Ibbotson + Moscatelli

Client Information Newsletter
- Tax & Super

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Tax and Christmas party planning

Christmas will be here before we know it, and the well-prepared business owner knows that a little tax planning can help make sure there's no unforeseen tax problems.

The three benefits typically provided include:

- Christmas parties for employees (and perhaps their family members, and even clients)
- gifts to employees, their family members and clients, and
- cash bonuses.

About this newsletter

Welcome to Ibbotson + Moscatelli's client information newsletter, your monthly tax and super update keeping you on top of the issues, news and changes you need to know. We invite you to read our monthly update and contact our office if you have any queries.

T: 03 9824 5533 | E: office@imaccountants.com.au

The Christmas party

There is no separate FBT category that relates to Christmas parties. While such social functions may result in FBT, income tax and GST outcomes, these are covered under the existing relevant legislation. The provision of "entertainment" at Christmas therefore mirrors the tax treatment such benefits will receive at other times of the year.

The ATO says that "meal entertainment", and therefore an FBT liability, arises when food or drink is provided in a way that has the character of entertainment. In fact, the

Tax and Christmas party planning *cont*

ATO holds that while having food or drink present may seem to satisfy the "entertainment" test, there are some cases where the mere provision of food or drink does not amount to entertainment.

For example, it considers that the provision of morning and afternoon tea to employees (and associates of employees) on a working day, either on the employer's premises or at a worksite of the employer, is not entertainment. The provision of light meals (finger food, etc), for example in the context of providing a working lunch, is also not considered to be entertainment. Note however that providing any alcohol typically brings "entertainment" into the picture.

The implications of benefits provided at the year-end Christmas function for an employer vary depending on:

- whether the function is provided at the employer's premises or provided externally
- the cost of the function per attendee, and
- the basis that the employer is using in working out the taxable value of such benefits.

FBT implications

With a Christmas party, FBT applies to an employer when they provide a benefit to an employee or their associate (for example, family members). Food, drink, entertainment and gifts provided at a Christmas party to employees and their associates may constitute either:

- an expense payment fringe benefit (eg. reimbursing an employee for expenses incurred or paying an expense on their behalf)
- a property fringe benefit (eg. provision of property such as meals or gifts by the employer), and
- a residual fringe benefit (eg. the provision of any right, privilege, service or facility such as the right to use a venue).

These benefits are generally valued for FBT purposes at their face value – typically referred to as an "actual basis" of valuation. However, an employer may elect to apply special valuation rules by using either the 50/50 split method or 12-week register method. Ask us about these valuation methods and their suitability for your business. If the employer does not make an election, the taxable value is determined according to actual expenditure.

However "meal entertainment" fringe benefits provided at a Christmas function can be exempt from FBT if it is:

- a "minor benefit" (more below)
- an exempt property benefit (see below) provided at the employer's premises on a work day.

Minor benefits

Broadly, a minor benefit is one where it:

- has a notional taxable value of less than $300 (inclusive of GST)
- is provided on an "infrequent" or "irregular" basis
- is not a reward for services, and
- satisfies other relevant conditions (ask us for details).

Note that other benefits (such as gifts) provided at a Christmas party may be considered as separate minor benefits in addition to meals provided (referred to as an "associated benefit"). In such cases, the $300 threshold generally applies separately to each benefit provided.

Exempt property benefit

A Christmas party held at the employer's business premises on a working day where food and drink, including alcohol, is provided is generally deemed to be an exempt property benefit, and is therefore usually FBT-free. This is no different to the occasional Friday drinks at work.

Tax law exempts such property benefits where:

- the benefit is provided to a current employee in respect of his or her employment, and
- it is provided to, and consumed by, the employee on a **working day** and on the **business premises** of the employer (our emphasis).

This exemption applies only to employees. Where members of the employee's family ("associates") also attend a function (such as the Christmas party), the cost attributable to each associate is subject to FBT unless it is a minor benefit. If clients are invited to the function, the cost of providing the entertainment to these attendees is excluded from the FBT regime as this not a "fringe benefit" to staff (and may qualify as a tax deduction — see below under "Gifts to clients").

External Christmas functions

The costs associated with Christmas parties held off business premises (such as food, drink and transport to a restaurant) will give rise to FBT unless these costs are under the minor benefit threshold. Again, FBT will not apply to the extent that the benefit is provided to a client.

The examples supplied by the ATO on the following page illustrate the difference in FBT and income tax treatment where a function is held on-premises compared to one being held offsite.

continued overleaf ⇨

Tax and Christmas party planning *cont*

Transport considerations

It may be the case that to get to the Christmas function, an employer will provide staff with taxi travel or some other form of transport. Taxi travel provided to an employee will generally attract FBT unless the travel is for a trip that either starts or ends at the employee's place of work.

For taxi travel to or from a Christmas function, employers should be mindful that:

- where the employer pays for an employee's taxi travel home from the Christmas party and the party is held on the business premises, no FBT will apply.
- where the party is held off premises and the employer pays for a taxi to the venue and then also pays for the employee to take a taxi home, only the first trip will be FBT exempt. The second trip may be exempt under the minor benefits exemption if the employer has adopted to value its meal entertainment on an actual basis.
- the exemption does not apply to taxi travel provided to "associates" of employees (eg. family members).

If other forms of transportation are provided to or from the venue, such as bus travel, then such costs will form part of the total meal entertainment expenditure and be subject to FBT. A minor benefit exemption for this benefit may be available if the threshold is not breached.

continued overleaf

Example 1.

A small manufacturing company decides to have a party on its business premises on a working day before Christmas. The company provides food, beer and wine. The implications for the employer in this situation would be as follows.

If ...	Then ...
current employees only attend	no FBT implications as it is an exempt property benefit
current employees and their associates attend at a cost of $180 per head	■ **for employees** – no FBT implications as it is an exempt property benefit; the minor benefit exemption could also apply ■ **for associates** – no FBT implications as the minor benefit exemption applies
current employees, their associates and some clients attend at a cost of $365 per head	■ **for employees** – no FBT implications as it is an exempt property benefit ■ **for associates** – a taxable fringe benefit will arise as the value is equal to or more than $300 ■ **for clients** – no FBT payable and no income tax deduction

Example 2.

Another company decides to hold its Christmas party function at a restaurant on a working day before Christmas and provides meals, drinks and entertainment. The implications for the employer in this situation would be as follows.

If ...	Then ...
current employees only attend at a cost of $195 per head	no FBT implications as the minor benefits exemption applies
current employees and their associates attend at a cost of $180 per head	no FBT implications as the minor benefits exemption applies
current employees, their associates and clients attend at a cost of $365 per head	■ **for employees** – a taxable fringe benefit will arise ■ **for associates** – a taxable fringe benefit will arise, and ■ **for clients** – no FBT payable and the cost of providing the entertainment is not income tax deductible

Tax and Christmas party planning *cont*

Gifts

Gifts provided to employees or their associates typically constitute a property fringe benefit and therefore are subject to FBT unless the minor benefit exemption applies. Gifts, and indeed all benefits associated with the Christmas function, should be considered separately to the Christmas party in light of the minor benefits exemption.

For example, the cost of gifts such as bottles of wine and hampers given at the function should be looked at separately to determine if the minor benefits exemption applies to these benefits. Gifts provided to clients are outside of the FBT rules (but may be deductible, see below — also note that deductibility may still apply even if the gift is a "minor benefit").

The income tax deductibility and entitlement to input tax credits (ITC) for the cost of the gifts depends on whether they are considered to be "entertainment". For example, an unopened bottle of spirits is deemed to be a property benefit (the entertainment starts after the cap is unscrewed). Again, in most cases the entitlement to an ITC for expenses incurred for the employer mirrors the income tax implications — so an ITC is only available to the extent that the expense incurred is deductible.

Gifts to clients

Regarding a business providing a gift a client, even a former client, the ATO confirms that such outgoings are generally deductible as they are being made for the purposes of producing future assessable income. However, the outgoing is not deductible where it is of a capital nature, relates to the gaining of exempt or non-assessable non-exempt income, or some other provision of the income tax law prevents it from being deductible.

To explain this quirk, the ATO provides the following examples:

EXAMPLE 1

Julia is carrying on a renovation business. She gifts a bottle of champagne to a client who had a renovation completed within the preceding 12 months.

Julia expects the gift will either generate future business from the client or make them more inclined to refer others to her business. Although Julia got on well with her client, the gift was not made for personal reasons and is not of a private or domestic character.

The outgoing she incurred for the champagne is not of a capital nature. Julia is entitled to a deduction.

EXAMPLE 2

David is carrying on a business of selling garden statues. David sells a statue to his brother for $200. Subsequently, David gifts a bottle of champagne to his brother worth $170. Apart from this transaction, he provides gifts only to clients who have spent over $2,500 over the last year.

The gift has been made for personal reasons, and is of a private or domestic character. David is not entitled to a deduction.

Examples of "entertainment" v not "entertainment"

Entertainment	Not entertainment
glasses of champagne	bottled spirits
hot meals	groceries
theatre tickets	games
holiday accommodation	TV sets, DVD players
hired entertainers	computers
hired sporting equipment	crockery
	swimming pools
	gardening equipment

Cash bonuses

Some generous/successful employers, budget permitting, may choose to provide cash bonuses to staff in their end-of-calendar-year payroll. Bonuses in the form of cash are considered to be a business cost, and therefore deductible under the general deduction provisions.

However, being a benefit in the form of "coin" there is another side to this coin, which is that cash bonuses are assessable in the hands of employees as ordinary income, no differently to salary and wages.

As a cash bonus is salary and wages, it is therefore not a taxable supply for GST purposes — so for these type of benefits, GST issues do not arise. Also there are no FBT issues to consider. However employers should consider PAYG withholding, superannuation guarantee and payroll tax issues. We can help with these decisions. ■

Taxation of foreign income derived by Australian residents

Under Australia's taxation regime, resident taxpayers are subject to income tax on both income derived in Australia and on foreign sourced income. As a general rule, where foreign income is derived by an Australian resident, the gross amount (including any foreign tax paid on the income) must be included as assessable income.

A foreign income tax offset is allowed (up to a limit) for any tax paid overseas. This mitigates the effects of double taxation (where the taxpayer pays tax on the same item of income in Australia and another country) by allowing taxpayers to claim the foreign tax paid against the Australian tax liability on the same income. The foreign tax is claimed as a non-refundable tax offset, subject to a cap.

The deductibility of certain expenditure that may be incurred in the derivation of foreign source income is determined under Australia's general deductibility rules and the specific deduction provisions. Furthermore, our domestic tax legislation contains various tax concessions and exemptions for specific items of foreign-source income.

These general rules may be modified by the various double taxation agreements, also known as treaties, that Australia has with other countries, of which there are more than 40. Double taxation agreements (DTAs) are designed to eliminate conflict where income or gains might be subject to tax in more than one country. These treaties allocate taxing rights over specific items of income and also provide double taxation relief.

As a general rule, under a DTA the taxing rights over a particular item of income are either exclusively allocated to one of the treaty countries or the taxing rights are given to both countries with provision made for relief from double taxation — the country of residence is generally required to grant relief on double taxed amounts by way of credit or exemption in accordance with its domestic laws, such as our foreign income tax offset mentioned above.

DIVIDENDS, INTEREST AND ROYALTIES

Dividends, interest and royalties derived from foreign sources are generally subject to income tax in Australia. Subject to any DTA between Australia and the source country, and subject to the source country's domestic laws, the foreign payer may be obliged to withhold foreign tax from the payment. In this case, the gross amount of the income (before withholding tax) is treated as assessable income for Australian tax purposes. The amount of foreign tax withheld may be creditable against Australian tax liabilities.

CAPITAL GAINS

Foreign source capital gains are generally subject to Australian income tax under the CGT regime, subject to any relevant DTA. Note that some treaties that were negotiated before the CGT measures were introduced (September 20, 1985) may be silent or unclear regarding the allocation of taxing rights over capital gains.

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Beware Division 7A when borrowing from your business

Business owners of private companies often borrow money from their own companies for all sorts of reasons. However there is an area of the tax law that seeks to sanction against situations in which private companies dole out money to those within a business, in a form other than salary or dividends, that needs to be understood by business owners. This is known as Division 7A.

What is Division 7A?

Division 7A exists as an integrity measure, and deals with benefits such as payments, loans, or even debt forgiveness made by private companies. The Division 7A law prevents private companies making tax-free profit distributions to shareholders (and their associates).

Such transactions can include:

- amounts paid by a private company to a shareholder (or associate), including transfers or uses of property for less than market value
- amounts lent to the same without a specific loan agreement constructed in conformity with prescribed legislative requirements (unless the relevant loans are fully re-paid by lodgment day*)
- debts that the business forgives.

Through applying the Division 7A rules, such loans, debt forgiveness or other payments are treated as assessable unfranked dividends to the shareholder (or associate), and taxed accordingly in their hands.

Who does it apply to?

"Private companies" are covered by Division 7A. The rules thereby apply to the shareholders of such companies (typically, the principals of the business) and their "associates". This last term is widely defined and can include family members and related entities. Employees may be affected if they are shareholders (although fringe benefits rules may also apply in preference).

If you find yourself in circumstances where there is a possibility of Division 7A provisions applying, and the tax consequences that go along with it, consult this office.

What commonly triggers Division 7A?

Most commonly, Division 7A applies where there is a loan by the company to the business's owners (that is, shareholders). A loan will generally be treated as a dividend if a company lends money to a shareholder (or associate) in an income year and the loan is not fully repaid by the lodgment day* of the same income year.

Another example, which is not all that uncommon, is where an asset of the company is made available for use of the shareholders — a holiday house owned by the company is a typical example. Where shareholders of the private company use that holiday house for free over a certain period, this will likely trigger Division 7A as a "payment", as this use is viewed as having a commercial value. That value is deemed to be a distribution to shareholders that would otherwise be tax-free were it not for the Division 7A provisions.

What can be the consequences?

Any loans, payments and debt forgiveness from the business to its shareholders (or associates) may be deemed to be an assessable dividend that should be taxed in the hands of the shareholder (or their associates) typically at their marginal tax rate, under the Division 7A rules. The dividend is "unfranked" meaning that there are no franking credits available to the recipient (unless the Commissioner exercises his discretion to the contrary).

But one important aspect of Division 7A, broadly speaking, is that there needs to be "profits" from which the business can make payments. This is referred to as a "distributable surplus".

In general terms, provided there is a sufficient distributable surplus in the company, all payments made by a private company to a shareholder (or their associate) to which Division 7A applies are treated as dividends at the end of the income year.

Can you avoid the adverse effect of Division 7A?

To avoid the Division 7A provisions, such transactions must be arranged correctly and at "arm's length". In particular there are certain payments, loans and debt forgiveness that are not always treated as dividends.

Beware Division 7A when borrowing from your business *cont from previous page*

Payments not always treated as dividends include:

- repayment of a genuine debt owed to a shareholder
- a payment to a company (not acting as trustee)
- any payment that is otherwise assessable for tax
- a payment made to a shareholder in the capacity of an employee (including their associates)
- a liquidator's distribution.

The following loans are not treated as dividends:

- a loan fully repaid within an income year
- loan to a company (if it is not acting as a trustee)
- loans made "in the ordinary course of business" on commercial terms
- a loan made to buy shares or rights under an employee share scheme
- any loan that is otherwise assessable for tax
- a loan that is put under a special type of loan agreement called a "Division 7A loan agreement" before the lodgment day of the company's tax return*
- other types of loans that meet the definition of "excluded loans" for Division 7A (see this office).

And not all debts that are forgiven end up being treated as dividends, such as:

- where the debtor is a company
- if the debt is forgiven because the shareholder becomes bankrupt
- where the loan that created the debt is itself treated as a dividend
- if the Tax Commissioner exercises discretion due to being satisfied that the shareholder would otherwise suffer undue hardship.

Borrowing money from a private company, even if it is your own business, can have serious pitfalls if not carried out correctly. It may be necessary to put in place a Division 7A loan agreement. Seek advice from this office if you find yourself in such circumstances.

*the earlier of the due date for, or actual date of, lodgment of the company's return.

Taxation of foreign income derived by Australian residents *cont from page 5*

EMPLOYMENT INCOME

Foreign source employment income derived by an Australian resident is generally assessable in Australia. Where there is a tax treaty between Australia and the source country, the other country may also have taxing rights over the income.

In limited circumstances, the income may be tax exempt in Australia under specific provisions within our tax laws. There are two main provisions in this regard, and both specify that the period of foreign service must be of 91 (consecutive) days duration or more. Certain conditions must also be met, but generally these relate to work performed in relation to delivering overseas aid, under deployment overseas as part of a disciplined force and so on.

FEES FOR INDEPENDENT SERVICES

Fees for independent services (such as contractor fees) derived by an Australian resident from a foreign source are generally assessable in Australia unless a relevant DTA between Australia and the source country allocates exclusive taxing rights over the income to the source country.

Many of Australia's DTAs contain a separate independent personal services article, such as the Australia/United States treaty. The Australia/New Zealand treaty does not include an independent personal services clause but includes such services in the expanded definition of "business", which means that such income is taxed according to the business profits article.

PENSIONS RECEIVED FROM OVERSEAS

Most DTAs provide that pensions and purchased annuities are generally assessable in the country of residence. Some treaties have separate articles for government and non-government pensions/annuities. The ATO has released a number of rulings relating to specific pensions received from specific countries.

ATTRIBUTED INCOME

As well as income which is "realised" and actually derived, an Australian resident with offshore interests in a non-resident company or trust may also be attributed a proportion of the non-resident entity's income that has not been distributed. This attributed notional income is assessable to the Australian resident taxpayer. ■

Is that a travel allowance or LAFHA?

Travel allowances are paid to employees where in some cases the period away from home is less than 21 days, and in others, more than 21 days.

With travel allowances, typically employees are:

- paid standard travel allowance for accommodation and food
- work at the one location
- visit home on weekends
- stay in accommodation provided by the supplier (which may be available for use by other customers when the employee is not there).

Some employees may be on a travel allowance for six weeks or more.

However it is often asked whether these transactions should be looked at under the FBT living away from home allowance (LAFHA) rules or the income tax travel allowance rules?

Deciding factors

The FBT framework would generally provide for a more concessional tax outcome where certain prescribed requirements for a LAFHA is met in comparison with the income tax effect of a travel allowance.

The 21-day standard is only a rule of thumb that the ATO uses as a default classification system. So you could have someone who is away from home for more than 21 days but is still considered to be only travelling. Alternatively you could have someone that is away from home for two weeks only, but in those two weeks was actually living away from home.

It is a test of substance whether someone is just travelling or is actually living away from home. If less than 21 days away from home, it would have to be substantiated to be proven in fact as a LAFHA. Similarly, if more than 21 days away from home and treated as a travel allowance, the ATO will generally not challenge such treatment if substantiated as travel.

The following general principles may be of guidance.

- When a person is living away from home, there will be a change in job location and a temporary residence will be taken up near the new work location. Often, but not always, the employee's spouse and family will accompany the employee to the new location.
- When a person is merely travelling, there will be no change in job location and there will be no establishment of a temporary residence – rather, the person will merely be accommodated while travelling. Usually the employee's spouse and family will not accompany the employee.
- However the issue of whether the family accompanies the employee is not determinative. The critical factor seems to be where the job is located. If it is temporarily located away from the employee's usual place of residence, the employee will usually be living away from his or her usual place of residence. Where the job location does not change, but the employee must travel to undertake duties, he or she will be regarded as travelling.
- While the length of period away from home is not determinative, the ATO will generally accept that where the travel does not exceed 21 days, the person will be travelling. In addition, the Tax Commissioner has stated that employees attending short-term staff training courses will generally be treated as travelling in the course of their employment.
- There is no minimum or maximum period of absence to qualify as living away from home, although the application of the FBT rules may be less concessional if someone lives away from their usual place of residence for more than 12 months. There would be a requirement to sleep away from home for at least one night. The period that a person is living away from home will end when the person returns to his or her usual place of residence, or changes his or her usual place of residence to the new location. ■