GRG Remuneration Insight 58

ATO Attacks LTI Tax Fiddles

Denis Godfrey | March 2014

INTRODUCTION

In draft Tax Ruling 2014/D1 the Australian Taxation Office announced its attack on certain types of tax fiddles that were becoming widespread. The draft is open to public comment until 18 April 2014.

The focus of the ruling seems to be on schemes that were designed to gain taxation advantages. In particular reference is made to "a large body of private rulings" where the new draft ruling is adopting a different (less generous) interpretation of the law for various arrangements. Several firms have been promoting schemes and obtaining tax rulings that confer advantages that are not consistent with either the specific provisions of the taxation laws or the clear intent of such provisions. Although not limited to unit trust arrangements it is clear that the new draft ruling has unit trusts in its sights.

When finalised the new ruling will apply:

a) to contributions made on or after 5 March 2014 to employee remuneration trusts (ERTs) that are subject to binding private tax rulings, and

b) retrospectively for all other ERT arrangements.

USE OF TRUSTS IN RELATION TO LTI PLANS

The draft tax ruling refers to employee remuneration trusts (ERTs) which covers a wide range of trusts used in relation to remuneration arrangements. One type of ERT is an employee share trust (EST) which is narrowly defined as discussed below.

There are two main uses of ESTs in relation to long term incentive (LTI) plans including:

a) acquisition of shares via on-market purchases or subscriptions to new issues when share rights (includes entitlements called options as well as rights) vest – subscriptions to new issues are mainly used so as to preserve cash for the company and because shares are only acquired in relation to vested rights, administration may be minimised, and

b) accumulation of shares via on-market purchases over the measurement period so that shares are available to be provided when rights vest – mainly used when dilution needs to be avoided, funds are available for on-market purchases and averaging of the cost to the company of the shares is seen as warranting the extra administration involved.

An EST is specifically defined in sub-section (4) of s130.85 of the Income Tax Assessment ACT 1997 in relation to employee share schemes (ESS) as:

"*An employee share trust , for an employee share scheme, is a trust whose sole activities are:*

a) obtaining shares or rights in a company; and

b) ensuring that ESS interests in the company that are beneficial interests in those shares or rights are provided under the employee share scheme to employees, or to associates of employees, of:

i. the company; or

ii. a subsidiary of the company; and

c) *other activities that are merely incidental to the activities mentioned in paragraphs (a) and (b).*"

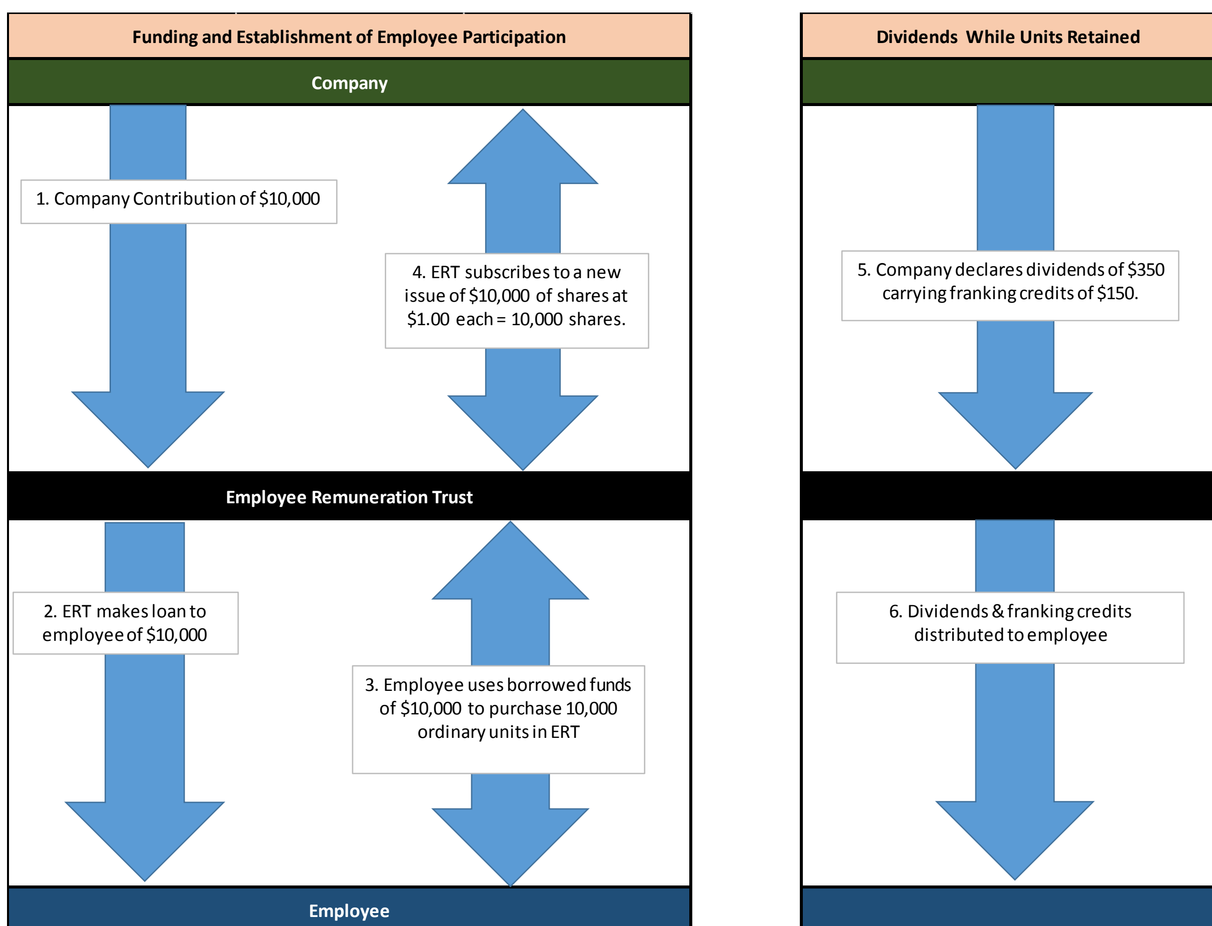
Using an EST brings important taxing implications including:

1. contributuons to the trust are:
    a. tax deductible for the employer, and
    b. not subject to fringe benefits tax (FBT),

2. the EST trustee is not taxed on:
    a. contributions received, or
    b. dividends and franking credits which are taxable to employee beneficiaries (trustee is taxed on dividends to which no beneficiary is entitled), and
    c. changes in the value of the shares held in the EST pending distribution to employees, and
3. employees are taxed on:
    a. the value of the shares received less any amount paid by the employee towards their cost, and
    b. dividends received by the trustee to which they are entitled.

Unit Trust Arrangements

In the draft Tax Ruling reference is made to Taxation Determination TD2010/10 and Taxation Ruling 2010/6 which reflected prior ATO views that are being revised in the new draft ruling. The following outlines one of the arrangements covered in TD2010/10. The following diagram covers the funding and establishment of an employee's participation as well as a treatment of a dividend while the shares are held in the trust.

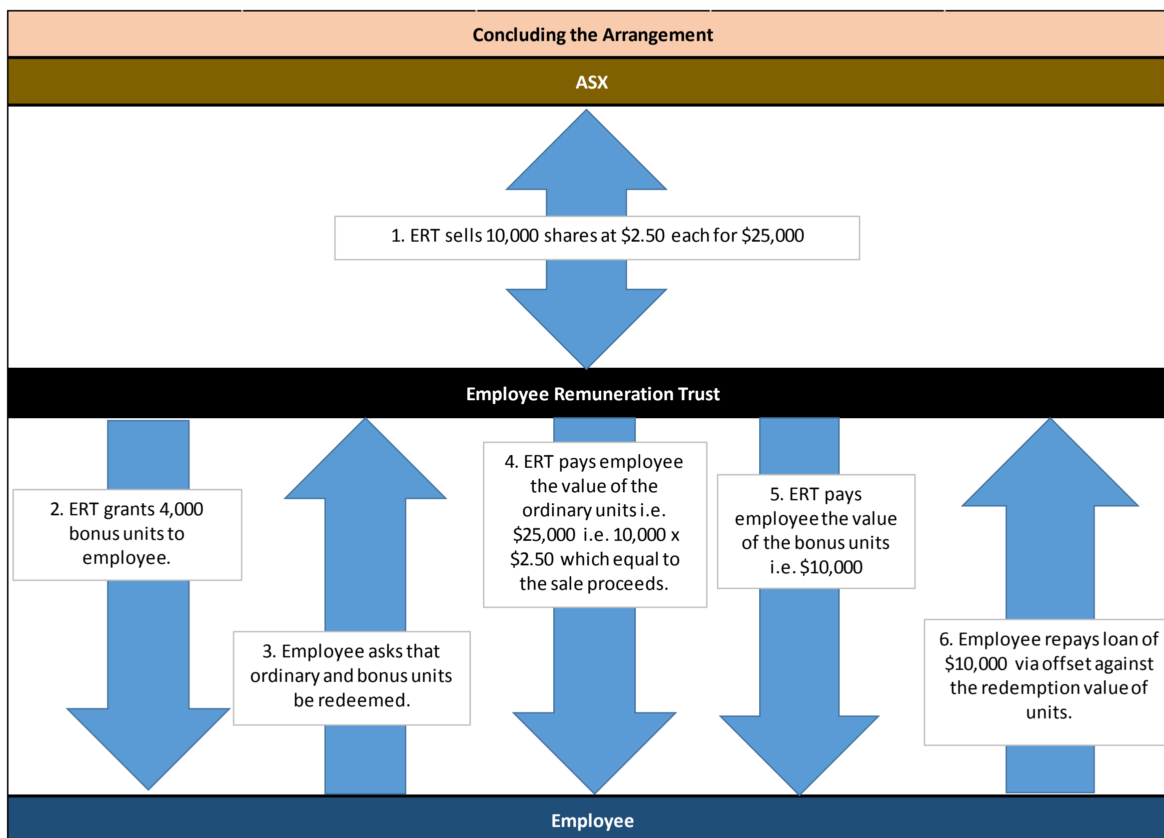


The establishment steps are as follows but it should be noted that the commentary relates to ASX listed company arrangements:

1. The company makes a contribution to the employee remuneration trust (ERT).
    a. Such contributions have long been held to be tax deductible and not subject to fringe benefits tax (FBT) and not income of the trust,
    b. This position will remain relatively unchanged under the new draft ruling provided benefits are provided to employees within 5 years of the contribution or 7 years if to an EST as defined in the forgoing, and
    c. FBT will not apply to contributions to ESTs (specific exemption applies) but will apply to contributions to other ERTs if made in relation to specified employees.

2. The ERT makes a loan to the employee.
    a. This loan will not attract FBT if the purchase of the units is expected to produce income via dividends or from trading activities of the trustee. This will often apply.
3. Dividends received by the trustee and passed on in full to the employee will be taxable to the employee. This aspect will not change.

The next diagram illustrates how the employee crystallises benefits from the arrangement.



The crystallisation steps are as follows but it should be noted that the commentary relates to ASX listed company arrangements:

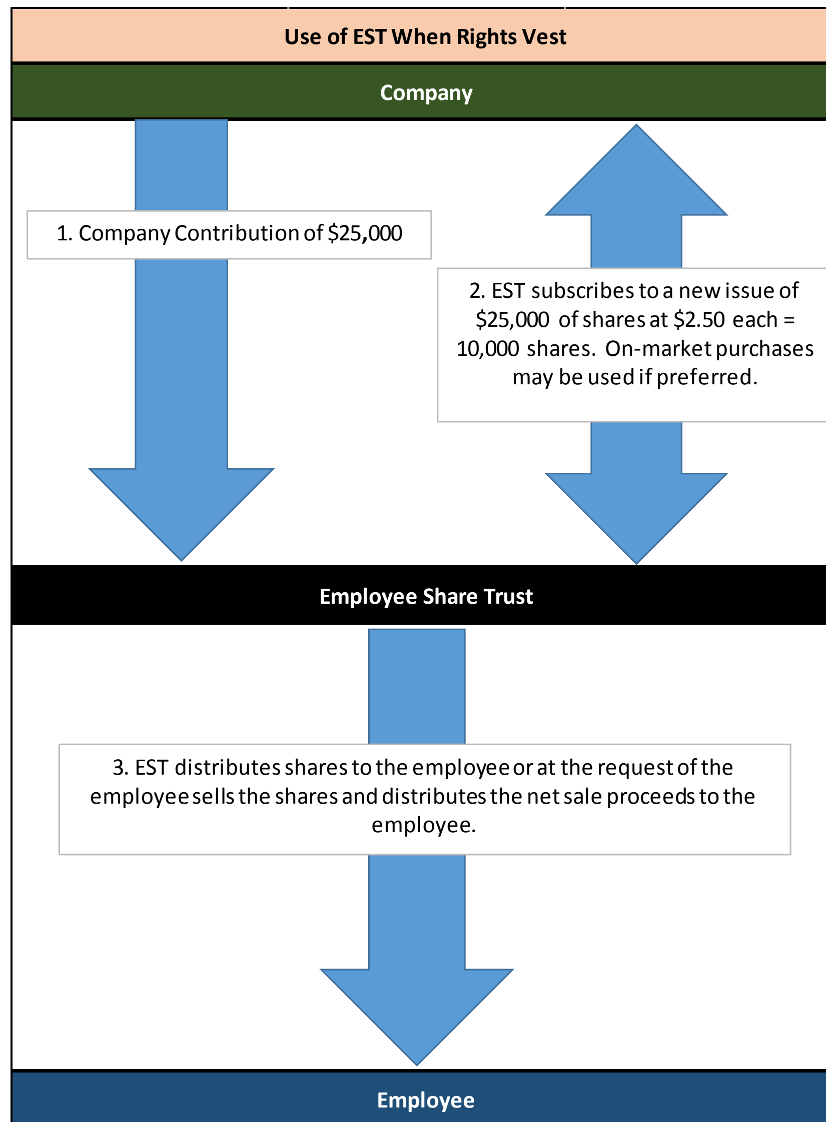
1. ERT sells the shares on the ASX and realises their market value.
    a. Provided that the shares had been held for more than 12 months the profit was seen as a capital gain which qualified for the 50% CGT concession. The new draft ruling indicates that the disposal will be seen as being on trading account and not subject to the 50% CGT concession. This change is critical as it was the means by which an ERT could provide more tax effective benefits to employees than could be provided via an EST.
2. Employee receives value on redemption of ordinary units.
3. Employee receives value on redemption of bonus units.
    a. The distribution from the ERT on redemption of ordinary units will be taxed as income of the employee to the extent to which it represents income of the ERT i.e. $15,000 ($25,000 less $10,000 cost of shares/units).
    b. The distribution from the ERT on redemption of bonus units has always been fully taxable and under the new draft ruling needs to have PAYG tax deducted.
    c. Broadly, for benefits provided under an EST the first taxing point is when securities vest and are not subject to dealing restrictions and 100% of the benefit is taxed. Then if the securities are held and subsequently sold any profit or loss is determined under the CGT provisions.

Assuming that the ATO continues to take the view that transactions in shares by trustees of ERTs (other than ESTs which are subject to specific relieving provisions) are to be recognised on a trading account basis and taxed in full as they do not qualify

for the 50% CGT concession it would seem prudent for all ASX listed companies that have been using ERTs for their LTI plans to replace them with EST arrangements.

Use of Employee Share Trusts

To illustrate the use of ESTs the previous example is converted into an offer of share rights which vest and for simplicity are not subject to dealing restrictions. The contribution occurs when the rights vest and shares need to be acquired to convert the vested rights into shares. The following diagram illustrates the operation of the EST.



Using the EST has several advantages over the unit trust arrangements including:

a) It is far less complex than the unit trust arrangements,

b) The tax saving for the company can be larger ($25,000 x 30% = $7,500) than that achieved using a unit trust ($10,000 x 30% = $3,000) and is consistent with the actual cost incurred (this aspect raises for consideration whether LTI plans should be operated to minimise tax for executives or to provide appropriate performance related remuneration for executives at the least cost to the company),

c) The taxation positions of the company, the trustee and employees are much clearer due to specific provisions that deal with ESSs and ESTs, and

d) The entitlements of employees are clearly defined in an long term incentive using an EST whereas in unit trust arrangements there needs to be wide trustee discretion to achieve the taxation outcomes contained in Taxation Determinations 2010/10 and Tax Ruling 2010/6.

The draft tax ruling will not be finalised until after consideration of submissions which need to be submitted no later than 18 April 2014. In the meantime if you have any concerns with your long term incentive plans, GRG will be pleased to assist.