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Tax Brief

11 May 2010

Budget 2010: Ten days of tax and more to come

For the third time in ten days the Government has announced a raft of tax measures, following on from the release of the Henry Review on 2 May and the Board of Taxation Report on Managed Investment Trusts (“MITs”) on 7 May – see our Tax Briefs at

http://www.gf.com.au/Tax_Brief_The_Henry_Tax_Review.pdf and
http://www.gf.com.au/tax_brief_new_mit_tax_regime_10_may.pdf.

There was some disappointment that the Government did not respond immediately to more than a few of the Henry Review’s wide ranging recommendations. This created the impression that further responses were being deferred until a second term of the Government (that is, after the election). The Government’s response to the MIT Report similarly deferred consideration of substantive recommendations of the Board of Taxation to a second term.

The 2010 Budget confirms that the Government’s approach to taxation is rolling reform (or change, depending on your point of view). Hence there are responses to more Henry Recommendations, to Board of Taxation Reports and to the Johnson Report on Australia as a Financial Centre, plus a range of micro-announcements generally designed to make the business and personal tax system work more effectively.

There is no sign of the pre-election cash handouts that have characterised Budgets in the last decade, no doubt because the Government wants to shore up its reputation as fiscally responsible. Australia is certainly well placed currently, compared to the rest of the world. The UK has a budget deficit of 12% of GDP and net public sector debt of 62% of GDP. Australia’s deficit is predicted to be less than 3% of GDP and net public sector debt will peak at 6.1% of GDP during the next year. While the Government may attribute this position to sound management, part of it clearly arises because Australia continues to live up to its claim to be the lucky country.

Johnson Report – Investment Manager Regime

The Government has tonight announced its in-principle or direct support for nearly all of the 19 recommendations contained in the Johnson Report released

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in January this year. We have commented here on the proposed Investment Manager Regime; other aspects of the Report are covered later in this Tax Brief.

One of the central recommendations in the Johnson Report that the Government has adopted is the introduction of an Investment Manager Regime (“**IMR**”). It has also issued a Consultation Paper to facilitate further discussion on the conceptual issues raised by this regime.

The Johnson Report recommendation for the IMR has the following key outcomes:

- 1 the IMR would have wide application to both retail and wholesale funds and to other areas of financial services beyond funds management, but would be confined to entities operating in the financial sector;
- 2 for non-resident investors using an **independent** Australian resident adviser, fund manager, broker, exchange or agent:-
 - no Australian tax on income earned on foreign assets; and
 - investments in Australian assets would be treated for tax purposes in the same way as if the investments had been made directly by the non-resident without the use of an Australian intermediary;
- 3 for non-residents using a **dependent** intermediary acting at arm’s length:-
 - investments in all foreign assets would be exempt from any tax liabilities in Australia; and
 - investments in Australian assets would be treated as they currently are, subject to a de minimis exemption where global investment strategies require a nominal portion of Australian assets to be held. In this exceptional case, any Australian assets would be treated for tax purposes as if the investments were made directly by the non-resident without the use of an Australian intermediary; and
- 4 the location of central management and control in Australia of entities that are part of the IMR will not of itself cause those entities to be Australian residents for taxation purposes.

The Johnson Report in making the above recommendations sought to address the concerns of the funds management industry that the use of an Australian intermediary may be limiting the utilisation of Australian funds management expertise for non-resident clients due to perceptions that this Australian connection with investments may:

- result in income from foreign assets having an Australian source, such that it may attract tax in Australia;
- result in a foreign fund or investor having an Australian permanent establishment in connection with an investment; this could in turn result in

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Australia having a right to tax income from the investment where this would not otherwise be available or alternatively, bring the investment within the Australian capital gains tax net where this would not otherwise be so; and

- result in an investing entity which had not been established in Australia being treated as an Australian resident and potentially subject to tax on its worldwide income simply because its central management and control was in Australia.

The Report acknowledged these difficulties and recommended a regime be implemented that would allow Australian fund managers, investment advisers, brokers and agents to provide services to non-resident investors without attracting inappropriate Australian tax outcomes for those investors.

The Government's Consultation Paper released with the Budget poses a number of questions on which it seeks community input. The Government has also asked the Board of Taxation to consider some of the issues arising in relation to an IMR in the context of its work on Collective Investment Vehicles and the framework of the MIT Regime announced on 7 May.

Although the IMR is intended to have wide application across the finance sector, it seems that the regime is likely to exclude private equity and venture capital arrangements, as well as potentially direct property management.

The current consultation is to focus on the issue of conduit income. As such, the Consultation Paper seeks to address points 1 – 3 above, with the issue of central management and control effectively being deferred to form part of the Board of Taxation review. In the latter respect, there was a helpful acknowledgement that difficulties also currently arise for corporate limited partnerships which can be treated as Australian residents simply because they carry on business in Australia. It has long been recognised that this results in inconsistent treatment between these entities and companies, despite both being taxed as companies.

Although the proposed IMR regime represents a significant step in terms of attracting funds management to Australia, as with all reforms of this nature, there will be a number of critical areas to be worked through – any one of which will have the potential to de-rail the effectiveness of the regime. However, following the negative international press that has flowed from the position that the ATO have taken in relation to the recent Myer float (what is commonly referred to as the TPG saga), the Government's acceptance of the recommendations of the Johnson Report in relation to the IMR regime should be welcomed.

A start date for the IMR has not been specified; comments on the Consultation Paper have been invited by 22 June 2010.

Financial institutions changes

Phasing down interest withholding tax on financial institutions

Subject to some domestic law exceptions and the terms of specific tax treaties, interest withholding tax (“IWT”) is currently levied at 5% on interest paid by foreign bank branches to their offshore head offices and at 10% on all other interest paid to non-resident lenders. Notably excepted from IWT are borrowings that are publicly offered debentures or debt interests (s.128F) and borrowings by an offshore banking unit where the funds are on-loaned offshore. The existing hotchpotch of exceptions to IWT have been widely criticised for creating distortions in accessing foreign capital.

The Budget announces that with effect from 2013-2014, IWT paid by financial institutions on most interest paid on offshore borrowings will be phased down. The Budget proposals respond in part to recommendations contained in both the Henry Review and the Johnson Report. However, each of these reports recommended the outright removal of withholding tax paid on interest paid to non-residents by Australian financial institutions.

For instance, the Johnson Report recommended the removal of withholding tax in three circumstances relating to financial institutions operating in Australia. Specifically, interest paid in the following circumstances:

- foreign funding by Australian banks, including offshore deposits and Australian deposits by non-residents;
- funding from a foreign bank to its Australian branch; and
- a financial institution’s related party borrowings.

The Government has in part accepted these recommendations and announced some initial phased reductions and aspirational goals for interest withholding rates but it has limited the reduction only to Australian branches borrowing from their overseas head offices and for offshore borrowings by all financial institutions (but only to the extent that they are related party borrowings or foreign retail deposits that are on-lent in Australia).

Specifically, the Government announced that it intends to reduce IWT from the current 10% to 7.5% in 2013-14; to 5% in 2014-15; and subject to fiscal constraints, the Government is “favourably disposed” to reducing this rate ultimately to zero, for:

- financial institutions borrowing from other financial institutions (where not already treaty exempt);
- Australian-owned financial institutions borrowing from related parties offshore;

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- financial institutions borrowing offshore retail deposits that they on-lend in Australia; and
- local subsidiaries borrowing from overseas parents (this appears to relate only to financial institutions).

For Australian branches of foreign banks, the IWT applied to interest on borrowings from their overseas head offices will be reduced from the current 5% to 2.5% in 2013-14 and to zero from 2014-15.

The Budget announcement states that as an “integrity measure”, the reduced IWT rates will not apply to interest paid on non-resident retail deposits held in Australia, nor will they apply to offshore borrowings by entities that are not financial institutions.

The announcement does not specify the types of entities that will be treated as financial institutions for the purposes of the IWT reductions. The Henry Review recommended that the IWT exemption cover ADIs (i.e. banks, building societies and credit unions), as well as other financial institutions (such as money market corporations), but that it not extend to corporate treasuries of multinational groups, insurers and fund managers. It appears that the Government may adopt a similar approach.

The IWT reductions, although only effective some considerable time in the future, will be welcome news for financial institutions operating in Australia. The proposed reductions should increase financial institutions’ ability to access foreign capital and reduce the costs associated with borrowing offshore since, as a practical matter, the cost of IWT is generally borne by the borrower. Existing exemptions from IWT will not be affected by the proposals.

Tax concessions for savings products

The Government has announced measures to apply from 1 July 2011 that will provide concessional treatment for interest income from a number of savings products. Individuals will be provided with a tax discount equal to 50% on up to \$1,000 of interest income earned on savings products, seemingly without any form of means testing. The products will include deposits with banks, building societies and credit unions, bonds, debentures and annuity products. Interest income earned indirectly e.g. via trusts or managed investment schemes will also qualify.

Consultation on the details of the measures will be undertaken. There will be questions around the scope of the regime – for example, precisely which types of savings products will be eligible for the discount.

The measures are designed to overcome inequity in the treatment of savings, as compared to other investments, such as shares or property. The Henry Report recommended a 40% savings income discount for individuals’ non-business related income, and for that discount to apply to net interest income, net

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residential income and expenses, capital gains and losses, and interest expenses related to listed shares. It appears that the Government has accepted Henry's recommendation in part. That is, the amount of the discount will be higher (i.e. 50% as opposed to Henry's recommended 40% discount) and restricted to savings income (as opposed to extending it to residential income and negative gearing for listed shares – which the Government rejected in its official response to the Henry Review).

The Government has stated that the discount should encourage savings, and that this will in turn increase the supply of stable deposit funding to banks, building societies and credit unions, thereby reducing their dependence on international capital markets. However, given the modest nature of the amount of interest income that will benefit from the discount, the likely success of the measure on this score is not clear.

First Home Saver Accounts

The Government has announced changes to the First Home Saver Account ("**FHS Account**") scheme, which are designed to increase the flexibility and use of the accounts. To date, the take-up rate of FHS Accounts has been very low – seemingly because of the restrictions and complexity of the rules.

FHS Accounts were originally announced in the Rudd Government's 2007 election campaign, and have already been "refined" in the 2008 Federal Budget. In brief, under the existing model:

- the Government provides a co-contribution of 17% on the first \$5,000 (indexed) contributed to the account each year;
- personal contributions to the account are allowed until the total balance reaches \$75,000 (indexed); and
- earnings on the account balance are taxed at 15% and withdrawals are tax free where they are used to purchase a first home.

The above concessions will continue to apply. However, the Government has now announced that FHS Account holders will be allowed to withdraw their FHS Account balance after an (unspecified) minimum qualifying period and subject to conditions. The withdrawal must be in order to buy a first home, and the balance of the account must be transferred to an approved mortgage. This is more flexible than the existing rules, which (somewhat bizarrely) require any withdrawal within four financial years of the account being established to be transferred to a superannuation fund, rather than being used to reduce a mortgage. Consultation on the details is to occur.

Managed Investment Trust changes

The Budget contained five “announcements” that are relevant to managed investment trusts (“MITs”), all of which have been announced previously.

Definition of a MIT

First, the Government re-announced the proposed change to the definition of a managed investment trust.

The proposed changes to the definition of a MIT were discussed at the foot of our Tax Brief of 5 March 2010:

http://www.gf.com.au/Tax_Brief_CGT_treatment_for_MITs_New_draft_legislation.pdf

Since that Tax Brief, Treasury has released an Exposure Draft (“ED”) of the legislation that was intended “to achieve a closer alignment” between the MIT definition proposed in the CGT election changes (see below) and the MIT withholding tax definition.

Given that the proposed CGT election MIT definition is broader than the existing MIT withholding tax definition, one would have thought the “alignment” should allow more trusts to be MITs for these purposes. Unfortunately, a number of (apparently deliberate in some cases) additional limitations are contained in the amendments in that ED which could cause a number of trusts that are currently within the MIT definition to fall out. For example:

Example 1

The current definition requires that a MIT be operated or managed by a holder of an Australian financial services licence (“AFSL”), but the proposed change in the ED would require that a MIT be operated and managed by (either a single or multiple) AFSL licence holder/s – this would have the following consequences.

- Most listed and wholesale trusts that are managed in Australia have a responsible entity (“RE”) that holds an AFSL, but the manager is normally a related company of the RE or major investor and does not hold an AFSL - accordingly, a swathe of bona fide MITs would fall outside the definition.
- MITs established and managed by foreign entities which are currently within the definition of a MIT would fall outside the definition.

The Budget announcement confirms that the shift from “or” to “and” and the requirement that the manager now be in Australia, are deliberate changes as it states that the new MIT definition will exclude trusts that are not managed in Australia. Whilst Treasury has to date been unable to provide clarity on what constitutes ‘managed’, this issue will continue to be the subject of lobbying by

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many industry groups, as such a restriction would seem contrary to establishing Australia as financial services centre.

It is hoped that a “grandfathering” provision will be introduced so as not to disadvantage trusts managed by foreign entities that have been structured so as to fall within the current MIT definition.

Example 2

The proposed ED definition will introduce an exclusion for MITs where 20 or fewer individuals have a greater than 75% interest in the MIT.

A number of MITs would fail this requirement in the establishment phase.

Treasury has been asked to consider a start-up concession for this measure, and whether this rule makes the current restriction on individuals holding a 10% interest in a MIT redundant.

Despite the new limitations listed above, the Budget announcement nonetheless confirms the Government’s intention to otherwise expand the current MIT definition to include certain wholesale trusts and widely held pooled superannuation trusts.

New exchange of information countries

Secondly, the Government confirmed that it has entered into tax information exchange agreements with a further 15 countries – these countries should eventually be added to the list of “exchange of information” (“**EOI**”) countries for which reduced MIT withholding tax rates apply (currently 15%, and 7.5% from 1 July 2010). The relevant countries (or jurisdictions – which reads like an idyllic holiday itinerary) are Anguilla, Aruba, the Bahamas, Belize, the Cayman Islands, Dominica, Grenada, Monaco, Samoa, San Marino, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Turks and Caicos Islands, and Vanuatu. Singapore and Belgium continue to be curious omissions from the list of EOI countries.

Thirdly, the Government confirmed that 4 countries that have previously entered into exchange of information agreements with Australia will be added to the list of EOI countries for which the reduced MIT withholding tax rates will apply. These countries (or jurisdictions) are Antigua and Barbuda, the British Virgin Islands, the Isle of Man and Jersey. The announcements are silent as to an effective date, so with nothing more, it would be assumed to be the day the changes to the list of EOI countries in the regulations are Gazetted.

Clarifying the MIT CGT election

Fourthly, the Government reiterated its commitment to provide MITs with an irrevocable election to treat a range of assets under the CGT regime.

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As part of this measure, the Government states that it will expand the “definition of a MIT to ensure that a broader range of widely held trusts... are able to make an election” – however, keep in mind the proposed changes to the MIT definition for MIT withholding tax purposes referred to above, which is likely to limit the current MIT definition.

Again, this measure has been previously discussed in our Tax Briefs of 5 March 2010:

http://www.gf.com.au/Tax_Brief_CGT_treatment_for_MITs_New_draft_legislation.pdf,

and 17 December 2009:

http://www.gf.com.au/Tax_Brief_CGT_Treatment_for_MITs_Draft_Legislation.pdf.

Amendments to the Bill introducing the CGT election were introduced into the Senate today. The amendments remove the separate MIT definition for the CGT election. Instead, the MIT definition will run off the back of the proposed MIT definition referred to above (with slight modifications to expand the availability of the CGT election to State-operated trusts, certain wholesale trusts, and wholly-owned trusts of specified widely held entities). Accordingly, the outcome of lobbying on the MIT definition for the purposes of the MIT withholding tax is even more important.

Government response to Board of Tax MIT review

Finally, the Government announced (as it did last Friday) that it has responded to the Board of Taxation’s MIT review.

As stated in our Tax Brief yesterday ([New Managed Investment Trust](#)) the Government accepted 38 of the Board of Taxation’s 48 recommendations. The notable changes accepted by the Government were:

- introducing a separate taxation regime for MITs;
- establishing the concept of a Regime MIT, being a trust that is “widely held”, engaged in “primarily passive investment” under which the beneficiaries have “clearly defined rights” to capital and income;
- providing an elective attribution model to replace the notion of present entitlement;
- implementing rules in relation to ‘unders and overs’ to avoid re-issuing statements for revised distributions by trusts;
- removing double taxation of capital gains caused by differences between asset value and equity value; and
- abolishing the corporate unit trust provisions in Division 6B.

Merger and Acquisition changes

Earn out arrangements

The tax treatment of earn out arrangements – where on the sale of a business asset some part of the agreed price is contingent on future economic performance – has been in limbo since the ATO released Draft Taxation Ruling 2007/D10 in October 2007.

The Government has announced that all payments under “qualifying earn out arrangements” will be treated as relating to the sale and purchase of the underlying business assets. These changes will apply from the date of Royal Assent of the enabling legislation, and transitional provisions will also apply in certain cases from 17 October 2007 (being the date TR 2007/D10 was released and Taxation Ruling TR 93/15 was withdrawn).

The effect of the changes for qualifying earn out arrangements should be:

- **For vendors:** the earn out payments should be added to the disposal proceeds for the business asset, and subject to the CGT discount and small business concessions where applicable. This may require the vendor to request an amended assessment when earn out payments are received subsequent to the income year in which the sale occurred. Hopefully, no shortfall interest should apply in this situation.
- **For purchasers:** the earn out payments should be included in the cost base of the business asset in addition to the upfront payment for the business assets. Where the business asset is shares in a company, the tax consolidation rules already deal with such a cost base adjustment.

Unfortunately, there is no detail on what will constitute a qualifying earn out arrangement or how the transitional provisions will operate – all the Government has acknowledged is that the current tax treatment (albeit the ATO’s view of the world) can result in anomalous outcomes arising, particularly in relation to the availability of the small business CGT concessions and where the amount of the earn out payment differs from the estimated market value of the earn out right.

Facilitating access to CGT roll-overs where sale facilities are used for foreign-owned interests

Sale facilities are often used for foreign-owned shares or interests in entities when they undertake restructures involving the issue of new interests. This avoids the expense and compliance burden of satisfying the legal requirements regarding the issue of a prospectus or other public disclosure document to issue shares or interests to the residents of each relevant foreign jurisdiction.

Various CGT roll-overs for restructures require that all of the interest holders exchange their interests in the entity for interests in a new entity, and that

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proportionate ownership be retained. Under a sale facility, the new interests are issued to an agent or nominee which disposes of the new interests and returns the proceeds to the foreign investor. This method of dealing with foreign investors strictly can result in a contravention of the proportionality requirements of these CGT roll-overs.

This can mean that CGT roll-over relief is not available for Australian investors with respect to the restructure (roll-over relief is likely to be irrelevant for foreign investors unless the Australian entity is land-rich).

The current law is inconsistent in its treatment of these sale facilities. Where a share exchange occurs upon the interposition of a new head company of a tax consolidated group, shares sold under a sale facility are disregarded, but only if the restructuring entity is an ADI (Subdivision 124-G). There is also an express concession for sale facilities where stapled ownership interests are exchanged for interests in a unit trust (Subdivision 124-Q). There is also a note in Subdivision 124-M stating that sale facilities do not prevent scrip-for-scrip roll-over on the basis that shareholders do not participate on "substantially the same terms".

There is no clear policy basis for restricting the concession to certain CGT roll-overs, or to certain types of entities being restructured (such as ADIs under Subdivision 124-G).

As such, the Government is proposing to introduce concessions for sale facilities that could otherwise contravene the requirements for CGT roll-over under Subdivisions 124-H, 124-I, 124-N and 125 – in addition to the existing concessions in Subdivision 124-G and 124-Q, which will be repealed and restated.

The Government has released a Consultation Paper seeking comment on the proposed form of the concession for sale facilities, whether the concession is also required for any CGT roll-overs not mentioned above, or alternatively whether a generic rule for sale facilities could be introduced that applies for the purposes of all relevant roll-overs.

These amendments will apply to CGT events happening after 7.30pm (AEST) on 11 May 2010.

Limited extension of demerger relief

With effect from 11 May 2010, the application of the rules providing demerger relief will be extended to cover some additional but very limited circumstances. The extensions will allow demerger relief for groups which have a head entity without ownership interests (a 'corporation sole'), and also groups with a complying superannuation entity as head entity. The proposal will prevent the corporation sole or superannuation entity being the head entity, and thereby allow another member of the group to be the head entity. Regrettably the proposed amendments do not resolve other shortcomings in the rules that prevent demergers; e.g., where an unlisted company owns more than 20% of the shares

in a second company, thereby preventing the second company from being the head entity of the group.

Structured Product changes

Changes to capital protected borrowings – benchmark interest rate

A capital protected borrowing is typically a limited recourse borrowing to acquire securities where the borrower is protected against a fall in value of the securities, for example, by having a right (a put option) to transfer the securities to the lender in full satisfaction of the loan. If the cost of the capital protection is embedded in the interest charge, then under Division 247 the interest is effectively bifurcated for tax purposes so that it is treated as being partly (deductible) interest and partly (non-deductible) costs of acquiring a put option.

The bifurcation process uses a specified RBA rate – to the extent the interest rate exceeds the specified RBA rate, it is non-deductible (as being the cost of the put option). In the May 2008 Budget, the Government announced that the specified RBA rate for borrowings entered into after 13 May 2008 would be the RBA indicator rate for standard variable housing loans. Legislation to give effect to this announcement has never been enacted (or released), partly due to industry concerns that the May 2008 Budget announced rate is too low as it assumes that the underlying loan is typically risk-free (whereas it actually embodies a significant risk for the issuer).

In this Budget, the Government has announced that the specified rate will continue to be the RBA indicator rate for standard variable housing loans – although as a concession, the rate will be increased by 100 basis points. The new specified rate essentially replaces the rate announced in the May 2008 Budget as the new rate will apply to capital protected borrowings entered into on or after 13 May 2008 (or pre-13 May 2008 borrowings which are amended/extended after this date).

As a transitional measure, for loans entered into before 13 May 2008 (and not extended/amended after that date), the relevant rate will continue to be the more favourable (higher) rate that applied before the May 2008 Budget announcement (being the RBA indicator rate for personal unsecured loans – variable rate). This favourable (higher) rate will continue to apply to existing pre-13 May 2008 borrowings until 30 June 2013 (provided the borrowing is not amended/extended before then).

Exposure Draft legislation and an accompanying Explanatory Memorandum have been released to give effect to these announced changes in this Budget.

Look through treatment of instalment warrants

The Government has re-iterated its announcement on 10 March 2010 to amend the income tax treatment of 'traditional instalment warrants' and the treatment of the limited recourse borrowings of complying superannuation funds.

Traditional instalment warrants

An instalment warrant is a derivative that usually involves an investor borrowing to invest in an asset, such as a share (the underlying asset). In its simplest form, a 'traditional instalment warrant' involves the investor making an upfront payment, which will usually include prepaid interest and borrowing fees. The underlying asset is held on trust for the investor during the life of the loan. Once the investor has paid the required future instalment(s), the trustee transfers the underlying asset to the investor.

On a technical reading of the current law, the trustee owns the underlying asset in the trust. As a result, there is a CGT taxing point when the investor pays the final instalment (CGT event E5). However, the ATO has issued a number of product rulings for traditional instalment warrants that effectively ignore the trust and treat the investor as the owner of the underlying asset. Under this practice, there is not a CGT event on payment of the final instalment and transfer of the underlying asset. The law will now be amended to align with the ATO practice.

Non-traditional instalment warrants

'Non-traditional instalment' warrants include instalment warrants over real property. These have primarily been used by self managed superannuation funds to borrow to invest in commercial and residential property without contravening the borrowing restrictions of the SIS Act. The proposed amendments will see a superannuation trustee who enters into a non-recourse borrowing arrangement for the purpose of purchasing an asset, as permitted under subsection 67(4A) of the SIS Act, treated as the owner of the asset for income tax purposes.

Tax consolidation changes

Four areas of the Budget refer to tax consolidation amendments of relevance to Australian corporate groups. The following three appear to have already been included in legislation that is currently before the Senate in the *Tax Laws Amendment (2010 Measure No 1) Bill*, including:

- changes to the application dates of various previously announced measures;
- taking account of non-membership equity interests in both entry and exit tax cost setting calculations; and

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- various refinements including simplifying the approach to making consolidation choices, transitional foreign currency trade receivable measures, and adjustments for inherited deductions under the exit tax cost setting rules.

These matters were discussed in our Tax Briefs dated 19 March 2010 (http://www.gf.com.au/Consolidating_Consolidation_Complete_list_of_changes.pdf) and 30 April 2009 (http://www.gf.com.au/Tax_Brief_-_TOFA_-_refinements_to_the_puzzle.pdf).

Other areas of tax consolidation amendments are fairly limited in application, as follows:

- four amendments to the rules relating to the calculation and collection of tax liabilities of consolidated and MEC groups. While 3 of these amendments appear to be mainly technical amendments relating to the interaction of the PAYG rules, the Government also announced that it will “allow an entity in a tax sharing agreement to leave a consolidated group or MEC group clear of any future income tax liabilities relating to the group”. It is unclear what exactly is meant by this amendment as the purpose of a clear exit payment under the current law is to allow a leaving member to exit free of future liability for group tax liabilities that have not yet fallen due. Presumably this is intended as an improvement to the current law. It may mean that a subsidiary will be able to leave the group without liability for amended assessments of prior year liabilities. The Government will release a consultation paper by the end of May;
- an apparent correction of the eligibility rules for appointment of a MEC group member as provisional head company of the group, with retrospective effect from 1 July 2002; and
- further tidying up other parts of the tax legislation which in some circumstances mistakenly refer only to a consolidated group but not also a MEC group (with effect from 1 July 2002).

Johnson Report – other aspects

Offshore banking units

The Johnson Report strongly endorsed the offshore banking unit (“**OBU**”) regime. It even recommended that the Government, in its response to the Report, make a statement of support for, and commitment to, the OBU regime. It also recommended the following changes to improve the regime: removing the uncertainty about whether taxpayers have a choice as to whether to book transactions in the OBU, reviewing and updating the list of OBU activities, and streamlining the OBU application process.

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The Government has indicated it supports the recommendations “in principle”, and will commence a consultation process. This will start with the release of a discussion paper covering each of the above recommendations (which has not been released with the Budget itself).

LIBOR cap on Australian branch funding

Currently there is a restriction on the deductibility of interest on borrowings by Australian branches of foreign banks from their head offices. The Johnson Report recommended the removal of this cap and the Government has asked Treasury to review the implications of such a removal. The Government will respond to this recommendation following Treasury's review.

Islamic finance products

The Johnson Report recommended and the Government accepted (on 26 April 2010) that the Board of Taxation be asked to examine the need for amendment of the existing Commonwealth tax provisions to ensure tax parity between Islamic and conventional products taking into account the economic substance of Islamic finance products.

Tax compliance changes – individuals and miscellaneous

Personal tax rates, Medicare levy and concessions

The Government did not make any changes to the currently legislated tax rates for 2010-11. From 1 July 2010, the personal tax rates and thresholds for resident individuals (excluding the 1.5% Medicare levy) will be:

Personal tax rates and thresholds for residents From 1 July 2010

<i>Taxable income (%)</i>	<i>Rate (%)</i>
0 - 6,000	0
6,001 - 37,000	15
37,001 - 80,000	30
80,001 - 180,000	37
180,001+	45

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Relevant changes are an increase in the 30% threshold from \$35,000 to \$37,000 and the 38% marginal tax rate decreasing to 37%.

From 1 July 2010, the low income tax offset will increase from \$1,350 to \$1,500. This will allow Australians to earn up to \$16,000 before they pay income tax.

As a result of the increase in the low income tax offset from 1 July 2010, the amount of income a senior Australian (eligible for the senior Australian tax offset) can earn before they pay income tax or the Medicare levy will increase from \$29,867 to \$30,685 for singles, and from \$25,680 to \$26,680 for each member of a couple.

Increase in Medicare low-income thresholds

From 1 July 2009 the Medicare Levy low-income threshold will increase:

- to \$18,488 for singles (up from \$17,794); and
- to \$31,196 for couples ((up from \$30,025).

For families, the additional threshold amount for each dependent child/student will increase to \$2,865 (up from \$2,757).

In addition, the Medicare levy threshold for single pensioners below Age Pension Age will increase to \$27,697 (up from \$25,299).

Standard deduction for employee expenses

With a view to reducing the compliance burden for individuals, the Henry Report (see our Tax Brief at http://www.gf.com.au/Tax_Brief_The_Henry_Tax_Review.pdf) recommended the use of standard deductions for employees to cover work related expenses and the cost of managing tax affairs.

The Government has taken up this recommendation and announced that from 1 July 2012 individual taxpayers will be provided with an optional standard deduction of \$500 in lieu of claiming such expenses. The standard deduction will increase to \$1,000 from 1 July 2013.

The use of a standard deduction in lieu of claiming itemised deductions mirrors the system currently used in the USA.

Individuals with deductible expenses greater than the standard deduction amounts will still be able to claim their expenses subject to the existing substantiation rules.

Public ancillary fund

The Government has announced that it will introduce a new regulatory framework for public ancillary funds. Broadly, a public ancillary fund is a type of deductible gift recipient that provides gifts of money or property to other deductible gift funds.

The Government indicates that the new regulatory framework will be similar to the measures introduced for private ancillary funds in October 2009. If that is the case, then we can expect the introduction of guidelines for public ancillary funds enforceable through administrative penalties.

We can also expect that the Commissioner will be provided with the power to suspend or remove the trustee of a public ancillary fund if that trustee consistently breaches those guidelines.

The announcement follows a statement by the Commissioner earlier this year in which he indicated that the ATO has found a number of public ancillary funds in breach of their trust deeds (Non-Profit News Service No. 0262).

Superannuation changes

Extension of superannuation fund merger loss transfer relief

The Government will extend transitional superannuation fund merger loss transfer relief "to mergers into new funds" with effect from its implementation date on 24 December 2008. The relief is already available where two funds merge to create a new fund, provided that at least one of the existing funds had 5 or more members. Details were not provided in the Government announcement, but presumably the relief will be extended to the situation where the merging funds had fewer than 5 members, but the new merged fund has 5 or more.

Deductions for personal contributions to successor funds

The Government has announced that it will permanently allow a claim for deductions for eligible contributions made to successor funds with effect from 2010/11. Currently deductions for personal contributions to successor funds are limited to a situation where the successor fund qualifies for the transitional superannuation fund merger loss transfer relief, and a choice is made to transfer losses.

Exercise of the Commissioner's discretion to disregard excess contributions or reallocate them to another year

The Government has announced that with effect from the 2010/11 income year the Commissioner will be allowed to exercise his discretion to disregard concessional and non-concessional superannuation contributions or reallocate

them to another year before an excess contributions tax assessment is issued to the member. Currently an affected member can only make an application for the exercise of the discretion after receiving an excess contributions tax assessment.

Costs of providing terminal medical condition benefits

With effect from 16 February 2008 the legislative environment permitted a complying superannuation fund to pay benefits to a member with a terminal medical condition. Superannuation funds may have paid insurance premiums to effect cover to provide these benefits. The announcement makes clear that the cost of this cover will be deductible to the trustee of the affected fund.

Increase the time limit for deductible employer contributions made for former employees

This announcement, as with a number of the superannuation measures, is short on detail. Currently superannuation contributions in respect of former employees are, broadly, deductible where made to satisfy an employer's super guarantee obligation, but otherwise are deductible on a quite limited basis. Presumably, and it is not clear to what extent, the Government will be addressing this issue, by broadening the basis of deduction.

Reiteration of Henry Review response

The Government reiterated its announcements from Sunday 2 May that it will implement a staged increase in the Superannuation Guarantee rate and an equity measure for low income earners in the form of a Government contribution of up to \$500 – refer to part 2.5 of our Tax Brief dated 3 May 2010.

Other changes

Other announced minor changes include:

- clarifying the due date of the shortfall interest charge for the purpose of excess contributions tax;
- providing new arrangements to public sector defined benefit schemes which fund benefits through last minute contributions; and
- personal tax rates.

GST changes

Budget 2010 marks a continuation of the Government's implementation of the GST issues raised for discussion or further review in Budget 2009.

Various reviews were undertaken, including in respect of the treatment of financial supplies and the margin scheme for property dealings. Further, the Board of Taxation was tasked with undertaking a review into the application of GST to cross-border transactions, with a particular focus on minimising the involvement of non-Australian entities in the GST system. The Government has responded, in part, to those reviews.

Cross-border transactions and the Board of Taxation

After significant submissions and consultation, the Board made 14 recommendations and the Government has agreed to implement them all. The key outcomes will be:

- the 'connected with Australia' rules will be scoped down so that many supplies by non-residents will not attract GST. Broadly, this requires that the non-resident not be acting through an Australian business presence and for the recipient to be registered for GST. [Recommendations 1, 2 and 3];
- to keep those measures revenue neutral, the compulsory reverse charge on inbound supplies will apply to supplies of goods. [Recommendation 4];
- the denial of GST-free treatment for outbound supplies under section 38-190(3) will be limited to situations where the Australian entity (or its employees) to whom the service is 'provided' is not GST registered. [Recommendation 5];
- commission agents will be able to elect to take responsibility for GST compliance obligations under Division 57 when acting for a non-resident, even though not an agent at common law. [Recommendation 7]; and
- the GST registration process for non-residents will be streamlined (or eliminated in some circumstances) and the information requirements made less onerous. [Recommendations 8, 9 and 10].

These measures are to take effect from 1 July 2012, so draft legislation may be some time in coming. Subject of course to the detail of that legislation, these measures are welcome and will, to a large extent, simplify the GST treatment of cross-border transactions.

Financial supplies

While the 2009 Treasury Discussion Paper canvassed a broad ranging overhaul of the treatment of financial supplies, the Government is maintaining the current regime, including the reduced input tax credit ("RITC"), subject to targeted measures to commence from 1 July 2012:

- the de minimis 'financial acquisitions threshold' will be lifted to \$150,000;

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- hire purchase agreements will be treated as a single taxable supply, rather than a mixed supply of goods and credit, with up-front attribution of input tax credits for all registered recipients;
- bank deposits will be excluded from the 'borrowing' concession;
- the list of services for which RITCs can be claimed will be expanded to include: (a) acquisitions related to supplies of life insurance by superfunds; (b) lenders mortgage reinsurance; and (c) transactional fraud monitoring services; and
- amending the trustee and responsible entity RITC items to prevent the ability to bundle other services and claim an RITC.

These relatively minor changes will have a mixed impact for the financial services industry who will welcome the RITC rate being maintained, the expanded RITC categories and full credit recovery in their hire purchase businesses. However, the unwelcome news is the exclusion of bank accounts from the borrowing exemption (particularly after the battle to get GSTR 2009/D1 issued) and the loss of RITCs for trusts by limiting the trustee and responsible entity RITC items.

The Government budgets to recover \$7 million more GST per annum from these measures by 2013-14 (ie. less credits claimed by banks and trusts), which gives an indication of how much the last two measures will impact the industry.

The margin scheme

Similarly, the alternative options for the margin scheme contained in the 2009 Treasury Discussion Paper were rejected, as were minor technical changes sought by industry aimed at eliminating overtaxation.

The Government acknowledged that the current legislation did not always result in the correct outcome, but decided that the technical amendments sought by industry would increase complexity, add to compliance costs and involve significant revenue costs. So the measures announced on the margin scheme are a simple restructuring of the provisions, without apparent amendment and with no revenue impact, to make them easier to follow and a (welcome) minor amendment regarding the valuation of subdivided land from 1 July 2012.

Other matters

Finally, the Government has taken the opportunity to tidy up a few miscellaneous issues including:

- confirmation that some of the previously announced measures will have effect from 1 July 2011 and not 2010;
- a 'principles based' rewrite of Division 81 for Government taxes and charges;

- allowing 12 months for certain recreational vessels to be exported GST-free to encourage Australian boat building for foreign purchasers; and
- minor revisions to the new provisions involving the domestic transport of exported and imported goods.

Finally, the Government announced an additional \$337.5 million funding over four years to the ATO to fund GST compliance activities, expect to raise \$2.7billion.

Miscellaneous changes

Broadening of non-commercial loan rules

The Government has confirmed its intention, previously announced in the 2009-2010 Budget, to amend the private company non-commercial loan rules in Division 7A with effect from 1 July 2009. The proposed measures are contained in Tax Laws Amendment (2010 Measures No. 2) Bill 2010. In broad terms, the changes include:

- measures that result in a Division 7A payment (and possible deemed dividend) arising when a private company allows a shareholder or associate to use an asset (a payment will not arise where the asset is the main residence of the shareholder or associate and some other requirements are met);
- allowing Division 7A to apply to closely held corporate limited partnerships;
- broadening the circumstances where the repayment of a loan is disregarded for Division 7A purposes;
- allowing offsetting of amounts owed to an employee to be counted as a repayment of a loan;
- ensuring that a loan previously included in assessable income and subsequently forgiven does not result in a deemed dividend;
- amendments to the 'unpaid present entitlement rules' to extend the circumstances where a deemed dividend can arise; and
- putting beyond doubt that Division 7A can apply to arrangements involving non-resident private companies.

Film tax offset relaxation

The Australian Screen Production Incentive currently provides three forms of refundable tax offsets for certain expenditure on film, television and other screen production undertaken in Australia:

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- the Production Offset, an offset related to qualifying spend on feature films and other qualifying media;
- the Location Offset, an offset equal to 15 per cent of qualifying Australian spend on large-budget (more than \$15m) film and television productions; and
- the Post Digital and Visual (PDV) Offset, an offset equal to 15 per cent of qualifying post digital and visual effects production expenditure in Australia on large budget productions;

The Budget announcements will affect some of the qualification criteria for the Location Offset and the PDV Offset. The changes will "apply" from 1 July 2010. It isn't stated whether that cut-off date relates to, for example, the start of the relevant production, or only the incurring of the expenditure. The changes are:

- **Location Offset:** Productions valued between \$15m and \$50m will no longer need to spend a minimum 70% of their production budgets in Australia in order to qualify for the Location Offset. Instead, any productions with qualifying Australian production expenditure of at least \$15m will qualify for the offset regardless of the ratio of qualifying expenditure to the film's total production expenditure. The assumption seems to be that the 70% threshold removes the incentive for potential (lower proportion) Australian production rather than motivating Australian content to be lifted to 70%.
- **PDV Offset:** The PDV Offset was previously only available on productions where a minimum \$5m qualifying expenditure was incurred in relation to PDV work undertaken in Australia. The minimum expenditure threshold will be reduced such that the PDV Offset will become available for productions with a minimum \$500,000 of qualifying PDV expenditure in Australia. The motive seems to be that there are small scale operators who currently do not benefit from the incentive because of the high threshold.

New international tax agreements

The Budget papers provide a reminder of bilateral tax agreements which Australia has signed with other countries since July 2009. New full agreements have been signed with Chile and Turkey.

Improvements to the Tax Running Balance Account provisions

The Government has announced that it will undertake public consultation to simplify, improve and enhance the flexibility of running balance account provisions. As part of this exercise, consideration is being given to correct anomalies that currently exist in the scope of the entitlement to interest on overpayments, and early payments, of certain types of taxation obligations.

The changes will take effect from a date to be determined after the completion of public consultation.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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