

Coughlins Monthly Client Newsletter May 2015

The undercover employee

The Tax Office's ongoing compliance efforts have some constant focus. One of these is the often flawed characterisation of an employee as a contractor by businesses.

The mischief from the Tax Office's point of view is the avoidance of employer obligations relating to the Superannuation Guarantee (SG) and Pay As You Go (PAYG) withholding.

Characterisation is fraught with elements of complexity. This is because of the differing definitions for tax and for superannuation purposes and the consequences which may follow if an incorrect classification is made.

For instance, entitlement to annual leave, sick leave and other benefits may arise. An employer's liability to work cover and payroll tax in various states are also driven by this characterisation.

Notwithstanding these other issues, the actual employee/contractor characterisation relevant to PAYG and superannuation obligations are essential issues every business needs to be familiar with.

One staff member, two possibilities

The ordinary meaning of the word "employee" has been refined through a body of case law.

The distinction between an employee and a contractor can be encapsulated by the nature of the relationship these parties have to the organisation engaging them. Such a relationship may be categorized in one of two ways:

Employer/Employee: The first category is that an *employment* relationship is described as a "master and servant" type relationship where the parties enter into a contract *of* services. In other words, the employee serves the employer.

Principal/Contractor: The second category is that a *contracting* relationship and is a contract *for* service, which basically means that two businesses enter into a contractual arrangement to achieve a given result.

The activities of the relevant entity providing the services should first be analysed to determine whether they are an "employee" at general law. The factors that indicate whether there is an "employer/employee" or "principal/contractor" relationship are summarised in the table below.

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Factors in characterising an 'employee'		
FACTOR	WHEN INDICATION MAY LEAD TO	
	Employee characterisation	Other characterisation
Control over work (Predominant test)	does not control the way the work is done	does control the way the work is done
The ability to sub-contract/ delegate work	Where the taxpayer does not have this ability	Where the taxpayer has this ability
Basis of payment	Set amount per period OR price per item/activity	Quoted price for an agreed or pre-determined result
Equipment, tools or other assets	Not required to provide these items	Required to provide these items
Commercial risk	Does not assume commercial risk	Does assume commercial risk
Independence	Individual does not operate independently	Individual does operate independently

It is important to note that no single factor described in the table will be conclusive in determining whether the entity is an employee or contractor at general law. This determination is made by examining the whole working arrangement including the contractual relationship between the parties and the specific terms and conditions under which the work is performed.

In addition to the general law meaning of employee, the obligation to pay SG is extended to contractors where the contract is either entirely for the labour of a person or this is the main reason for the contract. Thus the terms of a contract as well as all the facts surrounding a particular relationship are important in establishing whether there is an SG obligation.

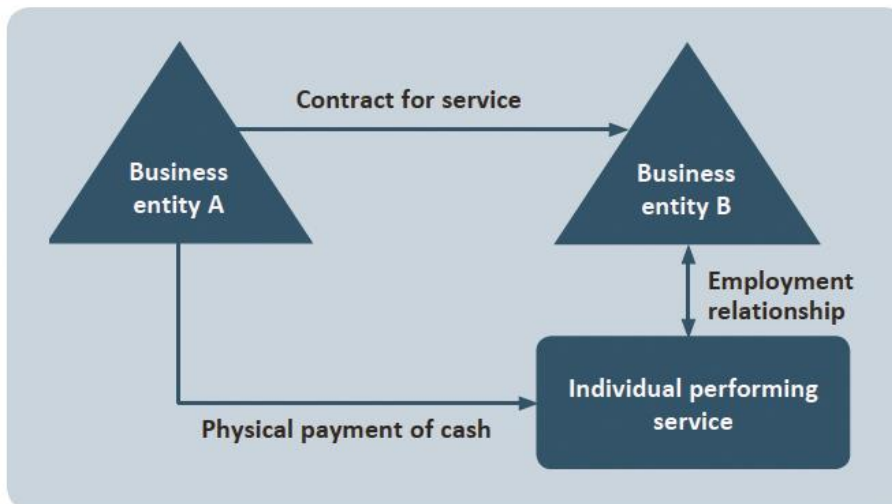
Look at the arrangement: Substance over form!

It is necessary to consider the formal contractual arrangement in light of each party's actions and the substance of the relationship between the parties.

A business taxpayer cannot simply require that services providers with whom they contract have an Australian business number (ABN). The test is more stringent than that.

Further, a business taxpayer is likely to have PAYG and SG obligations in situations where payments for services provided are made to the individual who did the work instead of the business entity which is the counterparty to the formal contract. This individual is typically an employee of the business entity. To illustrate this point refer to the figure below.

Liability for PAYG withholding and Superannuation Guarantee



The liability for SG and PAYG withholding in the illustrated case would be with “Business entity B” but for PAYG withholding purposes, because “Business entity A” is making the physical payment to the individual, it is the one liable.

PAYG withholding and SG represent significant costs of doing business in Australia. The importance of how a working relationship is characterised should not be ignored.

The taxation of employment termination payments

An employment termination payment (ETP) is generally a lump sum amount paid to an employee upon termination of their employment. Depending on the type of ETP, the employee’s age and years of service, the amount may be taxed in a number of different ways. An ETP may comprise of a tax-free portion, concessional tax portion and taxed portion.

In order for an ETP to be eligible for certain concessions, the employer must make a payment to the employee within 12 months of termination. Otherwise, the entire amount will be included in the employee’s assessable income and taxed at marginal rates.

ETPs can include the following types of transactions:

- a gratuity or “golden handshake”
- payment in lieu of notice
- compensation for loss of job
- compensation for wrongful dismissal
- payments for genuine redundancy or under an early retirement scheme
- unused rostered days off, or
- unused sick leave.

The extent of any concessional treatment will depend on the nature of the ETP paid – see below for discussion.

A common mistake employers make is including other payments made on or around the employee’s termination as components of the ETP. These include:

- payments for unused annual leave or leave loading
- payments for unused long service leave

- salary, wages, allowances, bonuses and incentives the employer owes the employee for work done or leave already taken
- compensation for personal injury
- payment for a restraint of trade
- foreign termination payments
- employee share scheme payments
- an advance or loan.

The aforementioned items are generally taxed as per the employee's normal payroll and do not form part of the actual ETP.

Note that there are concessional treatments available for certain types of lump sum payments made on termination, including the lump sum amounts for unused leave entitlements, with provisions on the PAYG Payment Summary (individual-non business) specifically for the disclosure of these payments.

Taxing ETPs: caps on certain aspects

The taxable components of an ETP will be subject to concessional rates up to certain caps. There are two caps that you need to be aware of when you are calculating the tax on an ETP.

ETP cap

For the 2014-15 financial year, the ETP cap is \$185,000, and for 2015-16 it is \$195,000. This cap is indexed annually.

The ETP cap specifically applies to "excluded" ETPs, which include:

- early retirement scheme (over tax-free limit)
- genuine redundancy (over tax-free limit), and
- invalidity.

Whole-of-income cap

The whole-of-income cap has been set at \$180,000 since its introduction, and it is not indexed. The cap is reduced by any other taxable income earned in the income tax year either before or after receiving the ETP.

The whole-of-income cap only applies to non-excluded ETPs, which include:

- non-genuine redundancy payments
- golden handshakes
- payment for rostered days off
- payment for unused sick leave, and
- gratuities.

For non-excluded ETPs, the lower of the caps (ie. ETP cap or whole-of-income cap) is applied. Given that the ETP cap is now \$185,000 and soon to be \$195,000, practically speaking the whole-of-income cap will always work out to be the lower cap applied.

Are ETPs subject to superannuation guarantee?

Determining whether an ETP is subject to superannuation guarantee (SG) depends on looking at the type/purpose of the ETP.

As SG is based on “ordinary times earnings” (OTE), the character of the termination payment is important. For example, if an ETP was paid in lieu of notice, that would be OTE as it would have been an amount that the employee would have ordinarily earned from rendering services under their employment.

Where the ETP is in relation to a redundancy, it is not considered to form part of their ordinary earnings (salary and wages) and therefore is not subject to SG.

Taxing genuine redundancies

Genuine redundancies are the main ETP that cause frustration and confusion. The confusion is often two fold, with *a)* determining whether the ETP is in fact a genuine redundancy and *b)* the calculation of the tax amount on the ETP.

Merely calling the ETP a “redundancy” does not mean that it is treated as a redundancy for tax purposes. A redundancy can be genuine or non-genuine, but only a genuine redundancy receives concessional tax treatment.

The basic requirement for a genuine redundancy payment is that it must be “received by an employee who is dismissed from employment because the employee’s position is genuinely redundant”.

There are four necessary components listed that fall within this requirement:

- the payment being tested must be received in consequence of an employee’s termination
- that termination must involve the employee being dismissed from employment
- that dismissal must be caused by the redundancy of the employee’s position, and
- the redundancy payment must be made genuinely because of a redundancy.

Dismissal from employment means that all ties must be severed between the employer and the employee. Therefore the employer cannot terminate the employment of the employee and then re-hire or arrange for the re-hiring of the employee at a later date.

Many employers say an employee “was made redundant” but for the purposes of determining whether it was a genuine redundancy, the position or role must become redundant. This means that the employer hiring someone else to perform the exact same role indicates that the role is not redundant.

Note: There are special considerations for employees in dual capacity roles. See this office for circumstances where that may be applicable.

Tax treatment

The genuine redundancy ETPs are tax free up to a limit based on the employee’s completed years of service with the employer.

The tax-free limit is calculated using the following formula:

$$\text{Tax-free ETP} = \text{base amount} + (\text{service amount} \times \text{years of service})$$

For the 2014-15 income year: Base amount = \$9,514 (indexed annually), and service amount = \$4,758 per year. For the 2015-16 income year, these amounts are \$9,780 and \$4,891.

The amount in excess of this is treated as an ETP and is included in the ETP cap for calculation purposes.

Example: Genuine redundancy calculation

Sonya is a 54-year-old chief financial officer (CFO) who has been working for Green Waste for 10 years. In 2014-15, Green Waste is taken over by a larger company, which already has a CFO.

Sonya's position is no longer needed and her employment is terminated. She accepts a redundancy and is paid \$190,000, \$140,000 of which she would not have received had she not been redundant. Her other taxable income for the 2014-15 year is \$200,000.

Sonya's payment is a genuine redundancy payment because her position is no longer required, even though the position of CFO still exists – the position does not need to be filled by two people.

The genuine redundancy part of Sonya's payment of \$140,000 is subject to the ETP cap, not the whole-of-income cap. The tax-free part of the payment is \$57,094, calculated as:

\$9,514 + (\$4,758 x 10 years of service)

{So, \$9,514 + \$47,580}

= \$57,094

In addition, the balance of \$82,906 (\$140,000 - \$57,094) relevant to the redundancy is taxed as a life benefit ETP and is taxed concessional because it is under the ETP cap.

For the remaining \$50,000 of the ETP (non-genuine redundancy), the lesser of the ETP cap or whole-of-income cap will apply.

Because Sonya has earned \$200,000 in other taxable income during that financial year, her calculated whole-of-income cap is zero and is the lower cap. As a result, Sonya's ETP amount of \$50,000 will not receive concessional tax rates and withholding will be at the top marginal rate (49%).

Reporting of an ETP

An employer is required to issue a separate PAYG Payment Summary – employment termination payment where they have terminated an employee's employment and paid an ETP.

This ETP Payment Summary must be supplied to the employee within 14 days of the employer making the payment and reflects the ETP amount and associated withholding. It also provides a code that the employee will use when lodging their income tax return at the end of that year.

Yes, you can claim GST credits for employee reimbursements

If you are an employer registered for goods and services tax (GST), you may be entitled to claim GST credits for payments you make to reimburse employees (including company directors) or partners in a partnership for certain work-related expenses.

If you are running a business, you will be entitled to a GST credit for an employee-reimbursed expense if the following criteria are met:

- the employee's (or associate's) expense is directly related to their activities as your employee *or* the reimbursement is an "expense payment benefit"
- the sale of the item bought by your employee was taxable (that is, not "input taxed"), and
- your employee is not directly entitled to a GST credit for the expense.

The Tax Office says a business can claim GST credits where it has relevant documents such as receipts or tax invoices issued to the employee. These will need to be provided to substantiate claims for reimbursement.

A business that is entitled to a GST credit can claim it in a Business Activity Statement once it has been provided with this documentation.

An "expense payment benefit" is made, according to the Tax Office, when a business makes a payment to, or reimburses, another person "in whole or in part, of an amount of money spent by

your employee as part of their employment with you". Fringe benefits tax (FBT) may apply however (see below).

A business is **not** entitled to a GST credit if it has:

- reimbursed "non-deductible expenses", such as the portion of expenses relating to entertaining clients (usually only half of such expenses are deductible for the provision of entertainment)
- reimbursed expenses that relate to input taxed sales that are made in the running of the business and it exceeds the special threshold for financial purchases (a reduced GST credit is therefore available on *specific* purchases), or
- paid the employee an "allowance" (see below).

The Tax Office says that if a business makes a payment to an employee based on a "notional" rather than an actual expense, it is not making a reimbursement. For example, if a business makes a cents-per-kilometre payment to cover work-related use of an employee's private car, it is paying an allowance and not making a reimbursement (again, consider the FBT implications).

Making reimbursements

A business makes a reimbursement where it pays an employee for the price, or part of the price, of a particular purchase they made.

For example, if an employee incurs an expense of \$220 for a purchase, and is re-paid the whole \$220 or even half of that, either payment will be a reimbursement.

A business will also have made a reimbursement if:

- it pays the employee for a particular expense they haven't paid, provided they have become liable for the expense
- it pays the employee an advance for an expense they have not yet incurred, providing they have to repay any unspent amount of the advance to the business, or
- it pays an expense on behalf of the employee, for example, to the business who has made a sale to the employee (the GST legislation treats this type of payment as a reimbursement).

Where any personal use of a purchased item is involved, or the expense relates to non-cash employee benefits, liability for FBT should be a consideration. Ask this office for more guidance on FBT, and if GST credits for staff reimbursements is an option for your business.

'Robo' advice for SMSFs: Can we trust machines?

With the advent and steady growth of the self-managed superannuation fund (SMSF) sector, superannuation professionals are steeped in discussion about financial services automation and where it will lead. Some believe automated advice will be the next huge innovation, but it's proving to be a divisive frontier.

Taking the work of human accountants and leaving it to machines and complex algorithms sounds a little dystopian — which is probably why the concept has been dubbed "robo advice" — but companies like FinDigital want trustees, and advisers, to consider the potential positives of the model. A recent survey found investors both young and old are warming to the idea.

The *2015 Automated Investment Advisers Global Market Review* found robo advice is becoming increasingly popular with investors aged 60 and over, because it offers greater transparency, control, and more flexibility. As far as traditional financial advice processes go, winning over the

elder camp is perhaps the biggest challenge. It's now the existing financial advisers, those with beating hearts, who need to be reassured.

And reassurance is what FinDigital managing director Ian Dunbar offers. "There's an opportunity for financial advisers to capitalise on the robo advice trend by white-labelling [re-branding] an existing solution and offering it to customers who aren't ready to engage a planner but who want some limited investment advice," he says. So robo advice might reach a client base that hasn't been reached before, and won't affect human advisers servicing clients with big investment portfolios. On the face of it, these are both good things.

But robo advice has its limitations. One is that its analysis is purely algorithmic and therefore not exhaustive. Most automated investment guidance models use "modern portfolio theory" (MPT, a set of principles used to construct an investment portfolio), "efficient market hypothesis" and a survey that determines a client's risk profile. MPT principles help to lay the foundations of an advisory package traditionally offered by living advisers, but omits crucial variables.

MPT, by design, cannot always take taxes and transaction costs into account when tailoring a portfolio. Nor can it predict volatility. Robo advice proponents suggest MPT is able to accurately summate volatility in a given market, but the simple fact is markets don't accurately price risk.

MPT neglects investor sentiment too. It's proven investors often don't act rationally, and their decisions influence prices and markets greatly. So automated investment guidance will fail to give some investors the complete and risk-minded advice they require. Hence the generally accepted adage that a machine will never trump a human's judgement.

Robo advice relies on robust software, which places unprecedented power in the hands of those writing the algorithms. Superannuation specialist Reece Agland is concerned unscrupulous providers may prime their robo advice software to promote particular investments. "You don't know the algorithms they use, so are they going to do it in such a way that it favours their product?" he asks. He's also worried about the lack of regulation. "I mean, the client has gone on to a computer system and typed things up. If the computer spits out bad advice, who's going to be responsible for that? Who's responsible for the best interests duty when it's the computer doing it?"

Agland says that even with robo advice there is role for the financial adviser. "Financial advisers needn't fear robo advice. A financial adviser is better able to shape the information fed to the robo advice and is the only one who can really determine if the suggested investments are good for their client," he says. "They will know things about the client that the robo advice can't understand because of the relationship they have with the client."

Despite his concerns, Agland concedes SMSF trustees will lead the charge with automation, because they have a better idea of what they want. And that seems to be the subtext of the robo advice debate — not that it's unpredictable or untrustworthy fundamentally, just that its appeal to different investor demographics is unclear. Investors who have been in the game for decades, those with big portfolios, and experienced advisers, will likely stay with what they know. Robo advice may be more attractive to the untested; those with new finances and the willingness to explore new territory.

Being a 'non-resident' makes a difference for tax treatment

One of the very first questions you are asked on your individual tax return is: "Are you an Australian resident?" It may seem an unusual or unnecessary question, but the Tax Office wants to get this one cleared up early as it makes a big difference to everything else that follows.

The tax law definition of "resident" is too cumbersome to repeat here, but the Tax Office views residency in an entirely different way to other Australian governmental agencies that deal with things like immigration, visas and citizenship.

Whether you're defined as a resident for Australian income tax purposes has no impact on your passport or even your status as a permanent resident, and vice versa. The Tax Office is really only interested in your earnings, and uses the term "*resident for tax purposes*" to decide how much you should be taxed for an income year.

What is an Australian "tax resident"?

Generally, the Tax Office considers you to be an Australian resident for tax purposes if you:

- have always lived in Australia or have come to Australia to live
- have been in Australia for more than half of the income year (unless your usual home is overseas and you don't intend to live in Australia — for example, you are a working holidaymaker), or
- are an overseas student enrolled in a course of study of more than six months duration.

You may still be a tax resident even though you are not physically in Australia — for example, if you go overseas on an extended holiday. Another situation is if you have moved to Australia from overseas and intend to stay for the foreseeable future and set up connections with Australia, you may also be a resident of Australia for tax purposes.

The tax law contains a series of tests to take to determine your status. But if you "reside" in Australia under the usual meaning of the word, you don't need to look at any of the prescribed tests. However should you have any questions or doubts about your status as a tax resident, please ask this office.

Why is tax residency important?

The reason the Tax Office gives such weight to residency is that a person's status as a resident or not can make quite a difference for tax purposes as the law treats residents and non-residents differently.

Some tax implications for non-resident taxpayers to consider include:

Non-residents taxed on Australian source

Australian residents are generally taxed on all of their income, from here and from overseas, and non-residents are taxed only on income sourced in Australia.

Tax rates for non-residents

Non-residents are not eligible for the tax-free threshold (which is \$18,200 for 2014-15, and \$19,400 for 2015-16) so income is taxed right from the first dollar. Further, for the 2014-15 income year, there is no incremental tax rate up to \$80,000 income but a straight-up rate of 33% (see table below).

General individual income tax rates for non-residents 2014-15

\$0 - \$80,000	33c for each \$1
\$80,001 - \$180,000	\$26,400 plus 37c for each \$1 over \$80,000
\$180,001 and above	\$63,400 plus 47c for each \$1 over \$180,000

Medicare levy

Non-residents do not pay the Medicare levy (and therefore cannot claim Medicare benefits).

Withholding taxes on interest

Non-residents will have 10% of any interest earned from Australian bank accounts withheld for tax, subject to any “double taxation agreement” (see below) that may impose a different rate. The interest is not included in assessable income, but a non-resident will need to provide an overseas address otherwise tax will be withheld at the resident top marginal rate.

Certain tax offsets

Non-residents cannot claim certain tax offsets and various other support schemes available to residents,. Examples include the Schoolkids Bonus, certain family payments and help with healthcare.

Other requirements

A non-resident taxpayer may have the right visas and permissions to work, but another administrative necessity is to have a tax file number (TFN). If you don't have a TFN, tax will be deducted from your wages at the top tax rate.

Summary of differences in residential status

Resident for tax purposes	Non-resident for tax purposes
Reduced tax rates at lower income levels (availability of tax-free threshold)	Pays tax on every dollar (no tax-free threshold)
Taxed on Australian and overseas sourced income	Only taxed on Australian sourced income
Pay Medicare levy (can claim on medical expenses)	No Medicare liability (can't make claims)
Interest income assessed at taxpayer's marginal tax rate	Interest taxed at flat 10%, or top resident marginal rate if no overseas address (or TFN) provided
Liable for capital gains tax on worldwide assets	CGT only on “taxable Australian property” (most commonly Australian real property)
Tax offsets available (if eligible)	Offsets typically not available

Double taxation agreements

An individual may be a resident of Australia and of another country at the same time. Australia's “tax residency” tests do not affect a taxpayer's residency status in another country.

Australia has “double taxation agreements” with several countries so that relevant employees, for example those working for foreign businesses that have a physical workplace in Australia, pay tax on their own country's terms. Most double taxation agreements have residency “tie-breaker” rules, where a dual resident will be deemed to be solely a taxpaying resident of only one country. Residency determinations should always include a check of whether a double taxation agreement with the other involved country is in place or not. Check with this office if you suspect this may be the case.

If a non-resident derives rental income from an Australian property, they will need to include this in their income tax return.

If the only income from an Australian source is in the form of interest from bank accounts, unfranked dividends or royalties, there will be no need to lodge an income tax return if withholding tax has been paid.

Conclusion

In cases where an Australian goes overseas for employment, even for some years, the maintenance or relinquishing of resident status very much depends on individual circumstances. In the case where an Australian takes up a post overseas but retains a domicile in Australia, the Tax Office is likely to consider that the taxpayer retains residency.

Should however the taxpayer rent out their home here due to an extended time of overseas employment, the likely outcome could be that the Tax Office may consider them as a foreign resident for tax purposes. The outcomes are very much determined on a case-by-case basis.

Tax Rates - Resident Individuals

2014/15 Taxable Income	Tax	% on Excess (marginal rate)
0 to 18,200	Nil	Nil
18,201 to 37,000	Nil plus →	19
37,001 to 80,000	3,572 plus →	32.5
80,001 to 180,000	17,547 plus →	37
Over 180,000	54,547 plus →	47

Plus Medicare levy 2.0%

2013/14 Taxable Income	Tax	% on Excess (marginal rate)
0 to 18,200	Nil	Nil
18,201 to 37,000	Nil plus →	19
37,001 to 80,000	3,572 plus →	32.5
80,001 to 180,000	17,547 plus →	37
Over 180,000	54,547 plus →	45

Plus Medicare levy 1.5%