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CHARTERED ACCOUNTANTS

FEDERAL BUDGET REVIEW | MAY 2018

SPECIAL EDITION

Introduction

In the run-up to the Federal Budget, two things were expected, a budget that responsibly delivered tax cuts and also a budget that delivered 'meaningful' tax reform. Of course this is a difficult balancing act for any government, as spending money on our priorities is 'responsible', while expenditure on others' priorities is not. Also, making fundamental changes to the tax system can be a significant risk that can easily back-fire come election time.

In this Federal Budget the Government has proposed a staged reduction of personal tax rates that is significant, although somewhat dampened by the extended period over which it will be delivered. Fundamental tax reform, however, was not a feature of this Federal Budget, but we were not completely disappointed, as a number of significant tax changes were announced that are likely to have an impact on your current tax affairs.

Personal Taxation

Staged reduction of personal tax rates

The Government has announced a 7-year 3-step plan for the reduction of the personal tax rates for 'low' and 'middle' income earners.

Step 1: Low and Middle Income Tax Offset

From 2018-19 to 2021-22, a new Low and Middle Income Tax Offset will give individuals who earn up to $90,000 a non-refundable tax offset of up to $530. For individuals who earn between $90,001 and $125,333, the offset will phase out at a rate of 1.5 cents per dollar.

This offset is in addition to the existing Low Income Tax Offset ("LITO").

Step 2: Reduction of marginal tax rate and increase of LITO

From 1 July 2018, the Government will progressively increase the top threshold of the 19% and 32.5% tax brackets, with a view to removing the 37% tax bracket by 2024-2025. The result of this is that more income will be taxed at the lower rates. The table below shows the current tax rates and thresholds for 2018-19 and the changes to the tax rates and thresholds (underlined and in bold) over the next 7 years (excluding the 2% Medicare levy).

Tax rates and thresholds

Rate	2017-18 (current)	2018-19 to 2021-22	2022-23 & 2023-24	2024-25 onwards
0%	$0- $18,200	$0 - $18,200	$0 - $18,200	$0 - $18,200
19%	$18,201 - $37,000	$18,201 - $37,000	$18,201 - $**<u>41,000</u>**	$18,201 - $41,000
32.5%	$37,001 – $87,000	$37,001 - $**<u>90,000</u>**	**$41,001 - <u>$120,000</u>**	$41,001 - **<u>$200,000</u>**
37%	$87,001 - $180,000	**<u>$90,001 -</u>** $180,000	**<u>$120,001 -</u>** $180,000	N/A
45%	$180,001+	$180,001+	$180,001+	**<u>$200,001+</u>**

From 2022-23, the LITO will also increase from $445 to $645 for individuals earning up to $37,000. The increased LITO will phase out at a rate of 6.5 cents per dollar for incomes between $37,000 and $41,000, and at a rate of 1.5 cents per dollar for incomes over $41,000. The LITO will phase out completely for incomes of $66,667 or more.

Step 3: Removal of 37% tax bracket

From 1 July 2024, the top threshold of the 32.5% bracket will increase from $120,000 to $200,000, removing the 37% tax bracket completely. Taxpayers will pay the top marginal tax rate of 45% from taxable incomes exceeding $200,000 and the 32.5% tax bracket will apply to taxable incomes of $41,001 to $200,000.

After these changes, the Government projects that around 94% of all taxpayers will have a marginal tax rate of 32.5% or less in 2024-25.

Deductions disallowed for holding vacant land

From 1 July 2019, the Government will deny deductions for expenses associated with holding vacant land. This is to address concerns that deductions are being improperly claimed for expenses, such as interest costs, related to holding vacant land, where the land is not genuinely held for the purpose of earning assessable income. It will also reduce tax incentives for 'land banking', where blocks of undeveloped land are held with a view to selling the land at a profit when it has been approved for development. Some holding costs that you are no longer able to claim may be added to the cost of the property and claimed against capital gains tax when the property is sold. However, other holding costs such as gardening fees or administration costs may not be able to be added to the cost.

This measure only applies to vacant land that is not being used to carry on a business. If there is a property constructed on the land and it is available for rent, you will still be able to claim these deductions. If you are carrying on a business on the land (including primary production) or you are holding the land for commercial development, you should still be able to claim deductions for holding costs.

Increased tax compliance activities and new anti-avoidance rules

The Government has announced some key areas of focus for compliance activities and new anti-avoidance rules.

1. Individuals and their tax agents

The ATO will receive extra funding to help them detect incorrect reporting of income and deductions, such as undeclared foreign source income of high wealth individuals and over-stated work-related expenses.

The funding will also allow for new compliance activities including additional audits and prosecutions, improving education and guidance materials, pre-filling of income tax returns, and improving real time messaging to tax agents and individual taxpayers to deter over-claiming of entitlements, especially in relation to higher risk taxpayers and their agents.

2. High profile individuals

High profile individuals will no longer be able to take advantage of lower tax rates by licensing their fame or image to another entity.

Currently, high profile individuals such as sports people or actors can license their fame or image to another entity (a related company or trust), so the income goes to that entity. This creates opportunities to split the income and take advantage of different tax treatments. This measure will ensure that all income received for the commercial exploitation of a person's fame or image will be included in the assessable income of the individual.

3. Family trust circular distributions

The Government will extend specific anti-avoidance rules that applies to other closely held trusts that engage in circular trust distributions to family trusts.

Currently, where family trusts act as beneficiaries of each other in a round robin arrangement, a distribution can ultimately be returned to the original trustee in a way that avoids any tax being paid. The measure will allow the ATO to pursue family trusts that engage in these arrangements and impose tax on such distributions at a tax rate of 47%.

Business Taxation

Application of Division 7A to unpaid present entitlements

The Government is proposing measures to clarify the scope of Division 7A to ensure that unpaid present entitlements (UPEs) come within the scope of the law. A UPE arises where a related private company becomes entitled to a share of trust income as a beneficiary but has not been paid that amount.

Division 7A requires benefits provided by private companies to related taxpayers to be taxed as dividends unless they are structured as Division 7A complying loans or another exception applies. This measure will ensure the UPE is either required to be repaid to the private company over time as a complying loan or subject to tax as a dividend.

It is unclear whether the proposed measures will capture UPEs existing prior to 16 December 2009 which, subject to conditions, are currently exempt from the operation of Division 7A. Therefore, we eagerly await the release of draft legislation which will confirm the extent of the proposed measures.

The new measures will apply from 1 July 2019. Measures announced in last year's budget which were to take effect as from 1 July 2018, have also been postponed to 1 July 2019. This is good news as draft legislation on these measures has not yet been released.

$20,000 instant asset write-off for SBEs extended by 12 months

Currently businesses with aggregated annual turnover of less than $10 million (small business entities or SBEs) are able to immediately deduct purchases of eligible depreciating assets costing less than $20,000. Eligible depreciating assets are assets acquired and first used or installed ready for use by 30 June 2019. This concession was due to expire on 30 June 2018, but has been extended by this Budget. Only a few assets are not eligible for the instant asset write-off such as horticultural plants and in-house software.

R&D tax incentive overhaul

The Government will amend the research and development (R&D) tax incentive and the changes will apply for income years starting on or after 1 July 2018.

For companies with aggregated annual turnover of $20 million or more, the Government will introduce an R&D premium that ties the rates of the non-refundable R&D tax offset to the 'incremental intensity' of the R&D expenditure. The marginal R&D premium will be the claimant's company tax rate plus:

+ 4 percentage points for R&D expenditure between 0% to 2% R&D intensity;
+ 6.5 percentage points for R&D expenditure above 2% to 5% R&D intensity;
+ 9 percentage points for R&D expenditure above 5% to 10% R&D intensity; and
+ 12.5 percentage points for R&D expenditure above 10% R&D intensity.

Budget Continued

Prior to the Budget, the introduction of the intensity threshold was mooted and came in for criticism, as this anticipated change is expected to contribute to the further decline of R&D expenditure that has occurred over the last 2 years.

The R&D expenditure threshold - the maximum amount of R&D expenditure eligible for concessional R&D tax offsets - will be increased from $100 million to $150 million per annum.

For companies with aggregated annual turnover below $20 million, the refundable R&D offset will be a premium of 13.5 percentage points above a claimant's company tax rate. Cash refunds from the refundable R&D tax offset will be capped at $4 million per annum, but refundable R&D tax offsets from R&D expenditure on clinical trials will not count towards the cap. R&D tax offsets that cannot be refunded will be carried forward as non-refundable tax offsets to future income years.

Startups that incur high R&D costs prior to earning any significant income and which rely on the R&D tax offsets to assist their cashflow, could be harshly penalised by the introduction of the $4 million per annum refund cap.

Changes to self-managed superannuation funds

SMSF member limit to increase from 4 to 6

The Budget confirmed that the maximum number of allowable members in new and existing self-managed superannuation funds (SMSFs) will be expanded from 4 to 6 members from 1 July 2019.

Allowing up to 6 SMSF members may provide opportunities for SMSFs to be used as intergenerational solutions for managing long-term, capital intensive investments, such as commercial property and business real property. For example, allowing an extra 2 members would enable the fund to use the contributions of the younger members to make pension payments to the members in retirement phase, without needing to sell a long-term investment.

However, all the members of the fund will still need to be either trustees in their own right or directors of the trustee company. A decision to add extra members should not be taken lightly as it can add complexity to the fund's management and investment strategy.

SMSF audits only required every 3 years for funds with good compliance history

From 1 July 2019, the annual audit requirement for self-managed superannuation funds (SMSFs) will be extended to a 3-yearly cycle for funds with a history of good record-keeping and compliance.

The measure will apply to SMSF trustees that have a history of 3 consecutive years of clear audit reports and that have lodged the fund's annual returns in a timely manner.

To discuss the implications of the federal budget for you and your business, please contact your Kelly+Partners Client Director.

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