client alert | explanatory memorandum

February 2018

CURRENCY:
This issue of **Client Alert** takes into account developments up to and including 19 January 2018.

ATO rethink on guidelines for profit allocation within professional firms

In reviewing its guidelines on Everett assignments and the allocation of profits within professional firms, the ATO has become aware that the guidelines are being misinterpreted in relation to certain arrangements that go beyond the guidelines' scope. The ATO has found a variety of arrangements that exhibit high risk factors are not specifically addressed within the guidelines, including the use of related-party financing and self managed superannuation funds (SMSFs).

As a result, the ATO has suspended the application of the guidelines with effect from 14 December 2017.

Practitioners contemplating entering into new arrangements after the cut-off date should pursue an "early engagement discussion" with the ATO under its private rulings processes.

Practitioners who have entered into arrangements before the cut-off date that comply with the guidelines and do not exhibit high risk factors can rely on those guidelines. Pre-14 December 2017 arrangements that exhibit any of the high risk factors may be subject to review. The ATO says it encourages anyone who is uncertain about how the law applies to their existing circumstances "to engage with us as soon as possible".

The ATO will consult with interested stakeholders on replacement guidelines and the application of any required transitional arrangements.

Housing affordability measures now law

Legislation to implement the 2017–2018 Federal Budget measures aimed at improving housing affordability has now been passed.

The *Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures No 1) Act 2017* and the *First Home Super Saver Tax Act 2017* implement the following measures (both of which start on 1 July 2018):

- the First Home Super Saver (FHSS) Scheme, which provides concessional tax treatment for amounts released from superannuation in order to purchase or construct a first home (starting from 1 July 2018); and
- an exemption for "downsizing" super contributions up to $300,000 when individuals aged 65 and over sell a home that they have owned for at least 10 years.

Note that as result of a Senate amendment during passage of the legislation, an exemption from meeting the "first home" requirement is now available. The exemption will apply if the ATO determines that the taxpayer has suffered financial hardship (the circumstances of which will be determined by regulation). It is envisaged that regulations would refer to circumstances where a taxpayer has limited savings, is currently renting and had an interest in a home many years ago that was in a cheaper real estate market or when the taxpayer was in a relationship that has since broken down. Taxpayers will still be limited to one withdrawal of their voluntary superannuation in their lifetime and it must be for their only home.

Fringe benefits tax: determining private use of vehicles

The ATO has issued employer guidance regarding how to determine an employee's private use of a vehicle for the purposes of the car-related FBT exemptions.

Draft Practical Compliance Guideline PCG 2017/D14 is the ATO's response to feedback that the application of the car exemptions is a compliance burden for employers and requires an overly detailed understanding of each vehicle's use. The draft guideline has been issued to provide more certainty and transparency about the circumstances in which the ATO will not apply compliance resources to determine if private use of a vehicle meets the car-related FBT exemptions.

Eligible employers who rely on the guideline do not need to keep records to prove that an employee's private use of a vehicle is minor, infrequent and irregular, and the ATO will not devote compliance resources to reviewing the employers' access to car-related exemptions for that employee.

Eligible employers

An employer can rely on the guideline if:

- the employer provides an eligible vehicle to an employee for performance of their work duties;
- the employer takes all reasonable steps to limit private use of the vehicle and has measures in place to monitor such use;
- the vehicle has no non-business accessories;
- when the vehicle is acquired, its GST-inclusive value is under the luxury car tax threshold;
- the vehicle is not provided as part of a salary packaging arrangement, and the employee cannot elect to receive additional remuneration in lieu of using the vehicle; and
- the employee uses the vehicle to travel between home and work, and
  - any diversion adds no more than 2 km to the ordinary length of that trip;
  - no more than 750 km of travel in total for each FBT year for multiple journeys is for a wholly private purpose; and
  - no single, return journey for a wholly private purpose exceeds 200 km.

Employers will need to assess their eligibility to rely on the guideline on a yearly basis.

Examples included in the guideline involve:

- incidental travel (regularly stopping at a newsagent) and wholly private travel (taking a relative to school 10 times during the FBT year) – the employer can rely on the guideline;
- travel to attend seasonal weekly football training, which adds more than 2 km to the journey from home to work – the employer cannot rely on the guideline;
- an employee who travels a total of 20,000 km and whose private use of the vehicle involves taking domestic rubbish to a tip (100 km return trip) and moving house three times (200 km in total) – the employer can rely on the guideline; and
- private travel, including a single return trip of 300 km – the employer cannot rely on the guideline.

When it is finalised, the guideline will apply to car and residual benefits provided from the 2017-18 FBT year, ie from 1 April 2017.

ATO ruling: tax consequences of trust vesting

The ATO has issued a long-awaited ruling which sets out its views about the vesting of a trust, changing the trust's vesting date and the income tax consequences of vesting (Draft Taxation Ruling TR 2017/D10).

A trust's "vesting date" is the day on which the beneficiaries' interests in the trust property become "vested in interest and possession". The trust deed will specify the vesting date and the consequences of that date being reached (eg that the trust property will be held from that date for the takers on vesting in equal shares absolutely). The ATO notes that vesting does not, of itself, ordinarily cause the trust to come to an end or cause a new trust to arise. In particular, the underlying trust relationship will continue while the trustee holds property for the takers on vesting.

The key points made in the draft ruling are that:

- before vesting, it may be possible to extend the vesting date (by applying to a court or by the trustee exercising a power to nominate a new vesting date);
- it is too late to change the vesting date once it has passed (and the ATO says it is unlikely that a court would agree to do so); and
- continuing to administer a trust in a way that is inconsistent with the vesting terms can have significant tax consequences (eg potentially, CGT event E1, creation of a new trust).

Capital gains tax consequences of trust vesting

The draft ruling considers whether various CGT events may occur on vesting or after vesting, noting that the terms of the trust deed are particularly relevant. The ATO says the following:

- CGT event E1 (creation of a new trust) "need not happen merely because a trust has vested", as vesting does not, of itself, cause the trust to come to an end and settle property on the terms of a new trust.

However, E1 may occur if the parties to a trust relationship subsequently act in a manner that results in a new trust being created by declaration or settlement (see the example below).

- CGT event E5 (beneficiary becoming absolutely entitled) may occur if the vesting results in the takers becoming absolutely entitled as against the trustee to CGT assets of the trust.
- CGT event E7 (disposal to a beneficiary to end a capital interest) may happen on actual distribution of CGT assets to beneficiaries, but it will not occur to the extent that the beneficiaries are already absolutely entitled to the CGT assets as against the trustee.

Taxation of trust net income after the vesting date

The draft ruling notes that, in the income year of vesting, different beneficiaries may be presently entitled to trust income derived before and after the vesting date. For example, the trustee of a discretionary trust may, prior to vesting, exercise a discretion to appoint pre-vesting income among those entitled to benefit under the trust. By contrast, the takers, on vesting, will be presently entitled to post-vesting income (usually in proportion to their vested interests in the trust property). In this situation, the ATO will accept a "fair and reasonable" allocation of trust income into pre-vesting and post-vesting trust income.

The draft ruling also states that:

- in the income year after vesting, all of the trust income will flow to the takers on vesting according to their entitlements, so the trustee will not be assessed on any net income; and
- a post-vesting payment or other purported distribution by the trustee will be void if it is not consistent with the vested beneficiaries' fixed interests, and the deemed present entitlement rules in ss 101 and 95A(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) will not apply.

Example

A discretionary trust holding several rental properties had a vesting date of 30 September 2016.

On 1 June 2017, the trustee became aware that the vesting date had passed and, with the acquiescence of the takers on vesting, continued to manage the trust as if the trust had not vested.

On 29 June 2017, the trustee executed a deed of extension that purported to extend the trust's vesting date to 30 September 2057.

This subsequent execution of a deed of extension is void and ineffective to change a vesting date that has already passed. Any power of the trustee to extend the vesting date ceased on 30 September 2016.

If, once it is realised that the deed of extension is ineffective to change the trust's vesting date, all of the takers on vesting agree that the trust assets should continue to be held on a new trust on the same terms as the original trust, and this is effective to create such a new trust over the assets by declaration or settlement, CGT event E1 would happen in relation to trust assets.

Disclosure of business tax debt information to credit agencies

The Federal Government has released draft legislation and a draft legislative instrument that, if passed, will authorise the ATO to disclose businesses' tax debts to registered credit reporting bureaus (CRBs) where the businesses have not effectively engaged with the ATO to manage their debt.

The draft legislation intends to place tax debts on a similar footing as other debts, to encourage timely payment or engagement with the ATO for businesses that want to avoid having their debt information affect their creditworthiness. Disclosure to CRBs will only be permitted if the ATO has given the taxpayer at least 21 days' notice beforehand.

The draft legislative instrument specifies the following criteria for the type of taxpayer that can be subject to the new disclosure arrangements:

- registered on the ABR;
- has a tax debt, and at least $10,000 of the debt is overdue for more than 90 days;
- is not a deductible gift recipient, not-for-profit entity, government entity or complying superannuation entity;
- is not effectively engaging to manage the tax debt; and
- the ATO has taken reasonable steps to confirm that the Inspector-General of Taxation does not have an active complaint from the entity.

According to the draft legislative instrument, an entity is not effectively engaging to manage its tax debt unless any of the following conditions are met:

- it has entered into an arrangement with the ATO to pay the debt by instalments;

- it has objected against a taxation decision to which the tax debt relates;
- it has applied to the Administrative Appeals Tribunal for review or appealed to the Federal Court against a decision made by the Commissioner to which the tax debt relates.

The disclosure provisions will apply in relation to records and disclosures of information on or after the first 1 January, 1 April, 1 July, or 1 October to occur after the day the Bill receives assent (regardless of when the information was acquired).

Tax treatment of dividend equivalent payments under employee share schemes

The ATO has stated that a dividend equivalent payment made under an employee share scheme (ESS) is assessable to an employee as remuneration when they receive the payment in respect of services they provide as an employee, or where the payment has a sufficient connection with the recipient's employment (Determination TD 2017/26).

The term "dividend equivalent payment" refers to a cash payment made by a trustee of a trust to an employee participant of an ESS (who is also a beneficiary of the trust), where the payment is funded from dividends (or income from other sources) on which the trustee has been assessed in previous income years because no beneficiary of the trust was presently entitled to the income. See below for an example taken from the determination.

A trustee that makes such a dividend equivalent payment is required to withhold an amount from the payment (even though the trustee is not an employer of the employee who receives the payment).

The ATO regards the following factors as indicative of a dividend equivalent payment being for, or in respect of, services as an employee:

- it is agreed that the payment is consideration for services rendered by the employee;
- the payment arises from a contract, an arrangement or a plan established by the employer to enable or facilitate the delivery of employment benefits (eg ESS interests) to the employee;
- the employer is able to make the payment;
- the payment is conditional on the employee meeting individual or specific employment-related targets;
- the payment depends on the employee's continued employment with the employer and is forfeited on cessation of employment; or
- the payment is provided at the discretion of the employer or trustee (based on the employer's direction or recommendations).

However, the determination offers a safe harbour from such payments being treated as remuneration where *all* of the following conditions apply:

- the trustee is not an associate of the employer;
- the payment is made because the employee is a beneficiary of the trust;
- the trustee exercises its power under the trust deed to make the payment, independent of any direction or wishes of the employer;
- the payment is not made in relation to:
  - the employee's continued employment with the employer;
  - the employee meeting individual employment-related targets; or
  - termination, redundancy or retirement;
- the payment does not arise from a contractual agreement to which the employee and employer are party;
- the payment cannot be made by the employer, in lieu of the trustee making the payment; and
- the trustee was assessed on the dividends (or other trust income) that the payment is calculated on in the income year the dividends or other income were received.

Example

A Co is an Australian resident company that carries on a business.

A Co establishes a trust for the purpose of providing shares (ESS interests) under an ESS to eligible Australian resident employees.

A Co makes a contribution to the trustee of the trust so the trustee can purchase and hold shares in A Co under the terms of the trust deed, plan handbook and invitation to the employees (together ESS agreement).

Under the terms of the ESS agreement an eligible employee is a beneficiary of the trust and has an interest in the trust that is a right to acquire the shares being held by the trustee. This interest does not entitle the employee to any income generated by the shares over the course of the ESS until such time as the employee satisfies certain conditions set by A Co that are specific to the employee's performance and their continuous employment with A Co being three years (performance conditions).

Upon satisfying the performance conditions the employee is entitled to own the shares held by the trustee of the trust. In addition, the employee is entitled to receive from the trustee an amount reflecting the dividends (post-tax) the employee would have earned had the employee owned the shares from the day the employee received their interest in the trust. The trustee funds this payment from trust capital. According to the ESS agreement, this payment can be made by the trustee or the employer.

As the dividend equivalent payment will be made to the employee because the employee has satisfied certain performance conditions, these payments are made to the employee for, or in respect of, services provided by the employee (they are, in substance, a reward for performance). They are assessable to the employee under s 6-5 of the *Income Tax Assessment Act 1997*. While the quantum of the payment reflects a dividend equivalent that may have been received had the employee acquired the shares at the outset of the arrangement, this is merely a calculation mechanism and does not reflect the character of the payment in the recipient's hands. The character of the payment in the employee's hands is remuneration.

Before TD 2017/26 was issued, it had been industry practice to treat the employee as not being assessable on a dividend equivalent payment, on the basis that the trustee had borne the tax under s 99A of the *Income Tax Assessment Act 1936* (ITAA 1936). The ATO apparently considers that this practice was adopted on the basis of an inappropriate reliance on Class Ruling CR 2013/151. While noting that CR 2013/151 applied only to the entities specified in that ruling, the ATO has effectively conceded that TD 2017/26 constitutes a change in its view on the issue, and has allowed limited grandfathering in its application.

The determination applies to dividend equivalent payments paid under the terms and conditions attached to ESS interests granted on or after 1 January 2018. Where a taxpayer is granted an ESS interest before that date and the terms and conditions attached to the interest include eligibility to receive a dividend equivalent payment, the ATO's general administrative practice will be to treat such dividend equivalent payments as not assessable as ordinary or statutory income. This is conditional on the dividends or other income (that the dividend equivalent payment is calculated on) being assessed to the trustee under s 99A of ITAA 1936 in the income year when the dividends (or other income) were received.

Superannuation: progress on new integrity measures

The Government has released a consultation paper and exposure draft legislation to give effect to the following superannuation taxation integrity measures it announced in the 2017–2018 Federal Budget:

- the non-arm's length income (NALI) rules in s 295-550 of the *Income Tax Assessment Act 1997* (ITAA 1997) for related-party superannuation fund transactions will be expanded from 1 July 2018 to also include expenses not incurred that would normally be expected to apply in a commercial arm's length transaction (eg reduced interest expenses, brokerage, accountancy fees or legal costs); and
- a member's share of the outstanding balance of a limited recourse borrowing arrangement (LRBA) will be included in the member's "total superannuation balance" (TSB) for new LRBAs entered into on or after 1 July 2018.

The measures are designed to ensure that related-party transactions with super funds and LRBAs cannot be used to circumvent the reduced contribution caps operating from 1 July 2017. The changes should generally not affect LRBAs entered into with unrelated third parties for commercial rates of interest (and other expenses).

Non-arm's length income to include expenses not incurred

The current NALI rules address non-commercial arrangements that could potentially shift income from a related party to a super fund (where the amounts would be taxed concessionally). The new non-arm's length expense rules aim to prevent an increase in a fund's capital by not incurring arm's length expenses.

Under the proposed amendments to s 295-550 of ITAA 1997, non-arm's length expenses incurred by a superannuation fund in gaining or producing assessable income would result in such income being taxed as NALI, at the top marginal rate of 45%. This will be the case for expenses of a capital or revenue nature.

Example

A self managed super fund (an SMSF) acquired a commercial property from a third party at its market value of $1 million on 1 July 2015. The SMSF derives rental income of $1,500 per week ($78,000 per annum) from the property. The SMSF financed the purchase of the property under an LRBA from a related party on terms consistent with s 67A of the *Superannuation Industry (Supervision) Act 1993* (SIS Act).

The LRBA was entered into on terms that include no interest, no repayments until the end of the 25-year term and borrowing of the full purchase price of the commercial real property (ie 100% gearing). The SMSF was in a financial position to enter into an LRBA on commercial terms with an interest rate of approximately 5.8%.

The proposed amendments to s 295-550 of ITAA 1997 would make it clear that, as the SMSF has not incurred expenses that it might have been expected to incur in an arm's length dealing in deriving the rental income, that income will be NALI. The income (less deductions attributable to the income) will form part of the SMSF's non-arm's length component and would be taxed at 45%.

For the NALI rules to apply to non-arm's length expenses, there must also be a sufficient nexus between the expenses and the income. That is, the expenditure must have been incurred "in" gaining or producing the relevant income. The amendments are also likely to require some sort of determination as to the expenses that a fund "might have been expected to have incurred" if the parties had been dealing with each other at arm's length.

LRBAs to count towards total super balance

An individual's TSB is used to determine eligibility for various super concessions, including the $1.6 million balance cap for making non-concessional contributions, transfer balance account reporting (TBAR) and whether an SMSF can apply the segregated method.

The definition of "total superannuation balance" in s 307-230 of ITAA 1997 will be amended to take into account the outstanding balance of an LRBA entered into by an SMSF.

An individual member's TSB will be increased by the share of the outstanding balance of an LRBA related to the assets that support their superannuation interests. This proportion would be based on the individual's share of the total superannuation interests supported by the asset that is subject to the LRBA. This will ensure that SMSF members who have attained a condition of release cannot circumvent the caps by withdrawing lump sums and re-contributing the funds as a loan.

For an LRBA-related increase in the individual's TSB, the SMSF must have used the borrowing to acquire one or more assets, and any such assets must support the superannuation interests of an individual at the time at which the total superannuation balance is determined.

This asset–member interest connection is determined by considering the way the fund has allocated its assets to meet its current and future liabilities in relation to each member's interests. This test will require the SMSF trustee to determine which of its LRBA assets support which members' interests, as well as the extent to which those interests are supported.

The outstanding balance of an LRBA is the amount still owing under the LRBA. Where an individual has a superannuation interest that is supported by an asset that is subject to an LRBA, the increase to their TSB is based on their share of this outstanding balance.

Including the proportion of the outstanding balance in a member's TSB seeks to prevent double-counting of the outstanding balance from occurring where more than one member has an interest supported by an asset that was acquired through an LRBA. While an individual's TSB can generally be measured "at a time", it is generally only relevant at the end of a particular income year on 30 June.

Example

Laura is the sole member of her SMSF, which holds $2 million in accumulation phase. Laura takes a lump sum of $500,000 from the SMSF on 1 June 2019, which reduces her TSB as at 30 June 2019 to $1.5 million. On 30 June 2019, Laura lends the $500,000 on commercial terms back to her SMSF under an LRBA. The SMSF uses $1 million of its existing assets and the borrowed $500,000 to acquire a $1.5 million investment property.

Under the current law, Laura's TSB as at 30 June 2019 is $1.5 million, comprising the net value of the property of $1 million ($1.5 million purchase price less the $500,000 LRBA) as well as the other assets valued at $500,000. As her TSB is below $1.6 million, Laura can make further non-concessional contributions of up to $100,000 in the year ending 30 June 2020. As the SMSF repays the LRBA, the net value of the fund will increase and Laura's TSB will approach the $1.6 million threshold. However, just prior to reaching the $1.6 million threshold, she could withdraw another lump sum and enter into a new LRBA to

acquire another income-producing asset. This would reduce her TSB again, allowing more contributions to be made to the SMSF.

Under the changes proposed in the Draft Bill, Laura's TSB at 30 June 2019 will be $2 million, comprising the net value of the property of $1 million, the other assets valued at $500,000 and the $500,000 outstanding loan balance under the LRBA. As her TSB exceeds $1.6 million, Laura would not be able to make non-concessional contributions in the year ending 30 June 2020. Entering into a new LRBA arrangement with the SMSF would no longer increase Laura's capacity to make non-concessional contributions for that year. The trustee could continue to repay the LRBA but could not use non-concessional contributions to do so.

Guidance for self managed super funds on reporting transfer balance events

The ATO has released further guidance on when self managed superannuation funds (SMSFs) need to report events affecting their members' transfer balance accounts (by making a transfer balance account report, or TBAR) for the purposes of the $1.6 million pension cap.

Transfer balance account reporting timeframes

From 1 July 2018, SMSFs that have any members with a total superannuation balance (TSB) of $1 million or more must report events impacting that member's transfer balance account (TBA) within 28 days after the end of the quarter in which the event occurs.

SMSFs in which all the members have TSBs less than $1 million can choose to report events which impact their members' transfer balances at the same time that the fund lodges its annual return.

If an SMSF member was receiving a pre-existing income stream on 30 June 2017 (and it has continued in retirement phase on or after 1 July 2017), a TBAR must be lodged with the ATO by 1 July 2018. TBAR events that that occur during 2017–2018 should be reported at the same time the first TBAR form is due. That is, by:

- 28 October 2018 (for those reporting quarterly); or
- at the time the SMSF annual return is lodged (for those reporting annually where all of the SMSF members have total super balances less than $1 million).

Testing the $1 million threshold

The $1 million total threshold will be tested as at 30 June in the financial year before a fund's first TBAR becomes due. If an SMSF member was receiving a retirement phase superannuation income stream from the fund just before 1 July 2017, the members' TSB is measured at 30 June 2017.

If an SMSF member enters retirement phase for the first time after 1 July 2018, the ATO says that the SMSF will need to assess its position, in relation to the $1 million threshold, on 30 June immediately before the start of the relevant income stream. If the $1 million threshold is triggered at the first time an SMSF member starts an income stream, the SMSF will be locked into the quarterly TBAR reporting regime. A fund will not move between annual and quarterly TBAR reporting due to subsequent fluctuations to any of its members' balances.

It would appear that if one member of an SMSF has TSBs of $1 million or more across all their funds (not just the SMSF), all of the other SMSF members will be dragged into the into the quarterly TBAR reporting net.

Reporting events

Superannuation funds are required to report events for retirement phase income streams that result in a credit or debit in an individual's TBA. Common reportable events include:

- income streams that a member was receiving just before 1 July 2017 (and that continued to be paid on or after 1 July 2017 in the retirement phase);
- new retirement phase income streams (including death benefit income streams);
- commutations of retirement phase income streams (partially or fully); and
- converting a transition to retirement pension into a retirement phase superannuation income stream.

Events to be reported sooner

If a member exceeds their transfer balance cap of $1.6 million, they must report the following events sooner:

- commutations (in response to an excess transfer balance determination issued by the ATO to an SMSF member) must be reported 10 business days after the end of the month in which the commutation occurs; and

- commutation authorities – the response must be reported within 60 days of the date the commutation authority was issued.

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