PROFILE
FINANCIAL SERVICES

FEDERAL BUDGET ANALYSIS 12 MAY 2010

May 2010 Federal Budget

The Australian government unveiled its annual budget yesterday evening on Tuesday 11 May 2010. The Treasurer was true to his word in promising a 'no frills' budget, with few new policy initiatives beyond those announced in the Government's response to the Henry Tax Review. Much of the Budget speech was focused on reforms to health, infrastructure and jobs, all in the context of challenges faced in managing a two-speed economy.

In our analysis we have focused on budget announcements that may affect your financial planning strategy or investments. It is important to bear in mind that these announcements have not yet been legislated. In addition, the information in this update is general – please contact us if you would like to discuss your specific situation in more detail.

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1 ECONOMY AND MARKETS

1.1 Summary

Yesterday's budget forecasts a return to financial surplus three years faster than previously expected, helped by quicker economic growth that will be fuelled by a revived resources boom. The 2010-11 Budget is expected to be in deficit to the tune of $40.8bn, with a return to surplus projected for 2012-13.

Key treasury forecasts

FINANCIAL YEAR	GDP % (CHANGE)	INFLATION % (CHANGE)	UNEMPLOYMENT % (CHANGE)	FISCAL POSITION (DEFICIT / SURPLUS)	
				($bn)	% of GDP
THIS YEAR (e)	+2.00 (-0.50)	+3.25 (+1.75)	5.25 (8.25)	-57.1	-4.4
NEXT YEAR (e)	+3.25 (+2.25)	+2.50 (+1.50)	5.00 (8.50)	-40.8	-2.9
2011/12 (p)	+4.00 (+4.50)	+2.50	4.75	-13.0	-0.9
2012/13 (p)	n/a	n/a	n/a	+1.0	+0.1
2013/14 (p)	n/a	n/a	n/a	+5.4	+0.3

1.2 Breakdown

The earlier than expected return to surplus is based on upgraded growth forecasts and stronger company profits. According to forecasts, a renewed commodities boom will propel Australia's economy toward full capacity within the next two years, and ensure it will continue to be one of the strongest globally. Australia's growth rate is set to accelerate towards an above-average pace in the fiscal year starting 1 July 2010, and the country's labour market will head toward full employment in the following year, the government said.

Key measures (over 4 years)

SPENDING	$ BILLION
HEALTH	2.20
INFRASTRUCTURE FUND	1.40
COMPANY TAX CUT	5.10
SUPER REFORM	2.60
50% DISC ON INTEREST	1.10
RENEWABLE ENERGY FUND	0.70
STANDARD DEDUCTIONS	0.70

SAVINGS	$ BILLION
RESOURCE SP-TAX	12.00
TOBACCO TAX HIKE	5.00
PBS CHANGES	1.80
CO-CONTRIBUTION	0.80
TAX COMPLIANCE PROG	1.70

1.3 Analysis

Even though the Budget does not contain many new economic initiatives, it confirms a shift in government rhetoric away from discussing the downside risks to growth, to acknowledging that the key challenge now is to manage prosperity.

The updated forecasts are mostly in line with analysts' expectations - although some economists may question whether the government can achieve its forecast of moderate inflation, while at the same time saying the economy will soon be operating at nearly full capacity. With unemployment projected to fall to 4.75% in 2011/12, gross domestic product (GDP) expected to rise to 4.0% in 2011/12, and the government continuing to run a budget deficit of $40.8B in 2010/11, we would question how inflation is supposed to reduce from current levels of 2.9% (forecast to increase to 3.25% by the end of this financial year), to 2.5% by next year. Add to this treasury's expectation that commodity prices will continue to rise, supporting a sixty-year high national terms of trade, and you have an apparent conflict of economic fundamentals – something to bear in mind when considering the likelihood of these forecasts being achieved.

The budget confirms that Australia's fiscal position is strong compared to most other developed economies, with net debt now expected to peak at 6.1% of GDP (the previous treasury forecast was 10.0% of GDP).

The sharp improvement in the projected budget balance over the next few years suggests that fiscal policy will be playing an appropriate role. While much of the improvement simply reflects the government reaping the benefit of a stronger economy, the fact that the government has largely resisted the temptation to spend the additional revenue (given that 2010 will be an election year) is commendable. However, a key question is whether this discipline will be maintained during the election campaign itself.

Although fiscal policy may not be putting additional upward pressure on interest rates at present, fiscal policy could be doing more to support monetary policy in its attempts to dampen inflationary pressures. Several of the policy initiatives - such as those on health, bank savings or superannuation – could be perceived as supporting political more than fiscal objectives.

1.4 Impact

Financial markets

In financial markets, Australian government bonds and the Australian dollar were largely unchanged in the minutes after the federal budget. Post-budget prices were the same as they were at 19:25 AEST, before the budget was released at 19:30 AEST. Commonwealth Bank economists said the Australian bond market and local dollar rarely reacted to the federal budget. However, they said that had there been a more aggressive spending program, bonds or the domestic currency might have had more of a reaction.

Australian interest rates & sovereign bonds

The Australian government's plan to cut borrowing and pay back debt may surprise some interest rate traders, drive a bid (rather than ask) tone in government securities, and fuel fears that liquidity in government securities may dry up as issuance drops. A robust fiscal picture painted by the government in its budget, with no mention of any new maturities, may concern some traders. With less debt to trade, we may see the price premium on new issuance rise. Still, if the global crisis illustrated anything, it's that fiscal positions can change swiftly. The government may yet need to increase its borrowing in the event of an external shock.

Australia's budget will put finances on a more stable platform and will allow the government to respond to future shocks with gusto, says S&P. "Relative to Australia's peers, its balance sheet is very strong and gives the flexibility to respond if needed." S&P also said the budget will offset the nation's large offshore liabilities and was consistent with maintaining the agency's AAA ratings on Australia.

Australian banking sector

The government's move to ease withholding tax paid by banks on most interest paid on foreign borrowings could spur a rash of offshore issuance, but whether it will help smaller banks as the government hopes remains to be seen. The measure will surely encourage foreign bank branches to lend more, but it's not clear how regionals would benefit much. The move also likely puts the kibosh on the push by some market participants for permission to issue covered bonds.

Australian bank shares could also get a bit of a boost after the government said it would reduce taxes on interest earned from bank deposits. The move, long argued for by the banks, could go some way to lowering the overall cost of funding for the banks as deposits become more attractive for investors. This would also give the banks a more stable, domestic source of funding. Under the plan, individuals will receive a 50% tax break on earned interest up to A$1,000 on deposits in banks, building societies or credit unions. Interest accrued on bonds, debentures, annuity products or through investment schemes will also qualify. See the Tax section of this document for more detail.

Australian health sector

The government's plans to slash pharmaceutical subsidies paid to drug companies for prescription medicines by about A$1.9 billion over five years have been well flagged, and are unlikely to have a major impact on drug companies. The reforms, which extend the number of PBS-listed drugs subject to mandatory price disclosure, will force manufacturers to disclose the market price of their products. The trade-off for manufacturers is certainty around PBS pricing over the next four years.

Australian resource sector

The government's expected return to surplus in the fiscal year starting 1 July 2012 coincides with the planned introduction of a controversial new 40% tax on so-called mining super profits. That new tax alone will boost government tax revenues by A$3 billion in 2012-13 and A$9 billion the year after. The tax has been strenuously opposed by the mining sector, which has been at the forefront of Australian economic strength in recent times.

The government said the strongest commodity price upturn in 60 years means Australia's terms of trade will rise by 14.5% in 2010-11. Spot prices for iron ore have almost trebled over the last year, while spot prices for thermal coal have increased by around 70%. Demand from Asian steel mills and energy producers has largely driven the upswing. Engineering construction investment overall is expected to rise by around 50% over the four-year forecast period as large projects, mostly resource sector related, come on line. An explosion in demand and investment in the liquefied natural gas sector could push investment in the sector to around 3% of GDP by 2013-14, the government said.

Tony Abbott has at this stage committed the coalition to opposing the tax. We believe that although some form of additional resource tax is likely to make it through the senate, it is going to face significant pressure in the interim, both from the mining sector and other industry sectors likely to face the trickle through effect. The equity and corporate debt market appear to have currently priced in the worse case scenario, but we must wait and see for the final outcome.

2 TAX

2.1 Individuals

Standard tax deduction to simplify tax returns

From 1 July 2012, individual taxpayers will have the option of receiving a standard deduction of $500 for work related expenses and the cost of managing tax affairs, increasing to $1,000 from 1 July 2013. Those with deductible expenses greater than this amount will be able to claim their higher expenses when lodging their tax return under the existing rules.

50% discount for interest income of up to $1,000

From 1 July 2010, individuals will receive a 50% tax discount on the first $1,000 of interest income earned. This includes interest on bank, credit union or building society deposits as well as bonds, debentures and annuity products. The discount will also apply to interest income earned indirectly, such as via a trust or managed investment scheme.

Impact: Based on an interest rate of 5%, a deposit of $20,000 per person would receive the full benefit of the discount. A taxpayer on the top marginal rate would pay on $225 in tax on the interest income of $1,000, instead of $450.

An increase to the Low Income and Senior Australians Tax Offset

From 1 July 2010, the Low Income Tax Offset will increase from $1,350 to $1,500, phasing out after $30,000 by 0.04 cents in the dollar to a maximum of $67,500.

Impact: Those with taxable income of up to $30,000 will receive the first $16,000 tax free. It will also provide a slight increase in flexibility for those distributing trust income to minors ($3,333, up from $3,000, will be able to be distributed tax free).

The Senior Australians Tax Offset thresholds will also increase accordingly, from 1 July 2010.

Impact: Single seniors will be able to have incomes up to $30,685 tax free, and each member of a senior couple can have incomes of up to $36,380 tax free.

Changes to personal tax rates

There were no changes made to the previously announced tax rate changes, which apply from 1 July 2010:

Residents: Rates and tax payable from 1 July 2010

TAXABLE INCOME ($)	TAX PAYABLE ($)
0 – 6,000	Nil
6,001 – 37,000	Nil + 15% of excess over 6,000
37,001- 80,000	4,650 + 30% of excess over 37,000
90,001 – 180,000	17,550 + 37% of excess over 80,000
180,000 +	54,550 + 45% of excess over 180,000

Relaxation of First Home Savers Accounts

First Home Savers Accounts currently require the investment to be held and contributed to over a minimum of four financial years before purchasing a home. Where this condition is not met, the funds must be transferred to a superannuation account. The proposal relaxes this condition so that if a home is purchased during this period, on completion of the qualifying period the funds will be able to be applied to an approved mortgage.

Increase in the net medical expense tax offset claim threshold

From 1 July 2010, the threshold above which individuals can claim the 20% net medical expense tax offset will rise from $1,500 to $2,000. In addition, this threshold will be indexed annually to the CPI.

Change to the benchmark interest rate of capital protected borrowing

The benchmark interest rate (that determines the level of interest that is deductable) that applies to capital protected borrowings will be increased by 1%.

Previously, capital protected borrowings entered into after 13 May 2008 only had deductable interest up to the Reserve Bank of Australia (RBA) indicator rate for standard variable housing loans (currently 7.15%). The allowable deductable interest is now 100 basis points plus the indicator rate (resulting in current rate of 8.15%).

Increase in tobacco excise

Excise on tobacco has increased by 25% as of 30 April 2010. This is expected to increase revenue by $5.5 billion, while also hopefully encouraging smokers to realise both the substantial health and financial rewards of quitting.

2.2 Business

Resource Super Profits Tax (RSPT)

From 1 July 2012, a proposed 40% tax on the realised value of non-renewable resource deposits aims to increase revenue by $12 billion by 2013-14. While the RSPT is to be applied to "Super Profits" rather than revenue (which is primarily the case with the existing system of state based royalties) there is substantial work that remains to be done defining "Super Profits".

Changes to company tax rates

INCOME YEAR	RATE FOR SMALL COMPANIES	RATES FOR OTHER COMPANIES
Up to and Including 2011/12	30%	30%
2012/13	28%	30%
2013/14	28%	29%
2014/15 and later years	28%	28%

Impact: Companies should have an improved cash flow resulting in either further reinvestment or increased dividends. Some shareholders may need to consider their cash flow and allowance for tax payable, where they previously relied on tax paid via franking credits.

Small business tax relief

From 1 July 2012, small businesses (those with annual turnover of under $2 million or net assets less than $6 million) can immediately write-off expenses for assets worth up to $5,000 in value (increased from the current limit of $1,000).

Additionally, small businesses will be able to have one depreciation pool for all other assets (excluding buildings) and write-off this pool of assets at 30%.

Impact: This will increase cash flow by deferring tax liabilities. It will simplify depreciation calculations and reduce compliance costs, and increase the attractiveness of asset ownership versus leasing or debt financing.

Lowering of withholding tax

In a staggered implementation from 1 July 2013, the rate of interest withholding tax paid by financial institutions to offshore lenders is to be reduced from 10% to 5%.

Impact: This should effectively reduce the funding cost of domestic banks and hence reduce the need for banks to increase rates over and above any increases announced by the RBA.

3 SUPERANNUATION

3.1 Permanent reduction in the government co-contribution

The government will permanently retain the current matching rate for co-contributions, overriding last year's budget announcement that the reduction would be temporary.

Matching rates before and after the budget

	BEFORE BUDGET		AFTER BUDGET	
Year ending	Matching rate	Max government co-contribution	Matching rate	Max government co-contribution
30 June 2009	150%	$1,500	100%	$1,000
30 June 2010	100%	$1,000	100%	$1,000
30 June 2011	100%	$1,000	100%	$1,000
30 June 2012	100%	$1,000	100%	$1,000
30 June 2013	125%	$1,250	100%	$1,000
30 June 2014	125%	$1,250	100%	$1,000
30 June 2015	150%	$1,500	100%	$1,000

In addition, the income threshold is to be frozen for two years ending 2011/12. Incomes of up to $31,920 will receive the maximum, phasing out totally at $61,920.

Profile's view: This strategy remains viable for clients (less than 71 years of age) who earn less than $61,920 from eligible employment, and can source $1,000 from a bank account and contribute the funds into an eligible superannuation fund. It is important to note that 'income' now includes:

- your assessable income
- your reportable fringe benefits; and
- your reportable employer super contributions

3.2 Henry review proposals confirmed

SG rate increases

The superannuation guarantee (SG) rate will increase gradually from 9% to 12% from 1 July 2013:

Year ending	SG rate	Proposed increase	Proposed rate
30 June 2014	9.00%	0.25%	9.25%
30 June 2015	9.25%	0.25%	9.50%
30 June 2016	9.50%	0.50%	10.50%
30 June 2017	10.50%	0.50%	11.00%
30 June 2018	11.00%	0.50%	11.50%
30 June 2019	11.50%	0.50%	12.00%
30 June 2020	12.00%	0.00%	12.00%

Profile's view: The retirement adequacy debate has long held that the current 9% compulsory contribution rate is inadequate. Various academic institutions have shown that an increase is necessary to reduce the future financial burden on governments. The proposal to increase is welcome, however the implementation will need to be managed with care. The burden will fall on employers and they will need to assess how the increase is passed onto employees without incurring unnecessary costs in their businesses. It will also depend on the employment landscape in 2013/14.

SG contribution age limits

The SG contribution age limit will increase from 70 to 75 from 1 July 2013.

Government super tax offset

A government super contribution of up to $500 pa will be made for people earning up to $37,000 pa from 1 July 2012. This measure is designed to offset the contributions tax payable of 15% on SG contributions (i.e. $9% x $37,000 x 15% = $499.50)

Profile's view: The $500 contribution for people earning less than $37,000 is a fair and equitable proposal, given that there is currently no tax advantage for contributing to super, compared to taking it as salary and wages. The 2007 Simple Super System is being somewhat complicated and only time will tell if the administration costs to make the $500 payments outweigh the benefit to superannuation members.

Permanent concessional contributions cap increase for over 50s

The concessional contribution cap will be reinstated to $50,000 pa from 1 July 2012 for people aged 50 or over, with super balances below $500,000.

Profile's view: We would welcome an extension of this measure to all people over 50 years of age in the future, to further enhance the future retirement savings of Australians. There are no details on the administration yet, but these will no doubt surface as the 1 July 2012 deadline draws near.

3.3 Account-based pension minimums returned to normal

The government relaxed the minimum pension draw rate in the middle of the global financial crisis, to ease the burden on some pension holders who were being forced to sell assets to fund pension payments. The table below outlines the new rates from 1 July 2010:

Year ending	Minimum (now)	Minimum (1 July 2010)
Under 65	2%	4%
65-74	2.5%	5%
75-79	3%	6%
80-84	3.5%	7%
85-89	4.5%	9%
90-94	5.55	11%
95 and over	7%	14%

Profile's view: The increase in minimum drawings will result in increased cash flow for those clients who have reduced their drawing levels over the past 2 years. For those over 60, this will have no direct tax impact. Your adviser will be discussing your required cash flow requirements over the course of the coming months to ensure that a suitable strategy is implemented.

3.4 Super funds can now obtain a tax deduction for providing terminal medical benefits (TMC)

- Eligible benefits have now been extended to include payment of benefits for terminal medical conditions (TMC)
- TMC was announced on 16 February 2008 and this measure aligns the tax treatment of such benefits
- Section 295-470 of the ITAA 1997 currently only covers benefits relating to death, permanent incapacity and temporary incapacity conditions of release.

Profile's view: This measure brings consistency to the existing legislation. The major benefit of this announcement is to SMSF members. Trustees of SMSFs should ensure that their trust deed is updated to reflect this change in legislation. The potential tax deduction is advantageous, but cannot be quantified until the time of calculation.

4 SOCIAL SECURITY

4.1 50% interest income discount and Centrelink entitlements

Further to the 50% discount on the first $1,000 of interest income discussed in the Tax section, the Government has indicated that the discounted amount will be excluded when determining eligibility for transfer payments and other concessions (e.g. Family Tax Benefit, the Baby Bonus, Child Care Benefit, Education Tax Refund, Commonwealth Seniors Health Card and the Pensioner Supplement). So if you earn interest income and it is currently affecting your Centrelink entitlements, then from 1 July 2011 you may be entitled to extra benefits.

4.2 War Widow (or widower) Pension

Under the new rule, if you are a war widow (or widower) and you are either remarried or enter into a de facto relationship before you apply for the War Widows Pension, you will not be eligible. Previously this rule did not apply to widows (or widowers) entering into a de facto relationship.

4.3 Proposed changes to Family Tax Benefit arrangements

The Government proposes the following amendments to Family Tax Benefits (FTB):

- FTB recipients who do not lodge tax returns will cease to receive their benefit payments, except where the recipient has no FTB debt, or where the cessation of the payment will cause undue hardship.
- Children aged 16 to 20 need to be in full-time study in approved education or training (or part-time education or training in combination with other approved activities), which will lead to a Year 12 or equivalent qualification, in order for families to remain eligible for FTB-Part A benefits

- The annual Child Care Rebate will be reduced, and capped at $7,500 per child (down from the current $7,778 per child) and indexation of this amount will be frozen for four years from 1 July 2010. Out of pocket expenses will continue to be rebated at 50% of the annual cap.

4.4 Special Disability Trusts — greater accessibility

Special Disability Trusts enable parents and immediate family members to put money aside for the future care and accommodation needs of a family member with a severe disability. Under Special Disability Trusts, up to $551,750 (indexed annually) and the family home can be kept in the trust without being counted as income or assets under the pension means tests for the beneficiary of the trust.

The changes mean that the definition of a beneficiary will include people with disabilities who can work up to 7 hours per week (excluding work in an Australian Disability Enterprise). The changes will amend the allowable uses for the trust to include all medical expenses, including membership costs of private health funds, maintenance expenses of Special Disability Trust property and discretionary spending of up to $10,000 per year.