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CLIENT ALERT

Explanatory Memorandum

December 2008/January 2009

Medicare Levy Surcharge

The Tax Laws Amendment (Medicare Levy Surcharge Thresholds) Bill (No. 2) 2008 received Royal Assent on 31 October 2008. The Bill, after the Senate's amendments, increased the Medicare levy surcharge threshold:

- for individuals from $50,000 to $70,000 which will be indexed annually to average weekly ordinary time earnings (AWOTE) rounded down to the nearest $1,000; and
- for families, from $100,000 to $140,000, and going forward will be doubled the single threshold.

Note that the individual threshold and the family threshold initially proposed in the Bill were $75,000 and $150,000 respectively.

The Medicare levy surcharge thresholds applicable from 1 July 2008 are as follows:

No of dependent children or students	Surcharge threshold ($)
0	70,000 (single[1]) / 140,000 (couple[2])
1	140,000
2	141,500
3	143,000
4	144,500
5	146,000
Each extra child	1,500

1. For a single taxpayer, the surcharge applies if the sum of taxable income and any reportable fringe benefits of taxpayer exceeds the amount shown.
2. For couples, the surcharge applies to both members if the sum of combined taxable income and any reportable fringe benefits of the taxpayer and spouse (adjusted to include any net income of a trust on which the trustee is assessed under section 98 on the spouse's behalf) exceeds the amount shown. However, if the taxable income of one taxpayer in a couple does not exceed the individual Medicare levy threshold, the surcharge does not apply to that taxpayer, but still applies to the other taxpayer. No concession applies to the surcharge if one member is merely within the shading-in range (but the shading-in concession still applies to ordinary Medicare levy to which surcharge is added). If the taxpayer had a spouse for only part of the year, the spouse's taxable income is not included in determining whether the threshold has been exceeded

Transitional provision

A transitional provision operates to ensure that an individual (including his or her dependants) is taken to be covered by private hospital policy for the period 1 July 2008 to 31 December 2008 if:

- the person is covered by that policy during any part of that period; and
- on 1 January 2009.

If the transitional provision applies, the individual will avoid the levy surcharge for that period.

Date of effect

The increase to the Medicare levy surcharge thresholds applies from 1 July 2008.

Lifetime health cover

Professional advisers and their clients should consider the potential loading for private hospital policy under the Lifetime Health Cover (LHC) prior to terminating a policy.

Broadly, the LHC provisions penalise individuals who take out private hospital cover later in their life. Under the provisions, if an individual does not have private hospital cover on the 1st of July following his or her 31st birthday, the individual will pay a 2% LHC loading on top of his or her private health insurance premiums for each year he or she remains without cover. However, the LHC loading does not apply to people who were born on or before 1 July 1934.

Note that special rules apply to certain groups of people including:

- Australians returning from overseas;
- new migrants to Australia;
- Veterans' Affairs Gold Card holders; and
- former members of the Australian Defence Force.

The LHC loading will only be removed after an individual has held an appropriate private hospital cover for a continuous period of 10 years.

Deductibility of Legal Expenses

In a majority decision (4:1) handed down on 12 November 2008, the High Court upheld the Full Federal Court's decision that legal expenses incurred by a taxpayer were deductible. In doing so, the Court rejected the Commissioner's contention that the expenses were incurred in defending charges extraneous to the performance of the taxpayer's income producing activities and therefore did not satisfy the requirements of subsection 8–1(1)(a) of ITAA 1997.

Background

The taxpayer was a former customs officer. He incurred legal expenses in defending charges made against him under the now repealed *Public Service Act 1922*, which alleged that he engaged in improper conduct as an officer and failed to fulfil his duty as an officer.

The first charge related to the activities of the taxpayer in attempting to secure information regarding the issue of a search warrant over his property and that of another person. The second charge related to inaccurate recording of attendance records in connection with his employment. The inquiry officer for the charges found the charges to be proven and directed that $400 be deducted from the taxpayer's salary. The taxpayer appealed to the Disciplinary Appeal Committee and was unsuccessful. In the process of his appeal, the taxpayer incurred $220 of legal expenses.

The third charge related to the taxpayer failing to fulfil his duty as an officer which arose as a result of a joint criminal investigation between the Australian Federal Police and the Internal Affairs Unit of Customs. The investigation involved phone taps of the taxpayer's private and work phones. The taxpayer commenced legal action on the basis that the telephone interceptions were unlawful, which was eventually dismissed by the High Court. The taxpayer had incurred legal expenses over two income years (2001/02 and 2002/03) relating to the third charge.

The case was first heard by the Federal Court as an appeal against a decision by the Commissioner on an objection by the taxpayer against an assessment to tax for the year ended 30 June 2002. The Federal Court held that the legal expenses incurred by the taxpayer in defending the charges were partially deductible under section 8–1 of ITAA 1997. The taxpayer was denied a deduction for legal expenses relating to the first charge because he was not able to prove that a nexus existed between the expenses and in carrying out his duties as a customs officer. The taxpayer was allowed a deduction for legal expenses relating to the second charge because the Court held that it was incurred by the taxpayer in carrying out his duties.

For legal expenses incurred in defending the third charge, the Court found that an insufficient nexus existed between the expenses and the carrying out of the taxpayer's duties. However, the Court held that the Commissioner was estopped from denying a deduction for those expenses on the basis of an order of the Federal Court in December 2003 that legal expenses incurred in the 2001/02 tax year in relation to the third charge were deductible. Since the legal expenses incurred in the 2002/03 tax year related to the same matter, the Court held that the Commissioner was estopped from arguing that these legal expenses were not allowed.

As a consequence of the Federal Court's decisions, the Commissioner appealed against the application of issue estoppel in respect of the legal expenses with the third charges to the Full Federal Court. The taxpayer cross-appealed against the finding that the legal expenses in association with the first and third charges were not deductible.

Only the first and third charges were subjected to the Full Court hearing. Further, the Commissioner did not press the appeal in relation to the legal expenses, which related to the second charge.

The Full Court found that the Federal Court had erred in holding that the Commissioner was estopped concerning the deductibility of the legal expenses regarding the third charge. This was because neither deductibility of the legal expenses incurred in the 2002 year, nor their connection with the gaining or producing of assessable income, was discussed in the Federal Court order in December 2003. Therefore, there was no estoppel in relation to the issues raised in the current proceeding. It ordered that the Commissioner's appeal and the taxpayer's cross-appeal be allowed.

Following the Full Federal Court's decision, the Commissioner appealed to the High Court. In particular, the focus of the appeal was the requirement for deductibility of expenses in subsection 8–1(1)(a) of ITAA 1997.

Decision

In reaching its decision, the Court referred to judgments handed down in cases relating to the deductibility of expenses. These cases included *FCT v. Payne* (2001) 46 ATR 228, *Amalgamated Zinc (De Bavay's) Ltd v. FCT* (1935) 54 CLR 296 and *FCT v. Cooper* (1991) 21 ATR 1616.

The Court considered the expression 'in the course of' as contained in subsection 8–1(1)(a). It was of the view that the expression did not require a direct connection between an expenditure and the activity which produced the assessable income. Rather, the requisite connection could be direct or indirect, provided the connection was not too remote.

The Court also considered the expression 'incidental and relevant' which was stated in subsection 8–1(1)(a). It said that the expression should not be thought to add more to the meaning of the section or to narrow its operation. It proceeded to say that the expression 'should be taken to describe an attribute of an expenditure in a particular case, rather than being an exhaustive test for ascertaining the limits of the operation of the provision'. It further said that due to the language and breadth of subsection 8–1(1)(a), a formula capable of application to the circumstances of each case would be difficult. It noted that while previous judgments were helpful, the judgments might not always explain how the search for a requisite connection was to be undertaken.

The Court stated that the deductibility of the expense incurred by the taxpayer depended on the determination of what was the productive of assessable income, which might take into account the positive and negative duties to be performed or observed by the taxpayer. It also stated that the deductibility also depended upon the employment and the duties imposed on the taxpayer which arose from his occupation.

The Court noted that the Public Service Act imposed an obligation to observe standards of conduct, breach of which might entail disciplinary charges. Therefore, it found that a nexus existed between the legal expenses incurred by the taxpayer and the deriving of his assessable income. In conclusion, it held that the legal expenses were allowable deductions. It also concluded that the expenses cannot be view as private or domestic in nature.

GST and Cancellation Fees

The Tax Office has released Draft GST Ruling GSTR 2008/D4 in which it states the Commissioner's preliminary view on GST consequences resulting from payments made when an arrangement under which a particular supply was intended to be made does not proceed or does not proceed in the manner originally contemplated. The Draft refers to these payments as 'cancellation fees'.

The Draft focuses on arrangements that are cancelled by a 'customer'. It also focuses on cancellations made by a supplier in relation to a ticketed arrangement for the supply of performances, events or similar arrangements.

In particular, it examines whether a cancellation fee relates to the provision of a 'supply' and whether consideration is provided for the supply.

The Draft states that supply can be for consideration if the consideration is in connection with the supply. Further, it states that the supply will be a taxable supply if the requirements of section 9–5 of *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act) are satisfied. However, it notes that the GST characteristic of the supply is not necessarily determined by the GST status of the intended supply.

According to the Draft, a supply to be provided for the cancellation fee can be either the intended supply or a different supply (e.g. a release supply or a facilitation supply).

Cancellation fees for an intended supply

The Draft states that any payment for an intended supply remains consideration for that supply. It also states that a cancellation fee is consideration for the intended supply if it represents payment for work done by a supplier in making the intended supply.

Cancellation fees for a different supply

Generally, the Draft notes that where the cancellation fees relate to a different supply, the fee may be consideration for that different supply. It also notes that a cancellation fee paid for a release supply may not be consideration for the supply if the fee has a sufficient nexus with an earlier supply.

Damages, penalties or compensation

The Commissioner states that the determination of whether an amount payable is consideration for a supply does not depend on its classification (i.e. damages, penalties or compensation). Rather, he states that all relevant factors surrounding the amount must be taken into account before making a determination.

Ex gratia payments

It is the Commissioner's view that if a customer makes an ex gratia payment, the payment does not constitute consideration for a supply as there is no connection between the ex gratia payment and any supply.

Security deposits

The Draft states that if a security deposit is forfeited under a clause of a contract, the deposit is treated as consideration for a supply under Division 99 of the GST Act. It also considers the High Court's decision in *Reliance Carpet v. FCT* [2008] HCA 22. While the Commissioner notes that the decision was made in the context of a contract for the sale of land, he considers the decision to be applicable to situations where a security deposit is forfeited under a cancellation clause provided for in a contract.

Examples

The Draft contains examples to demonstrate the application of the principles to common factual situations involving cancellation fees. These situations include:

- appointments made for the provision of services of a personal nature such as medical services and massages;
- hotel reservations;
- ticketed arrangements;
- package tours; and
- airline and other travel tickets.

Date of effect

When finalised, the Ruling will apply to all GST tax periods.

Refunds, payments and credits for indirect taxes

The Tax Office has also released Draft Miscellaneous Taxation Ruling MT 2008/D4 in which it sets out the Commissioner's views on what constitutes 'notification' by an entity to the Commissioner under section 105–55 of Schedule 1 to *Taxation Administration Act 1953*.

Section 105–55 provides a four-year time limit for entitlements to refunds, other payments or credits in relation to GST, luxury car tax, wine tax and fuel tax in respect of a tax period or importation. However, the four year time limit does not apply if within the required period:

- an entity notifies the Commissioner that they are entitled to the refund, other payment or credit; or
- the Commissioner notifies an entity that the entity is entitled to the refund, other payment or credit.

The Draft states that there is no specific form which is required for a notification for the purposes of section 105–55. However, the notification must be in writing. It further states that the following constitutes valid notification for the purposes of section 105–55:

- an activity statement or revised activity statement which includes the relevant entitlement; and
- an application for a private indirect tax ruling, an objection or other correspondence from an entity that asserts the entity has an entitlement, and which also:
  - a) provides a description of the nature of the entitlement to a refund, etc which brings to the Commissioner's attention the basic factual and legal basis for the entitlement, and
  - b) specifies the tax period(s) or importation to which the entitlement relates.

Furthermore, the notification need not quantify the amount of the entitlement, provided that the entitlement is clearly identified

However, the Draft provides that correspondence will not meet the notification requirements if it is speculative in nature, in the sense that it is directed at reserving an entity's rights in relation to possible future claim(s), rather than being directed at one or more particular entitlements. Nevertheless, if the entity subsequently provides further information it may then be sufficient to meet the requirements of a valid notification, but the notification will only be valid from the date the further information is received.

Requirements for a valid notice

For a notification to be valid, the Draft states that the notification must:

- ***be in writing*** — there is no particular form of words required to notify the Commissioner of an entitlement;
- ***bring the entity's entitlement to the Commissioner's attention*** — the notification must prominently assert that the entity is entitled to the refund, other payment or credit. The Draft notes that an oblique reference will not suffice;
- ***identify the entitlement*** — the notification must state an explanation for the entitlement to the refund, other payment or credit. The Draft notes that the notification does not have to persuade the Commissioner of the entitlement to claim. Rather, the notification must provide a reason to bring to the Commissioner's attention for the entitlement;
- ***identify the tax period*** — the tax period(s) concerned must be clearly identified. The notification can cover more than one tax period but it will be necessary to identify those tax periods; and
- ***assert the entitlement*** — the notification needs to assert that the entity has the entitlement for the refund, the other payment or the credit.

The Draft also states that the absence of a specific amount to which an entity is entitled will not invalid a notification, provided all other requirements are satisfied. It further states that the notification may be lodged on behalf of more than one entity, provided the person lodging the notification has the authority to act on behalf of those entities. However, the notification must explain how the relevant entitlement relates to each entity.

Date of effect

When finalised, the Ruling will apply to all tax periods.

Allowances and Foreign Earnings

In ATO ID 2008/143, the Tax Office discusses whether allowances received by an Australian resident taxpayer to cover various expenses related to their employment in a foreign country are assessable income under subsection 6–5(2) of ITAA 1936.

The ID says the part of the allowances received by the Australian resident taxpayer in respect of expenses that are attributable to the period that the taxpayer is engaged in foreign service is not assessable under subsection 6–5(2). It is exempt under subsection 23AG(1) of ITAA 1936 as it is foreign earnings derived from foreign service.

However, the ID says the part of the allowances received by the taxpayer in respect of expenses that are attributable to a period prior to the commencement or after the completion of the foreign service, is not exempt from tax under subsection 23AG(1) as it is not derived from foreign service.

Foreign earnings

Foreign earnings derived by an Australian resident taxpayer engaged in service in a foreign country for a continuous period of not fewer than 91 days are exempted from Australian tax under section 23AG, subject to certain exceptions.

The term ‘foreign earnings’ is defined in subsection 23AG(7) to mean income consisting of earnings, salary, wages, commission, bonuses or allowances. Foreign earnings also include amounts assessable under the employee share scheme provisions in Division 13A of ITAA 1936 in relation to employee shares and rights acquired on or after 26 June 2005 and employee shares and rights acquired at any time (including before 26 June 2005) by a person who does not become an Australian employee (i.e. employed in Australia) until that or a later day (in such a case, these provisions apply from the date the person becomes an Australian employee).

However, the following amounts are specifically excluded from the definition of foreign earnings:

- assessable pensions and annuities;
- assessable superannuation benefits;
- employment termination payments; and
- certain amounts transferred from a foreign superannuation fund in relation to the taxpayer.

In the ID, the Tax Office referred to the Federal Court’s decision in *Chaudhri v. FCT* (2001) 47 ATR 126. According to the ID, ‘the foreign earnings need [not] to be received at the time of engaging in a period of foreign service’. It is the Tax Office’s view that the ‘important test is that the foreign earnings need to be attributable to that period of service in a foreign country rather than to a period before or after the period of foreign service’.

It is important to note that subsection 23AG(7) defines ‘foreign service’ to mean service in a foreign country. Therefore, an individual’s foreign service period generally cannot begin or end at a time when the taxpayer is not actually in the foreign country where the service will be performed. However, the ID notes that the mere presence of a taxpayer in the foreign country does not mean that the taxpayer is engaged in foreign service. As such, whether the foreign earnings derived will depend on the terms of the taxpayer’s employment.

Abolishing Trust Cloning

In a media release dated 31 October 2008, the Assistant Treasurer, Chris Bowen, announced that the Government will remove one of the capital gains tax (CGT) exceptions to CGT events E1 and E2. According to the media release, the Government will abolish the ‘trust cloning’ exception. This exception provides a CGT exemption for capital gains arising from a change in ownership of an asset that typically occurs on the creation of a trust over a CGT asset (CGT event E1) and on transferring a CGT asset to an existing trust (CGT event E2).

However, the other exception to CGT events E1 and E2 will be retained (see below).

The media release stated that the amendments will resolve uncertainty surrounding the application of the exception. It also stated that the amendments will remove the possibility of using the trust cloning exception to eliminate tax liabilities on accrued capital gains.

The Assistant Treasurer said legislation giving effect to this measure will be introduced as soon as practicable. He also said that the amendments will apply to CGT events happening after 31 October 2008.

The Government is currently inviting interested parties to comment on the policy design of the proposed amendments and subsequently on an exposure draft of the legislation.

Trust cloning – CGT events E1 and E2

CGT event E1 — creating trust over asset

CGT event E1 deals with creating a trust over a CGT asset. The event happens if a taxpayer creates a trust over a CGT asset by declaration or settlement: subsection 104–55(1) of ITAA 1997. An example of this event is the situation where a trust is created over shares in a company in liquidation.

However, subsection 104–55(5) provides that CGT event E2 does not happen if

- a taxpayer is the sole beneficiary of a trust, is absolutely entitled to the asset as against the trustee (ignoring any legal disability) and the trust is not a unit trust; or
- a trust is created by transferring the asset from another trust that has the same beneficiaries and terms.

In addition, subsection 104–55(6) provides that a capital gain or capital loss is disregarded for trusts created over assets acquired before 20 September 1985.

CGT event E2 — transfer of asset to trust

CGT event E2 deals with transferring a CGT asset to a trust. The event happens if a taxpayer transfers a CGT asset to an existing trust: subsection 104–60(1) of ITAA 1997.

Subsection 104–60(5) provides two exceptions to CGT event E2:

- a taxpayer is the sole beneficiary of a trust, is absolutely entitled to the asset as against the trustee (ignoring any legal disability) and the trust is not a unit trust; or
- a trust is created by transferring the asset from another trust that has the same beneficiaries and terms (ie interests and conditions) as the transferee trust.

In addition, subsection 104–60(6) provides that a capital gain or capital loss is disregarded for trusts created over assets acquired before 20 September 1985.

Trust cloning

The two common reasons that the practice of trust cloning is used are:

- succession planning, i.e. transferring assets to the younger generation of a family; or
- asset protection, i.e. segregating passive (or personal) assets from business assets.

For the trust cloning exception to apply, strict requirements must be satisfied. In Taxation Ruling TR 2006/4, the Tax Office states that the beneficiaries and terms of the original trust and the new trust must be the same for the exception to apply. It also states that these requirements must be met at the time the asset is transferred.

Broadly, the following terms of the original trust and the net trust must be the same:

- each beneficiary must have the same rights, entitlements and interests in the new trust which he or she had in the original trust;
- the vesting date of both trusts must be the same;
- the same state laws must govern each trust; and

- if one trust has made a family trust election or an interposed entity election in respect of a family group, then the other trust must have made the same type of election in respect of the same family group.

However, it is not necessary for the following to be the same:

- the trustees;
- the trust names;
- the commencement or establishment dates;
- the settlor of the trusts; or
- the trust property (other than the transferred asset).

It is important to note that the requirements for the exceptions to apply must be adhered. However, practical difficulties often arise, in particular when cloning discretionary trusts whether the original trust and the new trust are the same.

While the proposed amendments will apply from 1 November 2008, the Government has not announced any transitional provisions. In addition, the Government has yet to release an exposure draft of the legislation. Therefore, professional advisers and their clients face a degree of uncertainty regarding trust cloning.

Superannuation Guarantee

The Tax Office has released Draft Superannuation Guarantee Ruling SGR 2008/D2 in which it explains the Commissioner's preliminary view on what constitutes 'ordinary time earnings' (OTE) as defined in subsection 6(1) of *Superannuation Guarantee (Administration) Act 1992* (the SGA Act). The Draft also explains the meaning of 'salary or wages' as defined in section 11 of the SGA Act.

The Draft proposes that when the Ruling is finalised it will replace Superannuation Guarantee Rulings SGR 94/4 and SGR 94/5, which currently states the Commissioner's views on OTE and salary or wages.

Background

From 1 July 2008, employers must use OTE when calculating the prescribed minimum superannuation guarantee contributions required for their employees. If employers provide less than the required minimum level of contributions, they will be liable to pay a non-deductible superannuation guarantee charge which is calculated using salary or wages.

The Draft states that payments included in OTE are also included in salary or wages. It also states that payments specifically excluded from OTE are not necessarily excluded from salary or wages. In other words, 'salary or wages' as defined in section 11 has a broader concept than OTE.

Ordinary time earnings

The term OTE is defined in subsection 6(1) of the SGA Act. It prescribes a requirement that earnings be in respect of ordinary hours of work. However, the terms 'earnings' or 'ordinary hours of work' are not specifically defined in the SGA Act. Therefore, the Draft states that the terms take their ordinary meanings within the context of the Act.

According to the Draft, the word 'earnings' refers to the remuneration paid to an employee, as a reward for the services of the employee. It states that an employee's ordinary hours of work are the usual hours of work that the employee works. It also states that where an offer of employment specifies only the minimum hours of work, it is the actual hours worked plus any hours of paid leave that is considered the ordinary hours of work. It further states that if the employee has entered into an award or industrial agreement and:

- has not entered into a workplace agreement, the standard working hours are as prescribed in the award or agreement; or
- has entered into a workplace agreement, the standard working hours are as prescribed in the workplace agreement.

The Draft notes that 'ordinary hours of work' are not limited to hours between 9am to 5pm, Monday to Friday but could include night and weekend shifts. It also notes that the OTE of an employee cannot exceed the maximum contribution base for a quarter.

The Draft says that two elements must be satisfied for a payment to be considered 'earnings in respect of ordinary hours of work'. Firstly, the payment must constitute the earnings of an employee in relation to a particular quarter of an income year. The Draft says that it is the economic substance rather than the legal label affixed to the payment which characterises the payment. Secondly, the earning must be in respect of the employee's ordinary hours of work. The Draft notes that where a payment is wholly unconnected or incidental to the services of the employee, the payment is not OTE.

The Commissioner provides his view on whether certain payments receive by employees is OTE. These payments include:

- ***allowances*** — all allowances (other than an expense allowance or an allowance that is a fringe benefit) paid in relation to an employee's ordinary hours of work form part of OTE. This is because 'the allowances are paid as a reward for services to the employer, they are earnings in respect of ordinary hours of work'. However, he says that if an allowance is received in respect of services outside ordinary hours of work, the allowance does not form part of OTE;
- ***bonuses*** — bonuses received by an employee will be included in OTE if the bonuses are reward for the services provided to his or her employer;
- ***piece rates*** — all wages payments made on a piece rate basis are included in an employee's OTE; and
- ***leave*** — all leave payments are considered OTE. (Note that the Draft does not distinguish the different forms of leave payments. Lump sum payments for unused sick leave, unused annual leave and unused long service leave on termination of employment do not form OTE: subsection 6(1) of the SGA Act)

Salary or wages

It is the Commissioner's view that the salary or wages of an employee can be paid by the employer or by another party on behalf of the employer. He states that salary or wages are not restricted to cash or cash equivalent payments but can include payments made in-kind to the employee. He also states that a payment is included in salary or wages if the employee has the entitlement to receive the money for himself or herself.

The Draft states that whether a payment constitutes 'salary or wages' is to be determined in the circumstances of each case, having regard to relevant case law. It also states that the meaning of 'salary or wages' requires an employment relationship to exist. It further states that a nexus between the provision of services by an employee and payments received by the employee needs to be present.

The Draft examines whether certain payments received by an employee constitute salary or wages. These include:

- ***expense allowances*** — if there is a reasonable expectation that the allowances will be fully expended by an employee in the course of employment, the allowances do not constitute salary or wages;
- ***unfair dismissal payments*** — these payments do not constitute salary or wages because they are not consideration or a reward for services rendered by a former employee to their former employer;
- ***bonuses*** — where bonuses are paid to an employee by reason of the employee's services and not on a personal basis, the bonuses will constitute salary or wages;
- ***leave payments*** — all leave payments are directly related to services provided as an employee and are considered salary or wages;
- ***workers compensation payments*** — any workers compensation payments received by an injured employee (if the employee performs work or is required to attend work) form part of salary or wages; and
- ***lump sum payments on termination of employment*** — these payments are a reward for services rendered by an employee and therefore form part of salary or wages.

Examples

The appendix accompanying the Draft contains a table summarising whether common payments received by employees are considered to be OTE and/or salary or wages. It also contains 24 examples setting out common scenarios which employers may encounter.

The table below, which is adapted from the Draft, provides a general guide the treatment of common payments.

Payment	OTE	Salary or wages
Occasional overtime under an award	No	Yes
Additional hours to award under an agreement	Yes	Yes
Additional hours in an agreement over an award's ordinary hours	Yes	Yes
Varied ordinary hours in an agreement which includes regularly worked overtime	Yes	Yes
Piece rates – no ordinary hours of work stipulated	Yes	Yes
Piece rates based on 'cents-per-kilometre' stipulated in award (e.g. long distance truck drivers)	Yes	Yes
Allowance (other than an expense allowance or an allowance that is a fringe benefit)	Yes	Yes
Expense allowance	No	Yes
Danger allowance	Yes	Yes
Retention allowance	Yes	Yes
Reimbursement of expenses (if fully expended)	No	No
Petty cash	No	No
Reimbursement of travel costs (e.g. calculated using the 'cents-per-kilometre' method	No	No
Annual leave	Yes	Yes
Maternity leave	Yes	Yes
Jury duty leave	Yes	Yes
Release from work duties on full paid leave (e.g. at the direction of an employer)	Yes	Yes
Bonus received as a reward for services provided, irrespective of if the bonus was for long works worked by an employee	Yes	Yes
Accrued bonus received as a reward for services provided in respect of ordinary hours of work	Yes	Yes
Bonus labelled as ex gratia but in respect of ordinary hours of work	Yes	Yes
Christmas bonus	No	No
Bonus for completing specific training	No	No
Discretionary incentive payment	Yes	Yes

Date of effect

When finalised, the Ruling will apply from 1 July 2009.

It is important to note the Ruling will not apply retrospectively, which means that employers will need to rely on the Commissioner's current views on OTE and salary or wages stated in Superannuation Guarantee Rulings SGR 94/4 and 94/5.

Discussion of Draft

While the Commissioner's view of whether a payment is taken into account for OTE or salary or wages has not significantly departed from his current view, his view relating to certain payments appears to have changed.

In SGR 94/4 and 94/5, the Commissioner considered that annual leave loading, maternity leave and jury duty leave payments are not included in OTE. He also considered Christmas bonuses to be part of salary or wages. However, the Draft now appears to convey a different view — see table above.

It is important to note that the Draft does not distinguish between the different types of leave payments. Rather, it says that 'all leave payments are considered OTE'. It also says that 'all leave payments are directly related to services provided as an employee and are considered salary or wages'.

On 3 September 2008, the Tax Office released Draft Superannuation Guarantee Ruling SGR 2008/D1 in which the Commissioner stated his preliminary view on whether a payer is required to remit superannuation guarantee for payments paid to sportspersons and persons providing services in connection with sporting activities. In particular, this Draft Ruling discusses whether prize monies and other payments made to sportspersons are 'salary or wages' under subsection 11(1)(d) of the SGA Act and are 'ordinary time earnings' for the purpose of subsection 6(1) of the SGA Act.

Legal status of Superannuation Guarantee Ruling

A Superannuation Guarantee (SG) Ruling, whether draft or final, represents the Commissioner's views about the operation of the superannuation guarantee legislation and related regulations.

An SG Ruling is not legally binding on the Commissioner. However, if the Commissioner later takes the view that the law applies less favourably to a taxpayer than the Ruling, the fact that the taxpayer acted in accordance with the Ruling would be a relevant factor in the Commissioner exercising his discretion as to what action to take in response to the breach of that law.

SMSFs and In-house Assets

The Tax Office has released Draft Self Managed Superannuation Fund Ruling SMSFR 2008/D5 in which it explains the core concepts in the definition of 'in-house asset' in section 71 of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act) as they apply to self-managed superannuation funds (SMSFs). The key definitions explained are:

- asset;
- loan;
- investment in;
- lease; and
- lease arrangement.

Basic definition of 'in-house asset'

An 'in-house asset' is defined in subsection 71(1) of the SIS Act as:

> 'an asset of the fund that is a loan to, or an investment in, a related party of the fund, an investment in a related trust of the fund, or an asset of the fund subject to a lease or lease arrangement between a trustee of the fund and a related party of the fund …'

This part of the definition contains several terms which are defined in the SIS Act and require further consideration.

Asset

An ‘asset’ means ‘any form of property’ and includes money whether Australian currency or foreign currency: subsection 10(1) of the SIS Act. The Commissioner considers that the phrase ‘any form of property’ has a very wide meaning and includes every type of right, interest or thing of value that is legally capable of ownership. It encompasses real property and personal property and includes any right or interest (including legal, equitable or statutory) that is of value and legally capable of ownership. While assignability generally is a characteristic of a proprietary right, the Tax Office says it is not in all cases an essential characteristic.

Loan

A ‘loan’ includes the provision of credit or any other form of financial accommodation, whether or not enforceable, or intended to be enforceable, by legal proceedings: subsection 10(1).

The Draft states that the term ‘loan’ in subsection 10(1) extends to include arrangements that are in substance, financing arrangements deferring the payment of an amount. Such arrangements would include, but are not limited to, the loan of money, sale of goods or land on credit, instalment payment arrangements and arrangements for the deferral of payment of debts or entitlements.

However, the Commissioner states that not every situation where a payment is deferred necessarily amounts to a ‘loan’ under the extended definition. The Tax Office also accepts that payment of goods on normal commercial terms will not amount to a ‘loan’, nor will late payments which were not agreed to by the trustee of the superannuation fund.

In addition, it is the Commissioner’s view that ‘loan’ also encompasses arrangements where there is no objective purpose of gaining interest, income, profit or gain, e.g. an interest free loan. It therefore covers arrangements that may not be an ‘investment’ under subsection 71(1).

Meaning of ‘investment in’

While the term ‘investment’ is not defined in the SIS Act, the term ‘invest’ is defined to in subsection 10(1) to mean:

- apply assets in any way; or
- make a contract; for the purpose of gaining interest, income, profit or gain.

In this context, the Tax Office says the corresponding meaning of the term ‘investment’ is the asset resulting from applying the assets of an SMSF or entering into a contract for the purpose of gaining interest, income, profit or gain.

Having identified that an asset of an SMSF is properly classified as an investment, the Commissioner says it is then necessary to determine whether that investment is ‘in’ a related party or a related trust. Whether an investment is ‘in’ a particular entity is determined by reference to the legal rights acquired by the SMSF in return for its expenditure.

It is the Commissioner’s view that where money or assets are provided for, the benefit of a related party or related trust for the purpose of receiving income, interest, profit or gain, a sufficiently close connection will be established between the investment and that entity to enable it to be described as an investment ‘in’ that entity. The Tax Office notes that it is the reliance on the related party or the related trust for payment on the investment which will be determinative, as this is what gives rise to the financial risk that the in-house assets rules in Part 8 of the SIS Act are designed to reduce.

Leases

The term ‘lease’ is not defined in the SIS Act and therefore is given its ordinary meaning.

In respect of real property, the Draft Ruling states that a lease is a ‘demise’ that grants a leasehold estate in the property to the lessee for a term. That is, the lessee has an interest in the land (a chattel real). This can be contrasted with a licence to enter land, which does not confer any interest in the real property. Of particular importance to determining whether an agreement amounts to a lease or a licence agreement, is

whether exclusive possession is granted to the property. That is, the tenant has not only the right to occupy the premises, but to exclude access to all others, including the legal owner of the land.

Therefore, the Commissioner considers that a lease in respect of real property will occur where the lessee is granted exclusive possession of the property, generally in exchange for a rent.

The Tax Office says that a key difference between a lease of real property and a lease of chattels (non-real property) is that no proprietary interest in the asset is created in respect of a chattel lease. However, the right of possession granted to the hirer under the agreement, although not referred to as 'exclusive possession', nonetheless includes the right to debar the legal owner from resuming possession.

It is therefore the Commissioner's view that the term 'lease' in subsection 71(1) in respect of non-real property means a legally enforceable hiring agreement involving the payment of consideration by the hirer in exchange for enforceable temporary possession of the asset.

Lease arrangements

It is the Commissioner's view that the term 'lease arrangement' (defined in subsection 10(1)) expands the definition of in-house assets to include informal arrangements under which a person uses or controls the use of fund property. This includes arrangements where a related party gains possession of an asset of the superannuation fund, even where no rent is payable in exchange for that possession.

Where an SMSF trustee enters into a lease or lease arrangement with a related party in respect to part of some property, the Tax Office says the in-house asset is the part of the property that is leased to the related party.

Where an asset is leased or subject to a lease arrangement for part of the year, the Draft Ruling states that the full value is an in-house asset for the period that it is leased or subject to a lease arrangement with a related party.

Examples

The Draft Ruling includes Examples illustrating how section 71 of the SIS Act applies in given fact situations, such as:

- the late payment of rent;
- annuity arrangements;
- contractual funding arrangements;
- the display of artwork;
- part of an asset subject to a lease;
- part-year leases; and
- related party scenarios — employer sponsors, company a related party, controlling entity of a company and where members and associates control a trust together.

Importantly, the Draft warns that it does not provide the Commissioner's views on how other the SIS Act and the SIS Regulations provisions apply to any of the arrangements discussed in the Draft.

Date of effect

When finalised, the Ruling will apply to SMSFs and former SMSFs both before and after its date of issue.

In-house assets rules

Broadly, the in-house assets rules, which are contained in Part 8 of the SIS Act, prevent a regulated superannuation fund (including an SMSF) from having more than 5% of the total market value of its invested in in-house assets at the end of an income year.

An in-house asset is defined in section 71 of the SIS Act to include (unless an exception applies):

- a loan to, or an investment in, a 'related party' of the fund;

- an investment in a 'related trust' of the fund; and
- an asset of the fund subject to a lease or lease arrangement with a 'related party' of the fund.

The definition of an in-house asset relies on the core concepts which are discussed in the Draft Ruling. Therefore, it is of paramount importance for a trustee of an SMSF to understand these concepts to ensure that the SMSF does not breach the in-house assets rules.

Section 84 of the SIS Act prescribes that every trustee of an SMSF must take all reasonable steps to ensure compliance with the rules. A contravention of the rules is a civil penalty which may result in civil and criminal consequences.

Legal status of SMSF Ruling

An SMSF Ruling, whether draft or final, represents the Commissioner's views about the way in which provisions of the SIS Act, or regulations under that Act, apply to SMSFs.

An SMSF Ruling is not legally binding on the Commissioner. However, if the Commissioner later takes the view that the law applies less favourably to a taxpayer than the Ruling, the fact that the taxpayer acted in accordance with the Ruling would be a relevant factor in the Commissioner exercising his discretion as to what action to take in response to the breach of that law.

Trustee of SMSF Charged

In a media release from ASIC, the corporate regulator said that a trustee of a self-managed superannuation fund (SMSF) has been charged under sections 62 and 202 of *Superannuation Industry (Supervision) Act 1993* (the SIS Act). The proceedings were brought against the trustee following an investigation conducted with the assistance of the Tax Office.

ASIC alleged that the preserved superannuation benefits of 121 superannuants, totalling over $3.5 million, were deposited into the bank accounts of the SMSF. These funds were rolled over from 11 complying superannuation funds. The trustee then allegedly used the fund to unlawfully obtain early access to these benefits by withdrawing and distributing the funds to the superannuants. The trustee also retained over $685,000 for himself by way of a commission.

ASIC also alleges that the trustee was aware he had an obligation to preserve the superannuants' benefits until the superannuants had satisfied a condition of release but had no intention of doing so.

SIS Act requirements

Section 62 of the SIS Act requires each trustee of a regulated superannuation fund (including an SMSF) maintains the fund solely for at least one core purpose, or at least one core purpose and one ancillary purpose. A trustee who maintains the fund only for one or more ancillary purposes will contravene the test. Essentially, the core purposes are the provision of benefits:

- on or after a member's retirement;
- for a member upon attaining 65 years of age; or
- to a deceased member's dependent or legal personal representative, provided that the death occurred before the member retired or attaining 65 years of age.

Ancillary purposes are those that a fund may maintain in conjunction with at least one of the core purposes. These purposes are as follows:

- the provision of benefits for a member on or after termination of employment from an employer who had, or any of whose associates had, at any time contributed to the fund in relation to the member;
- the provision of benefits for a member on or after the member's temporary or permanent cessation of work because of physical or mental ill-health;
- the provision of benefits to a deceased member's dependants or legal personal representative, provided that the member dies after retirement or attaining 65 years of age; and
- the provision of other ancillary benefits as APRA approves in writing.

It is important to note that the operation of the sole purpose test must not be viewed in a vacuum but in conjunction with the payment standards as prescribed by Part 6 of Superannuation Industry (Supervision) Regulations 1994 (the SIS Regulations).

A trustee who contravenes the sole purpose test can be prosecuted under the civil penalty provisions of Part 21 of the SIS Act. If the trustee is found guilty of either a civil and/or criminal offence under the provisions, the maximum penalties which may apply are a fine of $220,000 (for civil penalties) and/or five years imprisonment (for criminal proceedings).

Observation

This is the second case to be laid against an SMSF trustee under the SIS Act. (The first case brought against a trustee of an SMSF was in August 2008. It was also alleged that the trustee had breached his duties under the sole purpose test. The case was reported in the October 2008 issue of *Client Alert*.)

Prima facie, the corporate regulator and the Tax Office are increasing their compliance activities for SMSFs, in particular ensuring that trustees of SMSFs are aware and fulfil their duties as required by the SIS Act and the SIS Regulations.

Duties and obligations of trustees

A trustee has a fiduciary relationship with an SMSF. This relationship imposes on the trustee the requirement to maintain the highest standard of care both at equity and trust law, which means that the trustee must not put his or her personal interests above that of the SMSF. The trustee is bound by certain duties imposed by trust law, including a duty to observe the governing rules of the fund, a duty to act impartially between beneficiaries, a duty not to profit from his or her position, and a duty of care.

In addition to trust law duties, section 52 of the SIS Act states that the governing rules of a superannuation fund needs to include certain covenants, which relate to the duties of a trustee. If the rules of a fund do not contain covenants to the effect of those stated in the section, the rules are taken to contain covenants to that effect. Broadly, the covenants require each trustee of the fund to:

- act honestly in all matters concerning the fund;
- exercise the same degree of care, skill, and diligence as an ordinary prudent person when dealing with property of the fund;
- ensure the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries;
- ensure the money and other assets of the fund are separated from those held by the trustee;
- formulate and give effect to an investment strategy that has regard to the whole circumstances of the fund;
- formulate and give effect to a strategy for the prudential management of reserves (if any), consistent with the fund's investment strategy and its capacity to discharge its liabilities; and
- allow a beneficiary access to any prescribed information or any prescribed documents.

It is important to realise that the duties prescribed in the SIS Act do not necessarily override trust law. Therefore, a conflict of law potentially arises if a trust law duty is more onerous than a SIS Act covenant. However, if the SIS Act conflicts with the governing deed, the SIS Act will prevail.

As a general principle, a trustee should follow and comply with the terms of the governing deed in the course of his or her duties. In *N M Superannuation Pty Ltd v. Hughes*, the New South Wales Supreme Court would not authorise departure from the strict terms of the fund's rules even though it would have produced a fairer result.

In addition, a proviso in the governing deed to indemnify a trustee from personal liability cannot override core trustee obligations. In *Reader v. Fried [2001] VSC 495*, the Victorian Supreme Court held that an exemption clause in the fund deed did not protect the trustees from personal liability for breaches of trust.

A trustee should also be aware of the relevant sections in *Corporations Act 2001* (the Act), which impacts on the trustee's duties and obligations to the fund and its members. For example, section 1041H of the Act

states that a person who engages in misleading or deceptive conduct in relation to a financial product or a financial service can be liable for a civil penalty.

A trustee must also be familiar and understand other provisions in the SIS Act and SIS Regulations that will impact on the trustee discharging his or her duties and obligations. The key provisions include:

- the sole purpose test;
- the in-house assets rule;
- the conditions of release of superannuation benefits to the fund's member;
- the investment rules, which includes the restrictions on borrowing; and
- the standards for accepting contributions under the SIS Regulations.

A trustee of an SMSF also has the responsibility to appoint an approved auditor to audit the operations of the fund for each year or part of the year the fund is in existence.

In addition to the SIS Act and the SIS Regulations, a trustee must be mindful of the obligations prescribed in the income tax legislations, which include ensuring the fund lodges its annual tax return and maintains records for up to ten years.

Specific penalties can apply for certain contraventions of the SIS Act. For example, if a trustee intentionally acquires an asset from a related party, it is a punishable offence, on conviction, by imprisonment for a term not exceeding one year.

A trustee of an SMSF is also liable for income tax penalties. For instance, if a trustee makes a false or misleading statement that results in an underpayment of tax by the SMSF, the trustee may be liable for an administrative penalty. The base penalty ranges from 25% to 75% of the shortfall depending on the trustee's conduct.

Depending on the severity of the breach, which arises from the misconduct of a trustee, an SMSF may lose its complying status for taxation and superannuation guarantee purposes. A complying fund that has been rendered non-complying can suffer serious tax consequences. For instance, the income of the fund is subject to tax at the highest marginal rate (currently 45%) as oppose to the concessional tax rate of 15%.

Furthermore, a trustee may face legal actions from a member of an SMSF if the member has suffered a loss or damage as a result of the trustee breaching his or her duties and obligations.

Social Security Payments

Income test and deeming rates

From 17 November 2008, the social security income test deeming rates for pensions and allowances has been lowered to take into account deceased returns on deposits or other investments.

The new deeming rates are:

- ***for a single person*** — 3% (previously 4%) for the first $41,000 of his or her total financial investments. For the balance of financial investments over this amount, the rate is 5% (previously 6%);
- ***for a couple (both receiving a pension)*** — 3% for the first $68,200 of their total combined financial investments. For the balance of financial investments over this amount, the rate is 5%;
- ***for a couple (one person receiving a pension and the other receiving an allowance)*** — 3% for the first $68,200 of their total combined financial investments. For the balance of financial investments over this amount, the rate is 5%; and
- ***for a couple (both receiving an allowance)*** — 3% for the first $34,100 of their total combined financial investments. For the balance of financial investments over this amount, the rate is 5%.

The changes to the deeming rates mean that part-rate pensioners paid under the income test may receive an increase in their pension payments. However, pensioners already paid at the maximum rate will have no change to their pension payments.

Payments affected by the decrease to the deeming rates include:

- age pension;
- disability support pension;
- carer payment;
- parenting payment; and
- Newstart allowances.

For the purposes of the deeming rates, the following financial investments are taken into account:

- bank, building society and credit union accounts balances;
- term deposits and debentures;
- friendly society bonds;
- managed investments;
- listed shares and securities;
- shares in unlisted public companies;
- gold and other bullion;
- certain income streams (e.g. short-term assets tested income streams);
- approved deposit funds, deferred annuities and superannuation fund investments held by people over age pension age (i.e. 65 for males and 63.5 for females);
- loans, including those to family trusts and companies; and
- gifts of money or assets of either more than $10,000 in an income year or $30,000 over five income years.

Veterans

The lower social security income test deeming rates will also apply for veterans from payday 4 December 2008. Department of Veterans' Affairs payments which are affected by the lower deeming rates include service pension and income support supplement.

Veterans who already are paid at the maximum rate will have no change to their pension payments.

Pensioner financial investment revaluations complete

Centrelink has completed its revaluation of more than 840,000 pensioners' listed securities and managed investments using available market data. However, pensioners receiving a full pension rate have generally not been affected by the process.

As a result of the revaluation, 370,000 pensioners received an average increase of $4 a fortnight and in some cases the increase was more than $100 per fortnight. However, around 440,000 people experienced no change in their payments and 30,000 experienced having an average decrease of less than $2 per fortnight. The new payment rates came into effect on 3 November 2008.

Economic Security Strategy

The Government introduced the Social Security and Other Legislation Amendment (Economic Security Strategy) Bill 2008 into the House of Reps on 11 November 2008. The Bill proposes to amend the social security law, the family assistance law, the *Veterans' Entitlements Act 1986* and the tax law to provide for payments to pensioners, seniors, people with disability, carers, veterans and families with dependent children, as announced by the Government on 14 October 2008 as a key part of its $10.4 billion Economic Security Strategy.

The Bill proposes to provide a one-off lump sum payment of:

- $1,400 for single recipients;

- $2,100 for couples combined, where both members of a couple receive a pension or allowance; and
- $1,050 for couples, where only one member of the couple receives a pension or allowance.

The lump sum payment will not count as income for social security, family assistance and veterans' entitlement purposes and will be tax-free. The payment will be paid during the fortnight commencing 8 December 2008.

Recipients of the following social security payments and cards will be eligible for the payment:

- age pension;
- disability support pension;
- wife pension;
- widow B pension;
- service pension;
- income support supplement;
- carer payment;
- partner allowance;
- widow allowance;
- bereavement allowance;
- parenting payment (if recipient is of age pension age, i.e. 65 for males and 63.5 for females);
- special benefit (if recipient is of age pension age);
- Austudy payment (if recipient is of age pension age);
- ABSTUDY (if recipient is of age pension age and receiving a living allowance);
- Commonwealth seniors health card; and
- Veterans' Affairs gold card (if recipient is also eligible for seniors concession allowance).

The Bill will also provide a lump sum payment to families with dependent children. The payment of $1,000 will be made for:

- each child who attracts Family Tax Benefit (FTB) Part A on 14 October 2008; or
- each dependent child who on 14 October 2008 either attracts or receives youth allowance, ABSTUDY living allowance or an education allowance under the Veterans' Children Education Scheme or the Military Rehabilitation and Compensation Act Education and Training Scheme.

For families receiving FTB Part A as a lump sum after the end of an income year, the payment will be paid after their family tax benefit claim is determined.

The Bill will further provide a lump sum payment for recipients of carer allowance. A payment of $1,000 will be made for each person cared for.

Tax Practice Update

Reform to income tests

The Treasury has released a consultation paper and Exposure Draft Tax Laws Amendment (Budget Measures No 1) Bill 2009 on the 2008/09 Budget measures to reform income tests for comment.

The measures announced in the Budget will expand the definition of income used to determine eligibility for government support programs and tax offsets to include:

- certain salary sacrificed contributions to superannuation;
- net financial investment losses and net rental property losses where appropriate; and
- adjusted fringe benefits.

The measures will also align the definition of income between dependency tax offsets and family assistance payments. Further, the $150,000 income threshold which applies to those offsets will be indexed annually from 1 July 2009.

Note that the 2008/09 Budget initially proposed to include reportable fringe benefits in the definition of income. However, the Government in June 2008 announced that adjusted fringe benefits rather than reportable fringe benefits would be included in the definition of income.

Adjusted fringe benefits

The Exposure Draft states that the adjusted fringe benefits total of a taxpayer for a year of income is the amount calculated using the formula below:

Taxpayer's reportable fringe benefits total x (1 - FBT rate)

UK Pensioners in Australia

In a press release from the European Court of Human Rights, 13 British nations have been unsuccessful before the Court in arguing that their UK pensions should be indexed. The applicants had argued that the UK authorities' refusal to up-rate their pensions in line with inflation was discriminatory.

The Court did not find an analogy between applicants who live in a 'frozen pension' country and British pensioners resident in countries outside the UK where up-rating was available through a reciprocal agreement. While it was noted that there was some force in the applicants' argument, that an elderly person's decision to move abroad might be driven by a number of factors, including the desire to be close to family members, the Court concluded that the place of residence was nonetheless a matter of choice.

The Minister for Families, Jenny Macklin, said the Australian Government was disappointed with the Court's decision which she said continues to deny indexed pensions to more than 245,000 UK pensioners living in Australia. Ms Macklin said the Government will continue to pursue the matter with the UK Government on behalf of all UK pensioners in Australia.