10 May 2018

Global Tax Alert

Australia issues 2018-19 Federal Budget

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Executive summary

On 8 May 2018, Australia's Federal Treasurer, Scott Morrison, delivered the Australian Federal Budget, *Federal Budget 2018 – punting on growth*. Accelerating growth has seen tax revenues above forecasts while spending has maintained a steady path. Cautious growth forecasts underpin future reform plans and the path to surplus.

This Tax Alert focuses on the key tax measures announced and foreshadowed. Key business tax measures announced include:

- Changes to the tax treatment of research and development (R&D) expenditure with positive and negative impacts for companies. An intensity test introduced for larger companies will see improved incentives of up to 12.5% for R&D-intensive companies, but reduced to 4% for the least R&D-intensive companies. These compare with the current 8.5% and (previously) 10% incentives for larger companies.
- A consultation paper to be released in the next few weeks covering Australia's participation in the G20 countries' review of digitization of business and changes required to tax systems.

Numerous integrity measures to be introduced will impact businesses and forward planning for financing and tax compliance purposes. These include:

Building a better working world

- Establishing thin capitalization integrity measures to align the valuation of intangible and internally-generated assets for tax and financial reporting purposes and, closing access to thin capitalization tests intended only for outbound investors
- Removing the ability of Managed Investment Trusts and Attribution Managed Investment Trusts to apply capital gains tax discounts at the trust level
- Launching transparency initiatives to expand "significant global entity" definitions
- Instituting numerous future black economy measures including denial of deductions for some payments where there has not been compliance with Pay As You Go (PAYG) rules
- Providing major funding of the Australian Taxation Office (ATO) "big data"' compliance initiatives creating greater ATO data analytics which will require corporate readiness

Indirect tax and customs duty measures saw changes also.

This Tax Alert outlines the key proposed tax measures, categorized into changes affecting:

- Businesses including international businesses
- Financial services and real estate
- Indirect taxes

Detailed discussion

Business tax measures

R&D offset significant changes

The Government's response to the *2016 Review of the R&D Tax Incentive* proposes significant changes to the R&D offsets (incentives). The changes will apply for income years starting on or after 1 July 2018.

For companies with over AU$20m[1] aggregated annual turnover (eligible for non-refundable offsets):

- A sliding rate offset, to replace the current fixed offset, will vary with the claimant's "R&D Intensity." The R&D intensity will be a ratio of R&D expenditure divided by total expenditure for the year, though further details are to be released (EY has opened discussions with Treasury)
- The final offset benefit will be tiered with the potential for an effective benefit rate between 34% and 42.5% (assuming a 30% corporate income tax rate)

R&D Intensity tier	Marginal R&D premium	Added to claimant tax rate (at 30%) gives
0 - 2%	4.0%	34.0%
2 - 5%	6.5%	36.5%
5 - 10%	9.0%	39.0%
>10%	12.5%	42.5%

- Increase in the R&D expenditure threshold from $100m to $150m annually

Many large global and domestic based companies will now only receive 4% support for every $1 of R&D expenditure. Only 18 months ago this same level of R&D expenditure by these companies received 10% support. This is not competitive with other local foreign jurisdictions to encourage R&D investment in Australia.

For companies with under $20m aggregated annual turnover (eligible for refundable offsets):

- Offset rate will be a premium of 13.5% above the company tax rate (from a fixed 43.5% offset)
- Cash refunds will be capped at $4m annually with the balance carried forward to future income years as non-refundable tax offsets. Clinical trials will not be counted towards this cap
- Other general R&D changes include: Increased integrity measures including increased funding for the ATO and regulators, improved guidance material, a public findings register and R&D Tax administrative and technical changes
- New transparency measures, including publication of company names and amounts of R&D expenditure claimed

During the consultation process, impacted businesses can provide feedback directly to the Government. Alternatively, in this regard, EY will make a submission to the Government and we would welcome input from impacted businesses.

Significant global entity companies

The definition of significant global entities (SGEs) is to be broadened for income years commencing on or after 1 July 2018.

Broadly, an SGE is currently defined as either a "global parent entity" with annual global income of $1b or more or, an entity that is a member of a group of entities containing a global parent entity and the annual global income of the group is $1b or more.

The SGE definitions are proposed to include (in addition to the current groups headed by a company required to provide consolidated financial statements) members of large groups headed by private companies, trusts, partnerships and also by investment entities (e.g., private equity funds). This broader range of companies will be subject to SGE higher tax penalties, obligations for general purpose financial statements and Country-by-Country reporting, and will need to adjust compliance and reporting processes.

Transparency, black economy and ATO Big Data

The full Government response to the Black Economy Taskforce Report is expected to bring in $5.3 billion over the next four years. From broadly 1 July 2019, key measures include:

Business deductions

- Businesses will not be able to claim deductions for employee payments without withholding PAYG
- Deductions will also be disallowed for payments to contractors without any PAYG withheld and where the contractor does not provide an Australian Business Number (ABN)
- Cash payments made to businesses will be limited to $10,000 maximum

Transparency measures

- Businesses seeking to tender for Australian Government procurement contracts over $4 million (including Goods and Services Tax (GST)) must provide an ATO statement indicating that they are "generally compliant with their tax obligations."

Illegal phoenixing

- Measures to combat illegal phoenixing of companies include:
  - Expanded ATO powers to retain tax refunds where there are outstanding tax filings
  - Extending the director penalty provisions to make directors personally liable for some GST, luxury car tax and wine equalization tax debts
- These measures are to be supported by the introduction of specific offenses and Corporations Law changes to limit directors' ability to resign to avoid liability and related creditors rights to vote on the appointment of external administrators. No express start date has been announced

Taxable payments reporting

- Security and investigation services, road freight transport and computer system design services will fall under the taxable payments reporting system (TPRS) requiring payers to report payments to contractors to the ATO

Other

- Designing a new regulatory framework for the ABN system in 2018-19; developing options for improving how businesses interact with government to be considered in the 2019-20 Budget
- New funding to support small businesses with fewer than 20 employees during the transition to Single Touch Payroll Reporting from 1 July 2019
- New funding to the Tax Practitioners Board (TPB)

The ATO receives significant funding under the black economy, R&D, superannuation and other initiatives, including $318.5 million over the next four years for new ATO mobile strike teams, increased audit presence, black economy hotline, improved data analytics and educational activities.

Businesses can expect significantly increased ATO activities including data analytics and systems reviews, and should prepare for efficient response management.

Small business instant asset write-off for assets under $20,000 extended

The instant asset write-off for assets under $20,000 for small businesses with aggregated annual turnover of less than $10m will be extended yet again, for assets first used or installed ready for use by 30 June 2019. The write off was due to expire 30 June 2018.

Eligible entities will welcome the further time to access this concession. Retailers and suppliers of assets to small businesses will also benefit.

Private group integrity measures

Tax integrity announcements aimed at private groups include:

- **Unpaid present entitlements (UPE) of companies** – From 1 July 2019, UPEs to trust income conferred on a private company beneficiary without then being paid will be treated as loans for tax purposes under the Division 7A private company tax integrity regime. This will codify existing ATO administrative treatment of such UPEs. The Division 7A concessional changes announced in the 2017 Budget have been deferred until 1 July 2019.

- **Income to individuals from image rights** – From 1 July 2019, individuals (typically high profile persons) will no longer be able to alienate income from image or brand rights that are disposed of or licensed to a related entity. Such income will be assessable to the relevant individual.
- **Testamentary trusts** – From 1 July 2019, an integrity measure will be introduced to ensure income and gains derived from non-estate assets is not subject to concessional taxation where distributed to minors. In such cases, the income will be subject to the existing higher tax regime applying to minors deriving investment income.
- **Circular trust distributions** – From 1 July 2019, an anti-avoidance measure will apply to family trusts using a circular trust distribution strategy to reduce or avoid tax. Such distributions will be taxed at the highest marginal tax rate plus Medicare levy.
- **Partnership Everett assignment changes** – From Budget night (8 May 2018), the small business Capital Gains Tax (CGT) concessions will no longer be available to partners who derive a capital gain on disposing part of their partnership interest to a related party (commonly referred to as an Everett Assignment). While the general CGT discount will still be available, such assignments are likely to be less tax effective.

International tax

Thin capitalization rules integrity changes

Valuation of assets – to align the value of assets for thin capitalization purposes with the value included in their financial statements.

The Government will tighten Australia's thin capitalization rules by requiring entities to align the value of their assets for thin capitalization purposes with the value included in their financial statements.

- Companies will no longer be able to revalue assets for the purpose of the safe harbor thin capitalization test if the asset value is not contained in their financial statements.
- This places the onus on those preparing financial statements and their auditors to ensure that valuations adopted are appropriate and in accordance with accounting standards.
- This measure applies to income years commencing on or after 1 July 2019 and suggests that valuations before the Budget will be accepted. However valuations undertaken after Budget Night cannot be included in this intervening period unless adopted in the entity's financial statements.

These measures may adversely impact entities that hold assets which have an accounting value that is significantly less than market value, and also where there is reluctance to revalue assets on its accounting balance sheet.

Asset valuations for thin capitalization purposes have recently been contentious, with several ATO Tax Alerts and a number of significant ATO audit processes and disputes. The acceptance of valuations before the Budget will be a positive development in management of outstanding matters.

This change will impact many sectors including not only services groups but also infrastructure and resources. Mining and exploration companies will need to consider the impact of the above in conjunction with soon to be released ATO guidance on the classification of "mining, quarrying and prospecting right" assets.

The thin capitalization arm's-length debt test remains available and may be a potential option for some.

Inbound investors – closing access to thin capitalization tests intended only for outbound investors

Foreign controlled Australian consolidated entities and multiple entry consolidated groups that control a foreign entity will be treated as both outward and inward investment vehicles. This measure will ensure that inbound investors cannot access tests (such the worldwide gearing test for outward investors) that were only intended for outward investors. This change is applicable for income years commencing on or after 1 July 2019.

Income tax base for international digital companies

The Treasurer stated in the Budget speech that the "next big challenge is to ensure big multinational digital and tech companies pay their fair share of tax" and he has been working with the G20 to bring the digital economy into the global tax net. In a few weeks he will release a discussion paper that will explore options for taxing digital business in Australia.

EY supports the issue of a paper to inform and engage the community that:

- There is now global action by governments to address the perceived problem of cross-border digital business with an Organisation for Economic Co-operation and Development and G20 process to develop proposals by 2019.
- Australia has already introduced measures such as the Multinational Anti Avoidance Law and Diverted Profits Tax to increase digital companies' and other multinational enterprises' income tax, as well as measures that arose from the global action to counter base erosion and profit shifting.
- There is no need to act in haste and if Australia is to introduce a digital tax, it should be done in consultation with other G20 members – the approach of the United Kingdom. The European Commission's recent recommendations show the risks of moving out of line with other countries.

Digital economy companies need to prepare for consultation. Businesses with a digital presence in Australia need to assess the potential future implications of a broader digital transactions tax.

Financial services and real estate

Removing the CGT discount for MITS and AMITs

Managed Investment Trusts (MITs) and Attribution MITs (AMITs) will no longer be eligible to apply the 50% CGT discount at the trust level from 1 July 2019. MITs and AMITs will still be able to distribute a capital gain that can be discounted in the hands of the beneficiary, when entitled.

Given this measure will only apply to MITs and AMITs it is likely to create significant complexity and system development costs for custodians and administrators to comply with CGT rules as they apply to various types of investment entities. Further in relation to beneficiaries that have investments in non-MIT trusts, MITs and AMITs, this will increase the complexity of their tax affairs.

The proposed changes align to the treatment of capital gains in the proposed Corporate Collective Investment Vehicle rules and for Listed Investment Companies.

These further proposals, impacting the funds and asset management industry, will warrant careful review and involvement in consultation as they develop, given the significant complexity and systems issues for participants.

Updated list of Information Exchange Countries

Effective from 1 January 2019, the Exchange of Information (EOI) countries will be expanded. Fifty-six countries to be added include Austria, Lichtenstein, Luxembourg, the Philippines and Switzerland but not Hong Kong. The updated list in the regulations will allow investors to benefit from lower MIT withholdings.

Deductions denied for vacant land

Deductions for expenses associated with holding vacant land will be denied to address concerns they are being improperly claimed for expenses, such as interest costs, where the land is not genuinely held for the purpose of earning assessable income. We understand that this measure, applicable from 1 July 2019, is not intended to apply to landholders who carry on a business of property development. Thus it may have limited application.

Indirect tax, customs and trade-related measures

GST – online hotel bookings

Following the extension of the GST to digital products and other services provided by offshore suppliers from 1 July 2017 and to low value imported goods from 1 July 2018, the GST will be extended to offshore sellers of hotel accommodations in Australia from 1 July 2019.

The impact of the measure will be that offshore sellers of Australian hotel accommodations will pay GST on the mark-up over the wholesale price of the respective accommodation. It will ensure the same tax treatment of Australian hotel accommodations, whether booked through an offshore company or an Australian company.

Alcohol excise refund scheme and concessional excise changes to benefit craft brewers and distillers

As previously announced, the alcohol excise refund scheme cap will increase from $30,000 a year to $100,000, for all brewers and distillers, and the concessional draught beer excise rate will be extended to smaller kegs typically used by craft brewers and distillers. This applies from 1 July 2019.

Illicit tobacco taskforce and tobacco duty measures

As previously announced, the Government will further crackdown on the illicit tobacco trade with a new Illicit Tobacco Taskforce, new framework to protect tobacco duty, and further resources to combat illegal domestic production. Importers must have permits and pay all duty and tax liabilities when tobacco enters the country, rather than when it leaves a licensed warehouse and enters the domestic market, from 1 July 2019.

New levy on sea cargo

A new levy is to be imposed on port operators from 1 July 2019 in relation to sea cargo. The levy will be payable on a quarterly basis calculated at $10.02 per twenty foot container (or equivalent) and $1 per ton for non-containerized cargo. Relevant costs can be expected to be passed on to importers and should be taken into account in pricing and budgeting decisions.

Removal of custom duty related to clinical trials

From 1 July 2018 customs duty will no longer be payable on placebos and clinical trial kits imported into Australia simplifying the import process associated with conducting clinical trials in Australia.

Extension of benefits for trusted traders

Importers accredited under the Australian Trusted Trader Program are set to benefit from the removal of the requirement to produce country of origin documentation under certain free trade agreements. It is unclear when this benefit will commence and which free trade agreements it will impact. Accreditation under the Australian Trusted Trader Program is becoming increasingly attractive for importers and exporters. Parties involved in international trade should assess the potential benefits of pursuing accreditation.

Endnote

1. Currency references in this Alert are to AU$.

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