

# **Interaction between GST, FBT and Income Tax: A Systematic Framework for Approaching Problems**

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## **1. Introduction**

For a number of reasons, the interaction between the GST, FBT and the income tax can be complex, and students often make mistakes in this area. The central purpose of this article is to provide a structured and coherent framework for approaching the tax rules that apply to the interaction between these three regimes. The starting point in this area though is that you must have an understanding of the central rules under each regime when that regime is viewed in isolation. Even though there is some commentary on this, this is largely assumed in this article. From there, the article focuses on the relevant rules that apply at the point where the regimes interact in regard to the transaction where an employer provides a fringe benefit to an employee. While the focus in this article is solely on expense payment fringe benefits (e.g. reimbursements), the approach outlined can, for the most part, be generalised or applied to other categories of fringe benefits.

The article is in seven parts. Parts 2-4 deal with the relevant rules and their interaction under the three combinations of regime interactions. Part 5 of the article builds on Parts 2-4 and sets out a suggested order of approach to an expense payment benefit situation. Part 6 sets out three examples of the application of the interaction rules. And finally, Part 7 contains a table that allows the reader to visually see the application of the tax interaction rules and to compare the application of these rules to Type 1 and Type 2 benefits on the one hand, and the provision of salary to an employee on the other.

## **2. Interaction between Income Tax and FBT**

### **2.1 Cost to Employer of Employee Benefit**

There is an analogy with (similar to) payments of wages or salaries to employees. Provided the employee who receives the wages is working on the employer's income-producing activity (business), the positive limbs of s 8-1(1) are satisfied. In other words, the provision of a benefit to the employee (especially one that confers a private benefit on the employee such as a gymnasium benefit) can be seen as a cost of retaining the services of the employee to further the goals of the business, which is to make income. With a reimbursement that is for costs associated with furthering the business interests of the employer, these can be seen as a cost of the business (rather than a cost of retaining the employee's service).

It should also be appreciated that the employer will satisfy the positive limbs of s 8-1(1) whether the benefit is salary, an allowance or a reimbursement. Further, costs associated with retaining the services of employees will nearly always be on revenue account (not capital account) under s 8-1 because such costs are regarded as recurrent: *BP Australia Ltd v FCT* (1965) 14 ATD 1 at 9. Finally, the amount of an input tax credit the taxpayer has obtained under the GST Act is excluded from the deductible amount (See Part 2).

### **2.2 Deductibility of FBT Payable by Employer**

The deductibility of the liability for FBT is similar to that in regard to costs of employee benefits in Part 2.1 above. Provided the employee who obtained the benefit that generated the FBT

liability, is working on the employer's income-producing activity (business), then the positive limbs of s 8-1(1) are satisfied. And, this cost also will nearly always be regarded as being on revenue account for the same reason given about the cost of the benefit.

### **2.3 Receipt of Benefit by Employee**

If the benefit is a fringe benefit, then it will be taxed (or dealt with) under the FBT regime, and it is not included in the recipient's (employee's) assessable income: s 23L(1).

If the benefit is not a fringe benefit, because for example it is an allowance, commission, bonus, etc, it will be not be taxed (or dealt with) under the FBT regime: paragraph (f) of the definition of "fringe benefit" in s 136(1) of the FBTAA. Rather, it is likely to be included in the recipient's (employee's) assessable income under s 6-5 (or maybe s 15-2).

### **2.4 FBT Payable by Employer**

For expense payment benefits, there is or could be a three-step process for determining the taxable value of the benefit. The three steps are: (i) Prima facie taxable value (PFTV) (ii) PFTV reduced by recipient's contribution and (iii) Further reduction to taxable value by otherwise deductible rule (otherwise deductible amount).

#### **2.4.1 Prima Facie Taxable Value (PFTV)**

For a reimbursement, this is the amount of the reimbursement: s 23. For the discharge of an expense incurred by the employee, this is the amount of expense discharged by the employer's payment: s 23. This prima facie taxable value of a benefit is the GST-inclusive amount (i.e. do not exclude GST on the "transaction").

#### **2.4.2 PFTV Reduced by Recipient's Contribution**

In the case of the discharge of an expense, if the employee makes a payment to the employer as a contribution towards the cost of the benefit, this will reduce the taxable value of the benefit: s 23. There can be no recipient's contribution in regard to a reimbursement.

#### **2.4.3 Further reduction to Taxable Value by Otherwise Deductible Rule (ODR) as it applies to the Employer**

At times, the FBT regime borrows concepts from the income tax to help calculate the taxable value in regard to a particular benefit. The ODR is a hypothetical rule that may reduce the taxable value of a particular fringe benefit. But first, note that the ODR has nothing to do with the calculation or determination of an employee's actual deductions. The ODR has nothing to do with the calculation or determination of an employer's deductions. The ODR only applies in determining the taxable value of a fringe benefit.

What is the ODR then? The ODR determines whether the taxable value of a fringe benefit can be reduced. It asks a hypothetical question. It is not fully based on actual facts. It asks: if the employee had incurred and paid for the benefit (and not been reimbursed) that he/she got from the employer, would the employee have got a once-only deduction under the income tax rules? This brings in all the deduction rules under the income tax (e.g. s 8-1, deduction denial rules, deduction conferral rules). (Note, s 82A is excluded from this). When addressing this question, you must view the "notional expenditure" and/or "notional transaction" from the employee's perspective.

If the answer to the notional question is no, then the ODR does not reduce the taxable value of the fringe benefit. If the answer is yes, the ODR reduces the taxable value by the amount of the notional deduction. This is not necessarily the full amount of the benefit provided to the employee.

Importantly, if there is an otherwise deductible amount, it is the GST-inclusive amount that is “deductible” (i.e. do not exclude GST on the “transaction”) because the employee cannot have obtained an input tax credit on their notional deduction because they cannot be registered under the GST Act.

#### **2.4.4 FBT Calculation**

If there is a taxable value after the three steps above, the taxable value has to be “grossed-up”. A Type 1 benefit has a higher gross-up amount applied to the taxable value of benefits compared to a Type 2 benefit: ss 5B(1B) and 5B(1C). For Type 1, it is 2.0647. For Type 2, it is 1.8692.

The test to distinguish between a Type 1 and Type 2 benefit is from answering this question: Is the employer entitled to an input tax credit on the purchase cost of the benefit (GST-creditable benefit: s 149A)? If yes, then it is Type 1. If not, then it is Type 2. In answering the GST-creditable benefit question, one needs to determine whether the supply that relates to the employer’s acquisition is a taxable supply, GST-free or input taxed, because an employer can only obtain an input tax credit on an acquisition made under a taxable supply.

Once the grossed-up value is determined, the amount is multiplied by the FBT rate of 46.5% to get the FBT payable.

#### **2.5 “Cost” to Employee**

Where the employee has had the expense reimbursed (or partly reimbursed), or has had the expense discharged by (paid for by) the employer, the employee will not obtain a deduction for the expense: s 8-1 and/or s 51AH.

### **3. Interaction between Income Tax and GST**

#### **3.1 GST on a Taxable Supply**

If a taxpayer makes a “taxable supply” as defined under the GST Act, the taxpayer will have a GST liability on that supply equal to 1/11<sup>th</sup> of the amount received: ss 9-5, 9-70 and 9-75. On the other hand, there is no GST on supplies that are GST-free or input taxed.

#### **3.2 GST on a Taxable Supply is not a Chargeable Receipt under the Income Tax**

A GST amount (or liability) on a taxable supply will not be included in the taxpayer’s assessable income: s 17-5. And, a GST amount on the sale of a depreciating asset or CGT asset will not be included as part of the sale proceeds (i.e. termination value, capital proceeds): ss 27-95(1) and 116-20(5).

#### **3.3 Input Tax Credit on a Creditable Acquisition**

If a taxpayer makes a “creditable acquisition” as defined under the GST Act, the taxpayer will obtain an input tax credit on the acquisition: s 11-20. The input tax credit is usually 1/11<sup>th</sup> of the amount paid under the acquisition: s 11-25. It is important to note that in most expense payment benefit situations, the entity making the taxable supply will have made the supply to the

employee, and not the employer. The employer would not be able to satisfy the normal requirements for a creditable acquisition in these circumstances: s 11-5(b). However, ss 111-5, 111-10 and 111-25 recognise and correct for this so that the employer can still get an input tax credit even though the employer did not purchase the supply directly from the supplier.

It is important to note that when determining the extent of creditable purpose for the purpose of working out the amount of the input tax credit of the employer (s 11-15), it is the perspective of the employee that is relevant. The perspective of the employer, namely, the extent of income-producing use made of the benefit by the employer, is not relevant to this question.

### **3.4 Input Tax Credit on a Creditable Acquisition does not obtain Recognition under the Income Tax Rules**

An input tax credit obtained on a creditable acquisition is not allowed as a deduction: s 27-5. And, an input tax credit on acquisition of a depreciating asset or a CGT asset is also not included in the relevant cost base: ss 27-80 and 103-30.

## **4. Interaction between GST and FBT**

In large part, this has already been dealt with in Part 2.4. However, a brief reminder is appropriate along with brief mention of another issue.

### **4.1 Values for FBT Purposes**

When determining the prima facie taxable value and the otherwise deductible amount under the FBT regime for a benefit, GST-inclusive amounts are to be used (i.e. do not exclude the GST on the “transaction”).

### **4.2 Difference between a Type 1 and a Type 2 Benefit**

A Type 1 benefit has a higher gross-up amount applied to the taxable value of benefits compared to a Type 2 benefit: ss 5B(1B) and 5B(1C). For Type 1, it is 2.0647. For Type 2, it is 1.8692.

The test to distinguish between a Type 1 and Type 2 benefit is whether the employer is entitled to an input tax credit on the purchase cost of the benefit (GST-creditable benefit: s 149A)? If such an entitlement exists, it is a Type 1 benefit. If not, then it is Type 2 benefit.

In answering the GST-creditable benefit question, one needs to determine whether the supply that relates to the employer’s acquisition is a taxable supply, GST-free or input taxed, because an employer can only obtain an input tax credit on an acquisition made under a taxable supply.

### **4.3 There is no GST on Taxes**

The employer will not obtain an input tax credit on paying their FBT liability because there is not GST liability on the receipt of FBT.

## **5. Suggested Order for Approaching an Expense Payment Fringe Benefit Problem**

Once it is established that the benefit is a fringe benefit and that it is an expense payment fringe benefit, the following order of approaching the tax issues is suggested:

**Step 1: work out the position under the GST Act.** This includes identifying: (i) whether the supply made to the employee or employer was a taxable supply and (ii) if the supply was a taxable supply, did the employer obtain an input tax credit for the GST on the acquisition made by the employer.

**Step 2: work out whether FBT is payable on the benefit.** This may involve a number of steps including the three steps that can be involved in determining the taxable value of a particular fringe benefit. In addition, determining whether the benefit is a Type 1 or Type 2 benefit is also an important step towards calculating the FBT liability.

**Step 3: work out the income tax issues that flow from provision of the benefit.** This should include: (i) the deductibility of the cost of the benefit and (ii) the deductibility of FBT payable.

However, it may also include dealing with the implications for the employee who received the benefit. This would include the exclusion from assessable income on receipt of the benefit. It may also include the exclusion of a deduction that could have been available if the benefit was not provided to the employee.

## **6. Examples of Application of the Tax Interaction Rules to Fringe Benefit Situations**

### **6.1 Reimbursement of Mobile Phone Expenses where Employee uses Phone partly for Work**

The employer reimburses the employee's mobile phone bill/account for six-months. It came to \$770. The employee uses the phone 30% for his employment.

**GST:** The supply of mobile phone services are a taxable supply, and therefore subject to GST. Assuming the employer's business makes taxable supplies and/or GST-free supplies, the employer is entitled to an input tax credit on the reimbursement. Importantly, the input tax credit is \$70 ( $1/11^{\text{th}}$  of \$770). The fact the employee uses the mobile phone only partly for their income-producing activity is not relevant to the employer's input tax credit question.

**FBT:** The prima facie taxable value is \$770, that is, the GST-inclusive amount. There can be no recipient's contribution. The otherwise deductible rule applies to give an otherwise deductible amount of \$231 ( $\$770 \times 30\%$ ). This reduces the taxable value to \$539 ( $\$770 - \$231$ ).

The taxable value is grossed-up by 2.0647 because the employer obtained an input tax credit on the provision of the benefit (Type 1). This means the grossed-up value is \$1,112 ( $\$539 \times 2.0647$ ). FBT payable is \$517 ( $\$1,112 \times 46.5\%$ ).

**Income Tax:** Assuming the employee is working in the employer's business (income activity), the employer's deduction for the cost of the benefit provided is \$700. It is not \$770 because the input tax credit is not a deduction. FBT of \$517 is also deductible.

The employee has not made assessable income on receipt of the \$770 reimbursement. And, the employee does not obtain a deduction for cost of the phone service because he has been reimbursed the cost.

### **6.2 Reimbursement of Child Care Expenses**

The employer reimburses the employee for \$1,000 of their child-care expenses.

**GST:** The supply of child-care services are GST-free, and therefore are not subject to GST. Accordingly, the employer is not entitled to an input tax credit on the reimbursement.

**FBT:** The prima facie taxable value is \$1,000. There can be no recipient's contribution. On application of the otherwise deductible rule, no otherwise deductible amount arises because child-care is not deductible when incurred by a parent. Therefore, the taxable value remains at \$1,000.

The taxable value is grossed-up by 1.8692 because the employer did not obtain an input tax credit on the provision of the benefit (Type 2). This means the grossed-up value is \$1,869 ( $\$1,000 \times 1.8692$ ). FBT payable is \$869 ( $\$1,869 \times 46.5\%$ ).

**Income Tax:** Assuming the employee is working in the employer's business (income activity), the employer's deduction for the cost of the benefit provided is \$1,000. FBT of \$869 is also deductible.

The employee has not made assessable income on receipt of the \$1,000 reimbursement. And, the employee does not obtain a deduction for the cost of the child-care services for a number of reasons (e.g. has been reimbursed the cost).

### **6.3 Reimbursement of Employee's Residential Rental Property Expenses**

The employer reimburses the employee's GST-inclusive revenue repair expenses on their residential rental property. The reimbursement came to \$880.

**GST:** The supply of repair services to a property is a taxable supply, and therefore subject to GST. Assuming the employer's business makes taxable supplies and/or GST-free supplies, the employer is entitled to an input tax credit on the reimbursement. The input tax credit is \$80 ( $1/11^{\text{th}}$  of \$880). The fact the employee, in their capacity as an owner of a residential rental property, could not have obtained an input tax credit for the \$80 (because it is related to making an input taxed supply) is not relevant to the employer's input tax credit question.

**FBT:** The prima facie taxable value is \$880, that is, the GST-inclusive amount. There can be no recipient's contribution. The otherwise deductible rule applies to give an otherwise deductible amount of \$880 ( $\$880 \times 100\%$ ) because the employee would have got a deduction for the cost of the \$880 had he/she not been reimbursed the expenditure: s 25-10. This reduces the taxable value to zero ( $\$880 - \$880$ ).

Accordingly, there is no need to go any further with FBT and the Type 1/Type 2 question becomes academic.

**Income Tax:** Assuming the employee is working in the employer's business (income activity), the employer's deduction for the cost of the benefit provided is \$800. It is not \$880 because the input tax credit is not a deduction. There is no deduction for FBT as there is no liability for this.

The employee has not made assessable income on receipt of the \$880 reimbursement. And, the employee does not obtain a deduction for cost of the revenue repairs because he/she has been reimbursed the cost.

## 7. Table Comparing Type 1 and Type 2 Benefits to Salary

**Tabular Summary Comparing the After-Tax, Tax Outcome of the Payment of Salary (\$1,869) to an Employee with the Provision of an Expense Payment Fringe Benefit(s) (both Type 1 and Type 2) of \$1,000 to the Employee**

	Payment of Salary, Wages, Commission, Bonus or Allowance (i.e. Cash)	Type 2 Expense Payment Fringe Benefit of a Private Nature (e.g. Council Rates on Home, Water Rates on Home, Private School Fees, Child Care Fees)	Type 1 Expense Payment Fringe Benefit of a Private Nature (e.g. Home Telephone Bill, Home Electricity Bill)
<b><u>INCOME TAX</u></b>			
<b>Employee's Tax Position</b>			
1. Assessable Income	\$1,869	Nil	Nil
2. Tax (Marginal Rate of 46.5% (Tax plus Medicare Levy))	\$869	Nil	Nil
3. After Tax Benefit/Economic Benefit	<u>\$1,000</u>	<u>\$1,000</u>	<u>\$1,000</u>
<b>Employer's Tax Position (Company Employer on 30% Tax Rate)</b>			
4. Cost of Benefit before Income Tax and before Input Tax Credit under the GST	\$1,869	\$1,000	\$1,000
5. Deduction for Cost of Benefit	\$1,869	\$1,000	\$909
6. Fringe Benefits Tax Paid (from 11 below)	Nil	\$869	\$960
7. Tax Saving Because of Deduction for Cost of Benefit and Deduction for Fringe Benefits Tax Paid ([5 + 6] x 30%)	\$560	\$560	\$560
8. After Tax Cost of Benefit ([5 + 6] - 7)	<u>\$1,309</u>	<u>\$1,309</u>	<u>\$1,309</u>
<b><u>FRINGE BENEFITS TAX (FBT)</u></b>			
9. Taxable Value of Benefit	Nil	\$1,000	\$1,000
10. Grossed-Up Taxable Value	Nil	\$1,869	\$2,064
11. Fringe Benefits Tax (10 x 46.5%)	<u>Nil</u>	<u>\$869</u>	<u>\$960</u>
<b><u>GOODS AND SERVICES TAX (GST)</u></b>			
12. Input Tax Credit (i.e. Refund) for GST Charged to Employer on Acquiring the Benefit for Employee	<u>Nil</u>	<u>Nil</u>	<u>\$91</u>

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