



THE TAX INSTITUTE

25 October 2019

Ms Lauren Pamenter
Australian Taxation Office
GPO Box 9990
MELBOURNE VIC 3001

By email: Lauren.Pamenter@ato.gov.au

Dear Ms Pamenter,

Draft Taxation Determination - Income Tax: what is an 'employee share trust'?

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the *Draft Taxation Determination - Income Tax: what is an 'employee share trust'?* (**Draft TD**).

Summary

Our submission below addresses our main concerns in relation to the Draft TD. In particular, we consider that, should the ATO not change the view held in the Draft TD, then a legislative change will be necessary.

Discussion

Our main concerns with the Draft TD relate to the concept of activities that are 'merely incidental' to the activities of obtaining share or rights in a company and ensuring that employee share scheme (ESS) interests in the company that are beneficial interests in those shares or rights are provided under the ESS to employees or their associates.

Institute members have been involved in extensive consultation with the ATO on the matter of "...waiving or relinquishing...the right to be paid or credited dividends pursuant to a dividend waiver clause contained in the governing trust documents..."¹ over recent years. This aspect of the Draft TD is of most concern as it is our members' experience that many purported share trusts have such arrangements in place.

If the ATO position remains unchanged, we expect that the law would need to be amended to ensure that what has been a commonplace arrangement adopted in Australia and overseas for the provision of employee shares and rights through a trust does not cause the trust to fail to qualify as an 'employee share trust' (**EST**).

¹ Included in the Draft TD's examples of activities that are not merely incidental - refer paragraph 12

Although we support the provision of guidance on the interpretation of subsection 130-85(4) of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**), if taxpayers are to rely on this guidance, we recommend that the foundations and basis for ruling that certain listed activities at paragraphs 11 and 12 of the Draft TD are considered to be / not to be 'merely incidental' **should be individually explained with the inclusion of detailed and sound reasoning supporting the positions taken**. As currently drafted, there is little technical reasoning as to why certain activities are acceptable and others are not.

In our opinion, other aspects of the Draft TD that are of concern include:

- **Consequences of failing to meet the qualifying requirements** - rather than accepting a trust being able to regain its status as an EST once it fails to meet any of the qualifying requirements, the Draft TD takes the view that the trust can no longer qualify for the duration of the Employee Share Scheme (**ESS**). Further elaboration of this point is required. We also recommend that a more practical approach be adopted such that the eligibility requirements for an EST be tested at or around the time that taxpayers wish to rely on a trust being an EST so as to not risk losing status as an EST once and for all after a particular breach (which in some cases may be quite minor or trivial) has occurred;
- **Compliance approach** - we appreciate the inclusion of a compliance approach (Appendix 2 of the Draft TD) if the ATO view does not change, however we submit that an increased transitional period (extended to say 1 January 2021) should be provided to allow taxpayers sufficient time to attend to any necessary changes to their current arrangements. Furthermore, the Draft TD should state that the waiver of a dividend in a prior period will not impact a trust being considered an EST in the future so long as there is no dividend waiver after the transitional date. An interpretation that the status of a trust as an EST at or around the time that taxpayers wish to rely on a trust being an EST would facilitate this approach.
- **Private rulings assumption** - the proposed assumption (paragraph 36) that a trust deed "...power will be exercised..." should be removed as it is not a practical outcome. In the event that a private ruling was made on an assumption as to the future that transpires to be not correct, the private ruling fails to apply by operation of the law, and there is no reason why a private ruling cannot be made based on applicable taxpayer statements of intent as to future activity that is outlined in the application for private ruling.

Our more detailed comments and recommendations are in the attached Appendix.

Final comments

The ATO's approach adopts an overly narrow construction of paragraph 130- 85(4)(a) which defeats the intention of the legislature and negates the evident policy and purpose of the relevant substantive provisions that adopt the definition of an employee share trust.

Should the ATO finalise its views based on those expressed in the Draft TD, taxpayers will need to carefully consider and manage any adverse commercial impacts. Based on the underlying policy objectives in the area, we would expect that a legislative change would be necessary to specifically allow for the waiver of

dividends on unallocated shares held by employee share trusts in appropriate circumstances to be acceptable in gaining status as an EST.

If you would like to discuss any of the above, please contact either myself or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours faithfully,

A handwritten signature in black ink, appearing to read "Tim Neilson". The signature is written in a cursive, flowing style.

Tim Neilson
President

Appendix - Detailed Comments

Waiver of dividends on unallocated shares held by employee share trusts

Dividend waivers are not a new concept. They are referenced in companies' Constitutions and the disclosure of dividend waivers is specifically regulated under the UK, Ireland and Hong Kong stock exchange listing rules. In fact, a majority of UK listed companies use dividend waivers on unallocated shares in an EST.

The genuine commercial rationale for dividend waivers is to prevent the unnecessary build-up of cash and after-tax profits in an EST where unallocated shares are held in the EST. The only rationale to make the EST more commercially efficient and to enable the trustee to administer and operate the EST without retaining funds which cannot be returned to the employer company or paid to participating employees without a risk of otherwise failing the sole activities test in subsection 130-85(4).

In relation to the sole activities test in subsection 130-85(4), although we support the view that the mere existence of a power or duty in a trust document does not mean that a trustee has breached the requirement to be an EST, we disagree with the ATO's preliminary view that a waiver or relinquishment of a dividend entitlement causes the trustee to fail the EST test. In particular, we recommend that further explanation and analysis be provided in relation to the following key aspects:

- Why the agreement of a trustee of an EST to waive dividends on unallocated shares is an 'activity' for the purposes of subsection 130-85(4);
- Reasons why the waiver of dividends on unallocated shares is considered to be 'not merely incidental' to the EST obtaining, holding and providing shares or rights under an ESS in the context of the commercial rationale for waiving dividends in an EST; and
- The history, purpose, policy and context of the relevant provisions, to provide further support for the legislative interpretations being adopted.

Is an agreement of a trustee to waive dividends an 'activity'?

The Draft TD contemplates (at paragraph 30) that agreeing to act in a certain way, and acting in that way, is sufficient to constitute an 'activity' for the purposes of subsection 130-85(4). However, it also indicates that not acting, or abstaining from acting, will not cause a breach of subsection 130-85(4), for example not exercising a right to vote or not participating in a rights issue (paragraph 29).

The Macquarie dictionary defines "activities" to mean "the state of action: doing" and defines action to mean "the process or state of acting or of being active." Arguably where the terms of the trust include a dividend waiver clause, the agreement of the trustee of an EST to waive dividends on unallocated shares is not an "activity" for the purposes of subsection 130-85(4) because:

- The mere entering into an agreement is not itself an activity;
- The agreement to waive a dividend is an agreement not to receive a dividend and an agreement to not do something is not an activity for the purposes of subsection 130-85(4); and

- In the context of employee share schemes, something more is required to constitute an activity. Given that the trustee of an EST may enter into a number of agreements during the course of operating and administering an EST, such an approach would reduce the risk of many ESTs inadvertently failing the sole activities test.

The Draft TD should also distinguish between the outcomes on the non-exercise of a dividend right and the non-exercise of voting rights in relation to unallocated shares held by the trust.

In the alternative, if an agreement of the trustee of an EST to waive dividends on unallocated shares is an “activity” for the purposes of subsection 130-85(4), it is submitted that the activity is part of “obtaining shares in a company” within the meaning of paragraph 135-85(4)(a). This conclusion would follow because:

- The Trust Deed of an EST sets out the circumstances in which shares may be obtained by the Trustee of an EST;
- The Trust Deed authorises the trustee of an EST to agree to waive dividends on unallocated shares while they are unallocated following a request from the employer company;
- Subscribing for shares in a company involves agreeing the terms of those shares (i.e. dividend, voting and capital rights);
- An agreement to waive dividends simply suspends the right to receive dividends while the shares are unallocated shares held by the EST and is part of the process of agreeing the terms of those shares, obtaining the shares and becoming a shareholder under the terms of Trust Deed;
- Such an approach would promote and not defeat the purpose and objects of the substantive provisions which adopt the definition of an EST and would not give rise to inappropriate outcomes; and
- Given that the trustee of an EST may agree to a number of corporate actions involving shares (e.g. participating in a Scheme of Arrangement, rights issue, share buy-back, dividend reinvestment plan), such an approach would reduce the risk of many ESTs inadvertently failing the sole activities test.

Is a waiver of dividends on unallocated shares ‘merely incidental’?

In the alternative, if the agreement of the trustee of an EST to waive dividends on unallocated shares is an “activity” for the purposes of subsection 130-85(4), it is argued that it is an activity that is merely incidental to those described in paragraphs 130-85(4)(a) and (b).

The phrase “merely incidental” is said to take its ordinary meaning, with further guidance drawn from the context and purpose of the legislation in which it appears. The Draft TD takes the view (paragraph 9) that as the EST rules are concessional in nature “...the restriction of those concessions to employee share trusts is an integrity measure and ensures that the concessions are only available to a specific subset of trusts that meet the statutory definition of an employee share trust. As such, the definition is not intended to be construed broadly.”

We disagree with that basis of interpretation and submit that subsection 130-85(4) is a “definition provision” referenced by section 995-1 to the meaning of an “employee share trust”. The purposes of the relevant substantive provisions which use the definition of “employee share trust” in subsection 130-85(4) are:

- The purpose of the definition of “fringe benefit” in subsection 136(1) of the *Fringe Benefits Tax Assessment Act 1986* (Cth) is to provide an FBT exemption for employer companies where contributions are made to an EST to ensure there is *no double taxation*;
- The purpose of section 130-90 is to provide a CGT exemption for Trustees of an EST when shares are transferred to employees and either CGT Events E5 or E7 occurs to ensure that there is *no double taxation*; and
- The purpose of subsection 130-185(2) is to provide deemed absolute entitlement of beneficiaries of an EST to ensure that an employee who acquired an ESS interest under an EST will be *taxed consistently* with an employee who directly acquired legal title to the relevant share or right.

In this context, we refer to *Burt v FCT*² and *Bull v Attorney General*³ as authority for the proposition that an exemption provision should be construed widely so as to give the fullest relief which the language allows.

At paragraph 10 of the Draft TD, the ATO notes that “Activities are merely incidental under paragraph 130-85(4)(c) if they are a natural incident or consequence of the trust obtaining, holding and providing shares or rights under an ESS...”

It is our view that in the context of an employee share scheme, the agreement of the trustee of an EST to waive dividends on unallocated shares furthers the obtaining of shares and happens in subordinate conjunction with obtaining shares and therefore is another activity that is merely incidental to obtaining shares within the meaning of paragraph 135-85(4)(c). This conclusion follows because:

- The primary activity is the obtaining of shares;
- It is clear that an incident of holding ordinary shares is the right to vote, and participate in dividends or capital;
- A subordinate activity is the agreement to waive dividends attributable to the shares;
- The Trust Deed of an EST sets out the circumstances in which both the shares may be obtained and dividends waived by the trustee of an EST;
- For the trustee, its undertaking in the Trust Deed to waive dividends on unallocated shares is connected with its obtaining of shares and becoming a shareholder under the Trust Deed;
- A dividend waiver occurs in subordinate conjunction with the obtaining of shares because in the context of an employee share scheme, there is a genuine commercial motivation to *prevent the unnecessary build-up of cash and after tax profits in an EST* where unallocated shares arise in the EST (see also comments below);
- It is not a primary activity for the trust to build up cash or investments other than the applicable shares; and
- As a matter of degree, a dividend waiver is casual and minor and does no more than further the activity of obtaining and distributing shares to employees.

² (1912) 15 CLR 469

³ (1913) 19 CLR 370

Examples of activities

Paragraphs 11 and 12 of the Draft TD provides a list of activities that are merely incidental (refer paragraph 11) and not merely incidental (refer paragraph 12) without any detailed reasoning or explanation in relation to the basis of the classifications adopted. As previously stated, for clarity and understanding, the basis for each of these classifications should be supported by detailed and sound reasoning.

For example, it would be useful to better understand when the operation of a bank account to facilitate the receipt and payment of money and the receipt of interest from bank accounts may become more than 'merely incidental' in light of the view that investing in assets other than shares or rights to shares in the employer company is not considered merely incidental. This distinction may become important especially should cash reserves now increase as a result of the adverse taxation implications associated with the waiving of dividend rights and also noting that the distribution of 'mainly cash payments to participating employees' is not considered merely incidental. For example, would investing surplus cash in a term deposit be considered not to be merely incidental? Example 1 shows the receipt of dividends on unallocated shares but fails to address the investment of those dividends in the period prior to being distributed to an employee at the end of the vesting period.

The Draft TD should also consider the receipt of bonus shares and the trustee either exercising or failing to exercise a right to take up bonus shares in lieu of dividends.

Further, the Draft TD should deal with the situation where the trustee of a trust waives its rights to participate in a rights issue or where the trust is directed or required to exercise its rights to participate in a rights issue in a particular manner.

We note that 'dealing with shares forfeited under an ESS' is stated as an example of a 'merely incidental' activity. However, such dealings may generate surplus cash unless the shares are transferred to another trust for no consideration, and practically would shares be sold only for purposes of obtaining funds to obtain more shares in the employer company? It would be useful to clarify the position and provide additional commentary on the various types of acceptable (or non) incidental 'dealings' with forfeited shares.

In recently withdrawn ATO ID 2010/108, the payment or transfer of trust income and property to a default beneficiary on the winding up of the trust was specifically listed as an eligible incidental activity, whereas this has failed to be mentioned in the Draft TD. The ATO's position on this should be made clear as it is not uncommon for trust deeds to specify such default beneficiaries, including charities.

Consequences of failing to meet the requirements of an EST

According to paragraph 5 of the Draft TD, "...it is the activities of the trustee in relation to *a particular trust* that must be tested" in the context of meeting the requirements of subsection 130-85(4).

However paragraph 13 of the Draft TD then goes on to say that "Once the trust fails to meet the requirements of an employee share trust...it will no longer be an employee share trust for the *duration of the ESS*. That is, the trust cannot regain its status as an employee share trust *for that ESS*."

Although paragraph 5 suggests that it is any failure of the EST to comply that is critical, presumably based on paragraph 13, once a *particular* ESS in the 'offending EST' comes to an end, a new ESS can commence in the existing trust without necessarily being tainted by the prior activities of that trust. Further clarification around this point is necessary so that affected taxpayers can have certainty of the need to set up any new ESS activity in a new trust or not.

In any event, it is submitted that the eligibility requirements for an EST should be tested when required, and any relevant tax concessions only excluded in relation to a non-qualifying period. This would provide a more practical approach against which taxpayers could assess their compliance and not risk losing status as an EST once and for all after a relevant breach has occurred.

It is further submitted that a de minimis approach should be adopted by the Commissioner to avoid taxpayers being penalised for minor, unintentional breaches or in relation to historical events and improve the practical application of the rules. We note that section 130-85(4) refers to a trust the activities of which "are" relevantly confined, not the activities of which are and always have been so confined. That should, it is submitted, enable an interpretation which at least does not permanently disqualify a trust by reference to infrequent minor past breaches. (In any event it is submitted that the provisions could be administered that way pursuant to the power of general administration under section 8 of the Income Tax Assessment Act 1936 (Cth)).

If the ATO view does not change, it should be made clear that if an EST has only participated in a dividend waiver prior to the effective commencement of the TD that the ATO will continue to treat the Trust as an EST going forward, subject to no further waivers being done. This will give taxpayers comfort that such trusts can continue to be used, provided no further waivers are done.

Compliance approach

We appreciate the inclusion of a compliance approach, although we submit that an increased transitional period (extended to say 1 January 2021) should be provided to allow taxpayers sufficient time to attend to any necessary changes to their current arrangements. This may include multiple documentation changes, obtaining updated legal, taxation and accounting advice and communications with relevant employees and other stakeholders where required.

Private rulings assumption

We are concerned by the statement that in considering any private or class ruling, the Commissioner will make an assumption that if the applicable trust deed confers the existence of a power to the trustee that the most appropriate assumption in making the ruling will generally be that that power will be exercised (paragraph 36).

We are aware that there are current applications for rulings to be made by the Commissioner in relation to existing trusts set up for ESS purposes which have dividend waiver clauses in the applicable trust deed. It is inappropriate for the Commissioner to fail to positively rule on those arrangements where having regard to

the current view of the Commissioner in the Draft TD, that the applicant intends they would not exercise such a power given the adverse consequences.

The Draft TD is clear in its statements that it is the actual activity or actions that causes a breach, not just the fact that there is a clause in the trust deed might provide the trustee with a power to waive its right to be paid a dividend (paragraph 29) .

In fact, paragraph 29 of the draft indicates that “not acting, or abstaining from acting, will not cause a breach of subsection 130-85(4)”. Accordingly, it would seem inappropriate for the ATO to disregard a statement of intention by the trustees of a trust that it will not waive any dividend entitlement in spite of the existence of a clause in the trust deed in any application for a private ruling or class ruling, i.e. the Commissioner should not assume that such a statement is not a realistic outcome. The practical and technical reality is that in the event that a statement of intention to not exercise the applicable power is in fact not followed in the future, any ruling made based on the statement would not be binding. There seems to be no reason whatsoever for making the comments in paragraph 26 of the Draft TD.

It would appear quite restrictive, and impractical, to only allow a particular trust to obtain a ruling where the deed did not include any such dividend waiver clause, particularly where the compliance approach in Appendix 2 would otherwise allow such deeds to meet the EST definition provided that there is no longer any further waivers.