Submission

To

The Committee Secretary

House of Representatives Standing Committee on Employment, Education and Workplace Relations

From

The Australian Taxation Office

On the subject of

The extent to which employee share ownership schemes have been established in Australian enterprises and the resultant effects on:

(a) workplace relations and productivity in enterprises: and
(b) the economy

Dated
30 April 1999

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Introduction

The ATO does not have details as to the precise extent to which employee share ownership schemes have been established or the amount of contributions being made to these schemes. Nevertheless we hope that the following information, particularly the trend data provided below, will be of assistance to you in this regard.

Employee ownership schemes fit into a broader field of arrangements that we describe as "employee benefit arrangements" (EBAs).

Broadly these arrangements cover:-

- share acquisition or option arrangements,
- unit or discretionary trusts set up to provide incentive or reward payments
- welfare trusts that provide for medical, schooling and others similar costs, and
- superannuation schemes

The ATO is currently reviewing many current EBA's which we believe may have gone beyond the policy and operation of the law.

Historical Overview

The introduction of the *Fringe Benefits Tax Assessment Act 1986 (Cth)* severely restricted the ability of employers and employees to package salaries in a tax effective manner. Individuals had to examine other methods of enhancing their after tax income, which led many to contemplate alternative means of remuneration.

Employee share plans were also receiving favourable press in Australia on the basis of overseas experience. The plans were trumpeted as a potential cure for the nation's troubled industrial relations, with the advantage of being specifically exempted from the fringe benefits tax provisions (where section 26AAC applied).

Under the early employee share plan, shares in the employing company were offered at a small discount to all or most of a company's employees, and employee participation was often assisted by interest-free loans from the company. The loans were generally repayable in full on disposal of the shares, or on termination of employment.

However, these original plans had two major drawbacks. First, the employer did not qualify for a deduction because the share plan was often not considered part of employee remuneration.

Second, a downturn in the employer's financial performance or in general market sentiment would reduce the value of the shares, but not the size of the loans to employees, and any loan forgiveness would leave the employer with an FBT liability. Many individuals had these disadvantages amply demonstrated to them in the fallout of the 1987 Stock Market crash, and enthusiasm for loan-style share plans subsequently waned

To ameliorate the shortcomings of the original employee share plans, tax planners commenced interposing trusts in their structures. Thus, rather than have employees purchase shares, money was provided by the employer to a trustee for that trustee to acquire shares in the employing company (or other companies). Those shares were to be held by the trustee on behalf of participating employees and/or their associates.

This innovation relieved employees of the funding burden. Further, the schemes were suitably structured to improve the prospects of employers qualifying for a deduction for their trust contribution. This was achieved by making the plans integral to employee remuneration packages, principally by imposing trustee-administered performance-related and time-based restrictions on share distribution and dividend entitlement. Benefits arising from the contribution retained their exemption from fringe benefits tax.

The market recovered, and began to grow rapidly, attracting other promoters to the marketplace. The influx of competitors commodified the product, and put intense commercial pressure on members of the remuneration and tax planning industry. Their innovation led to the rise of the so-called 'new generation' employee share plans.

‘New generation’ employee share plans required employers to establish a special purpose company (SPC). To avoid the need for preparing a prospectus, the number of participating employees per SPC was kept below twenty one.

Employees could sacrifice part of their (pre-tax) salary to subscribe for shares in the SPC, with each participating employee acquiring a separate class of redeemable preference shares issued with, say, a nominal par value of $1 and a $999 premium. Contractual arrangements directed the company to invest the premium according to the employee’s wishes, and the investments were usually made by the SPC through a trust. Subsequent income of the trust was passed on to the SPC, to be taxed at the corporate rate, and the employee was assessable on any fully franked dividend distributions made by the SPC.

Because the employee’s shares were generally subject to employer stipulated restrictions, the employee was not assessable on the employer’s contributions pursuant to subsection 26AAC(15) until the employer-imposed restrictions on the redeemable preference shares were lifted, or the employee ceased to be liable to be divested of his ownership of the shares. Thus, tax could be (and often was) deferred indefinitely.

In spite of this, employers obtained a deduction for the contributions in the year the contributions were made. These contributions were not subject to fringe benefits tax because the arrangements were within section 26AAC.

Concurrent with the growth of ‘new generation’ employee share plans, Australian companies were following the overseas trend of issuing 1c options to key executives. The options were generally issued with a strike price equivalent to the market value of the shares at the time of issue, and conditions were often imposed by employers on the exercise of those options. Called ‘golden handcuffs’, employees were contractually prevented from exercising the options until various performance criteria and/or temporal requirements were fulfilled. Such restrictions were imposed in part because of increasingly vocal shareholder demands that executives truly earn their often substantial gains, rather than merely catch a ride on the back of a rising sharemarket.

Most executives made elections under subsection 26AAC(8A), so that they were assessed at the time the options were granted on the value of the option less the amount paid or payable as consideration for that option. According to Taxation Ruling *IT 2609*, the value of an option was to be calculated by reference to the market price of the underlying share. Thus, unless the option price was less than the underlying market value of the share (ie. issued at a discount), no amount was assessable[1]. The next taxing point was not until a capital gain (if any) was realised on the sale of the underlying shares (assuming the option was in fact exercised).

Thus, the ability to make a subsection 26AAC(8A) election allowed those individuals who were granted options to effectively defer their income. It also gave them the ability to acquire shares at today’s price or a concessional price, without committing funds until a later date, and negligible loss if the share price did not rise.

[1] For example, if an option was granted to purchase a share at $2.50 and the underlying value of the share at the time of issue was $2.50, then the option would be of no assessable value

The tax effectiveness of options was further enhanced by the capital gains tax rules – the cost base for the purpose of indexation was the underlying value of the share at the time the option was issued, rather than the 1c paid for the option.

The increasing popularity of 'new generation' share schemes and 1c option plans, and the threat they posed to the PAYE system and overall revenue, influenced the Commissioner to raise the matter with the Treasurer. Subsequent discussions led the Treasurer to announce amending legislation as part of the 1994-1995 Budget process on 10 May 1994.

On 30 March 1995, the Taxation Laws Amendment Bill (No.2) 1995 was introduced into the Senate. The Bill was passed in December 1995, although transitional provisions ensured the legislation was effective from 28 March 1995 (the date the new amendments were announced by the Treasurer).

Division 13A (as the new provisions are known) is the successor to section 26AAC, applying to the acquisition of a share, or a right to acquire a share under an employee share scheme, where the acquisition occurred after 6:00pm (in the Australian Capital Territory) on 28th March 1995.

The introduction of Division 13A required tax planners to contemplate other means for maximising the after tax returns of their clients. Their focus swiftly fell on trust structures, which provided adequate potential to avoid the operation of the increasingly restrictive legislation. Promoters developed many trust-based products to mirror the advantages of past employee share schemes – that is, immediate deductions for contributions, avoidance of any kind of tax on the contributions themselves, performance and time criteria, employee/employer control of investments, and minimal (if any) tax paid on ultimate distribution of the money. The schemes have been too numerous to individually outline their mechanics. However, they evolved to the point where promoters were claiming 'total tax wipeouts'.

Unlike section 26AAC and Division 13A schemes, fringe benefits tax could apply to the benefits provided under these trust structures. To avoid imposition of the tax, many products relied on an arguable interpretation of the fringe benefits tax provisions, specifically the definition of 'associate'. Put simply, promoters asserted that if employees were incapable of benefiting from the trust when the benefit was provided, then the employees could not possibly be associates of the trust(ee), and fringe benefits tax could not apply to the contribution/s. Consequently, the majority of the trust products utilised temporal and transactional delays so that, at the time of contribution, it could be argued that the employees were not capable of benefiting from the trust.

These schemes flourished until the Commissioner began questioning the strength of their 'associate' reasoning. The Commissioner's doubts eventually led to the release of Draft Taxation Ruling *98/D12* in November 1998, which outlines his view on the meaning of 'associate' in the context of trustees and the FBT provisions. That view is at odds with promoters' claims that the legislation requires a temporal nexus between the contribution and an individual's ability to benefit under the trust in order for FBT to apply.

Although the application of FBT is yet to be tested in the courts - as some promoters suggest it will - anecdotal evidence suggests that promoters have dramatically slowed the roll out of such employee benefit arrangements. This slowdown can be attributed to the Commissioner's recent focus on high risk promoters and their products.

The Commissioner's actions in this regard has shifted some promoters' attention back to superannuation. In particular, 'controlling interest' superannuation schemes and offshore superannuation. The ATO is currently reviewing all known arrangements, including new products.

In reviewing these arrangements the ATO is considering the full range of issues and possible responses to those arrangements. We believe that many of them may have gone beyond the policy and operation of the law. Areas of focus include the deductibility of contributions, the incidence of FBT and the role of general anti-avoidance provisions.

Legislation

Background

Employee share acquisition schemes (ESAS) developed during the 1970s and 1980s operated either indirectly through an intermediary such as a trust (where the employer company made contributions to the scheme trustee who used the funds to buy shares in the employer company and allots the shares to employees) or directly, where the employer issued existing or new shares to employees. Shares acquired in these schemes were structured to take advantage of the reduction in discount provisions in sections 26AAC(A) to (4F) of the ITAA.

Division 13A of Part III of the *Income Tax Assessment Act 1936* (ITAA) countered arrangements which exploited provisions of the ITAA previously applying to ESASs. It provides for the taxation of shares or rights acquired under an ESAS. It attempts to direct available concessions at ESASs which encourage investment by employees in their employer company, or in their employer company's holding company, and which are available to all permanent employees.

Section 26AAC

Operation of section 26AAC

Section 26AAC and ESASs were intended to encourage employees to acquire an interest in their employer company and to allow employees some control. Employees would benefit from the increase in the value of shares if the employer were a successful company.

Section 26AAC provided for the taxation of benefits that arise from shares, or rights to acquire shares, acquired under an ESAS by an employee, or a relative of an employee, for services rendered by the employee. It replaced section 26(e) of the ITAA as the basis for taxing benefits acquired under an ESAS.

Under section 26AAC, a taxpayer is taken to have acquired a share or right to acquire a share in a company under a scheme for the acquisition of shares by employees if the share or right to acquire the share is in relation, directly or indirectly, to the employment or services rendered by the taxpayer or a relative of the taxpayer.

In general, there are two types of arrangements under which shares or rights to acquire shares can be received. The first is where a company issues shares or rights to acquire shares in the company or in another company to employees or to the employee's relatives. The second is where shares of the company, or of another company, are issued to a trustee to be held on behalf of the employees or their relatives. In this case, the trustee must be authorised to sell or transfer the shares to the employees or their relatives.

In the case of rights to acquire shares, the normal taxing point is when the rights are sold or exercised. However, the taxpayer can elect to be assessed in the year in which the right is issued and not in the year in which the right is sold or exercised.

In the case of the allotment of shares the taxing point will depend on whether any conditions or restrictions apply to the shares and if the taxpayer makes an election under section 26AAC (15A). If conditions or restrictions then, the taxing point is when those conditions or restrictions cease, or on disposal unless an election is lodged in which case it is the year of acquisition. If no conditions or restrictions then they are assessable in the year of acquisition.

Problems with section 26AAC

ESASs made under section 26AAC had a number of problems, such as:

- difficulties with the valuation of rights to acquire shares;
- difficulties experienced by employees with cash flows, requiring the sale of shares to satisfy the income tax liability on discounts at the time of issue of shares or to pay provisional tax or both;
- double taxation of non-residents participating in foreign employee schemes;
- loss of the reduction in discount where directors were excluded from participating in ESAS; and
- double taxation resulting from the interrelation between section 26AAC and the CGT provisions.

Continued application of section 26AAC

Section 26AAC continues to apply where a share is acquired by a taxpayer after 6pm in the ACT (and the equivalent time elsewhere) on 28 March 1995 as a result of exercising a right which was acquired under an ESAS prior to that time and which was held by the taxpayer at that time.

Section 26AAC also applies to:

- offers to employees of employer company (or holding company) shares or rights or invitations to employees to make offers to acquire such shares or rights made prior to the relevant time where the benefits are provided prior to 1 July 1995;
- employer (or holding company) shares and rights provided to employees prior to 1 July 1996 by public companies (as defined in Corporations Law) or their subsidiaries under schemes approved by shareholders prior to the relevant time; and
- offers of non-employer company shares up to a value of $1000 per recipient (not just employees) or offers of rights to acquire shares up to a value of $1000 of shares where the offer was made prior to the relevant time and the shares or rights are

acquired prior to 1 July 1995. For the purpose of this transitional provision the value of the right is equivalent to the value of its underlying share.

A taxpayer may elect that Division 13A instead applies.

Division 13A

Background to Division 13A

The *Taxation Laws Amendment Act (No. 2) 1995* amended the ITAA to remedy the problems with the operation of section 26AAC by introducing Division 13A to replace section 26AAC. Division 13A provides for the taxation of shares or rights acquired under an ESAS. It countered the arrangements which exploited section 26AAC and attempted to ensure that the concessions available are directed at ESASs which encourage investment by employees in their employer company, or in their employer company's holding company, and which are available to all permanent employees. The CGT provisions in Part IIIA of the ITAA were also amended, to avoid double taxation and so that the advantage gained by concessions for qualifying shares or rights were not clawed back under the CGT provisions. The definition of 'fringe benefit' in subsection 136(1) of the *Fringe Benefits Tax Assessment Act 1986* (FBTAA) was also amended to avoid double taxation.

In introducing the Bill for Division 13A into Parliament, the then Assistant Treasurer Senator George Gear said:

"The government is making these changes to reduce the exploitation of the existing legislation and to ensure that the tax concessions that are available under the new arrangements are directed at share schemes which encourage employees to own shares in the company in which they are employed or a holding company of the employer. The measures will increase the taxation benefits available to employees under these schemes."

Operation of Division 13A

The assessable amount under an ESAS is the difference between the market value of the share or right and any amount paid by the employee to acquire the share or right. Division 13A also provides for the taxation of shares or rights provided to an associate of an employee as if they were provided to the employee. Concessions are provided where the shares or rights to shares satisfy certain criteria.

Division 13A:

- provides that where a taxpayer acquires a share or a right to a share under an ESAS the discount on the share or right is included in the assessable income of the taxpayer;
- sets out when a taxpayer is to include the discount on the shares or rights obtained under an ESAS in his or her assessable income;
- sets out when a taxpayer is taken to have acquired a share or a right to acquire a share under an ESAS;
- sets out how to calculate the discount;
- describes qualifying shares and rights including the non-discriminatory requirement that must be satisfied before a share or right is a qualifying employee share or right;
- sets out the concessional tax treatment available for qualifying employee shares or rights;
- sets out the stricter non-discriminatory requirements that must be satisfied before the $1000 exemption can apply to qualifying shares or rights;
- provides that shares or rights acquired by an associate of the employee under an ESAS are taxed as if they were acquired by the employee;
- sets out the manner of determining the value of shares or rights acquired under an ESAS;
- provides that where both a legal and a beneficial interest in a share or right are acquired by the same taxpayer or by more than one taxpayer only the taxpayer holding the beneficial interest needs to include an amount in his or her assessable income;
- sets out when an employer is entitled to a deduction for the cost of providing shares or rights under an ESAS;
- provides a deduction to the employer for up to $1000 of certain qualifying shares or rights provided to employees;
- provides that in certain circumstances an employee is entitled to a refund of income tax paid on share rights;
- ensures that shares or rights provided to employees by a company group through investment companies are not taxed concessionally;
- specifies the meaning of ‘acquiring a share or right’;
- ensures that if an amount is assessable under Division 13A of Part III then no amount is assessable under section 26(e) or 21A; and
- determines the cost base of an employee share or right for CGT purposes.

Subject to certain transitional arrangements, the change applied from 6pm in the ACT (and the equivalent times elsewhere) on 28 March 1995.

Cost of Compliance Issues

A search of ATO records has revealed one submission from a tax adviser on compliance costs in respect of section 139FA. This section explains how to work out the market value of a listed share or right which can involve the determination of the weighted average of the shares traded on the exchange during the week before the share was acquired . The writer raised the following matter.

The information required by this section is only available from the Australian Stock Exchange at a cost of up to $500. This cost is incurred each time an employee leaves the company. Some employer companies would prefer a cheaper method of working out the market value of a listed share or right.

Recent Developments

Taxation Laws Amendment Bill (No 4) 1998

Amendments in the Taxation Laws Amendment Bill (No 4) 1998 will stop certain franking credit trading schemes and restore one principle of the imputation system, that the benefits of imputation should only be available to the true economic owners of shares and only to the extent that those taxpayers can use the franking credits themselves.

The amendments will limit the source of franking credits available for trading by ensuring that franked dividends paid by companies that are effectively wholly-owned by non-residents or tax exempt entities cannot generally provide franking benefits to resident shareholders.

Special provisions allow the payment of franked dividends by former exempting companies out of exempting accounts if they are paid to eligible continuing substantial shareholders or employees under eligible ESASs. In addition, it will ensure that non-resident shareholders in receipt of franked dividends from affected companies will continue to be exempt from withholding tax.

Ralph Review of Business Taxation

As part of the public consultation process leading to a final report to Government, the Ralph Review is currently examining submissions from interested parties on the business tax reform options put forward in the detailed discussion paper, *A Platform for Consultation*. The consultation process means that specific legislative measures are yet to be formulated. Accordingly, it would be inappropriate for the ATO to make any detailed comments at this stage concerning the impact of business tax reform on employee share ownership or incentive arrangements.

However, some brief comments can be made on some of the options put forward in *A Platform for Consultation*. Although it appears that there are no reform proposals directed specifically towards employee share ownership or incentive arrangements, a number of reform options may have an indirect or broad impact upon the tax treatment of these arrangements.

To the extent that employee benefit or incentive arrangements involve trust structures, the proposed entity tax regime would have a general impact upon the treatment of income derived by trusts. In broad terms, trusts would be taxed as entities and beneficiaries would be taxed on distributions with credit allowed for tax paid at the entity level. This would effectively bring the tax treatment of trusts into line with that of companies.

Where employees acquire shares or units pursuant to an employee share scheme or incentive arrangement they would also be impacted by the reform proposals relating to the tax treatment of entity distributions which are generally applicable to all holders of ownership interests in business entities. These proposals would determine the character for tax purposes of various entity distributions, including distributions associated with the extinguishment of ownership interests such as share buybacks.

Employee share ownership arrangements could also be impacted by the proposal to introduce a consolidated system of taxation for entity groups. Under this proposal, entities that are 100% commonly owned may elect to be treated as a single taxable entity. Where employee share ownership arrangements dilute a 100% shareholding, they have the potential to prevent an entity group from satisfying one of the fundamental criteria for consolidated tax treatment. However, this issue has been flagged at paragraph 26.6 of *A Platform for Consultation* where it is stated that consideration needs to be given to the question of whether there may be grounds for departing from the wholly owned requirement in the circumstances of employee share ownership.

After the Ralph Review has made its final report and the preferred policy options of the Government become apparent, it will be possible to assess more accurately the impact of business tax reform on employee share ownership and incentive arrangements.

ATO Intelligence and Compliance Activity

Although the ATO does not possess details of all ESAS participants, we believe that the Division 13A provisions have been very popular with publicly listed companies. We are aware that some of these larger companies also have share schemes which do not seek to take advantage of the provisions of Division 13A and are assessable under the capital gains tax provisions.

The ATO has been undertaking a coordinated review of aggressive tax planning practices involving “employee incentives” over the past year or so.

The picture that has been built to date is one that indicates that a small but aggressive segment of the legal, financial planning and accounting professions have moved to exploit government initiatives in relation to employee share ownership, incentives to increase productivity in the work place, and provision for retirement through superannuation.

The aggressive tax planning arrangements have been uncovered in:

- employee share acquisition or option arrangements;
- employee benefit / incentive or welfare trusts;
- superannuation, particularly through “non complying” schemes; and
- offshore superannuation arrangements

Attachment A maps the types of arrangements so far uncovered.

Analysis of share acquisition and incentive arrangements has indicated that these have been sold to the small, medium enterprise end of the market. They have attempted to provide the “controllers” of private companies with the ability to defer corporate income tax and or transfer income from the company to themselves in a non – taxable or lower taxed form.

In some instances promoters of these arrangements sought opinions or rulings from the ATO. We provided comfort to some of these arrangements on the basis of our understanding at that time as to the application of the law, and the features of the arrangements. However, when investigations are made into how the arrangements were implemented, the ATO has found that the arrangements were often not in accordance with the legal opinion and memorandum of explanation provided to the ATO. In some circumstances the arrangements appear to be no more than shams.

Fieldwork has been undertaken on several share acquisition and incentive trust arrangements with the following findings.

- All structures were set up with an alleged purpose of benefiting employees in the future. They all used either a company, trust or a superannuation fund as the vehicle to enable the employer to pass on benefits.

- The benefits attained via some of these arrangements are meant to compensate “controllers” (usually a husband and wife) for deflated salaries being paid. Some plans are also alleged to provide bonuses to employees to encourage greater productivity and act to retain key employees (usually the controllers of the business).

- In the case of Employee Share Acquisition Plans and some Employee Incentive Trusts, the deeds will contain disentitling events that will result in the employee becoming disentitled to redeem his or her shares or units. If such disentitling events occur the benefit will usually flow on the residuary shareholder or beneficiary (normally a family trust or a super fund). The disentitled employee and his or her associates will be a beneficiary of the entity holding the residuary share or unit and thus the ultimate benefit will always flow on to the employee (controllers) and or associates thereof.

- In a typical plan, the employer will contribute money into a special purpose company, a special purpose trust or a controlled interest super fund (the investment vehicle). This contribution (which we have found to range anywhere between $50,000 and $4,000,000) is said to be deductable to the employer at the time of contribution. The investment vehicle then invests these funds for the benefit of the employee participating in the plan. This is generally done via a loan back to the employer entity thus completing the round robin flow of the funds.

The promoters of such schemes claim that

- FBT does not apply to the contribution.
- In the case of employee share plans, the employees are not assessed under Div 13A on the value equivalent to the employer contribution (as a discount)
- Part IVA and section 67 of the FBTAA do not apply.
- The employer contribution into the plan is deductable at the date the of contribution
- If the employee derives an assessable benefit at all, the derivation is postponed and / or may be concessionally taxed (either as a capital gain or and eligible termination payment).

Our preliminary view is that these EBAs are not tax effective in these ways.

ATO Strategic Direction

The Commissioner's strategy in respect of the aggressive tax planning being undertaken in respect of EBAs includes:-

- Speeches to advise taxpayers and advisers of the "ATO view" concerning these schemes;

- Draft ruling TR 98/D12 to provide a substantive position in respect of the "associate" rules for FBT purposes;

- The progressive withdrawal of previous opinions in this area;

- Centralised control on the issuing of rulings and opinions concerning EBAs. This involves the development of a comprehensive "ATO view" on the tax implications of EBAs. This view will be communicated to taxpayers and advisers by the end of May 1999. Our position will be supported by an audit strategy and possible test cases

Speeches by Commissioner of Taxation

The Commissioner has for some time been referring to aggressive tax planning activities in public speaking engagements. In his speech to the Chartered Institute of Company Secretaries on 11 August 1998, in Sydney he made specific reference to employee share plans (Division 13A) and related salary sacrifice and deferral arrangements, principally in regard to FBT avoidance.

In a speech to the Financial Planning Association of Australia on 27 April 1999 the Commissioner made reference to aggressive tax planning in employee benefit arrangements. He foreshadowed the development of a hotline for people to give details of aggressive products or marketing techniques about which they have concerns.

Draft Public Ruling

The Commissioner issued TR 98D\12 on 28 October 1998. This draft ruling was issued to clarify the ATO's view on the meaning and application of the term "associate" for FBT purposes in response to the aggressive marketing of a number of schemes. This was accompanied by a Press Release, dated 28 October 1999 in the following terms.

"In this case the purpose is to provide employee remuneration in a non-salary form to secure a deduction for the employer but avoid the corresponding FBT liability that applies to non-cash benefits provided to employees. Benefits of up to $1m per employee are not unknown.

The common issue with these arrangements is the term ‘associate’ under the safeguarding provisions of the law. These safeguarding provisions are there to ensure that the intended operation of the law is not avoided, for example, by conferring a benefit on an associate of an employee rather than directly on the employee.

Commonly the attempts to avoid this safeguard involve techniques that distinguish the timing of the employer’s payment and when the employee’s entitlement is said to crystallise.

The public ruling today makes clear the Tax Office view that the structures used in these employee benefit arrangements do not avoid the concept of an associate. They are therefore subject to FBT under the clearly intended operation of the law.

The ruling identifies a range of vehicles used for this purpose, including non-complying superannuation funds and unit trusts. Both offshore and on-shore arrangements are involved.

Consistent with our search for systemic approaches, we believe the existence of these identified schemes are likely to be a signal of other arrangements seeking to overcome the association concept in the law. Our new intelligence network will continue to be on the alert.”

Following further consultation, a revised Draft Ruling on FBT matters associated with EBAs is expected to be issued by the end of May 1999.

Embargo

The ATO has centralised control on the issue of private binding rulings and advance opinions on employee benefit schemes, controlling interest arrangements, offshore and non-complying superannuation funds as the next step in tackling aggressive tax planning in this area.

In a Press Release, dated 26 March 1999 we advised that we would withdraw a range of advance opinions previously issued in this area. The Press Release added:

"This is being done while we undertake a review of all information and arrangements now available in the area.

We have also seen evidence in the past where advance opinions were used to heavily market arrangements that in the end event were not implemented according to the arrangement on which the opinion was given.

In the wake of last year's ruling (TR98/D12), a number of taxpayers are rolling into new arrangements. We will be paying particular attention to these arrangements and will be ensuring they meet the requirements of the law.”

Trends

The intelligence and compliance data gathered to date on tax aggressive employee share and incentive trust arrangements indicates that contributions peaked in the 1997 and 1998 income years. The pre-lodgment activities undertaken by the ATO last year and the resultant publicity appear to have reduced the attractiveness of these schemes. However, not all the promoters have stopped marketing products.

The tax aggressive employee share, welfare and incentive trust schemes detected and on which we have ascertained contribution levels, to date, have involved over $400,000,000 in contributions. The arrangers of these schemes are charging around $15,000 for "modest" contributions of between $100,000 to $600,000. For higher contributions they often work on a percentage basis. The more aggressive marketers we estimate are making up to $4,000,000 on their marketing efforts. On past experience, we would expect this income to be "washed" through their own EBA.

The ATO is not as progressed in relation to its investigations of superannuation schemes. AUSTRAC data has shown that many millions of dollars have left the country and have been deposited with offshore trustees of superannuation funds. The benefit in these arrangements are that many countries only tax income sourced in that country and therefore the super fund avoids payment of any tax.

The ATO is currently reviewing the products of over 40 promoters involved in the "employee benefit arrangements" described above. On the data we have to date, we would estimate that the total contributions made by the clients of these identified promoters will, on a conservative measure, amount to approximately $1.5 billion.

We have also recently detected early evidence that some aggressive marketing was taking place regarding new schemes for non-complying superannuation funds. The arrangements promise the ability for taxpayers, particularly PAYE employees to set up a structure that would allow them to claim a deduction for superannuation which reduces their taxable income to whatever level they choose and for the super fund to avoid the 47% tax. These arrangements are not included in the total contribution figure provided in the previous paragraph.

The ATO is now starting to see evidence that these arrangements have been implemented. The fee structure in these arrangements ($60,000 to $4,000,000 and over) appears to be flexible between a 5 to 10 percent range. One promoter has made over $300,000 on just four sales.

In recent times the ATO has emphasised the need to be more pro-active regarding "real time" intelligence activity. In respect to the detection of mass marketed arrangements this has meant that the ATO has interacted with the promoters of these arrangements while selling is still in progress and months before the due date for the lodgment of tax returns.

The intelligence sought by the ATO is usually marketing material and client lists. The ATO is meeting determined resistance to the provision of client lists and has had to resort to formal information gathering powers. These formal powers have also been resisted and ATO has been and currently is involved in Federal Court proceedings to obtain lists of clients involved in taxation arrangements.

The ATO predicted and is now seeing evidence that professionals would seek to avoid direct contact with their clients and would instead use “agents” to market their products to their clients. This has been particularly evident in relation to off shore superannuation arrangements.

Another trend detected is that legitimate arrangements to provide clients with access to concessionally taxed arrangements (eg: ESAS) are being modified. For example, we have seen instances where individuals within a firm leave the firm and, on their own behalf, market heavily a more tax aggressive variant of the original plan.

This process places the originator of the arrangement and other tax professionals under pressure from their clients to match the perceived benefits of the aggressive plans being marketed. The ATO has received many complaints from tax professionals about the activities of the “lower end” of the market and for the need for the ATO to quickly make a decision on the effectiveness of the arrangements.

Conclusion

Higher levels of accountability and public scrutiny suggest that share ownership schemes appear to be working well and on a bona fide level at the publicly listed company end of the market. The issues encountered at this end are usually related to valuation matters or the unique circumstances of the corporate involved. Share option arrangements, however, do have the potential for tax avoidance and are being closely monitored.

The problems mostly occur in the small to medium segment where privately held companies predominate. It would appear, on the evidence available, that employee share ownership schemes are not looked upon as an option, as they would dilute the "controller's" interest in the company or the employee would have a limited resale market for the shares.

The creation of incentive and welfare trusts for employees of this small to medium segment initially appeared to conform to the policy direction of rewarding improvements in productivity or to assist in the retention of key staff. However, closer inspection and investigation of the implementation of these arrangements indicated that "controllers" were the predominant beneficiaries. Where arms length employees were involved, the trust deed invariably allowed the trustee ("controller" vehicle) to have various other classes of beneficiary that could direct both income and capital away from arms length employees.

The drivers for entering into these arrangements appear to be predominantly profit stripping or permanent tax deferral. In many cases the contribution by the employer to the incentive trust is the projected taxable income for that financial year.

At this point in time the ATO considers that aggressive tax planning in EBAs can be regulated under existing tax laws, including the anti-avoidance provisions.

Attachment A

Attachment A