TD 2017/D2 - Income tax: when will a dividend equivalent payment, made by a trustee under an employee share scheme that delivers ESS interests taxed by Subdivision 83A-B or 83A-C of the Income Tax Assessment Act 1997 be assessable as remuneration under section 6-5?

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Draft Taxation Determination

Income tax: when will a dividend equivalent payment, made by a trustee under an employee share scheme that delivers ESS interests taxed by Subdivision 83A-B or 83A-C of the *Income Tax Assessment Act 1997*[1] be assessable as remuneration under section 6-5?

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Ruling

1. For the purpose of this draft Determination, the term 'dividend equivalent payment' refers to a cash payment paid by a trustee of a trust to an employee[2] participant of an employee share scheme (ESS) (who is also a beneficiary of the trust) and that cash payment is funded from dividends (or income from other sources) that the trustee has been assessed on in previous income years because no beneficiary of the trust was presently entitled to the income.[3] The amount of the dividend equivalent payment is ordinarily calculated by reference to the amount of the dividends (or other income) received by the trustee during a specified period, less the amount of tax paid by the trustee on that income.

2. In this draft Determination, the term 'trust' is a reference to a trust that is set up by an employer under an ESS to provide employees with an ESS interest.[4]

3. A dividend equivalent payment is assessable under section 6-5 when the payment made to an employee under an ESS by a trustee of a trust:

- has the character of ordinary income

[1] In this draft Determination, all legislative references are to the *Income Tax Assessment Act 1997 (*ITAA 1997*)* unless otherwise stated.

[2] 'Employee' in this draft Guideline has its common law meaning, as extended by section 83A-320 (which includes relationships similar to employment within the scope of Division 83A). It includes a director of an incorporated company and may include a past employee who is still a participant of the ESS.

[3] The trustee is assessed and liable to pay tax on this income under section 99A of the *Income Tax Assessment Act 1936* (ITAA 1936).

[4] As defined in section 83A-10.

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

4. Amounts that are paid by a trustee of a trust to an employee as remuneration are included in the employee's assessable income under section 6-5 to the extent they are derived by the employee and are not amounts of:

- the trust's net income as defined in section 95 of the ITAA 1936 (other than net capital gains) which are assessed to the employee under Division 6 of Part III of the ITAA 1936 (Division 6), Subdivision 115-C or Subdivision 207-B (the trust assessing provisions), or
- the employee's exempt income or non-assessable non-exempt income.[5]

5. A payment made to an employee is remuneration when the employee receives such a payment for, or in respect of, services they provide under a contract of employment. That is, where the payment has sufficient connection with the employee's employment such payments are assessable under section 6-5.

Examples

Example 1 Dividend equivalent payment conditional on employee performance

6. A Co is an Australian resident company that carries on a business.

7. A Co establishes a trust for the purpose of providing and delivering shares (ESS interests) under an ESS to eligible employees.

8. A Co makes a contribution to the trustee of the trust so the trustee can purchase and hold shares in A Co under the terms of the trust deed, plan handbook and invitation to the employees (ESS agreement).

9. Under the terms of the ESS agreement an eligible employee is a beneficiary of the trust and has an interest in the trust that is a right to acquire the shares being held by the trustee. This interest does not entitle the employee to any income generated by the shares over the course of the ESS until such time as the employee satisfies certain conditions set by A Co which is specific to the employee's performance and their continuous employment with A Co being three years (performance conditions).[6]

10. Upon satisfying the performance conditions the employee is entitled to own the shares held by the trustee of the trust. In addition, the employee is entitled to receive from the trustee an amount reflecting the dividends (post-tax) the employee would have earned had the employee owned the shares from the day the employee received their interest in the trust. The trustee funds this payment from trust capital.

[5] Refer to section 23L of the ITAA 1936.
[6] The trustee is assessed on this income under section 99A of the ITAA 1936.

11. As the dividend equivalent payment will be made to the employee because the employee has satisfied certain performance conditions, these payments have a sufficient connection with the employee's employment and are assessable to the employee under section 6-5. Whilst the quantum of the payment reflects a dividend equivalent had the employee acquired the shares at the outset of the arrangement, this is merely a calculation mechanism and does not reflect the character of the payment in the recipient's hands. The character of the payment in the employee's hands is remuneration.

Example 2 Dividend equivalent payment not assessable under section 6-5

12. Assume the same facts as in Example 1 but, in addition, under the terms of the trust deed the trustee of the trust may, at its discretion, make distributions of trust capital to an employee in consultation with A Co. During the first year of the arrangement A Co pays a dividend to its shareholders, which includes the trustee of the trust.

13. During the second year of the arrangement (prior to any employee satisfying the performance conditions), floods affect many of the eligible employees' homes. The trustee of the trust (in agreement with A Co) decides to exercise its general discretion to make distributions from the trust capital, to pay a class of eligible employees affected by the flood a dividend equivalent payment. The payment is to cover immediate expenses for meals and food supplies, clothing and emergency accommodation.

14. As the dividend equivalent payment made to the employees is a one off payment due to a situation external to the employee's employment and is not a payment in respect of the employees' incidence of actual service, it is not assessable to the employee under section 6-5.

Example 3 Dividend equivalent payment not in connection with employment

15. B Co is an Australian resident company that carries on a business.

16. B Co establishes a trust for the purpose of providing and delivering shares (ESS interests) under an ESS to eligible employees.

17. B Co makes a contribution to the trustee of the trust so the trustee can purchase and hold shares in B Co under the terms of the ESS agreements.

18. Under the terms of the ESS agreement an eligible employee is a beneficiary of the trust and has an interest in the trust that is a right to acquire the shares being held by the trustee. This interest does not entitle the employee to any income generated by the shares over the course of the ESS until such time as the employee satisfies certain conditions set by B Co which is specific to the employee's performance and their continuous employment with B Co being three years (performance conditions).

19. Separate to the terms and conditions stated in the plan rules, employee handbook and the invitation to participate in the ESS provided to the employees, the trustee at its own absolute discretion and under the terms of the trust deed may make a dividend equivalent payment to the beneficiary. The trustee takes no recommendation from B Co and has no regard to the continuing service of the employee, or the satisfaction of any performance conditions, before it makes such a payment. Indeed, the employee may no longer be an employee and still receive the payment. The payment can only be made by the trustee.

20. The dividend equivalent payment is not assessable under section 6-5 as the payment is made by the trustee utilising its unfettered discretion and in accordance with the terms conferred on the employee as a beneficiary under the terms of the trust deed. The payment can no longer be considered to have anything but a distant causal connection to the employee's employment. As such, it is not remuneration but rather an amount received by the employee as a beneficiary of the trust.

Date of effect

21. When the final Determination is issued it will apply to dividend equivalent payments where they are paid under the terms and conditions attached to ESS interests issued on or after 1 October 2017.

22. If an employee is issued an ESS interest prior to 1 October 2017, and the terms and conditions attached to the ESS interest include eligibility to receive a dividend equivalent payment, the Commissioner's general administrative practice will continue to reflect the position outlined in paragraphs 40 and 77 of Class Ruling CR 2013/15 *Income tax: Leighton Holdings Limited Equity Incentive Plan*. That is, the dividend equivalent payment paid by the trustee will not be assessable to the employee under Division 6 of the ITAA 1936, section 6-5 or section 15-2. This is conditional on the trustee having paid tax on the dividends or other income (that the dividend equivalent payment is calculated on) under section 99A of the ITAA 1936 in the income year the dividends (or other income) were received.

Commissioner of Taxation
8 June 2017

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

How is an employee assessed on benefits received from a trust?

23. An employee who is a beneficiary of a trust, who is not under a legal disability:

- is assessable on so much of a franked distribution from the trust that is attributed to them under Subdivision 207-B, along with their share of the attached franking credit
- is assessable under paragraph 97(1)(a) of the ITAA 1936, if they are presently entitled to a share of the income of the trust estate, on that same share of the net income of the trust[7] (excluding any net capital gain, franked distributions (net of directly relevant deductions) and franking credits), and
- includes in the calculation of their net capital gain so much of a capital gain of the trust they are taken to have made under Subdivision 115-C (except to the extent that it is otherwise assessable to the employee under section 6-5).

24. Where any benefit received by an employee from the trust is a fringe benefit, it is non-assessable non-exempt income of the employee.[8]

When are dividend equivalent payments assessed to the employee under section 6-5?

25. A dividend equivalent payment received from a trust is assessable to an employee as remuneration under section 6-5 where it meets the requirements in paragraph 3 of this draft Determination.

When does a dividend equivalent payment provided by the trustee have the character of ordinary income of an employee?

26. 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.[9]

27. The nature of the income must be determined in the hands of the recipient.[10] It is irrelevant whether:

- it is paid in advance of the services to be performed or after[11]

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[7] As defined in section 95 of the ITAA 1936.
[8] Section 23L of the ITAA 1936.
[9] We have confined the discussion of ordinary income principles to that income derived from the provision of services. Benefits from a trust may nevertheless be ordinary income, other than as consideration for the provision of employment services. However, we do not deal with those other ordinary income principles in this draft Determination.
[10] See 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.

- the remuneration is paid by the employer or another entity[12]
- it is paid from the income or the capital of the trust,[13] or
- it is paid from an amount previously assessed to the trustee under the trust assessing provisions in an earlier year.[14]

28. Trust distributions not dealt with by the trust assessing provisions can be assessed as ordinary income to the employee if they bear that character in the hands of the employee. Division 6 of Part III of the ITAA 1936 is not an exclusive code in assessing distributions from a trust.[15]

When do dividend equivalent payments provided by a trustee have a sufficient connection with employment?

29. Factors that will evidence that a dividend equivalent payment provided by a trustee to an employee has sufficient connection with their employment, and is therefore assessable as remuneration, include the following:

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

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[11] *Sent v. Commissioner of Taxation* [2012] FCA 382; 2012 ATC 20-318; (2012) 85 ATR 1 at FCA [41]-[44]; ATC 13,563-13,564; ATR 15-16 and *Blank v. Commissioner of Taxation* [2016] HCA 42; 2016 ATC 20-587 at HCA [56].
[12] *Federal Commissioner v. Dixon* (1952) 86 CLR 540; [1952] HCA 65; (1952) 10 ATD 82; (1952) 5 AITR 443.
[13] *Murdoch v. Commissioner of Pay-roll Tax (Vic)* (1980) 143 CLR 629 at 645; [1980] HCA 33 at [10]; 80 ATC 4424 at 4432; (1980) 11 ATR 135 at 144.
[14] 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 trust 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 trust described in this draft Determination. See also Hill J's comments in *Traknew Holdings Pty Ltd v. FC of T* 91 ATC 4272 at 4284; (1991) 21 ATR 1478 at 1492.
[15] *Federal Commissioner of Taxation v. Belford* (1952) 88 CLR 589; [1952] HCA 73; (1952) 10 ATD 105; (1952) 5 AITR 392 and *Union Fidelity Trustee Co. v. Federal Commissioner of Taxation* (1969) 119 CLR 177; [1969] HCA 36; 69 ATC 4084; (1969) 1 ATR 200.

When do dividend equivalent payments provided by a trustee have an insufficient connection with employment?

30. Dividend equivalent payments have an insufficient connection with employment and are unlikely to be remuneration when they are received by the employee other than in their capacity as an employee such that it can be concluded, after a consideration of all relevant circumstances, that the dividend equivalent payment is not being provided to the employee in respect of employment. This will arise where the consideration for the dividend equivalent payment is not the employment services.[16] Factors that will evidence that a dividend equivalent payment provided by a trustee are not remuneration in nature include the following:

- the dividend equivalent payment is consideration for an arm's length surrender, exercise or disposal of an asset (property or rights)[17] 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 dividend equivalent payment arises 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 dividend equivalent payment does not rely on continuing employment nor have regard to, nor is conditional upon, individual employment-related performance conditions. and
- the timing and amount of the dividend equivalent payment is identical in respect of all recipients who hold the same property or rights, regardless of their employment relationship with the employer.

31. Where a contribution[18] is paid to a trustee by the employer on an employee's behalf or as they direct, and the employee is taken to have derived the contribution as remuneration[19] at that point, the employee cannot derive that same amount again should it be paid out of the trust as a dividend equivalent payment and to the extent it is made up of that earlier contribution.[20]

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

[17] *Federal Commissioner of Taxation v. McArdle* 89 ATC 4051 at 4058-4059; (1988) 19 ATR 1901 at 1909.

[18] 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.

[19] And the employee has included that amount of the contribution in their assessable income under section 6-5 or the employer is taken to have provided a fringe benefit in respect of the contribution with a taxable value equal to the amount of the contribution referrable to the employee for the purposes of the *Fringe Benefits Tax Assessment Act 1986*.

[20] In addition, section 6-25 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.

When are dividend equivalent payments statutorily excluded from the operation of section 6-5?

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

- the trust's net income[21] (other than net capital gains) assessed to the employee under the trust assessing provisions, or
- the employee's exempt income or non-assessable non-exempt income (such as ordinary income derived by a taxpayer by way of the provision of a fringe benefit).[22]

33. To the extent that an amount would be assessable to the employee beneficiary under both section 6-5 and Division 6 of the ITAA 1936 or Subdivision 207-B, section 6-25 operates to include the amount as assessable income only once and gives preference to the amounts being assessed under Division 6 of the ITAA 1936 of Subdivision 207-B over section 6-5.

34. However, the general structure, language and purpose of the income tax law, including provisions dealing with the interactions between the CGT provisions and other regimes within the income tax system,[23] indicate a clear intent that, without more, where an amount is otherwise included in assessable income under both section 6-5 and section 102-5, the CGT provisions should give way to section 6-5.[24]

[21] As defined in section 95 of the ITAA 1936.
[22] See section 23L of the ITAA 1936. In addition, where a distribution includes amounts that form part of the exempt or non-assessable non-exempt income of a trust estate, provisions within Division 6 of the ITAA 1936 may treat the distribution as exempt or non-assessable non-exempt income of a beneficiary. Such amounts are not assessed to the beneficiary as ordinary income, even if received as remuneration: refer to section 6-15.
[23] This conflict is not specifically resolved by section 118-20 (which can operate to reduce a capital gain made from a CGT event if, because of the event, an amount was included in assessable income by a provision of the Act outside the CGT provisions) – because a gain taken to be made by a beneficiary under Subdivision 115-C is not a capital gain from a CGT event (the trustee is the entity who has the CGT event).
[24] See *Project Blue Sky v. ABA* (1998) 194 CLR 355 at 381-382; [1998] HCA 28 at [70].

Appendix 2 – Your comments

35. You are invited to comment on this draft Determination including the proposed date of effect. Please forward your comments to the contact officer by the due date.

36. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments, and
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	**7 July 2017**
Contact officer:	**Michelle Maffia**
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2017/D5

Previous Rulings/Determinations:

CR 2013/15

Legislative references:

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- ITAA 1997 6-5
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- ITAA 1997 6-25
- ITAA 1997 15-2
- ITAA 1997 Div 83
- ITAA 1997 Subdiv 83A-A
- ITAA 1997 83A-10
- ITAA 1997 Subdiv 83A-C
- ITAA 1997 83A-320
- ITAA 1997 102-5
- ITAA 1997 Subdiv 115-C
- ITAA 1997 118-20
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- ITAA 1936 23L
- ITAA 1936 Div 6
- ITAA 1936 95
- ITAA 1936 97(1)(a)
- ITAA 1936 99A
- ITAA 1936 99B(1)
- ITAA 1936 99B(2)(c)(ii)
- FBTAA 1986

Cases relied on:

- Cases Nos 260-262/1982 – (1983) 27 CTBR (NS) 80; Case Q85 83 ATC 430
- Case C57 71 ATC 250
- Blank v. Commissioner of Taxation [2016] HCA 42; 2016 ATC 20-587
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- Federal Commissioner of Taxation v. McArdle (1988) 19 ATR 1901; 89 ATC 4051
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- Project Blue Sky Inc v. Australian Broadcasting Authority (1998) 194 CLR 355; (1998) 72 ALJR 841; (1998) 153 ALR 490; [1998] HCA 28
- Sent v. Federal Commissioner of Taxation [2012] FCA 382; (2012) 57 AAR 27; [2012] ALMD 3661; (2012) 128 ALD 34; 2012 ATC 20-318; (2012) 85 ATR 1
- Traknew Holdings Pty Ltd v. Federal Commissioner of Taxation (1991) 21 ATR 1478; 91 ATC 4272
- Union-Fidelity Trustee Co (Aust) Ltd v. Federal Commissioner of Taxation (1969) 119 CLR 177; (1969) 43 ALJR 313; (1969) 1 ATR 200; 69 ATC 4084; [1969] HCA 36

Other references:

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ATO references

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