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## **Economic Focus**

### **The Global Economic Recovery is Nigh – So soon?**

Apparently, the global economic recovery has arrived. While we are not convinced just yet, there is no denying that a wave of positive sentiment has been injected into global markets, driven by sometimes over-zealous economists and media commentators.

Recent economic data indicates that the pace of the global decline is slowing but there is still a big question mark over the timing of a recovery.

US economic data remains inconsistent but there are further signs that the initial recovery period has begun. Manufacturing activity continues to recover with the Institute for Supply Management index rising again and home sales surging in June. In reality, the man on the ground will tell you that the situation in the US is still dire.

Consumer confidence slid for the second consecutive month, probably as a direct result of a further rise in unemployment numbers. The bottom line is that there will be no sustainable economic recovery in the US until the consumer starts spending again, given that consumer spending contributes to 70% of GDP in the largest economy in the world.

Europe, the UK and Japan also experienced mixed economic data. Again, there are signs the worst is over but there is very little evidence that the recession will end soon.

China's industrial production numbers continue to grow, led by domestic demand boosted by the Government's stimulatory packages. However, a cut back in lending by China's leading banks to slow credit growth could limit the upside for growth in the short term.

Australia appears to be 'the lucky country'. Consumer and business confidence is rising and employment numbers are declining at a much slower pace than other developed economies. Building approval numbers rebounded in June after slumping in May.

Glenn Stevens, the Reserve Bank of Australia's Governor, says Australia has been 'travelling rather better' than others. Thanks to his aggressive interest rate cuts and the Government's enthusiastic stimulatory measures, we may yet escape the worst global recession in 80 years relatively unscathed.

Share markets have been the main beneficiary of the resurgent confidence as investors flood back into equities. While corporate earnings have fallen sharply, the market had factored in a depression.

Analysts have a habit of overshooting the mark when forecasting future earnings, both on the upside and the downside. Whether this is the case in Australia remains to be seen.

### **U, V or W shaped recovery**

A plethora of positive economic data during August has provided further evidence that the worst of the global economic crisis is behind us. Indeed, US Federal Reserve Chairman Ben Bernanke believes the US and global economy "appear to be levelling out". While this view is shared by most leading economists and central bankers, the pace of the recovery is still being fiercely debated.

Upbeat US economic indicators support the optimism. Although the US economy shrank at an annualised rate of 1% in the June quarter, this was a much better result than projected by economists. New home sales jumped a massive 9.6% in July, house prices rose for the second successive month and consumer confidence improved unexpectedly. The latest manufacturing survey confirmed that



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business is contracting at a lesser rate than expected.

Data released from other developed economies showed similar signs of improving business confidence as factory output continued to improve, especially in Japan and Germany. However, consumer activity remains subdued in many countries. Although a strong retail sales number in the UK defied this trend, heavy discounting by retailers at the end of June may have artificially inflated this data. China continues to grow with their 2009 economic growth target of 8% looking very achievable.

The chance of a severe contraction in the Australian economy now appears minimal. Economic conditions have been much stronger than anticipated, led by a surprisingly resilient labour market and impressive consumer spending. As a result, the Reserve Bank has moved from an interest rate easing bias to a more neutral stance and it appears highly unlikely that we will see another rate cut in this cycle.

Which shape will the global economic recovery take? The optimistic economists predict a V-shaped recovery i.e. a sharp fall followed by a swift, sharp rise. The more conservative economists expect a U-shaped recovery - a sharp fall followed by a subdued recovery. A few believe we will get a W-shaped recovery, where a sharp fall and sharp rise is followed quickly by another sharp fall. Either way, there is a collective sigh of relief that a new Great Depression will not occur - this time.

## **Superannuation Focus**

### **Trustees' Obligations for SMSFs**

The Australian Taxation Office (ATO), as the regulator of self-managed superannuation funds (SMSFs), has recently made it very clear that they will taking a hard line with fund trustees who

do not follow their obligations and responsibilities.

If a trustee does not comply with the requirements of the SIS Act, they risk having their SMSF deemed to be a non-complying fund, which would result in a loss of tax concessions and other financial expenses to themselves as fund members.

SMSF trustees are required to ensure that their SMSF complies with all relevant rules and legislation and, importantly, the fund trust deed.

Trustees must act honestly, exercise skill and diligence, and act in the best interest of the members. They must formulate and implement an investment strategy.

This includes monitoring the fund's investments to ensure that they are made in accordance with the investment strategy. Trustees must have knowledge about SMSF rules such as:

- The sole purpose test
- Acceptance of contributions
- In-house asset restrictions
- Acquisition of assets from related parties
- Commercial basis of transactions

Administration and record keeping is a key issue for trustees. This includes tax returns, auditing, actuary certificates and notification of any changes within the fund.

While trustees are always responsible for the operation, activities and decisions of their fund, they can outsource tasks such as trust deed reviews, fund administration and making appropriate investment choices to experts. In many cases, non-complying SMSFs would have remained complying had their trustees sought help from SMSF experts.



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### **Claiming a deduction for personal contributions to superannuation prior to commencing an income stream**

For substantially self-employed individuals, it is possible to claim a tax deduction for personal contributions made to superannuation. The Australian Tax Office has recently reaffirmed the conditions around claiming this deduction in respect to benefits applied to commencing an income stream (e.g. an account-based pension).

Should personal contributions form part of the benefits being applied to an income stream, the member must notify the trustee of the superannuation fund of their intention to claim a deduction prior to its commencement in order for the notification to be effective. Should notification not occur prior to commencement of the income stream, the contribution will be considered to be a non-concessional contribution by both the fund and the member. This can substantially reduce the tax-effectiveness of the strategy.

#### **Case Study**

David decided to commence an account based pension from his fund effective on his 60th birthday on 1 September 2009. He is self employed and made a contribution of \$50,000 to his fund in August 2009. During the year ended 30 June 2008, David had made non-concessional contributions of \$450,000.

David provided a notice to the fund on 7 June 2010 in respect of his intention to claim a tax deduction of \$50,000. As the pension had commenced on 1 September 2009 and he did not notify the fund of his intention to claim a deduction for the contribution before the pension commenced, David was not entitled to claim the deduction and the contributions made were classed as non-concessional contributions.

Furthermore, as David had made \$450,000 of non-concessional contributions in the previous year, the non-

concessional contribution of \$50,000 in the 2010 year will be taxed at 46.5% as David has exceeded the non-concessional cap. Effectively \$42,500 of after tax benefits is now reduced to \$26,750. David will also pay tax on additional income of \$50,000 (as much as \$23,250) as he cannot claim a deduction for the contribution.

### **Employee Share Scheme Budget Changes**

Following the shock 2009 Budget announcement that all employee share schemes would be taxed upfront, the Government has back flipped on most of the changes.

This has resulted in the Government introducing new draft legislation reforming the employee share scheme rules. In most cases the new rules will have a similar result to the current rules with some new integrity measures.

Under the new rules, the upfront \$1,000 tax exemption will be income tested and the tax deferral will only be accessible where there is a real risk that the shares or rights may be forfeited.

It may also be possible for employees to **access both the \$1,000 upfront tax concession and the tax deferral concession in the same year**. Another important change is the basis upon which employees will be eligible for upfront or deferred tax concessions.

This will now depend on the structure and characteristics of the scheme and not an election of the employee. The changes will also focus on taxing the value of benefits received by employees so taxpayers are taxed consistently regardless of the form of remuneration they receive. If these changes become law, the new employee share scheme rules will apply to shares and rights acquired on or after 1 July 2009.



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### **Upfront taxation changes**

Generally any discount that an employee receives to the market value of shares provided under an employee share scheme is included in the employee's assessable income in the year the shares are acquired. Under current rules a \$1,000 upfront concession is available for shares that meet the requirements for "qualifying shares".

Unlike the current rules, eligibility for the \$1,000 upfront concession will be based on the characteristics of the employee share scheme and a new income test will be applied.

Under the income test, the tax concession will be available to taxpayers participating in an employee share scheme who pay tax upfront, provided they have a taxable income (after adjustments) of \$180,000 or less, and the employee and the scheme meet certain conditions.

Taxable income will be adjusted by adding an employee's reportable fringe benefits, super contributions and total net investment loss for the year. The other conditions for the upfront concession are:

- The employee must be employed;
- the scheme must be offered to at least 75 per cent of permanent employees;
- the shares or rights provided must not be at real risk of forfeiture;
- the shares or rights must be required to be held by the employee for at least three years or until the employee ceases employment, whichever is earlier; and
- the employee must not receive more than five per cent ownership of the company, or co

### **Deferred taxation changes**

Under the current rules, an employee can choose to defer the assessability of the discount on shares or rights provided the shares meet the all the conditions to be "qualifying shares" which are similar to the conditions for the upfront exemption described above.

Under the new rules, deferral of tax will no longer depend on whether the shares or right are "qualifying shares". However, for the deferred tax rules to apply there are some further requirements as outlined below:

- the relevant employee share scheme interests must be acquired at a discount under an employee share scheme, the interest must relate to ordinary shares and be subject to a "real risk of forfeiture". A "real risk of forfeiture" means there is a real risk that the benefits of shares or rights are never realised because the employee share scheme interests are forfeited. Therefore deferral of taxation will be the appropriate treatment in these circumstances; or
- the relevant employee share scheme interests must be acquired under a salary sacrifice arrangement, and the employee must receive no more than \$5,000 worth of shares under those arrangements in an income year.

### **New deferred taxing point**

#### *Current Rules*

When an employee qualifies for tax deferral, under the current provisions the taxing point is the earliest of:

- when the restrictions on sale are lifted;
- when the employee sells the shares or exercises the options;
- when the employee ceases employment; or



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- 10 years after the shares or rights were acquired

#### *New Rules*

Where the tax is deferred under the new rules, the taxing point is the earliest of:

- When there is no risk of forfeiture of the benefits and any restrictions on the sale or exercise are lifted;
- When the employee ceases employment; or
- 7 years after the shares or rights were acquired

Note that under the current provisions, there is no upfront concession if the tax deferral is chosen. However, under the proposed changes, it may be possible for employees to access both the \$1,000 upfront tax concession and the tax deferral concession in the same year.

#### **Tax refunds for forfeited shares**

Under current law, employees are eligible for a refund of tax on forfeited rights only but not shares. The refund is available if the employee loses the right without having exercised it.

By comparison, an employee is eligible for a refund of tax on forfeited shares and rights under the proposed changes, if the forfeiture was not the result of:

- A choice of the employee; or
- A condition of the scheme that protects the employee against a fall in market value

#### **Reporting requirements for employers**

Employers will be subject to new annual reporting requirements. Among the information required to be reported to the Commissioner, employers will be required to estimate the market value of shares and rights acquired under an employee share scheme at the employee's taxing point and the number of shares and rights an employee has obtained at both grant and at taxing point.

#### **Withholding tax arrangements**

Withholding tax will be payable in circumstances where an employee fails to provide their employer with a tax file number (TFN) or Australian Business Number (ABN) by the end of the year.

#### **Seasonal Adjustments to Tax Talk**

We have received a few phone calls over the past month asking about the August edition of Tax Talk. Don't worry, you haven't missed anything!

Over the spring and summer months, when the volume of tax-related changes and information decreases somewhat, we at CRM have elected to reduce the frequency of the Tax Talk newsletter to bi-monthly instead of monthly. Hopefully this will result in more focused and valuable newsletters that contain all the useful tax information that you need in fewer emails to your Inbox.

As always, if there is anything that we can help clarify or answer for you with regards to the information contained in these newsletters or any other tax-related topic, please don't hesitate to contact us here at CRM in either Myrtleford or Bright.

Happy spring!