client alert | explanatory memorandum

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CURRENCY:

This issue of **Client Alert** takes into account developments up to and including 12 October 2016.

Budget superannuation changes on the way

The Federal Government has been releasing exposure draft legislation intended to give effect to most of its 2016–2017 Budget superannuation proposals. The first and second tranches of exposure drafts were released for public consultation in September, with submissions due by 16 September 2016 for the first tranche and by 10 October 2016 for the second tranche.

First tranche of draft legislation

On 7 September 2016, the Federal Government released its first tranche of exposure draft legislation. This draft legislation includes:

- *Exposure Draft: Superannuation (Objective) Bill 2016*, https://consult.treasury.gov.au/retirement-income-policy-division/superannuation-reform-package/supporting_documents/Exposure_Draft_Superannuation_Objective_Bill.pdf;
- *Exposure Draft: Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016*, https://consult.treasury.gov.au/retirement-income-policy-division/superannuation-reform-package/supporting_documents/Exposure_Draft_Omnibus_Superannuation_Bill_Tranche_1.pdf; and
- *Exposure Draft: Treasury Laws Amendment (Fair and Sustainable Superannuation) Regulation 2016*, https://consult.treasury.gov.au/retirement-income-policy-division/superannuation-reform-package/supporting_documents/Exposure_Draft_Superannuation_Amending_Regulation.pdf.

The draft legislation proposes to amend the *Income Tax Assessment Act 1997* (ITAA 1997) and *Superannuation Industry (Supervision) Regulations 1994* (SIS Regs) to implement the following Budget measures:

- **Objective of superannuation:** to be enshrined in stand-alone legislation. Namely, "to provide income in retirement to substitute or supplement the age pension". According to the Government, enshrining the primary objective of the superannuation system in legislation, in combination with the subsidiary objectives, will provide a framework against which future superannuation policy proposals can be assessed.
- **Deducting personal contributions:** all individuals up to age 75 would be able to deduct personal superannuation contributions, regardless of their employment circumstances. This would be achieved by repealing the existing 10% test in s 290-160 of ITAA 1997, which requires that an individual earn less than 10% of their income from their employment-related activities in order to be able to deduct a personal superannuation contribution. Of course, such deductible contributions would still effectively be limited by the concessional contributions cap of $25,000 proposed from 1 July 2017.
- **Work test:** the work test for making contributions between the ages 65 and 74 would be removed from reg 7.04 of the SIS Regs. Consequential amendments would also amend the "Attaining age 65" condition of release in Sch 1 to the SIS Regs, allowing the release of amounts held in superannuation at any time after a member attains the age of 65. However, see also *Revisions to super reforms* in this issue of Client Alert.
- **Spouse contributions tax offset:** the low income threshold would be increased to $37,000 (phasing out up to $40,000) for a tax offset (up to $540). Proposed changes to s 290-230(4A) of ITAA 1997 would also mean taxpayers would not be entitled to a tax offset when making contributions for a spouse whose non-concessional contributions exceed the non-concessional contribution cap in the corresponding financial year.
- **Low income superannuation tax offset:** this would replace the government low income superannuation contributions. The tax offset (up to $500) would apply to concessional contributions for those with adjusted taxable income up to $37,000.

Date of effect

This draft legislation would generally come into effect on 1 July 2017.

Source: Treasury, Superannuation reform package, 7 September 2016, https://consult.treasury.gov.au/retirement-income-policy-division/superannuation-reform-package.

Revisions to super reforms

On 15 September 2016, the Federal Government announced that it will not proceed with its 2016–2017 Budget proposal for a $500,000 lifetime cap on non-concessional superannuation contributions (backdated for contributions since 1 July 2007). Instead, the Government has proposed a non-concessional contributions cap of $100,000 per annum (down from the current $180,000 cap). Individuals under age 65 would still be able to use the three-year "bring forward" rule for non-concessional contributions (ie to make $300,000 of contributions over a three-year period).

Individuals with a superannuation balance of more than $1.6 million will no longer be eligible to make non-concessional (after tax) contributions from 1 July 2017. This limit will be tied and indexed to the proposed $1.6 million transfer balance cap for retirement accounts (ie pension phase). This $1.6 million eligibility threshold will be based on the individual's superannuation balance as at 30 June the previous year. According to the Government, individuals will be able to contribute a total of $125,000 per year – that is, $25,000 of concessional contributions plus $100,000 of non-concessional contributions – until they reach $1.6 million. If a taxpayer takes advantage of the "bring forward" rule, total contributions of $325,000 could be made in any one year, the Treasurer said.

In addition, as part of the Coalition's compromise on its superannuation package, it will not proceed with the Budget proposal to remove the work test for making contributions between ages 65 and 74. As such, people aged 64 to 75 will still need to satisfy the work test (ie undertake gainful employment for at least 40 hours in a 30-day period in the financial year) to make voluntary superannuation contributions. The Government also announced that the start date for the proposal to allow catch-up concessional contributions for superannuation balance less than $500,000 would be delayed to 1 July 2018 (instead of 1 July 2017).

Further details and fact sheets are available on the Treasury website at www.treasury.gov.au/Policy-Topics/SuperannuationAndRetirement/Superannuation-Reforms.

Source: Treasurer and Minister for Revenue, joint media release, 15 September 2016, http://sjm.ministers.treasury.gov.au/media-release/096-2016/.

Second tranche of draft legislation

On 27 September 2016, the Federal Government released the second tranche of its exposure draft legislation proposing to give effect to some of its 2016–2017 Budget superannuation proposals. Tranche two includes:

- *Exposure Draft: Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016*, https://consult.treasury.gov.au/retirement-income-policy-division/super-reform-package-tranche-2/supporting_documents/Treasury%20Laws%20Amendment%20Fair%20and%20Sustainable%20Superannuation%20Bill%202016.pdf;
- *Exposure Draft: Superannuation (Excess Transfer Balance Tax) Imposition Bill 2016*, https://consult.treasury.gov.au/retirement-income-policy-division/super-reform-package-tranche-2/supporting_documents/Superannuation%20Excess%20Transfer%20Balance%20Tax%20Imposition%20Bill%202016.pdf; and
- *Exposure Draft: Treasury Laws Amendment (Fair and Sustainable Superannuation) Regulation 2016*, https://consult.treasury.gov.au/retirement-income-policy-division/super-reform-package-tranche-2/supporting_documents/Treasury%20Laws%20Amendment%20Fair%20and%20Sustainable%20Superannuation%20Regulation%202016.pdf.

The draft legislation proposes to amend ITAA 1997, the *Taxation Administration Act 1953* (TAA), the *Superannuation Industry (Supervision) Act 1993* (SIS Act), the SIS Regs and related legislation to implement the following budget measures:

- **Pension $1.6 million transfer balance cap:** the total amount of accumulated superannuation an individual can transfer into retirement phase (where earnings on assets are tax-exempt) would be capped at $1.6 million from 1 July 2017. Those with pension balances over $1.6 million at 1 July 2017 would be required to "roll back" the excess amount to accumulation phase by 1 July 2017 (where it would be subject to 15% tax on future earnings).
- **Concessional contributions cap:** to be reduced to $25,000 for all individuals (regardless of age) from 1 July 2017. The concessional cap would be indexed in increments of $2,500 (down from $5,000). Contributions to constitutionally protected funds and untaxed or unfunded defined benefit superannuation funds would count towards an individual's concessional contributions cap. However, any

excess concessional contributions in respect of such funds would not be subject to tax, but instead limit an individual's ability to make further concessional contributions.

- **Division 293 contributions tax:** the income threshold above which the additional 15% Division 293 tax cuts in for concessional contributions would be reduced from $300,000 to $250,000 from 1 July 2017. The notification requirements for Division 293 tax debt accounts in relation to defined benefit interests would also be simplified.
- **Catch-up concessional contributions:** individuals with total superannuation balances less than $500,000 would be allowed to make additional catch-up concessional contributions for unused cap amounts for the previous years. Unused cap amounts would be carried forward on a five-year rolling basis (starting from 1 July 2018). The draft legislation introduces the new concept of a "total superannuation balance" to ensure consistent treatment for the valuation of an individual's total superannuation balance across various 2016–2017 Budget measures, including the $500,000 superannuation balance threshold.
- **Transition to retirement income streams:** the tax exemption on earnings for pension assets supporting transition to retirement income streams (TRIS) would be removed from 1 July 2017 (irrespective of when the pension commenced). As a result, earnings from assets supporting a TRIS would be taxed at 15% (instead of the current 0%). In addition, reg 995-1.03 of the *Income Tax Assessment Regulations 1997* (ITA Regs) would be repealed so that individuals can no longer make an election to treat certain TRIS payments as lump sums for tax purposes.
- **Retirement income products:** a new category of tax-exempt pensions rules is proposed to remove tax barriers to the development of new retirement income products. The earnings tax exemption would be extended to cover a "deferred superannuation income stream" (which would include guaranteed annuities and group self-annuities).
- **Anti-detriment deduction:** s 295-485 of ITAA 1997 would be repealed so that complying superannuation funds will no longer be entitled to an anti-detriment deduction for paying certain lump sum death benefits to the spouse, former spouse or child of the deceased member.

Date of effect

This draft legislation would generally come into effect on 1 July 2017 (except for the catch-up provisions for concessional contributions, which would apply from 1 July 2018).

Source: Treasury, Superannuation reform package – tranche two, 27 September 2016, https://consult.treasury.gov.au/retirement-income-policy-division/super-reform-package-tranche-2.

More draft legislation to come

Exposure draft legislation for the changes to the non-concessional caps (ie tranche three) "will be released in the coming weeks". The Treasurer said the Government remains on track to have its budget superannuation measures introduced into Parliament before the end of 2016. With the support of the Senate, there will be no impediment to this occurring, Mr Morrison said.

Source: Treasurer and Minister for Revenue, joint media release, 27 September 2016, http://sjm.ministers.treasury.gov.au/media-release/105-2016.

Primary producer income tax averaging

The *Tax and Superannuation Laws Amendment (2016 Measures No 2) Bill 2016* has been introduced in the House of Representatives. The Bill proposes to amend ITAA 1997 to allow primary producers to access income-tax averaging 10 income years after choosing to opt out, instead of that opt-out choice being permanent.

If a primary producer wants to opt out again, they may still do so, but that choice to opt out is effective for 10 income years. After the 10-year opt-out period has ended, primary producers are effectively treated as new primary producers in applying the basic conditions.

The averaging adjustment applies again to a taxpayer's assessment where the following conditions are satisfied:

- income-tax averaging has not applied to the taxpayer because they permanently opted out 10 or more income years ago;
- the taxpayer has been carrying on a primary production business for two income years in a row; and
- their basic taxable income in the first year (after the 10-year opt-out period has passed) is less than or equal to their basic taxable income in the following year.

If these basic conditions are not met, an averaging adjustment will not be made until they are met in a later income year.

This change would apply to the 2016–2017 income year and later income years.

Other amendments

The Bill also proposes the following amendments.

Remedial power for Commissioner

The Bill proposes to amend Sch 1 to the TAA by inserting a new Div 370 to establish a remedial power for the Commissioner of Taxation. This is intended to allow for more timely resolution of certain unforeseen or unintended outcomes in the taxation and superannuation laws. The power would allow the Commissioner to make, by disallowable legislative instrument, one or more modifications to the operation of a taxation law to ensure the law can be administered to achieve its intended purpose or object. This measure would commence on the day after Royal Assent, and would allow the Commissioner to make legislative instruments from that date to modify the operation of a taxation law.

Luxury car tax relief: cars for display

The Bill would amend the *A New Tax System (Luxury Car Tax) Act 1999* to provide relief from luxury car tax (LCT) to certain public institutions that import or acquire luxury cars for the sole purpose of public display. The changes would apply to public museums, galleries and libraries that are registered for GST and that have been endorsed as deductible gift recipients (DGRs). The amendments would apply for luxury cars that are imported or acquired from the day after the Bill receives Royal Assent.

Source: Tax and Superannuation Laws Amendment (2016 Measures No 2) Bill 2016, still before the House of Representatives at the time of publication, *http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;page=0;query=BillId%3Ar5685%20Recstruct%3Abillhome.*

Research and development tax incentive rate changes

The *Budget Savings (Omnibus) Bill 2016* received Royal Assent on 16 September 2016 as Act No 55 of 2016. The Act reduces the rates of the tax offset available under the research and development (R&D) tax incentive for the first $100 million of eligible expenditure by 1.5%. The higher (refundable) rate of the tax offset will be reduced from 45% to 43.5% and the lower (non-refundable) rates of the tax offset will be reduced from 40% to 38.5%. The changes apply from 1 July 2016.

The R&D tax incentive aims to boost competitiveness and improve productivity across the Australian economy by:

- encouraging industry to conduct R&D that may not otherwise have been conducted;
- improving the incentive for smaller firms to undertake R&D; and
- providing businesses with more predictable, less complex support.

The ATO and AusIndustry (on behalf of Innovation Australia) jointly administer the R&D tax incentive. Claimants' R&D activities must be registered with AusIndustry before the tax offset is claimed, and the ATO determines if the expenditure claimed for R&D activities in the taxpayer's tax return is eligible for the tax offset.

Other amendments in the Bill

The Bill also implements measures announced in the 2016–2017 Federal Budget and earlier budget updates, including:

- single touch payroll (STP) reporting for substantial employers (those with 20 or more employees) to automatically provide payroll and superannuation information to the Commissioner of Taxation at the time it is created;
- changed fringe benefits treatment under the income tests for family assistance and youth income support payments and for other related purposes;
- pension means testing for aged care residents;
- other family tax benefit (FTB) and welfare changes.

The Bill had previously been passed by the House of Representatives with 19 government amendments that:

- add a new schedule which provides an income limit of $80,000 on payment of the FTB Part A supplement. If an individual's adjusted taxable income (which includes the adjusted taxable income of their partner if any) is more than $80,000 for the relevant income year, then the individual's FTB Part A supplement in relation to that year will be nil;
- remove proposed amendments that would have stopped relevant social security payments to individuals undergoing psychiatric confinement because of serious offences;
- remove the Energy Supplement only for new recipients of FTB Part A, FTB Part B and the Commonwealth Seniors Health Card;

- restore funding to the Australian Renewable Energy Agency (ARENA) of $800 million over five years to 2021–2022; and
- remove proposed amendments to create a Child and Adult Public Dental Scheme.

Source: Budget Savings (Omnibus) Bill 2016, http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;page=0;query=BillId%3Ar5707%20Recstruct%3Abillhome.

SMSF related-party borrowing arrangements

The ATO has issued Taxation Determination TD 2016/16, which sets out the Commissioner's views on when it would be reasonable to conclude that a trustee of a self managed superannuation fund (SMSF) would enter into a "hypothetical" limited recourse borrowing arrangement (LRBA) with a related party on arm's length terms for the purposes of s 295-550 of ITAA 1997.

Non-arm's length income

Where the parties to a LRBA are not at arm's length, the ordinary and statutory income of the SMSF generated from the LRBA asset will be taxed at 47%, as non-arm's length income (NALI), if the income derived by the SMSF under the scheme is more than the amount it might have been expected to derive if the parties had been dealing with each other at arm's length: s 295-550(1) of ITAA 1997.

To determine whether the NALI provisions apply, the ATO says it is necessary to identify both the steps of the relevant scheme and the parties. Section 295-550(1)(b) of ITAA 1997 then requires a determination of the amount of income that the SMSF "might have been expected to derive" if the same parties to the scheme had been dealing with each other on an arm's length basis under each identified step of the scheme.

Hypothetical borrowing arrangement

According to the ATO, it is necessary to identify what the terms of the "hypothetical borrowing arrangement" may have been if the parties were dealing with each other at arm's length. Where it is reasonable to conclude that the SMSF could not have, or would not have, entered into the hypothetical borrowing arrangement, the ATO says the SMSF will have derived more income under the scheme than it might have been expected to derive under the scheme with the hypothetical borrowing arrangement. In this instance, the income derived under the scheme is NALI (taxable at 47%).

Arm's length terms

The ATO says it is necessary to identify what the terms of the borrowing arrangement would have been if those same parties had been acting on an arm's length basis under a hypothetical borrowing arrangement in respect of the same steps of the scheme, without introducing any new steps or parties to the scheme. The terms of the borrowing arrangement to be considered include (but are not limited to):

- the interest rate;
- whether the interest rate is fixed or variable;
- the term of the loan; and
- the loan to market value ratio (LVR).

Consideration is then required as to whether it is objectively reasonable to expect that the SMSF trustee could have and would have entered into the hypothetical borrowing arrangement on those terms. While the "safe harbours" in Practical Compliance Guideline PCG 2016/5 (see also *ATO "safe harbours": PCG 2016/5 updated* in this issue of Client Alert) may be applied to determine what the arm's length terms of the borrowing arrangement would be, the ATO notes it is not mandatory to use the safe harbours if the SMSF trustee can otherwise demonstrate what the arm's length terms would have been.

Relevant factors in considering whether an SMSF trustee could have and would have acquired the asset under the hypothetical borrowing arrangement include:

- the terms of the SMSF trust deed (eg any impediment to the SMSF acquiring the asset);
- whether the SMSF has sufficient capital, liquidity and cash flow to complete the purchase, subject to the arm's length borrowing limits;
- the SMSF's ability to service the arm's length terms;
- any legislative impediments that might prevent the SMSF from acquiring the asset (eg s 52B of the SIS Act);
- the SMSF's investment strategy;
- the optimal use of the SMSF's money; and
- whether the asset acquired would be "earnings accretive".

Example

TD 2016/16 includes an example of a related-party LRBA to acquire commercial property. The Commissioner's approach essentially involves comparing the terms of the particular related-party LRBA with the ATO's hypothetical borrowing arrangement.

Based upon the facts of the example ($1 million borrowing; 100% LVR; 0% interest rate; 25-year term; $0 monthly repayments), the ATO concluded that it was clear that the SMSF could not and would not have entered into the arm's length hypothetical borrowing arrangement. The ATO essentially reached this conclusion based upon the particular facts that:

- the SMSF did not have sufficient funds available to reduce the level of borrowings to finance the purchase to a level that satisfies the maximum LVR of 70% (under the safe harbour rules in PCG 2016/5); and
- the hypothetical borrowing arrangement, taking into account the weekly rental and any future capital gains, would not be "earnings accretive".

After concluding that the SMSF could not have, and would not have, acquired the commercial real property under the hypothetical borrowing arrangement, the ATO said that the income that the SMSF would be expected to derive from the scheme if the parties were dealing with each other at arm's length was "nil". According to the Commissioner, if the parties were dealing with each other at arm's length in relation to the scheme, the investment in the commercial real property would not occur, as no arm's length LRBA could have been entered into. Therefore, the ATO considered the $1,000 per week rental income the SMSF received under the LRBA as NALI (taxable at 47%).

Date of effect

The determination applies both before and after its date of issue.

Source: ATO, Taxation Determination TD 2016/16, 28 September 2016, https://www.ato.gov.au/law/view/pdf/pbr/td2016-016.pdf.

ATO "safe harbours": PCG 2016/5 updated

On 28 September 2016, the ATO also released an updated version of Practical Compliance Guideline PCG 2016/5, which sets out the Commissioner's "safe harbour" terms for LRBAs. The guideline has been amended to incorporate references to TD 2016/16 and the withdrawal of ATO ID 2015/27 and ATO ID 2015/28. If an LRBA is structured in accordance with PCG 2016/5, the ATO will accept that the LRBA is consistent with an arm's length dealing and the NALI provisions (47% tax) will not apply. Trustees who do not meet the ATO safe harbour terms will need to otherwise demonstrate that their LRBA was entered into and maintained consistent with arm's length terms (ie in accordance with TD 2016/16).

PCG 2016/5 has also been updated to reflect the previously announced extension of the ATO grace period to 31 January 2017 (from 30 June 2016) for an SMSF to restructure its LRBA on terms consistent with the ATO's safe harbour terms (or to bring the LRBA to an end before that date).

Source: ATO, Practical Compliance Guideline PCG 2016/5, 28 September 2016, https://www.ato.gov.au/law/view/view.htm?docid=%22COG%2FPCG20165%2FNAT%2FATO%2F00001%22.

ATO IDs withdrawn

The ATO has also withdrawn the following ATO IDs from 28 September 2016, as the issues are now covered in TD 2016/16:

- ATO ID 2015/27: *Non-arm's length income – related party non-commercial LRBA to acquire listed shares,* https://www.ato.gov.au/law/view/view.htm?docid=%22AID%2FAID201527%2F00001%22; and
- ATO ID 2015/28: *Non-arm's length income – related party non-commercial LRBA to acquire real property*, https://www.ato.gov.au/law/view/view.htm?docid=%22AID%2FAID201528%2F00001%22.

Travel expense and transport of bulky tools claim denied

The Administrative Appeals Tribunal (AAT) has affirmed the Commissioner's decision to refuse a taxpayer's deduction claim for certain work-related travel expenses.

Background

During the relevant year, the taxpayer worked as a first-class "sheet metal worker" and he was required to drive to the Alcoa Alumina Refinery at Wagerup WA, which was located 57.5 kms from his home, on a daily basis. He was also required to drive to the Alcoa Alumina Refinery at Oakley WA (near Pinjara), which was located 20.5 kms from his home, on one occasion.

The taxpayer drove his own vehicle and he was paid, according to payslips, a “travel allowance” and “overtime meal allowance” by his employer. For his 2012 income tax return, the taxpayer disclosed a taxable income of $102,277 after claiming various deductions for work-related travel, work-related clothing expenses, other work-related expenses, donations and the cost of managing his tax affairs, totalling $18,331. The Commissioner allowed the taxpayer’s claim for union fees, donations, the cost of managing his tax affairs, tools and overtime meals, but refused the other claims, thereby increasing the taxpayer’s taxable income to $118,756. The Commissioner also imposed 50% shortfall penalty for “recklessness”, totalling $3,255.

Before the AAT, the taxpayer conceded claims for overtime meals, work socks, work clothing, sun protection and mobile phone expenses. The Commissioner also conceded the claim for laundry expenses and that the penalty should be remitted in full. Therefore, the only issue before the AAT was whether the taxpayer was entitled to a deduction for work-related travel expenses. It was not in dispute between the parties that if the AAT allowed the deduction, the maximum deduction available was $5,444, and not $14,901 as previously claimed by the taxpayer.

The taxpayer argued that he was required by his employer to provide his own tools, that the tools were too bulky or awkward to be transported to work other than by car, and that the fact the occupation’s enterprise agreement provides reimbursement for tools stored at work that are lost during breaking and entering gave “rise to the doubt that the employer fully believed in their security”. Accordingly, a key issue was whether the employer provided a “secure” storage locker, which was a question of fact.

Decision

The AAT refused the taxpayer’s claim, finding the travel was private in nature. It found the taxpayer was not required by his employer to carry his bulky tools and equipment from home to work. In this regard, the AAT noted the ATO had contacted the taxpayer’s employer to verify details. It further noted the taxpayer’s own admission, that it was his own personal choice to transport his tools (various hand tools) out of security concerns, which the AAT said was “not supported by objective evidence”. Accordingly, the AAT affirmed the Commissioner’s decision, but allowed for the laundry expenses and remission of penalties in full as conceded by the Commissioner.

Re Reany and FCT [2016] AATA 672*, www.austlii.edu.au/au/cases/cth/AATA/2016/672.html.*