

The inherent danger of salary sacrifice

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Salary sacrifice is the employment arrangement of foregoing gross salary in favour of other forms of remuneration, such as superannuation or fringe benefits. It is commonplace in Australia.

Another prevalent term is ‘salary packaging’. This concept looks more at the total remuneration that an employer is providing to an employee, and how that total package is constituted.

Salary sacrifice has a ‘top down’ approach, i.e. reducing the cash in favour of other benefits. Salary packaging has a more ‘bottom up’ approach, i.e. a focus on the total cost to the employer, however constituted.

Technically, either term, or either process, should have the same outcome for both the employer and employee. An employer should be no worse off, and possibly better off by virtue of reduced payroll tax and workers’ compensation premiums. An employee should be better off by virtue of increased overall net pay, and reduced levels of remuneration reported on the Payment Summary (which affects things like HECS/HELP, welfare payments etc.)

However, my experience has been that in almost every case of the numerous remuneration arrangements I have encountered, salary sacrifice arrangements result in employees being incorrectly paid; mostly underpaid. Employers engaging in salary packaging arrangements are less likely to underpay their staff, but I still have encountered a disturbingly large number of underpayments.

REMUNERATION COMPONENTS

The problem stems from a basic misunderstanding of the complicated components of a remuneration agreement.

Assume that an employer is offering an employee a salary of \$60,000 per annum. This equates to a remuneration package of \$65,400 per annum, when nine percent superannuation guarantee is included. The most important figure is the bottom

line of \$65,400, being the amount the employer is contracting to provide to the employee.

Given that the whole point of salary sacrifice or salary packaging is to improve the employee’s overall net pay, the employee should receive no less than \$65,400 from the employer, irrespective of what form that total remuneration takes.

Hence, if an employee decides to include a non-cash item in the package, such as a car under a novated lease, or a laptop computer, the employer’s total outlay must remain unchanged at \$65,400, taking into account the fringe benefits tax (FBT) now payable and any goods and services tax (GST) input tax credits (ITCs) that may be gained. If the employee makes an after tax contribution to the employer for a benefit received, such a contribution would attract GST. If the employer also included an administration fee for providing salary packaging, the remuneration package might then become:

Cash	45,046
9% Superannuation	4,054
Fringe benefits	11,000
FBT	7,000
GST ITCs from fringe benefits	(1,000)
Employee contribution	(1,100)
GST on employee contribution	100
Administration fee	300
Total Package	\$65,400

Note: in the above package the concept of salary sacrifice disappears.

GST

The GST ITCs relate to the fringe benefits provided. The employer is entitled to claim the ITCs under the GST legislation. However, those ITCs must be credited back to the employee’s package for two reasons.

Firstly, the FBT charged to the package is calculated at either a higher (2.0647) or lower (1.8692) factor

based on whether or not the benefit is a GST-credit-able benefit. If the employer charges the higher FBT to the employee's package, then the ITCs obviously belong to the employee. (Some employers 'net off' the gross fringe benefits with the ITCs.)

Secondly, unless the ITCs are returned to the package, the employer is not providing the full contracted remuneration. The employee might still be receiving an overall increase in net remuneration under the package, but such net remuneration should be even higher if the package had been properly implemented.

PACKAGED CARS

A further serious concern is novated lease cars. This is where an employee leases a car, novates the lease to the employer, and then the employer provides the vehicle to the employee as part of his or her package. The reason for the novation in the first place is to employ the statutory formula method under the FBT Assessment Act (FBTAA), which taxes cars on a concessional basis.

Normally speaking, under a novated lease arrangement the car is used 100 percent privately. Thus, the employer would charge the employee's package with the full car running expenses, lease payments and FBT, with a credit for the GST ITCs on the lease payments and the running expenses. However, the underpayment occurs when the employee uses that novated lease car for work purposes. Given that fringe benefits are akin to net salary, the employee using his or her novated lease vehicle for business purposes is akin to the employee spending his or her net pay on the employer's business expenses.

In such a case the employer should credit the employee's package with the business use of the vehicle. While the keeping of a full log book in this circumstance might be inappropriate, the employee should record the kilometres travelled for business and then a credit be granted to the package. A common method of calculating such a credit is using a c/km rate. However, such a c/km calculation is only for the purpose of providing a credit to the package, and would not appear separately on the employee's payment summary in the allowances box, nor would the employee be entitled to claim an income tax deduction against this payment (s 51AF Income Tax Assessment Act 1936).

Novated leases aside, in the case where an employee is required to use a car for business purposes, if the business use of the car is high, or at least significant, the employer should consider providing the car, rather than requiring a novated lease arrangement. Even so, only the private use of the car is charged to the employee's package, as this represents the employee's pay. The danger for the employer in

cases such as these, is that it is often necessary for the employer to request the employee to keep a log book to determine the business-private dichotomy so that the FBT operating cost method may be applied. However, that same log book will be used to determine the amount of running expenses charged to the employee's package. Inaccurate or fraudulent entries in a log book may produce a high business percentage which would advantage the employee by having less car expenses and FBT charged to the package. In essence, the employee may be overpaid.

One final point on cars, I often hear employers state that two of their employees are on identical remuneration because "they each receive \$50,000 plus a car". Unfortunately, those employees are on different remuneration levels. It is highly unlikely that two cars will have identical running expenses.

PERFORMANCE BONUSES

Another issue that causes employees to be underpaid is that of performance bonuses - such as bonus over and above the total package if certain performance indicators are reached. Performance bonuses, if paid in cash, are subject to the nine percent superannuation guarantee: Superannuation Guarantee Ruling SGR 94/4 (Appendix A). Thus, the employer should consider whether any bonus is inclusive or exclusive of superannuation.

RECONCILIATION

Salary packaging, if done correctly, will cause the employer to undertake an end-of-year reconciliation to ensure that the amount contracted was fully provided to the employee. When a remuneration package is originally determined at the beginning of the year, many of the figures are estimates (such as car expenses). It is highly unlikely that the employee's total package would have been fully and accurately provided by the employer by year end. Failure to undertake a reconciliation leaves both the employer and employee at risk of paying and receiving incorrect levels of remuneration.

EMPLOYMENT LAW

All of the above is premised on the fact that an employee is entitled to a package under any prevailing employment law. If an award or agreement does not make allowance for reducing the cash salary, then by so doing could result in a breach of the instrument, and may give rise to a claim by the employee for underpayment of salary, perhaps with counterclaim by the employer for overpayment of benefits. However, even if an instrument does permit the sacrificing of salary for other benefits, some instruments are so poorly written that there is

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Lawyer-client relationships put under the microscope

The Australian Law Reform Commission (ALRC) says its new review of legal professional privilege could have a major impact on the way clients and lawyers will interact in future.

The ALRC inquiry will concentrate on the application of legal professional privilege to the coercive information gathering powers of Commonwealth bodies - such as the Australian Federal Police, the Australian Crime Commission, the Australian Securities and Investments Commission, the Australian Taxation Office and federal royal commissions.

ALRC President Professor David Weisbrot said the ALRC had looked at legal professional privilege generally in its recent report Uniform Evidence Law (ALRC 102), released earlier this year, and in somewhat greater detail in its 2002 report, Principled Regulation (ALRC 95).

“In both of those reports, the ALRC highlighted the need for a ‘root and branch’ review of legal professional privilege in the context of the coercive investigatory powers of federal regulatory agencies and royal commissions,” Professor Weisbrot said.

“This also was squarely raised as an issue in the recent report of the Cole inquiry into the Australian Wheat Board and, before that, in the report of the HIH Royal Commission.

“Commissioner Cole noted that a conflict sometimes arises between the public interest in discovery of the truth - which is the prime function of a royal commission - and the right of persons to communicate with their lawyers and obtain legal advice under conditions of confidentiality.

“We are pleased to have been asked to conduct this inquiry, the essence of which will be to determine if there are circumstances in which maintaining client legal privilege must bend to the broader public interest.

“Common law courts have held consistently that legal privilege is a fundamental right and not merely a procedural safeguard.

“The ALRC will identify experts and key stakeholders in this area. We’ll be seeking their input - as well as views from the wider community - about both perceived problems and potential solutions.



“This obviously involves some very complicated technical issues and we anticipate that the legal profession, judges, former royal commissioners and counsel assisting, and Commonwealth investigatory bodies will have considerable input into the ALRC’s inquiry.”

The terms of reference are available on the ALRC website (www.alrc.gov.au) and the Commission has started work on an Issues Paper.

The ALRC is due to report by December 2007.

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no recognition of the total remuneration due to the employee.

NOT-FOR-PROFIT ORGANISATIONS

My experience has shown me that not-for-profit organisations are a large category of offenders. Complexities aside, because such organisations often receive significant FBT concessions, some of these employers encourage salary packaging more so for the benefit of the organisation, rather than as increased benefits for the employee. In other words, by packaging, the employee does receive increased net pay, but not as much as he or she should have received had the employer not kept (perhaps unknowingly) some of that increased benefit for the organisation.

I think the only reason that we do not see more legal actions taken against employers is that there are so few professionals who have a sufficient understanding of the interaction of employment and taxation law.