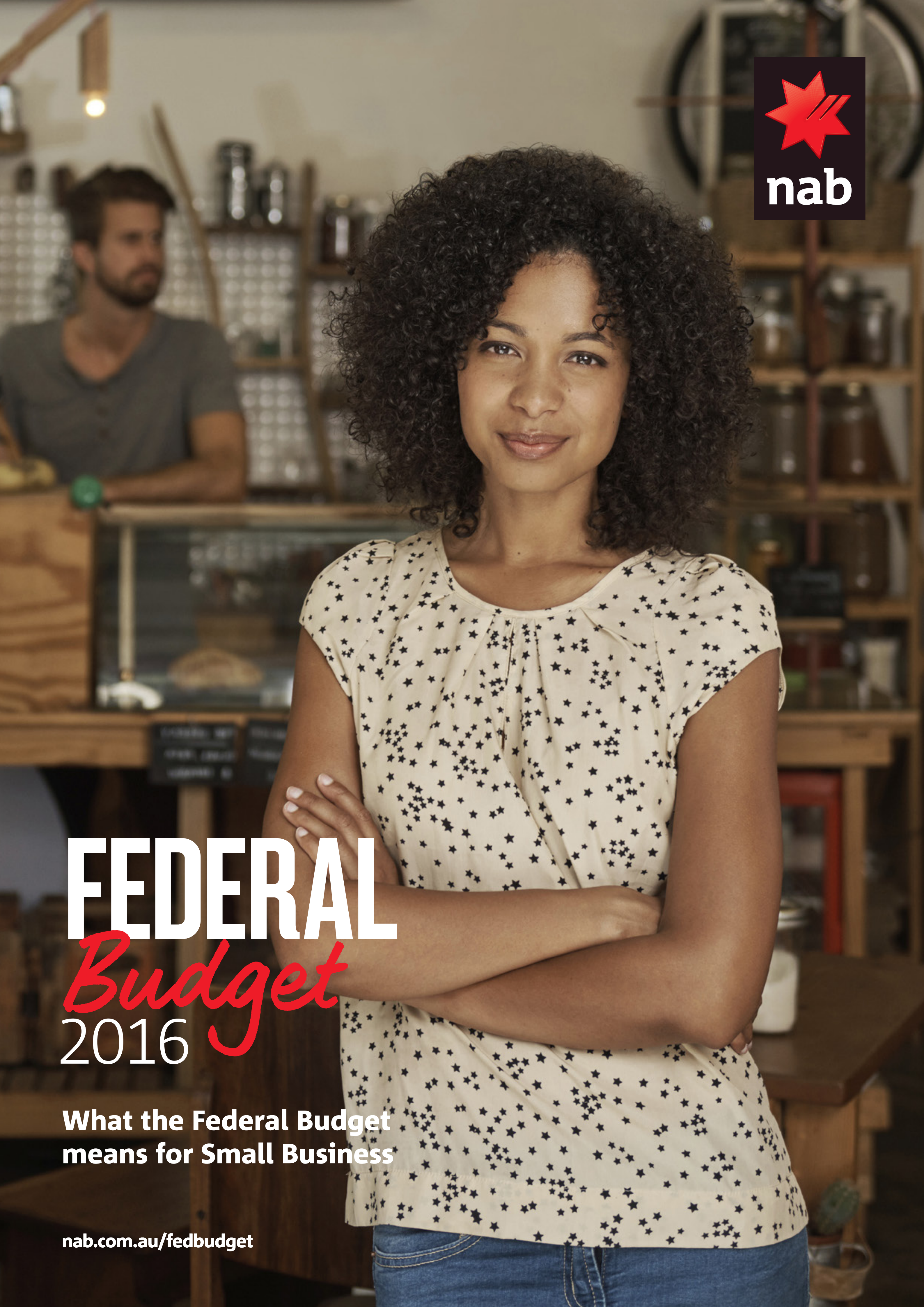

FEDERAL *Budget* 2016

What the Federal Budget means for Small Business

nab.com.au/fedbudget

ABOUT SMALL BUSINESS

We understand that small business forms the backbone of our economy and communities. We take the time to listen and understand the unique challenges and opportunities you face, and empower our bankers to respond to your needs by making decisions themselves.

We recognise that knowledge is power and believe in sharing ours with our clients. We'll supply you with insights based on experience and quality analysis, and have small business bankers who specialise in different markets.

And if you have not-so-small ambitions for your business, we're committed to helping you flourish with those too.

FEDERAL BUDGET OVERVIEW

Our Group Economics view

Alan Oster, Group Chief Economist, NAB

This Budget clearly has a political as well as economic dimension – and in particular is framed against the assumption of an upcoming election. As such, it's really an exercise in selected refocusing outlays and receipts to achieve the Government's focus of growth and jobs – but achieved within a realpolitik framework of burden sharing and keeping debt at sustainable (AAA) levels. The current environment means there is little scope for large structural reforms. And with a Budget not likely to get back to surplus by 2020-21 – and then only marginally – it clearly remains vulnerable to the vagaries of the economic cycle.

Key measures are largely as signaled in recent days. On improving the 'equity' theme, the Budget raises the 32.5% personal income threshold from $80k to $87k to help offset some effects of bracket creep; imposes tougher rules on top end superannuation (lowering the threshold for the higher tax on super from $300k to $250k and imposing annual and lifetime caps on extra super contributions); and eases the tax treatment of super for lower to middle income contributors. Also on the equity theme is stricter enforcement of multi-national tax (essentially a 'Google tax' with diverted income to be taxed at 40%).

On the 'adding to growth' theme is business tax cuts (from 28.5% to 27.5% for small and middle business with the turnover threshold raised to $10m. Thereafter the turnover limit is progressively raised until all businesses are on the rate by 2023-34. The rate then falls to 25% in 2024-25. There is an extra benefit in that the investment tax write off has been extended for an extra year. That said, the size of the short-term cuts are limited (around $5.3bn over four years) – and our modeling suggests very small short-term benefits. There is also extra money for infrastructure ($5bn); extra money for health ($2.9bn); and education ($1.2bn – albeit much less than full Gonski). Also helping to repair the Budget bottom line is the (12.5%) increase in tobacco taxation.

Outlays remain under 26% of GDP before moving a touch lower in the long run. By way of context, outlays peaked at around 27% during the GFC stimulus and before that around 23% of GDP. Revenue still does most of the repair job on the Budget balance, with a combination of policy and economic recovery. Overall net debt peaks a touch higher in 2019 at 19.2% (previously 18.5%) and starts to edge lower thereafter. Rating agencies have been much more guarded in their reaction than usual. As set out in the Medium Term Economic Outlook, the Budget would represent a slight drag on economy going forward (around 0.5% per year) and as such is probably doable.

Of course the Budget may not be the final word on medium-term fiscal sustainability given the forthcoming election campaign. Our bottom line is there is not a lot of scope for pulling more 'rabbits from the hat'. And that Budget repair will be a long and difficult slog given the economic environment. We are more cautious in 2018-19 forecasts.

Fiscal outcome

Estimates of the underlying cash deficit are slightly larger at A$39.9bn (2.2% of GDP) in 2015-16 and $37.1bn (2.4% of GDP) in 2016-17 (slightly below market expectations – but near the viewpoint of NAB). The projected deficit then moves down through the out-years with an eventual return to surplus in 2021-22.

Economic outlook

There is little fundamental difference between Treasury and NAB's economic forecasts in the next few years. A sharp increase in commodity export volumes, offset by subdued domestic demand, remains the common theme. However, NAB forecasts become notably more pessimistic as we move into the forward projections (from 2018-19) reflecting significant headwinds as LNG exports reach their peak and dwelling construction reduces. Over the forward estimates, expectations for the unemployment rate are similar, easing to around 5.5% in the short-term before stabilising. On the nominal GDP forecasts, NAB and Treasury expectations are similar in 2016-17 (around 4.25%) but the Treasury's 2017-18 forecasts are more optimistic.

Financial markets

There was little discernible market reaction to the Budget. Ratings agencies have been circumspect in their initial reaction to the Budget, choosing instead to allow more time for analysis.

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Key initiatives

- The company tax rate will be cut to 25% over 10 years. From 2016-17 the tax rate for businesses with annual turnover under $10m will be 27.5%. The $10m threshold will be gradually increased so that all companies face a 27.5% tax rate by 2023-24.
- After 2023-24 the tax rate on all companies will be cut to 27% and then cut by one percentage point until it reaches 25% in the 2026-27 tax year. Franking credits will be distributed in line with the rate of tax paid by the company making the distribution.
- The tax discount for unincorporated small businesses will be gradually increased from the current 5% to 16% by 2026-27 and the current annual cap of $1,000 per individual will be retained. Access to this tax discount will be extended to individual taxpayers with business income from an unincorporated business that has annual turnover of less than $5m, up from the current $2m.
- The tax threshold for small businesses will be lifted from $2m to $10m from 1 July 2016. The existing threshold value will be retained for access to the small business capital gains tax concessions. Access to the small business tax discount will be limited to businesses with turnover less than $5m.
- Division 7A of the tax acts has posed problems of complexity and uncertainty to many businesses. The rules will be made clearer and outcomes more certain and inadvertent breaches of 7A will have a self-correction mechanism.
- The wine equalisation tax (WET) has been a controversial arrangement and the rebate cap is to be cut from $500,000 to $350,000 in July 2017 and further to $290,000 in July 2018. Tighter eligibility criteria governing access to the rebate will also be introduced.
- The pro-innovation measures that followed on from last year's National Innovation and Science Agenda have been refined. These include cutting holding periods for investors to be able to access the capital gains tax exemption, putting a $50,000 cap on non-sophisticated investors claiming a tax offset and putting time limits on incorporation and setting criteria to identify a start-up innovation company.

NAB's view

The Budget measures deliver on much – but not all – that small business wanted.

A range of issues were raised by industry bodies including: cuts to the rate of company tax; more spending on training; lowering/reforming personal tax; increased infrastructure spending; more support for R&D and innovation; and reducing the number and complexity of taxes.

Some other issues raised in pre-Budget submissions were never likely to be resolved in a Budget – eg migration policy, workplace relations and free trade agreements.

Business groups recommended a mix of broad tax reforms – like abolishing or winding back state taxes like stamp duties or payroll tax. They suggested replacing them with higher GST receipts or altering the tax mix by raising the GST and cutting company tax – with more targeted measures aimed at specific business concerns, such as lifting the tax threshold for small businesses, having FBT taxable by employees rather than employers and achieving a more equitable treatment of tax losses.

Issues raised in business organisation pre-budget submissions

	AIG	ACCI	COSBOA
Cut company tax	✓	✓	✓
Accelerated depreciation	✓		
Lift small business threshold		✓	✓
Reform tax loss treatment	✓		
Support innovation	✓ *	✓	
Reform fringe benefits tax	✓	✓	✓
Retain dividend imputation system	✓	✓	
Lift GST rate/base	✓	✓	✓
Support R&D tax concessions	✓	✓	
Reform inefficient State taxes (payroll, stamp duty)	✓	✓	
Align personal and company tax		✓	
Take super collection from business or ease its admin	✓		✓
Support training and skill acquisition	✓	✓	✓

*patent box

Industry reaction

- The business measures have been well received by business groups. The Australian Industry Group (AIG) thinks it will boost competitiveness and lower Australia's high corporate tax burden. Small business gets significant tax benefits early on in a decade-long process of lowering company tax that involves taxing different sized firms at different rates – but by then the global rate for business tax competitiveness might have been cut from the current 25% to around 20%. Lifting the tax threshold for small business to $10m is "a shot in the arm" and could cut the tax bill for up to 90,000 SMEs. Leaving the R&D tax incentive untouched was a relief to the AIG as the whole system of tax support for R&D has been under close scrutiny.
- The Australian Chamber of Commerce and Industry (ACCI) also welcomed the Budget's business measures – calling it "an enterprise Budget" that delivers real help right now for small business, the "engine room of the economy". Lower business tax rates boost Australia's international competitiveness and lifting business eligibility from $2m to $10m for lower taxes and the $20,000 instant asset write off will help businesses invest and grow.
- The Council of Small Business of Australia (COSBOA) was particularly enthusiastic about the Budget, calling it the best one small business has ever seen.
- Kate Carnell, the Australian Small Business and Family Enterprise Ombudsman, has also given the business measures in the Budget a warm reception. The Budget's measures, she says, will give SMEs certainty and the ability to confidently plan for the future through investing to grow. Lifting the tax eligibility threshold to $10m means tens of thousands more SMEs will be better placed to expand and employ, and the tax cuts helping small business can be used to reinvest and grow the enterprise.
- Although the annual revenue cost of tax incentives for early stage investors was lifted by $15m, start-up business organisations were less impressed by the Budget. StartupAUS felt that the Budget provided only a limited advance on what had already been announced.

While small business missed out on some parts of its agenda for change, important advances have been made – especially toward a lower and more internationally competitive rate of business taxation that more SMEs can access in the near term.
The move towards lower company taxation begun in last year's Budget has continued with the turnover threshold for small companies able to access the lower tax rate lifted from $2m to $10m from the 2016-17 tax year and the small business tax rate dropping from the current 28.5% to 27.5% next year. The cuts resume in 2024-25 and the rate is taken down to 25% by 2026-27. This 25% rate is where business organisations have said Australian company tax should be and the annual benefit to business should be worth almost $1bn by the end of the decade.

Also building on last year's Budget, the tax discount for unincorporated small businesses will be increased from the current 5% to 8% in July 2016 and then phased up to 16% in 2026-27 – roughly cutting the tax burden on unincorporated businesses in line with the drop in corporate taxes. Again the threshold size allowing business to benefit from the lower tax rate has been lifted from $2m in the 2015 Budget to $5m. The benefits to business of the reform are, however, limited by the retention of the current annual cap of $1,000 per individual, which helps explain its relatively modest annual cost to revenue of $150m.

Business groups have been arguing for years that the $2m tax threshold for defining a small business is outdated and should be increased. If that happens, more businesses should be eligible for the set of advantageous tax provisions uniquely available to small firms – depreciation pooling, the $20,000 instant asset write off provisions introduced last year and preferential tax treatment of capital gains.

Preferential tax treatment of capital gains for small businesses is among the most important of these tax measures. However, although the government has gone beyond the $3m and $5m normally suggested for a revised tax definition of small business by moving it all the way to $10m, it has reduced some of the benefits of this change by keeping the current $2m threshold for access to the small business capital gains concessions. Large annual sums are already lost to revenue through these capital gains concessions – around $1.3bn and extending the arrangements by allowing more businesses access to the concession would presumably cost large amounts of revenue.

Unfinished business for small business

Although the last two Budgets have greatly improved the tax position of small business, there are still issues in the system that need to be addressed:

- The tax treatment of losses is a long-running issue with the 2012 Business Tax Working Group report, the 2014 Board of Taxation report and last year's Tax Review. All noted the problems of the existing loss carry-forward scheme and showing the benefits (and cost to revenue) of either a loss carry-back arrangement or one that treated losses and profits symmetrically and gave business immediate year refunds for losses incurred. These costly reforms did not get up in this year's Budget but business can be expected to continue making the case.
- Some business organisations argued in favour of continuing the $20,000 instant asset write-off beyond its current end date of June 2017. Prior to the Budget, there were reports that the government was considering extending this scheme beyond mid-2017. The cost in lost revenue may have led to the non-announcement of an extension.
- The issue of effective life for depreciation was not addressed in the 2016-17 Budget.
- The structural issues of tax reform highlighted by most business organisations remain unaddressed – including the rate or base of the GST and payroll taxes and stamp dutuies. Only the ACT has widened its use of land taxes to lower stamp duties on property. Little has been done on Fringe Benefits Tax (which requires a lot of administration for many SMEs), and SMEs are still an inherent part of running the superannuation arrangements of their staff.

Important NAB information