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30 April 2014

Dear Ms Garnar

Draft Taxation Ruling TR 2014/D1

The Taxation Committee of the Business Law Section of the Law Council of Australia (**Committee**) welcomes the opportunity to comment on Draft Taxation Ruling TR 2014/D1 (**Draft Ruling**) concerning the taxation consequences for employers, trustees and employees who participate in an employee remuneration trust arrangement (**ERT**).

As an overarching comment in relation to the Draft Ruling, the Committee notes that the Draft Ruling covers a vast number of issues in relation to ERTs, many of which have been the subject of both private rulings for particular taxpayers and proceedings before the Tribunals and the Courts. To the extent that the Commissioner seeks to adopt an approach different to that in respect of which a Court or Tribunal has ruled, the Committee wishes only to note that such an approach is not open to the Commissioner.

The Committee is concerned with several aspects of the approach taken by the Commissioner in the Draft Ruling. In particular, the 85 page Draft Ruling seeks to draw together numerous regimes contained in the *Income Tax Assessment Act 1997* (**1997 Act**), the *Income Tax Act 1936* (**1936 Act**) and the *Fringe Benefits Tax Assessment Act 1986* (**FBTAA**). Some of these regimes, most notably Division 7A and Division 6 of the 1936 Act, represent intricate and complex areas of taxation law which are themselves subject to ongoing review and simplification. The intersection of these regimes with the diverse array of ERT arrangements that are present in the market needs to be very carefully thought through.

The Committee has not sought to comment on the specific examples contained in the Draft Ruling, but has highlighted three areas of particular concern which impact a number of parts of the Draft Ruling. These are:

- The deductibility of contributions to an ERT.

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- The “recharacterisation” of capital gains forming part of the net income of a trust estate as employment income.
- The interaction of the Draft Ruling with Division 83A of the 1997 Act.

Each of these issues is discussed in further detail below.

1 Deductibility of contributions to an ERT

1.1 The Commissioner states that a contribution will meet the statutory tests for deductibility where:

(a) an employer carries on a business of gaining and producing assessable income and engages employees in the ordinary course of carrying on that business;

(b) an employer makes a contribution to an ERT; and

(c) at the time the contribution is made the primary purpose of the contribution is for it to be applied within a relatively short period of time to the direct remuneration of employees.

1.2 The Committee agrees that in these circumstances a deduction would be available for the contribution given that the payment would appear to be made directly in connection with the employee's employment. The Committee notes, however, that such an arrangement would be extremely unusual in a commercial environment given that the employer could simply pay the sum directly to the employee without utilising the ERT.

1.3 The Draft Ruling goes on to state that a contribution by an employer to the trustee of an ERT is considered to be capital or of a capital nature where the contribution is made for the purpose of securing a capital advantage by way of:

(a) establishing or forming part of a fund which is applied to make loans or otherwise provide finance to employees; or

(b) being ultimately and in substance applied by the trustee to acquire shares in the employer.[1]

1.4 In the Committee's opinion, it is the establishment of a fund such as the one described which is the arrangement most commonly utilised, because the purpose of the employer in establishing such a fund is to enable employees to participate in the success of the company, reflected ultimately in the increase in value of the company’s shares. In the Committee's opinion, when determining whether there is a capital purpose to expenditure, one considers the purpose of the expenditure from the position of the payer, not the recipient.

1.5 Where a payment by an employer is made in the form of a contribution to an ERT for the purpose of incentivising staff, the issues around the correct characterisation of such contributions are settled by the Courts. The decision of the House of Lords in *British Insulated and Helsby Cables, Limited* v *Atherton* [1926] AC 205 (**Atherton**) is generally considered to be the starting point for any consideration of the issue as to the deductibility of payments made to employee benefit trusts. In *Atherton* the taxpayer

[1] Paragraphs 14, 15 and 18 of the Draft Ruling.

established a pension fund for its salaried employees who, with the taxpayer, were expected to contribute to the fund. The dispute in *Atherton* related to the deductibility of the substantial lump sum payment made by the taxpayer, which formed the nucleus of the fund and provided the amount necessary to enable past years of service of senior staff to rank for pension. The payment was made out of current year's profits and was calculated on the basis that the sum would ultimately be exhausted when the object for which it was paid was attained.

1.6 The House of Lords was divided on the deductibility of the payment for income tax purposes. Viscount Cave LC (at 213-214) regarded the payment as one which was made, "not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade" and therefore considered that "in the absence of special circumstances leading to an opposite conclusion" there was very good reason for treating the expenditure as properly attributable to capital.

1.7 However, subsequent cases held that the decision in *Atherton* was limited to situations where there were one off payments being considered and such cases have held that payments by an employer to establish a fund for the benefit of employees are generally payments on revenue account. In explaining his approach to that issue Lord Denning MR, in *Heather* v *P-E Consulting Group Ltd.* [1973] Ch 189 at 217 (**Heather**), referred to Viscount Cave in *Atherton* and stated:

> *It seems to me that the purpose of these payments was to provide an incentive for the staff, to make them more contented and ready to remain in the service of the taxpayer company, and also to help in the recruitment of new staff. They were annual payments too; all of which made them more like the annual payments in Atherton's case than the nucleus fund. They were like the taxpayer company's contribution to a cash profit-sharing scheme and to the pension fund. They were all regarded by the taxpayer company as rewards to staff for the profits they had helped to make.'*

1.8 In holding that the payments to the fund established to buy shares for the benefit of employees were deductible, Buckley LJ in *Heather* described one of the objectives of the incentive scheme as:

> *.... intimately connected with the day-to- day operation of the taxpayer company's business; for the goodwill of the staff was something which might change or fluctuate from day to day. The advantage to be obtained by giving the staff an incentive to greater effort is one which would depend upon the state of the taxpayer company's business from time to time and the state of the employer/employee relation between the taxpayer company and its employees from time to time. It was also an objective directly related to the profitability of the taxpayer company's business from time to time.'*

1.9 The decision in *Heather* was affirmed in *Jeffs (HM Inspector of Taxes) v Ringtons Limited* [1995] BTC 585 where a company's contributions to a trust fund for the benefit of its employees was held to be wholly and exclusively incurred for the purposes of the company's trade. The company's intention in making the payments was to provide for its employees. The payments were not "once and for all" payments, the company did not acquire an asset and nor was there any enduring advantage of a capital nature.

1.10 In the Draft Ruling, not one of these cases directly on point in relation to employee share funds is cited. In the Committee's view, the Draft Ruling fails to recognise that the Courts have consistently identified a nexus between a contribution to a fund for the benefit of a Company's employees and the derivation of income. Further, it is only in those circumstances such as *Atherton* where the Court identified an enduring benefit as arising that the contribution will be prohibited from deductibility on the basis that the expense was of a capital nature.

1.11 Further, in Australia, more recently, there have been a number of cases where the Courts have applied Part IVA, the general anti avoidance provision, to deny a deduction for payments made by employers as contributions to employee benefit funds. In those cases the Courts consistently determined that absent a finding in relation to Part IVA, the contributions were deductible. Examples of such cases are *Pridecraft Pty Limited and Spotlight Stores Pty Limited, Cameron Brae* and *Walstern*.

1.12 The most recent of these, *Spotlight*, considered the capital / revenue issue which arose in *Atherton* and formed the view that, subject to Part IVA, ongoing payments to an employee incentive trust did satisfy the test for deductibility. The Commissioner contended Spotlight's contribution to the incentive trust was of a capital nature and therefore not be deductible under section 51(1) of the Act for reasons not dissimilar to those contained in this Draft Ruling. Merkel J made reference to oft cited passages regarding the income capital distinction and placed particular emphasis on the character of the advantage sought by Spotlight in making the contribution to the Incentive Trust. Merkel J at paragraphs 54-55 stated that:

> *'The manner in which the advantage was to be used and enjoyed was the maintenance, from year to year, of Spotlight's employees' trust and confidence in the Post 1997 Scheme (Plan) thereby improving Spotlight's annual profitability. Thus, the advantage, being sought from year to year was recurrent...In so far as the contribution was concerned, the means adopted to obtain the advantage was the prepayment of the bonuses expected to become payable (by payment or being part of the employee's reserves)...The advantage was secured from year to year by part of the contribution being applied towards annual bonuses, with further contributions being required when the bonuses paid exceeded the initial contribution.*

1.13 Merkel J considered the decision of Lord Denning MR in *Heather* and could see no reason why the contribution of the $15 million to the Incentive Trust was not deductible on the basis that the contribution was akin to those contributions. Merkel J distinguished the decision in *Atherton* on the basis that Spotlight's contribution to the Incentive Trust was not a contribution to provide a nucleus of the fund.

1.14 Spotlight appealed the finding in relation to Part IVA and the Commissioner cross appealed on the issue of the deductibility of the contribution. The Full High Court held that the primary Judge correctly concluded that in relation to the contribution of $15 million by Spotlight, a deduction was available. Further, it was held that the primary Judge's rejection of the Commissioner's contention that the contribution was of capital or of a capital nature was correct.

1.15 In paragraphs 177 to 180 of the Draft Ruling, the Commissioner provides his views on what is meant by the concept of "application within a relatively short period of time", as a criterion in determining whether the payment is of a capital or revenue nature. These views are based on what is a very narrow reading of the decisions in Spotlight and *Pridecraft Pty Ltd v Federal Commissioner of Taxation*[2] (**Pridecraft**). The Commissioner relies on the fact that in those cases the employer intended from the outset that the contribution be applied by the trustee of the ERT to provide for bonuses for employees over a five year period. On this basis, the Commissioner notes at paragraph 178 of the Draft Ruling:

[2] [2004] FCAFC 339; 2005 ATC 4001; (2004) 58 ATR 210.

The Commissioner will generally accept a relatively short period of time for the trustee of an ERT to diminish a contribution for the direct provision of remuneration to employees to be up to five years from the date the contribution was made by an employer to the trustee of an ERT.

1.16 And at paragraph 179:

> *However, one may question whether an employer has a primary purpose of providing remuneration to employees if the contribution is first intended to be accumulated for a longer period of time (for example, in excess of a five year period) before such remuneration is paid.*

1.17 The test for determining the character of an item of expenditure is correctly identified by the Commissioner[3] as that articulated by Dixon J in *Sun Newspapers Ltd and Associated Newspapers Ltd v Federal Commissioner of Taxation*[4]. In applying the test in Sun Newspapers, Merkel J held in Spotlight (affirmed by the Full Court in Pridecraft) that[5]:

> *From a practical and business point of view the criteria stated by Dixon J in Sun Newspapers Limited v FC of T … point to the $15 million contribution being on revenue, rather than capital, account. The contribution was made as part of the restructuring of Spotlight's annual employee bonus scheme by implementing the Post-1997 Scheme as form 1 July 1997. The advantage sought by the contribution was securing the prepayment of bonuses so as to obtain the trust and confidence of Spotlight's employees from year to year in the Post-1997 Scheme, which was expected to yield improved staff retention rates, lower staff turnover and improved staff morale, efficiency, productivity and loyalty. The incentive given to staff by the Post-1997 Scheme was expected to result in the enhancement of Spotlight's profit for each year in which the scheme operated. That advantage did not have a lasting quality as it could only be expected to be enjoyed during each annual period in which the Post-1997 Scheme operated. That is consistent with the fact that the trust fund established by the contribution was to be diminished as each year's bonuses were paid in return for the advantage secured in respect of the year for which the bonuses were paid.*

1.18 As can be noted from the above passage, Merkel J's analysis of the character of the outgoing focused on, correctly, the purpose of the employer and the advantage sought by the contribution in question. The fact that the contributions were to be diminished over a five year period was held to be consistent with the maintenance of Spotlight's employees' trust and confidence (and therefore an improvement in annual profitability) but not determinative of the overall character of the contribution.

1.19 The Committee is concerned that the Commissioner is taking an overly narrow interpretation of the decisions in Spotlight and Pridecraft and, in determining the character of the contribution, is placing too much emphasis on the period of time over which the contributions are to be diminished. The inference to be drawn from the Commissioner's comments in paragraphs 198 to 202 of the Draft Ruling is that in circumstances where the contributions are to be applied to employees other than over a "short period of time", then the nature of the advantage sought by the employer is necessarily that of a "capital structure advantage".

1.20 That narrow proposition is not consistent with the authority in this area, and that authority binds the Commissioner.

[3] Paragraph 184 of the Draft Ruling.
[4] (1938) 61 CLR 337; [1938] HCA 73.
[5] at paragraph [53].

1.21 The Commissioner cannot be seen to be administering taxation laws, including section 8(1) of the 1997 Act, in a way known to be contrary to how the courts have declared the meaning of the relevant statute. The Committee is concerned that the overly-prescriptive approach of the Commissioner to the determination of the character of a contribution to an ERT may be seen as contrary to how the courts have generally approached the issue across a range of cases, each of which involved a different set of facts and circumstances.

2 Recharacterisation of capital gains

2.1 The terms of the Draft Ruling impact a number of specific taxation regimes, possibly the most significant of all being Division 6 of the 1936 Act which deals with the taxation of trusts.

2.2 Part C of the Draft Ruling deals with the consequences for an employee in respect of "benefits provided to an employee via the operation of an ERT". It is stated at paragraph 260 of the Draft Ruling that these benefits may include any or all of:

(a) the payment of a contribution amount to the Trustee of an ERT (on behalf of, for the benefit of or at the direction of, the employee);

(b) non arms' length finance provided by the Trustee;

(c) an annual entitlement to income of the Trust estate; or

(d) an interest in the capital of the Trust estate.

2.3 The underlying premise of Part C is that where an ERT has been established, any amount which the employee receives from the ERT is remuneration for services which the employee provides under his or her contract of employment with the employer.

2.4 The Committee submits that this is clearly not the case. Where the Trustee of the ERT receives an amount from an employer, whether by way of cash contribution or by loan, and the Trustee uses that money to invest in assets, whether these are shares in the employing entity, shares in another entity or some other asset (income producing or otherwise), distributions made by the Trustee of the ERT to the beneficiaries have no connection to the services provided by the employee to the employer at the time the distribution by the ERT is made.

2.5 The connection between the Trustee and the employer arises at the time the contribution is made to the Trust. That connection, or nexus, ensures that the contribution is deductible. However, unless that contribution is essentially paid to the Trustee of the ERT as a bare trustee or nominee for the employees so that there is a direct connection between the contribution and the subsequent distribution, it is submitted that the distributions cannot be characterised in the hands of a beneficiary as income from employment. Once the Trustee of the ERT invests the contribution and acquires shares or other assets, distributions from the ERT of either income or capital lack any nexus with the provision of services by the employee to the employer. To suggest otherwise is to disregard the different parties involved and the legal nature of the arrangements.

2.6 The Draft Ruling cites the decision in *FCT v Dixon* (1952) 86 CLR 540 as support for the proposition that, essentially, any benefit provided by an employer to an ERT to satisfy an employee's entitlement to receive money for the performance of services as being income from employment. The Committee submits that the decision in *Dixon* does not assist the Commissioner here. That case concerned an amount paid by an employer to an employee who had enlisted to serve in the War, to ensure that the enlisted man would receive the same amount he would have received from his employment for the period he was at war. In fact the Court held in *Dixon* that a payment can be made in respect of past, present or future employment and in those circumstances it would be assessable to the employee.

2.7 In relation to payments received under an ERT, the distribution from the ERT is not made by reference to any services provided by the employee – those have already been remunerated through ordinary salary or wages or bonuses. Rather the distribution from the ERT is referrable solely to the existence of income or capital in the ERT arising as a result of an investment.

2.8 Paragraph 268 of the Draft Ruling also seeks to rely on the decision in *Murdoch v Commissioner of Payroll Tax (Vic)* (1980) 143 CLR 629 as further support for the proposition that all trust distributions from trusts to people who are employees will be treated as income from employment. *Murdoch* is not authority for that proposition. In that case the Court, by a majority, held that to determine whether a payment was made to an employee in that capacity, the key features to consider in relation to the payments are their source and their destination. In *Murdoch* the payments were made by the employer, they came from the net profits of the business, and they were made only to persons who were employees for the time being of that business. The Court held on that basis that the payments were "wages" paid to "employees as such", and the Commissioner was correct in assessing them to pay-roll tax.

2.9 In the common example of an ERT, the payments are not made by an employer, their source is not the net profit of the business (but rather the net income of the ERT), and they are not payments made to the employees in their capacity as employees.

2.10 Accordingly, it is the Committee's submission that the analysis in the Draft Ruling in relation to the characterisation of the distributions from the ERT to an employee beneficiary is in error, and the character of the distribution will be determined by the proper application of the trust provisions contained in Division 6 of the Act as to whether the distribution includes a distribution of income or capital.

2.11 Further, the Committee submits that the error in the analysis is the premise that the income is assessable both as employment income and as trust income, and the conclusion is that with the exception of amounts which are capital gains the trust assessing provisions will prevail. It is submitted that there is no competition between the two regimes, because the distributions payable by the ERT do not constitute employee income at all and are not taxable under section 6 -5.

3 Interaction between the Draft Ruling and Division 83A (formerly Division 13A) arrangements

3.1 Paragraph 5 of the Draft Ruling provides that the ruling:

> *… does not deal with circumstances in which a contribution to, or benefits received from, an ERT may be statutory income under … Division 83A of the ITAA 1997 and former Division 13A of Part III of the ITAA 1936*

3.2 The apparent intent of this statement would be to seemingly exclude arrangements that fall within Division 83A-C of the 1997 Act (and its predecessor) from the scope of the Draft Ruling. The Committee believes that such a position is entirely correct and appropriate on the basis that Division 83A (and its predecessor) provides a comprehensive and stand-alone regime for the taxation of employee share scheme interests. Importantly, there already exists specific provisions governing the interaction of Division 83A with some of the other taxing regimes that are discussed in the Draft Ruling, for example, Division 7A and fringe benefits tax.

3.3 However, the Committee believes that if it is the Commissioner's intent that such Division 83A arrangements are to be excluded from the scope of the Draft Ruling, then that intent must be expressed in a more clear and unequivocal manner.

3.4 To further highlight the potential confusion as to the overlap (if any) between the Draft Ruling and Division 83A (and its predecessor), the Committee makes the following observations:

- The Commissioner's fact sheet on employee remuneration trusts and tax specifically <u>excludes</u> from the definition of an "ERT":

  > *complying employee share schemes, which are covered by former Division 13A of the Income Tax Assessment Act 1936 (ITAA 1936) or Division 83A of the Income Tax Assessment Act 1997*

- Somewhat confusingly, in the Draft Ruling the Commissioner notes the following with regard to what will be considered a relatively short period of time in the context of applying a contribution for the purposes of obtaining a deduction[6]:

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

3.5 If the intention is to carve out arrangements to which Division 83A applies, then there seems little utility in including a statement in the ruling which deals with the circumstances in which the Commissioner will consider contributions made to an employee share trust used to hold or acquire interests to which Division 83A applies to be deductible. If this is the case then the references to Subdivision 83A-C interests in paragraph 178 of the Draft Ruling should be removed. It is noted that the reference to Division 83A in paragraphs 5 and 178 are the only references to Division 83A in the Draft Ruling.

3.6 The Committee respectfully suggests that the Draft Ruling should contain a clear statement excluding Division 83A arrangements from the scope of the ruling, including to the extent that such arrangements include the use of an "employee share trust" (as that term is defined in Subdivision 130-D of the 1997 Act). It is noted that such a statement does not preclude the application of some of principles applied by the Commissioner in the Draft Ruling to Division 83A arrangements where appropriate.

3.7 If our recommendation to explicitly carve out Division 83A arrangements from the scope of the Draft Ruling is not accepted, then the Draft Ruling should include one or more examples that demonstrate Division 83A arrangements are not impacted.

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[6] Paragraph 178 of the Draft Ruling.

If you have any questions, in the first instance please contact the Committee Chair, Mark Friezer, on (02) 9353 4129 or via email: mfriezer@claytonutz.com.

Yours sincerely,

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