SUBMISSION 16

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House Standing Committee on Economics
House of Representatives
PO Box 6021
Parliament House
Canberra ACT 2600

Sent via email: economics.reps@aph.gov.au

Review of the Tax Laws Amendment (2012 Measures No. 6) Bill 2012

Dear Sir / Madam

Ernst & Young is pleased to provide this submission in respect of the above mentioned inquiry on behalf of our clients operating in the NSW electricity industry as electricity distribution businesses (Essential Energy, Endeavour Energy and Ausgrid).

This submission addresses Schedule 7 of the Tax Laws Amendment (2012 Measures No.6) Bill 2012 ("the Bill") only.

The focus of this submission is to highlight concerns with the legislative reforms to Fringe Benefit Tax (FBT) set out in Schedule 7 of the Bill and the accompanying Explanatory Memorandum. In particular, the submission makes the following recommendations:

1. Not to proceed with the in-house benefit legislative reforms to FBT; or
2. Defer the legislative reforms to take effect from 1 April 2014 (with no transitional rules); or
3. At the very least, provide further clarification and/or relaxation regarding the operation of the transitional provisions.

Please refer to Appendix One for the detailed submission.

If you would like to discuss this submission, please contact me on 02 8295 6250. Furthermore, we would be pleased to appear before the Committee during the inquiry process to discuss these matters in greater detail.

Yours sincerely,

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Partner
Human Capital - Employment Taxes

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Appendix One

Background

In-house fringe benefits arise when employees receive goods or services from their employer that are identical or similar to those offered to members of the general public in the ordinary course of its (or an associate's) business.

Currently employers who provide in-house fringe benefits can value these benefits concessionally at either 75 per cent of the lowest price at which an identical benefit is sold to the public or under an arm's length transaction depending on the nature of the benefit. Further, the aggregate taxable value of the in-house fringe benefits can also be reduced by $1,000 per employee per FBT year.

In the Mid-Year Economic and Fiscal Outlook (MYEFO) released on 22 October 2012, reforms were announced to remove the above concessions for in-house benefits where those benefits are accessed by way of salary sacrifice arrangement. The legislation is proposed to apply to all new arrangements entered into from 22 October 2012, with limited transitional relief available for salary sacrifice arrangements entered into prior to 22 October 2012 until 1 April 2014, or until the arrangement is materially varied.

The Bill to implement the reforms was introduced into Parliament on 29 November 2012. The House of Representatives thereafter referred the Bill to the House Standing Committee on Economics for further inquiry and report.

In the MYEFO, it was indicated that the legislative reforms are intended to return the use of the in-house benefit concessions to its original intent prior to the wide spread use of salary sacrifice arrangements. However it is submitted that the changes do not achieve any significant policy objectives (and are in fact counter intuitive to other government policy objectives) and will have a number of unintended consequences for many taxpayers, and also result in additional administrative burden / cost to the employers.

We urge the Committee to consider the impact of these changes on segments of the economy that should not be jeopardised. Please refer to our comments below in relation to various recommendations that can be considered in order to minimise any unintended consequences.

1. Recommendation - Do not proceed with the in-house benefit reforms

The policy objectives for the reform appear counter intuitive to other government policy initiatives and there are numerous unintended consequences, including heavily impacting low - medium income earners and adversely impacting employers (both financially and administratively) for an insignificant gain in government revenue

Our chief recommendation is not to proceed with the reforms to the in-house benefits FBT concessions due to the following considerations.

1.1 Policy objectives for reform are not clear

As noted above, in the MYEFO, it was indicated that the legislative reforms will return the use of the in-house benefit concessions to its original intent prior to the wide spread use of salary sacrifice arrangements. However in reviewing the *Taxation Laws Amendment (Fringe Benefit and Substantiation) Act 1987*('the Act') and the supporting Explanatory Memorandum ('EM'), there is nothing to indicate that the intention of the legislation is anything other than how it is worded, which is to allow employers to provide the same products or services to their employees that they ordinarily provide to the public, at a concessional valuation which is further reduced by $1,000 per employee per FBT year.

There is nothing in the Act or the EM that indicates the intent of the legislation is not to allow employees to access these benefits by way of a salary sacrifice arrangement. Additionally it is noted that the proposed measures in the Bill are not intended to stop salary sacrifice benefits generally, nor does there appear to be any public policy to do so, as salary sacrifice arrangements are still widely available for a range of other benefits where the potential revenue gain would be significantly greater than that which is proposed under these measures.

Therefore, as the intent of the original legislation cannot be clearly demonstrated and there does not appear to be any other policy restrictions placed generally on salary sacrifice of other benefits, the policy objectives for the reform are not clear. In addition there are numerous unintended consequences, as outlined in further detail below.

Based on the above, there doesn't appear to be a justifiable policy reason to proceed with the legislative changes.

1.2 Insignificant revenue versus significant impact on affected taxpayers

For reasons set out below, the cost to employers and employees is expected to be substantial and the financial impact will be widespread. However the estimated revenue that will be generated from the in-house benefit reforms would be insubstantial in comparison.

In the 2012-13 budget estimated tax receipts totalled $343.1 billion, whereas the anticipated annual savings to be generated from the introduction of this measure is only $190 million annually, which is a wholly immaterial percentage of total tax receipts.

On the other hand, it is expected that the proposed legislative changes could affect the three electricity distribution business represented in this submission to the amount of as much as $10 million per year and this is a pattern that will be repeated across the electricity industry in all states. The revenue raised, whilst insignificant to total government tax receipts, has significant impact across these organisations and across the electricity industry.

1.3 Impact heavily on low-medium income earners

The removal of the concessional treatment in relation to in-house benefits (by way of salary sacrifice arrangements) would impact heavily on the low-medium income earners, which is not consistent with the intentions of the 2012-13 Federal Budget.

The Federal Budget intends to target medium-high income earners by reducing access to various tax concessions (e.g. removal of concessional tax rates on superannuation contributions for taxpayers with adjusted taxable income over $300,000 and employment termination payments (ETPs) for taxpayers with total taxable income above $180,000). However, in NSW alone there are almost 10,000 employees across the three electricity distribution businesses which will be adversely impacted by the proposed changes and the majority of the employees are blue collar workers who are low-medium income earners.

It is more likely that low - medium income earners will be salary sacrificing in- house fringe benefits, because proportionate to their earnings, the tax savings are higher for this group of taxpayers, and therefore they will have the most to gain from entering into these arrangements. Therefore the removal of the concessional treatment will have the most impact on low - medium income earners and have little (if any) impact, proportionately to high income earners.

Additionally, in the case of electricity businesses, the entitlement to salary sacrifice in-house benefits has been entrenched in the industry for a number of years and referenced in many industrial awards and agreements. Therefore, employees have a sense of entitlement to this benefit that will cause significant industrial relations tension to unwind.

1.4 Adverse impact on employers

The impact of the proposed legislation changes on the NSW Electricity network distribution businesses is widespread, not only in terms of potential additional FBT liability, but also in terms of additional administrative requirements (including assessing the eligibility of the transitional rules, communications to employees and relevant policy updates). In addition, the proposed changes will also have an impact on HR and remuneration policies given each of the NSW Electricity network distribution business are highly unionised workforces and the ability to salary sacrifice in-house benefits is a long standing expectation.

With the various additional costs associated with the reforms, there is a possibility that the distribution business will be forced to pass on the additional costs to the electricity retailers, who in turn are likely to pass it on to the end user consumers (by way of increasing the utility rates). Given the current perception within the community in relation to increasing electricity costs following the introduction of the carbon tax, a further increase in the cost paid by consumers will have an adverse impact. As a key policy objective of the current Government is to reign in electricity costs, this will have the opposite effect, making this FBT reform proposal counter intuitive to broader electricity industry policy.

2. Alternative recommendation - Defer the reforms to 1 April 2014 (with no transitional rules)

Deferral to 1 April 2014 would allow proper planning and fair and equitable application of the legislation. Deferral would also remove the requirement for transitional rules.

If the reforms are still deemed necessary, we suggest at least deferring the effective date to 1 April 2014, and not to proceed with the transitional rules given the ambiguity in determining whether the salary sacrifice arrangements have been entered into before 22 October 2012.

Given the legislation is proposed to take effect from 22 October 2012, which is the date the measure was first announced in the MYEFO, employers who provide these benefits had no time in which to consider the potential impact of the changes to their business. **Furthermore, by having the new legislation to take effect part way through an FBT year, it produces an inconsistent and inequitable result within a large employee base where some employees will be able to benefit from concessional treatment and others will not.**

Deferral to 1 April 2014 will allow employers the necessary time to consider the impacts that the changes will have to their business and act upon them appropriately and will ensure fair and equitable application of the legislation to their large unionised employee populations.

As such, if our primary recommendation of not proceeding with the reforms is rejected, we propose that our secondary suggestion of deferral of the reforms to 1 April 2014 be considered. Deferral would ensure sufficient time is given to the employers to communicate with their employees, and to minimise the additional costs that would result from the reforms. Additionally, in our view if the legislation is deferred, transitional rules may not be necessary as they result in ambiguity and additional costs for employers and the ATO.

It should also be noted that the potential revenue forgone in the 2011-12 and 2012- 13 income years by implementing a deferral is minimal based on the projected revenue ($20 million in 2011-12 and $55 million in 2012-13) in the MYEFO statement.

3. Alternative recommendation 2: Further clarity and relaxation of transitional rules needed

The transitional rules as currently worded are ambiguous and appear to produce inconsistent and inequitable results for the two main different types of salary sacrifice arrangements – accrual vs. deduct and pay. The transitional rules if left unchanged will also adversely affect employers in terms of costs (legal and tax advisory) as well as administrative burdens.

If the transitional rules will be introduced, further clarifications in relation to the application of transitional rules is necessary.

3.1 Ambiguity in relation to 'existing salary packaging arrangements'

Based on initial discussions with Treasury following the announcement in the MYEFO during consultation to draft the legislation, it was understood it was not the intention of the Parliament to impose uncertainty/ risk or additional costs to companies by removing the in-house benefit concessions where there was an expectation that benefits would be sacrificed during the current FBT year. However the transitional rules as currently worded are ambiguous and appear far stricter than initially indicated by Treasury during these discussions.

Of particular concern is the wording provided in the EM as to an arrangement that was given 'legal force' before 22 October 2012. The legal implications of arrangements can be complex and uncertain, impacted by employment law (including impact of awards, agreements employers stated policies and employers common law rights) and contract law. **Therefore determining the eligibility for transitional arrangements will result in significant administration costs as both legal and tax advice may possibly be required (noting that tax practitioners are typically unqualified to determine questions of law).** Therefore, given the ambiguity in relation to the transitional rules, further interpretation and guidance will be necessary to be provided to the employers, which will result in additional burden on the ATO.

Furthermore, in practice salary packaging arrangements can be quite varied in their structure and administration, but they broadly fall into one of the following two categories:

- Accrual Benefits: under an accrual benefit the participating employee elects to sacrifice a set amount of pre-tax salary each pay period (or year) and this money 'accrues' in their salary packaging account. When the employee incurs a qualifying benefit cost they claim reimbursement of that cost from the funds that have accumulated in their account through submission of a salary packaging claim form.

- Deduct and Pay Benefits: under a deduct and pay benefit there is no regular pre-tax deduction and money does not accrue throughout the year in the employee's salary packaging account - under this salary packaging option pre-tax salary deductions do not commence until *after* the employee submits a salary packaging claim and are limited to the amount claimed. Pre-tax deductions under this benefit option tend to be ad-hoc as they only occur when the employee sends in a claim - which is often on an irregular basis.

Under the accrual style salary sacrifice arrangement, an employee usually completes a form to indicate their agreement to forgo future salary in exchange for the relevant benefit. The form can be renewed periodically or can remain in for a number of years until an employee indicates otherwise.

Under the deduct and pay style salary sacrifice arrangement there are differing approaches in terms of documenting the agreement. Employees can complete a form at the outset similar to an accrual style or the agreement to forgo salary in exchange for the relevant benefit may form part of the employees claim for reimbursement, which occurs as and when the employee makes a claim (which can be once a month, quarter up to once a year).

The transitional rules in the legislation as currently worded, appear to only consider the first type of salary sacrifice arrangement, accrual benefits. This produces an inequitable result for employers (and their employees) that operate salary sacrifice arrangements under the second approach, deduct and pay benefits. Such employers will be left in a position where some employees will have benefited from the in-house concessions prior to 22 October 2012, whereas others will not have, as they were waiting until later in the FBT year (ending 31 March) to submit their claims. This notwithstanding that employees were clearly of the belief that they had an entitlement to the benefit during the FBT year, however may have not "committed" to an arrangement as appears to be required given the explanation in the EM.

We propose that the transitional arrangements should be sufficiently broad enough to allow both the accrual and the deduct and pay approaches over the life of the transitional period, in order to provide a fair and equitable application of the legislation.

3.2 Material alteration or variation to salary packaging arrangement

Further guidance will be necessary to determine whether an existing salary packaging arrangement is materially altered or varied on or after 22 October 2012, in which case the benefits will no longer be subject to the transitional arrangements. For example, employees may seek to vary the amounts sacrificed due to change in the circumstances. In this regard, more specific guidance will be necessary to confirm whether a change in dollar values would result in material alteration or variation of the arrangement and therefore would not be eligible for the transitional rules.

Another example given in the Explanatory Memorandum in relation to alterations or variations of an existing salary packaging arrangement includes 'a change of employer'. However, it is fairly common practice for employees to be transferred within a group of related companies. In such case, there will be a change in employer. However, the content of the salary sacrifice arrangement may not necessarily differ from the original arrangement. It does not seem that it should be the intent of this legislation to place unnecessary restrictions on the ways employers conduct their businesses by discouraging the movement of employees within groups of related companies. Therefore a relaxation of the rules in relation to this is recommended should the transitional rules be introduced.