not For Profit Sector – Defining 'Charity'

The Government proposes to introduce a statutory definition of the term 'charity' for all Commonwealth laws to take effect from 1 July 2013.

As there is currently no definition in the tax law for the term 'charity' the Tax Office and the Courts rely on its common law meaning, that being in essence a non-for-profit organisation that exists for the public benefit, or for the relief of poverty, or advancement of education or religion.

The adoption of a consistent definition across all jurisdictions would reduce red tape and improve transparency and accountability of the sector.

The definition will be based on the 2001 Report of the Inquiry into the Definition of Charities and Related Organisations, taking account of the findings of recent judicial decisions, such as *Aid/Watch Incorporated v Commissioner of Taxation*.

The Government will consult with the industry as well as with the states and territories with the intention of developing and introducing a definition of 'charity' that can be adopted by all respect of those unrelated commercial activities.

The new arrangements will commence on 1 July 2011 and will initially affect only new unrelated commercial activities that commence after 10 May 2011.

Not For Profit Sector – Restricting Tax Concessions for Unrelated Commercial Activities

The Government will reform the tax concessions provided to not-for-profit (NFP) entities to ensure they are targeted only at those activities that directly further a NFP's charitable purposes. Under this measure, the NFP income tax concessions will only apply to profits generated by unrelated commercial activities that are directed back to the NFP's charitable activities. This means NFP entities will pay income tax on profits they retain from their commercial undertakings.

NFP entities will also not have access to the FBT exemptions, FBT rebate, GST concessions, or deductible gift recipient support in commercial cleaning industry.

» Managed Investment Trusts - The Government will defer by 12 months the start date of the new tax system for managed investment trusts (MITs) and also clarify certain aspects of it.

» Instalment warrants - As previously announced by the Assistant Treasurer in January 2011, with effect from the 2007-08 financial year the 'look through' treatment of instalment warrants will be extended to warrants over direct and indirect interests in listed securities, unlisted securities in widely-held entities, and bundles of such assets. In the absence of this measure, CGT could have applied upon payment of the final instalment on the warrant.

» Security Lending Arrangements - The Government will amend the tax rules to ensure that lenders under a securities lending arrangement will be treated as not having disposed of the lent securities.

» Taxation Of Financial Arrangements (TOFA) - Amendments will be made to the TOFA tax hedging rules to ensure that they operate as intended. The TOFA Stages 3 and 4 transitional election provisions will also be amended to allow the Commissioner the discretion to allow taxpayers further time, under certain circumstances, for the notification of transitional election to existing financial arrangements.

Capital Gains Tax – General Changes

Script for scrip rollover provisions contain various integrity provisions that apply to transactions where stakeholders have the ability to influence both entities. These provisions will be improved to clarify that they apply to trusts, superannuation funds and the like. These entities have sometimes argued that because they own the investments on behalf of others, they do not have the ability to influence both entities.

Similarly, in claiming the small business CGT concessions, some trusts have been arguing that they are not connected with other entities, therefore avoiding the need to be aggregated. These provisions will be "clarified" under new rules to be introduced.

Both of these changes have immediate effect.

Other minor changes will be introduced. Of particular interest is that the income tax law relating to deceased estates will be rewritten and clarified to ensure that it is written in line with a "principle based" format. In particular, the legislation will clarify

that a testamentary trust may distribute the asset of a deceased person to the beneficiary without a CGT event arising.

Capital Gains Tax – Special Disability Trusts

The establishment of Special Disability Trusts was enabled some years ago, in order to better provide for the care and accommodation needs of a person with a severe disability.

Various tax barriers to the establishment of Special Disability Trusts have been removed, as follows:

» A CGT exemption will now be available for assets transferred into a Special Disability Trust for no consideration;

» A CGT exemption for the recipient of the principal beneficiary's main residence, if disposed of within two years of the principal beneficiary's death;

» Ensure equivalent taxation treatment amongst Special Disability Trusts no matter under which regime they are established.

Recouping Company Tax Losses

In an attempt to make it easier for companies to recoup their prior year tax losses, the rules which require tracing through certain superannuation entities are to be relaxed.

In essence, with effect from the 2011-12 financial year, companies will no longer be required to trace their ownership through superannuation funds and similar entities when seeking to prove that they have passed the 'continuity of ownership' test.

Previously, if a company was unable to prove that it passed the continuity of ownership test (for example, by not being able to trace its ownership through entities), it could not automatically resort to the fall-back 'same business test' in order to claim its prior year tax losses.

This change will help remove one of the potential barriers to companies accessing their prior year tax losses.

Tax Losses of Infrastructure Projects

A scheme of 'designating' infrastructure projects will be introduced. Once 'designated infrastructure project' status has been conferred, the entity carrying out the project will be permitted to index its tax losses at the government bond rate so that their real value is maintained into the future. In addition, those losses will be exempted from the 'continuity of ownership' and 'same business' tests, making it easier for the losses to be recouped.

Debt/Equity Rules– Clarification of the Scope of Integrity Provisions

Currently, under the existing debt/equity integrity provision, an interest from an arrangement that funds a return through connected entities is deemed to be an equity interest in certain circumstances.

The proposed changes will limit the application of that integrity provision to arrangements where both the purpose and effect is that the ultimate investor has, in substance, an equity interest in the issuer company.

In addition, changes will allow the Commissioner to not apply the integrity provision where he considers that it would be unreasonable for it to apply.

The amendment will apply from the commencement of the debt/equity rules (generally 1 July 2001).

Debt/Equity Rules – Extending the Debt/Equity Transitional Period for Upper Tier 2 Capital Instruments

The Government will extend the debt/equity transitional period for Upper Tier 2 capital instruments to 1 July 2011, with effect from the date of Royal Assent of the enabling legislation.

The extension will enable issuers of certain Upper Tier capital instruments (e.g. Upper Tier 2 perpetual subordinated notes) the opportunity to amend their instruments so that they come within the terms of the new regulations. Under the new regulations certain Upper Tier 2 perpetual subordinated notes are not precluded from being a debt interest. The measure will apply to Upper Tier 2 instruments issued before 1 July 2001.

General Business Measures

A range of other measures relevant to business include:

» The Government will require certain businesses to report annually on payments made to contractors in the building and construction industry, with effect from 1 July 2012. This measure will improve voluntary tax compliance in this industry. The Government will also consult publicly on whether to introduce a similar reporting regime for payments to contractors in the jurisdictions.

The Government will assist the proposed Australian Charities and Not-For-Profits Commission to develop new guidelines for the sector and re-assess the charitable status of entities on the basis of the new statutory definition.

International Tax Changes - Foreign Managed Funds

The Treasurer has confirmed that foreign managed funds will be exempted from Australian tax on their 'portfolio' earnings. The sunset date of this exemption has now been extended from the 2009-10 financial year to the 2010-11 financial year.

Similarly, foreign managed funds which are taken to have a 'permanent establishment' in Australia because of the management role of Australian investment managers will effectively be exempted from Australian tax on their non-Australian sourced earnings from that portfolio of assets.

International Tax Changes - Tax Information Sharing Treaties and Withholding Taxes

Following the introduction of Tax Information Exchange Agreements (information sharing treaties) with Montserrat, Mauritius and a number of other tax haven countries, a reduction of withholding tax rates on distributions from Australian managed funds will now be made available to a broader list of countries.

Functional Currency Rules- Extension to Trusts and Partnerships

Certain trusts and partnerships that keep their accounts predominately in a particular foreign currency will be allowed to calculate their net income in that foreign currency. This measure will take effect from the date of Royal Assent.

Superannuation - Pension Rates

In recognition of the effects of the GFC, the minimum rate at which super pensions had to be drawn was halved for the 2008- 09, 2009-10 and 2010-11 financial years. This was intended to assist funds by not requiring the disposal of assets when the market for them had fallen.

Starting with the 2011-12 financial year, this reduction of the minimum rate at which super pensions must be drawn will be phased out, with the 2011-12 minimum rate reduced by only 25% and the 2012-13 rate reverting to the 'normal' level.

This means that a super pensioner (receiving either an allocated, account based or market linked [or "term allocated"] pension) under age 65 will be required to take at least the following minimum percentages of their opening account balance each year as pension payments:

- » 2010-11 2%
- » 2011-12 3%
- » 2012-13 4%

Superannuation - Contribution Cap for Over-50s

The current rule under which people aged over 50 can contribute \$50,000 a year into super as 'concessional contributions' is due to expire on 30 June 2012. People aged under 50 are limited to making \$25,000 a year of concessional contributions.

As announced in last year's Federal Budget, people aged over 50 will be allowed to continue to make concessional contributions at the higher rate after 30 June 2012 provided their super entitlements are less than \$500,000.

This year's change is that the limit for over-50s will be set at \$25,000 higher than the limit for under-50s (which will be indexed from time to time). As a result, the limit for over-50s will also increase in line with the lower limit instead of being forever fixed at \$50,000.

Superannuation - Excess Contributions

Presently, concessional contributions in excess of the applicable cap (\$25,000 or \$50,000) are subjected to Excess Contributions Tax. An effective tax rate of 46.5% applies regardless of the fund member's personal marginal tax rate.

With effect for contributions in the 2011-12 and later financial years, first-time offenders will be given the choice of either incurring Excess Contributions Tax at 46.5% or withdrawing the excess contributions from the fund and paying tax on it at their personal marginal tax rate. Only up to \$10,000 of contributions may be so withdrawn.

Disappointingly, this change in no way addresses the excessive potential tax liability of up to 93% on excess contributions.

Superannuation - Contribution Reporting

With effect from 1 July 2012, a requirement will be introduced to report on employees' payslips the super contributions actually made by the employer. This is intended to ensure that employees are made aware in a more timely way of when (and that) their employers make contributions for them.

All employers will need to ensure that their payroll systems will be capable of reporting this information.

Superannuation - Government Co-Contribution

Under the co-contribution scheme, the government matches dollar-for-dollar non-concessional (ie, undeducted) contributions of up to \$1,000 made by people whose income is below \$31,920, phasing out where their income is up to \$61,920. These thresholds were previously indexed, but were frozen at these levels until the 2011-12 financial year.

The freezing of these thresholds is now to be extended to the 2012-13 financial year.

Superannuation - Fund Administration

In an attempt to simplify the administration of funds where members may have multiple accounts, funds will from 1 July 2011 no longer be required to use tax file numbers as a last resort when seeking to locate and consolidate a member's accounts.

Superannuation - Fund Mergers – Temporary Loss Relief

Under existing rules, super funds which merge before 30 June 2011 may, providing relevant conditions are satisfied, transfer their accumulated losses to the new fund so that fund members are not disadvantaged because of the loss of the tax benefit of those losses.

As announced by the Assistant Treasurer on 3 May, that deadline will now be extended to 30 September 2011.

SMSF Compliance Costs and Auditor Registrations

The processes for registering a SMSF and for initiating the rollover of super account balances will be made more strict, with 'proof of identity' checks and other changes that are said to protect SMSF trustees against fraud.

A new administrative penalty regime, requirements for SMSF auditors to be registered and be subject to competency and independence standards will also be introduced, as will stricter rules about the holding of collectables and personal use assets.

Compliance costs for SMSFs will be set to increase, with the annual levy to rise from \$150 to \$180 for 2011 and SMSF auditors to be charged registration fees (from 1 July 2012) in order to recoup the \$48.6m cost of the proposals.

Superannuation Funds and CGT

With effect from 7.30pm on 10 May 2011, the 'trading stock' exception for super funds will be repealed in respect of sales of shares, trust units and land. As a result, the CGT regime will be the sole system under which losses on such assets will be recognised and losses on them will no longer be able to be deducted from other assessable income.

Assets held by super funds on revenue account before Budget Night will benefit from transitional rules allowing continuation of their non-CGT treatment.

Farm Management Deposits – Early Access for Primary Producers Suffering from Natural Disasters and Improved Administration Arrangements

Primary producers affected by natural disasters will be allowed to access their farm management deposits (FMDs) within 12 months of making the deposit while retaining concessional tax treatment under the scheme. This measure provides the same taxation relief as those provided to primary producers affected by severe draught or natural disasters.

Further, primary producers will be allowed to hold FMDs with more than one financial institution. Amendments will also be made to the unclaimed monies provisions of the Banking Act 1959 to prevent FMD accounts that are dormant for at least seven years from being treated as unclaimed monies unless reasonable efforts have been made by the financial institutions to contact the FMD holder.

Tax Roll-overs for Water Reform Transactions

With effect from the 2009-10 financial year, CGT and capital allowance (depreciation) roll-overs are to be introduced in order to ensure that transfers of water assets because of State and Territory changes to the governance of private water supply and drainage systems do not cause undesirable income tax outcomes.

Natural Disaster Recovery and Rebuilding - Certain Payments Are Tax Exempt

The Government has made the disaster income recovery subsidy payments for the recent floods in Australia and Cyclone Yasi exempt from income tax.

Ex-gratia payments to New Zealand non-protected special category visa holders who are affected by the 2010-11 disasters in Australia are also exempt from income tax.

Further, an income tax exemption will also be provided for certain Category C clean up and recovery grants paid to small businesses and primary producers under the Natural Disaster Relief and Recovery Arrangements.

Tax Treatment of Payments Made Under Sustainable Rural Water Use and Infrastructure Program (SRWUIP)

The Government will amend the tax law to eliminate the timing difference between when payments under the SRWUIP are taxed and when deductions are available for amounts spent under program agreements with effect from 1 April 2011.

Tax Compliance Measures – Fraudulent Phoenix Activity

The Government will introduce a number of measures to implement the previously announced crack down on fraudulent phoenix activity. Fraudulent phoenix activity involves a company with accumulated debts, liquidating to avoid paying the debts and the business is then 'reborn' in a new corporate entity, controlled by the same person or group and free of their previous debts and liabilities.

With effect from 1 July 2011:

» the director penalty regime will be extended to superannuation guarantee amounts, making directors personally liable for their company's failure to pay employee superannuation;

» the ATO will be given the power to commence recovery against directors under the director penalty regime, without providing a 21 day grace period, for certain unpaid company liabilities that remain unreported after three months of becoming due; and

» in certain circumstances directors and associates of directors will be prevented from obtaining credits in their individual tax returns for the amounts withheld from their salary where the company has failed to pay the withheld amounts to the ATO.

General Interest Charge – Technical Amendments

The current transitional rules do not impose general interest charge (GIC) and shortfall interest charge on income tax liabilities due on or after 1 July 2010 which relate to financial year ending 30 June 2001 or earlier. The technical amendments will ensure the ongoing imposition of GIC and will take effect from 1 July 2010

Other Budget Measures

» In response to representations from industry the Government will delay the introduction of excise and excise-equivalent customs duty on alternative fuels until 1 December 2011, allowing additional time to implement the tax changes. The Government will also simplify the arrangements by applying transitional tax rates to gaseous fuels and biodiesel at the scheduled effective tax rates during the transition to 2015-16, instead of imposing tax at the final rate and providing offsetting production grants.

» The Government has signed additional benefits agreement with Mauritius. This agreement allocates taxing rights the two countries over certain income derived by individuals and establishes an administrative mechanism to help resolve transfer pricing disputes between Australia and Mauritius.

» The Government has deferred the start date of the Tax Breaks for Green Buildings measure to 1 July 2012

» The Government will provide \$56.4 million to the ATO over four years to strengthen the ATO's resources for addressing fraudulent tax refund claims

» The Government will provide \$43.3 million over four years to the ATO to allow it to monitor the accurate accounting of government grants and payments.

» The Christchurch Earthquake Appeal Trust has been approved as deductible gift recipients (DGRs) from 22 March 2011 to 22 March 2013.

» Excise and Excise-Equivalent Customs Duty - The Government will not proceed with the 2007-08 Budget measure to expand the access to refunds, remissions and drawbacks of duty for particular goods.

» Minerals Resource Rent Tax - The Government will adopt the recommendations of the Policy Transition Group as the basis for the detailed design of the New Minerals Resource Rent Tax. Some key recommendations that will be adopted are those concerning the taxing point, starting base, starting base losses, deductions, test for deductibility, and a phased extension of the \$50million threshold and the transferability of expenditure and project losses. Other recommendations that will be adopted are those concerning the extension of the Petroleum Resource Rent Tax and the recommendations pertaining to exploration.

» Minor amendments will be made to provide the Commissioner a discretion to extend the two-year ownership period concerning the disposal of the deceased's dwelling under the main residence exemption provision.

» Minor amendments will be made to allow taxpayers to have a non-zero direct small business participation percentage in situations where shares in a company are jointly held and a discretionary trust has not made a distribution in an income year because the trust had a tax loss or no net income for that year.

» Minor amendments will be made to allow a parent or guardian of a self managed superannuation fund member that is a minor to be a director of that fund's body corporate trustee.

» Effective from the 2011-12 income year, the marginal tax rate for non-residents individuals participating in the Pacific Seasonal Worker Pilot Scheme will be reduced to 15% and will apply to the first dollar of income up to \$37,000 (currently that rate is 29%).