

Budget 2.0: reset or recycle?

EY Federal Budget Brief 2017
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Executive Summary

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A chance to borrow at the bottom of the cycle to invest in long-term infrastructure and growth initiatives is the centre piece of an otherwise cautious Budget. The Treasurer has dialled back many of the unpopular measures from 2014 and appealed to 'ordinary' Australians by sharing the pain and gains fairly across the board.

Winners are small businesses and Australian workers, with new jobs being created through substantial investment in new infrastructure projects paid for with debt.

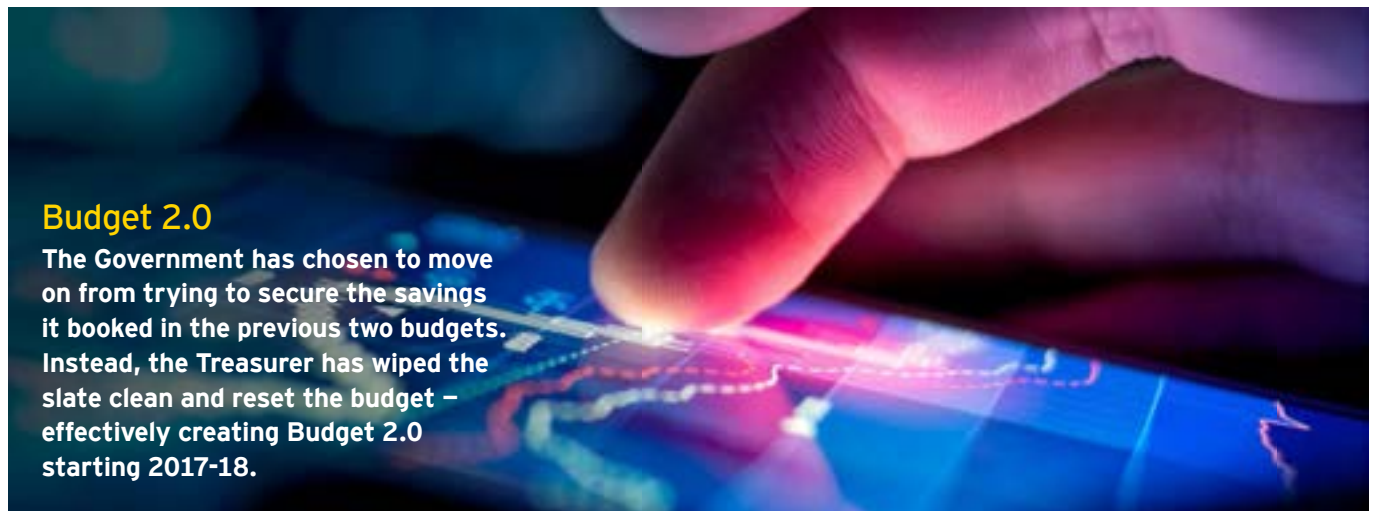
The Government is also tinkering with housing affordability, through new Commonwealth land releases, superannuation measures and restrictions on foreign owners and investors. But this may not be enough to 'fix the cost of living'.

In an unexpectedly big-taxing budget, the Treasurer is aiming to secure the government's AAA credit rating. The hoped for repair is being funded by the major banks, foreign property investors and most Australian taxpayers – on the back of an increase of the Medicare levy to 2.5%.

Whether this will be enough to restore the Budget to balance by 2021 remains to be seen. Budget estimates assume wages, investment, employment and economic activity will all begin to improve. But these green shoots on which the Government appears to be depending have yet to emerge.

Economy

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This Budget can be characterised as cautious, looking to boost its revenue through additional initiatives, while holding expenditure growth tight. It is also balancing the 'pain and gains' in a fairer way along the path to fiscal consolidation.

The question remains: is this a budget to save Australia's AAA credit rating? Although the surplus is at the very end of the forward estimates, which has been missed on more than one occasion, this year's projections seem to be based on more credible measures. The Budget seems genuinely set to live within its means. While the government is introducing more than \$17b of new expenditure, it is also raising an additional \$23b of revenue through new measures.

Economic settings: green shoots

The Budget is underpinned by economic settings that perceive green shoots on the horizon. Effectively, the Government is picking the bottom of the economic cycle. Wages, investment, employment and economic activity are all projected to begin moving back towards trend.

Although Australia's GDP is expected to fall significantly in 2016-17 (1.75% in real terms), recovery as high as 3% is expected by the end of the forward estimates. In the midst of current volatility in both geopolitics and commodity prices, Australia's GDP forecasts/projections presume improvements in household consumption, non-mining investment and exports. CPI is expected to recover from the current low figure of 1.0% to 2.5% by

2020/21, which might reflect the ongoing record low interest rate. Wage price is expected to grow strongly to 3.75% in 2020/21, potentially contributing significantly to a rise in income tax revenue.

Is this a revenue budget?

While the Budget has introduced a number of new levies, it is still heavily reliant on increases in growth in personal income tax and company tax to reach the projected surplus in 2020-21. Personal income tax is responsible for \$60b of the increase in Government's revenue and company tax at \$27b, which accounts for 51% and 23% of the projected increase in total revenue at over \$117b.

For a long time, the budget balance has been hurt by revenue dragging on the bottom line. This has largely been due to economic activity staying below trend and impacting individual and company tax collections. Revenue is projected to increase in line with the growth in economic settings. However, there is still concern of a structural deficit. To deal with this, the Government has proposed revenue measures, including the increase in the Medicare levy and a levy on the major banks.

Projections also suggest company tax will grow at the much faster rate of 8.6% annually. This is likely a result of the pool of tax deductions drying up after years of offsetting company profits, first accumulated during the investment phase of the mining boom.

Holding expenditure tight

The Budget shows continued discipline towards restraining expenditure growth. It focuses on managing recurrent expenses in line with recurrent revenue to ensure essential services continue, while redirecting spending to productivity investments designed to generate a return to the economy in terms of growth and jobs.

Despite this general conservatism, education and health are set to receive large amounts of additional funding, in the form of Gonski 2.0 and gradual lifting of the indexation freeze on the Medicare Benefit Schedule.

Infrastructure is a big winner

The Government has made strong commitments to enable major infrastructure. The Budget heralded \$70b of commitments heavily focused on economy-building infrastructure.

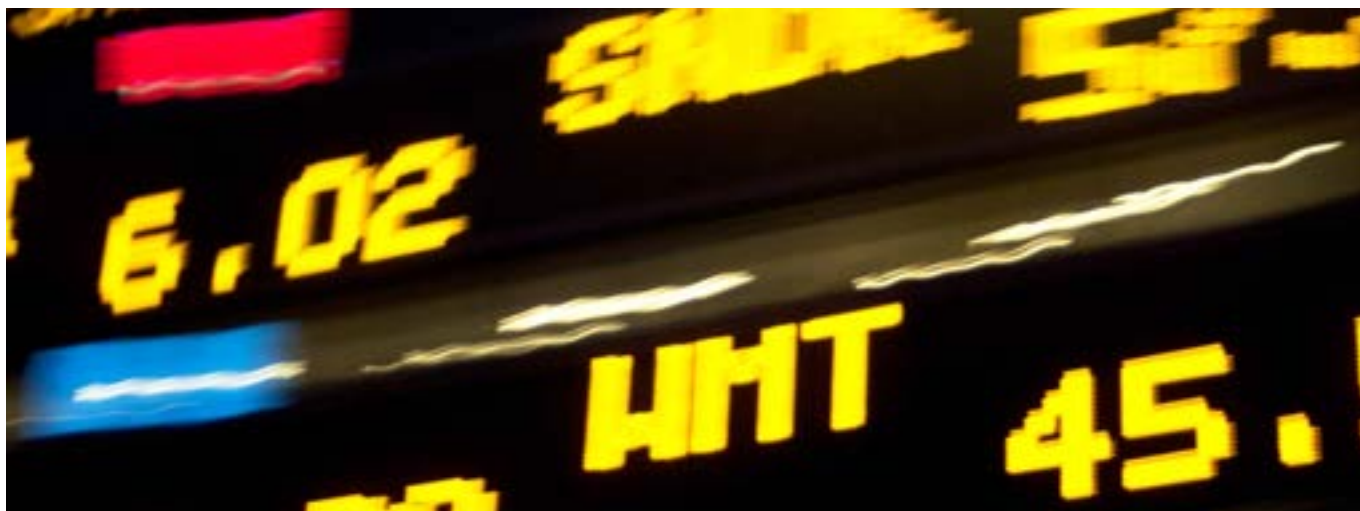
While many are not new projects, the equity cheques announced for the ARTC-led Inland rail (\$8.4b) and Western Sydney Airport (\$5.3b) are significant and should enable progress. The potential acquisition and expansion of the entire Snowy Hydro scheme may require another cheque. Any funds raised by the states would need to be recycled for priority state-based infrastructure investments, which could only mean more investment in New South Wales and Victoria infrastructures.

New approaches to projects may emerge with the establishment of the Infrastructure and Project Financing Agency within the Prime Minister and Cabinet portfolio with the mandate to identify, develop and assess innovative financing options.



Banking

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Big bank levy

The Government has announced that it will introduce a levy (of 6 bps) on banks with liabilities greater than \$100b from 1 July 2017. This measure captures Australia's Big 4 retail banks as well as Macquarie Group Limited. However, it is not clear whether foreign banks with Australian branches are also intended to be subject to the levy. To exclude foreign banks operating in Australia from the levy would seemingly put the Australian headquartered banks at a competitive disadvantage.

Based on the Government's forecast, the levy is expected to raise at least \$1.5b per year and \$6b over four years. Time will tell whether this is a temporary measure to assist with the Budget repair or if it will become a longer-term revenue raising exercise.

Currently, the tax base includes liabilities such as corporate bonds, commercial paper, certificates of deposit and Tier 2 capital instruments. But it excludes Additional Tier 1 capital (regulatory hybrid capital) and ordinary deposits and deposits protected by the Financial Claims Scheme (i.e. deposits of less than \$250,000). It is not clear whether, in calculating the tax base, all group liabilities (including liabilities pertaining to offshore businesses) or only Australian liabilities or only banking liabilities would be taken into account. These details are expected shortly, given the levy commences from 1 July 2017.

This levy, on top of proposed increases in regulatory capital, as well as the proposed anti-hybrid rules applying to regulatory capital, presents further challenges for Australian banks to achieve earnings growth.

This measure is very similar to the UK bank levy which was initially set at 5 bps but has increased steadily to 21 bps. As a response to concerns that the UK bank levy had hurt the competitiveness of the UK banks and cost jobs, plans are now afoot to reduce the levy.

The question remains: who will ultimately bear the cost of the levy and any other unintended consequences?

Putting the consumer in the driver's seat

The Government will introduce the following measures to improve competition in the financial services sector by encouraging new entrants, empowering consumers and levelling the playing field in the banking sector:

- ▶ Introducing Open Data through the interconnectivity of financial institutions will enable customers to gain access and control of their banking data. This is aimed at empowering consumers with the benefits of data portability, providing consumers with greater choice and better services, encouraging new entrants and improving competition. Implementation will be coordinated by an independent review that will report by the end of 2017.

- ▶ Reducing barriers for the new entrants, including relaxing the current 15% ownership cap, removing the prohibition on the use of the term 'bank' for ADIs with less than \$50m in capital and enabling smaller institutions to benefit from this designation.
- ▶ Other measures include consideration of a phased licensing approach for new banking licence entrants and further expansion of ASIC's regulatory sandbox that will enable new financial services business to test a wider range of financial services to retail customers for two years while only adhering to minimum consumer protection measures.
- ▶ As expected, the Government has announced changes to existing dispute resolution schemes. A new body, the Australian Financial Complaints Authority (AFCA), will be able to hear disputes of a higher value and will deal with all financial disputes including superannuation.

Giving the regulators a 'bigger stick'

Senior bank executives will be registered with APRA, which will have advance oversight of appointments, along with problems that emerge under each senior executive's management.

Greater expectations on banks will be established, covering matters such as conducting business with integrity, due skill, care and diligence, and acting in a prudent manner. A new civil penalty regime, with fines of up to \$200m, will be implemented for failing to meet these new expectations.



Real Estate

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Housing affordability measures that bite

The Budget introduces initiatives designed to improve housing affordability without disrupting the broader housing market while retaining negative gearing for existing 'mum and dad' investors.

Key incentives

- ▶ Attracting foreign capital into affordable housing through broadening the Managed Investment Trusts regime
- ▶ Attracting domestic investors into affordable housing by increasing the CGT discount from 50% to 60% for resident individuals
- ▶ Releasing Commonwealth land for housing in Sydney and Melbourne

These are welcome measures, heading in the right direction to increase the availability of affordable housing for Australians.

Direct foreign ownership into residential property has been specifically targeted with measures that:

- ▶ Restrict foreign ownership in new developments to 50%
- ▶ Broaden the non-resident capital gains tax withholding by increasing the rate from 10% to 12.5%, and decreasing the threshold from \$2m to \$750,000
- ▶ Remove the main residence exemption for non-residents

The market impact of these measures has yet to be tested. But, when combined with existing state taxes applying to foreign investors, it could be far reaching.

Restrictions on residential property deductions for travel and existing plant and equipment depreciation have also been introduced. The limitations of depreciation will particularly impact investors who are highly geared and reliant on tax refunds to fund their rental property investment.

The changes are designed to reduce market pressure without causing a hard landing on housing prices. These are strong measures. The question will be whether the mix of incentives and disincentives is appropriate to discourage investment into residential real estate by foreigners and encourage broader investment into affordable housing.

Energy

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Energy security measures

Australia's energy security, and particularly domestic gas supply on the east coast of Australia, has been subject to significant public scrutiny over recent months. In response, the Budget includes \$86.3m to increase gas supply and production and support affordable electricity prices. The initiatives include:

- ▶ Assessments of potential impacts on water resources and other environmental assets in connection with three prospective onshore unconventional gas sites
- ▶ Measures to accelerate development of onshore gas reserves for the domestic market
- ▶ Improvements to gas market efficiency and transparency through increased funding of the Gas Market Reform Group

\$7.6m is also allocated for studies into:

- ▶ Merits of gas pipelines from Northern Territory and Western Australia to South Australia
- ▶ Improvements to the National Gas Services Bulletin, designed to provide users with real-time data about gas availability
- ▶ Constraints on increased gas supply on the east coast of Australia
- ▶ Current and potential gas production in offshore South Eastern Australia

The Budget also refers to Australia's Energy Security Plan, reiterating previously announced initiatives including:

- ▶ The Snowy Mountains Scheme 2.0, increasing its generation capacity by 50%
- ▶ Energy infrastructure support for expanded pumped hydro storage schemes in Tasmania
- ▶ Tackling energy security, given moratoria and restrictions introduced by state governments, by way of the Australian Domestic Gas Security Mechanism

Although aspects of project and infrastructure development and market reform are welcome, more needs to be done. Australia requires outcomes-based regulation to attract smart capital. This will ensure that the end consumer does not incur the cost of an unreformed market. Hopefully, the findings of the Finkel review, due to be released in June, will address this issue along with the second phase of the Energy Security Plan.

Media

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Media reform update

The Federal Government announced a reform package for the Australian media industry a few days before the Budget. Although the reform package includes a number of changes to existing laws that are yet to be passed by the Parliament, reactions from the media industry have been positive.

Proposed changes under the reform package

- ▶ Eliminating the 'two out of three' rule – companies will no longer be restricted from being present in metropolitan newspapers, TV stations and radio stations in capital cities
- ▶ Eliminating the 'reach' rule – companies will no longer be restricted from controlling commercial TV networks with a licence area exceeding 75% of the Australian population
- ▶ Eliminating TV licence fees for free-to-air (FTA) companies – which will save them approximately \$130m a year. This cost saving will be offset by a new annual spectrum fee of approximately \$40m a year
- ▶ Reducing the anti-siphoning list – Pay TV operators will be allowed to bid for the rights to a larger number of sporting events. Pay TV operators will also receive \$30m in subsidies to increase their coverage of women's sports and niche sports
- ▶ New restrictions on gambling advertisements during live sports events, expected to negatively impact revenue for both FTA and Pay TV operators

What this means for the industry

In light of the competitive issues facing the industry, including declining advertising demand, competition from online players and large fixed cost bases, the Government's package will encourage consolidation and rationalisation of the media industry and provide a degree of relief from high licence fees.

Removing the 'two out of three' and 'reach' rules is likely to trigger financial restructuring in media, with mergers/acquisitions (M&A) and asset sales across the major players. The driver of M&A activity is expected to be share of addressable market, with radio and print assets possibly changing hands as companies try to build more synergistic media portfolios.

The reforms could also prove to be a lifeline for companies currently weighed down by substantial debt and declining profit margins. Television companies, which have suffered from video streaming entrants, are expected to benefit from the elimination of licence fees, albeit losing some advertising revenue from sports betting companies and paying a new spectrum fee. Pay TV operators will benefit from being able to bid for the rights to more sports events as well as the Government subsidy for niche sports.

These reforms have been in the pipeline for several years now and, if passed by Parliament, are expected to lead to substantial M&A activity in the sector over the next year or two. In the short term, the industry can expect some uncertainty as segments are merged/divested. However, those left standing at the end will be able to compete more effectively in the digital world.

Tax Highlights

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The Budget contains some marquee tax measures:

- ▶ A housing affordability package with benefits and impacts for investors, first home buyers and older Australians
- ▶ A bank levy of 0.06% pa of bank liabilities, together with a measure addressing hybrid securities used for regulatory capital
- ▶ An increase in the Medicare levy on personal tax

It also contains numerous tax integrity and housekeeping measures, affecting personal tax, superannuation, small business and multinational business. The international tax measures build on changes announced in the 2016 Budget that take effect soon. These are outlined in the Tax Appendix, together with details of other measures where the Government is consulting on developing further tax changes.

Superannuation

The current tax loss transfer and Capital Gains Tax (CGT) roll-over relief rules for merging superannuation funds, which were due to expire after 1 July 2017, will continue until 1 July 2020.

Appendix

Federal Budget Tax

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Tax Analysis

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The Budget's themes of fairness and opportunity carry through into the tax measures. A number of significant concessions, particularly for first home buyers and for small businesses, are balanced by revenue enhancement measures to fund social welfare, and a significant number of integrity measures to plug gaps in the tax system.

International tax anti-avoidance measures extended

The Government has announced a retrospective change to the multinational anti-avoidance law (MAAL) after the Australian Tax Office (ATO) Taxpayer Alert TA 2016/11 about corporate structures with trusts or partnerships interposed in response to the MAAL. A retrospective change will extend the MAAL to the use of foreign trusts and/or partnerships effective from 1 January 2016.

Although this and the banking regulatory capital change are the only major international tax changes in the Budget, a number of tax initiatives taking effect in the next two months will also have a significant impact on international businesses, including:

- ▶ Australia's Diverted Profits Tax to apply for income years starting on or after 1 July 2017
- ▶ Increased penalties to apply from 1 July 2017 for significant global entities with turnover in excess of AUD1b per annum
- ▶ The need to lodge general purpose financial statements with the ATO

Australia is also developing other measures to counter hybrid mismatch arrangements, to apply from the later of 1 January 2018 or 6 months after Royal Assent, and is participating in plans to implement the OECD Multilateral Instrument.

Further tax reviews under way

Two significant tax policy reviews, not mentioned in the Budget, are likely to lead to further tax changes:

- ▶ The review of Australia's petroleum resources rent tax recommended some fine-tuning. Treasury will now consult with the industry and report back in September on the recommendations
- ▶ The Treasury review of Australia's rules concerning stapled securities is to report by July to the Government

Indirect tax

Liability for GST on sales of residential property shifts to consumers.

From 1 July 2018, the Government plans to shift the burden of remitting the GST to the purchasers of residential property, which is to occur at settlement. This is despite the vast majority of property developers having correctly collected and remitted GST to the ATO upon settlement of sales of new residential premises.

The measure will result in additional compliance burdens for developers and purchasers, while delivering approximately \$660m in the first three years after introduction. However, it raises many questions, such as:

- ▶ Who is liable for the GST?
- ▶ Who claims refunds if GST is overpaid?
- ▶ What if GST is miscalculated, incorrectly advised or underpaid?

Other indirect tax measures

- ▶ **Digital currency** – From 1 July 2017, the definition of 'money' within the GST law will be amended to include digital currencies to remove the current double taxation when paying for goods and services with a digital currency. This aligns the approach in Australia to that of other GST/VAT regimes around the world.
- ▶ **Precious metals and fraud** – As previously announced, from 1 April 2017, the GST liability on sales of gold, silver and platinum will move from the supplier to the purchaser, with the purchaser applying a 'reverse charge' to calculate the GST liability and remit that GST to the ATO. This follows fraudulent practices where business sellers were not remitting GST liabilities, but purchasers were still able to recover an input tax credit.
- ▶ **Tobacco products** – From 1 September 2017, the Government intends to phase in changes to excise and excise-equivalent customs duty to align the taxation of roll-your-own tobacco and cigars to manufactured tobacco products. This change will occur alongside the previously legislated 12.5% tobacco tax increases, occurring on 1 September each year.

Small business measures

Instant write-off for assets under \$20,000 extended to 30 June 2018

The availability of the instant asset write-off for assets under \$20,000 for small businesses with aggregated annual turnover less than \$10m has been extended by a year, for assets first used or installed ready for use by 30 June 2018.

This welcome development will provide eligible small businesses more time to make use of this concession, which was due to expire from 1 July 2017. The extension will also benefit retailers and suppliers of assets to eligible small businesses.

Small business CGT integrity measures

The small business CGT concessions are to be amended to address the operation of what constitutes a small business for the purposes of the concessions. From 1 July 2017, the concessions can only be accessed in relation to assets either used in a small business or assets that are an ownership interest in a small business.

Personal income tax changes

Increase in Medicare levy

From 1 July 2019, the Medicare levy will increase from 2% to 2.5% of taxable income. This is to ensure the National Disability Insurance Scheme is fully funded. The current exemptions and low income relief from the Medicare levy, which will continue to be indexed, will remain in place.

Importantly, 30 June 2017 marks the end of the temporary budget repair levy, which was levied at 2% for taxable incomes over \$180,000 per annum.

Integrity measures for residential rental properties

From 1 July 2017, two integrity measures will address concerns associated with tax deductions being claimed on residential rental properties.

► Travel to rental properties

Deductions for travel expenses related to managing a residential rental property will be disallowed. Third party property management expenses will continue to be deductible.

► Limiting plant and equipment depreciation deductions

Depreciation deductions on plant and equipment (items that can typically be removed from a property) will be limited to outlays actually incurred by the investor. This will mean that the cost of

acquiring plant and equipment existing in the property at the time of acquisition, which typically forms part of a property's purchase price, will simply form part of the cost base for CGT purposes. As a result, subsequent owners of a property will be unable to claim depreciation deductions for plant and equipment acquired by the previous owner.

Existing arrangements will be grandfathered such that plant and equipment forming part of a residential rental property as of 9 May 2017 will continue to give rise to depreciation deductions under existing rules.

Housing and superannuation

First Home Super Saver Scheme

From 1 July 2017, first home buyers can make voluntary superannuation contributions of up to \$15,000 p.a and \$30,000 in total (within existing caps) towards their deposit.

Contributions and associated earnings withdrawn from 1 July 2018 will be taxable less a 30% tax offset. Both members of a couple can access this concession.

Downsizing home to upsize super

From 1 July 2018, people aged 65 or over can make up to \$300,000 of non-concessional contributions into super from proceeds of selling their principal residence owned for 10 or more years. Contributions will be permitted regardless of the contribution cap rules and available to both members of a couple. Consultation will be needed to develop the detail and implications of the proposal.

Integrity rules for limited recourse borrowing and non-arm's length arrangements

The Government will modify two recently announced superannuation integrity measures to apply from 1 July 2017, to ensure that:

- Loan principal repayments made by superannuation funds are included in the calculation of a relevant member's \$1.6m transfer balance cap, but only where they are made from an accumulation-phase interest
- The outstanding balance of a loan undertaken by a superannuation fund will be included in the calculation of a relevant member's total superannuation balance.

Both measures are proposed to apply irrespective of when the loan arrangements were entered into.

A further integrity measure, to apply from 1 July 2018, appears to legislate the ATO's existing 'safe harbour' terms with respect to related-party superannuation borrowings. It means that the tests to determine the existence of non-arm's length income will include expenses that would normally apply in commercial transactions; for example, interest (perhaps at benchmark rates). Consultation with stakeholders will help to develop the rules.

Advanced Manufacturing Fund

The Government has announced an Advanced Manufacturing Fund of \$101.5m over five years from 2016-17 to assist high technology businesses in South Australia and Victoria to establish and expand advanced manufacturing.

Business to pay levy on certain skilled visas

From March 2018, businesses that employ foreign workers on certain skilled visas will be required to pay a levy that will provide revenue for a new Skilling Australians Fund.

Crowd-Sourced Equity Framework (CSEF) regime extended to proprietary companies

The existing CSEF, which applies to public companies and is due to commence on 29 September 2017, will be extended to proprietary companies. The Government has released draft law and explanatory material for public consultation, with comments due by 6 June 2017.

Black economy measures

The Black Economy Taskforce is to report by October 2017 on measures to counter the 'shadow' economy. The Budget adopted two measures from its interim report, which was released on Budget night. The measures will:

- Extend the taxable payments reporting system to contractors in the courier and cleaning industries from 1 July 2018, with an estimated revenue gain of \$318m in the forward estimates period.
- Prohibit the manufacture, distribution, possession, use or sale of sales suppression technology and software. This will stop businesses from understating their incomes by untraceably deleting selected transactions from electronic records in point of sale equipment. This will have effect from the date of Royal Assent of the enabling legislation.

As well, the Government will provide \$32m additional funding for ATO audit and compliance programs to better target black economy risks.

Additional legislative drafting resources

The integrity measures, and the backlog of announced but unlegislated measures, give rise to additional Budget funding to draft financial services and tax reform laws.

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