




# ***TR 2018/7 - Income tax: employee remuneration trusts***

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 There is a Compendium for this document: **TR 2018/7EC** .

 This document has changed over time. This is a consolidated version of the ruling which was published on *31 October 2018*



## Taxation Ruling

### Income tax: employee remuneration trusts

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#### **❶ This publication provides you with the following level of protection:**

This publication (excluding appendices) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

## Summary – what this Ruling is about

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

2. This 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

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<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.

- 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).
3. Nothing in this 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 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  |

<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.

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

<sup>4</sup> As defined in subsection 83A-10(1) 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).

|                                |   |
|--------------------------------|---|
|                                | 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 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.  |
| <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.   |
| <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> | The Commissioner's approach to administration regarding this term is discussed in Appendix 1 of this Ruling.  |
| <b>Remuneration</b>            | <p>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>8</sup></p> <p>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.</p> <p>Remuneration does not include benefits provided in connection with termination of employment unless it is deferred remuneration.<sup>9</sup></p> |
| <b>Section 95 net income</b>   | The net income of a trust estate as defined in section 95 of the ITAA 1936.   |
| <b>TAA</b>                     | <i>Taxation Administration Act 1953.</i>  |

<sup>7</sup> Refer to Taxation Rulings TR 2005/16 *Income tax: Pay As You Go – withholding from payments to employees* and 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* for guidance on when an individual is an employee at common law.

<sup>8</sup> Refer to *Mutual Acceptance Company v. Federal Commissioner of Taxation* (1944) 69 CLR 389; [1944] HCA 34; (1944) 7 ATD 506.

<sup>9</sup> Refer to *Blank v. Commissioner of Taxation* [2016] HCA 42; 2016 ATC 20-587.

|                                   |   |
|-----------------------------------|---|
| <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. A reference to an 'entity' in this Ruling is a reference to the entity in its own capacity, unless otherwise indicated.

## Previous ruling

6. This Ruling finalises the Commissioner's view expressed in draft Taxation Ruling TR 2017/D5 *Income tax: employee remuneration trusts*.

## Ruling

7. This Ruling applies to all Australian resident employers, employees and trustees who participate in an ERT arrangement.<sup>10</sup>

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.<sup>11</sup>

<sup>10</sup> ERT arrangements can be variously described as employee bonus, benefit, incentive or reward schemes, arrangements, or trusts.

<sup>11</sup> 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* 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?*

**Consequences of making a contribution to an ERT*****Consequences for the employer****When can an employer deduct a contribution?*

9. A contribution an employer makes to an ERT 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<sup>13</sup> payment of cash<sup>14</sup>, made at a time when the employer carries on a business for the purpose of gaining or producing assessable income
- it is made because the employer reasonably expects their business to benefit<sup>15</sup> from the contribution via an improvement in employee performance, morale, efficiency or loyalty, and
- it is intended to be permanently and entirely dissipated in remunerating employees of that business<sup>16</sup> within a relatively short period<sup>17</sup> of the contribution being made (other than employees who are engaged in affairs of capital of the business<sup>18</sup>).

<sup>12</sup> Section 8-1 of the ITAA 1997 is the general deduction provision. There are numerous specific measures in the ITAA 1936 and ITAA 1997 that modify the application of section 8-1 of the ITAA 1997. This Ruling does not deal with all of these potential modifications. It does consider the application of the prepayment provisions to a section 8-1 of the ITAA 1997 deduction, see paragraphs 22 to 25 of this Ruling.

<sup>13</sup> Refer to *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. Federal Commissioner of Taxation* [2004] FCA 650 at [77]-[116]; 2004 ATC 4674 at 4695-4703; (2004) 55 ATR 745 at 769-778 (*Spotlight*).

<sup>14</sup> Refer to paragraph 21 of Taxation Ruling TR 97/7 *Income tax: section 8-1 – meaning of 'incurred' – timing of deductions*.

<sup>15</sup> Refer to *Ronpibon Tin NL v. Federal Commissioner of Taxation* (1949) 78 CLR 47 at 55-58; HCA 15 at [9]-[15]; (1949) ATD 431 at 434-436; and *Re 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>16</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>17</sup> Refer to Appendix 1 of this Ruling for the Commissioner's compliance approach to the meaning of 'relatively short period'.

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

10. The following considerations are relevant to establishing a sufficient connection between a contribution and the benefit to the employer's business such that the expenditure may be deductible:

- the nature and timing of the benefits to be derived by the employer and the employees<sup>19</sup>
- employee awareness of the scheme<sup>20</sup>, and
- whether the scheme and the contribution addresses (or has the capacity to address) the business-related need, function or complaint.<sup>21</sup>

Example 1 – connection with business

11. *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.*

12. *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 construction 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 building company.*

13. *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>22</sup>

<sup>19</sup> As to the nature of benefits refer to *Wensemius v. Federal Commissioner of Taxation* [2007] AATA 1006 at [97]-[98]; 2007 ATC 2035 at 2051-2052; (2007) 66 ATR 144 at 163-164 (*Wensemius*).

<sup>20</sup> Refer to *Benstead Services Pty Ltd v. Federal Commissioner of Taxation* at [2006] AATA 976 at [47]-[52]; 2006 ATC 2511 at 2517-2518; (2006) 64 ATR 1232 at 1240.

<sup>21</sup> Refer to *Essenbourne Pty Ltd v. Federal Commissioner of Taxation* [2002] FCA 1577 at [32]; 2002 ATC 5201 at 5208; 51 ATR 629 at 636 (*Essenbourne*).

<sup>22</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.

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

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

14. 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 an employer, or their associates.<sup>23</sup>

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

15. *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 purpose of making the contribution is to benefit the shareholders of App Pty Ltd, so the share sale can proceed without impediment. The contribution to the ERT is not paid out as remuneration. It is not deductible under section 8-1 of the ITAA 1997 as it lacks the requisite connection with business.*

When the contribution is of a capital nature

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

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

18. A contribution is of a capital nature and not deductible under section 8-1 of the ITAA 1997 to the extent it is to be applied in

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<sup>23</sup> 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. Refer to *Essenbourne*.

remunerating employees who are engaged in affairs of capital of the business.<sup>24</sup>

19. When considering the character of expenditure, it is critical to consider the advantage sought by the payer<sup>25</sup> from a practical and business point of view.<sup>26</sup> Where a contribution is made to an ERT to secure any of the following benefits (without limitation), it is likely to be capital expenditure by the employer:

- 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>27</sup>
- to provide loans, on a continuous basis, to employees
- to 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
- to acquire arm's length investments<sup>28</sup> where the intention is to derive a return to be paid to employees, whilst keeping the capital of the trust fund intact.

Example 3 – contributions to make loans and acquire shares are of a capital nature

20. *Oil Ltd sets up an ERT and makes a voluntary contribution of \$3 million 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 Securities 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*

<sup>24</sup> Refer to *Goodman Fielder Wattie Ltd v. Federal Commissioner of Taxation* (1991) 29 FCR 376; 91 ATC 4438; (1991) 22 ATR 26.

<sup>25</sup> Refer to *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>26</sup> Refer to *Hallstroms Pty Ltd v. Federal Commissioner of Taxation* (1946) 72 CLR 634 at 648; [1946] HCA 34; (1946) 8 ATD 190 at 196.

<sup>27</sup> Refer to *British Insulated and Helsby Cables v. Atherton* [1926] AC 205 at 215-216.

<sup>28</sup> Refer to *Ransburg Australia Pty Ltd v. Federal Commissioner of Taxation* [1980] FCA 31; 80 ATC 4114 at 4121; (1980) 10 ATR 663 at 669, per Fisher J.

*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 other participating employees in the scheme and are never held for the benefit of a particular employee.*

21. *The contribution of \$3 million 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 million be permanently or entirely dissipated in providing remuneration to employees. The contribution is of a capital nature and is not deductible under section 8-1 of the ITAA 1997.<sup>29</sup>*

*When do the prepayment provisions apply?*

22. Where a contribution is deductible under section 8-1 of the ITAA 1997, the prepayment provisions will apply to spread out the deduction claimed for the contribution over an 'eligible service period'<sup>30</sup> where the contribution is not 'excluded expenditure'<sup>31</sup> and is incurred by an employer:

- under an agreement with the trustee<sup>32</sup>
- in return for the doing of a thing<sup>33</sup>, 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.<sup>34</sup>

<sup>29</sup> Two separate examples of the most common circumstances are identified at paragraphs 15 and 20 to 21 of this Ruling. However there may be other circumstances in which a contribution is not deductible to the employer.

<sup>30</sup> As defined in subsection 82KZL(1) of the ITAA 1936.

<sup>31</sup> The prepayment provisions will not apply to 'excluded expenditure', which is defined in subsection 82KZL(1) of the ITAA 1936 to mean, 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 that contract between the employer and the employee.

<sup>32</sup> 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.

<sup>33</sup> The 'doing of a thing' can include making loans to employees from the contribution or paying the contribution to employees as remuneration, or both.

23. Where the employer making the contribution is a small business entity for the year in which the contribution is incurred, that employer may choose to apply section 82KZMD of the ITAA 1936 to the contribution.<sup>35</sup> Where a small business entity does not choose to apply section 82KZMD to the contribution, section 82KZM of the ITAA 1936 requires an apportionment of the deduction for the contribution over the eligible service period, unless the eligible service period:

- is not longer than 12 months, and
- ends before the income year following the year that the contribution was made.

Example 4 – when to spread out a deduction for a contribution

24. *A trustee receives a contribution of \$6 million from an employer, Build Co Ltd. The contribution (as agreed between the employer and trustee 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. The funds are reasonably expected to be expended within five years.*

25. *Build Co Ltd is entitled to a deduction for the \$6 million contribution but will be required to spread the deduction over the 'eligible service period'. The \$6 million contribution is not excluded expenditure as it has been paid voluntarily to the trustee pursuant to an agreement between the trustee and Build Co Ltd and not directly under a contract of service with the employees.*

*When is a contribution a fringe benefit?*

26. 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

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<sup>34</sup> Refer to 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.

<sup>35</sup> The choice to apply section 82KZMD of the ITAA 1936 must be made before lodging its income tax 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.

take a share of the benefit is known with sufficient particularity'.<sup>36</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.

27. 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.

28. 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

29. *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 three 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 an employee?*

30. A contribution to an ERT is assessable income of an employee under section 6-5 of the ITAA 1997 where it has the

<sup>36</sup> Refer to *Federal Commissioner of Taxation v. Indooroopilly Children Services (Qld) Pty Ltd* (2007) 158 FCR 325 at 345; [2007] FCAFC 16 at [37]; (2007) 65 ATR 369 at 388 (*Indooroopilly*).

character of ordinary income, is applied or dealt with on the employee's behalf or as the employee directs,<sup>37</sup> and is not excluded from the operation of section 6-5.<sup>38</sup>

31. 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>39</sup>

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

32. *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>40</sup> 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.*

### **Consequences for the trustee**

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

33. 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

<sup>37</sup> Subsection 6-5(4) of the ITAA 1997.

<sup>38</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.

<sup>39</sup> Refer to *Sent v. Commissioner of Taxation* [2012] FCA 382 at [83]; 2012 ATC 20-318 at 13,570; (2012) 85 ATR 1 at 23 (*Sent*).

<sup>40</sup> Which reflects the notional amount of interest as defined in subsection 136(1) of the FBTA, since no amount of interest is payable under the loan. The contribution will not be an effective salary sacrifice arrangement as the notional value of the benefit is less than the value of the foregone salary. Refer to *Re Yip v. Federal Commissioner of Taxation* [2011] AATA 785; 2011 ATC 10-214; (2011) 82 ATR 761 (*Yip*).

contribution is made, the recipient is a shareholder (or associate of a shareholder) or a former shareholder (or former associate of a shareholder<sup>41</sup>) of the private company and no exception or exclusion to section 109C, and Division 7A more generally, applies.<sup>42</sup>

34. Accordingly, if the trustee, who is the recipient of the contribution, 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.

35. In addition, where the trustee is not a shareholder themselves, but is an associate of a shareholder of the private company, a contribution by the private company is also deemed under section 109C of the ITAA 1936 to be a dividend. This may include the case where the trustee is an associate of an employee who is a shareholder of the private company. An employee and a trustee will be associates where the employee is capable of benefiting from the trust being administered by the trustee.

36. However, 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>43</sup> This is because such a payment will be dealt with under the FBTAA. In considering benefits provided to employees or associates of employees in the context of the FBTAA, reference to an employee is a reference to a **particular** employee.<sup>44</sup>

37. 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

<sup>41</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>42</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>43</sup> Under subsection 109ZB(3) of the ITAA 1936.

<sup>44</sup> Subsection 109ZB(3) of the ITAA 1936 substantially mirrors the approach in relation to 'employee' under the FBTAA. Refer to *Indooroopilly* per Edmonds J in the FBTAA context.

arises, it is 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.

38. The contribution is also not a deemed dividend if the contribution itself is an actual dividend to the trustee<sup>45</sup>, or if it is a payment which discharges a pecuniary obligation of the employer to the trustee.<sup>46</sup>

39. 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>47</sup> (which is designed to broadly equate to the realised and unrealised profits of the private company).<sup>48</sup>

Example 7 – subsection 109ZB(3) of the ITAA 1936 does not apply to exclude the contribution as a deemed dividend

40. *Medical Pty Ltd makes an undissected contribution of \$800,000 to the trustee to hold 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 also each 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.*

<sup>45</sup> Where the contribution is a payment of an actual dividend 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.

<sup>46</sup> Section 109J of the ITAA 1936. The exemption does not apply to contributions voluntarily gifted or settled on the trustee, and only applies to contributions to discharge an obligation under which parties who were dealing at arm's length would be similarly obliged. For a broader discussion of the relevant principles, 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>47</sup> Distributable surplus is calculated in accordance with section 109Y of the ITAA 1936.

<sup>48</sup> Refer to *Federal Commissioner of Taxation v. H* (2010) 188 FCR 440 at 447; [2010] FCAFC 128 at [36]; (2010) 85 ATR 357 at 365.

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

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

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

41. Where, under an arrangement with the employer, the trustee of an ERT<sup>49</sup> applies the contribution to make loans to employees<sup>50</sup>, the employer will be taken to have provided a loan fringe benefit.

42. To be a fringe benefit, the benefit must be provided to the employee (or an associate of the employee) in respect of the employment of the employee.<sup>51</sup>

43. Where a fringe benefit is provided by a third party (such as the trustee of the ERT) it is the employer, not the third party, who is liable under the FBTA.<sup>52</sup>

44. The taxable value of a loan fringe benefit may be reduced by the 'otherwise deductible' rule in section 19 of the FBTAA<sup>53</sup> only where (and to the extent) that had the employee incurred interest, it would have been deductible.<sup>54</sup> This generally requires the loan to be used for a purpose attended with a reasonable expectation of sufficient income.

45. The employee will not have a reasonable expectation of sufficient income where the loan funds are applied to acquire an interest in an ERT, and one of the following applies:

<sup>49</sup> The provision of benefits by the trustee of an ERT to employees may nevertheless be fringe benefits, despite not being provided by the employer, because the trustee is expected to fall within one of paragraphs (d) to (ea) in the definition of 'fringe benefit' in subsection 136(1) of the FBTAA.

<sup>50</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.

<sup>51</sup> In addition, the benefit must not be excluded from the definition of 'fringe benefit' in paragraphs (f) to (s) in the definition of 'fringe benefit' in subsection 136(1) of the FBTAA.

<sup>52</sup> Refer to section 5 of the FBTA.

<sup>53</sup> The general effect of section 19 of the FBTAA is to reduce the taxable value of a loan fringe benefit provided to an employee to the extent that the employee would be entitled to a once only deduction for interest paid on that loan.

<sup>54</sup> This will generally depend on whether the borrowed funds have been applied by the employee for an income producing purpose. Taxation Ruling TR 95/25 *Income tax: deductions for interest under section 8-1 of the Income Tax Assessment Act 1997 following FC of T v. Roberts; FC of T v. Smith* (particularly paragraph 3) sets out general propositions as to when interest will be deductible.

- the rights of an employee to income of the trust are at the discretion of the trustee<sup>55</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>56</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>57</sup>

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

46. *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.*

47. *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 Tom 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,*

<sup>55</sup> Refer to Taxation Determination TD 2018/9 *Income tax: deductibility of interest expenses incurred by a beneficiary of a discretionary trust on borrowings on-lent interest-free to the trustee.*

<sup>56</sup> Refer to Taxation Ruling TR 95/33 *Income tax: subsection 51(1) – relevance of subjective purpose, motive or intention in determining the deductibility of losses and outgoings* 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 v. Federal Commissioner of Taxation* [1981] FCA 9; (1981) 50 FLR 219; (1981) 34 ALR 237; (1981) 11 ATR 484; 81 ATC 4100.

<sup>57</sup> Refer to section 51AAA of the ITAA 1936.

*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.*

48. Other benefits provided by the trustee to employees of an employer are fringe benefits if they are made in respect of the employment of the employee.

### **Consequences for the employee**

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

49. A private company is taken to pay a dividend directly to an employee under section 109D of the ITAA 1936<sup>58</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>59</sup> (or former associate of a shareholder) of the private company.<sup>60</sup>

50. The amount of the deemed dividend taken to be paid to the employee is determined by the Commissioner<sup>61</sup> and will have reference to the private company's distributable surplus.

### Example 9 – an interposed entity arrangement for the purposes of Division 7A

51. *Accounting Co Pty Ltd contributes \$800,000 to the trustee under an incentive arrangement put in place for its employees. According to:*

- *the plan documentation*
- *the trust deed, and*
- *the general understanding of the employees, Accounting Co Pty Ltd and the trustee,*

<sup>58</sup> Other than in situations where the payment or loan to the trustee is itself a deemed dividend.

<sup>59</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>60</sup> Refer to sections 109T and 109W of the ITAA 1936.

<sup>61</sup> 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.*

*the trustee can only apply the contribution in one way: to making loans to employees to enable those employees to acquire rights to shares in Accounting Co Pty Ltd.*

52. *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 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 \$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 from an ERT assessed to an employee?*

53. An employee who is a beneficiary of an ERT (employee beneficiary) may receive an amount that is taxable under more than one provision, so the tax laws include ordering rules which are intended to operate to ensure an amount is taxed only once to that employee. In addition, an amount may consist of several components, each taxed under different provisions.

54. Trust distributions not dealt with by the trust assessing provisions can be assessed as ordinary or statutory 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>62</sup>

55. Therefore, 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

<sup>62</sup> Refer to *Federal Commissioner of Taxation v. Belford* (1952) 88 CLR 589; [1952] HCA 73; (1952) 10 ATD 105; and *Union-Fidelity Trustee Co.(Aust) Ltd v. Federal Commissioner of Taxation* (1969) 119 CLR 177; [1969] HCA 36; (1969) 1 ATR 200.

and are not under a legal disability, on that same share of the section 95 net income of the ERT.<sup>63</sup>

- (c) Section 6-5 of the ITAA 1997, for amounts paid as remuneration.<sup>64</sup>
- (d) So much of a capital gain of the ERT they are taken to have made under Subdivision 115-C of the ITAA 1997.

56. 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>65</sup>

57. 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 and is not statutorily excluded.<sup>66</sup> 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>67</sup>

58. The nature of the payment must be determined in the hands of the employee.<sup>68</sup> It is irrelevant whether:

<sup>63</sup> The amount assessable to an employee under paragraph 97(1)(a) of the ITAA 1936 may be modified by Division 6E of the ITAA 1936 if a net capital gain or franked distribution is taken into account in calculating the section 95 net income of the ERT. These amounts are effectively taken out of Division 6 and dealt with under Subdivisions 115-C and 207-B of the ITAA 1997, as appropriate.

<sup>64</sup> A trustee has an obligation to withhold an amount from such a payment at the time the payment is made 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>65</sup> Section 23L of the ITAA 1936.

<sup>66</sup> For example, amounts that are properly assessed under another provision in priority (such as the trust's section 95 net income, capital gains or franked distributions properly assessed to the employee under the trust assessing provisions) (section 6-25 of the ITAA 1997), or other exempt income or non-assessable non-exempt income such as fringe benefits (section 23L of the ITAA 1936). Note, however, that section 6-5 of the ITAA 1997 will apply in priority to section 102-5 of the ITAA 1997 where an amount is assessable as income and a capital gain.

<sup>67</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 Ruling.

<sup>68</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*.

- it is paid in advance of the services to be performed or after<sup>69</sup>
- the remuneration is paid by the employer or another entity<sup>70</sup>
- it is paid from the income or the capital of the ERT<sup>71</sup>, or
- it is paid from an amount previously assessed to the trustee under the trust assessing provisions in an earlier year.<sup>72</sup>

59. Factors which 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 when employment ends, or
- the benefits are provided at the discretion of either the employer or the trustee who takes direction or recommendations from the employer.

<sup>69</sup> Refer to *Sent* at FCA [41]-[44]; ATC 13,563-13,564; ATR 15-16.

<sup>70</sup> Refer to *Federal Commissioner of Taxation v. Dixon* (1952) 86 CLR 540; [1952] HCA 65; (1952) 10 ATD 82.

<sup>71</sup> Refer to *Murdoch v. Commissioner of Pay-roll Tax (Vic)* (1980) 143 CLR 629 at 645; [1980] HCA 33 at [10]; (1980) 11 ATR 135 at 144.

<sup>72</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 Ruling.

60. Benefits have an insufficient connection with employment and are unlikely to be remuneration or 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 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 is not the employment services.<sup>73</sup> Factors that will evidence that benefits provided by a trustee are not remuneration or remuneration in nature include the following:

- the benefits are consideration for an arm's length surrender, exercise or disposal of an asset (property or rights)<sup>74</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.<sup>75</sup>

61. Where a contribution is paid on the employee's behalf or as they direct and they are taken to have derived the contribution as

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<sup>73</sup> Refer to *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) 49 ATR 196 at 202.

<sup>74</sup> Refer to *Federal Commissioner of Taxation v. McArdle* 89 ATC 4051 at 4058-4059; (1988) 19 ATR 1901 at 1909.

<sup>75</sup> The Commissioner has considered the nature of trust distributions and when they are in respect of employment in Taxation Determination TD 2017/26 *Income tax: employee share schemes – when a dividend equivalent payment is assessable to an employee as remuneration*. At paragraph 21 of that Determination, the Commissioner describes a compliance approach and considers it to be equally applicable to ERT arrangements.

remuneration<sup>76</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>77</sup>

Example 10 – a payment from the trustee in relation to employment

62. *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.*

63. *Raj acquires an interest in the ERT. This interest does not entitle Raj to any income of the ERT 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) Raj can redeem the interest and receive the growth in value of the interest. The value is determined by the market value of the notionally allocated shares attached to that interest.*

64. *In addition Raj, once vesting conditions are satisfied, also will 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. The value of the payment equates to the dividends that the trustee 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 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.*

65. *Whether the payment is made by the trustee or Legal Services Ltd is irrelevant for the purpose of determining whether the receipt is remuneration. However, given the requirement that Raj remain in employment, meet particular key performance targets before receiving the payment, and considering the contractual agreements between the parties, it is apparent that the payment is*

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<sup>76</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>77</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.

*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. While 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 Raj's hands is remuneration.*

Example 11 – operation of the interaction between Division 6 and section 6-5 of the ITAA 1997

66. *Insurance Co Ltd makes a contribution to an ERT with the intention that the trustee invests the contribution in listed shares and securities. 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). While the trustee intends to hold assets for long-term gain, over the second year of operation, the trustee 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.*

67. *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 and \$60 is a distribution of other trust income).*

68. *The \$100 payment is a bonus payable to Jerry in respect of Jerry's 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 paragraph 97(1)(a) of the ITAA 1936. Section 6-5 of the ITAA 1997 will then apply to the balance of the distribution (\$40) (in preference to section 102-5 of the ITAA 1997).*

69. *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 12 – operation of the interaction between Division 6, Subdivision 207-B and section 6-5 of the ITAA 1997

70. Assume the same facts as in Example 11, 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 his 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 paragraph 97(1)(a) of the ITAA 1936 as Robbie's share of the section 95 net income of the ERT
- nil amount included under section 6-5 of the ITAA 1997 as section 6-25 of the ITAA 1997 reduces section 6-5 of the ITAA 1997 amounts by those included under Division 6 and Subdivision 207-B of the ITAA 1997.

71. Whether Robbie is entitled to a tax offset for the \$30 franking credit depends on the relevant integrity rules, including whether he and the trustee are qualified persons in respect of the dividends for the purposes of Division 1A of the former Part IIIA of the ITAA 1936.

*How is a gain from the disposal or redemption of interest assessed to an employee?*

72. When an employee disposes of or redeems an interest<sup>78</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>79</sup>

73. 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>80</sup> A gain made from the disposal or redemption of an interest is assessable

<sup>78</sup> Other than an interest of a discretionary beneficiary in a discretionary trust.

<sup>79</sup> Section 102-5 of the ITAA 1997 then includes a net capital gain in assessable income for the income year.

<sup>80</sup> Refer to section 118-20 of the ITAA 1997.

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.

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

74. An employee having a relevant share of the franked distributions<sup>81</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.<sup>82</sup>

75. 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<sup>83</sup>, unless they qualify for the small shareholder exemption.

76. Pursuant to former subsection 160APHT(1) of the ITAA 1936, the small shareholder exemption applies 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. In such cases, the taxpayer is deemed to be a qualified person in relation to those dividends.

<sup>81</sup> Within the meaning of Subdivision 207-B of the ITAA 1997.

<sup>82</sup> Division 1A of former Part IIIAA of the ITAA 1936 continues to have application by operation of paragraph 207-145(1)(a) of the ITAA 1997. See Taxation Determination TD 2007/11 *Income tax: imputation: franked distributions: qualified persons: does an entity have to be a qualified person within the meaning of Division 1A of former Part IIIAA of the Income Tax Assessment Act 1936 to avoid the application of paragraphs 207-145(1)(a) and 207-150(1)(a) of the Income Tax Assessment Act 1997 in respect of a franked distribution made directly or indirectly to the entity on or after 1 July 2002?*

<sup>83</sup> In order to be a qualified person, the employee beneficiary must be sufficiently subject to the risks of loss and opportunities for gain generally associated with the share ownership for at least 45 days. Refer to paragraphs 4.6 to 4.9 of the Explanatory Memorandum to the Tax Laws Amendment Bill (No. 2) 1999.

77. Circumstances that are relevant and likely to impact on whether an employee beneficiary of an ERT has a vested and indefeasible interest sufficient<sup>84</sup> 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>85</sup>:

- (a) 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.
- (b) 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 or otherwise dispose of the property of the trust (such as shares held by the trustee), without regard to the interests of the employee beneficiary.
- (c) 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 ERT.<sup>86</sup>
- (d) 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 ERT may have the result of diminishing the interest of existing employee beneficiaries in the ERT.<sup>87</sup>

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<sup>84</sup> This involves establishing the employee's 'net position' (former section 160APHJ of the ITAA 1936) in relation to the shares held by the trustee, worked out by netting off positive deltas (long positions) and negative deltas (short positions). In order to be a qualified person, the employee must be exposed to at least 30% of those risks and opportunities (a delta of at least 0.3). 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 will start at 0. Deltas can only be added to this starting position if the employee's interest is vested and indefeasible.

<sup>85</sup> Refer to *Re Soubra v. Federal Commissioner of Taxation* [2009] AATA 775; 2009 ATC 10-113; (2009) 77 ATR 946.

<sup>86</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>87</sup> Such interests will generally be deemed to be defeasible. Refer to former subsection 160APHL(12) of the ITAA 1936.

78. The Commissioner has a discretion to treat some interests that are not vested or indefeasible as being vested and indefeasible. In deciding whether to exercise this discretion, the Commissioner must have regard to the following circumstances in which the interest may not vest or may be defeated<sup>88</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 an 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 can affect (and if so, the likelihood of such discretions affecting) the vesting of relevant shares in the employee beneficiary, and
  - whether the ERT is generally promoted or operated on the basis that employee beneficiaries will receive cash rather than an in-specie distribution of the shares they have a relevant interest in.

79. 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 section 95 net income of the ERT.<sup>89</sup>

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

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

80. 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

<sup>88</sup> Refer to former paragraph 160APHL(14)(c) of the ITAA 1936.

<sup>89</sup> Refer to subsections 207-150(3) and 207-50(3), and subparagraph 207-35(4)(b)(i) of the ITAA 1997.

amounts of ordinary income, net capital gains and other statutory income.<sup>90</sup>

81. A gain made by the trustee on the realisation of trust assets is included in the trust's section 95 net income as a revenue gain, and therefore ordinary income if the gain is made from:

- the 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.<sup>91</sup>

#### Example 13 – trustee holds assets on revenue account

82. *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.*

83. *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*

<sup>90</sup> A trustee has an obligation 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>91</sup> Taxation Determination TD 2011/21 *Income tax: does it follow merely from the fact that an investment has been made by a trustee that any gain or loss from the investment will be on capital account for tax purposes?* and Taxation Ruling TR 92/3 *Income tax: whether profits on isolated transactions are income* provide guidance on the relevant factors to consider.

*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.*

*When is a trustee assessed on amounts of the section 95 net income?*

84. The trustee will generally be assessed under section 99A of the ITAA 1936 on amounts of the section 95 net income that are not assessable to or on behalf of a presently entitled beneficiary.

## **Date of effect**

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85. This Ruling applies to years of income commencing both before and after its date of issue. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

86. 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 Ruling and the previous Taxation Ruling TR 2014/D1 *Income tax: employee remuneration trust arrangements*. Accordingly, the Commissioner will not undertake compliance activities to apply the views expressed in this 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 Ruling.

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**Commissioner of Taxation**

31 October 2018

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## Appendix 1 – Compliance approach

**1** *This Appendix sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow the advice in this appendix in good faith and consistently with the ruling section, the Commissioner will administer the law in accordance with this approach.*

### Relatively short period

87. Throughout this Ruling, the Commissioner concludes that the characterisation of a contribution by an employer to an ERT will be deductible if the contribution is intended to be permanently and entirely dissipated by the ERT in providing remuneration within a 'relatively short period'.

88. The term is not clearly or easily defined. Specifically, whether a particular period can be considered 'relatively short' depends on the context and all of the surrounding facts and circumstances.

89. As a matter of practical administration, subject to paragraph 90 of this Ruling, the Commissioner will treat 'relatively short period' as a period of no more than five years from the date of the relevant contribution to an ERT.

90. Provided that:

- the evidence reasonably leads to the conclusion that the contribution will in fact be permanently and entirely dissipated in providing remuneration within five years from the date of the contribution, and
- the arrangement is not part of a scheme to which an anti-avoidance rule (general or specific) might reasonably apply,

the Commissioner will not apply compliance resources to further investigate whether such a period is in fact a 'relatively short period' for the purposes of applying this Ruling.

### Application of Part IVA of the ITAA 1936 to ERTs

91. Although this 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>92</sup>

<sup>92</sup> Refer to *Spotlight* at FCA [77]-[116]; ATC 4695-4703; ATR 769-778, *Yip* at AATA [73]-[134]; ATC 4300-4325; ATR 789-806, *Re Experienced Tours Pty Ltd v. Federal Commissioner of Taxation* [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.

92. Where one or more of the following factors is present in an ERT arrangement, the Commissioner will regard the arrangement as high risk and is likely to apply compliance resources to determine whether Part IVA of the ITAA 1936 should apply 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 an 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>93</sup> to an employee).

93. 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 engage with us early, or seek independent professional advice.

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<sup>93</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 finance results in no genuine economic risk as to principal or interest for either the borrower or lender.

94. The application of Part IVA of the ITAA 1936 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 does not have any of the indicia listed in paragraph 92 of this Ruling. Without considering all of the relevant information, it is not possible to state definitively whether or not Part IVA applies to a particular scheme.

## Appendix 2 – Detailed contents list

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TR 2014/D1; TR 2017/D5

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