

# client alert | explanatory memorandum

March 2006

## Salary Packaging Opportunities

### Superannuation

Assume an employee on the 48.5% marginal tax rate wishes make an investment using \$10,000 from gross salary.

If the investment were made as either an employee contribution to a superannuation fund or as a purchase of shares etc., the net amount invested would be \$5,150 (i.e.  $\$10,000 - \$10,000 \times 48.5\%$ ).

If the investment were made as an employer contribution to a superannuation fund by way of a salary sacrifice, the net amount invested would be \$8,500 after deduction of the 15% contributions tax (i.e.  $\$10,000 - \$10,000 \times 15\%$ ).

Therefore, salary sacrificing into superannuation immediately results in an additional \$3,350 invested, and the compounding effect of this over many years can obviously result in significant savings for the employee. Of course, there is also the issue of access to the funds to consider, as well as the tax effects in the superannuation fund and on exit from the fund. However, as a general rule, superannuation is taxed concessionally when compared to other investment options. This is now even more the case since the superannuation surcharge applicable to high income earners was abolished with effect from 1 July 2005.

An exception to the rule that salary sacrifice is the most effective way of making additional superannuation contributions applies to employees who qualify for the government co-contribution. In these cases, the employee should make an additional contribution of up to \$1,000 from after-tax income to obtain the government co-contribution and then only salary sacrifice for any further investments.

### Laptops, electronic diaries and personal digital assistants (PDAs)

Given that these benefits are exempt from tax, an employee on the highest marginal tax rate will save about half the cost of the item by salary packaging it. And don't forget the GST component, which does not form part of the salary sacrifice where the employer can claim an input tax credit.

The savings for an employee on a tax rate of 48.5% who purchases a \$3,300 laptop would be:

Gross salary used to purchase laptop without packaging	\$6,407
Gross salary used to purchase laptop via salary packaging	\$3,000
Saving — gross salary	\$3,407
Saving — after-tax salary	\$1,755

### Portable printers

Portable printers are included in this category as of 1 April 2006. However, if an employee has purchased a portable printer prior to this time, the cost may be reimbursed as part of a salary packaging arrangement after 1 April 2006 and still qualify for FBT exemption.

## Cars — novated leases

The following example shows the significant savings achievable via a novated car lease. It is important to note that many different factors affect this calculation and therefore, it is important to ‘run the numbers’ for each scenario before deciding whether packaging is a good idea. In general, a car worth around \$30,000 that does at least 15,000 kms per annum has a good chance of producing worthwhile savings via a novated lease.

### NOVATED LEASE

#### Assume:

Employee’s marginal tax rate	48.5%
Car capital value (incl. GST)	\$30,000
Annual lease payments (incl. GST)	\$7,000
Residual (incl. GST)	\$14,000
Annual running costs — paid by employee (incl. GST)	\$4,000
Additional after-tax employee contribution	\$2,000
Statutory fraction (based on kms travelled)	20%
Percentage business use	0%

#### Salary sacrifice:

Lease payments less GST	\$6,364
Luxury car salary sacrifice adjustment	\$0
Additional after-tax employee contribution	-\$2,000
FBT	\$0
Total salary sacrifice	<u>\$4,364</u>
Plus pre-tax cost of running costs and additional contribution	<u>\$11,650</u>
Total pre-tax salary used	<u><u>\$16,014</u></u>

#### Pre-tax salary used if don’t package — lease:

Lease payments	\$7,000
Running costs	\$4,000
Tax effect of deductions	\$0
Total	<u>\$11,000</u>
Gross-up to pre-tax equivalent	<u><u>\$21,359</u></u>

Each year, employee is better off from packaging by:

Pre-tax	\$5,345
After-tax	\$2,753

Over the lease term, employee is better off from packaging by:

Pre-tax	\$16,035
After-tax	\$8,258

**Note:**

1. Assumes only one marginal tax rate is relevant to the calculation, i.e. the salary sacrifice does not cause a drop to a lower tax bracket.

**Cars — associate leases**

Associate leases can provide an additional level of saving compared to a novated lease. Not only do they get the car into the FBT net, but they have an income-splitting effect where the associate (usually spouse) has a lower taxable income than the employee. This is shown in the example below.

Associate car leases are also very practical as they can be used for cars currently sitting in the employee's driveway. There is no need to go out and purchase a new car or find a financier. A new car obtained under finance can also be used. In fact, associate leases are appropriate in many different situations, even including where the employee may sell a car they currently own to a financier and lease it back before entering into the associate lease arrangement. This would free up funds that the employee may wish to use elsewhere.

The main issue is that the car must be held (owned or leased) in the associate's (spouse's) name before being leased to the employer. If the employee were to replace the associate in this arrangement there would be adverse tax consequences. In particular, the associate is entitled to claim running costs as a tax deduction; however, employees are specifically denied such deductions for cars provided as fringe benefits.

**ASSOCIATE LEASE**

**Assume:**

Employee's marginal tax rate	48.5%
Associate's marginal tax rate	16.5%
Car capital value (incl. GST)	\$30,000
Market lease to be paid to associate (excl. GST)	\$11,000
Any claim for depreciation by associate	\$3,750
Annual running costs — paid by associate (incl. GST)	\$4,000
Statutory fraction (based on kms travelled)	11%
Percentage business use	0%
Associate registered for GST (Y/N)	N

**Associate's income and expenses:**

Lease income	\$11,000
Holding costs for associate	\$0
Depreciation claim	-\$3,750
Running costs	-\$4,000
Taxable income	<u>\$3,250</u>
Tax at marginal rate	-\$536
Net income (adds back any depreciation)	<u><u>\$6,464</u></u>

**Salary sacrifice:**

Lease payments to associate (net of any GST)	\$11,000
Luxury car salary sacrifice adjustment	\$0
Additional after-tax employee contribution	\$0
FBT	\$0
Total salary sacrifice	<u><u>\$11,000</u></u>

**After-tax cost of car if package:**

Salary sacrifice	\$11,000
Less tax	-\$5,335
Plus additional after-tax employee contribution	\$0
Less associate net income	-\$6,464
Net after-tax cost	<u><u>-\$799</u></u>

**After-tax cost of car if don't package:**

Lease payments/holding costs	\$0
Running costs	\$4,000
Tax effect of deductions (assumes above costs deductible)	\$0
Total	<u><u>\$4,000</u></u>

**Employee is better off from packaging by:**

<b>After-tax</b>	<u><u><b>\$4,799</b></u></u>
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**Notes:**

1. Some running costs may not include GST, but the calculations assume they all do.
2. The employee's deductions for business use where not packaging may be claimed using different methods.
3. A GST input tax credit will be available on the purchase of a new vehicle to registered associates.
4. Eligibility for the spouse rebate may be affected.
5. Assumes only one marginal tax rate applies, for each of the employee and associate, i.e. there is no change in tax bracket.
6. There is no FBT due to the running costs being paid as a recipient's contribution.

## **Sale subject to Anti-avoidance**

For further information, please refer to *Cummins v. FCT* [2006] FCA 43 (Federal Court, Nicholson J, 6 February 2006):

[www.austlii.edu.au/au/cases/cth/federal\\_ct/2006/43.html](http://www.austlii.edu.au/au/cases/cth/federal_ct/2006/43.html)

## **GST and Residential Renovations**

The Tax Office recently released GSTA TPP 068 and GSTA TPP 069 on whether certain additions to houses constitute ‘substantial renovations’ making the premises ‘new residential premises’ for the purposes of the GST law.

Under section 40–65 of the GST Act, a sale of real property is input taxed, but only to the extent that it is residential premises to be used predominantly for residential accommodation. However, the sale is not input taxed to the extent that the residential premises are commercial residential premises or new residential premises (other than those used for residential accommodation before 2 December 1998).

### **New residential premises**

Defined in section 40–75 of the GST Act, new residential premises:

- have not previously been sold as residential premises and have not previously been the subject of a long-term lease; or
- have been created through substantial renovations of a building; or
- have been built, or contain a building that has been built, to replace demolished premises on the same land.

### **Substantial renovations**

The term ‘substantial renovations’ is defined in section 195–1 as renovations in which all, or substantially all, of a building is removed or replaced. However, substantial renovations need not involve the removal or replacement of foundations, external walls, interior supporting walls, floors, roof or staircases.

In GSTR 2003/3, the Tax Office provides a detailed explanation of the criteria that need to be satisfied for renovations to be considered ‘substantial’. Importantly, the renovations must affect the building as a whole and result in the removal or replacement of all, or substantially all, of the building.

The Tax Office considers that a substantial part of a building has been removed or replaced where there is a removal or replacement of a substantial part of the structural components of a building, such as:

- altering or replacing foundations;
- replacing, removing or altering floors or supporting walls, or parts thereof (interior or exterior);
- lifting or modifying a roof; or
- replacing existing windows and doors when it is necessary to alter brickwork.

However, it can also include non-structural building work such as:

- replacing electrical wiring;
- replacing, removing or altering non-supporting walls, or parts thereof (interior or exterior);
- plastering or rendering an entire wall or walls;
- plumbing (e.g. replacing old metal pipes with copper pipes or plastic pipes);
- removing or replacing kitchen cupboards, bathroom fixtures, etc.; or
- removing or replacing airconditioning or security systems.

***GSTA TPP 068: Would the addition of a second storey to a single storey house constitute ‘substantial renovations’ so as to make the premises ‘new residential premises’?***

In GST Advice GSTA TPP 068, the Tax Office considers whether or not the addition of a second storey to a single storey house by removing the entire roof, adding another storey (without replacing existing ceilings) and converting an existing room into a staircase, constitutes substantial renovations for GST purposes.

The Tax Office’s advice is that the addition of the second storey does not constitute ‘substantial renovations’, because it does not involve the substantial removal or replacement of a building. Hence, such premises are not ‘new residential premises’ and their sale would be an input taxed supply of residential premises.

***GSTA TPP 069: Would the addition of four rooms onto the end of a six-room house constitute ‘substantial renovations’ so as to make the premises ‘new residential premises’?***

In GST Advice GSTA TPP 069, the Tax Office considers whether or not the addition of four rooms onto the end of a six-room house by removing the end wall of one existing room (to open it up to the four new rooms) constitutes substantial renovations for GST purposes.

The Tax Office’s advice is that the addition of the four new rooms does not constitute ‘substantial renovations’ as the existing rooms in the building remain predominantly unchanged. Hence, these premises are also not ‘new residential premises’ and their sale would be an input taxed supply of residential premises.

For further information, please view:

GSTA TPP 068 Goods and services tax: Would the addition of a second storey to a single storey house constitute ‘substantial renovations’ so as to make the premises ‘new residential premises’?, at:

<http://law.ato.gov.au/atolaw/view.htm?docid=GSA/GSTA068/NAT/ATO/00001>

GSTA TPP 069 Goods and services tax: Would the addition of four rooms onto the end of a six-room house constitute ‘substantial renovations’ so as to make the premises ‘new residential premises’?, at:

<http://law.ato.gov.au/atolaw/view.htm?docid=GSA/GSTA069/NAT/ATO/00001>

GSTR 2003/3 Goods and services tax: When is a sale of real property a sale of new residential premises?, at:

<http://law.ato.gov.au/atolaw/view.htm?rank=find&criteria=AND~GSTR~basic~exact:::AND~2003%2F3~basic~exact&target=ED&style=java&sdocid=GST/GSTR20033/NAT/ATO/00001&recStart=1&recnum=3&tot=8&pn=ALL:::ED>



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