

# Cover sheet for: TR 2017/D5

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# Draft Taxation Ruling

## Income tax: employee remuneration trusts

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### Summary – what this ruling is about

1. This draft Ruling sets out the Commissioner’s views on how the taxation laws apply to an employee remuneration trust (ERT) arrangement that operates outside of Division 83A of the *Income Tax Assessment Act 1997* (ITAA 1997).<sup>1</sup>

2. This draft Ruling does not consider:

- the circumstances in which contributions to, or benefits from, an ERT are statutory income under section 15-2 or Parts 2-40 and 2-42 of the ITAA 1997
- the application of section 40-880 of the ITAA 1997 to a contribution that is capital or of a capital nature<sup>2</sup>
- contributions that are made by a head company, or subsidiary member, of a consolidated group to an Australian resident ERT that is a member of the same consolidated group
- the application of Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936).

<sup>1</sup> That is, it does not apply to arrangements that deliver an ESS interest under an employee share scheme (within the meaning of the ITAA 1997) that is taxed under Subdivision 83A-B or 83A-C of the ITAA 1997.

<sup>2</sup> 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.

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3. Nothing in this draft Ruling should be taken as applying to:

- employee share schemes<sup>3</sup> where either Subdivision 83A-B or Subdivision 83A-C of the ITAA 1997 applies to an ESS interest<sup>4</sup>
- superannuation funds<sup>5</sup>
- approved worker entitlement funds<sup>6</sup>, or
- financial arrangements to which Division 230 of the ITAA 1997 applies.

## Definitions

4. The following terms and abbreviations are used in this draft Ruling:

<b>Associate</b>	Associate as defined in section 318 of the ITAA 1936.
<b>CGT</b>	Capital gains tax.
<b>Contribution</b>	A payment of money by an employer (other than by way of a loan) to the trustee which increases the value of the trust estate.
<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>Employee</b>	The word 'employee' has its common law meaning <sup>7</sup> and includes a director of an incorporated company.
<b>ERT</b>	A trust established as part of an ERT arrangement.
<b>ERT arrangement</b>	An arrangement as described in paragraph 8 of this draft Ruling.
<b>FBT</b>	Fringe benefits tax.
<b>FBTAA</b>	<i>Fringe Benefits Tax Assessment Act 1986</i> .
<b>Fringe benefit</b>	A fringe benefit as defined in subsection 136(1) of the FBTAA.

<sup>3</sup> As defined in subsection 83A-10(2) of the ITAA 1997.

<sup>4</sup> As defined in subsection 83A-10(2) of the ITAA 1997.

<sup>5</sup> As defined in section 10 of the *Superannuation Industry (Supervision) Act 1993*.

<sup>6</sup> As defined by section 58PB of the *Fringe Benefits Tax Assessment Act 1986* (FBTAA).

<sup>7</sup> The following Taxation Rulings provide guidance on when an individual is an employee at common law: Taxation Ruling TR 2005/16 *Income tax: Pay As You Go – withholding from payments to employees*; Taxation Ruling TR 2013/1 *Income tax: the identification of 'employer' for the purposes of the short-term visit exception under the Income from Employment Article, or its equivalent, of Australia's tax treaties*.

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<b>Income of the ERT</b>	The income of the ERT is the 'income of the trust estate' that is the ERT, as that phrase is used in section 97 of the ITAA 1936. <sup>8</sup>
<b>ITAA 1936</b>	<i>Income Tax Assessment Act 1936.</i>
<b>ITAA 1997</b>	<i>Income Tax Assessment Act 1997.</i>
<b>Prepayment provisions</b>	Sections 82KZL, 82KZM, 82KZMA and 82KZMD of the ITAA 1936.
<b>Relatively short period</b>	Has the meaning outlined in paragraph 83 of this draft Ruling.
<b>Remuneration</b>	A payment or other benefit that is provided to an employee in respect of, for or in relation directly or indirectly to, any employment. <sup>9</sup>  Remuneration can be provided to a third party to the employment contract, where it is applied or dealt with in any way on the employee's behalf or as the employee directs.  Remuneration does not include benefits provided in connection with termination of employment unless it is deferred remuneration. <sup>10</sup>
<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>	Subdivisions 115-C and 207-B of the ITAA 1997 and Division 6.
<b>Trustee</b>	The trustee of an ERT.

5. Entities referred to in this draft Ruling are referred to in their capacity as such an entity unless otherwise indicated.

## Previous rulings

6. This draft Ruling replaces draft Taxation Ruling TR 2014/D1 *Income tax: employee remuneration trust arrangements.*

## Ruling

7. This draft Ruling applies to all Australian resident employers, employees and trustees who participate in an ERT arrangement.<sup>11</sup>

<sup>8</sup> Refer to paragraph 5 of Taxation Ruling TR 2012/D1 *Income tax: meaning of 'income of the trust estate' in Division 6 of Part III of the Income Tax Assessment Act 1936 and related provisions.*

<sup>9</sup> *Mutual Acceptance Company v. Federal Commissioner of Taxation* (1944) 69 CLR 389; [1944] HCA 34; (1944) 7 ATD 506.

<sup>10</sup> *Blank v. Commissioner of Taxation* [2016] HCA 42; 2016 ATC 20-587.

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8. An ERT arrangement involves a trust being established to facilitate the provision of payments and/or other benefits to employees of an employer. The trustee provides the benefits at the direction of, or by arrangement with, the employer. Examples of ERT arrangements are set out 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 5 to 7 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 5 to 7.

## **Consequences of making a contribution to an ERT**

### ***Consequences for the employer***

*When can an employer deduct a contribution?*

9. A contribution is deductible to the employer under section 8-1 of the ITAA 1997<sup>12</sup> where all of the following apply:

- it is an irrevocable payment of cash, made at a time when the employer carries on a business for the purpose of gaining or producing assessable income
- the employer reasonably expects their business to benefit from the contribution via an improvement in employee performance, morale, efficiency or loyalty, and
- the contribution is intended to be permanently and entirely dissipated in remunerating employees of that business<sup>13</sup> within a relatively short period<sup>14</sup> of the contribution being made (other than employees who are wholly engaged in affairs of capital of the business<sup>15</sup>).

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<sup>11</sup> ERT arrangements can be variously described as employee bonus, benefit, incentive or reward schemes, arrangements, or trusts.

<sup>12</sup> Where section 8-1 of the ITAA 1997 applies to a contribution the prepayment provisions may apply to set the amount and timing of the deduction. See paragraphs 20 and 21 of this draft Ruling.

<sup>13</sup> That is, it is intended that amounts equal to the contribution will be paid out of the ERT to the employee as benefits that are remuneration in nature.

<sup>14</sup> See paragraph 83 for a discussion of what a 'relatively short period' means in this context.

<sup>15</sup> For example, those employees who are engaged to perform work on projects to construct and upgrade depreciating assets of the taxpayer.

**Example 1 – Connection with business**

10. *A building company employs construction managers who are essential to the effective and successful management of construction projects. In a highly competitive labour market, the loss of construction managers to competitors has been significantly detrimental to the running of the construction business.*

11. *The building company sets up an ERT arrangement that delivers performance bonuses to its construction managers, once those construction managers complete minimum terms of service and meet key performance indicators. The building managers are made fully aware of the operation of the ERT and their potential to benefit from it. It is reasonable to conclude that the operation of the ERT will benefit the business by encouraging and rewarding construction managers to remain employed with the construction company.*

12. *In the absence of mitigating factors, a commercially appropriate amount contributed to an ERT will be considered to have a sufficient connection with the business.<sup>16</sup>*

*What are some of the circumstances<sup>17</sup> in which a contribution is not deductible?*

(a) When the contribution is applied for the benefit of owners, controllers or shareholders

13. *A contribution is not deductible under section 8-1 of the ITAA 1997 to the extent the contribution is intended to be applied for the benefit of the owners, controllers or shareholders of the employer, or their associates.*

**Example 2 – Contributions to facilitate a business sale for the benefit of shareholders**

14. *Shareholders of an IT company, App Pty Ltd, enter into an agreement to sell their shares in App Pty Ltd to a competitor. As part of the conditions of the sale, App Pty Ltd must make a large contribution to the trustee of its pre-existing ERT. The purpose of the contribution is to enable the trustee to provide payments to beneficiaries of the ERT in return for their forfeiture of any interest in the equity of App Pty Ltd. By doing so, App Pty Ltd can terminate the ERT, relieve itself of the obligations under the ERT and the shareholders of App Pty Ltd can settle the share sale agreement. The contribution by App Pty Ltd to the trustee has insufficient connection with the business being carried on by App Pty Ltd. The purpose in*

<sup>16</sup> A sufficient connection with business is but one factor that needs to be satisfied before it could be concluded that the contribution would be deductible to the building company under section 8-1 of the ITAA 1997.

<sup>17</sup> Two separate examples of the most common scenario are identified here. However there may be other circumstances in which a contribution is not deductible to the employer.

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*making the contribution is to benefit the shareholders of App Pty Ltd, who can proceed with the share sale with all impediments removed. The contribution to the ERT is not paid out as remuneration. Such an expense is not deductible under section 8-1 of the ITAA 1997 as it lacks the requisite connection with business.*

(b) When the contribution is capital in nature

15. A contribution is not deductible under section 8-1 of the ITAA 1997 to the extent it secures a capital advantage for the employer, unless that advantage is small or trifling.

16. A capital advantage is considered to be small or trifling (and therefore disregarded) when, within a relatively short period of the contribution (which secures the capital advantage) being made, so much of the trust fund as comprises that contribution is permanently and entirely dissipated in remunerating employees.

**Example 3 – Contributions to make loans and acquire shares are capital in nature**

17. *Oil Ltd sets up an ERT and makes a voluntary contribution of \$3,000,000 to the ERT for the benefit of all its employees. The trustee uses the cash to acquire shares in Oil Ltd – from both freshly issued share capital and from the Australian Stock Exchange. Before an employee can participate in the scheme, the employee must agree to pay to the trustee the full purchase price of the shares at the expiration of three years from the date the employee is accepted as a beneficiary of the ERT. At the conclusion of the three year vesting period, the trustee will value the shares being held for the employee's benefit and pay to the employee the value of those shares, less the principal amount the employee has agreed to pay for the shares. The trustee funds this payment via receipt of an additional contribution from Oil Ltd or can sell some of the shares of the ERT. The employee is not entitled to the shares themselves and cannot demand that the trustee transfer the shares to the employee. The shares are continuously held by the trustee for the benefit of another participating employee in the scheme.*

18. *The contribution of \$3,000,000 is used to acquire capital of the ERT that is intended to form the nucleus of a permanent investment fund to be held for employees. The employer has secured a benefit of a capital nature with no intention that the \$3,000,000 be permanently or entirely dissipated in providing remuneration to employees. The contribution is capital in nature and not deductible under section 8-1 of the ITAA 1997.*

19. A contribution is of a capital nature and not deductible under section 8-1 of the ITAA 1997 to the extent to which the contribution is

to be applied in remunerating employees who are wholly engaged in affairs of capital of the business.<sup>18</sup>

*Application of the prepayment provisions*

20. Where a contribution is deductible under section 8-1 of the ITAA 1997, the amount of the deduction will, in some circumstances, be spread over an 'eligible service period'.<sup>19</sup> The deduction will be spread<sup>20</sup> where the contribution is paid under an agreement with the trustee in return for the doing of a thing (which may include providing benefits to employees) that is not to be wholly done by the trustee within the financial year in which the contribution is paid.

21. However, where the contribution is an amount of 'excluded expenditure'<sup>21</sup> the prepayment provisions will not apply. 'Excluded expenditure' means, amongst other things, expenditure under a contract of service. A contribution will be expenditure under a contract of service if it is an amount that is paid in satisfaction of a liability that arises under a contract of service between the employer and the employee.

**Example 4 – When to spread out a deduction for a contribution**

22. *A trustee receives a large contribution from an employer, Build Co Ltd of \$6,000,000. The contribution (as agreed between the employer, employees and trustee of the ERT and written into plan rules and documentation) is to be applied in the following way. The trustee is to invest the funds and pay, from the capital and income from the trust funds, amounts of salary, wages or bonus to employees of Build Co Ltd within 5 years of the contribution being made. If Build Co Ltd is entitled to a deduction for the \$6,000,000 contribution, Build Co Ltd will be required to spread the deduction over the 'eligible service period'. The \$6,000,000 contribution is not excluded expenditure as it has been paid voluntarily to the trustee and not under a contract of service with the employees.*

*When is a contribution a fringe benefit?*

23. A contribution is a fringe benefit where the trustee is an associate of an employee and the contribution is a benefit provided in respect of the employment of a particular employee, or two or more employees, 'provided the identity of each of the employees who will

<sup>18</sup> For example, those employees who are engaged to perform work on projects to construct and upgrade depreciating assets of the taxpayer.

<sup>19</sup> As defined in subsection 82KZL of the ITAA 1936.

<sup>20</sup> In accordance with sections 82KZMA and 82KZMD of the ITAA 1936. Section 82KZMD of the ITAA 1936 will not apply and section 82KZM of the ITAA 1936 will apply where the employer is a small business entity for the year of income and has not chosen to apply section 82KZMD to the expenditure.

<sup>21</sup> 'Excluded expenditure' is defined in subsection 82KZL(1) of the ITAA 1936.



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take a share of the benefit is known with sufficient particularity'.<sup>22</sup> This requires both the employee, and the share of the benefit the employee will take, to be known at the time of the contribution.

24. A contribution is not a fringe benefit if it is a payment of salary or wages, or to the extent to which it is to be applied by the trustee to make payments of salary or wages, to employees on behalf of the employer within a relatively short period of the contribution being made. A step in a series of steps having the effect of delivering a payment of salary or wages to an employee does not in itself constitute a separate benefit provided to the employee with separate taxation consequences.

25. A contribution is not a fringe benefit if it is a deemed dividend under Division 7A.

## **Example 5 – A contribution applied to make salary or wages payments**

26. *Gas Co Limited makes a contribution of \$100,000 to its ERT. It instructs the trustee that the contribution is being made for the benefit of Rob, Ash and Mel (who are existing beneficiaries of the ERT) in equal shares, and instructs the trustee to invest the funds on behalf of Rob, Ash and Mel. According to the terms of the ERT, Rob, Ash and Mel will each be entitled to an equal share of the \$100,000 (plus any capital growth), spread out over a vesting period of 3 years, provided that each meet individual performance hurdles and remain employed with Gas Co Limited. The receipt of their share of the initial \$100,000 plus any capital growth (when paid by the trustee to Rob, Ash and Mel) is a receipt of a bonus and is included in their assessable income under section 6-5 of the ITAA 1997. As the contribution was made as part of a series of steps to deliver the bonus to employees, which is considered to be salary or wages, and the contribution itself was applied to pay those bonuses within a relatively short period of it being made, it will not be a fringe benefit at the time it was paid to the trustee.*

## **Consequences for the employee**

*When is a contribution assessable to the employee?*

27. A contribution to an ERT is assessable income of an employee under section 6-5 of the ITAA 1997 where it has the character of ordinary income, is applied or dealt with on the employee's behalf or as the employee directs, and is not excluded from the operation of section 6-5.

<sup>22</sup> Refer to *Federal Commissioner of Taxation v. Indoороopilly Children Services (Qld) Pty Ltd* (2007) 158 FCR 325 at 345; [2007] FCAFC 16 at [37]; 2007 ATC 4236 at 4254; (2007) 65 ATR 369 at 388 (*Indoороopilly*).

**Example 6 – employee derives the contribution via direction**

28. An employee and employer, Investment Bank Co Ltd, agree that the employee will forego future salary entitlements amounting to \$80,000. In lieu, the employee and Investment Bank Co Ltd agree that the amount of the salary will be contributed to an ERT. In turn, the trustee will provide an interest free loan of \$80,000 to the employee. The approximate taxable value of the loan fringe benefit is \$16,000.<sup>23</sup> The salary of \$80,000 has not been made subject to an effective salary sacrifice arrangement. The employee has not exchanged an entitlement to future salary for an entitlement to be remunerated in a non-cash form that has resulted in a fringe benefit of an equivalent value. The loan itself is not a benefit as it is a liability which the employee must repay. The contribution to the ERT has been made pursuant to an agreement with the employee. The contribution is derived by the employee as a salary direction under subsection 6-5(4) of the ITAA 1997 at the time Investment Bank Co Ltd makes the contribution to the ERT.

29. As the \$80,000 is a payment of salary or wages, Investment Bank Co Ltd is required to withhold an amount when it makes the contribution to the ERT, under section 12-35 of Schedule 1 to the TAA.

**Consequences for the trustee**

*When is a contribution a deemed dividend to the trustee?*

30. A contribution made by a private company is deemed under section 109C of the ITAA 1936 to be a dividend if, at the time the contribution is made, the trustee is a shareholder (or associate of a shareholder) or a former shareholder (or former associate of a shareholder<sup>24</sup>) of the private company and no exception or exclusion to section 109C, and Division 7A more generally, applies.<sup>25</sup>

31. A contribution is not a deemed dividend to the trustee under Division 7A if the contribution is provided by a private company to the trustee in its capacity as an associate of a particular employee<sup>26</sup> or the contribution itself is an actual dividend to the trustee.<sup>27</sup>

<sup>23</sup> Which reflects the notional amount of interest as defined in subsection 136(1) of the FBTAA, since no amount of interest is payable under the loan.

<sup>24</sup> Refer to paragraph 109C(1)(b) of the ITAA 1936 for the circumstances required to be satisfied in respect of a former shareholder or former associate.

<sup>25</sup> Relevant exceptions and exclusions include payments which are converted to loans (but refer to subsection 109D(4A) of the ITAA 1936), payment of genuine debts (section 109J of the ITAA 1936), and payments which are otherwise assessable or that are specifically excluded from assessable income (section 109L of the ITAA 1936). Further, a payment which is a payment to a shareholder or an associate of a shareholder in their capacity as an employee or an associate of such an employee is not a payment to which Division 7A applies (subsection 109ZB(3) of the ITAA 1936).

<sup>26</sup> Under subsection 109ZB(3) of the ITAA 1936.

<sup>27</sup> Under section 109L of the ITAA 1936.

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32. The amount of the deemed dividend taken to be paid is the lesser of the amount of the contribution and the employer's distributable surplus.<sup>28</sup>

***Example 7 – subsection 109ZB(3) of the ITAA 1936 doesn't apply to exclude the contribution as a deemed dividend.***

33. *Medical Pty Ltd makes an undissected contribution of \$800,000 to the trustee for its employees generally. The funds are to be held on trust for the benefit of all employees of the private company at any one point in time. Employees, for the purposes of the ERT, also include those employees who are shareholders in Medical Pty Ltd. Lyn and Lee are medical practitioners who are employed by Medical Pty Ltd and are, therefore, beneficiaries of the ERT. Lyn and Lee are each also 50% shareholders in Medical Pty Ltd. On this basis, the trustee is an associate of both shareholders (Lyn and Lee) of Medical Pty Ltd. The exclusion in subsection 109ZB(3) of the ITAA 1936 does not apply because it cannot be identified that the trustee received the contribution in the capacity as an associate of a specific and identifiable employee. The contribution is a deemed dividend to the trustee under section 109C of the ITAA 1936.*

**Consequences of investing the contribution and providing benefits to employees from the ERT**

***Consequences for the employer***

*When are loans and other benefits provided by a trustee a fringe benefit?*

34. Where, under an arrangement with the employer, the trustee applies the contribution to make loans to employees,<sup>29</sup> the employer will be taken to have provided a loan fringe benefit.

35. The taxable value of a loan fringe benefit is not reduced by the 'otherwise deductible' rule in section 19 of the FBTAA to the extent that the loan is used to acquire an interest or an asset that is expected to produce no (or only a negligible amount of) assessable income during the period over which the interest is intended to be held. In this situation, the taxable value of the loan fringe benefit is only reduced to the extent of assessable income actually received. Further, the taxable value is not reduced in circumstances where the interest or asset is held solely to generate a capital gain or exempt or non-assessable non-exempt income.

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<sup>28</sup> Distributable surplus is calculated in accordance with section 109Y of the ITAA 1936.

<sup>29</sup> Except where the loan is taken to be a deemed dividend for the purposes of Division 7A or would be so deemed if it were not on terms complying with section 109N of the ITAA 1936.

**Example 8 – no reduction in taxable value of a loan fringe benefit where there is no expectation of dividend income**

36. An employee, Tom, uses a loan from the trustee to acquire an interest in the ERT pursuant to an arrangement between the Trustee and Tom's employer. The trustee in turn uses the loan funds to acquire shares in the employer, Horse Breeders Pty Ltd. However, the shares in Horse Breeders Pty Ltd are unlikely to pay dividends over the ensuing three year period. Under the plan rules, Tom must hold the trust interest for a three year period, after which time the interest in the ERT will be automatically redeemed and the loan repaid. The trust interest is unlikely to generate any trust income for Tom over the three year period but will most likely deliver a sizeable capital gain to the employee on disposal of the trust interest. This is because the business is currently in a start-up phase and it is expected that the share value in Horse Breeders Pty Ltd will begin to achieve significant growth after the first two years of operations. In this situation, the otherwise deductible rule would not apply to reduce the taxable value of the loan fringe benefit, because the interest in the trust is not likely to generate any trust income over the holding period. The same result would arise if, in lieu of shares, the trustee was acquiring rights to shares.

**Example 9 – the otherwise deductible rule and a trust interest that produces additional section 6-5 income**

37. Assume the same situation as in Example 8. However, in addition to the rights to trust income and a payment of the capital gain on disposal of the trust interest, Tom also obtains a right to capital of the trust, payable to Tom if he remains in the employment of Horse Breeders Pty Ltd at the conclusion of the 3-year period. The capital payment from the ERT is regarded by Horse Breeders Pty Ltd, Tom and the trustee as a payment of an amount of a deferred bonus which Tom will be required to return in his assessable income under section 6-5 of the ITAA 1997. The capital payment to Tom will equal, or exceed, any hypothetical interest expense that he would incur in relation to the loan.

38. There is a sufficient connection between the payment of the deferred bonus from the capital of the ERT and the acquisition by Tom of an interest in the ERT. Whilst continuing employment is a condition precedent to the payment, were it not for acquiring the trust interest, Tom would not have become entitled to the payment. Tom's purpose, in taking out the loan, was to acquire the trust interest and enjoy the fruits of any gains made from the trust interest – including the capital gain on disposal of the trust interest together with the deferred bonus he receives from the capital of the trust. In this situation, the otherwise deductible rule would reduce the taxable value of the loan fringe benefit.

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39. Other benefits<sup>30</sup> provided by the trustee to employees of an employer are fringe benefits if the trustee meets the requirements of paragraphs (d), (e) or (ea) to the definition of 'fringe benefit' and the benefit is provided to the employee (or an associate of the employee) in respect of the employment of the employee.<sup>31</sup>

## **Consequences for the employee**

*When is a loan by a trustee taken to be a deemed dividend?*

40. A private company is taken to pay a dividend directly to an employee under section 109D of the ITAA 1997<sup>32</sup> where a reasonable person would conclude that a contribution to the trustee is made solely or mainly as part of an arrangement that involves a loan by the trustee to the employee who is a shareholder (or an associate of a shareholder) or former shareholder<sup>33</sup> (or former associate of a shareholder) of the private company.<sup>34</sup>

41. The amount of the deemed dividend taken to be paid to the employee is determined by the Commissioner: refer to Taxation Determination TD 2011/16 *Income tax: Division 7A - payments and loans through interposed entities - factors the Commissioner will take into account in determining the amount of any deemed payment or notional loan arising under section 109T of the Income Tax Assessment Act 1936* and by the private company's distributable surplus.<sup>35</sup>

## **Example 10 – An interposed entity arrangement for the purposes of Division 7A**

42. *Accounting Co Pty Ltd contributes \$800,000 to the trustee under an incentive arrangement put in place for its employees. All of the plan documentation, the trust deed and the general understanding of the employees, Accounting Co Pty Ltd and the trustee is such that the trustee can only apply the contribution in one way (that is, to making loans to employees to enable those employees to acquire rights to shares in Accounting Co Pty Ltd).*

43. *One of the employee participants, Pat, is the spouse of the controlling shareholder of the private company. Therefore, Pat is an associate of a shareholder of the private company. Pat receives \$300,000 of the contribution as a loan. Having regard to all of the*

<sup>30</sup> Other benefits may include rights, shares, cash or other property.

<sup>31</sup> And the benefit is not excluded from the definition of fringe benefit in paragraphs (f) to (s) of the definition of fringe benefit.

<sup>32</sup> Other than in situations where the payment or loan to the trustee is itself a deemed dividend.

<sup>33</sup> Refer to paragraph 109D(1)(d) of the ITAA 1936 for the circumstances to be satisfied in respect of a former shareholder or former associate.

<sup>34</sup> Refer to sections 109T and 109W of the ITAA 1936.

<sup>35</sup> Distributable surplus is calculated in accordance with section 109Y of the ITAA 1936.

*circumstances, a reasonable person would conclude that the contribution was paid to the trustee mainly or solely as part of an arrangement that involved the loan of the amount of \$300,000 to Pat. Accounting Co Pty Ltd is taken to have made a notional loan directly to Pat. The amount of the notional loan is taken to be \$300,000. Accounting Co Pty Ltd is taken to pay a dividend of \$300,000 to Pat (as Accounting Co Pty Ltd has distributable surplus in excess of \$300,000).*

*How are benefits assessed to the employee?*

44. An employee who is a beneficiary of an ERT may receive an amount that is taxable under more than one provision, so the tax laws include ordering rules which operate to ensure an amount is taxed only once. In addition, an amount may consist of several components, each taxed under different provisions. Excluding the employee's exempt income or non-assessable non-exempt income, benefits paid by the trustee to an employee are taxed in the following order:

- (a) Subdivision 207-B of the ITAA 1997, on so much of a franked distribution of the ERT that is attributed to the employee, along with their share of the attached franking credit.
- (b) Paragraph 97(1)(a) of the ITAA 1936, if they are presently entitled to a share of the income of the ERT and are not under a legal disability, on that same share of the section 95 net income of the ERT (excluding any net capital gains).
- (c) Section 6-5 of the ITAA 1997, for amounts paid as remuneration.
- (d) Amounts included in the calculation of their net capital gain, so much of a capital gain of the ERT they are taken to have been made under Subdivision 115-C of the ITAA 1997.

45. Where a benefit received by an employee from the trustee is a fringe benefit, it is non-assessable non-exempt income of the employee.<sup>36</sup>

46. When an employee disposes of or redeems an interest<sup>37</sup> (including units) in an ERT, a CGT event occurs. The employee must include a capital gain made from a CGT event in the calculation of their net capital gain (or loss) for each year of income.<sup>38</sup>

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<sup>36</sup> Section 23L of the ITAA 1936.

<sup>37</sup> Other than an interest of a discretionary beneficiary in a discretionary trust.

<sup>38</sup> Section 102-5 of the ITAA 1997 then includes a net capital gain in assessable income for the income year.

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47. A capital gain is reduced to the extent that, because of the CGT event, an amount is otherwise included in the employee's assessable income under section 6-5 of the ITAA 1997.<sup>39</sup> A gain made from the disposal or redemption of an interest is assessable under section 6-5 of the ITAA 1997 where the employee acquires the interest with the intention of making a profit or gain on its disposal or redemption (in the course of a business or commercial transaction) or the profit or gain is otherwise ordinary income of the employee.

### *Is an employee entitled to tax offsets for franking credits?*

48. An employee having a relevant share of the franked distributions<sup>40</sup> of an ERT 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 trustee or 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.

49. An employee beneficiary of an ERT will generally not satisfy the qualified person test in respect of the franked distributions because their interest will not be vested and indefeasible, unless they qualify for the small shareholder exemption.<sup>41</sup>

50. 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:<sup>42</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

<sup>39</sup> Refer to section 118-20 of the ITAA 1997.

<sup>40</sup> Within the meaning of Subdivision 207-B of the ITAA 1997.

<sup>41</sup> 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.

<sup>42</sup> Refer to *Soubra v. Federal Commissioner of Taxation* [2009] AATA 775; 2009 ATC 10-113; (2009) 77 ATR 946.

- 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>43</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>44</sup>

51. The Commissioner has a discretion 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.

**Example 11 – A payment from an ERT in relation to employment**

52. *An ERT operates to acquire shares for the benefit of the employees of the employer, Legal Services Ltd. The trustee acquires shares in Legal Services Ltd and the employees acquire an interest in the ERT where shares are notionally allocated to that interest.*

53. *Raj acquires an interest in the ERT. This interest does not entitle him to any income of the trust during the vesting period. Once Raj satisfies vesting conditions (which is to remain employed for a minimum of three years and to meet key performance targets) he can redeem his interest and receive the growth in value of his interest. The value is determined by the market value of the notionally allocated shares attached to that interest.*

54. *In addition Raj will, once vesting conditions are satisfied, also be entitled to an additional payment from the ERT, known as a 'dividend equivalent payment'. The entitlement to this payment arises from an agreement entered into with Legal Services Ltd and the value of the payment equates to the dividends that the trustee of the ERT has received on the notionally allocated shares, acquired by it over the vesting period (three years) less the tax paid by the trustee on those dividends. The payment can be made by the trustee of the ERT from the capitalised income it received during the vesting period when it held the shares and received dividend payments or it can be made directly by Legal Services Ltd.*

<sup>43</sup> If the amount payable is less than the value of the interest, the interest will generally be deemed to be defeasible: Refer to former subsection 160APHL(12) of the ITAA 1936.

<sup>44</sup> Such interests will generally be deemed to be defeasible: Refer to former subsection 160APHL(12) of the ITAA 1936.



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55. *Whether the payment is made by the trustee or Legal Services Ltd is irrelevant for the purposes of determining whether the receipt is remuneration. However, given the requirement that Raj remain in employment and meet particular key performance targets before receiving the payment, considered in conjunction with the contractual agreements between the parties, it is clear that the payment is made in respect of Raj's employment. It is payment of an additional benefit, the consideration for which comes from his employment services provided to Legal Services Ltd. Whilst the quantum of the payment reflects a dividend equivalent had Raj acquired the shares at the outset of the arrangement, this is merely a calculation mechanism and does not reflect the character of the payment in the recipient's hands. The character of the payment in the Raj's hands is remuneration.*

## **Example 12 – A payment from a trust lacking the connection with employment**

56. *An ERT operates to acquire shares for the benefit of the employees of the employer, Investment Co Ltd. The trustee acquires shares in Investment Co Ltd and Yusuf, an employee, acquires an interest in the ERT where shares are notionally allocated to his interest. Once Yusuf satisfies vesting conditions (which is to remain employed for a minimum of three years and to meet key performance targets) he can redeem his interest and receive the growth in value of his interest. The value is determined by the market value of the notionally allocated shares attached to that interest.*

57. *Separate to the terms and conditions stated in the plan rules, Yusuf's employee handbook and his invitation to participate in the ERT, the trustee at its own absolute discretion and under the terms of the trust deed makes a dividend equivalent payment to Yusuf.*

58. *The entitlement to the dividend equivalent payment arises separately to the entitlement to the interest vesting and the right to the payment arises not from a contractual agreement with Investment Co Ltd, but a right purely attributable to the operation of the trust deed, conferred on Yusuf as a beneficiary of that trust. The trustee has a complete discretion to distribute capitalised income of the trust. Ordinarily, the trustee will exercise its discretion and make such a payment, in full, if it has sufficient capital to satisfy the payment. The trustee takes no recommendation from Investment Co Ltd and has no regard to whether Yusuf continues to be employed by Investment Co Ltd or meets any performance conditions before it makes such a payment (indeed, Yusuf may no longer be an employee and still receive the payment). The payment can only be made by the trustee. The payment can no longer be considered to have anything but a distant causal connection to Yusuf's employment. As such, it is not remuneration but rather an amount received by Yusuf as a beneficiary of the trust.*

**Example 13 – operation of the interaction between Division 6 and section 6-5**

59. Insurance Co Ltd makes a contribution to an ERT with the intention that the ERT invest the contribution in listed shares and securities. It is intended that the combination of dividend and income returns, together with long term capital growth on those investments, will assist Insurance Co Ltd to meet future employment-related payments to its employees (primarily, annual bonuses). Whilst the trustee intends to hold assets for long-term gain, over the second year of operation, the trustee of the ERT decides to dispose of some assets it had acquired earlier. It has held these assets for a period of longer than 12 months and makes a capital gain on disposal.

60. In that same year, the trustee also received income from its investments. The income of the ERT is defined to equal its net income for tax purposes. An employee, Jerry, becomes entitled to receive \$100 in this same year from the ERT (\$40 is a specific entitlement to a share of the capital gain made by the trustee of the ERT and \$60 is a distribution of annual trust income).

61. The \$100 payment is a bonus payable to Jerry in respect of her employment with Insurance Co Ltd. However, Division 6 will apply (in preference to section 6-5 of the ITAA 1997) to assess Jerry on her share of the section 95 net income of the ERT (\$60) under section 97 of the ITAA 1936. Section 6-5 of the ITAA 1997 will then apply to the balance of the distribution (\$40) (in preference to the CGT provisions).

62. As the entire amount of \$100 is a bonus, the trustee is required to withhold an amount calculated on the \$100, not just the \$40 included in Jerry's assessable income under section 6-5 of the ITAA 1997.

**Example 14 – operation of the interaction between Division 6, Subdivision 207-B and section 6-5**

63. Assume the same facts as identified in Example 13, with the following differences. In year three, the trustee has not made any capital gains, but has received franked distributions from some of its shares, as well as interest income from other investments. In this year, Robbie receives a distribution of \$170 from the ERT. Again, the amount of \$170 is a bonus, and is Robbie's ordinary income under section 6-5 of the ITAA 1997. Of the \$170, \$100 is attributable to interest derived by the trustee and \$70 is Robbie's share of the franked dividend. Robbie will be required to include in her assessable income a total of \$200, as follows:

- \$70 (franked dividends) plus \$30 (share of attached franking credit) under Subdivision 207-B of the ITAA 1997
- \$100 under section 97 of the ITAA 1936 as Robbie's share of the net income of the trust

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- *Nil amount included under section 6-5 of the ITAA 1997 as section 6-25 of the ITAA 1997 would reduce section 6-5 amounts by those included under Division 6 and subdivision 207-B.*

64. *Whether Robbie is entitled to a tax offset for the \$30 franking credit they must include in their assessable income depends on the relevant integrity rules, including whether Robbie and the trustee are qualified persons in respect of the dividends for the purposes of Division 1A of the former Part IIIAA of the ITAA 1936.*

## **Consequences for the trustee**

*When is a gain derived by the trustee ordinary income?*

65. A gain made by the trustee on the realisation of trust assets is included in the trust's section 95 net income as ordinary income if the gain is made from:

- normal operation in the course of carrying on a business of investment or an extraordinary operation of that business entered into with the intention of making a profit or gain, or
- a one-off or isolated transaction where the asset was acquired in a business operation or commercial transaction for the purpose of profit-making, 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?* and Taxation Ruling TR 92/3 *Income tax: whether profits on isolated transactions are income*, provide guidance on the relevant factors to consider.

66. To the extent to which no beneficiary is presently entitled to the ERT's section 95 net income (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.

## **Example 15 – trustee holds assets on revenue account**

67. *The trustee uses the \$100,000 contribution it has received from the employer, Land Developments Ltd, to acquire, in part, shares in Land Developments Ltd. The purpose of the ERT arrangement is not to deliver those shares to employees but to deliver a phantom-share right. That is, the employee, River, will receive a cash payment at the conclusion of a three year period equal to the growth in the value of the Land Developments Ltd share, if the shares have increased in value from the time River enters the scheme to the three year anniversary mark. River*

*obtains a right to be paid a cash amount equal to the increase in value of the shares in Land Developments Ltd over a finite period.*

68. *The trustee acquires some shares in Land Developments Ltd as well as some other listed shares and rights – which it believes will increase in value and ensure that the trustee can meet its obligations to make this cash payment to the employee at the end of the three year period (either by selling the employer shares or the other listed shares and rights). As it happens, the trustee has taken good advice and the trustee needs to sell only a small portion of the third-party listed securities to satisfy the obligations it has to make the phantom share payment to River. Any gains made by the trustee on disposal of the third-party listed securities will be on revenue account. It has clearly acquired them in the course of a commercial transaction with the intention of making a profit from their disposal.*

## **Date of effect**

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69. Subject to any transitional arrangements discussed in paragraph 70, 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).

70. 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 than some of the views contained in this draft Ruling and the previous TR 2014/D1. 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 5 March 2014 (when TR 2014/D1 issued) 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**

7 June 2017

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## Appendix 1 – Explanation

**❶** *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.*

### Consequences of making a contribution to an ERT

#### **Consequences for the employer**

*When can an employer deduct a contribution?*

71. Prima facie, a contribution is deductible under subsection 8-1(1) of the ITAA 1997 to the extent that it:

- is incurred in gaining or producing the employer’s assessable income, or
- is necessarily incurred in carrying on a business for the purpose of gaining or producing the employer’s assessable income.

72. However, an employer cannot deduct an expense under that section to the extent that:

- it is an expense of capital, or of a capital nature
- it is an expense of a private or domestic nature
- it is incurred in relation to gaining or producing the employer’s exempt income or non-assessable non-exempt income, or
- a provision of the ITAA 1997 or ITAA 1936 prevents the employer from deducting the amount.<sup>45</sup>

73. A contribution is deductible to the employer<sup>46</sup> where all of the criteria in paragraph 9 of this draft Ruling are met.

74. The use of ‘to the extent’ in section 8-1 of the ITAA 1997 indicates that apportionment of expenditure may be required between different categories, for example:

- where distinct and severable parts are devoted to gaining income and other parts are devoted to some other end
- where a single outlay serves both an income-earning purpose and some other purpose indifferently.<sup>47</sup>

<sup>45</sup> Subsection 8-1(2) of the ITAA 1997.

<sup>46</sup> Where a contribution is deductible under section 8-1 of the ITAA 1997, the prepayment provisions may apply to set the amount and timing of the deduction. Refer to paragraphs 91 to 96 of this draft Ruling.

<sup>47</sup> *Ronpibon Tin NL and Tongkah Compound NL v. Federal Commissioner of Taxation* (1949) 78 CLR 47; [1949] HCA 15; (1949) 8 ATD 431; (1949) 4 AITR 236 (*Ronpibon*) and *Fletcher & Ors v. Federal Commissioner of Taxation* (1991) 173 CLR 1; [1991] HCA 42; (1991) 22 ATR 613; (1991) 91 ATC 4950 (*Fletcher*). Refer also paragraph 39 of Taxation Ruling TR 95/33 *Income tax: subsection 51(1) –*

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

*When does an employer incur a contribution?*

76. A contribution is incurred only when the ownership of that contribution passes from the employer to the trustee and there is no circumstance in which the employer can retrieve any of the contribution.<sup>48</sup>

77. A voluntary contribution is incurred when it is paid<sup>49</sup> in cash. Such a contribution cannot be affected only by way of book or journal entry. A 'payment' by way of journal entry can only occur under the doctrine of 'set off'<sup>50</sup> where two parties both have a present liability or legal obligation to the other (mutual liabilities or mutual obligations) and they make an agreement and set off the liabilities against each other using a book entry.<sup>51</sup> However, set off cannot arise in relation to a contribution to an ERT because the contribution is a voluntary and gratuitous payment that does not arise from any presently existing liability owing by the employer.

78. Issuing shares to the trustee, even if labelled a contribution, is neither a loss nor an outgoing (or expenditure) *incurred* by an employer.<sup>52</sup>

*When does a contribution have a sufficient connection with business?*

79. Whether a contribution is deductible under subsection 8-1(1) of the ITAA 1997 depends on whether the contribution is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.<sup>53</sup> An outgoing has the relevant connection with business when it is 'desirable or appropriate in the pursuit of the business ends of the business'.<sup>54</sup>

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*relevance of subjective purpose, motive or intention in determining the deductibility of losses and outgoings.*

<sup>48</sup> *Pridecraft Pty Ltd v. Federal Commissioner of Taxation* [2004] FCAFC 339 at [38]; 2005 ATC 4001 at 4010; (2004) 58 ATR 210 at 220 and *Spotlight Stores Pty Ltd & Anor v. FC of T* [2004] FCA 650 at [77] [116]; 2004 ATC 4674 at 4695 4703; (2004) 55 ATR 745 at 769 778 (*Spotlight*).

<sup>49</sup> Refer to paragraph 21 of Taxation Ruling TR 97/7 *Income tax: section 8-1 - meaning of 'incurred' - timing of deductions*.

<sup>50</sup> The doctrine of 'set off' has been considered by the Commissioner in Taxation Ruling TR 2001/10 *Income tax: fringe benefits tax and superannuation guarantee: salary sacrifice arrangements* (at paragraphs 79 to 83) and Taxation Ruling TR 2008/5 *Income tax: tax consequences for a company of issuing shares for assets or for services*.

<sup>51</sup> *Re Harmony and Montague Tin & Copper Mining (Spargo's)* (1873) LR 8 LR Ch App 407; [1861-73] All ER Rep 261.

<sup>52</sup> Refer to TR 2008/5 for the Commissioner's view on companies issuing shares for assets or for services.

<sup>53</sup> This, of course, does not preclude the first limb from applying in the right circumstances, but refer for example to *Benstead Services Pty Ltd v. FC of T* [2006] AATA 976 at [42] – [59]; 2006 ATC 2511 at 2516-2518; (2006) 64 ATR 1232 at

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80. A contribution will be ‘desirable or appropriate in the pursuit of the business ends of the business’ where the employer reasonably expects the business of the employer to benefit in the form of improved employee performance, morale, efficiency or loyalty.

81. The following factors are relevant to establishing a sufficient connection between a contribution and the benefit to the employer’s business:

- the nature and timing of the benefits to be derived by the employer and the employees<sup>55</sup>
- employee awareness of the scheme<sup>56</sup>, and
- whether the scheme and the contribution addresses (or has the capacity to address) the business-related need, function or complaint.<sup>57</sup>

*When is a contribution intended to be permanently and entirely dissipated in remunerating employees?*

82. Subject to the other requirements outlined in this draft Ruling, a contribution will be deductible under section 8-1 of the ITAA 1997 when, and to the extent that, within a relatively short period of the contribution being made, the contribution held in trust is intended to be permanently and entirely dissipated in providing remuneration<sup>58</sup> to employees (other than employees who are wholly engaged in affairs of capital of the business). The provision of remuneration occurs when the trustee makes the payment or provides the benefit to the employee or in respect of the employee.

83. A ‘relatively short period’ is less than five years from the date the contribution was made by an employer to the trustee. Where a contribution is intended to be retained within the ERT for a longer period, it is questionable whether the contribution serves appropriate business-related needs of the employer and whether any advantages obtained from the contribution are revenue in nature.<sup>59</sup>

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1239-1241 (*Benstead*); Kiefel J’s conclusions in *Essenbourne Pty Ltd v. Federal Commissioner of Taxation* [2002] FCA 1577 at [36]; 2002 ATC 5201 at 5209; (2002) 51 ATR 629 at 637 (*Essenbourne*); Hill J’s analysis in *Walstern Pty Ltd v. Commissioner of Taxation* (2003) 138 FCR 1 at 19-20; [2003] FCA 1428 at [74]-[75]; (2003) 54 ATR 423 at 438; 2003 ATC 5076 at 5089-5090 (*Walstern*) and the Full Federal Court analysis in *Cameron Brae v. Federal Commissioner of Taxation* (2007) 161 FCR 468 at 485-486; [2007] FCAFC 135 at [57]-[59]; 2007 ATC 4936 at 4950-4951; (2007) 67 ATR 178 at 194-195 (*Cameron Brae*).

<sup>54</sup> *Ronpibon* at CLR 55-58; HCA [9]-[15]; ATD 434-436; AITR 244-246 and *Magna Alloys & Research Pty Ltd v. Federal Commission of Taxation* [1980] FCA 150; 80 ATC 4542 at 4559-4561; (1980) 11 ATR 276 at 294-297.

<sup>55</sup> As to the nature of benefits refer to *Wensemius v. FC of T* [2007] AATA 1006 at [97]-[98]; 2007 ATC 2035 at 2051-2052; (2007) 66 ATR 144 at 163-164 (*Wensemius*).

<sup>56</sup> Refer to *Benstead* at AATA [47]-[52]; ATC 2517-2518; ATR 1240.

<sup>57</sup> *Essenbourne* at FCA [32]; ATC 5208; ATR 636.

<sup>58</sup> See the definition of Remuneration at paragraph 4 of this draft Ruling.

<sup>59</sup> However, each case will be considered on its individual facts and circumstances.

*What are some of the circumstances in which a contribution is not deductible?*

(a) Contribution is applied for the benefit of owners, controllers or shareholders

84. A contribution is not deductible under section 8-1 of the ITAA 1997 to the extent the contribution is intended to be applied for the benefit of the owners, controllers or shareholders of the employer, or their associates. A contribution in these circumstances does not have the necessary connection to the business being carried on – even where the business owners are acting in a dual capacity as employees.<sup>60</sup> Such a contribution will generally be seen as a transfer of the profits of the employer to the ERT so that they can be shared, unless it can be demonstrated that there is a clear business need and intention to provide incentives or encourage loyalty and goodwill of an employee, linked directly to their employment.

(b) When the contribution is capital in nature

85. A contribution is not deductible under section 8-1 of the ITAA 1997 to the extent it secures a capital advantage for the employer, unless that advantage is small or trifling.<sup>61</sup>

86. The nature of an outgoing as either capital or revenue can generally be determined by examining the character of the advantage sought, the manner in which it is to be used, relied upon or enjoyed and the means adopted to obtain it.<sup>62</sup>

87. When considering the character of expenditure, it is critical to consider the advantage sought by it<sup>63</sup> from a practical and business point of view, not just on the basis of a 'juristic classification of legal rights'.<sup>64</sup> In the context of an ERT arrangement, a contribution will be considered to secure a capital advantage for the employer where it secures an asset or investment of a permanent nature. For example, the contribution is applied by the trustee to:

- acquire an asset that is likely to generate an enduring or permanent improvement to employee goodwill (for example, an acquisition of a holiday house for use by employees)<sup>65</sup>
- provide loans, on a continuous basis, to employees

<sup>60</sup> Refer to *Essenbourne*.

<sup>61</sup> See paragraphs 15 to 16 of this draft Ruling.

<sup>62</sup> *Sun Newspapers Ltd and Associated Newspapers Ltd v. Federal Commissioner of Taxation* (1938) 61 CLR 337 at 363; [1938] HCA 73; (1938) 1 AITR 403 at 413; (1938) 5 ATD 87 at 96.

<sup>63</sup> *GP International Pipecoaters Pty Ltd v. Commissioner of Taxation* (1990) 170 CLR 124 at 137; [1990] HCA 25 at [13]; 90 ATC 4413 at 4419; (1990) 21 ATR 1 at 7.

<sup>64</sup> *Hallstroms Pty Ltd v. Federal Commissioner of Taxation* (1946) 72 CLR 634 at 648; [1946] HCA 34; (1946) 8 ATD 190 at 196; (1946) 3 AITR 436 at 444.

<sup>65</sup> *British Insulated and Helsby Cables v. Atherton* [1926] AC 205 at 215-216 (*British Insulated*).



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- acquire shares and/or equity in the employer or a holding company of the employer in circumstances where it is not intended to divest legal and beneficial ownership of these shares to employees within a relatively short period of the contribution being made, or
- acquire arm's length investments<sup>66</sup> where the intention is to derive a return to be paid to employees, whilst keeping the capital of the trust fund intact.

88. In addition, expenditure incurred in relation to salary or wages paid to employees engaged wholly in affairs of capital is also properly characterised as capital in nature.<sup>67</sup> If the contribution goes to remunerating employees who are engaged solely in the construction and upgrade of the employer's depreciating assets, and those assets form part of the taxpayer's profit yielding structure, the contribution will also be of a capital nature.

89. Further, an advantage obtained from a contribution is to be considered in the context of both the manner in which it is to be used, relied upon or enjoyed and the means by which the advantage was obtained. In this context, the Commissioner considers the following factors to be indicators that a contribution is a capital expense:

- it is a lump sum or instalments of a lump sum<sup>68</sup>
- it forms the permanent and enduring nucleus of a fund<sup>69</sup>
- it 'secure[s] and retain[s] the services of a contented and efficient staff' over the employer's business life, or it is otherwise intended to endure over an employer's business life (whether or not the contribution is depleted during this time)<sup>70</sup>, and
- it is 'a final payment to secure future benefits'<sup>71</sup> for employees.

90. There may be other circumstances in which a contribution is not deductible to the employer. Only the two most common scenarios are identified here.

<sup>66</sup> Per Fisher J in *Ransburg Australia Pty Ltd v. Federal Commissioner of Taxation* [1980] FCA 31; 80 ATC 4114 at 4121; (1980) 10 ATR 663 at 669.

<sup>67</sup> *Goodman Fielder Wattie Ltd v. Federal Commissioner of Taxation* (1991) 29 FCR 376; 91 ATC 4438; (1991) 22 ATR 26.

<sup>68</sup> *British Insulated* at AC 214; *Benstead* at AATA [69]; ATC 2520; ATR 1243; *Walstern* at FCR 20-21; FCA [77]-[80]; ATR 439-440; ATC 5090-5091.

<sup>69</sup> *British Insulated* at AC 214; *Walstern* at FCR 20-21; FCA [77]-[80]; ATR 439-440; ATC 5090-5091; *Cameron Brae* at FCR 487; FCAFC [64]; ATC 4951-4952; ATR 196.

<sup>70</sup> *British Insulated* at AC 214.

<sup>71</sup> *Walstern* at FCR 20; FCA [77]; ATR 439; ATC 5090.

*Application of the prepayment provisions*

91. The prepayment provisions will apply to spread out the deduction claimed for a contribution under section 8-1 of the ITAA 1997 over an 'eligible service period'<sup>72</sup> where the contribution is not 'excluded expenditure' and is incurred by an employer:

- under an agreement with the trustee
- in return for the doing of a thing (which may include providing benefits to employees), and
- that doing of a thing is not to be wholly done by the trustee within the financial year in which the contribution is paid.

92. Where the employer making the contribution is a small business entity for the year in which the contribution is incurred, that employer must choose to apply section 82KZMD of the ITAA 1936 to the contribution.<sup>73</sup> Where a small business entity does not choose to apply section 82KZMD of the ITAA 1936 to the contribution, section 82KZM applies to allow a deduction in the year the contribution was made if the eligible service period is not longer than 12 months and ends before the income year following the year that the contribution was made.

*Meaning of 'agreement'*

93. Terms of a trust deed, plan rules, plan agreements or an understanding between the trustee and an employer all constitute possible agreements for the purposes of the definition of 'agreement' contained in subsection 82KZL(1) of the ITAA 1936.

*Meaning of 'doing of a thing'*

94. The contribution must be incurred in return for the doing of a thing under the agreement that is not to be wholly done within the expenditure year.<sup>74</sup> The broad wording of 'doing of a thing' can include making loans to employees from the contribution or paying the contribution to employees as remuneration, or both.

*The expenditure must not be excluded expenditure*

95. The prepayment provisions will not apply to spread out the deduction where the contribution is an amount of excluded

<sup>72</sup> As defined in subsection 82KZL of the ITAA 1936.

<sup>73</sup> The taxpayer must choose to apply section 82KZMD of the ITAA 1936 to the expenditure before lodging its income return for the year in which the expenditure is incurred or within such further time as the Commissioner allows – paragraph 82KZMA(2)(b) of the ITAA 1936.

<sup>74</sup> Paragraph 82KZMA(3)(c) of the ITAA 1936 and refer to the definition of 'eligible service period' in subsection 82KZL(1) of the ITAA 1936.

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expenditure,<sup>75</sup> including an amount of expenditure under a contract of service. Whether a contribution by an employer to the trustee will be expenditure *under a contract of service* is a question of fact to be determined by a consideration of all the circumstances.

## *Spreading the deduction*

96. Where all of the requirements of the prepayment provisions are met, the formula in section 82KZMD of the ITAA 1936 then applies to set the amount and the timing of the expenditure.

## *When is a contribution a fringe benefit?*

97. A contribution made by an employer to the trustee is a fringe benefit where the trustee is an associate of an employee and the contribution is a benefit provided in respect of the employment of a particular employee, or two or more employees.<sup>76</sup> 'In respect of employment' requires a sufficient or material, rather than a causal, connection or relationship between the benefit and the employment.<sup>77</sup>

98. A contribution is not a fringe benefit if it is a payment of salary or wages<sup>78</sup> or a deemed dividend under Division 7A.<sup>79</sup>

## **Consequences for the employee**

### *When is a contribution assessable to the employee?*

99. A contribution is assessable income of an employee under section 6-5 of the ITAA 1997 where it has the character of ordinary income, is being paid or applied on the employee's behalf or as the employee has directed<sup>80</sup> and is not excluded from the operation of section 6-5 of the ITAA 1997.<sup>81</sup>

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<sup>75</sup> Excluded expenditure is defined in subsection 82KZL(1) of the ITAA 1936.

<sup>76</sup> See paragraph 23 of this draft Ruling.

<sup>77</sup> *J & G Knowles & Associates Pty Ltd v. Federal Commissioner of Taxation* (2000) 96 FCR 402 at FCR 410; [2000] FCA 196 at FCA [26]; 2000 ATC 4151 at ATC 4158.

<sup>78</sup> Refer to paragraph (f) of the definition of fringe benefit in subsection 136(1) of the FBTA. An employer is required to withhold an amount from a payment of salary or wages. Refer to sections 12-35 and 12-40 of Schedule 1 to the TAA.

<sup>79</sup> Refer to 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 the trustee see paragraphs 101 to 111 of this draft Ruling.

<sup>80</sup> Subsection 6-5(4) of the ITAA 1997.

<sup>81</sup> The employee's employer has an obligation to withhold an amount from such a contribution at the time the contribution is made under section 12-35 of Schedule 1 to the TAA, or under section 12-40 of Schedule 1 to the TAA when the contribution is paid to a director of a company as remuneration (as ordinarily defined). However, an employer does not have to withhold an amount where the contribution is exempt or non-assessable non-exempt income of the employee or director.

100. A contribution to an ERT will be derived by an employee for the purposes of subsection 6-5(4) of the ITAA 1997 regardless of whether the employee has legal standing to enforce the payment to the ERT.<sup>82</sup>

### **Consequences for the trustee**

#### *When is a contribution a deemed dividend to the trustee?*

101. Division 7A is directed at ensuring that disguised or informal distributions of private company profits to shareholders or their associates<sup>83</sup> are included in the assessable income of those shareholders or associates.<sup>84</sup>

102. Under paragraph 109C(1)(a) of the ITAA 1936, a private company is 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), unless an exception or exclusion applies. 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>85</sup>

103. Accordingly, if the trustee is a shareholder of an employer that is a private company at the time when the employer, in its own capacity, makes a contribution to the ERT, the contribution is deemed under section 109C of the ITAA 1936 to be a dividend, and 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.

#### *Exceptions and exclusions to Division 7A*

104. A payment can only be deemed a dividend where no exception or exclusion to section 109C of the ITAA 1936, and Division 7A more generally, applies.

#### *No part of the contribution is provided in respect of a particular employee – subsection 109ZB(3)*

105. Subsection 109ZB(3) of the ITAA 1936 is designed to set an 'ordering' between Division 7A and the FBTA.<sup>86</sup> Subsection 109ZB(3) of the ITAA 1936 prevents a deemed dividend

<sup>82</sup> *Sent v. Commissioner of Taxation* [2012] FCA 382; 2012 ATC 20-318; (2012) 85 ATR 1 (*Sent*) at FCA [83]; ATC 13,570; ATR 23.

<sup>83</sup> Refer to section 109ZD of the ITAA 1936.

<sup>84</sup> Refer to paragraph 1.4 of the Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 2) Bill 2010.

<sup>85</sup> Refer to *Federal Commissioner of Taxation v. H* (2010) 188 FCR 440 at 447; [2010] FCAFC 128 at [36]; 2010 ATC 20-218 at 11603; (2010) 85 ATR 357 at 365.

<sup>86</sup> Refer to the Explanatory Memorandum to the Tax Laws Amendment Bill (No. 3) 1998.

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arising under section 109C of the ITAA 1936 in relation to a payment made to a shareholder or an associate of a shareholder in their capacity as an employee (as that term is defined in the FBTA) or an associate of such an employee.

106. In considering benefits provided to employees or associates of employees in the context of the FBTA, reference to an employee is a reference to a *particular* employee.<sup>87</sup> The use of the definite article in reference to ‘employee’ in subsection 109ZB(3) of the ITAA 1936 substantially mirrors the approach in the FBTA. As such, the views of the Full Federal Court in *Federal Commissioner of Taxation v. Indooroopilly Children Services (Qld) Pty Ltd*<sup>88</sup> (*Indooroopilly*) are equally applicable to the interpretation of subsection 109ZB(3) of the ITAA 1936.

107. Therefore, where no part of a contribution is provided in respect of a particular employee, subsection 109ZB(3) of the ITAA 1936 does not prevent the payment from being treated as a dividend under subsection 109C(1) of the ITAA 1936. Where a deemed dividend arises, it is included in the section 95 net income of the ERT to the extent of the employer’s ‘distributable surplus’ as worked out in section 109Y of the ITAA 1936.

### *The contribution is a payment of an actual dividend – section 109L*

108. Where the contribution is a payment of an actual dividend<sup>89</sup> to the trustee, it will be included in the section 95 net income of the ERT under section 44 of the ITAA 1936. In these instances, section 109L of the ITAA 1936 would exclude it from being a deemed dividend.

### *Pecuniary obligations – section 109J*

109. Section 109J of the ITAA 1936 provides that a deemed dividend won’t arise in relation to a payment to the extent that the payment discharges an obligation of the private company to pay money to the trustee.<sup>90</sup>

110. This exclusion will not ordinarily apply to a contribution as an employer is under no *obligation* to make a payment of money to the trustee. Contributions voluntarily gifted or settled on the trustee to be applied in accordance with a trust deed are not payments made under an obligation to which this exclusion can apply.

<sup>87</sup> Refer to *Indooroopilly* per Edmonds J at FCR 345; FCAFC [37]; ATC 4254; ATR 388.

<sup>88</sup> (2007) 158 FCR 325; [2007] FCAFC 16; (2007) 2007 ATC 4236; (2007) 65 ATR 369.

<sup>89</sup> For a full discussion of when a payment is a dividend, refer to Taxation Ruling TR 2014/5 *Income tax: matrimonial property proceedings and payments of money or transfers of property by a private company to a shareholder (or their associate)*.

<sup>90</sup> And is not more than what would have been required to discharge the obligation if the parties had been dealing at arm’s length.

111. Moreover, even if an employer has an obligation to pay money to the trustee, the exclusion is only relevant to the extent to which parties who were dealing at arm's length would be similarly obliged.<sup>91</sup>

### **Consequences of investing the contribution and providing benefits to employees from the ERT**

#### ***Consequences for the employer***

*When are loans and other benefits provided by a trustee a fringe benefit?*

112. In order for a benefit to meet the definition of a fringe benefit, the benefit must be provided by an employer or another person identified in paragraphs (d) to (ea) of that definition. The trustee will ordinarily satisfy one of the tests because the trustee:

- is an 'associate' of an employer<sup>92</sup>
- provides benefits to employees as an 'arranger' under an arrangement,<sup>93</sup> or
- is an entity that participates in a scheme or plan involving the provision of a benefit.<sup>94</sup>

113. The benefit must also be provided to the employee (or an associate of the employee) in respect of the employment of the employee.<sup>95</sup> For more guidance as to when it can be concluded benefits are provided to an employee in respect of employment, see paragraph 125 of this draft Ruling.

114. Where a fringe benefit is provided by a third party as described above it is the employer, not the third party, who is liable under the FBTA.<sup>96</sup>

115. In relation to a loan fringe benefit that arises from the trustee applying the contribution to make loans to an employee, the 'otherwise deductible' rule requires a consideration of the extent the employee would be entitled to an income tax deduction for interest on the loan had it been incurred.

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<sup>91</sup> For a full discussion of the operation of section 109J of the ITAA 1936, refer to TR 2014/5.

<sup>92</sup> Refer to paragraph (d) of the definition of a fringe benefit.

<sup>93</sup> Refer to paragraph (e) of the definition of fringe benefit.

<sup>94</sup> Refer to paragraph (ea) of the definition of fringe benefit.

<sup>95</sup> And the benefit is not excluded from the definition of fringe benefit in paragraphs (f) to (s) of the definition of fringe benefit.

<sup>96</sup> Refer to section 5 of the FBTA.

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116. Deductibility of interest accrued on a loan made under an ERT (if it had been incurred) is determined in accordance with section 8-1 of the ITAA 1997. For the purposes of section 8-1 of the ITAA 1997, the essential character of interest expense is derived from the purpose of the borrowing and the application or the use of the borrowed funds.<sup>97</sup> The laying out of the borrowed money for the purpose of gaining assessable income is supported by a direct connection between interest paid by the taxpayer and the income derived from the use or application of the amounts borrowed.

117. Circumstances that indicate an expectation of an insufficient amount of assessable income include loan funds that are applied to acquire an interest in an ERT, and:

- the rights of an employee to income of the trust are at the discretion of the trustee<sup>98</sup>
- the rights of an employee are to a fixed entitlement to trust income over a limited or finite period where the expected return is so disproportionately small in comparison to the interest expense such that the return does not provide an obvious commercial explanation for the expense<sup>99</sup>
- generation of assessable income has an insufficient or remote connection with the acquisition of the trust interest, or
- the employee is not expected to generate any assessable income, other than capital gains.<sup>100</sup>

## ***Consequences for the employee***

*When is a loan by a trustee taken to be a deemed dividend?*

118. An employer that is a private company is deemed<sup>101</sup> 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 (and the contribution was not made to the trustee in its capacity as an associate of a particular

<sup>97</sup> Refer to *Ure v. Federal Commissioner of Taxation* [1981] FCA 9; 81 ATC 4100 at 4109-10; 11 ATR 484 at 494-5 (*Ure*); *Kidston Goldmines Ltd v. FC of T* 91 ATC 4538 at 4545; (1991) 22 ATR at 176; *Fletcher* at ATC 4958-61; ATR 623-6.

<sup>98</sup> Refer to Taxation Ruling IT 2385 *Income tax: expenses incurred by beneficiaries of discretionary trusts*.

<sup>99</sup> Refer to TR 95/33 for the Commissioner's approach to circumstances where the amount of assessable income expected is disproportionately less than the amount of the interest expense. Refer also to *Ure*.

<sup>100</sup> Refer to section 51AAA of the ITAA 1936.

<sup>101</sup> Under section 109D of the ITAA 1936, through the operation of sections 109T and 109W of the ITAA 1936.

employee<sup>102</sup> and is not itself treated as a deemed dividend under Division 7A<sup>103</sup>)

- the trustee 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<sup>104</sup>, and
- it would be reasonable to conclude that that contribution was made solely or mainly as part of an arrangement involving a loan to that employee beneficiary.

*How are benefits assessed to the employee?*

119. Amounts that are paid by the trustee to an employee as remuneration<sup>105</sup> are included in the employee's assessable income under section 6-5 of the ITAA 1997 to the extent to which they are derived 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.<sup>106</sup>

*Benefits assessed under the trust assessing provisions*

120. An employee who is a beneficiary of an ERT, who is not under a legal disability:

- is assessable on so much of a franked distribution of the ERT attributed to them under Subdivision 207-B of the ITAA 1997, along with their share of the attached franking credit
- is assessable under paragraph 97(1)(a) of the ITAA 1936, if they are presently entitled to a share of the *income of the ERT* (as defined in paragraph 4 of this draft Ruling), on that same share of the section 95 net income of the ERT (excluding any net capital gain, franked distributions (net of directly relevant deductions) and franking credits), and

<sup>102</sup> Refer to subsection 109ZB(3) of the ITAA 1936.

<sup>103</sup> Refer to subsection 109T(3) of the ITAA 1936.

<sup>104</sup> Refer to sections 109ZD and 318 of the ITAA 1936.

<sup>105</sup> The trustee is required to withhold an amount from such a payment except to the extent that the payment is made to a director as remuneration (as ordinarily defined for these purposes), is exempt or non-assessable non-exempt income of the employee or consists of a non-cash benefit. Refer to sections 11-5 and 12-10 of Schedule 1 to the TAA.

<sup>106</sup> For example, a fringe benefit is non-assessable non-exempt income of the employee: section 23L of the ITAA 1936.



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- includes in the calculation of their net capital gain so much of a capital gain of the ERT they are taken to have made under Subdivision 115-C of the ITAA 1997 (except to the extent that it is otherwise assessable to the employee under section 6-5 of the ITAA 1936).

## *When are benefits assessed to the employee under section 6-5?*

121. Remuneration received from an ERT is assessable to an employee under section 6-5 of the ITAA 1997 where it:

- has the character of ordinary income
- is derived by the employee
- is in the form of money or money's worth, and
- is not excluded from the operation of section 6-5 of the ITAA 1997.

## *When does a benefit provided by the trustee have the character of ordinary income of an employee?*

122. An employee's ordinary income includes benefits (in the form of money or money's worth) that the employee receives for, or in respect of, services they provide under a contract of employment.<sup>107</sup>

123. The nature of the income must be determined in the hands of the recipient.<sup>108</sup> It is irrelevant whether:

- it is paid in advance of the services to be performed or after<sup>109</sup>
- the remuneration is paid by the employer or another entity<sup>110</sup>
- it is paid from the income or the capital of the ERT,<sup>111</sup> or
- it is paid from an amount previously assessed to the trustee under the trust assessing provisions in an earlier year.<sup>112</sup>

<sup>107</sup> We have confined the discussion of ordinary income principles to that income derived from the provision of services. Benefits from a trust may nevertheless be ordinary income, other than as consideration for the provision of employment services. However, we do not deal with those other ordinary income principles in this draft Ruling.

<sup>108</sup> Refer to for example, *Case C57 71 ATC 250*; *Jackson's Trustees v. Commissioners of Inland Revenue* (1942) 25 TC 13; *Inchyra (Baron) v. Jennings (Inspector of Taxes)* [1966] 1 Ch 37; [1965] 2 All ER 714; *Case Q85 83 ATC 430*; *Case Nos 260-262/1982 27 CTBR(NS) 80*.

<sup>109</sup> *Sent* at FCA [41]-[44]; ATC 13,563-13,564; ATR 15-16.

<sup>110</sup> *Federal Commissioner v. Dixon* (1952) 86 CLR 540; [1952] HCA 65; (1952) 10 ATD 82; (1952) 5 AITR 443.

<sup>111</sup> *Murdoch v. Commissioner of Pay-roll Tax (Vic)* (1980) 143 CLR 629 at 645; [1980] HCA 33 at [10]; 80 ATC 4424 at 4432; (1980) 11 ATR 135 at 144.

124. Trust distributions not dealt with by the trust assessing provisions can be assessed as ordinary income to the employee if they bear that character in the hands of the employee. Division 6 is not an exclusive code in assessing distributions from a trust.<sup>113</sup>

*When do benefits provided by a trustee have a sufficient connection with employment?*

125. Factors that will evidence that benefits provided by a trustee are remuneration or remuneration in nature include the following:

- it is agreed between the parties that the benefit is consideration for services rendered by the employee and is a payment of salary, wage or bonus
- the benefit arises from a contract, arrangement or plan established by the employer for employees, to enable or facilitate the delivery of remuneration to employees
- the benefits provided by the trustee can also be provided by the employer, in lieu
- the benefits are conditional on meeting individual or specific performance targets
- the benefits depend upon continued employment with the employer and are forfeited on cessation of employment, or
- the benefits are provided at the discretion of either the employer or the trustee who takes direction or recommendations from the employer.

*When do benefits provided by a trustee have an insufficient connection with employment?*

126. Benefits have an insufficient connection with employment and are unlikely to be remuneration in nature when they are received by the employee other than in their capacity as an employee such that it can be concluded, after a consideration of all relevant circumstances, that the benefit is not being provided to the employee in respect of employment. This will arise where the consideration for the payment

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<sup>112</sup> While subsection 99B(1) of the ITAA 1936 provides that certain property of a trust estate paid to, or applied for the benefit of, a resident beneficiary, is assessable to the beneficiary, it does not apply unless the ERT is or was a non-resident trust estate. Accordingly, neither it, nor the exception to it in subparagraph 99B(2)(c)(ii) of the ITAA 1936 (concerning amounts previously assessed to the trustee), generally applies to the ERT arrangements described in this draft Ruling. Refer also to Hill J's comments in *Traknew Holdings Pty Ltd v. FC of T* 91 ATC 4272 at 4284; (1991) 21 ATR 1478 at 1492.

<sup>113</sup> *Federal Commissioner of Taxation v. Belford* (1952) 88 CLR 589; [1952] HCA 73; (1952) 10 ATD 105; (1952) 5 AITR 392 and *Union Fidelity Trustee Co. v. Federal Commissioner of Taxation* (1969) 119 CLR 177; [1969] HCA 36; 69 ATC 4084; (1969) 1 ATR 200.

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is not the employment services.<sup>114</sup> Factors that will evidence that benefits provided by a trustee are not remuneration or remuneration in nature includes the following:

- the benefits are consideration for an arm's length surrender, exercise or disposal of an asset (property or rights)<sup>115</sup> and that asset was acquired in return for valuable and arm's length consideration (or as remuneration, and those rights were appropriately dealt with as such)
- the benefits arise because the recipient is a beneficiary of a trust and the trustee has exercised its power under the deed to provide those benefits to the recipient independent of an arrangement or understanding with, or direction by, the employer
- the benefits do not rely on continuing employment nor have regard to, or are conditional upon, individual employment-related performance conditions, or
- the timing and amount of benefits is identical in respect of all recipients who hold the same property or rights, regardless of their employment relationship with the employer.

127. Where a contribution is paid on the employee's behalf or as they direct and they are taken to have derived the contribution as remuneration<sup>116</sup> at that point, the employee cannot derive that same amount again should it be paid out of the trust and to the extent it is made up of that earlier contribution.<sup>117</sup>

## *When are benefits statutorily excluded from the operation of section 6-5?*

128. Amounts of ordinary income of the employee are excluded from the employee's assessable income under section 6-5 of the ITAA 1997 to the extent to which they are amounts of:

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<sup>114</sup> *Deputy Commissioner of Taxation v. Applied Design Development Pty Ltd (In Liq)* (2002) 117 FCR 336 at 342-343; [2002] FCA 205 at [25]-[26]; 2002 ATC 4193 at 4198; (2002) 49 ATR 196 at 202.

<sup>115</sup> *Federal Commissioner of Taxation v. McArdle* 89 ATC 4051 at 4058-4059; (1988) 19 ATR 1901 at 1909.

<sup>116</sup> And the employee has included that amount of the contribution in their assessable income under section 6-5 of the ITAA 1997 or the employer has treated that amount of the contribution as a fringe benefit with a taxable value equal to the amount of the contribution referable to the employee for the purposes of the FBTA.

<sup>117</sup> In addition, section 6-25 of the ITAA 1997 would apply to ensure that same amount cannot be assessed to the employee again in a later year. Section 6-25 operates such that an amount is included only once in the employee's assessable income for an income year, and is then not included in the employee's assessable income for any other income year.

- 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 (such as ordinary income derived by a taxpayer by way of the provision of a fringe benefit).<sup>118</sup>

129. To the extent that an amount would be assessable to the employee beneficiary under both section 6-5 of the ITAA 1997 and Division 6 or Subdivision 207-B of the ITAA 1997, section 6-25 of the ITAA 1997 operates to include the amount as assessable income only once and gives preference to the amounts being assessed under Division 6 or Subdivision 207-B over section 6-5.

130. However, 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>119</sup> indicate a clear intent that, without more, where an amount is otherwise included in assessable income under both section 6-5 of the ITAA 1997 and section 102-5 of the ITAA 1997, the CGT provisions should give way to section 6-5 of the ITAA 1997.<sup>120</sup>

*When are amounts exempt income or non-assessable non-exempt income?*

131. 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 treat the distribution as exempt or non-assessable non-exempt income of a beneficiary. Such amounts are not assessed to the beneficiary as ordinary income, even if received as remuneration.<sup>121</sup>

132. Further, non-assessable non-exempt income includes income derived by an employee by way of the provision of a fringe benefit.<sup>122</sup>

*How does an employee treat a gain made on disposal of an interest in an ERT?*

133. When an employee disposes of or redeems an interest<sup>123</sup> (including units) in an ERT, a CGT event occurs. The employee must

<sup>118</sup> Refer to section 23L of the ITAA 1936.

<sup>119</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).

<sup>120</sup> Refer to *Project Blue Sky v. ABA* (1998) 194 CLR 355 at 381-382; [1998] HCA 28 at [70].

<sup>121</sup> Refer to section 6-15 of the ITAA 1997.

<sup>122</sup> Section 23L of the ITAA 1936.

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include a capital gain made from a CGT event in the calculation of their net capital gain (or loss) for each year of income.<sup>124</sup>

134. A capital gain is reduced to the extent that, because of the CGT event, an amount is otherwise included in the employee's assessable income under section 6-5 of the ITAA 1997.<sup>125</sup> A gain made from the disposal or redemption of an interest is assessable under section 6-5 of the ITAA 1997 where the employee acquires the interest with the intention of making a profit or gain on its disposal or redemption (in the course of a business or commercial transaction) or the profit or gain is otherwise ordinary income of the employee.

*Is an employee entitled to tax offsets for franking credits?*

135. The integrity rules in former Division 1A of Part IIIAA of the ITAA 1936<sup>126</sup> require that an employee, amongst other things, be a 'qualified person' in relation to the franked distribution from the ERT.<sup>127</sup> This requires that the employee beneficiary be sufficiently subject to the risks of loss and opportunities for gain, for at least 45 days, generally associated with the share ownership.<sup>128</sup>

136. The employee beneficiary is taken to have materially diminished risks of loss or opportunities for gain (and therefore will not meet the qualified person test) if their net position<sup>129</sup> in relation to

<sup>123</sup> Other than an interest of a discretionary beneficiary in a discretionary trust.

<sup>124</sup> Section 102-5 of the ITAA 1997 then includes a net capital gain in assessable income for the income year.

<sup>125</sup> Refer to section 118-20 of the ITAA 1997.

<sup>126</sup> Refer to 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. Refer to 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>127</sup> Consideration as to whether an ERT is a *widely held trust* or a *non-widely held trust* as defined under the ITAA 1997 and ITAA 1936 is a factual enquiry and will need to be considered on a case by case basis.

<sup>128</sup> Refer generally at paragraphs 4.6 to 4.9 of the Explanatory memorandum to the *Tax Laws Amendment Act (No. 2) of 1999* (Cth).

<sup>129</sup> 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

their interest in the shares held by the trustee, worked out by netting off positive deltas (long positions) and negative deltas (short positions)<sup>130</sup>, has less than 30% of those risks and opportunities.<sup>131</sup> This means the employee beneficiary's net position must be at least 0.3 to satisfy the qualified person test.

137. Due to 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>132</sup> will effectively start at 0. Deltas can only be added to this starting position if the employee's interest is vested and indefeasible.<sup>133</sup>

138. As noted in paragraph 51 of this draft Ruling, the Commissioner has a discretion to treat some interests as being vested and indefeasible. A taxpayer must apply to the Commissioner to request that the discretion be exercised.

139. In deciding whether to exercise this discretion, the Commissioner must have regard to the circumstances in which the interest may not vest or may be defeated:<sup>134</sup>

- 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

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relevant securities, behaving in effect as an option in relation to those securities, is also a relevant position.

<sup>130</sup> Refer to former subsection 160APHM(3) of the ITAA 1936, which refers to former 160APHJ of the ITAA 1936.

<sup>131</sup> Refer to former subsection 160APHM(2) of the ITAA 1936.

<sup>132</sup> Not being a family trust within the meaning of Schedule 2F to the ITAA 1936 or a deceased estate.

<sup>133</sup> Refer to former subsections 160APHL(3), 160APHL(4), 160APHL(10), and 160APHL(11) of the ITAA 1936. See paragraph 50 of this draft Ruling for a list of factors relevant to determining whether an employee's interest is vested and indefeasible.

<sup>134</sup> Refer to former paragraph 160APHL(14)(c) of the ITAA 1936.

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- 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.

140. Where an employee beneficiary is not a qualified person, the franking credit 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>135</sup>

## ***Consequences for the trustee***

141. An ERT's section 95 net income broadly equals the sum of the assessable income of the ERT, calculated as if the trustee were a resident taxpayer, less allowable deductions. It will therefore include amounts of ordinary income, net capital gains and other statutory income.<sup>136</sup> 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.

## *When is a gain derived by the trustee ordinary income?*

142. Having regard to the purposes of the trust, if the trust exists with a view to acquiring and disposing of trust property in order to generate profits from which distributions to employees can be made, then that fact lends support to a conclusion that the profits are made on revenue account.

## **Application of Part IVA to ERTs**

143. Although this draft Ruling does not consider the application of Part IVA of the ITAA 1936 to ERT arrangements, Part IVA has been applied to the specific operation of some ERTs<sup>137</sup>, and the presence

<sup>135</sup> Refer to subsections 207-150(3) and 207-50(3), and subparagraph 207-35(4)(b)(i) of the ITAA 1997.

<sup>136</sup> A trustee is required to withhold an amount from a payment of salary, wages, a commission, a bonus or an allowance to an individual as an employee (or applies or deals with such an amount on the employee's behalf or as the employee directs) except to the extent that the payment is made to a director as remuneration (as ordinarily defined), is exempt or non assessable non exempt income of the employee or consists of a non-cash benefit. Refer to sections 11-5 and 12-10 of Schedule 1 to the TAA.

<sup>137</sup> *Spotlight* at FCA [77]-[116]; ATC 4695-4703; ATR 769-778, *Yip v. Federal Commissioner of Taxation* [2011] AATA 785 at [73]-[134]; 2011 ATC 10-214 at 4300 – 4325; (2011) 82 ATR 761 at 789-806, *Experienced Tours Pty Ltd v. FC of T* [2006] AATA 517 at [102]-[112]; 2006 ATC 2232 at 2240-2241; (2006) 63 ATR 1147 at 1156-1157 and *Wensemius* at AATA [102]-[112]; ATC 2052-2054; ATR 164-166; TR 2010/6 at paragraphs 16-17, 34-43 and 80-87 and TD 2010/10 at paragraphs 1-19.

of one or more of the following factors may indicate that Part IVA applies to a particular ERT:

- a deduction created or generated for an expense that is unnecessary or lacks commercial rationale; for example, where the contribution:
  - is disproportionate to what is necessary to achieve its commercial objectives
  - results in no economic loss for the contributing entity, or
  - results in the bringing forward of a deduction that would ordinarily be incurred in later income years
- investment or application by the trustee of contributed amounts in such a way that is inconsistent with delivering benefits to employees
- use of, or economic benefit from, the ERT funds by the employee at a time before those funds become assessable to the employee, or
- the provision of a benefit to an employee through the ERT results in the benefit being taxed in a manner that is inconsistent with it being remuneration, for example:
  - distribution of amounts which have a different tax character, including franked dividends, discount capital gains or tax deferred distributions
  - income splitting or alienation, which may result in amounts being assessed to persons other than the relevant employee, and
  - the provision of a benefit in a non-taxable form (for example, through the use of uncommercial loans or finance facilities<sup>138</sup> to an employee).

144. If you have entered into, or are contemplating entering into, an ERT arrangement that exhibits one or more of these features, we encourage you to ask us for our view of the arrangement through a private ruling, or seek independent professional advice.

145. The application of Part IVA to a particular scheme depends on a careful weighing of all the relevant facts and surrounding circumstances of the case, and Part IVA may still apply if an ERT arrangement doesn't have any of the indicia listed above. Without considering all of the relevant information, it is not possible to state definitively whether or not Part IVA applies to a particular scheme.

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<sup>138</sup> An 'uncommercial loan or finance facility' includes (but is not limited to) loans or finance entered into on terms that are not arm's length or where the loan or



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## Appendix 2 – Your comments

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146. You are invited to comment on this draft Ruling. Please forward your comments to the contact officer by the due date.

147. 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:** 19 July 2017  
**Contact officer:** Michelle Maffia  
**Email address:** [michelle.maffia@ato.gov.au](mailto:michelle.maffia@ato.gov.au)  
**Telephone:** 03 8601 9251  
**Address:** Australian Taxation Office  
PO Box 9977  
Moonee Ponds VIC 3039

**Appendix 3 – Detailed contents list**

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