



# ***TR 2014/D1 - Income tax: employee remuneration trust arrangements***

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## Draft Taxation Ruling

### Income tax: employee remuneration trust arrangements

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### What this Ruling is about

1. This draft Ruling explains the taxation consequences for employers, trustees and employees who participate in an employee remuneration trust arrangement (ERT). In particular, it explains how the taxation laws apply when a contribution is made by an employer to the trustee of an ERT and benefits are paid or provided by the trustee of the ERT to employees.

2. Part A of this draft Ruling considers the consequences for an employer who participates in an ERT. In particular, it is about when, and in what circumstances:

- a) a contribution made by an employer to the trustee of an ERT (a ‘contribution’) is deductible under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- b) an amount must be withheld from a contribution under section 12-35 of Schedule 1 to the *Taxation Administration Act 1953* (TAA) (and paid to the Commissioner in accordance with Subdivision 16-B of Schedule 1 to the TAA);
- c) a contribution constitutes a fringe benefit as defined in subsection 136(1) of the *Fringe Benefits Tax Assessment Act 1986* (FBTAA) (a ‘fringe benefit’) in relation to an employee; and
- d) any benefit otherwise provided to an employee from an ERT constitutes a fringe benefit.

3. Part B of this draft Ruling considers the consequences for a trustee who participates in an ERT. In particular, it is about when and in what circumstances:

- a) the net income of the trust, as defined in section 95 of the *Income Tax Assessment Act 1936* (ITAA 1936) (the 'section 95 net income'):
  - takes gains made or losses incurred by the trustee of the ERT into account as revenue or capital;
  - is taken, pursuant to Division 7A of Part III of the ITAA 1936 (Division 7A), to include a dividend;
- b) an amount must be withheld from a payment by the trustee to an employee under section 12-35 of Schedule 1 to the TAA (and paid to the Commissioner in accordance with Subdivision 16-B of Schedule 1 to the TAA); and
- c) a share of the section 95 net income is assessable to the trustee of the ERT under Division 6 of Part III of the ITAA 1936 (Division 6).

4. Part C of this draft Ruling considers the consequences for an Australian resident employee (an 'employee') who participates in an ERT. In particular it is about when and in what circumstances:

- a) a contribution constitutes the derivation of ordinary income by an employee, assessable to the employee under section 6-5 of the ITAA 1997;
- b) an employee is assessable in respect of a benefit they receive from an ERT under Division 6 or Subdivision 207-B of the ITAA 1997, or via Subdivision 115-C of the ITAA 1997 (the 'trust assessing provisions') or under section 6-5 of the ITAA 1997 as ordinary income;
- c) an assessable dividend is taken by Division 7A to be paid to an employee; and
- d) an employee, assessable under section 207-35 of ITAA 1997 in respect of franked distributions of the trust, is entitled to offsets for franking credits.

5. This draft Ruling does not deal with circumstances in which a contribution to, or benefits received from, an ERT may be statutory income under (or as a result of):

- section 15-2 of the ITAA 1997 (allowances and other things provided in respect of employment or services);
- Division 83A of the ITAA 1997 and former Division 13A of Part III of the ITAA 1936 (employee share schemes);
- section 82-130 of the ITAA 1997 (employment termination payments);

- Subdivision 83-A of the ITAA 1997 (unused annual leave payments);
- Subdivision 83-B of the ITAA 1997 (unused long service leave payments);
- Subdivision 83-C of the ITAA 1997 (genuine redundancy payments and early retirement scheme payments);
- Subdivision 83-D of the ITAA 1997 (foreign termination payments); or
- Part 2-42 of the ITAA 1997 (personal services income).

6. This draft Ruling also does not consider

- the circumstances in which Part IVA of the ITAA 1936 might apply to an ERT arrangement. There are circumstances where this has occurred;<sup>1</sup>
- the application of section 40-880 of the ITAA 1997 to a contribution that is capital or of a capital nature;<sup>2</sup> and
- the extent to which section 82KZMA of the ITAA 1936 applies to determine when a contribution, to the extent to which it is otherwise deductible under section 8-1 of the ITAA 1997, can be deducted.

7. Nothing in this draft Ruling should be taken as applying to superannuation funds as defined in section 10 of the *Superannuation Industry (Supervision) Act 1993* or to approved worker entitlement funds as defined by subsections 58PB(1) and (2) of the *FBTAA* or financial arrangements to which Division 230 of the ITAA 1997 applies to.

<sup>1</sup> The Federal Court and Administrative Appeals Tribunal have decided that Part IVA of the ITAA 1936 applies to ERTs or arrangements similar to ERTs in the following cases: *Spotlight Stores Pty Ltd & Anor v. Federal Commissioner of Taxation* [2004] FCA 650 at [77]-[116]; 2004 ATC 4674 at 4695-4705; (2004) 55 ATR 745 at 764-778, *Yip v. Federal Commissioner of Taxation* [2011] AATA 785 at [73]-[134]; 2011 ATC 10-214; (2011) 82 ATR 761 at 789-806, *Experienced Tours Pty Ltd v. Federal Commissioner of Taxation* [2006] AATA 517 at [102]-[112]; 2006 ATC 2232 at 2240-2241; 63 ATR 1147 at 1156-1157 and *Wensemius v. Federal Commissioner of Taxation* [2007] AATA 1006 at [102]-[112]; 2007 ATC 2035 at 2240-2241; (2007) 66 ATR 144 at 164-166. The application of Part IVA to ERTs has been considered in Taxation Ruling TR 2010/6 *Income tax, Pay As You Go Withholding and fringe benefits tax: tax consequences on the issue, holding and redemption of bonus units as part of an employee benefits trust arrangement* at paragraphs 16-17, 34-43 and 80-87 and Taxation Determination TD 2010/10 *Income tax: can Part IVA of the Income Tax Assessment Act 1936 apply to an employee savings plan as described in Taxpayer Alert TA 2008/13?* at paragraphs 1-19.

<sup>2</sup> The application of section 40-880 of the ITAA 1997 depends on the particular nature of the business and is fact specific. Taxation Ruling TR 2011/6 *Income tax: business related capital expenditure - section 40-880 of the Income Tax Assessment Act 1997 core issues* sets out the Commissioner's views on the interpretation, operation and scope of section 40-880 of the ITAA 1997.

## Class of entity/arrangement

8. This draft Ruling applies to employers and their employees, and trustees, who participate in an ERT as described at paragraph 9 of this draft Ruling regardless of how it is labelled by the participants (noting that ERTs may be described in various ways, including as employee bonus, benefit, incentive or reward schemes or arrangements). Examples of ERTs are set out in detail in Taxation Ruling TR 2010/6<sup>3</sup> and Taxation Determination TD 2010/10.<sup>4</sup>

9. The essential elements of an ERT for the purposes of this draft Ruling are:

- a) an employer carries on business for the purpose of gaining or producing assessable income;
- b) Australian resident employees<sup>5</sup> are employed by the employer in the ordinary course of carrying on that business;
- c) a trust is established by or at the instruction of the employer;
- d) the trust is a resident trust for the purposes of Division 6;<sup>6</sup>
- e) the employer makes one or more contributions to the trustee of the trust;
- f) the trustee applies the contributions to make loans to employees and/or to acquire shares or other assets;
- g) employees of the employer are capable of benefiting under the trust (for example, in the form of loans, distributions of cash and/or a transfer of assets); and
- h) the value of any benefits provided to employees is determined by the employer or the trustee, having regard to
  - the performance of the employees;
  - the growth in value of, or generation of income from, investments held by the trustee; and/or
  - objective indices, for example, movements in the value of shares in the employer or a related entity.

<sup>3</sup> Taxation Ruling TR 2010/6 *Income tax, Pay As You Go Withholding and fringe benefits tax: tax consequences on the issue, holding and redemption of bonus units as part of an employee benefits trust arrangement* at paragraphs 5-7.

<sup>4</sup> Taxation Determination TD 2010/10 *Can Part IVA of the Income Tax Assessment Act 1936 apply to an employee savings plan as described in Taxpayer Alert TA 2008/13?* at paragraphs 5-7.

<sup>5</sup> Although certain ERT arrangements may involve non-resident employees, this draft Ruling only considers relevant tax consequences for employees who are Australian residents as defined in subsection 6(1) of the ITAA 1936.

<sup>6</sup> This will be where, during the year in question, either the trustee is an Australian resident or the central management and control of the trust is in Australia. See subsection 95(2) of the ITAA 1936.

**Defined terms**

10. In this draft Ruling, the following terms and abbreviations are used:

<b>Capital structure advantage</b>	A capital advantage sought to be secured by an employer in making a contribution to the trustee of an ERT for the purpose of being ultimately and in substance, applied by the trustee to acquire a direct interest in the employer (for example shares).
<b>Contribution</b>	A payment, provision or crediting of money or property by an employer to the trustee of an ERT which increases the value of the trust estate. A loan by an employer to the trustee of an ERT is not considered to be a contribution for the purposes of this draft Ruling.
<b>Division 6</b>	Division 6 of Part III of the ITAA 1936
<b>Division 7A</b>	Division 7A of Part III of the ITAA 1936
<b>ERT</b>	An employee remuneration trust arrangement, as described in paragraph 9 of this draft Ruling.
<b>FBT</b>	Fringe benefits tax, being the tax imposed on the fringe benefits taxable amount of an employer of a year of tax ending on 31 March.
<b>FBTAA</b>	<i>Fringe Benefits Tax Assessment Act 1986</i>
<b>Financing facility advantage</b>	A capital advantage sought to be secured by an employer in making a contribution to the trustee of an ERT for the purpose of establishing or forming part of a fund which is applied to make loans or otherwise provide finance to employees.
<b>Fringe benefit</b>	A fringe benefit as defined in subsection 136(1) of the FBTAA.
<b>ITAA 1936</b>	<i>Income Tax Assessment Act 1936</i>
<b>ITAA 1997</b>	<i>Income Tax Assessment Act 1997</i>
<b>Remuneration</b>	A payment or other benefit provided in 'connection with and by reason of [services performed or to be performed] as an employee or in respect of some incident of [that] service'. <sup>7</sup> It includes (but is not limited to) salary or wages as defined in subsection 136(1) of the FBTAA, which in

<sup>7</sup> Per Latham J in *Mutual Acceptance Company v. FC of T* (1944) 69 CLR 389 at 396; [1944] HCA 34.

	<p>turn includes payments covered by section 12-35 of Schedule 1 to the TAA being salary, wages, bonuses, allowances or commissions paid to an individual as an employee. Remuneration can be paid or otherwise provided:</p> <ul style="list-style-type: none"> <li>• expressly under an employment contract, or an agreement relating to employment or remuneration, entered into by an employee with their employer;</li> <li>• as part of a general or implied understanding between an employer and an employee that the payments or other benefits are a reward for services; and</li> <li>• in any other way by which an employer delivers rewards for services to its employees.<sup>8</sup></li> </ul> <p>A payment or other benefit received by an employee is not remuneration if the consideration provided for the payment is not services provided by the employee to their employer,<sup>9</sup> or is not otherwise referable to the employment relationship between the employee and the employer. Paragraphs 36 and 37 of this draft Ruling contain further examples of amounts that are not derived as remuneration.</p>
<b>Section 95 net income</b>	The net income of a trust estate as defined in section 95 of the ITAA 1936.
<b>TAA</b>	<i>Taxation Administration Act 1953</i>
<b>Trust assessing provisions</b>	Division 6 of the ITAA 1936 and Subdivisions 115-C and 207-B of the ITAA 1997.
<b>Trustee</b>	The trustee of a trust established as part of an ERT.
<b>PAYG WH</b>	An amount withheld or required to be withheld from a payment for the purposes of section 12-35 of Schedule 1 to the TAA (PAYG withholding).

<sup>8</sup> The trustee of an ERT is usually aware of these arrangements and generally acts at the direction of an employer.

<sup>9</sup> *Deputy Federal Commissioner of Taxation v. Applied Design Development Pty Ltd (In Liq)* (2002) 117 FCR 336 at 342-343; [2002] FCA 205 at [25]-[26].

## Ruling

### Part A – consequences for an employer

11. This Part considers the consequences for an employer who participates in an ERT.

#### *Is a contribution deductible to the employer?*

12. An employer is entitled to a deduction under section 8-1 of the ITAA 1997 for a contribution paid to the trustee of an ERT that is either

- incurred in gaining or producing assessable income ('first limb') or
- necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income ('second limb'),

to the extent the contribution is not private or domestic in nature, is not of capital or of a capital nature, does not relate to the earning of exempt income or non-assessable non-exempt income and deductibility is not precluded by another provision of the ITAA 1997 or ITAA 1936.

13. Where an employer carries on a business for the purpose of gaining or producing assessable income, the question arises as to whether a contribution made to the trustee of an ERT is necessarily incurred in carrying on that business so as to satisfy the second limb.

#### *Is the contribution necessarily incurred in carrying on a relevant business?*

14. Subject to paragraph 15 of this draft Ruling, where an employer

- carries on a business for the purpose of gaining or producing assessable income and engages employees in the ordinary course of carrying on that business;
- makes a contribution to the trustee of an ERT; and
- at the time the contribution is made, the primary purpose of the contribution is for it to be applied, within a relatively short period, to the direct provision of remuneration of employees (who are employed in that business),

then, such a contribution will satisfy the nexus of being necessarily incurred in carrying on that business.



15. A contribution by an employer to the trustee of an ERT will not satisfy either limb of subsection 8-1(1) of the ITAA 1997 (and will therefore not be deductible) where that contribution is:

- intended to be applied for the benefit of the owners, controllers or shareholders of the employer (in, or by reason of, that capacity), or associates of any of them; or
- not intended, with any great certainty, to be substantially diminished in providing remuneration to employees within a relatively short period of making the contribution.

*A contribution that is capital or of a capital nature is not deductible under section 8-1 of the ITAA 1997*

16. A contribution that is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income will not be deductible to an employer to the extent to which it is capital or of a capital nature.

17. A contribution by an employer to the trustee of an ERT is considered to be capital or of a capital nature in whole or in part where the contribution is made for a purpose of securing a capital advantage by way of:

- establishing or forming part of a fund which is applied to make loans or otherwise provide finance to employees (a 'financing facility advantage'); or
- being ultimately and in substance, applied by the trustee to acquire a direct interest in the employer (for example shares) (a 'capital structure advantage').

18. A contribution by an employer to the trustee of an ERT in part made for a purpose of securing a capital advantage is only deductible under section 8-1 of the ITAA 1997 to the extent that the contribution is incurred for the primary purpose of being applied, within a relatively short period of time, to the direct provision of remuneration of employees (who are employed in the ordinary course of their employer's business carried on for the purpose of gaining or producing assessable income).

19. The Commissioner will accept all fair and reasonable bases of apportionment.

20. Where the contribution is made in part for securing a capital advantage referred to in paragraph 17, but the capital advantage is only expected to be very small or trifling compared to the advantage expected to be secured by directly remunerating employees (employed in the ordinary course of the employer's income producing business) within a relatively short period of time, it may be fair and reasonable for no part of the contribution to be apportioned to that capital advantage.

21. A capital advantage referred to in paragraph 17 will be accepted as only being very small or trifling where, the primary purpose of the employer in making the contribution is to remunerate its employees (employed in the ordinary course of the employer's income producing business) within a relatively short period of time and the capital advantage is:

- a financing facility advantage, where:
  - loans of the contributed funds are only made by the trustee of the ERT to employees; and
  - within a relatively short time of the contribution being made both:
    - the loans have to be repaid; and
    - equivalent funds are to be permanently diminished in directly providing remuneration to those employees;

and / or

- a capital structure advantage where any direct interest in the employer acquired by the trustee of the ERT (for example shares) will be transferred to those employees within a relatively short period of the contribution being made, with the expectation of not being immediately disposed of.

***Is a contribution subject to PAYG WH?***

22. An employer will be required to withhold an amount from a contribution to the trustee of an ERT for the purposes of section 12-35 of Schedule 1 to the TAA when the contribution constitutes a payment of salary, wages, commission, bonuses or allowances that:

- is paid to an employee, or applied or dealt with in any way on the employee's behalf or as the employee directs, and
- is not exempt income or non-assessable non-exempt income of the employee.

## ***When might a FBT liability arise for an employer under an ERT?***

### *Contribution*

23. A contribution by an employer to the trustee of an ERT is not a 'fringe benefit' for the purposes of the FBTAA where, at the time it is made, that contribution is not provided in respect of a particular employee and it cannot be said at that time that 'the identity of each of the employees who will take a share of the benefit is known with sufficient particularity'.<sup>10</sup>

24. A contribution is also not a 'fringe benefit' to the extent that it is remuneration of an employee, assessable to the employee under section 6-5 of the ITAA 1997 as a payment of salary or wages (see paragraph 38 of this draft Ruling).

### *Loans*

25. Except as explained in paragraph 27 of this draft Ruling, a loan provided by the trustee of an ERT to an employee is a fringe benefit by an employer if it is made:

- under an arrangement between the trustee and the employee's employer; and
- in respect of the employment of the employee (where the connection between the employment and the provision of the loan is sufficient or material).

26. A loan fringe benefit described in paragraph 25 of this draft Ruling will have a positive taxable value<sup>11</sup> where the employee uses the loan principal to acquire an interest in the ERT:

- that is not expected to produce assessable income;
- in respect of which the employee is not presently entitled to income, their future right to income from the ERT is subject to the discretion of the trustee and the employee does not have an indefeasible interest, in proportion to their unit holding, in any accumulated income and / or in the trust capital;
- where the likelihood of generating assessable income in excess of the interest expense, is remote; or
- for the primary purpose of making a capital gain.

27. A loan provided by the trustee of an ERT to an employee in respect of which Division 7A deems a dividend to be paid to that employee (refer to paragraphs 46 to 47 of this draft Ruling), or would so deem a dividend to be paid if the loan were not on terms complying with section 109N of the ITAA 1936, is not a fringe benefit.

<sup>10</sup> *Commissioner of Taxation v. Indooroopilly Children Services (Qld) Pty Ltd* (2007) 158 FCR 325 [2007] FCAFC 16; per Edmonds J at FCR 345; FCAFC [37].

<sup>11</sup> What is included in the taxable value of a loan fringe benefit is outlined in Subdivision B of Division 4 of the FBTAA.

*Other benefits provided by the trustee*

28. Other benefits (such as units, shares or rights) provided by the trustee of an ERT to an employee of an employer, are fringe benefits if they are provided:

- under an arrangement between the trustee and the employee's employer; and
- in respect of the employment of the particular employee (where the connection between the employment and the provision of the non-cash benefits is sufficient or material); and
- are not otherwise specifically excluded from the definition of 'fringe benefit'.

**Part B – consequences for the trustee**

29. This Part considers the consequences for a trustee who participates in an ERT.

***Calculation of section 95 net income****Gains made on revenue account*

30. Gains made by a trustee of an ERT on the realisation of trust assets are included in the trust's section 95 net income as ordinary income if after a wide survey and exact scrutiny of all of the relevant factors, it is determined that the gain or loss was made:

- in the ordinary course of carrying on a business of investment;
- outside of the ordinary course of that business but from an arrangement entered into with the intention of making a profit or gain; or
- from a one-off or isolated transaction where the investment was acquired in a business operation or commercial transaction for the purpose of profit-making.

*Dividends deemed to have been paid to the trustee*

31. A contribution to the trustee of an ERT made by an employer that is a private company will be deemed under section 109C of the ITAA 1936 to be a dividend, included in the section 95 net income of the ERT to the extent of the employer's 'distributable surplus' as defined in section 109Y if, at the time the contribution is made:

- the trustee of the ERT is a shareholder of the employer;
- no part of the contribution is provided in respect of a particular employee (in that capacity); and

- the contribution is made by the employer (otherwise than as an agent of an employee).

### ***Trustee's liability to tax***

32. To the extent to which there is a share of the income of the trust estate of an ERT to which no beneficiary is presently entitled (expressed as a percentage of that income), the trustee is assessed and is liable to pay tax on that same percentage of the section 95 net income of that ERT under section 99A of the ITAA 1936.

### ***Is the trustee of an ERT required to withhold an amount from payments to an employee?***

33. A trustee of an ERT that makes a payment to an employee of (or applies or deals with an amount on the employee's behalf or as the employee directs as) salary, wages, bonuses, commission or allowances, that is not exempt income or non-assessable non-exempt income of that employee, is required to withhold an amount under section 12-35 of Schedule 1 to the TAA.

### **Part C – consequences for an employee**

34. This Part considers the consequences for an Australian resident employee who participates and receives benefits<sup>12</sup> under an ERT.

### ***General rules for assessing benefits as ordinary income***

35. Subject to the limitations described in paragraph 36 of this draft Ruling, a benefit provided or an amount paid under an ERT will be assessable to an employee under section 6-5 of the ITAA 1997 where the benefit or payment:

- has the **character of ordinary income** in the hands of the employee – such as if it meets the definition of 'remuneration' set out in the table to paragraph 10 of this draft Ruling (regardless of whether the remuneration is in respect of services already provided or services yet to be provided and regardless of how it is funded by the provider);
- is **derived** by the employee (regardless of whether it is provided by an entity other than the employee's employer, and regardless of whether it is paid to someone other than the employee – noting that an amount will be deemed to have been received by the employee under subsection 6-5(4) of the ITAA 1997 where it is applied for their benefit or dealt with as they direct);

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<sup>12</sup> Benefits include payments of money.

- is in the **form of money or money's worth**; and
- is **not derived by way of the provision of a fringe benefit**.

36. A benefit provided or an amount paid by an employer or the trustee of an ERT to an employee participating in an ERT will not be remuneration (having the character of ordinary income in the hands of that employee) where it is provided:

- as a result of the employee exploiting existing rights, specifically:
  - valuable rights were obtained by the employee for arm's length consideration (otherwise than as remuneration); and
  - the benefit is provided as commercially-negotiated consideration for the surrender or disposal of those rights (rather than as remuneration for services provided as an employee);
- solely in the employee's capacity as a beneficiary of the ERT and received by the employee independently of any employment relationship or any services rendered by the employee for the employer; or
- as consideration, amongst other things, for the employee incurring a genuine obligation to repay that sum (for example, as an amount of loan principal).

37. A benefit provided or an amount paid in respect of the services provided by an employee to an employer will not be remuneration derived by that employee at that time, to the extent to which it has previously been derived by the employee as ordinary income. For example, where:

- the amount is provided to the employee out of amounts that are attributable to, or made up of, contributions made by the employer in respect of that employee, and
- those amounts have already been included in the employee's assessable income under section 6-5 of the ITAA 1997.

***Is a contribution assessable to the employee?***

38. An amount of remuneration paid by an employer as a contribution to the trustee of an ERT at the direction of a particular employee, or remuneration to which a particular employee is entitled to and is contributed to the trustee of an ERT on behalf of that particular employee, is assessable to that employee under section 6-5 of the ITAA 1997.

39. A contribution made for a general class of employees where the employees who will benefit from the contribution are not known with sufficient particularity at the time the contribution is made is not, at the point of contribution, ordinary income that has been derived by any one employee.

***Is the employee assessable in respect of benefits provided by the trustee of an ERT?***

*Benefits assessed to an employee under section 6-5 of the ITAA 1997*

40. Amounts that are paid by the trustee of an ERT to an employee, are included in the employee's assessable income under section 6-5 of the ITAA 1997 to the extent to which they are remuneration for the provision of services by the employee and are not amounts of:

- the trust's section 95 net income (other than net capital gains) assessed to the employee under the trust assessing provisions; or
- the employee's exempt income or non-assessable non-exempt income.

*Benefits in respect of which an employee is assessed under the trust assessing provisions*

41. An employee who is a beneficiary of an ERT, who is not under a legal disability and who is presently entitled to a share of the income of the trust estate of the ERT (expressed as a percentage), is assessable under paragraph 97(1)(a) of the ITAA 1936 on that same percentage share of the section 95 net income of the ERT, excluding net capital gains, franked distributions and franking credits.

42. An employee who is a beneficiary of an ERT, who is not under a legal disability and who has a share of a capital gain of the ERT (within the meaning of Subdivision 115-C of the ITAA 1997), is treated as having a capital gain included in the calculation of their net capital gain, assessable to them under section 102-5 of the ITAA 1997 (but only to the extent to which the amount of that capital gain was not assessable to the employee under section 6-5 of the ITAA 1997 – see paragraph 40 of this draft Ruling).

43. An employee who is a beneficiary of an ERT, who is not under a legal disability and who has a share of a franked distribution of the ERT (within the meaning of Subdivision 207-B of the ITAA 1997) is:

- assessable on an amount calculated under section 207-37 by reference to their share of the franked distribution,
- assessable on their share of the franking credit attached to that franked distribution, and

- subject to meeting relevant integrity rules (discussed at paragraphs 44 to 45 of this draft Ruling), entitled to a tax offset equal to that share of that franking credit.

***When will an employee be entitled to tax offsets for franking credits?***

44. An employee having a relevant share of the franked distributions of an ERT (within the meaning of Subdivision 207-B of the ITAA 1997) will not be entitled to a tax offset for their share of any franking credits attached to those distributions if any of the circumstances set out in section 207-150 of the ITAA 1997 apply. This includes the situation where the employee is not a *qualified person* in respect of those distributions for the purposes of Division 1A of former Part IIIAA of the ITAA 1936.

45. An employee is not a qualified person (and therefore will not be entitled to a tax offset) in respect of those distributions if:

- the trustee of the ERT is not itself a qualified person in respect of those distributions, or
- the employee's relevant interest in the ERT is not an *employee share scheme security* as defined in former section 160APHD of the ITAA 1936, and the employee does *not*:
  - qualify for the small shareholder exemption under former section 160APHT of the ITAA 1936;
  - have a vested and indefeasible interest in part of the trust fund comprising shares and interests in shares, if the ERT is a widely-held trust for the purposes of former Division 1A of Part IIIAA of the ITAA 1936; or
  - have a vested and indefeasible interest in the relevant dividend-yielding share, if the ERT is not such a widely-held trust.

***When will an employee be taken to have been paid a deemed dividend for the purposes of Division 7A?***

46. Under an ERT, an employee will be deemed (under section 109D of the ITAA 1936) to have been paid a dividend from an employer that is a private company where:

- the employer makes or has made a contribution to the trustee of an ERT;
- that contribution is not made or was not made to the trustee in its capacity as an associate of a particular employee;



- the contribution is not taken to be a dividend of the trustee as described in paragraph 31 of this draft Ruling;
- the trustee of the ERT makes a loan to the employee;
- at the time the loan is made, the trustee is a shareholder of the employer and the employee is a beneficiary of the ERT; and
- it would be reasonable to conclude that the contribution was made solely or mainly as part of an arrangement involving a loan to that employee.

47. The amount of the dividend paid to the employee in the circumstances outlined in paragraph 46 of this draft Ruling is, subject to the extent of the employer's 'distributable surplus' as defined in section 109Y of the ITAA 1936, taken to be the amount of the loan provided by the trustee of the ERT to the employee.

## Examples

### **Example 1 – capital contribution used to generate income to provide bonuses (Niamh Co)**

48. *Niamh Co, a large retail company (the employer), estimates the likely bonus amounts to be paid to its employees on a yearly basis and the quantum required to be invested to deliver a rate of return to meet those bonus payments. Pursuant to those calculations Niamh Co voluntarily makes a contribution of \$20,000,000 to the trustee of an ERT. The trustee has a discretion as to how to appoint the trust income. The eligible beneficiaries (being discretionary objects) of the ERT include all employees of Niamh Co, from time to time who have remained in continuous service of Niamh Co for at least a 12 month period. Niamh Co recommends to the trustee which beneficiaries are to receive income from the ERT in a particular year.*

49. *The trustee of the ERT invests the contribution amount in capital assets, including publicly listed units, shares and bonds which the trustee intends to hold for a significant period, in order to generate both annual income and a long term capital return. Niamh Co intends for the annual income derived by the trustee of the ERT to be used to meet future bonus payments to employees (akin to the bonuses currently being met by Niamh Co). The contribution is not intended to be accessed or depleted to meet such bonus payments. However, the contribution to the ERT is intended, by Niamh Co, to be irretrievable.*

50. *The Trust Deed of the ERT provides that the ERT is terminated on the 80<sup>th</sup> year after it has been settled. On termination, the capital of the ERT (which includes the contribution of \$20,000,000) is distributed, equally, amongst all eligible beneficiaries at the time of termination (this is commonly referred to as a 'last man standing' clause).*

51. *Bonuses are paid by the trustee of the ERT to beneficiaries on an annual basis on the recommendation of Niamh Co.*

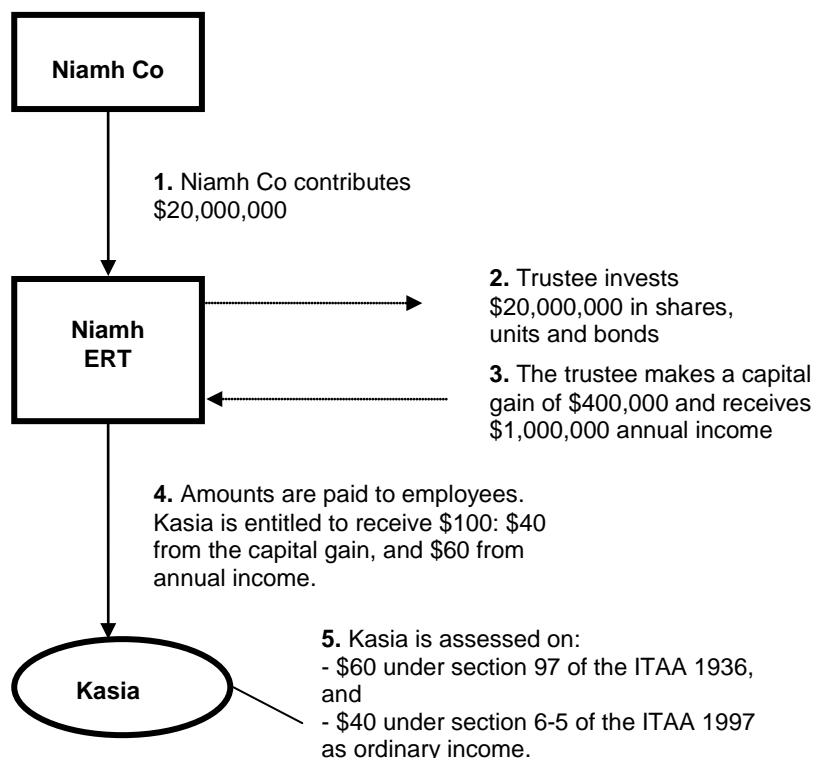
52. *Whilst the trustee intends to hold its assets for long term gain, in the ERT's second year of income, the trustee decides to change its investment strategy. In the course of doing so, it disposes of some assets and makes a \$400,000 capital gain (in respect of assets held for longer than 12 months). In that year, the trustee of the ERT also receives \$1,000,000 of annual income from its investments.*

53. *The income of the ERT is defined to equal its net income for tax purposes.*

#### *Specific employee scenario – Kasia*

54. *Kasia, an employee of Niamh Co and eligible beneficiary of the ERT, becomes entitled to receive a gross bonus payment from the ERT of \$100 in its second year of income: \$40 of this is a specific entitlement to a share of the capital gain made by the trustee of the ERT, and the remaining \$60 is a distribution of the annual income.*

#### *Diagram for Example 1*



## *Treatment under this Ruling*

### Income tax

55. The contribution lacks the requisite connection with the retail business being carried on by Niamh Co. There is no intention that the contribution amount itself be applied in making direct payment of remuneration to employees. It secures for Niamh Co an enduring and lasting benefit, namely, the funding of bonus payments for 80 years. The contribution is not deductible under section 8-1 of the ITAA 1997.

56. The contribution to the trustee of the ERT is not remuneration of a particular employee. It is not assessable to any employee under section 6-5 of the ITAA 1997 in the year in which the contribution is made.

57. It is accepted that the ERT holds its investments on capital account, the ERT made a capital gain of \$400,000 and its trust income is only \$1,000,000.

58. Despite being trust distributions, the bonuses paid by the trustee of the ERT to employees form part of the remuneration of those employees, including to Kasia as the payments are for services.

59. Nonetheless, Division 6 will apply to assess Kasia on her share of the section 95 net income of the ERT – that is, \$60 – under section 97 of the ITAA 1936.

60. Section 6-5 (applying in preference to the Capital Gains Tax (CGT) provisions) will only apply to assess the \$40 balance to Kasia (representing the capital gains component).

### PAYG Withholding

61. As the trustee of the ERT has paid bonuses to employees, the trustee is required to withhold an amount from those bonuses, in their entirety. In respect of Kasia, the trustee is required to calculate the amount to be withheld on the entire \$100.

62. Niamh Co is not required to withhold any amount from contributions it makes to the trustee of the ERT.

### Fringe benefits tax

63. The contribution made to the trustee of the ERT is for a general class of employees and is not attributable to any identifiable employee. Therefore, the \$20,000,000 contribution is not a 'fringe benefit'. Moreover, any bonuses paid to employees by the ERT, being payments to employees subject to PAYG WH are specifically excluded from being a fringe benefit.

**Example 2 – deemed dividends and fringe benefits (Elizabeth Co)**

64. *Elizabeth Co, a private company, has a small but highly specialised workforce. Elizabeth Co wants to establish an incentive arrangement that puts its employees ‘in the shoes of’ its shareholders, but without actually giving employees shares. Elizabeth Co establishes an ERT in an effort to achieve this outcome.*

65. *On 8 August in Year 1, Elizabeth Co makes a contribution of \$300,000 to the trustee of the ERT. At that time the contribution is not referable to any specific employees. On 10 August the trustee lends the initial \$300,000 (less a small amount to cover minor administrative costs) to particular employees on the recommendation of Elizabeth Co on an interest-free basis. The employees use the loan funds to acquire units in the ERT. The units are not transferable.*

66. *The trustee of the ERT uses the consideration received for the issue of units to acquire newly issued shares in Elizabeth Co. The trustee intends to hold the shares indefinitely, as no secondary market exists to trade in Elizabeth Co shares.*

67. *Employees have the option of redeeming 33% of their units after 12 months, 66% after 24 months and 100% after 36 months. Any units remaining at the earlier of: 36 months or on termination of employment will be automatically redeemed.*

68. *The redemption amount for the units is equal to the value of the underlying shares. The trustee of the ERT applies the redemption amount to discharge the employee’s loan balance. In effect, employees only have a residual entitlement to (and only receive payment of) the growth in value of Elizabeth Co’s shares. Where a ‘redemption amount’ is insufficient to cover the outstanding loan balance, the trustee accepts the redemption amount in full satisfaction of the loan (the loan is therefore limited recourse).*

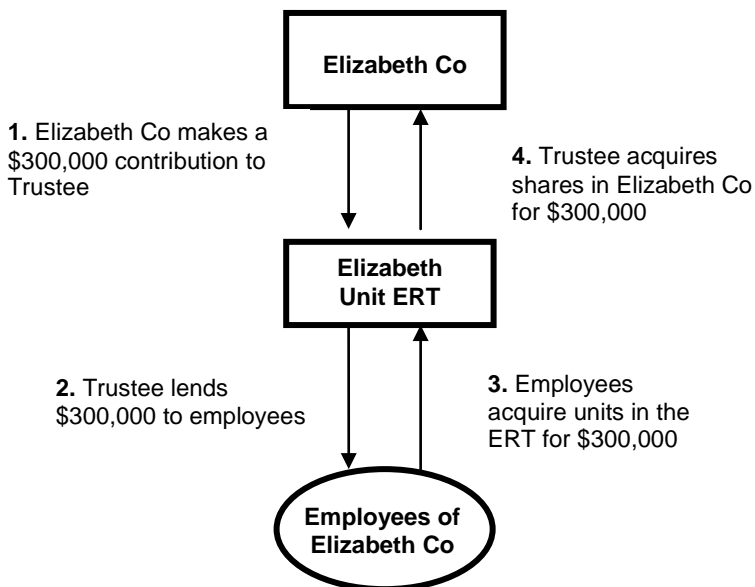
69. *The trustee does not hold any cash reserves (as the contribution has been applied to acquire shares and cover minor administrative costs). It therefore does not have the cash available to make any payments of redemption amounts to employees. It cannot dispose of Elizabeth Co shares as there is no secondary market for them. At the time of payment of the redemption amount, Elizabeth Co is therefore required under the terms of the trust deed to make additional contributions, called ‘supplementary contributions’ to the trustee of the ERT in order to fund these redemption payments to employee unitholders.*

70. *The trustee also has discretion to distribute trust income to employees (who are discretionary objects of the ERT). However, the only investment made by the trustee of the ERT is in Elizabeth Co shares. Elizabeth Co has a long history of not declaring dividends. Over the course of the ERT arrangement, Elizabeth Co does not expect to declare any dividends in favour of the trustee of the ERT.*

71. Further, in accordance with the Trust Deed, the ERT Rules and Employee Information Circular, ERT funds may, at the recommendation of the Board of Elizabeth Co, and on exercise of the discretion by the trustee of the ERT, be applied, at any time, in making payment of bonuses to employees, as a reward for their services. However given the trustee of the ERT does not hold cash reserves, Elizabeth Co will either need to make further contributions or agree to buy back some of its shares issued to the trustee of the ERT to fund such bonuses.

72. The distributable surplus, for the purposes of section 109Y of the ITAA 1936 of Elizabeth Co in each year of the arrangement will exceed the amount of each annual contribution.

*Diagram for Example 2 – Year 1*



73. In Year 2, Elizabeth Co makes an additional annual contribution of approximately \$300,000. The trustee of the ERT utilises these funds to make loans to employees to acquire units, and subsequently acquire newly issued shares in Elizabeth Co in the same manner as in Year 1.

*Specific employee scenario – Bowie*

74. Bowie, who is an employee of Elizabeth Co, acquires 3,000 units at \$1 each in Year 1 using the loan of \$3,000 provided to him by the trustee of the ERT. After 36 months, all of the units Bowie acquired in Year 1 are automatically redeemed. The value of the units has increased to \$1.25 each, based on the growth in value of Elizabeth Co's shares.

75. *The trustee determines that Bowie's redemption entitlement is \$3,750. Bowie receives a cash payment of \$750, calculated as his \$3,750 redemption entitlement less his outstanding loan amount of \$3,000. The trustee funds this payment of \$750 through a 'supplementary contribution' received from Elizabeth Co.*

*Treatment under this Ruling*

Income tax

76. The Year 1 and 2 contributions of \$300,000 to the trustee of the ERT are not incurred in gaining or producing assessable income nor necessarily incurred in the carrying on of a business for the purpose of gaining or producing assessable income of Elizabeth Co. At the time each contribution is made, there is no definite intention by Elizabeth Co that the contributions be applied to the provision of bonuses, salary or wages to employees. Whilst there is a possibility that there may be payments of bonuses out of these contributions under the arrangement, there is no objective evidence available to indicate that such payments are reasonably expected or intended by either Elizabeth Co or Bowie at the time Elizabeth Co makes each contribution. The contribution cannot be considered to be an expense that is desirable or appropriate in the pursuit of the business ends of the business. Instead, the evidence suggests each contribution is intended (at the time it is made) to be subsequently used by the trustee to provide loans to employees on interest free terms. A loan in itself is not a form of remuneration (however, a loan may give rise to a loan fringe benefit).

77. Further, the unit subscription amounts are being applied by the trustee of the ERT to acquire shares in Elizabeth Co. The capital advantage obtained by Elizabeth Co, in making each contribution, is ultimately, an advantage linked to accretions to share capital (effectively shifting retained profits into share capital). It cannot be said that the advantage sought and obtained by Elizabeth Co is to do with the recurrent nature of employee remuneration (notwithstanding the fact that the contributions themselves may be recurrent).

78. The contributions are not deductible to Elizabeth Co under section 8-1 of the ITAA 1997.

79. Similarly, considered on its own merits, the 'supplementary contribution' of \$750 made by Elizabeth Co to the trustee of the ERT is not a deductible expense to Elizabeth Co for the purposes of section 8-1 of the ITAA 1997. It is a payment made by Elizabeth Co under the constituent documents of the ERT, and is not remuneration paid by Elizabeth Co. Specifically it does not facilitate a payment to its employee Bowie of anything greater than what he is entitled to receive from the trustee of the ERT as a result of exploiting his existing rights, held separately to his employment relationship (namely, the rights he has as a unit holder in the ERT). It is a capital contribution by Elizabeth Co to the trustee of the ERT.

80. Neither the \$750 supplementary contribution nor any part of the redemption entitlement of \$3,750 is remuneration of Bowie. The redemption entitlement is paid (including in part by being set-off against Bowie's outstanding loan balance) to Bowie in respect of his existing rights and primarily as a consequence of being a beneficiary in the ERT.

81. Bowie however will make a \$750 capital gain on the redemption of his units in the ERT.

82. At the time the second \$300,000 contribution is made by Elizabeth Co, the trustee of the ERT is a shareholder of Elizabeth Co. This second contribution will be deemed to be a dividend under section 109C of the ITAA 1936, and included in the section 95 net income of the ERT.

83. Whilst the supplementary contribution of \$750 on the other hand is made in respect of a particular employee (Bowie), it is not being made to the trustee of the ERT in its capacity as an associate of Bowie as an employee, but rather, of Bowie as a unit holder in the ERT. As such, subsection 109ZB(3) of the ITAA 1936 will not prevent this contribution being deemed to be a dividend of the ERT.

## PAYG Withholding

84. Elizabeth Co is not required to withhold an amount of PAYG WH under section 12-35 of Schedule 1 to the TAA from contributions it pays to the ERT as the contribution is not remuneration of an employee.

85. Neither Elizabeth Co nor the trustee is required to withhold an amount of PAYG WH under section 12-35 of Schedule 1 to the TAA from the payment of the redemption entitlement of \$3,750 as it also is not remuneration of an employee.

## Fringe benefits tax

86. Both \$300,000 contributions are made to the trustee of the ERT by Elizabeth Co in respect of all its employees generally. At the time the contribution is made, the employees who are likely to benefit from the contribution are not known with sufficient particularity. A 'fringe benefit' is not provided to an employee or an associate of an employee at the time the contribution is made to the ERT.

87. Whilst the \$750 supplementary contribution made by Elizabeth Co is in respect of funding Bowie's redemption payment, it is in respect of his unit holding in ERT. Although there is some connection with his employment, it is made primarily as a consequence of being a beneficiary or unit holder in the ERT and is not made in respect of his employment. It is not a fringe benefit.

88. The loan of \$3,000 provided by the trustee to Bowie in Year 1 is materially connected with, and is 'in respect of' his employment with Elizabeth Co. The loan benefit constitutes a 'fringe benefit' under subsection 136(1) of the FBTAA. Its taxable value is included by Elizabeth Co in the calculation of its aggregate fringe benefits amount for FBT purposes.

89. The taxable value of the loan fringe benefit in Year 1 is \$3,000 multiplied by the applicable benchmark interest rate. As Bowie is not expected to derive any assessable income from the holding of the units acquired by the loan, this taxable value is not reduced by the otherwise deductible rule in section 19 of the FBTAA.

***Example 3 – trust income and benefits provided by the trustee of the ERT (Felix Investment Unit Trust)***

90. *The Felix Investment Unit Trust (the employer) would like to reward its employees by extending an investment opportunity to them and establishes an ERT to assist with this.*

91. *The employer makes a contribution to the trustee of the ERT. Subsequently the employer informs the trustee of the ERT which employees are to participate in the ERT arrangement. The trustee of the ERT uses that contribution to make loans to eligible employees (at an interest rate of 1%). Employees use the borrowed funds to acquire units in the ERT. The units in the ERT entitle unitholders to:*

- *a right to be considered by the trustee when appointing income of the trust – such appointments are made having regard to any recommendation of the employer (based on the employee/unitholders performance);*
- *an amount on redemption of the units, equal to their market value (to be paid first by way of set-off against the outstanding balance of any loan owed to the trustee, with the balance to be paid in cash). Receipt of this amount is not dependent on employees meeting employment-related service conditions nor does it depend on, or relate to, any services employees provide; and*
- *on redemption of a unit and where the employee has satisfied prescribed 'service conditions', the employee will also be entitled to a cash payment from the trustee of the ERT of an amount equal to the value of the unit issue price. This cash payment is called a 'capital reward' and is sourced from the capital of the trust estate.*

92. *The employer does not make any additional contributions to the ERT. The employer intends and anticipates that the single contribution will most likely be diminished in providing payments of 'capital rewards' over a 5 year period.*



93. *Employees must hold their units for at least 12 months, after which they can redeem their units at any time. There are no service conditions to be met before the units can be redeemed. However, there are specific and tailored service conditions that an employee must meet before they are entitled to receive any ‘capital reward’ payment.*

94. *The trustee of the ERT uses the unit subscription amounts to acquire options listed on the Australian Securities Exchange (ASX). The trustee of the ERT intends to generate assessable income, from time to time, from the sale of options at a profit.*

95. *The options acquired by the trustee of the ERT are inherently, non-income producing in nature but are acquired for the capital growth that is expected. The ERT has no exempt or non-assessable non-exempt income, and makes no capital gains for tax purposes. During the year in question the ERT generates assessable income from the sale of options.*

#### *Specific employee scenario – Edward*

96. *Edward, an eligible employee uses \$8,000 lent to him by the trustee of the ERT to acquire 100 units in the ERT (at \$80 each). His primary intention is to hold them for 12 months and then dispose of or redeem them for a profit. Over this time, he also hopes to potentially receive distributions of trust income and ‘capital rewards’.*

97. *Edward is prescribed service conditions on acquisition of the units (which must be satisfied if he is to receive the ‘capital reward’ payment). These service conditions are realistic and attainable – specifically, Edward must remain in the employment of the employer for a period of at least 9 months and must sustain a ‘good and meritorious’ performance rating during this time.*

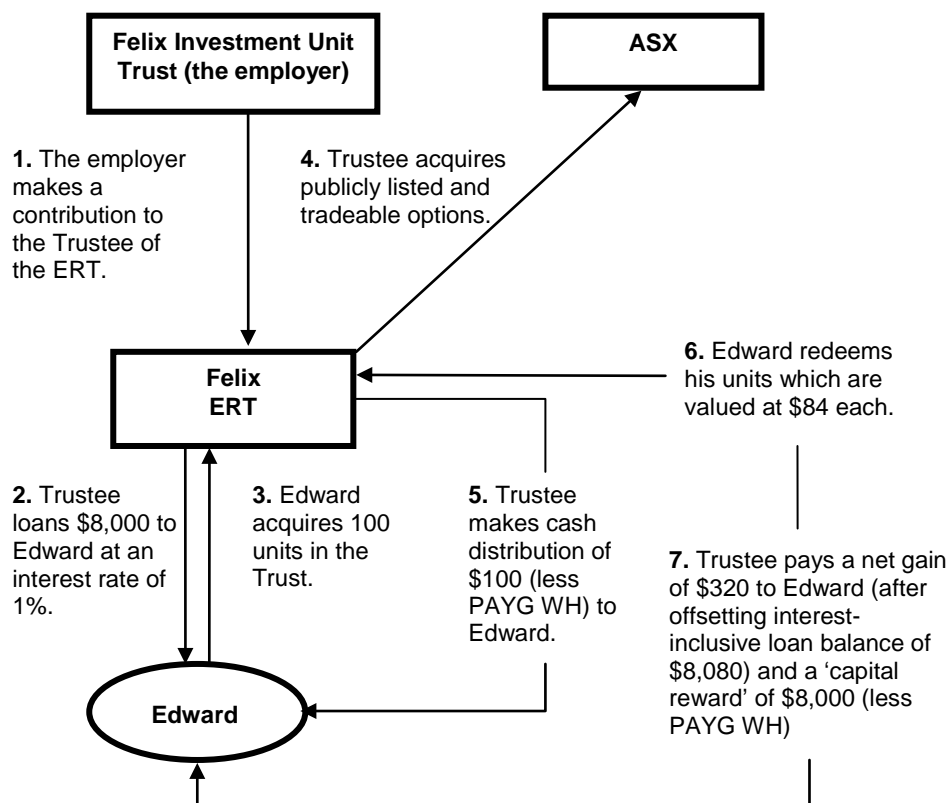
98. *Throughout the entire 12 month period that Edward holds his units in the ERT, he sustains (and even exceeds) a good and meritorious performance rating.*

99. *During this period, Edward receives a distribution of \$100 (less PAYG WH) income from the trustee, at the recommendation of the employer, given his exemplary performance as an employee during the year.*

100. *After 12 months, the units have increased in value to \$84 each. Edward decides to redeem his units. Edward receives his first net cash payment out of capital of \$320 from the trustee of the ERT as a redemption amount, calculated as follows:*

- *100 units valued at \$84 at the time of redemption (\$8,400);*
- *less the amount owed by Edward to the Trustee of \$8,080 (being \$8,000 principal plus \$80 interest).*

101. *In addition, Edward receives a second cash payment from the trustee of the ERT as a ‘capital reward’ of \$8,000 (less PAYG WH).*

*Diagram for Example 3**Treatment under this Ruling*Income tax

102. The employer's contribution to the trustee of the ERT is incurred in carrying on its business for the purpose of gaining or producing assessable income. At the time the contribution is made, the employer intends that that contribution will, ultimately, be used to provide a 'capital reward' payment to employees, as remuneration, within a five year period. Whilst the trustee of the ERT is, in the interim, utilising those funds to make loans to employees, any capital advantage sought to be obtained by the employer through that function is trifling compared to the advantage secured in remunerating its employees. The contribution is fully deductible under section 8-1 of the ITAA 1997.

103. Edward receives the income distribution of \$100 (less PAYG WH) both in his capacity as a unit holder of the ERT and an employee of the employer.

104. To the extent, if any, that the \$100 is not attributable to amounts included in the section 95 net income of the ERT (other than a net capital gain) and assessed to Edward under the specific provisions dealing with that income, it is included in Edward's assessable income under section 6-5 of the ITAA 1997.

105. Having acquired the units with the intention of disposing or redeeming them within a relatively short period for a profit, any gain that Edward has made on the units is included in his assessable income as ordinary income under section 6-5 of the ITAA 1997 (and not as a capital gain).

106. Further, Edward has received the 'capital reward' payment as an extra reward or bonus related to the provision of his services to his employer. This amount is a receipt of ordinary income by Edward and is included in his assessable income under section 6-5 of the ITAA 1997.

## PAYG Withholding

107. The employer is not required to withhold an amount from the contribution under section 12-35 of Schedule 1 to the TAA it makes to the trustee of the ERT.

108. Irrespective of the extent to which the trust assessing provisions and/or section 6-5 of the ITAA 1997 apply to assess Edward in respect of the \$100 income distribution, both this distribution and the \$8,000 'capital reward' are payments of salary, wages or a bonus to Edward, from which the trustee must withhold an amount of PAYG WH.

## Fringe benefits tax

109. The contribution is made by the employer to the trustee of the ERT in respect of all employees in a general sense. At the time the contribution is made, the employees who are likely to benefit from the contribution are not known with sufficient particularity. A 'fringe benefit' is not provided to Edward or an associate of Edward at the time the contribution is made.

110. The loan provided by the trustee to Edward forms part of the ERT arrangement to confer benefits on Edward 'in respect of' his employment. The loan provided by the trustee to him has a 'sufficient or material' connection with his employment and constitutes a 'fringe benefit' under subsection 136(1) of the FBTA.

111. The units held by Edward are likely to produce income for Edward (the trustee of the ERT is buying and selling assets for profit). Whilst any entitlement to a distribution of trust income in respect of these units is subject, primarily, to the recommendations of his employer and the discretion of the trustee of the ERT, from the outset of the arrangement Edward is likely to derive assessable income (the 'capital reward') as a result of participating in the ERT of an amount greater than what would otherwise be the taxable value of the loan fringe benefit. That taxable value will therefore be reduced in full by the application of the otherwise deductible rule in section 19 of the FBTA, so no FBT liability will arise for the employer in respect of this loan.

**Example 4 – deductibility of subsequent contributions and provision of fringe benefits (Angelina Co)**

112. Angelina Co makes an initial contribution of \$10,000 to the trustee of an ERT to establish a unit trust. Only employees of Angelina Co are entitled to hold units in the ERT. Angelina Co invites Nalani and Hugo to participate in the ERT arrangement.

113. The trustee lends \$5,000 of the initial contribution to each of Nalani and Hugo who both use the loan to subscribe for one unit each (each unit is valued at \$5,000). The trustee uses the unit subscription money to acquire investments, primarily publicly listed and tradeable securities on the ASX to generate profits primarily through trading. Income and profits generated from assets relating to unit holdings are distributed to relevant unit holders from time to time.

114. Nalani and Hugo must hold their units in the ERT for a minimum of three years before they are entitled to redeem them.

115. Angelina Co contemplates, from the outset, that it will make additional contributions to the trustee to enable the trustee to issue additional units to employees, as a reward or bonus for their services provided to Angelina Co. Employees of Angelina Co are advised of this additional contribution that can be made to the 'bonus pool' and that this amount will, at the discretion of the trustee on the recommendation of Angelina Co, be provided to employees in the form of additional units in the ERT as a reward for exemplary performance.

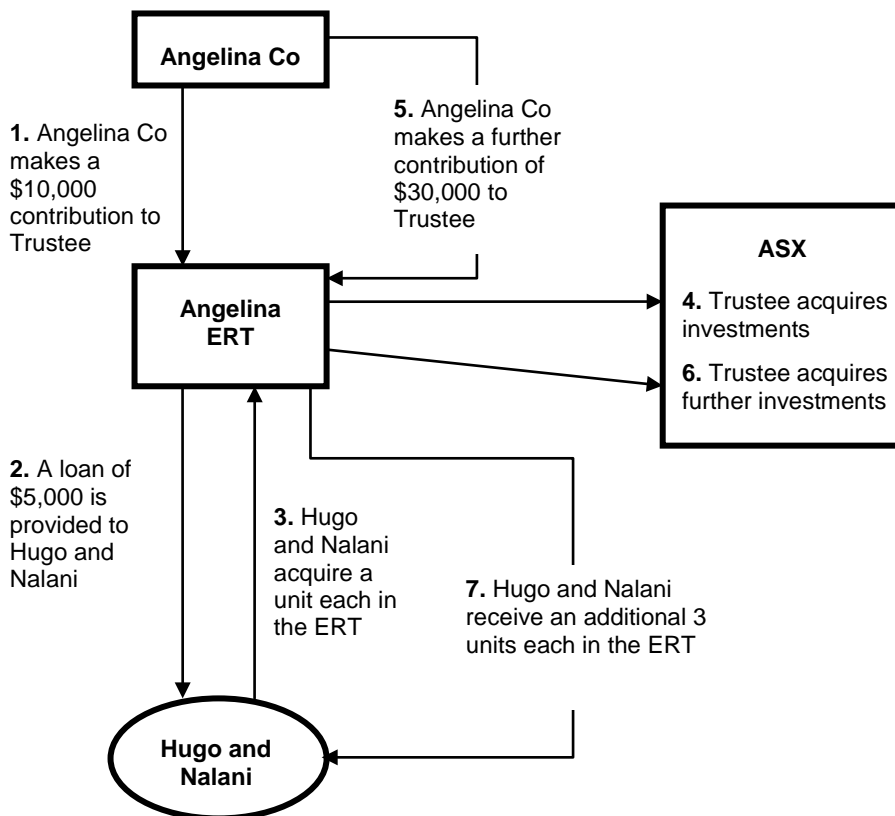
116. The board of Angelina Co meets and decides that Angelina Co should make a second contribution to the trustee of the ERT. Angelina Co then makes a second contribution of \$30,000 to the trustee of the ERT with a specific direction that it be allocated amongst employees of Angelina Co at a future time (but within an 18 month period from the time it is contributed) and as Angelina Co directs. The \$30,000 is also applied by the trustee to make investments for the purposes of gaining income from the contribution to be accumulated within the ERT (and not held for the benefit of or distributed to any particular unit holder or employee unless and until those investments are notionally attributed to unit holders or, failing this, upon vesting).

117. A few months after making the second contribution, Nalani and Hugo complete work on a particularly challenging project. Angelina Co wishes to reward Nalani and Hugo for their work on the project and directs the trustee to attribute the \$30,000 investments (acquired by the trustee of the ERT out of the second contribution), between Nalani and Hugo by way of issuing additional units.

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118. The trustee issues an additional 6 units to the total value of \$30,000 together to Hugo and Nalani. Hugo and Nalani now have 4 units each, worth \$20,000. Neither Hugo nor Nalani were required to pay any consideration for the additional units. The full \$40,000 of investments of the ERT are now being held for the benefit of Hugo and Nalani.

Diagram for Example 4



### Treatment under this Ruling

#### Income tax

119. Angelina Co is not entitled to a deduction for the initial contribution of \$10,000 to the trustee of the ERT under section 8-1 of the ITAA 1997. This amount was intended to form the capital of the fund, not to be diminished in providing benefits to employees and was paid to the trustee with the intention that it be loaned to employees.

120. Angelina Co is entitled to a deduction for the subsequent contribution of \$30,000 as it was necessarily incurred by Angelina Co in carrying on a business for the purpose of gaining or producing its assessable income. When that contribution was made, Angelina Co intended that it would be expended, in full, in the provision of benefits to employees within a short period being 18 months. It is akin to a payment of a bonus as it was paid to the trustee with the intention that the trustee issue units to the value of the contribution to employees as remuneration, at some point in the future. Employees are then able to redeem the units so issued after three years. The \$30,000 contribution effects a payment of future bonuses within a short period of time and whilst it is a once-off contribution, the contribution is made in relation to a recurring matter of employee remuneration and is therefore revenue in nature and deductible.

121. At the time the contribution of \$30,000 was paid to the trustee of the ERT, it could not be said that it was assessable income derived by any particular employee. At that time, nothing had 'come home' to an employee. No amount of the contribution of \$30,000 is ordinary income in the form of salary or wages for Nalani or Hugo.

122. As the subsequent provision of units in the ERT to Nalani and Hugo is not itself salary and wages, and constitutes the provision of a fringe benefit, it is not assessable income and is not exempt income of Nalani and Hugo.

#### PAYG Withholding

123. Angelina Co is not required to withhold an amount of PAYG WH under section 12-35 of Schedule 1 to the TAA from contributions it pays to the ERT as the payments are not remuneration.

#### Fringe benefits tax

124. The loan provided by the trustee of the ERT to Nalani and Hugo is a fringe benefit, provided by the trustee to the employees of Angelina Co, under an arrangement with Angelina Co and having a 'sufficient or material' connection with their employment.

125. However, as these units are likely to produce income for Nalani and Hugo (the trustee of the ERT trades in securities for profit and distributes income to unit holders), the taxable value of the loan fringe benefit will be reduced by the application of the otherwise deductible rule in section 19 of the FBTAA.

126. The provision of 3 units in the ERT each to Nalani and Hugo constitutes the provision of a property fringe benefit. The fringe benefit arises when the trustee issues the additional units. It is a benefit provided under an arrangement with Angelina Co, to deliver property benefits to specific employees, that is, Nalani and Hugo in respect of their employment with Angelina Co.

127. The value of the property benefit, as an external property fringe benefit, is determined in accordance with section 43 of the FBTAA to be \$30,000, which is taken into account by Angelina Co in the calculation of its FBT liability.

**Example 5 – contribution assessable to employee (Halle Co)**

128. *Halle Co, a large private company (the employer), wishes to establish an arrangement to provide benefits to its employees.*

129. *Halle Co decides to implement an ERT and settle on the trustee contributions for the benefit of employees of Halle Co as a general class.*

130. *The trustee of the ERT will use funds it receives to acquire shares listed on the ASX and to hold such shares on behalf of employees for a reasonable period, in order to make a gain from the sale of the shares.*

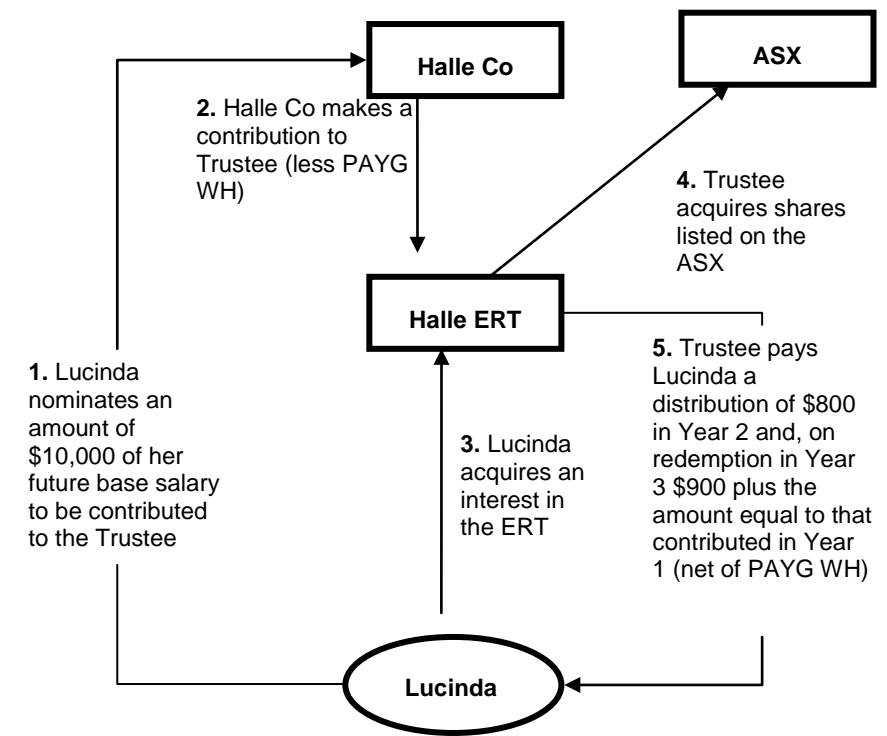
*Specific employee scenario – Lucinda*

131. *Lucinda, an employee of Halle Co, completes an application form to participate in the arrangement. In that form she nominates \$10,000 from a bonus she has earned, but is yet to be paid to be contributed to the ERT. This application form does not constitute an effective salary sacrifice arrangement (as that phrase is used in Taxation Ruling TR 2001/10: Income tax: fringe benefits tax and superannuation guarantee: salary sacrifice arrangements).*

132. *In Year 1, Halle Co contributes the \$10,000 nominated by Lucinda, less PAYG WH, to the trustee of the ERT. The trustee uses the contribution to acquire listed shares and hold them in an account that is notionally allocated to Lucinda.*

133. *In Year 2, when the trustee of the ERT calculates its income for trust purposes, it includes gains and losses from the sale of shares throughout the year. The Trustee of the ERT makes an income distribution to Lucinda in Year 2 of \$800.*

134. *In Year 3, Lucinda decides to withdraw from the arrangement. The value of her interest in the ERT is determined by the value in her notional share account, which has now increased in value by \$900. Because of her withdrawal, the trustee therefore makes Lucinda an income distribution of \$900 along with a capital distribution equal to the salary amount that was contributed at her direction (less the PAYG WH amount withheld by the employer).*

*Diagram for Example 5**Treatment under this Ruling*Income tax

135. The contribution by Halle Co to the trustee of the ERT and the amount of PAYG WH (together totalling \$10,000) are both related to the remuneration of a specific employee. The full amount of \$10,000 is deductible under section 8-1 of the ITAA 1997.

136. Lucinda's direction to Halle Co to deduct a fixed amount of her future base salary and contribute it to the trustee of the ERT is a direction to Halle Co to apply or deal with that part of Lucinda's remuneration. Lucinda has derived that sum and is assessable on the \$10,000 in the year Halle Co pays that amount (net of PAYG WH) to the ERT.

137. Lucinda is assessed under the trust assessing provisions in respect of income distributions she received in Years 2 and 3.

138. No amount distributed (including the capital distribution in Year 3) by the trustee to Lucinda is salary or wages when it is distributed. This is because the trustee made those payments in respect of her interest in the ERT and not as remuneration for services provided to Halle Co.



139. Lucinda makes a \$900 capital gain in respect of the redemption of her units in Year 3, reduced pursuant to section 118-20 of the ITAA 1997 to the extent an amount is included in her assessable income under the trust assessing provisions (other than via Subdivision 115-C of the ITAA 1997) because of her withdrawal from the ERT.

## PAYG Withholding

140. The \$10,000 bonus nominated by Lucinda to be paid to the trustee of the ERT is a payment of salary or wages from which an amount of PAYG WH must be withheld. Section 11-5 of Schedule 1 to the TAA treats the contribution made by Halle Co to the trustee as a redirection of Lucinda's salary or wages.

## Fringe benefits tax

141. The \$10,000 bonus nominated by Lucinda to be paid to the trustee of the ERT is a payment of salary or wages and is excluded from the definition of a 'fringe benefit' under subsection 136(1) of the FBTA.

## **Example 6 – entitlement to tax offsets (Camelot Co)**

142. *Camelot Co, a private company, wants to establish an incentive arrangement that puts its employees 'in the shoes of' its shareholders, but without actually giving shares to the employees.*

143. *An ERT is established for these purposes. On 12 October in Year 1, Camelot Co makes a contribution to the trustee of the ERT of \$100,000, which is paid by being set off against the issue of 10,000 Camelot Co shares to the trustee (at \$10 a share). The contribution is not referable to any particular employee, although Camelot Co has some idea how many employees will participate (and to what extent they will participate) in the ERT.*

144. *Under the terms of the trust deed and plan rules, only specific employees of Camelot Co are invited to apply to participate in this arrangement by purchasing Class A units in the ERT (worth \$10 each). Class A units are issued to employees on application (with payment deferred until such time as a 'redemption event' happens). A share in Camelot Co held by the ERT is notionally allocated against each such unit (although the shares are not directly held for the benefit of a particular unit holder and it cannot be said that a unit holder has a vested and indefeasible interest in any of the assets of the trust).*

145. *The income of the ERT can be distributed at the complete discretion of the trustee of the ERT amongst Class A unit holders.*

146. *A redemption event will happen three years from the Class A units being issued, or such earlier time as Camelot Co, in its*

*discretion, determines. When a redemption event happens, the employee is liable to pay for their units, and:*

- *if the employee has paid what is owed for their units, the trustee must either (in its discretion but subject to the recommendation of Camelot Co) pay the employee the market value of the Camelot shares notionally allocated to the employee's units, or make an in specie distribution of those shares to the employee; or*
- *If not, the trustee must pay the employee the market value of the relevant Camelot shares (first set off against the amount owing by the employee), or, where this market value is less than what is owed by the employee, accept that value in full satisfaction of the debt owed by the employee.*

147. *Camelot Co has a policy of declaring bi-annual dividends to shareholders of Camelot Co shares. In Year 1, the trustee of the ERT receives fully franked dividends from Camelot Co of \$7,000. The trust derives no other income that year.*

148. *The trustee of the ERT exercises its discretion and distributes the franked dividend to the employees in accordance with how many Class A units they hold.*

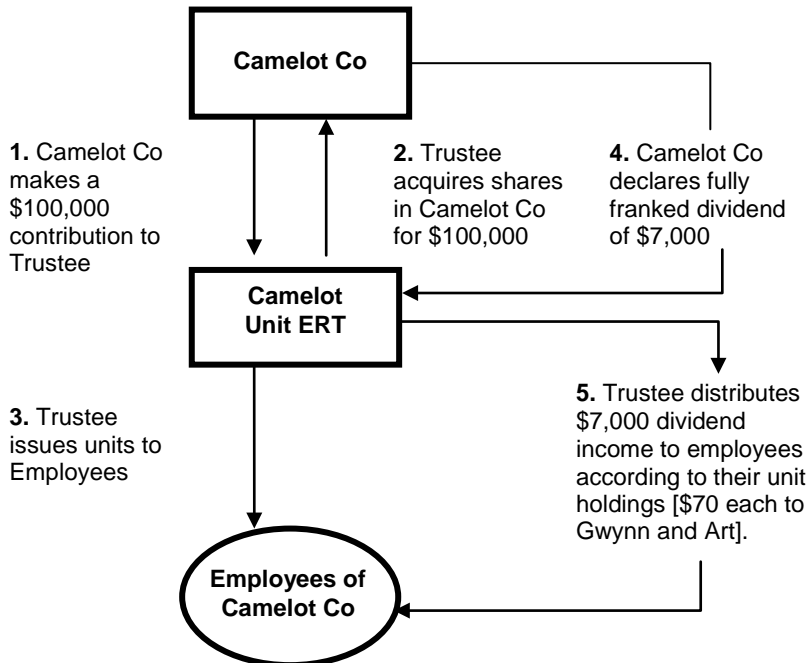
149. *No redemption events arise in Year 1.*

#### *Specific employee scenario – Gwynn*

150. *In Year 1 Gwynn, an Australian resident, participates in the ERT and receives a \$70 distribution. Gwynn does not hold any shares.*

#### *Specific employee scenario – Art*

151. *In Year 1 Art, an Australian resident, also participates in the ERT and receives a \$70 distribution. Art has extensive shareholding in other (unrelated) entities and in Year 1 receives fully franked dividends well in excess of \$12,000 (with attached franking credits therefore well in excess of \$5,000).*

*Diagram for Example 6**Treatment under this Ruling*Income tax

152. The contributions to the trustee of the ERT are not necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income of Camelot Co. At the time each contribution is made, there is no intention by Camelot Co (or the trustee), to apply those contributions to the provision of bonuses, salary or wages to employees. The contributions are being applied by the trustee of the ERT to acquire shares in Camelot Co. Employees only have the possibility of accessing those shares if they are paid for (and even then, at the discretion of the trustee in consultation with Camelot Co). The advantage obtained by Camelot Co, in making each contribution, is ultimately, an advantage linked to accretions to share capital. The contribution lacks the requisite connection with the business being carried on and is of a capital nature.

153. The dividends of \$7,000 paid to the trustee of the ERT by Camelot Co, and the attached franking credits of \$3,000, are both included in the trust's section 95 net income.

154. Gwynn is required to include \$100 in her assessable income under Subdivision 207-B of the ITAA 1997, comprising an amount calculated by reference to her share of the franked dividend (\$70), together with her share of the attached franking credits (\$30).

155. Gwynn's entitlement to a tax offset in respect of this \$30 share of the franking credit depends on if she satisfies the relevant integrity rules, including whether both Gwynn and the trustee of the ERT are qualified persons in respect of the dividend for the purposes of Division 1A of former Part IIIAA of the ITAA 1936. The trustee of the ERT holds its Camelot Co shares at risk and is a relevantly qualified person. As the franking credits assessable to Gwynn do not exceed \$5,000, Gwynn is deemed by virtue of the small shareholder test in former section 160APHT of the ITAA 1936 to also be a qualified person. Accordingly, Gwynn is entitled to a tax offset in respect of her \$30 share of the franking credit.

156. Art will also be assessed on \$100 under Subdivision 207-B of the ITAA 1997 and will also only be entitled to a tax offset for his \$30 share of the franking credit if he is such a qualified person. As Art is assessable on franking credits in excess of \$5,000 (and will not therefore satisfy the small shareholder test), he will need to look to other rules in former Division 1A of Part IIIAA of the ITAA 1936 for this purpose.

157. As the ERT is not a fixed trust, whether Art is a qualified person will depend on whether he has held his interest in the shares of the ERT – from which he was distributed the \$70 dividend – sufficiently at risk. This is determined by considering his 'net position' in respect of his interest.

158. As (amongst other things) no relevant exceptions apply to former subsection 160APHL(10) of the ITAA 1936, Art would only have a sufficient net position if his interest in the shares on which the dividend was paid was vested and indefeasible, which it is not. Moreover, because (amongst other things) the trustee has limited recourse to recover payment of the amount Art owes for this interest, and because any access Art has to the relevant shares is subject to the trustee's discretion, the Commissioner would not exercise the discretion otherwise available to treat Art's interest as being vested and indefeasible.

159. Art will consequently not be a qualified person in relation to the dividends paid on the shares, and will not be entitled to a tax offset for his share of the franking credit.<sup>13</sup>

#### PAYG Withholding

160. Camelot Co is not required to withhold an amount from contributions it pays to the ERT under section 12-35 of Schedule 1 to the TAA as the contribution is not remuneration.

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<sup>13</sup> Art will however be entitled to a \$30 tax deduction in respect of his share of the franking credit: See subsections 207-150(3) and 207-50(3), and subparagraph 207-35(4)(b)(i) of the ITAA 1997.

## Fringe benefits tax

161. The contribution made to the trustee of the ERT by Camelot Co is in respect of all its employees generally. At the time the contribution is made, the employees who are likely to benefit from the contribution are not known with sufficient particularity. A 'fringe benefit' is not provided to an employee or an associate of an employee at the time the contribution is made to the ERT.

## **Date of effect**

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162. Subject to any transitional arrangements discussed in paragraph 163 of this draft Ruling, when the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

163. The Commissioner has issued a large body of private rulings in the past which evidence a more favourable prior general administrative practice in respect of the deductibility to employers of contributions made to the trustee of an ERT than some of the views contained in this draft Ruling. Accordingly, the Commissioner will not undertake compliance activities to apply the views expressed in this draft Ruling in this regard to those contributions made prior to this draft Ruling issuing that would have been accepted as being deductible under this prior practice. However, if the Commissioner is asked or required to state a view (for example in a private ruling or in submissions in a litigation matter), the Commissioner will do so consistently with the views set out in this draft Ruling.

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**Commissioner of Taxation**

5 March 2014

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## **Appendix 1 – Explanation**

**ⓘ** This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.

### **Employee remuneration trust arrangements**

164. As set out in paragraph 9 of this draft Ruling, an Employee Remuneration Trust arrangement (ERT) is established by an employer for the benefit of its employees. The employer funds the activities of the ERT by making one or more contributions to the trustee of the ERT. The trustee’s activities may include making loans of these contributions to employees and/or investing contributions to make a return.

### **Part A – consequences for an employer**

165. This Part considers the consequences for an employer who participates in an ERT. It explains when an employer will be entitled to a deduction for a contribution to an ERT and what amounts the employer may be liable to fringe benefits tax on.

### **When is an employer entitled to a deduction under section 8-1 of the ITAA 1997 for a contribution to an ERT?**

166. An employer is entitled to a deduction under section 8-1 of the ITAA 1997 for a contribution paid to the trustee of an ERT that is either

- incurred in gaining or producing assessable income (‘first limb’) or
- necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income (‘second limb’),

to the extent the contribution is not private or domestic in nature, is not of capital or of a capital nature, does not relate to the earning of exempt income or non-assessable non-exempt income and deductibility is not precluded by another provision of the ITAA 1997 or ITAA 1936.

### ***The contribution must be incurred***

167. To qualify for a deduction under section 8-1 of the ITAA 1997 a contribution to the trustee of an ERT must be incurred.

168. As a broad guide, a taxpayer incurs an outgoing at the time the taxpayer owes a present money debt that they cannot escape.<sup>14</sup> This must be read subject to the propositions developed by the courts, which are discussed in more detail in Taxation Ruling TR 97/7<sup>15</sup> and Taxation Ruling TR 94/26<sup>16</sup>.

169. A contribution made to the trustee of an ERT is incurred only when the ownership of that contribution passes from an employer to the trustee of the ERT and there is no circumstance in which the employer can retrieve any of the contribution – *Pridecraft Pty Ltd v. Federal Commissioner of Taxation*<sup>17</sup> (*Pridecraft*); *Spotlight Stores Pty Ltd v. Commissioner of Taxation*<sup>18</sup> (*Spotlight*).

***The contribution must be incurred in gaining or producing assessable income or necessarily incurred in carrying on a relevant business***

170. Secondly, to be deductible under section 8-1 of the ITAA 1997, a contribution must have been incurred in gaining or producing assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

171. The focus, in recent judicial consideration of the deductibility of contributions made to trustees of ERTs, has been satisfaction of the ‘second limb’<sup>19</sup> and whether the expense which is the contribution is referable to the income producing business<sup>20</sup> or desirable or appropriate from the point of view of the business ends of the employer.<sup>21</sup>

172. Accordingly, in most cases, whether a contribution is deductible under section 8-1 of the ITAA 1997 will depend on whether the contribution is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income (‘second limb’). Given the similarity between the two limbs,<sup>22</sup> this does not preclude the possible application of the ‘first limb’ in appropriate circumstances.

<sup>14</sup> Taxation Ruling TR 97/7 *Income tax: section 8-1 - meaning of 'incurred' - timing of deductions* at paragraph 5.

<sup>15</sup> Taxation Ruling TR 97/7 *Income tax: section 8-1 - meaning of 'incurred' - timing of deductions*.

<sup>16</sup> Taxation Ruling TR 94/26 *Income tax: subsection 51(1) - meaning of incurred - implications of the High Court decision in Coles Myer Finance*.

<sup>17</sup> [2004] FCAFC 339 at [38]; 2005 ATC 4001 at 4010; (2004) 58 ATR 210 at 220.

<sup>18</sup> [2004] FCA 650; 2004 ATC 4674; (2004) 55 ATR 745.

<sup>19</sup> Though in the main, whilst focusing on the second limb, in these cases the Courts have not generally actively delineated between the two limbs. An exception can be found in *Benstead Services Pty Ltd v. FC of T* [2006] AATA 976; 2006 ATC 2511; (2006) 64 ATR 1232 where the AAT dealt only with the business limb of section 8-1: See at AATA [42]- [59]; ATC 2516-2517; ATR 1239-1240.

<sup>20</sup> See Kiefel J's conclusions in *Essenbourne Pty Ltd v. FC of T* [2002] FCA 1577 at [36]; 2002 ATC 5201 at 5209; 51 ATR 629 at 637.

<sup>21</sup> See Hill J's analysis in *Walstern Pty Ltd v. FC of T* (2003) 138 FCR 1 at 19-20; [2003] FCA 1428 at [74]-[75] and the Full Federal Court analysis in *Cameron Brae v. FC of T* (2007) 161 FCR 468 at 485 - 486; [2007] FCAFC 135 at [57] – [59].

<sup>22</sup> *Ronpibon Tin NL and Tongkah Compound NL v. FC of T* (1949) 78 CLR 47; [1949] HCA 15.

***Requisite connection with carrying on of the business***

173. In order to satisfy the second limb of section 8-1 of the ITAA 1997 there must be a relevant connection between the outgoing and the business. An expense will have the relevant connection to the business when it is ‘desirable or appropriate in the pursuit of the business ends of the business’ (*Ronpibon Tin NL and Tongkah Compound NL v. FC of T*<sup>23</sup> (*Ronpibon*); *Magna Alloys & Research Pty Ltd v. Federal Commission of Taxation*<sup>24</sup> (*Magna Alloys*)).

174. In deciding whether a contribution made to the trustee of an ERT is ‘necessarily incurred’ in the sense of ‘clearly appropriate’ to that business<sup>25</sup> regard must be had to:

- the nature of the business activity (*Magna Alloys*),<sup>26</sup>
- the business purpose for which the outgoing was incurred (*Federal Commissioner of Taxation v. The Midland Railway of Western Australia Ltd*),<sup>27</sup>
- the objective circumstances surrounding the incurring of the expenditure (*Federal Commissioner of Taxation v. South Australia Battery Makers Pty Ltd*),<sup>28</sup> and
- the character of the outgoing (*John Fairfax & Sons Pty Ltd v. Federal Commissioner of Taxation*).<sup>29</sup>

175. The characterisation of an outgoing is a question of fact to be considered in the context of the business itself and in the context of what the outgoing was intended or expected to achieve. The objective circumstances that give rise to the expenditure will typically provide a clear explanation of the benefit intended to be achieved by the expenditure and thereby its essential character.

176. Subject to paragraph 182 of this draft Ruling, where an employer:

- carries on a business for the purpose of gaining or producing assessable income and engages employees in the ordinary course of carrying on that business; and
- makes a contribution to the trustee of an ERT; and
- at the time the contribution is made, the primary purpose of the contribution is for it to be applied, within a relatively short period of time, to the direct provision of remuneration of employees (who are employed in that business),

then, such a contribution would ordinarily satisfy the nexus of being necessarily incurred in carrying on that business.

<sup>23</sup> (1949) 78 CLR 47 at 55-58; [1949] HCA 15 at [9]-[15].

<sup>24</sup> [1980] FCA 150; 80 ATC 4542 at 4559-4561; (1980) 11 ATR 276 at 294-297.

<sup>25</sup> *Federal Commissioner of Taxation v. Snowden and Willson Pty Ltd* (1958) 99 CLR 431 at 443-444; [1958] HCA 23 at [5].

<sup>26</sup> At ATC 4547-4550; ATR 281-284.

<sup>27</sup> (1952) 85 CLR 306 at 313; [1952] HCA 5 at [11].

<sup>28</sup> (1978) 140 CLR 645 at 654-660; [1978] HCA 32 at [14]-[23] per Gibbs CJ.

<sup>29</sup> (1959) 101 CLR 30 at 46, 48; [1959] HCA 4 at [5]-[6] per Menzies J.



**Application within a relatively short period of time**

177. In *Spotlight* and *Pridecraft*, both the Federal Court and Full Federal Court agreed that the employer's contribution to an ERT was deductible under former subsection 51(1) of the ITAA 1936 because the employer intended from the outset that the contribution be applied by the trustee of the ERT to provide bonuses for employees over a five year period. The contribution was characterised as a 'prepayment of bonuses'.<sup>30</sup>

178. The Commissioner will generally accept a relatively short period of time for the trustee of an ERT to diminish a contribution for the direct provision of remuneration to employees to be up to five years from the date the contribution was made by an employer to the trustee of an ERT. However, where the contribution has been made to facilitate an employee having an interest in the ERT corresponding to a particular number of shares (or rights to acquire shares) in the employer or in its subsidiaries to which Subdivision 83A-C of the ITAA 1997 applies, the statutory scheme is such that a relatively short period of time for these arrangements will generally be accepted as being up to seven years from the date the contribution is made.

179. However, one may question whether an employer has a primary purpose of providing remuneration to employees if the contribution is first intended to be accumulated for a longer period of time (for example, in excess of a five year period) before such remuneration is paid. Furthermore, the existence of an absolute discretion in the trustee to pay remuneration is evidence against the certainty of diminution. If the trustee of an ERT is required to apply a contribution in making payments of remuneration but has a discretion as to employee selection, then it could be said that there is a greater degree of certainty that rewards for services will be paid.

180. When determining the likelihood of a contribution being diminished in the form of remuneration, and if so, over what time period, the Commissioner will consider objective evidence in the form of a trust deed, scheme documentation and extraneous supporting documentation such as employment agreements. Similarly, past practices of an employer and the ERT or related ERTs may also be taken into account by the Commissioner.

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<sup>30</sup> *Spotlight* at FCA [53]; ATC 4690-4691; ATR 764-765.

**To remunerate employees**

181. There is no relevant connection with business when a contribution made to an ERT is considered to be for the benefit of the principals of the business (in that capacity), and not employees. In *Essenbourne Pty Ltd v. Federal Commissioner of Taxation*<sup>31</sup> (*Essenbourne*), Kiefel J sought to identify the genuine objective the principals of the taxpayer were attempting to achieve when making the contribution to the ERT. Justice Kiefel concluded that the payment was in effect a ‘sharing of profits’ by the principals of the business and did not have the ‘necessary connexion to Essenbourne’s business’.<sup>32</sup> The payment was not ‘referrable to the conduct of its income-producing business’<sup>33</sup> and was therefore not deductible.

**A contribution that does not satisfy subsection 8-1(1)**

182. A contribution by an employer to the trustee of an ERT will not satisfy either limb of subsection 8-1(1) of the ITAA 1997 (and will therefore not be deductible) where that contribution is:

- intended to be applied for the benefit of the owners, controllers or shareholders of the employer (in, or by reason of, that capacity), or associates of any of them; or
- not intended, with any great certainty, to be substantially diminished in providing remuneration to employees within a relatively short period of time (which the Commissioner will treat as being within a five year period) of making the contribution.

**A contribution that is capital or of a capital nature**

183. Even where a contribution satisfies either limb of subsection 8-1(1) of the ITAA 1997, it may still be capital or of a capital nature. Pursuant to subsection 8-1(2) of the ITAA 1997, the contribution will not be deductible to an employer under section 8-1 to the extent to which it is capital or of a capital nature.

184. Whether an outgoing is capital or revenue in nature can generally be determined by reference to the test articulated by Dixon J in *Sun Newspapers Ltd and Associated Newspapers Ltd. v. Federal Commissioner of Taxation*:<sup>34</sup>

There are, I think, three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay...<sup>35</sup>

<sup>31</sup> [2002] FCA 1577; 2002 ATC 5201; 51 ATR 629.

<sup>32</sup> At FCA [33], ATC 5208, ATR 636.

<sup>33</sup> At FCA [36], ATC 5209, ATR 637.

<sup>34</sup> (1938) 61 CLR 337; [1938] HCA 73.

<sup>35</sup> At CLR 363.

185. The advantage sought by an item of expenditure is critical in determining its character.<sup>36</sup> The advantage sought should be considered from a practical and business point of view, not just on the basis of a juristic classification of legal rights.<sup>37</sup>

186. A contribution to the trustee of an ERT is of capital or of a capital nature, where the contribution secures for an employer an asset or advantage of an enduring or lasting nature that is independent of year to year benefits that the employer derives from a loyal and contented workforce.<sup>38</sup>

187. A contribution by an employer to the trustee of an ERT is considered to be capital or of a capital nature, in whole or in part, where the contribution:

- establishes or forms part of a fund which is applied to make loans to employees; or
- is ultimately and in substance, applied by the trustee to acquire a direct interest in the employer (for example shares).

#### **Loan funds (financing facility advantage)**

188. Where a contribution is made by an employer that establishes or forms part of the capital of an ERT which is applied in part or in full, to make loans to employees over a significant period of time or for an indeterminate period, the employer obtains an asset or advantage of an enduring nature. The employer, in effect, has capitalised a finance facility to be utilised by its employees (and usually, at its direction). The finance facility or the funds contributed is an asset to be used by the trustee to make loans to employees on a continuous basis. These amounts are not intended, over this time, to be diminished.

189. The character of the advantage obtained by the employer in establishing or contributing to such a finance facility is structural and enduring. Contributions used for such purposes are (at least in part) of a capital nature.

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<sup>36</sup> *G.P. International Pipecoaters Pty Ltd v. Federal Commissioner of Taxation* (1990) 170 CLR 124 at 137; [1990] HCA 25 at [13].

<sup>37</sup> *Hallstroms Pty Ltd v. Federal Commissioner of Taxation* (1946) 72 CLR 634 at 648; [1946] HCA 34.

<sup>38</sup> *Pridecraft* at FCAFC [97]-[99]; ATC 4010-4011; ATR 233-234.

**Equity interests (capital structure advantage)**

190. Similarly, where a contribution is, ultimately and in substance, applied by the trustee of an ERT to subscribe for equity interests in the employer (for example shares), the employer has also acquired an asset or advantage of an enduring nature. The asset or advantage, obtained by the employer is the advantage that flows to it from enlarging its own equity structure. In effect, the advantage obtained by the employer is a movement of value out of profit or capitalised profit (via the ERT) to share capital. The asset or advantage obtained is the alteration or transformation of profit to share capital. The advantage is a maintenance or enhancement of the capital value of the employer. It is structural and enduring. As such, it is (at least in part) of a capital in nature when applied in this way.

**Apportionment of a contribution**

191. Losses or outgoings are not deductible to the extent to which they are not incurred in gaining or producing assessable income, are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income. The combined operation of subsections 8-1(1) and 8-1(2) of the ITAA 1997 may require apportionment of a loss or outgoing into deductible and non-deductible components, where a single loss or outgoing is incurred for more than one purpose or on items of a differing nature.

192. Both *Ronpibon* and *Fletcher & Ors v. Commissioner of Taxation of the Commonwealth of Australia*<sup>39</sup> (*Fletcher*) recognise there are at least two kinds of expenditure that require apportionment under section 8-1 of the ITAA 1997.<sup>40</sup> The first is expenditure in respect of a matter where distinct and severable parts are devoted to gaining income and other parts are devoted to some other end. The second kind of apportionable expenditure is a single outlay that serves both an income-earning purpose and some other purpose indifferently.<sup>41</sup>

193. Where an outlay serves both a revenue and capital object indifferently, the method of apportionment between both objects must give a fair and reasonable assessment of the extent to which it relates to revenue advantages. Since each case depends on its own facts, it is not possible to prescribe a single method for apportioning a contribution so as to give a fair and reasonable assessment of the extent to which the outlay relates to a non-capital advantage.

<sup>39</sup> (1991) 173 CLR 1; [1991] HCA 42.

<sup>40</sup> See *Ronpibon* at CLR 59; HCA [18] and *Fletcher* at HCA [21]; CLR 16.

<sup>41</sup> *Fletcher* at CLR 16; HCA [21] quoting *Ronpibon* at CLR 59; HCA [18]. See also paragraph 39 of Taxation Ruling 95/33 *Income tax: subsection 51(1) - relevance of subjective purpose, motive or intention in determining the deductibility of losses and outgoings*.

194. In relation to expenditure that is a 'single outlay' the High Court said in *Ronpibon* that:

...there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or rateable division because it is common to both objects.<sup>42</sup>

195. The High Court also stated in *Fletcher*, relying on *Ronpibon*, that what represents the appropriate apportionment of such items of expenditure is essentially a question of fact in each case.<sup>43</sup> See also *Kidston Goldmines Ltd v. FC of T*.<sup>44</sup>

196. Where a contribution by an employer to the trustee of an ERT serves both the purposes of remunerating employees who provide services to the employer in carrying on a business for the purpose of gaining or producing assessable income and for purposes of a capital nature, the available deduction must be apportioned, recognising that there are dual benefits to be obtained by the employer in making the contribution.

197. The Commissioner will consider all fair and reasonable bases of apportionment. In the absence of evidence supporting a fair and reasonable basis of apportionment, where either of the features described in paragraph 187 of this draft Ruling are present, the Commissioner will attribute 50% of a contribution to the securing of capital advantages.

### **De Minimis**

198. Where a contribution is made for the purpose of securing for the employer advantages of both a revenue and capital nature, but the advantages of a capital nature are only expected to be very small or trifling by comparison, apportionment may not be required.

199. The Commissioner will accept that where a contribution secures a financing facility advantage or a capital structure advantage (discussed in paragraphs 188 to 190 of this draft Ruling), it is fair and reasonable that no part of the contribution be apportioned to the obtaining of such an advantage where that advantage is only expected to be very small or trifling compared to the advantage expected to be secured by directly remunerating employees (employed in the ordinary course of the employer's income producing business) within a relatively short period of time (as discussed in paragraph 178 of this draft Ruling) from making that contribution. This is because the law is not concerned with trifles.<sup>45</sup>

<sup>42</sup> At CLR 59; HCA [18].

<sup>43</sup> *Ronpibon* at CLR 59; HCA [18]; *Fletcher* at CLR 16; HCA [21].

<sup>44</sup> [1991] 30 FCR 77; 91 ATC 4538; (1991) 22 ATR 168.

<sup>45</sup> In *Farnell Electronic Components Pty Ltd v. Collector of Customs* (1996) 72 FCR 125; (1996) 142 ALR 322; (1996) 24 AAR 72, Hill J confirmed the principle that the law is not concerned with trifles (*de minimis non curat lex*), and quoted (at FCR 127; ALR 324) with approval the observation in Butterworths, 1994, *Halsbury's Laws of England*, vol. 44(1), 4th edn, London at paragraph 1441 that 'if an enactment is expressed to apply to matters of a certain description it will not apply where the description is satisfied only to a very small extent'. The principle has also been recognised in a number of income tax cases: For example *National Mutual*

200. Where the primary purpose of the employer in making the contribution is to remunerate employees within a relatively short period (as discussed in paragraph 178 of this draft Ruling) of the contribution being made, it is considered that any amount of the contribution attributable to securing a financing facility advantage will only be very small or trifling if it is expected that:

- loans of the contributed funds will only be made by the trustee of the ERT to employees;
- within that relatively short period of time both:
  - the loans will be repaid; and
  - equivalent funds will be permanently diminished in directly providing remuneration to those employees.

201. In such cases it might reasonably be considered that the funds contributed by the employer are designed to be applied to remunerate employees within a relatively short period of time, and the trustee is merely applying those funds in respect of those employees in a particular way until such time as they are so remunerated.

202. Likewise, where the primary purpose of the employer in making the contribution is to remunerate employees within a relatively short period (as discussed in paragraph 178 of this draft Ruling) of the contribution being made, it is considered that any amount of the contribution attributable to securing a capital structure advantage will only be very small or trifling where the employer:

- intends that any direct interest in the employer acquired by the trustee of the ERT (for example shares) will be transferred to employees within that relatively short period, and
- does not anticipate that such shares will be on-sold to third parties at that time or shortly thereafter.

203. In such cases it might reasonably be considered that the funds contributed by the employer are designed to be applied to remunerate employees in the form of an equity interest in the employer and provide a further incentive to secure the ongoing provision of effective services by employees.

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*Life Association of Australasia Ltd v. FC of T* (1970) 122 CLR 13 at 17; [1970] HCA 51 at [7]; *J Hammond Investments Pty Limited v. FC of T* (1977) 31 FLR 349 at 359-360; 77 ATC 4311 at 4318; (1977) 7 ATR 633 at 641; *Garrett v. FC of T* (1982) 58 FLR 101 at 109; 82 ATC 4060 at 4065; (1982) 12 ATR 684 at 690; *FC of T v. Elton* 90 ATC 4078 at 4082; (1990) 20 ATR 1796 at 1800; *Industry Research and Development Board v. Unisys Info Services* (1997) 77 FCR 552 at 558; 97 ATC 4848 at 4852; (1997) 37 ATR 62 at 67.

***When will an employer be required to withhold an amount from a contribution to an ERT for the purposes of section 12-35 of Schedule 1 to the TAA?***

204. Section 12-35 of Schedule 1 to the TAA provides that an entity making a payment of salary or wages, or bonus to an individual as an employee (that is not exempt income or non-assessable non-exempt income of that employee) is required to withhold an amount from that payment.<sup>46</sup> Section 11-5 of Schedule 1 to the TAA states that in working out whether an entity (the 'first entity') has paid an amount to another entity (the 'other entity'), and when the amount is paid, the amount is taken to have been paid to the other entity when the first entity applies or deals with the amount in any way on the other entity's behalf or as the other directs.

205. An employer will therefore be required to withhold an amount from a contribution to an ERT for the purposes of section 12-35 of Schedule 1 to the TAA when the contribution constitutes a payment of salary, wages, commission, bonuses or allowances and that payment satisfies the constructive payment provision in section 11-5 of Schedule 1 to the TAA.

206. The amounts, formulas and procedures to be used to work out the amount required to be withheld are set out in the relevant withholding schedule (called tax tables).<sup>47</sup> An entity that fails to withhold an amount as required by Division 12 of Schedule 1 to the TAA is liable to pay to the Commissioner a penalty equal to that amount.<sup>48</sup> The amount of penalty is subject to remission guidelines contained in Law Administration Practice Statement PS LA 2007/22.<sup>49</sup>

***When does a 'fringe benefit' arise under an ERT that is taken into account by an employer?***

207. Where an employer has provided a 'fringe benefit' as defined in subsection 136(1) of the FBTAA in the course of participation in an ERT, the employer will be required to include that 'fringe benefit' in its aggregate fringe benefits amount as defined in section 5C of the FBTAA.

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<sup>46</sup> See Taxation Ruling TR 2005/16 *Income tax: Pay As You Go - withholding from payments to employees for more information*.

<sup>47</sup> See section 15-25 of Schedule 1 to the TAA. At the time of publication of this draft Ruling, the tax tables published by the Commissioner include several for regular payments, as well as a 'Tax table for back payments, commissions, bonuses and similar payments', each available on the ATO's web site [ato.gov.au/taxtables](http://ato.gov.au/taxtables)

<sup>48</sup> Section 16-30 of Schedule 1 to the TAA.

<sup>49</sup> Law Administration Practice Statement PS LA 2007/22 *Remission of penalty for failure to withhold as required by Division 12 of Schedule 1 to the Taxation Administration Act 1953*.

208. A benefit provided to an employee (or their associate) will constitute a ‘fringe benefit’ as so defined when the benefit (including money)<sup>50</sup> is provided:

- by an employer or the trustee in circumstances where the trustee is a person identified in paragraphs (d) to (ea) of the definition of fringe benefit in subsection 136(1) of the FBTA; and
- in respect of
  - the employment of the particular employee; or
  - a number of employees provided that the identity of each of the employees who will take a share of the benefit is known with sufficient particularity at the time the contribution is made,<sup>51</sup> and
- unless an exception contained in paragraphs (f) to (s) of the definition of fringe benefit in subsection 136(1) of the FBTA applies (relevantly, exceptions include benefits that are payments of salary or wages as also defined in that subsection<sup>52</sup> and benefits that give rise to deemed dividends<sup>53</sup> for the purposes of Division 7A of Part III of the ITAA 1936<sup>54</sup>).

*Benefit to be provided by an employer (or a third party)*

209. In order for a benefit to meet the definition of a ‘fringe benefit’ in subsection 136(1) of the FBTA, the benefit must be provided by an employer or another person identified in paragraphs (d) to (ea) of that definition. The trustee of an ERT will ordinarily satisfy one of these definitions because the trustee

- is an ‘associate’<sup>55</sup> of an employer as referred to in paragraph (d); or
- provides benefits to employees as an ‘arranger’ under an arrangement as referred to in paragraph (e); or
- is an entity that participates in a scheme or plan involving the provision of a benefit as referred to in paragraph (ea).

<sup>50</sup> *Caelli Constructions (Vic) Pty Ltd v. Commissioner of Taxation* (2005) 147 FCR 449 at 462, 465-466; [2005] FCA 1467 at [54], [63]-[68].

<sup>51</sup> *Commissioner of Taxation v. Indooroopilly Children Services (QLD) Pty Ltd* (2007) 158 FCR 325 at 344-345; [2007] FCAFC 16 at [35]-[39].

<sup>52</sup> See paragraph (f) of the definition of fringe benefit in subsection 136(1) of the FBTA. For a discussion of when a benefit is derived by way of a payment of salary or wages refer to paragraphs 262 to 280 of this draft Ruling.

<sup>53</sup> Or loans that would be deemed dividends, if they were not on terms complying with section 109N of the ITAA 1936: See paragraph (s) of the definition of fringe benefit in subsection 136(1) of the FBTA.

<sup>54</sup> See paragraph (r) of the definition of fringe benefit in subsection 136(1) of the FBTA. For a discussion of when Division 7A will apply to deem dividends to be received by employees refer to paragraphs 334 to 341 of this draft Ruling.

<sup>55</sup> ‘Associate’ is defined in section 318 of the ITAA 1936.



210. Where a benefit is provided by a third party as described at paragraph 209 of this draft Ruling, it is the employer, not the third party, who must include that benefit in the calculation of its aggregate fringe benefits amount as defined in section 5C of the FBTA. This is because fringe benefits tax is levied on an employer.<sup>56</sup>

*Benefit to be provided in respect of the employment of a particular employee*

211. The definition of a ‘fringe benefit’ contained in subsection 136(1) of the FBTA requires, amongst other things, that in order for a ‘benefit’ to be a ‘fringe benefit’ the benefit must be provided to ‘the employee or an associate of the employee’ and that the benefit be provided ‘in respect of the employment of the employee’.

212. In *J & G Knowles & Associates Pty Ltd v. FC of T*<sup>57</sup> (*Knowles*) the Federal Court considered the meaning of ‘in respect of employment’ in the FBTA. The Court noted that what has to be established in determining if a benefit is ‘in respect of employment’ is whether there is a sufficient or material, rather than a causal, connection or relationship between the benefit and the employment.

213. Further, in determining whether a ‘fringe benefit’ has been provided the Full Federal Court held in *Commissioner of Taxation v. Indooroopilly Children Services (Qld) Pty Ltd*<sup>58</sup> (*Indooroopilly*) that a particular employee must be identified.

214. Justice Edmonds provided, and Stone and Allsop JJ agreed, that whilst a benefit provided to a trustee of a trust estate can be a fringe benefit, for this to occur

.....the identity of each employee who will take a share of the benefit is known with sufficient particularity, at the time the benefit is provided to enable it to be said that the benefit is provided in respect of the employment of each of those employees.<sup>59</sup>

215. His Honour further found that the shares provided to the trustee (which constituted the contribution to the ERT) were not provided in respect of the employment of any particular employee, nor was it the case that all of the employees capable of benefiting would in fact receive a benefit – only some employees may later benefit and their identity was not known.<sup>60</sup>

<sup>56</sup> See section 5 of the FBTA.

<sup>57</sup> (2000) 96 FCR 402; [2000] FCA 196.

<sup>58</sup> (2007) 158 FCR 325; [2007] FCAFC 16.

<sup>59</sup> At FCR 345; FCAFC [37].

<sup>60</sup> At FCR 345; FCAFC [38].

216. On the other hand, in *Caelli Constructions (Vic) Pty Ltd v. Commissioner of Taxation*<sup>61</sup> a fringe benefit was held to be provided where the trust deed noted that contributions were to be made 'in respect of each worker'.<sup>62</sup> Further, the calculation on a weekly basis of the contribution was directly related to the employee's salary and the contribution was credited to a particular employee's account which also contributed to a fringe benefit being provided in respect of a particular employee.

#### *Benefit not to be a payment of salary or wages*

217. Where the provision of a benefit by the trustee of an ERT to an employee is a payment of 'salary or wages' that payment will not satisfy the definition of 'fringe benefit' in the FBTAA. Paragraph (f) of the definition of 'fringe benefit' in subsection 136(1) of the FBTAA specifically excludes the payment of 'salary or wages'.

218. 'Salary or wages' is defined in subsection 136(1) of the FBTAA to mean a 'payment from which an amount must be withheld (even if the amount is not withheld) under a provision in Schedule 1 to the TAA listed in the table, to the extent that the payment is assessable income.' Such payments would include payments of salary, wages, bonuses, allowances or commissions paid to an individual as an employee.<sup>63</sup>

219. For the purposes of the definition of 'salary or wages' in the FBTAA, to the extent remuneration consists of property or services in any form except money, it is not a payment of salary or wages for the purposes of the exclusion to the definition of 'fringe benefit' in subsection 136(1) of the FBTAA.

#### *Contributions*

220. Contributions not made for the benefit of identifiable employees are not fringe benefits as defined.<sup>64</sup>

221. Contributions that are provided to the trustee of an ERT for the benefit of a particular employee by reason of the services performed by the employee will be assessable to that employee as salary or wages (see discussion at paragraph 293 of this draft Ruling). In such cases, as explained in paragraphs 217 to 219 of this draft Ruling, that contribution will not amount to a fringe benefit as defined in the FBTAA.

<sup>61</sup> (2005) 147 FCR 449; [2005] FCA 1467.

<sup>62</sup> At FCR 465; FCA [62].

<sup>63</sup> See for example section 12-35 of Schedule 1 to the TAA.

<sup>64</sup> Refer to the discussion at paragraphs 213 to 216 of this draft Ruling.

*Loans*

222. An ERT may operate to extend a low or no interest loan to an employee. The loan may be provided to enable an employee to purchase assets. In these cases, the employer may be required to include the taxable value of the loan fringe benefit in the calculation of its aggregate fringe benefits amount as defined in section 5C of the FBTA.

223. A loan provided by the trustee of an ERT to an employee is a fringe benefit taken into account by the employer:

- when it is made under an arrangement between the trustee and the employee's employer;
- when it is made in respect of the employment of the employee (where the connection between the employment and the provision of the loan is sufficient or material – *Knowles*), and
- where the employee is a shareholder or an associate of a shareholder of the employer – to the extent to which it is not either deemed to be a dividend by Division 7A of the ITAA 1936 (see paragraphs 339 to 341 of this draft Ruling) or a loan that would be deemed to be a dividend if it were not on terms complying with section 109N of the ITAA 1936.

224. The 'fringe benefit' that arises as a result of the provision of a loan is a 'loan fringe benefit'.

225. The taxable value of a loan that is a 'loan fringe benefit' under Division 4 of Part III of the FBTA is determined in accordance with section 18 of the FBTA. The taxable value of the loan fringe benefit may be reduced by application of the 'otherwise deductible rule' in section 19 of the FBTA.

**Application of the otherwise deductible rule**

226. Broadly, the 'otherwise deductible rule' operates to reduce the taxable value of the loan fringe benefit to the extent to which interest payable on the loan is, or would have been, allowable as a once-only income tax deduction to an employee.<sup>65</sup>

227. Interest on a loan made under an ERT (if it had been incurred) would be deductible under section 8-1 of the ITAA 1997 to the extent that it would be incurred in gaining or producing assessable income or in carrying on a business for that purpose, except to the extent that it would be of a capital, private or domestic nature, incurred in gaining or producing exempt income or non-assessable non-exempt income and deductibility is not precluded by another provision of the ITAA 1997 or ITAA 1936.

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<sup>65</sup> See section 19 of the FBTA.

228. Whether an interest expense would be incurred in the course of producing assessable income generally depends on the use to which the borrowed funds have been put. The 'use' test, established in *Federal Commissioner of Taxation v. Munro*,<sup>66</sup> is the basic test for the deductibility of interest, and looks at the application of the borrowed funds as the main criterion.

229. Where an employee applies loan funds to acquire an interest (such as a unit) in an ERT, the nature of that interest needs to be examined. Where, in accordance with the trust deed, the rights of the employee to income of the trust are at the discretion of the trustee, ordinarily, interest deductions are not allowable under section 8-1 of the ITAA 1997 unless it is established that the employee is presently entitled to the trust income when the expenditure was incurred.<sup>67</sup>

230. Even in cases where an employee, as a beneficiary, has fixed rights to income, the employee may not always be able to claim a deduction for interest incurred on loans to acquire the interest in the ERT. An interest expense is not fully deductible in situations where the expected return from the interest, both income and capital growth, does not provide an obvious commercial explanation for incurring the interest. This may arise in situations where the total amount of income and capital growth which can reasonably be expected from the interest is less than the total interest expense, especially if the amount of assessable income expected is disproportionately less than the amount of the interest expense.<sup>68</sup>

231. In such cases, it is necessary to carefully examine all of the relevant circumstances, including the direct and indirect objects and advantages sought by the employee in acquiring the interest in the trust and (hypothetically) incurring interest on the loan for the purposes of determining the effect of the otherwise deductible rule. If it can be concluded that the (hypothetical) interest expense is incurred for dual or multiple purposes which include a purpose other than gaining or producing assessable income, it is necessary to apportion the expense.

232. Situations may arise where in a particular income year interest ceases to be deductible in full and in later income years is either no longer deductible or (because of the need for apportionment) is only deductible in part.

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<sup>66</sup> (1926) 38 CLR 153; [1926] HCA 58.

<sup>67</sup> See Taxation Ruling IT 2385 *Income tax: expenses incurred by beneficiaries of discretionary trusts*.

<sup>68</sup> See the Commissioner's approach to circumstances where the amount of assessable income expected is disproportionately less than the amount of the interest expense in Taxation Ruling TR 95/33: *Income tax: Subsection 51(1) relevance of subjective purpose, motive or intention in determining the deductibility of losses or outgoings*. TR 95/33 considers the decision of the Full High Court of Australia in *Fletcher* and in particular, considers situations in which a taxpayer's subjective purpose, intention or motive is relevant in determining the availability of an income tax deduction under former subsection 51(1) of the ITAA 1936. It also relates these principles to the usual kind of negatively geared investments.

233. Additionally, in the case of an interest in a trust which the only assessable income expected to arise to the beneficiary is capital gains, section 51AAA of the ITAA 1936 will operate to deny a deduction for any interest expense incurred on borrowed money to purchase that interest.

234. In summary, after applying the otherwise deductible rule, all or part of the taxable value of the loan fringe benefit arising under an ERT will still remain where an employee uses the loan principal to acquire an interest in an ERT:

- that is not expected to produce income;
- in respect of which the employee is not presently entitled to income and their future right to income from the ERT is subject to the discretion of the trustee and the employee does not have an indefeasible interest, in proportion to their unit holding, in any accumulated income and / or in the trust capital;
- where the likelihood of generating assessable income in excess of the interest expense, is remote; or
- for the primary purpose of making a capital gain.

### ***Cash distributions***

235. A distribution of money by the trustee of an ERT to an employee (other than by way of a loan) may be made as part of the employee's remuneration. When the distribution is made by reason of the services performed by the employee, it is considered to be paid in the form of salary, wages or a bonus (refer to the definition of remuneration in paragraph 10 of this draft Ruling).

236. However, salary or wages as defined in subsection 136(1) of the FBTAA (which includes payments to which sections 12-35, 12-40 and 12-45 of Schedule 1 to the TAA apply as discussed at paragraphs 217 to 219 of this draft Ruling), are specifically excluded from being fringe benefits.<sup>69</sup>

### ***Other benefits***

237. The trustee of an ERT may provide non-cash benefits to an employee. This may be by way of property in the form of shares, units or options. If this provision of property otherwise satisfies the definition of a 'fringe benefit' as discussed at paragraphs 207 to 219 of this draft Ruling (including by being provided in respect of the employment of the employee), this type of fringe benefit will be a 'property fringe benefit'.<sup>70</sup> Subdivision 11-B of Part III of the FBTAA determines the taxable value of the property fringe benefit.

<sup>69</sup> See further the discussion at paragraphs 216 to 217 of this draft Ruling.

<sup>70</sup> Subsection 136(1) of the FBTAA. Note further that property is defined in that subsection to include both tangible and intangible property, and that the provision of such property is broadly defined by section 40 of the FBTAA to be a property benefit.

**Part B – consequences for the trustee**

238. This Part considers the consequences for the trustee of an ERT. This Part includes an explanation of how the section 95 net income of an ERT is calculated.

239. Where there is a share of the income of an ERT (for trust purposes) to which no beneficiary is presently entitled, the trustee of the ERT is assessable on that share of the trust's section 95 net income under section 99A of the ITAA 1936.

**Calculation of the section 95 net income of an ERT**

240. The section 95 net income of an ERT is broadly equal to the sum of the assessable income of the ERT, calculated as if the trustee of the ERT were a resident taxpayer, less allowable deductions. It will therefore include amounts of ordinary income, net capital gains and other statutory income.

***Gains made from the disposal of assets and investments of an ERT may be assessable on revenue account***

241. Whether the trustee of an ERT is required to treat gains or losses from the disposal of assets on revenue or capital account is considered, in detail, in Taxation Determination TD 2011/21.<sup>71</sup>

242. If, on the facts, a disposal of an investment by the trustee of an ERT amounts to no more than a mere realisation or change of investment, the gain or loss is on capital account. But if, on an assessment of all the facts, including the nature of the trust and the content of the trustee's duties, the disposal of the investment is a normal operation in the course of carrying on a business of investment, any gain is income according to ordinary concepts and any loss deductible (*London Australia Investment Co Ltd v. FC of T*).<sup>72</sup>

243. Similarly, a profit or gain from a transaction is assessable as income if:

- the trustee entered into the transaction to make a profit or gain; and
- the transaction was entered into, and the profit was made, either outside the normal course of the taxpayer's business, or in the carrying out of an isolated or one-off business operation or commercial transaction (*Federal Commissioner of Taxation v. The Myer Emporium Ltd*).<sup>73</sup>

<sup>71</sup> Taxation Determination TD 2011/21 *Income tax: does it follow merely from the fact that an investment has been made by a trustee that any gain or loss from the investment will be on capital account for tax purposes.*

<sup>72</sup> (1977) 138 CLR 106; [1977] HCA 50.

<sup>73</sup> (1987) 163 CLR 199; [1987] HCA 18.

244. In the ordinary operation of most ERTs, the trustee of an ERT will acquire assets (for example shares, options, securities) with an intention to make a profit or gain from their disposal or other realisation. This is a necessary part of the arrangement, as the profit or gain forms the basis of a benefit that is provided to employees. As such, it is the Commissioner's view that the trustee of an ERT ordinarily holds assets on revenue account and any gain from the realisation of the assets is income according to ordinary concepts. Conversely any loss from the realisation of assets held on revenue account may be deductible.

*Division 7A may apply to deem dividends to be included in the section 95 net income of an ERT*

245. Division 7A is directed at ensuring that disguised or informal distributions of private company profits to shareholders or their associates<sup>74</sup> are included in the assessable income of those shareholders or associates.<sup>75</sup> In very broad terms, Division 7A does so by deeming such shareholders (or their associates) to have derived dividends if they, directly or indirectly, receive certain payments or loans from, or have debts forgiven by, the private company, and the private company has profits.

246. Under paragraph 109C(1)(a) of the ITAA 1936, a private company is (unless an exception or exclusion applies) taken to pay a dividend to one of its shareholders (or their associate) if it makes a payment or transfers property to them (or their associate). The amount taken to be paid as a dividend is capped at the private company's distributable surplus as defined in section 109Y of the ITAA 1936 (which is designed to broadly equate to the realised and unrealised profits of the private company).<sup>76</sup>

247. Accordingly, if the trustee of an ERT is a shareholder of an employer that is a private company at the time when that employer makes any contribution to the ERT, that contribution will be deemed under section 109C of the ITAA 1936 to be a dividend, included in the section 95 net income of the ERT to the extent of the employer's 'distributable surplus' as defined in section 109Y of the ITAA 1936, unless a relevant exception or exclusion applies.

248. One of the exclusions in Subdivision D of Division 7A is contained in section 109J of the ITAA 1936, which provides that payments discharging certain pecuniary obligations do not give rise to a deemed dividend under section 109C of the ITAA 1936, specifically:

A private company is not taken under section 109C to pay a dividend because of the payment of an amount, to the extent that the payment:

- (a) discharges an obligation of the private company to pay money to the entity; and

<sup>74</sup> For Division 7A purposes, a shareholder's associates are as defined in section 318 of the ITAA 1936: See section 109ZD of the ITAA 1936.

<sup>75</sup> See for example, paragraph 1.4 of the Explanatory memorandum to *Tax Laws Amendment (2010 Measures No. 2) Act of 2010* (Cth).

<sup>76</sup> See *FC of T v. H* (2010) 188 FCR 440 at 447; [2010] FCAFC 128 at [36].

- (b) is not more than would have been required to discharge the obligation had the private company and entity been dealing with each other at arm's length.

249. Therefore, where an employer that is a private company is under no *obligation* to make contributions to the trustee of an ERT, the exclusion in section 109J of the ITAA 1936 will not be enlivened. Moreover, even if the employer has an obligation to make contributions to the trustee of an ERT, section 109J will only be relevant to the extent to which parties dealing at arm's length would be similarly obliged.

250. Subsection 109ZB(3) of the ITAA 1936 may also apply, in certain circumstances, to prevent a payment being treated as a deemed dividend under section 109C. Subsection 109ZB(3) provides as follows:

... this Division does not apply to a payment made to a shareholder, or an associate of a shareholder, in their capacity as an employee (as defined in the *Fringe Benefits Tax Assessment Act 1986*) or an associate of such an employee.

251. Whether the requirements of subsection 109ZB(3) of the ITAA 1936 are satisfied is a factual enquiry and will be determined on a case by case basis.

252. The trustee of the ERT is an associate of any employee who is a beneficiary of the trust.<sup>77</sup>

253. Subsection 109ZB(3) of the ITAA 1936 appears within a provision designed to set an 'ordering' between Division 7A and the fringe benefits tax provisions in the FBTAA.<sup>78</sup> Specifically, what is meant by 'an employee' for the purpose of this provision takes on the meaning it is given in the FBTAA. In considering benefits provided to employees or associates of employees in the context of that Act (specifically, in the definition of a 'fringe benefit'), Edmonds J in *Indooroopilly* concluded that the reference to an employee is a reference to a *particular* employee.<sup>79</sup>

254. Where a contribution is made to the trustee of an ERT by an employer that is a private company in respect of a general class of employees, it will not be able to be said that the contribution was made to the trustee in its capacity as an associate of any particular employee (or that any employee has the requisite connection with the contribution), it cannot be said that subsection 109ZB(3) of the ITAA 1936 is enlivened.

<sup>77</sup> See sections 109ZD and 318 of the ITAA 1936.

<sup>78</sup> See further the Explanatory memorandum to the Tax Laws Amendment Bill (No.3) of 1998 (Cth).

<sup>79</sup> At FCR 344; FCAFC [35].



255. If an employer that is a private company makes a voluntary contribution to the trustee of an ERT in respect of a general class of employees, and the trustee is a shareholder of the employer at that time, the contribution will be deemed under section 109C of the ITAA 1936 to be a dividend, included in the section 95 net income of the ERT to the extent of the employer's 'distributable surplus' as defined in section 109Y.

256. However, any remuneration that an employee directs their employer to make as a contribution to an ERT as their agent (instead of directly to the employee) will not be a payment made in the employer's own capacity.<sup>80</sup> As such, Division 7A will have no application to such contributions.

### **PAYG Withholding**

257. Section 12-35 of Schedule 1 to the TAA requires an entity to withhold an amount from salary, wages, or bonuses it pays to an individual as an employee (whether of that or another entity).

258. A payment of remuneration (as defined in paragraph 10 of this draft Ruling) by the trustee of an ERT will require the trustee to withhold (even though the trustee is not an employer of the employee who is in receipt of the payment), unless it is exempt or non-assessable non-exempt income of that employee.<sup>81</sup>

259. The amounts, formulas and procedures to be used to work out the amount required to be withheld are set out in the relevant withholding schedule (called tax tables).<sup>82</sup> An entity that fails to withhold an amount as required by Division 12 of Schedule 1 to the TAA is liable to pay to the Commissioner a penalty equal to that amount.<sup>83</sup> The amount of penalty is subject to remission guidelines contained in Law Administration Practice Statement PS LA 2007/22.<sup>84</sup>

### **Part C – consequences for an employee**

260. Benefits may be provided to an employee via the operation of an ERT. These benefits may include:

- the payment of a contribution amount to the trustee of an ERT (on behalf of, for the benefit of or at the direction of, the employee); and/or
- non-arm's length finance provided by the trustee; and/or

<sup>80</sup> See subsection 960-100(4) of the ITAA 1997.

<sup>81</sup> See subsections 12-1(1) and 12-1(1A) of Schedule 1 to the TAA. Paragraph 308 of this draft Ruling provides an example of when all or part of such a distribution may be exempt or non-assessable non-exempt income of the employee.

<sup>82</sup> See section 15-25 of Schedule 1 to the TAA. At the time of publication of this draft Ruling, the tax tables published by the Commissioner include several for regular payments, as well as a 'Tax table for back payments, commissions, bonuses and similar payments', each available on the ATO's web site [ato.gov.au/taxtables](http://ato.gov.au/taxtables)

<sup>83</sup> Section 16-30 of Schedule 1 to the TAA.

<sup>84</sup> Law Administration Practice Statement PS LA 2007/22 *Remission of penalty for failure to withhold as required by Division 12 of Schedule 1 to the Taxation Administration Act 1953*.

- an annual entitlement to income of the trust estate; and/or
- an interest in the capital of the trust estate.

261. This Part considers the general rules relating to the ordinary income of an employee, and then the specific consequences of these benefits provided under an ERT for the employee.

***When are benefits amounts of ordinary income of an employee assessable under section 6-5 of the ITAA 1997?***

262. A benefit<sup>85</sup> is assessable to an employee under section 6-5 of the ITAA 1997, where it:

- has the **character of ordinary income**;
- is **derived directly or taken to be received**, such that it can be said that the amount ‘comes home’<sup>86</sup> to the employee; and
- is in the **form of money or money’s worth**;
- is **not derived by way of the provision of a fringe benefit**.

*Remuneration has the character of ordinary income of an employee*

263. Section 6-5 of the ITAA 1997 includes in the assessable income of an employee, all amounts of income according to ordinary concepts. An employee’s ordinary income will include benefits (in the form of money or money’s worth) that the employee receives as remuneration for services the employee provides pursuant to a contract of employment with their employer.

264. A benefit is a reward for services, and remuneration, if provided in connection with and by reason of those services as an employee or in respect of some incident of that service.<sup>87</sup> In *Mutual Acceptance Company v. FC of T*<sup>88</sup>, Latham CJ stated:

The payments (in cash or kind) which are included in ‘wages’ are payments made ‘to any employee as such.’ They therefore comprehend only payments made to an employee in connection with and by reason of his service as an employee or in respect of some incident of his service. Thus a merely personal gift by an employer to a person who happened to be an employee would not be included within ‘wages,’ though a bonus paid to employees because they were employees would be so included.<sup>89</sup>

<sup>85</sup> A benefit includes a payment of money.

<sup>86</sup> Per Murphy J in *Sent v. Commissioner of Taxation* [2012] FCA 382 at [84]; 2012 ATC 20-318 at 13,571; (2012) 85 ATR 1 at 23 quoting the Explanatory memorandum to the Income Tax Assessment Bill of 1997 (Cth) at Chapter 4.

<sup>87</sup> *Mutual Acceptance Company v. FC of T* (1944) 69 CLR 389 at 396; [1944] HCA 34.

<sup>88</sup> (1944) 69 CLR 389; [1944] HCA 34.

<sup>89</sup> At CLR 396.

265. Once an employee has an entitlement to receive money or something that is of money's worth (discussed at paragraphs 278 to 280 of this draft Ruling) for the performance of services, any benefit provided by an employer or the trustee of an ERT to the employee to satisfy that entitlement has the character of ordinary income for the employee. The timing of a payment, that is, whether it is paid in advance of the services to be performed or after, is not determinative of its character.<sup>90</sup>

266. The nature of the income must be determined in the hands of the recipient.<sup>91</sup> Moreover, the fact that the entity who pays the remuneration is not an employer does not change its character as ordinary income of the employee. Relevantly, in *FC of T v. Dixon*,<sup>92</sup> Dixon CJ and Williams J observed:

Indeed, it is clear that if payments are really incidental to an employment, it is unimportant whether they come from the employer or from somebody else and are obtained as of right or merely as a recognized incident of the employment or work.<sup>93</sup>

267. Similarly, in *Deputy Federal Commissioner of Taxation v. Applied Design Development Pty Ltd (In Liq)*<sup>94</sup> it was held that a payment, made under paragraph 556(1)(e) of the *Corporations Act 2001* to a former employee who had proved a debt for wages, retained its character as salary or wages (for the purposes of section 12-35 in Schedule 1 to the TAA), despite there being no subsisting employment relationship. It was found that the consideration for the payment was the services rendered by the former employee to his employer before its liquidation. The nature of the payment remained unaltered by the liquidation process. It was also found that the payment was made to the taxpayer in his capacity as a former employee as required by section 12-35 notwithstanding that he was also a creditor of his employer.

268. More specifically, in *Murdoch v. Commissioner of Pay-roll Tax (Vic)*<sup>95</sup> the High Court found that trust distributions made to employees were nevertheless still salary or wages despite being made to those employees as beneficiaries of a trust and pursuant to the terms of a trust deed.<sup>96</sup>

269. However, where a benefit or payment received by an employee arises as a result of a personal relationship or as a result of a right or entitlement that arises outside of an employment relationship, the benefit or payment is not remuneration.

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<sup>90</sup> *Sent v. Commissioner of Taxation (No 1)* [2012] FCA 382 at [41]-[44]; 2012 ATC 20-318 at 13,563-13,564; (2012) 85 ATR 1 at 15-16.

<sup>91</sup> See for example, *Case C57 71* ATC 250; *Jackson's Trustees v. Commissioners of Inland Revenue* (1942) 25 TC 13; and *Inchyra (Baron) v. Jennings* [1966] 1 Ch 37; [1965] 3 WLR 166 and *Case Q85 83* ATC 430; *Case Nos 260-262/1982* 27 CTBR(NS) 80.

<sup>92</sup> (1952) 86 CLR 540; [1952] HCA 65.

<sup>93</sup> At CLR 557; HCA [5].

<sup>94</sup> (2002) 117 FCR 336 at 342-343; [2002] FCA 205 at [25]-[26].

<sup>95</sup> (1980) 143 CLR 629; [1980] HCA 33.

<sup>96</sup> At CLR 644; HCA [8].

**Exploitation of existing rights**

270. Where a benefit (for example a gain) is received by an employee as a result of exploitation of existing valuable rights it is unlikely that this benefit or gain will also constitute a reward for services, or remuneration

271. For example, in *FC of T v. McArdle*<sup>97</sup> (*McArdle*), an employee (McArdle) was granted valuable rights in respect of his employment which he surrendered some time later in return for a lump-sum payment. The surrender agreement did not require McArdle to continue his employment with his employer nor achieve any performance hurdles or targets. The benefit that flowed to McArdle, from the surrender agreement, came about as a result of arm's length commercial negotiations between McArdle, as the holder of the options, and his employer. The Full Federal Court noted that what had occurred under the surrender agreement was not the granting of a benefit, but the exploitation of rights received from his employer in previous years.<sup>98</sup>

272. At first instance, Justice Fisher had also concluded that McArdle may have been selected as a recipient of options because he was an employee, but this fact 'has no bearing on the character of the payment received by him under the surrender agreement.'<sup>99</sup>

273. The applicability of the *McArdle* principle in an ERT in respect of benefits received from exploiting rights is likely only to arise in circumstances where

- an employee obtains, at the outset, genuine and inherently valuable rights, provided for valuable and arm's length consideration (or as remuneration and those rights were appropriately dealt with as such); and
- the benefit that the employee receives from exploitation of those rights results from commercial negotiation and the surrender or disposal of valuable rights, not as a reward, or remuneration for services.

**Receipt otherwise than in employee capacity**

274. Another instance where a benefit provided under an ERT may not be a reward, or remuneration for services, is where the benefit is provided to an employee solely in the employee's capacity as beneficiary of the ERT and the employee receives the benefit completely independent of an employment relationship and independent of services rendered by the employee, such as in *Constable v. Federal Commissioner of Taxation*<sup>100</sup> (*Constable*).

275. In *Constable*, the employee received a significant lump sum benefit from a fund established by the employer to deliver payments to employees as a result of retirement. The High Court was asked to

<sup>97</sup> 89 ATC 4051 at 4058-4059; (1988) 19 ATR 1901 at 1909.

<sup>98</sup> At ATC 4058; ATR 1909.

<sup>99</sup> *McArdle v. Commissioner of Taxation* (1988) 19 ATR 985 at 1003-1004; 88 ATC 4222 at 4237-4238.

<sup>100</sup> (1952) 86 CLR 402 at 418; [1952] HCA 64 at [11].

consider whether payments from the fund were payments to which former paragraph 26(e) of the ITAA 1936 applied. Constable became entitled to the payments because the terms governing the fund stated that where an alteration was made to the terms and that alteration resulted in a curtailing of the rights of members (Constable was a member) or increasing their obligations, then any member was entitled to withdraw amounts in their account in the fund. Such an alteration was made and Constable became entitled to withdraw amounts. Chief Justice Dixon, McTiernan, Williams and Fullagar JJ stated:

It appears to us that the taxpayer became entitled to a payment out of the fund by reason of a contingency (viz: an alternation of the regulations curtailing the rights of members) which occurred in that year enabling him to call for the amount shown by his account. It was a contingent right that became absolute. The happening of the event which made it absolute did not, and could not, amount to an allowing giving or granting to him of any allowance, gratuity, compensation, benefit, bonus or premium.<sup>101</sup>

276. The High Court subsequently concluded that the payment from the fund was not a payment to which former paragraph 26(e) of the ITAA 1936 could apply.

### **Capital receipts**

277. Whilst the provision of a loan by the trustee of an ERT to an employee may constitute a benefit provided to the employee in respect of their employment (and therefore, may satisfy the definition of a loan fringe benefit for the purposes of the FBTA), the receipt of the amount of the loan principal (when coupled with a genuine obligation to repay that sum), does not have the character of income. Even if received in respect of employment, genuine loans are not assessable as remuneration.

### ***Assessable remuneration must be in the form of money or money's worth***

278. In order for an amount to constitute ordinary income, it must be money or something that can be converted to money.<sup>102</sup>

279. The question of cash convertibility was considered in *FC of T v. Cooke and Sherden*<sup>103</sup> (*Cooke and Sherden*). In that case, a free holiday provided to taxpayers could not be cashed in or transferred to anyone else, the Full Federal Court held that the value of the free holiday was not income.<sup>104</sup>

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<sup>101</sup> At CLR 418; HCA [11].

<sup>102</sup> *FC of T v. Cooke & Sherden* [1980] FCA 37; 80 ATC 4140 at 4150; 10 ATR 696 at 705.

<sup>103</sup> [1980] FCA 37; 80 ATC 4140; (1980) 10 ATR 696.

<sup>104</sup> Taxation Ruling IT 2631 *Income Tax: Lease Incentives* at paragraph 11.

280. The Full Federal Court in *Cooke and Sherden* concluded that if a taxpayer were to receive a benefit and that benefit 'cannot be turned to pecuniary account'<sup>105</sup>, it could not be said that the taxpayer has received an amount of ordinary income.

***Remuneration is assessable to an employee in the year in which it is derived by the employee***

281. Ordinary income is derived by an employee, usually, at the time of receipt (see *Brent v. FC of T*<sup>106</sup>). An amount of ordinary income is derived by an employee if that amount is paid directly to the employee. Direct derivation by way of 'receipt' implies that the amounts have 'come home' to an employee. Such amounts are received unaffected by contractual restrictions.

282. The concept of when income has 'come home' to a taxpayer was first considered in *Commissioner of Taxes (SA) v. Executor Trustee And Agency Co. of South Australia Ltd.*<sup>107</sup>

In the assessment of income the object is to discover what gains have during the period of account come home to the taxpayer in a realized or immediately realizable form.<sup>108</sup>

283. Income can be said to have come home to a taxpayer when there is neither legal nor business unsoundness in regarding it as income derived (*Arthur Murray (NSW) Pty Ltd v. Federal Commissioner of Taxation*)<sup>109 110</sup>.

**Subsection 6-5(4) of the ITAA 1997**

284. Subsection 6-5(4) of the ITAA 1997 expands when an amount is taken to have been received (for the purpose of considering whether the amount has been derived) to include amounts that are applied or dealt with, in any way, on an employee's behalf or as the employee directs. Subsection 6-5(4) has two limbs and it applies if either an amount is applied or dealt with: on an employee's behalf **or** as the employee directs. An amount can be applied or dealt with on an employee's behalf whether or not the employee makes a direction.

<sup>105</sup> At ATC 4148; ATR 704.

<sup>106</sup> (1971) 125 CLR 418 at 429; [1971] HCA 48 at [13].

<sup>107</sup> (1938) 63 CLR 108; [1938] HCA 69.

<sup>108</sup> At CLR 155 per Dixon J.

<sup>109</sup> (1965) 114 CLR 314 at 318; [1965] HCA 58 at [4].

<sup>110</sup> Taxation Ruling TR 1999/11 *Income tax: basis of assessment of interest paid in advance and received in advance by financial institutions* at paragraph 16.

285. In *Sent v. Commissioner of Taxation*<sup>111</sup> (*Sent No 1*), the taxpayer, Sent, entered into an agreement with his employer, Primelife Corporation Limited (Primelife) to be issued with shares in Primelife to the value of \$11,600,000 as consideration for Sent waiving his entitlements to any remuneration or bonuses payable to him. Later, in substitution of the issuance of shares, a cheque for \$11,600,000 was deposited by Primelife into the bank account of the trustee under an ERT at the request or direction of Sent.<sup>112</sup>

286. Justice Murphy in *Sent No 1* considered the operation of subsection 6-5(4) of the ITAA 1997:

... The legislative intent of the provision is clear. In the absence of a provision such as subs 6-5(4) it would be a simple matter for a taxpayer to avoid income tax on amounts that if received by him would be income, merely by arranging for those amounts to be paid to another person, even though the taxpayer is receiving some benefit from the other person's receipt of the amount.<sup>113</sup>

287. Justice Murphy, in applying subsection 6-5(4) to Sent's circumstances concluded that the payment to the trustee of the ERT was constructively derived by Sent at the time it was paid as it was unconditionally received and therefore derived:

48. In any event, it is not correct to describe Mr Sent's entitlements as contingent or subject to claw back at the time of the Payment. Some of Mr Sent's bonus entitlements were contingent until 30 November 2001 insofar as they related to the future financial performance of Primelife. Some of the bonus entitlements could also be described as being subject to claw back until that date as Primelife's future performance could reduce his accruing entitlement. However, once the Share Issue Deed was executed and then approved by the shareholders on 30 November 2001, Mr Sent had an unconditional entitlement to be issued with five million Primelife shares in substitution of these bonus entitlements. It is even clearer that at the time the Payment was made on 21 December 2001 there was no longer any contingency as to the entitlement to the Payment or possibility of its claw back....<sup>114</sup>

...

89. Mr Sent contends that he did not derive any income because his right to receive an amount was subject to eligibility conditions and claw back. Insofar as the eligibility conditions and claw back are related back to contingencies in Mr Sent's bonus entitlements I do not accept this for the reasons I set out at [48]. On 30 November 2001 – when the agreement in the Share Issue Deed was approved by the Shareholder Resolution – his entitlement became unconditional. At that point he was not required to do anything further to 'earn' the shares: *BARM* at [116]. That there is no contingency associated with the Payment is at least clear on 21 December 2001 when it was actually made to the Trust without condition.<sup>115</sup>

<sup>111</sup> [2012] FCA 382; 2012 ATC 20-318; (2012) 85 ATR 1.

<sup>112</sup> *Sent No 1* at FCA [16]; ATC 13,558-13,559; ATR 9.

<sup>113</sup> At FCA [66]; ATC 13,567, ATR 19.

<sup>114</sup> At FCA [48]; ATC 13,565, ATR 16-17.

<sup>115</sup> At FCA [89]; ATC 13,571; ATR 24.

288. Justice Murphy noted that even where the contribution is made to the trustee of an ERT in advance of the performance of services, such a payment in advance does not alter the character of that payment. Further, where an amount is contributed to the trustee of an ERT by an employer in substitution for another amount, it 'has the same tax character as the amount substituted or compensated for'.<sup>116</sup> Finally, Murphy J also stated that for subsection 6-5(4) of the ITAA 1997 to operate, there need not be an ability by an employee to enforce a direction, 'all that subs 6-5(4) requires is that there be a request by the taxpayer that is acted upon, regardless of whether the employee has a legal right to require performance of the request.'<sup>117</sup> Justice Murphy's decision at first instance was upheld on appeal to the Full Federal Court by Emmett, Edmonds and Rares JJ in *Sent v. Federal Commissioner of Taxation* (No 2).<sup>118</sup>

289. If an employee enters into an agreement with their employer to have an amount of their ordinary income paid to the trustee of an ERT, instead of directly to the employee, the employee does not directly receive that amount of their ordinary income. However, the agreement in effect contains a direction by the employee to the employer to pay part of the remuneration owing to the employee to a third party.<sup>119</sup> Subsection 6-5(4) of the ITAA 1997 applies to that direction so as to include the amount paid to the trustee of the ERT in the employee's assessable income under section 6-5.

### ***Fringe benefits are non-assessable non-exempt income***

290. The practical implication of the interaction of section 6-5 of the ITAA 1997 and the FBTAA is that an employee's remuneration which is ordinary income (or which would be ordinary income if it were money or money's worth) is either:

- assessed to the employee under section 6-5 as a derivation of salary or wages,<sup>120</sup> or
- derived by the employee as other cash or property that are 'fringe benefits'. Such benefits would be non-assessable, non-exempt income of the employee because of the operation of section 23L of the ITAA 1936.<sup>121</sup> Rather the employer may be liable to fringe benefits tax.

<sup>116</sup> At FCA [45]; ATC 13,564; ATR 16.

<sup>117</sup> At FCA [83]; ATC 13,570; ATR 23.

<sup>118</sup> (2012) 208 FCR 462; [2012] FCAFC 187.

<sup>119</sup> This could be contrasted with advance dealings of income in effective salary sacrifice arrangements as described in Taxation Ruling TR 2001/10 *Income tax: fringe benefits tax and superannuation guarantee: salary sacrifice arrangements*.

<sup>120</sup> To the extent it is not dealt with under more specific statutory provisions.

<sup>121</sup> Further subsection 23L(1A) of the ITAA 1936 provides that '[i]ncome derived by a taxpayer by way of the provision of a benefit (other than a benefit to which section 15-70 of the *Income Tax Assessment Act 1997* applies) that, but for paragraph (g) of the definition of fringe benefit in subsection 136(1) of the *Fringe Benefits Tax Assessment Act 1986*, would be a fringe benefit is exempt income of the taxpayer.'



291. As salary or wages are specifically excluded from being fringe benefits (see paragraph 217 of this draft Ruling), they will instead be assessable under section 6-5 of the ITAA 1997.

292. Paragraphs 207 to 219 of this draft Ruling provide further explanation of when other forms of remuneration or other benefits provided in respect of employment may be ‘fringe benefits’.

***When are contributions derived as ordinary income and assessable to employees?***

293. A contribution paid to the trustee of an ERT to satisfy an employee’s entitlement to receive remuneration has the character of ordinary income for the employee. A contribution that is made up of such remuneration that is paid to the trustee of an ERT on behalf of or as directed by an employee is deemed to have been derived by the employee at the time it is paid by application of subsection 6-5(4) of the ITAA 1997.

294. As observed by the Federal Court in *FC of T v. White*,<sup>122</sup> ‘what the... [trustee of the ERT] then decides, or is bound, to do with that sum is not relevant to the issue of whether [the employee] derived that amount as income’.<sup>123</sup> Moreover, the nature of a payment in the hands of the trustee of an ERT is not determinative of its character in relation to an employee.<sup>124</sup>

295. However, a contribution made for a general class of employees where the employees who will benefit from the contribution are not known with sufficient particularity at the time the contribution is made is not, at the point of contribution, ordinary income that has been derived by any one employee.<sup>125</sup>

***Will an employee be assessable in respect of benefits provided by the trustee of an ERT?***

296. Where the intention of an employer, in establishing an ERT, is to attract, motivate and retain its employees through the delivery of an extra source of reward or remuneration for services performed, certain distributions from the ERT to an employee are likely to be remuneration.<sup>126</sup>

297. Such distributions will be remuneration:

- despite being paid or provided to an employee who is a beneficiary of the ERT,<sup>127</sup> and

<sup>122</sup> [2010] FCA 730; [2010] ATC 20-195; (2010) 79 ATR 498.

<sup>123</sup> At FCA [29], ATC 11,177, ATR 505-506.

<sup>124</sup> Sent at FCA [49]-[50]; ATC 13,565; ATR 17.

<sup>125</sup> *Indooroopilly* at FCR 344-345; FCAFC [35]-[39].

<sup>126</sup> It would be unusual for an ERT to never deliver remuneration, in some form, to employees. It may be suggested that if this were the case, then what an employer intends to deliver is an investment for an employee to obtain income and capital accretion from an ERT, independent of the employment relationship.

<sup>127</sup> See paragraphs 263 to 269 of this draft Ruling.

- regardless of whether the payment of that benefit is sourced from either the income or the capital of the ERT.<sup>128</sup>

298. Amounts that are paid by the trustee of an ERT to an employee, as remuneration, are therefore included in the employee's assessable income under section 6-5 of the ITAA 1997 in the year in which they are paid to the employee.

*Amounts previously assessed to the employee*

299. Where an employee receives a benefit or payment from the trustee of an ERT and the benefit or payment

- is attributable to and made up of contributions made by an employer in respect of the employee; and
- has previously been included by the employee in their assessable income as ordinary income under section 6-5 of the ITAA 1997,

then the employee is not required to include in their assessable income as ordinary income, that benefit or payment.

*Amounts assessed to the employee under the trust assessing provisions*

300. An employee who is capable of benefiting under an ERT may be subject to the trust assessing provisions.

301. Where an employee, who is a resident beneficiary of the ERT who is not under a legal disability, is presently entitled to a share of the income of the trust estate (expressed as a percentage), paragraph 97(1)(a) of the ITAA 1936 requires the beneficiary to include in their assessable income that same percentage share of the ERT's section 95 net income (subject to the modifications made by Division 6E of the ITAA 1936 in respect of any capital gain and franked distributions of the trust).

302. Where the section 95 net income of an ERT includes a net capital gain, the capital gains making up that net capital gain will be dealt with under Subdivision 115-C of the ITAA 1997.<sup>129</sup> Where a beneficiary has a share of such a capital gain,<sup>130</sup> Subdivision 115-C will treat that beneficiary as having themselves made a capital gain,<sup>131</sup> which is then included in the calculation of their own net capital gain, assessable under section 102-5.

<sup>128</sup> *Murdoch v. Commissioner of Pay-roll Tax (Vic)* (1980) 143 CLR 629 at 645; [1980] HCA 33 at [10].

<sup>129</sup> See Division 6E of the ITAA 1936.

<sup>130</sup> A beneficiary may have a share of a capital gain made by the trustee of a trust by virtue of being entitled to the benefits of that gain and / or as a result of otherwise being entitled to income of the trust: See section 115-227 of the ITAA 1997.

<sup>131</sup> See subsection 115-214(3) of the ITAA 1997.

303. Similarly, where the section 95 net income of an ERT includes a franked distribution, it will be dealt with under Subdivision 207-B of the ITAA 1997.<sup>132</sup> Where an employee who is a beneficiary (an 'employee beneficiary') has a share of such a distribution,<sup>133</sup> Subdivision 207-B will include an amount referable to that distribution, and any franking credit attached to it, in the beneficiary's assessable income.<sup>134</sup> Subject to satisfying the integrity rules in section 207-150 of the ITAA 1997 (discussed in paragraphs 311 to 333 of this draft Ruling), that beneficiary will also be entitled to a tax offset equal to their share of that franking credit.<sup>135</sup>

*Where more than one provision applies, which provision will apply to assess an employee?*

304. To the extent that distributions to an employee beneficiary represent the ERT's section 95 net income assessed to the employee beneficiary under the trust assessing provisions and are also remuneration assessable as ordinary income in their hands, with one exception, the trust assessing provisions will prevail to assess that income in preference to the rules in section 6-5 of the ITAA 1997 dealing with ordinary income. The exception is that where the remuneration paid represents a capital gain included in whole or in part in the section 95 net income and dealt with under Subdivision 115-C of the ITAA 1997, the rules in section 6-5 dealing with ordinary income will prevail to assess that amount.

305. This approach is supported by subsection 6-25(2) of the ITAA 1997, which in broad terms provides that specific assessing provisions are to prevail over those dealing with ordinary income unless a contrary intention appears, and by the courts which look to alleviate conflicts between taxing provisions as far as possible by giving effect to their language and purpose while maintaining the unity of the statutory scheme.<sup>136</sup> Relevantly, the general structure, language and purpose of the income tax law, including provisions dealing with the interactions between the CGT provisions and other regimes within the income tax system,<sup>137</sup> indicate a clear intent that, without more, where an amount is otherwise included in assessable income under both section 6-5 and section 102-5 of the ITAA 1997, the CGT provisions should give way to section 6-5.

<sup>132</sup> See Division 6E of the ITAA 1936.

<sup>133</sup> A beneficiary may have a share of a franked distribution that was made to the trustee of the trust by virtue of being entitled to the benefits of that distribution and / or as a result of otherwise being entitled to income of the trust: See section 207-50 of the ITAA 1997.

<sup>134</sup> See paragraph 207-35(4)(b) of the ITAA 1997.

<sup>135</sup> See section 207-45 of the ITAA 1997.

<sup>136</sup> See *Project Blue Sky v. ABA* (1998) 194 CLR 355 at 381-382; [1998] HCA 28 at [70].

<sup>137</sup> This conflict is not specifically resolved by section 118-20 of the ITAA 1997 (which can operate to reduce a capital gain made from a CGT event if, because of the event, an amount was included in assessable income by a provision of the Act outside the CGT provisions) – because a gain taken to be made by a beneficiary under Subdivision 115-C of the ITAA 1997 is not a capital gain from a CGT event (the trustee is the entity who has the CGT event).

306. Accordingly, where an amount distributed to an employee beneficiary is assessable under section 6-5 of the ITAA 1997 and also represents a share of the section 95 net income of the ERT assessed to that employee, section 6-25 will apply to resolve the conflict by reducing the amounts assessed under section 6-5 to the employee beneficiary by any amount assessed to them under Division 6 of Part III of the ITAA 1936 and Subdivision 207-B of the ITAA 1997, and in turn reducing any relevant capital gain they are taken to have made under Subdivision 115-C to the extent to which it is assessable to them under section 6-5.

307. This is consistent with the Commissioner's long held view that trust distributions not dealt with by the specific trust assessing provisions (such as Division 6) can be assessed as ordinary income if they bear that character in the hands of the beneficiary. The scope of Division 6 was considered by the High Court in *Tindal v. Federal Commissioner of Taxation*<sup>138</sup>, *Federal Commissioner of Taxation v. Belford*<sup>139</sup> (*Belford*) and *Union Fidelity Trustee Co v. Federal Commissioner of Taxation*<sup>140</sup> (*Union Fidelity*). The majority view in *Belford*, that Division 6 is not an exclusive code, was affirmed in *Union Fidelity*.

*Amounts of exempt income or non-assessable non-exempt income*

308. Where a distribution includes amounts that form part of the exempt or non-assessable non-exempt income of a trust estate, provisions within Division 6 may apply to treat the distribution as exempt or non-assessable non-exempt income of a beneficiary.

309. Such amounts will not be assessed to the beneficiary as ordinary income, even if received as remuneration.<sup>141</sup>

*Summary of how trust distributions that are remuneration will be assessed to an employee*

310. In summary, where an amount is paid by the trustee of an ERT to an employee as remuneration for services provided or to be provided by that employee,<sup>142</sup> the amount that employee is to include in their assessable income for the purposes of section 6-5 of the ITAA 1997 is the gross amount of the remuneration ('gross amount') less

- *amounts previously assessed to the employee: so much of the 'gross amount' (if any) previously included by the employee in their assessable income as ordinary income under section 6-5 when the amount was contributed to the trust;*

<sup>138</sup> (1946) 72 CLR 608; [1946] HCA 26.

<sup>139</sup> (1952) 88 CLR 589; [1952] HCA 73.

<sup>140</sup> (1969) 119 CLR 177; [1969] HCA 36.

<sup>141</sup> See section 6-15 of the ITAA 1997.

<sup>142</sup> As discussed in paragraphs 296 to 297 of this draft Ruling.

- *amounts assessed to the employee under the trust assessing provisions* (other than in respect of capital gains); and
- *amounts of exempt income or non-assessable non-exempt income*: the amount (if any) of that 'gross amount' that is taken to be the employee's exempt income or non-assessable non-exempt income.

### ***Entitlement to tax offsets in respect of franking credits***

311. As stated in paragraph 303 of this draft Ruling, an employee beneficiary who within the meaning of Subdivision 207-B of the ITAA 1997 has a share of a franked distribution that was made (or flowed indirectly) to the trustee of the ERT will – subject to the integrity rules in section 207-150 of the ITAA 1997 – be entitled to a tax offset<sup>143</sup> for their share of the franking credit attached to that distribution.

312. Amongst other things, those integrity rules will operate to deny an employee beneficiary the entitlement to such a tax offset where they are not a 'qualified person' in relation to the franked distribution for the purposes of former Division 1A of Part IIIAA of the ITAA 1936.<sup>144</sup> That is, in general terms, a tax offset may be so denied where the employee beneficiary is not sufficiently subject to the risks of loss and opportunities for gain generally associated with direct share ownership.<sup>145</sup>

### ***Trustee and beneficiary must both be qualified persons***

313. A beneficiary of a trust will only be a qualified person under former Division 1A of Part IIIAA of the ITAA 1936 in relation to dividends flowing indirectly through that trust if, amongst other things, the trustee itself is a qualified person in relation to the dividends.<sup>146</sup>

<sup>143</sup> By reason of section 207-45 of the ITAA 1997

<sup>144</sup> See paragraph 207-150(1)(a) of the ITAA 1997. Whether the employee beneficiary is a qualified person for these purposes necessarily requires a consideration of those former provisions. Subject to certain transitional rules, Part IIIAA ceased to have application from 1 July 2002 (refer former section 160AOAA of the ITAA 1936). This was due to the introduction of the Simplified Imputation System into the ITAA 1997. The qualified persons rules of Division 1A, although repealed, continue to perform an important integrity role in the income tax law. It is the Commissioner's view that it is necessary to have regard to the rules in the Division, as in force at 30 June 2002, for the purposes of applying the test in paragraph 207-150(1)(a), which makes specific reference to those former provisions. See Taxation Determination TD 2007/11 *Income tax: imputation: franked distributions: qualified persons: does an entity have to be a qualified person within the meaning of Division 1A of former Part IIIAA of the Income Tax Assessment Act 1936 to avoid the application of paragraphs 207-145(1)(a) and 207-150(1)(a) of the Income Tax Assessment Act 1997 in respect of a franked distribution made directly or indirectly to the entity on or after 1 July 2002?*

<sup>145</sup> See generally at paragraphs 4.6 to 4.9 of the Explanatory memorandum to the *Tax Laws Amendment Act (No. 2) of 1999* (Cth).

<sup>146</sup> See former section 160APHU of the ITAA 1936.

314. If this condition is satisfied, then whether or not the employee beneficiary is a qualified person in relation to those dividends further depends on:

- whether the employee beneficiary satisfies the 'small shareholder test' in former section 160APHT of the ITAA 1936 (in which case they will be taken to be a qualified person), or
- if not, whether the trust is widely held as defined in former section 160APHD of the ITAA 1936 (as the remaining qualified person rules are effectively easier to satisfy for beneficiaries of widely held trusts than for beneficiaries of non-widely held trusts).

*Small shareholder exemption – former section 160APHT*

315. Pursuant to former subsection 160APHT(1) of the ITAA 1936, where the total franking credits on all of the dividends paid on shares that a taxpayer who is an individual holds or holds an interest in is less than \$5,000, then the taxpayer is deemed to be a qualified person in relation to those dividends.

316. The result of this rule is that an employee beneficiary of an ERT to whom dividends flow indirectly through the trust will be treated as a qualified person in relation to those dividends without the need to satisfy any other conditions if:

- the franking credits on those dividends together with those on all other franked dividends received directly or indirectly by that employee beneficiary total less than \$5,000, and
- the trustee itself is a qualified person with respect to those dividends.

*Other tests – widely held and non-widely held trusts*

317. Most relevantly,<sup>147</sup> a trust will be a widely held trust for the purposes of former Division 1A of Part IIIAA of the ITAA 1936 when it is:

- not a non-fixed trust (that is, it *is* a fixed trust as defined in section 272-65 of Schedule 2F to the ITAA 1936),<sup>148</sup> and

<sup>147</sup> The concept of a widely held trust is defined in former section 160APHD of the ITAA 1936. Only paragraph (a) of those trusts it defines to be widely held trusts are considered here.

<sup>148</sup> See the definition of a non-fixed trust in section 272-70 of Schedule 2F to the ITAA 1936, and in former section 160APHA of the ITAA 1936.

- not a closely held fixed trust (that is, more than 20 non-associated entities have interests in the trust that together entitle them to not less than 75% of the beneficial interests in the income or in the capital of the trust).<sup>149</sup>

318. Whether an ERT is a widely held trust is a factual enquiry and will need to be considered on a case by case basis.

#### *Beneficiaries of non-widely held trusts*

319. A beneficiary of a trust that is not a widely-held trust who holds an interest in shares on which a dividend has been paid is a qualified person in relation to the dividend if the taxpayer has held that interest at risk, not counting the day of acquisition or disposal, for a continuous period of at least 45 days (or 90 days for certain preference shares).<sup>150</sup>

320. Pursuant to former subsection 160APHG(3) of the ITAA 1936, if a trustee of a non-widely held trust acquires, holds or disposes of shares (or an interest in shares), each beneficiary of the trust (including each object if the trust is a discretionary trust) is also taken to acquire, hold or dispose of an interest in the shares.

#### *Beneficiaries of widely held trusts*

321. A beneficiary of a widely held trust who has held an interest in the shares of the trust for a continuous period of at least 45 days is a qualified person in relation to a dividend paid on *any of the* shares to which a distribution from the trust to the beneficiary is attributable.<sup>151</sup>

322. Over any period during which they are a beneficiary of that trust the beneficiary is taken to have an interest in the shares that are or were included in the trust estate over that period.<sup>152</sup>

#### *Days with 'materially diminished' risks and opportunities not counted*

323. In calculating the number of days for which any beneficiary (that is, a beneficiary of either a widely held or non-widely held trust) continuously held their interest in shares of the trust, any days on which the beneficiary has 'materially diminished' risks of loss or opportunities for gain in respect of the interest are to be excluded.<sup>153</sup>

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<sup>149</sup> See the definition of a closely held fixed trust in former section 160APHD of the ITAA 1936.

<sup>150</sup> See former section 160APHO of the ITAA 1936.

<sup>151</sup> See former section 160APHP of the ITAA 1936.

<sup>152</sup> See former subsection 160APHG(6) of the ITAA 1936.

<sup>153</sup> See former subsections 160APHO(3) and 160APHP(2) of the ITAA 1936.

324. A beneficiary of a trust is taken to have ‘materially diminished’ risks of loss or opportunities for gain on a particular day in respect of their interest in shares held by the trust if their ‘net position’ on that day in relation to their interest in the shares is less than 30% of those risks or opportunities.<sup>154</sup>

325. This net position is worked out using the financial concept known as delta.<sup>155</sup> The net position of a beneficiary in relation to their interest in shares held by the trustee is calculated by adding their long positions (positive deltas) and short positions (negative deltas) with respect to the interest. A position is anything that has a delta in relation to the interest.

326. Examples of positions are given in former subsection 160APHJ(2) of the ITAA 1936. Short sales, sold futures, sold call options, bought put options, and sold share index futures are given as specific examples of short positions in former subsection 160APHJ(3); and share purchases, bought futures, bought call options, sold put options, and bought share index futures are given as specific examples of long positions in former subsection 160APHJ(4). A non-recourse loan in respect of relevant securities, behaving in effect as an option in relation to those securities, is also a relevant position.<sup>156</sup>

327. A net position at least equal to 30% of the risks and opportunities with respect to a beneficiary’s interest in shares held by the trust requires a delta of at least 0.3.

328. Because of the combined operation of former subsections 160APHL(7) and 160APHL(10) of the ITAA 1936, the net position of an employee beneficiary’s interest in shares held in an ERT<sup>157</sup> that are not employee share scheme securities as defined in former section 160APHD<sup>158</sup> will effectively start at 0, to which the *only* things that can be added are:

- where the ERT is a widely held trust:
  - the delta of a long position defined to equal the employee beneficiary’s **vested and indefeasible** interest (if any) in that part of the trust fund that comprises shares and interests in shares from time to time;<sup>159</sup> or

<sup>154</sup> See former subsection 160APHM(2) of the ITAA 1936.

<sup>155</sup> See former subsection 160APHM(3) of the ITAA 1936, which refers to former 160APHJ of the ITAA 1936.

<sup>156</sup> See former paragraph 160APHJ(2)(f) and paragraph 4.54 of the Explanatory memorandum to the Tax Laws Amendment Bill (No. 2) of 1999 (Cth).

<sup>157</sup> Not being a family trust within the meaning of Schedule 2F to the ITAA 1936 or a deceased estate.

<sup>158</sup> This is in turn determined by reference to former Division 13A of Part III of the ITAA 1936. Note further that an interest of a beneficiary in a trust cannot be an employee share scheme security as defined unless, amongst other things, the *sole* activities of the trust comprise obtaining shares (or rights to acquire shares) and providing those shares or rights to employees of a company or their associates: See paragraph (c)(iii) of the definition.

<sup>159</sup> See former subsections 160APHL(10), 160APHL(11) and 160APHL(4) of the ITAA 1936.



- where the ERT is *not* a widely held trust and the employee beneficiary has a **vested and indefeasible** interest in the relevant dividend-yielding share:
  - the delta of a long position defined to equal that **vested and indefeasible** interest;<sup>160</sup>  
*plus or minus*
  - the delta of a position of the trustee in respect of the particular dividend-yielding share, to the extent that it relates to the beneficiary's interest in that share.<sup>161</sup>

329. Circumstances that are relevant and likely to impact on whether an employee beneficiary of an ERT has vested and indefeasible interest sufficient to admit the conclusion that the employee beneficiary is a qualified person with respect to dividends passing to the employee through the ERT include (*Soubra v. Federal Commissioner of Taxation*):<sup>162</sup>

- Vesting or holding periods. An employee may not be able to redeem interests in an ERT until a minimum period of employment has been satisfied;
- Investment powers conferred on the trustee or the administrators by the trust deed that have the effect of reducing or diminishing the employee beneficiary's right to capital in the trust. This may include a power conferred on the trustee to acquire, sell and otherwise dispose of the property of the trust (such as shares held by the trustee), without regard to the interests of the employee beneficiary;
- Amount payable on redemption. The amount payable upon redemption of an employee beneficiary's interest in the ERT at a particular point in time might be less than the acquisition / subscription price paid by the employee beneficiary for the interest in the trust;<sup>163</sup> and
- Dilution of value of interest. An effect of increasing the number of employee beneficiaries of the ERT without a corresponding accretion to the capital of the trust may have the result of diminishing the interest of existing employee beneficiaries in the ERT.<sup>164</sup>

<sup>160</sup> See former subsections 160APHL(10), 160APHL(11) and 160APHL(3) of the ITAA 1936.

<sup>161</sup> See former subsection 160APHL(8) of the ITAA 1936. Former subsection 160APHL(9) of the ITAA 1936 provides examples of when a position of the trustee in a share relates to the beneficiary's interest in the share.

<sup>162</sup> [2009] AATA 775; 2009 ATC 10-113; (2009) 77 ATR 946.

<sup>163</sup> If the amount payable is less than the value of the interest, the interest will generally be deemed to be defeasible: See former subsection 160APHL(12) of the ITAA 1936.

<sup>164</sup> Such interests will generally be deemed to be defeasible: See former subsection 160APHL(12) of the ITAA 1936.

330. The Commissioner has a discretion under former subsection 160APHL(14) of the ITAA 1936 to treat some interests that are not vested or indefeasible as being vested and indefeasible. However, the discretion is narrowly cast and its application factually dependent.

331. In deciding whether to exercise this discretion, the Commissioner must have regard to:<sup>165</sup>

- the circumstances in which the interest may not vest or may be defeated
- the likelihood of the relevant interest not vesting or being defeated
- the nature of the trust; and
- any other matter the Commissioner thinks relevant, which in the context of an ERT would include (but is not limited to):
  - whether the employee beneficiary is protected against a fall in the market value of the relevant shares due to a limited recourse loan arrangement
  - whether discretions of the trustee of the ERT can affect (and if so, the likelihood of such discretions affecting) the vesting of relevant shares in the employee beneficiary, and
  - whether the ERT is generally promoted or operated on the basis that employee beneficiaries will receive cash rather than an in-specie distribution of the shares they have a relevant interest in.

*No tax offset if not a qualified person.*

332. Where an employee who is a beneficiary of an ERT does not have a vested and indefeasible interest in relevant trust property and is therefore not a qualified person for the purposes of former Division 1A in relation to a distribution in respect of shares that are not employee share scheme securities as defined in former section 160APHD, the employee will not be entitled to a tax offset under section 207-45 of the ITAA 1997 for their share of any franking credits attached to that distribution.

333. Where a tax offset is not available, the employee beneficiary will be entitled to an offsetting deduction, equal to the lesser of the share of the franking credit included in their assessable income, and their proportionate share of the trust's section 95 net income.<sup>166</sup>

<sup>165</sup> Under former paragraph 160APHL(14)(c) of the ITAA 1936.

<sup>166</sup> See subsections 207-150(3) and 207-50(3), and subparagraph 207-35(4)(b)(i) of the ITAA 1997.

***When will an employee be taken to have been paid a deemed dividend for the purposes of Division 7A?***

334. The intent and application of Division 7A is described, in more detail, in paragraph 245 of this draft Ruling.

335. A contribution may be made to the trustee of an ERT in respect of a general class of employees in circumstances which do not result in Division 7A deeming a dividend to be paid to the trustee in the manner described in paragraphs 245 to 256 of this draft Ruling (for example, because the contribution was made at a time the trustee of the ERT was not a shareholder of the relevant private company). In these circumstances, subsequent loans of that contributed amount to employees may be deemed under Division 7A to be dividends paid to those employees.

336. Broadly, where a private company pays or loans an amount to an interposed entity on the understanding that the interposed entity or another interposed entity has paid or lent, or will pay or loan an amount to the shareholder of the private company or an associate of the shareholder (the 'target entity'), Subdivision E of Division 7A may operate to treat the private company as having made a payment (deemed payment) or loan (notional loan) directly to the target entity (to which the usual rules in Division 7A may then operate).

337. Specifically, subsection 109T(1) of the ITAA 1936 provides that Division 7A will operate as if a private company makes a deemed payment or notional loan, as described in section 109V or 109W of the ITAA 1936, to the target entity if:

- (a) the private company makes a payment or loan to another entity (the first interposed entity) that is interposed between the private company and the target entity; and
- (b) a reasonable person would conclude (having regard to all the circumstances) that the private company made the payment or loan solely or mainly as part of an arrangement involving a payment or loan to the target entity; and
- (c) either:
  - (i) first interposed entity makes a payment or loan to the target entity; or
  - (ii) another interposed entity between the private company and the target entity makes a payment or loan to the target entity.

338. The test in paragraph 109T(1)(b) of the ITAA 1936 is approached from the perspective of a reasonable person and applies having regard to the prevailing circumstances at the time when the interposed entity makes the payment or loan to the target entity.

339. Specifically, section 109T of the ITAA 1936, together with sections 109W and 109D of the ITAA 1936 will deem an employer that is a private company to have paid a dividend to an employee receiving a loan from the ERT if:

- the employer makes or has made a contribution to the trustee of an ERT (and the contribution was not made to the trustee of the ERT in its capacity as an associate of a particular employee,<sup>167</sup> and is not itself treated as a deemed dividend under Division 7A<sup>168</sup>);
- the trustee of the ERT makes a loan to the employee, at a time when the trustee is a shareholder of the private company and the employee is a beneficiary of the ERT (thus, at a time when the employee is an associate of a shareholder of the employer),<sup>169</sup> and
- it would be reasonable to conclude the contribution was made solely or mainly as part of an arrangement involving a loan to that employee beneficiary.

340. Specifically, in these circumstances section 109T of the ITAA 1936 will deem the private company to have made a notional loan to the employee, which the Commissioner will determine under section 109W to be the amount actually loaned by the trustee to the employee. Section 109D will then operate, subject to section 109Y, to treat that notional loan as a dividend. Section 109Y has the effect that the total amount of dividends taken to have been paid by an employer under Division 7A will be limited to the employer's distributable surplus.

341. Note that in accordance with subsection 109ZB(1) of the ITAA 1936, whether the loan (including the notional loan) was made to an employee in the capacity as an employee has no bearing on the application of Division 7A to that loan. Regardless of the employment relationship or context, Division 7A will continue to apply to that loan. However, a loan fringe benefit will not arise in relation to a loan which is a deemed dividend.

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<sup>167</sup> See subsection 109ZB(3) of the ITAA 1936.

<sup>168</sup> See subsection 109T(3) of the ITAA 1936. This may be the case, for example, if the trustee is not a shareholder at the time the contribution is made.

<sup>169</sup> See sections 109ZD and 318 of the ITAA 1936.

## Appendix 2 – Your comments

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342. You are invited to comment on this draft Ruling, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

343. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- be published on the ATO website at [www.ato.gov.au](http://www.ato.gov.au).

Please advise if you do not want your comments included in the edited version of the compendium.

**Due date:** 18 April 2014  
**Contact officer:** Faith Garnar  
**Email address:** [ATP-Technical-Advice@ato.gov.au](mailto:ATP-Technical-Advice@ato.gov.au)  
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MOONEE PONDS VIC 3039

**Appendix 3 – Detailed contents list**

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Not previously issued as a draft

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- income
- non cash benefits
- employee share ownership
- employee share trust

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