TR 2006/7 - Income tax: special income derived by a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust in relation to the year of income

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Taxation Ruling

Income tax: special income derived by a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust in relation to the year of income

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What this Ruling is about

1. This Ruling explains what amounts are considered to be 'special income' under section 273 of the *Income Tax Assessment Act 1936* (ITAA 1936).

1A. Section 273 of the ITAA 1936 was repealed with effect from 1 July 2007. Section 273 has been re-written, with some modifications in section 295-550 of the *Income Tax Assessment Act 1997* (ITAA 1997). To the extent that section 295-550 of the ITAA 1997 expresses the same ideas as section 273 this ruling is also taken to be a ruling about section 295-550 of the ITAA 1997.[A1]

[A1] Section 357-85 of Schedule 1 to the *Taxation Administration Act 1953*.

1B. Section 273(2) provided the Commissioner with a discretion about the treatment of dividends from private companies as special income, having regard to specified factors in paragraphs 273(2)(a) to (f). In contrast, subsection 295-550(2) of the ITAA 1997 does not confer a discretion on the Commissioner. Rather subsection 295-550(2) of the ITAA 1997 has an objective test requiring the amount received to be consistent with an arm's length dealing. However, the factors that need to be considered in applying this test (set out in subsection 295-550(3) of the ITAA 1997) are substantively the same as those in subsection 273(2).

1C. Section 295-550 of the ITAA 1997 refers to the income covered by it as 'non arm's-length income'. To the extent that this ruling addresses issues in section 295-550 of the ITAA 1997 that are the same as were in section 273 the references to 'special income' should be read as 'non-arm's length income'.

2. Section 273 applies to income derived by a complying superannuation fund, a complying approved deposit fund (ADF) or a pooled superannuation trust (PST). It covers private company dividends, including income derived indirectly from a dividend and non-share dividends, income from a non-arm's length transaction, income received from a trust in the capacity of beneficiary other than by virtue of holding a fixed entitlement and non-arm's length income received from a trust in the capacity of beneficiary with a fixed entitlement.

3. The Ruling sets out what amounts are indirectly derived from a dividend and are therefore included within subsection 273(2) by subsection 273(3). It also explains what is meant by a 'non-share dividend' in subsection 273(9) and how these amounts are also included within subsection 273(2). The Ruling clarifies the circumstances in which the Commissioner will exercise the discretion under subsection 273(2) to not treat a dividend as special income. This involves an explanation of how the Commissioner will have regard to the matters listed in paragraphs 273(2)(a) to (e) and what other matters the Commissioner will consider relevant under paragraph 273(2)(f).

4. The Ruling also sets out the circumstances in which income derived from a transaction is special income under subsection 273(4).

5. Finally, the Ruling explains which trust distributions are special income under subsection 273(6) and the requirements for a trust distribution to be special income under subsection 273(7).

6. All legislative references in this Ruling are to the ITAA 1936 unless otherwise indicated.

Previous Rulings

7. Draft Taxation Ruling TR 2000/D11 was withdrawn on and from the issue date of draft Taxation Ruling TR 2006/D1. To the

extent that our views in that Ruling still apply, they have been incorporated in this Ruling.

Ruling

8. Section 273 sets out four different types of special income. These are:

- dividends paid by a private company, including income derived indirectly from a dividend and non-share dividends;
- income from a transaction where the parties are not dealing at arm's length;
- income received from a trust in the capacity of a beneficiary other than by virtue of holding a fixed entitlement; and
- non-arm's length income received from a trust in the capacity of a beneficiary holding a fixed entitlement.

9. In order for any amount to be special income, it must be income derived in a year of income by a complying superannuation fund, a complying ADF or a PST in relation to a year of income.

10. The word 'income' in section 273 is to be interpreted widely. It can include both income according to ordinary concepts and amounts included in assessable income under a statutory provision. This means that franking credits and capital gains could be special income if they satisfy the other requirements set out below.

11. The 'income' referred to in subsections 273(6) and 273(7), which deal with trust distributions, is the amount included within assessable income under Division 6 of Part III.

12. An amount of income either has the character of being special income or it does not. When an amount of income is special income, the whole amount is special income. An amount of income that is characterised as special income cannot be divided between an amount that is special income and an amount that is not special income. The amount of income that is special income is not only the amount by which an amount of income is greater than the amount that might have been derived if the parties had been dealing at arm's length; it is the whole amount of income derived.

Dividends paid by a private company

13. Subsection 273(2) provides that a dividend that is paid by a private company to a complying superannuation fund, a complying ADF or a PST is special income of the entity unless the Commissioner is of the opinion that it would be reasonable not to

treat the dividend as special income, having regard to the matters listed in subsection 273(2).

Self-assessment

14. This Ruling sets out the way in which the discretion in subsection 273(2) will be exercised by the Commissioner. A trustee may self-assess as to whether or not to treat a dividend as special income by applying this Ruling to their particular circumstances. If the trustee is uncertain as to whether or not the Commissioner will exercise the discretion, the trustee should seek clarification by requesting a private ruling.

Income derived indirectly from a dividend

15. The application of subsection 273(2) is extended by subsection 273(3). Subsection 273(3) deems income that is derived by the entity indirectly from a dividend paid by a private company to be a dividend paid to the entity by the company. This means that private company dividends that are derived indirectly may also be special income under subsection 273(2). A private company dividend that is derived by a superannuation entity from an interposed entity is indirectly derived from a dividend and will be special income unless the Commissioner exercises the discretion in subsection 273(2). The Commissioner's view is that the test in subsection 273(3) can include private company dividends received indirectly by a superannuation fund through a publicly listed company. In these situations, the Commissioner would always exercise the discretion in subsection 273(2) so that the dividends were not special income.

Non-share dividends

16. Subsection 273(9) also extends the scope of subsection 273(2). It ensures that subsection 273(2) applies to distributions that are paid by a private company that are not dividends, but are non-share dividends as that term is defined in section 974-120 of the ITAA 1997. Non-share dividends are distributions to holders of equity that are not dividends paid to shareholders.

Matters to be considered by the Commissioner

17. In order to decide whether the Commissioner will form the opinion that it would be reasonable not to treat a dividend as special income, the Commissioner will have regard to all of the matters in paragraphs 273(2)(a) to (e) and any other matters that the Commissioner considers relevant in accordance with paragraph 273(2)(f). No one matter is determinative. The importance attached to any particular matter may vary depending on the facts of

the case. While some matters may be unfavourable to the Commissioner exercising the discretion, others may be favourable.

18. The Commissioner will form the opinion that it would be reasonable not to treat the dividend as special income when the dividends are derived on an arm's length basis. The Commissioner will consider paragraphs 273(2)(a) to (e) as matters that indicate whether or not the dividends are derived on an arm's length basis. The Commissioner will consider a matter to be relevant under paragraph 273(2)(f) if it indicates whether or not the dividends are derived on an arm's length basis.

19. Dividends are only derived on an arm's length basis when the shares are acquired, the investment is maintained, and the dividends are paid on an arm's length basis. If the shares are acquired at market value, the private company is not involved in non-arm's length dealings and the rate of dividend is the same as the rate of dividend paid on other shares in the company or is reasonable having regard to investment risk, and there are no other matters that the Commissioner will consider relevant, the Commissioner will form the opinion that it would be reasonable not to treat the dividend as special income.

20. The Commissioner will consider the matters listed in paragraph 273(2)(a) to (d) in comparison with each other. In cases where the dividend paid relates to a share which has a par value, the Commissioner will compare this value with the partly paid value under paragraph 273(2)(a). The cost of the shares considered under paragraph 273(2)(b) will be compared with the market value of the shares at the time of acquisition, which is considered under paragraph 273(2)(a). The rate of dividend considered under paragraph 273(2)(c) will be compared to the rate of dividend paid on any other shares in the company, which is considered under paragraph 273(2)(d).

Value of the shares

21. The Commissioner will, as required by paragraph 273(2)(a), have regard to the value of the shares.

22. The market value of the shares at the time the superannuation fund, ADF or PST acquires them will be compared to the cost of the shares, which is considered under paragraph 273(2)(b) (see paragraphs 26 to 28 of this Ruling).

23. The market value of the shares will also be compared to the rate of return on investment to determine whether the rate of return is consistent with an arm's length outcome. This matter is considered under paragraph 273(2)(f) in determining whether the payment of the dividend is consistent with an arm's length outcome.[A2]

[A2] *Darrelen Pty Ltd, Trustee of the Henfam Superannuation Fund v FCT* [2010] FCAFC 35

24. Where the shares of a company have a par value, the Commissioner will compare this value with the partly paid value of the shares under paragraph 273(2)(a). The paid-up value of the shares will also be compared with the paid-up value of shares held by other shareholders of the private company. This will be a relevant matter considered under paragraph 273(2)(f) in determining whether the payment of the dividend is consistent with an arm's length outcome.

25. If the shares in the private company are paid-up to different extents, and there are no other matters that the Commissioner considers adequately explain the difference, the Commissioner will treat the dividend as special income.

Cost of the shares

26. The Commissioner will, as required by paragraph 273(2)(b), have regard to the cost to the superannuation fund, ADF or PST of the shares.

27. The cost of the shares will have particular relevance in comparison to the market value of the shares at the time of acquisition.

28. If a superannuation fund, ADF or PST acquires shares in a company for an amount less than the market value of those shares, this will be a significant factor in determining whether the payment of the dividend is consistent with an arm's length outcome. This will especially be the case where other shareholders in the company paid market value for their shares.

Example 1

29. This example considers the relevance of paying full market value in the acquisition of shares in a company when determining whether dividends are special income.

The facts

30. On 1 June 2001 a self managed superannuation fund, the Toby Superannuation Fund, acquires 100,000 shares for 50 cents each in a private company, Extension Products Pty Ltd. The Toby Superannuation Fund pays a total of $50,000. At the time of the acquisition of the shares, the market value of one share in Extension Products Pty Ltd is $1.00. Also on 1 June 2001 nine other entities acquire 100,000 shares each in Extension Products Pty Ltd. The nine other entities pay $1.00 for each share, paying a total of $100,000 each. The members of the Toby Superannuation Fund are related to the directors and the other shareholders.

31. On 1 June 2003 Extension Products Pty Ltd pays dividends on all of its shares at the rate of 5 cents per share. All ten shareholders are paid a dividend of $5,000. In the following year no

dividends are paid on the shares. On 1 June 2005 Extension Products Pty Ltd pays dividends on all of its shares at the rate of 5 cents per share. All shareholders are paid a dividend of $5,000.

Consideration of the matters under subsection 273(2)

32. The rate of dividend paid on 1 June 2003 and on 1 June 2005 is the same rate for all of the shareholders.

33. The cost to the Toby Superannuation Fund of the shares in Extension Products Pty Ltd is 50 cents for each share. The market value of the shares at the time of acquisition is $1.00 per share. The cost of the shares is less than the market value of the shares.

34. The relationship between the Toby Superannuation Fund and Extension Products Pty Ltd appears not to be at arm's length and the result of their dealing is not consistent with an arm's length outcome.

The decision

35. On the whole, having regard to the matters listed in paragraphs 273(2)(a) to (f), including the fact that the parties are related, the Commissioner is not of the opinion that it would be reasonable to exercise his discretion. The dividends paid on 1 June 2003 and on 1 June 2005 to the Toby Superannuation Fund are not consistent with an arm's length outcome and will therefore be special income under subsection 273(2). In the absence of other factors, if full market value had been paid for the shares, the Commissioner would have exercised his discretion not to treat the dividend as special income.

Rate of the dividend

36. The Commissioner will, as required by paragraph 273(2)(c), have regard to the rate of the dividend paid to the superannuation fund, ADF or PST by the private company on the shares.

37. The rate of dividend will be considered in comparison with the rate of dividend paid on any other shares in the company which is considered under paragraph 273(2)(d).

38. In *Darrelen Pty Ltd, Trustee of the Henfam Superannuation Fund v FCT* [2010] FCAFC 35 (*Darrelen*), the Full Federal Court held that paragraph 273(2)(c) does not *also* permit reference to the rate of return on the investment. However, the court held that the Commissioner may nonetheless have regard to the rate of return on the investment under paragraph 273(2)(f).

39. Other relevant factors may also be taken into account in determining whether the payment of the dividend is consistent with an arm's length outcome.

40. Where the shares in the private company are of different classes, differing rates of dividend to shareholders will be an unfavourable factor unless the rate of dividend reflects the level of investment risk and is consistent with an arm's length outcome.

Example 2

41. This example considers the relevance of paying full market value for shares and the level of investment risk undertaken whilst holding those shares when determining whether the rate of dividend is consistent with an arm's length outcome.

The facts

42. A private company, Debvin Pty Ltd, was established in 2001 for the purpose of acquiring a parcel of land for development and resale. The company was to be wound up on completion of the project and sale of the lots. Ten separate entities unrelated to each other subscribed for 100,000 ordinary shares. Nine of the original investors were issued 10,000 shares for $1.00 per share, including the Ebony Superannuation Fund (a self managed superannuation fund). The tenth investor, the Jasmine Superannuation Fund was issued 10,000 shares for $0.75 per share. There were four directors of Debvin Pty Ltd being individuals related to four of the investor entities. The directors were not involved in the day to day management of the property development and did not receive any director's fees or other remuneration from Debvin Pty Ltd. The development and sale of the land was undertaken by unrelated parties on normal commercial terms.

43. Debvin Pty Ltd acquired a parcel of land recommended by Jasmine Lee, a director of the company, at the fair market value of $2.5 million from an unrelated party. Debvin Pty Ltd obtained additional finance from commercial lenders to fund the purchase of the land and the initial stages of the development. The profits from sale of the redeveloped land were initially used by Debvin Pty Ltd to repay the loans and fund future stages of the development. In February 2006 Debvin Pty Ltd paid a dividend of $3.85 per share and was wound up by returning $1.00 capital per share to each shareholder.

Consideration of the matters under subsection 273(2)

44. With respect to the dividend received by the Ebony Superannuation Fund the following factors are taken into consideration.

45. The fact that the Ebony Superannuation Fund paid the same price as the majority of the other shareholders who originally subscribed for shares provides a strong indication the shares were acquired at market value. While the dividend yield is high, a $3.85

dividend on a $1.00 share, it reflects the investment risk undertaken by the investors and the growth in the property market. The same dividend was also declared on all shares. These are favourable factors to the Commissioner determining that the payment of the dividend was consistent with an arm's length outcome.

The decision

46. On balance, the factors indicate that the Ebony Superannuation Fund invested in and received dividends on an arm's length basis. The Commissioner considers it reasonable to exercise the discretion so that the dividends are not treated as special income of the Ebony Superannuation Fund.

Whether a dividend is paid on any other shares in the company and the rate of that dividend

47. The Commissioner will, as required by paragraph 273(2)(d), have regard to whether the company has paid a dividend on other shares in the company and, if so, the rate of that dividend.

48. If the rate of dividend paid to the superannuation fund, ADF or PST for some or all of the shares it holds in a private company is greater than the rate of dividend paid to other shareholders, this will be a significant factor when determining whether the payment of the dividend is consistent with an arm's length outcome.

49. If, however, the differing dividend rates reflect differing levels of investment risk, the comparative rates of dividends will be a favourable factor towards the Commissioner exercising the discretion.

Whether shares have been issued in satisfaction of a dividend and the circumstances of issue

50. The Commissioner will, as required by paragraph 273(2)(e), have regard to whether the shares have been issued in satisfaction of a dividend and the circumstances of issue.

51. The Commissioner will not consider the income to be special income just because shares have been issued in satisfaction of a dividend. However, the circumstances of the issue will be considered by the Commissioner to determine whether the issue of the shares is consistent with an arm's length outcome.

52. If the private company has issued bonus shares to all of its shareholders on the same basis, the issue of bonus shares will be a neutral factor towards the Commissioner exercising the discretion.

Other matters that the Commissioner considers relevant

53. The Commissioner will consider under paragraph 273(2)(f) any other matters that are relevant to determining whether the payment of the dividend is consistent with an arm's length outcome.

54. The matters that the Commissioner may consider relevant include:

- the extent to which members who are at arm's length to the private company have an interest in the superannuation fund, ADF or PST;
- the relationship between the superannuation fund, ADF or PST and the private company;
- the relationship between the superannuation fund, ADF or PST and any party with which the private company has dealings;
- who the superannuation fund, ADF or PST acquires the shares from and the circumstances of that acquisition; and
- the rate of return on the superannuation fund's investment.

Example 3

55. This example considers the relevance of arm's length outcomes from related party dealings when determining whether dividends are special income.

The facts

56. A private company, Maz Pty Ltd, is in the biotechnological industry and has two shareholders. Both of the shareholders are self managed superannuation funds. The Tifco Superannuation Fund has two members, Tiffany and Colin. The Jubri Superannuation Fund has two members, Judy and Brian. Each self managed superannuation fund has acquired 500,000 shares at $1.00 a share. The market value of each share in Maz Pty Ltd is $1.00.

57. Brian and Tiffany are employees of Maz Pty Ltd. Judy and Colin are directors of Maz Pty Ltd. All employees and directors are paid a salary at the market rate. The Tifco Superannuation Fund owns the business premises from which Maz Pty Ltd runs its business. The Tifco Superannuation Fund leases the business premises to Maz Pty Ltd at a market rate. The business premises are less than 5% of the Tifco Superannuation Fund's total assets. Judy's father, Jose, loans money to Maz Pty Ltd at a market interest rate and on bona fide commercial terms.

58. Maz Pty Ltd makes a biotechnological breakthrough and thereby makes large profits. It pays the same amount of dividends to

both the Tifco Superannuation Fund and the Jubri Superannuation Fund. They are a reflection of the large profits made by the private company as a result of the biotechnological breakthrough.

Consideration of the matters under subsection 273(2)

59. The members of the Tifco Superannuation Fund and the Jubri Superannuation Fund are employees and directors of Maz Pty Ltd. The relationship between the funds and the private company is not at arm's length.

60. The cost of the shares is the market value.

61. In addition, the rate of dividend paid to the Tifco Superannuation Fund and the Jubri Superannuation Fund is consistent with the large profits that have been generated at arm's length.

62. Whilst Maz Pty Ltd and the Jubri Superannuation Fund are not at arm's length, their dealings in relation to the lease of the business premises produce an arm's length outcome. Although Maz Pty Ltd and Jose are not at arm's length, they deal with each other at arm's length in relation to the loan agreement. Equally, Maz Pty Ltd is not at arm's length with Judy, Brian, Colin and Tiffany, yet their dealings with each other in relation to their employment arrangements produce an arm's length outcome. These are relevant factors that the Commissioner will consider in determining whether the payment of the dividend is consistent with an arm's length outcome.

The decision

63. On the whole, having regard to the matters listed in paragraphs 273(2)(a) to (f), the Commissioner is of the opinion that it would be reasonable not to treat the dividends as special income of the Tifco Superannuation Fund and the Jubri Superannuation Fund. Whilst the party's were not at arm's length from each other the Commissioner is of the opinion that their dealing did produce arm's length outcomes.

Example 4 (incorporates the facts in paragraphs 42 and 43 from Example 2)

64. This example considers the relevance of arm's length outcomes in dealing with related parties when determining whether dividends will be special income.

Additional facts

65. Jasmine Superannuation Fund, a self managed superannuation fund, was the other original investor in Debvin Pty Ltd. The sole member of the Jasmine Superannuation Fund is Jasmine Lee, a director of Debvin Pty Ltd. Jasmine Lee had

undertaken a considerable amount of research and feasibility testing in locating a suitable site for development and preparing the original investment proposal. Shares were issued to the Jasmine Superannuation Fund for $0.75 per share.

Consideration of the matters under subsection 273(2)

66. With respect to the dividend received by the Jasmine Superannuation Fund the following factors are taken into consideration.

67. The fact that the Jasmine Superannuation Fund paid less than the other shareholders who subscribed for shares at the same time provides a strong indication that the shares were acquired for less than market value. Under paragraphs 273(2)(a) and (b) this is a factor that is inconsistent with an arm's length outcome.

68. While the dividend yield is high, a $3.85 dividend on a $1.00 share, it reflects the investment risk undertaken by the investors and the growth in the property market. The same dividend was also declared on all shares. These factors can be considered favourable in exercising the discretion. However, because the Jasmine Superannuation Fund paid less than the other original shareholders, the actual rate of return on its investment was higher than the other original shareholders receiving an arm's length return.

69. Under paragraph 273(2)(f), factors relevant to the Commissioner exercising the discretion are that Jasmine Lee undertook the initial preparatory steps to establish the investment, is a director of the company and has not received any remuneration for any of those services. On balance, the factors would indicate the Jasmine Superannuation Fund invested on terms more favourable than a party dealing at arm's length and that the payment of the dividend was not consistent with an arm's length outcome.

The decision

70. The dividends received by the Jasmine Superannuation Fund will be special income under subsection 273(2) as the Commissioner does not consider it appropriate to exercise the discretion. In the absence of other factors, if Jasmine Lee had been paid personally for the work she performed in locating a suitable property and Jasmine Superannuation Fund had paid market value for its shares, the Commissioner would have exercised his discretion not to treat the dividend as special income.

Income from a transaction where the parties are not dealing at arm's length

71. There are three requirements that must be satisfied in order for an amount of income to be special income under subsection 273(4):

- there must be a transaction;
- the parties to the transaction must not have been dealing with each other at arm's length; and
- the income derived from the transaction must be greater than the income that might have been expected if the parties were dealing with each other at arm's length.

72. The types of transactions that subsection 273(4) can apply to include interest on loans, rent from property, and profit on sale of assets. Capital gains that are assessable income may be included as special income under subsection 273(4). Franking credits on a dividend may be included as special income under subsection 273(4).

73. The subsection does not apply to private company dividends or trust distributions, which are dealt with elsewhere in section 273.

Transaction

74. The word 'transaction', for the purposes of subsection 273(4), is defined in subsection 273(5) to include a series of transactions. This means that the Commissioner, when deciding whether or not the parties were dealing at arm's length in relation to a series of transactions, will consider all of the transactions in that series. A series of transactions is a number of transactions linked together to obtain a definite objective.

75. This aside, the word 'transaction' should be interpreted in accordance with its ordinary meaning and the context of the section. A series of transactions for the purposes of section 273 must involve dealing between at least two parties.

Not dealing with each other at arm's length

76. The Commissioner considers that parties are dealing with each other at arm's length in relation to a transaction if the independent minds and wills of the parties are applied to the transaction and their dealing is a matter of real bargaining. If this is not the case, the Commissioner will consider that the parties are not dealing with each at arm's length in relation to the transaction.

77. If the relationship of the parties is such that one party has the ability to influence or control the other, this will suggest that the parties may not be dealing at arm's length, but it will not be determinative.

78. Parties that are not at arm's length can deal with each other at arm's length in relation to a transaction and parties that are at arm's length can deal with each other in a way that is not at arm's length. An amount of income can only be special income under subsection 273(4) if, in relation to the particular transaction, the parties are not dealing with each other at arm's length.

The amount of income derived from the transaction

79. The final requirement for an amount of income to be special income under subsection 273(4) is that the amount of income derived from the transaction must be greater than the amount of income that might have been expected if the parties were dealing with each other at arm's length in relation to the transaction.

80. This is a question of fact. When considering this issue, the Commissioner will take into account all relevant matters. The level of investment risk that the superannuation entity is exposed to will be a relevant matter.

Example 5

81. This example considers the relevance of real bargaining in negotiations between parties when considering whether income derived from such dealings is special income.

The facts

82. Ben and Sandra Wardell are the members and trustees of the Wardell Superannuation Fund, a self managed superannuation fund. The fund had previously purchased a property from an unrelated party on an arm's length basis. The Wardell Superannuation Fund leases the property to Stevros Shipwright Services (Stevros). The parties are not related or associated in any other way. For the past fifteen years Stevros has conducted a boat repair business from the property owned by the Wardell Superannuation Fund by entering into five year leases. Negotiations for a new lease were recently entered into by the parties. The agent acting on behalf of the trustees of the Wardell Superannuation Fund advised that a reasonable market rent for a five year lease would be $24,000 per annum. During negotiations the representatives of Stevros raised issues with repairs and improvements to the property and fixtures. This included the possibility of Stevros paying for improvements to the slipway and jetty in return for a reduced rental and longer lease. The trustees of the Wardell Superannuation Fund were reluctant to accept a lower rent.

83. The agent advised the trustees that if the improvements were made to the property a reasonable market rent for a five year lease would be $30,000 per annum. The preference of the trustees was to pay for the improvements and have Stevros enter into a fifteen year lease for $30,000 to increase each five years by the rate the consumer price index (CPI) had risen. For a variety of reasons the principals of Stevros were reluctant to accept the terms proposed by the trustees of the fund and instead agreed to enter into a five year lease for $8,500 per annum more than the market rent of $30,000. The lease also contained an option for Stevros to enter into two further five year leases upon the expiration of the new lease. The rental payable would revert back to the market rent applicable at the

time of taking up the option. The trustees of the Wardell Superannuation Fund engaged an unrelated party to carry out the improvements to the property on normal commercial terms.

Application of subsections 273(4) and (5)

84. The rental income derived by the Wardell Superannuation Fund from the new lease of the property falls for consideration under subsection 273(4) in determining if it is special income. The rental income received by the Wardell Superannuation Fund from entering into the new lease of $38,500 per annum is higher than the reasonable market rent as advised by the agent. Prima facie this could indicate the income will be special income. The first issue for consideration is determining if the dealings between the parties were at arm's length; that is, did the parties act severally and independently in forming their bargain. It should also be kept in mind that a reference to a transaction in subsection 273(4) includes a reference to a series of transactions.

85. In this case, the transactions for consideration include the purchase of the property, the improvements made to the property and entering into the new lease. Both the purchase of the property and the improvements were entered into by the trustees of the fund with unrelated parties on an arm's length basis. With regard to the new lease, Stevros and the trustees of the fund are not related parties. Each of the parties entered into genuine negotiations regarding the terms of the new lease. These negotiations were a matter of real bargaining. There is nothing to suggest the parties colluded to achieve a particular result or that the representatives of Stevros submitted the exercise of their will to the dictation of the trustees of the fund. The parties dealt with each other at arm's length in negotiating the new lease.

The decision

86. The rental amount received by the Wardell Superannuation Fund is not special income of the fund as the income received is consistent with an arm's length outcome.

Example 6

87. This example considers the relevance of arm's length outcomes in dealings between related parties when considering whether income derived from such dealings is special income.

The facts

88. A self managed superannuation fund, the Amti Superannuation Fund, forms a corporate limited partnership with a private company, Tiam Pty Ltd. The members of the Amti Superannuation Fund are

Amanda and Tim. Amanda and Tim are the only shareholders and directors of Tiam Pty Ltd. In the corporate limited partnership, the Amti Superannuation Fund is the limited partner and is entitled to 99% of the income of the corporate limited partnership. Tiam Pty Ltd is a general partner, only entitled to 1% of the income of the corporate limited partnership. Tim and Amanda are also the trustees of the Tim and Amanda Family Trust. The beneficiaries of the Tim and Amanda Family Trust are Tim, Amanda and their two daughters Marion and Jodi. On the same day as the corporate limited partnership is formed, the trust deed of the Tim and Amanda Family Trust is amended to include as beneficiaries the Amti Superannuation Fund and Tiam Pty Ltd jointly in their capacity as partners in the corporate limited partnership. One month later, Tim and Amanda, as trustees of the Tim and Amanda Family Trust exercise their discretionary trust powers by distributing $200,000 of income to the Amti Superannuation Fund and Tiam Pty Ltd in their capacity as partners in the corporate limited partnership. The corporate limited partnership distributes 99% of this amount, $198,000, to the Amti Superannuation Fund.

Application of subsections 273(4) and (5)

89. The formation of the corporate limited partnership, the amendment of the trust deed of the Tim and Amanda Family Trust to include the Amti Superannuation Fund and Tiam Pty Ltd jointly in their capacity as partners in the corporate limited partnership as beneficiaries, the distribution of income from the Tim and Amanda Family Trust to the beneficiaries, and the distribution of income from the corporate limited partnership to the Amti Superannuation Fund are all transactions in a series of transactions. In accordance with subsection 273(4), a transaction includes a series of transactions through the operation of subsection 273(5).

90. The parties to these transactions are all controlled by the same two individuals, Tim and Amanda. This suggests that the parties may not be dealing at arm's length but it is not determinative. The series of transactions is not a matter of real bargaining because it involves the distribution of $200,000 for no valuable consideration. For this reason the parties to the series of transactions are not dealing at arm's length.

91. The amount of income that the Amti Superannuation Fund derived is $198,000. No private company dividends were included in this income. The income of the corporate limited partnership increased as a result of the distribution received by the beneficiaries of the Tim and Amanda Family Trust. As a result the corporate limited partnership had more income available to be distributed to the partners. If the parties were dealing at arm's length no distribution to the Amti Superannuation Fund and Tiam Pty Ltd jointly in their capacity as partners in the corporate limited partnership from the Tim and Amanda Family Trust could be expected and much less income would have been available for distribution to the partners. Accordingly, the amount of income derived by the Amti Superannuation Fund from the transaction is greater than might have been expected to have been

derived by the fund if the parties had been dealing with each other at arm's length.

The decision

92. The income derived by the Amti Superannuation fund will be treated as special income under subsection 273(4).

Franking credits

93. A franking credit on a private company dividend may be special income under subsection 273(4). If a private company dividend derived by a superannuation entity is special income under subsection 273(2) and is franked, the franking credit needs to be considered under subsection 273(4). The franking credit will be special income under subsection 273(4) if it is derived from a transaction or series of transactions the parties to which were not dealing with each other at arm's length and the amount of income derived from the transaction or series of transactions is greater than the amount of income that might have been expected to have been derived if the parties had been dealing with each other at arm's length in relation to the transaction or series of transactions.

Example 7

94. This example considers the relevance of arm's length outcomes in the acquisition of shares between related parties when considering whether franking credits derived from such dealings are special income.

The facts

95. Steve and Mary are the only members and trustees of the Vale Superannuation Fund, a self managed superannuation fund. Steve and Mary are the directors of Vale Enterprises Pty Ltd, a private company. Steve and Mary hold 1 share each in Vale Enterprises Pty Ltd. After trading successfully, Vale Enterprises Pty Ltd makes a profit of $1 million in December 2004. At this time, Vale Enterprises also has $500,000 credit in its franking account. In January 2005, Vale Enterprises Pty Ltd issues 99,998 shares to the Vale Superannuation Fund for 1 cent per share. The Vale Superannuation Fund pays a total of $1,000 for their shares. In April 2005, Vale Enterprises Pty Ltd distributes all of its profits to its shareholders in proportion to their shareholding. It pays fully franked dividends at the rate of $10 a share. Vale Enterprises Pty Ltd pays a $10 dividend each to both Steve and Mary. Vale Enterprises Pty Ltd pays a fully franked dividend of $999,980 to the Vale Superannuation Fund. The dividend of $999,980 and the attached franking credits will be included in the assessable income of the Vale Superannuation Fund.

Application of subsection 273(2)

96. The Commissioner will consider all of the matters listed in paragraphs 273(2)(a) to (e) and any other relevant matters under paragraph 273(2)(f) to determine whether the payment of the dividend is consistent with an arm's length outcome. The fact that the shares are acquired for considerably less than market value will be of particular relevance under paragraphs 273(2)(a) and (b).

97. The dividend, being $10 per share on shares acquired four months earlier for 1 cent per share, received by the Vale Superannuation Fund will be special income under subsection 273(2). The Commissioner does not consider it appropriate to exercise the discretion where the parties' dealings have not produced an arm's length outcome.

Application of subsections 273(4) and (5)

98. The acquisition of the shares in Vale Enterprises Pty Ltd and the payment of the dividend are a series of transactions for the purposes of subsections 273(4) and (5). The franking credit is income derived from this series of transactions.

99. Since the shares were acquired for less than market value, the parties in relation to that transaction were not dealing with each other at arm's length. The amount of franking credits derived from the series of transactions was greater than the amount of franking credits that would have been derived if the parties were dealing at arm's length. If the parties were dealing at arm's length, the Vale Superannuation Fund would have received less shares for their outlay and would not have been entitled to as many franking credits. The franking credits are special income under subsection 273(4).

The decision

100. The franked dividend is special income of the Vale Superannuation Fund under subsection 273(2). The franking credits on the dividend are special income of the Vale Superannuation Fund under subsection 273(4).[1]

Trust distributions not arising from a fixed entitlement

101. If a complying superannuation fund, complying ADF or PST derives income from a trust by way of the trustee or any other person exercising a discretion, the income distributed will be special income under subsection 273(6).

[1] This example only considers the operation of the special income provisions. However other provisions may apply to these circumstances, for example, the dividend stripping provisions.

Trust distributions arising from a fixed entitlement

102. A trust distribution to a complying superannuation fund, complying ADF or PST will fall within subsection 273(7) rather than subsection 273(6) if the entity's entitlement to the distribution does not depend upon the exercise of the trustee's or any other person's discretion.

103. A trust distribution arising from a fixed entitlement will only be special income if three conditions are met:

- the entity must have acquired the fixed entitlement under an arrangement or the income must have been derived under an arrangement;
- some or all of the parties to the arrangement must not have been dealing with each other at arm's length; and
- the amount of the distribution must be greater than the amount of income that might have been expected if the parties had been dealing with each other at arm's length.

Example 8

104. This example considers the relevance of paying full market value for a fixed entitlement to a trust distribution and the non-arm's length nature of the earnings of that trust when considering whether a trust distribution is special income.

The facts

105. The members of the Salbo Superannuation Fund are Bobby and Sally. The corporate trustee of the Bosa Trust is Bruce Industries Pty Ltd. Sally's brother Bruce has a 75% shareholding and is a director of Bruce Industries Pty Ltd. The Bosa Trust issues 100,000 units, 10,000 each to 10 different unit holders, including the Salbo Superannuation Fund. The investment in the Bosa Trust is less than 5% of the Salbo Superannuation Fund's total assets. The units in the Bosa Trust confer a fixed entitlement to the income of the Bosa Trust. The Salbo Superannuation Fund and all of the 9 other unit holders pay $1.00 per unit, each paying a total of $10,000. The market value of a unit in the Bosa Trust is $1.00.

106. The Bosa Trust carries on a storage business. Bobby and Sally are employees of the Bosa Trust. They are paid a salary at the market rate. The Salbo Superannuation Fund owns the premises from which the Bosa Trust runs its business. The Salbo Superannuation Fund leases the business premises to the Bosa Trust at a market rate. The business premises are less than 5% of the Salbo Superannuation Fund's total assets. Bruce loans money to the Bosa Trust at a market interest rate and on bona fide commercial terms. The Bosa Trust distributes an equal amount of income to all of

the unit holders, including the Salbo Superannuation Fund, in accordance with the fixed entitlement. No amount of the distribution included private company dividends. The amount of income distributed is a market rate of return, having regard to the market value of the units.

Application of subsection 273(7)

107. The acquisition of the units in the unit trust and the distribution of income constitute an arrangement for the purposes of subsection 273(7). Other arrangements and dealings have occurred between the Salbo Superannuation Fund, the Bosa Trust and other parties who are not at arm's length with each other.

108. The relationship between some of these parties is such that one party has the ability to influence or control the other. The crucial issue, however, is that in all of these arrangements the dealing between the parties is a matter of real bargaining. The units are acquired at market value, the distributions are paid at a market rate, and the lease of the business premises is on commercial terms, as is the loan agreement between Bruce and the Bosa Trust. All of the parties involved in these arrangements are therefore dealing with each other at arm's length.

109. Accordingly, the facts of this example do not satisfy the test in paragraph 273(7)(a). Furthermore the amount of income derived by the Salbo Superannuation Fund is not greater than an arm's length amount. The facts of this example therefore do not satisfy the test in paragraph 273(7)(b).

The decision

110. The trust distribution derived by the Salbo Superannuation Fund from the Bosa Trust is not special income.

Arrangement

111. The word 'arrangement' is defined for the purposes of subsection 273(7) in subsection 273(8). The definition is very broad, including any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable. It also includes any scheme, plan, proposal, action, course of action or course of conduct. It follows that to acquire a fixed entitlement to the income of a trust or to derive income from a trust will involve an arrangement. More than two parties may be involved in the arrangement.

Not dealing with each other at arm's length

112. Some or all of the parties to the arrangement must not have been dealing with each other at arm's length. Subsection 273(7) does

not require that all persons who have entitlements to the trust were not dealing at arm's length. Nor does it require that all members of the superannuation entity benefit from the arrangement.

113. When considering whether some or all of the parties to the arrangement were dealing with each other at arm's length, the Commissioner will adopt an approach similar to that set out in paragraphs 76 to 78 of this Ruling. The only differences are that subsection 273(7) applies to an arrangement rather than a transaction and only requires that some of the parties to that arrangement are not dealing with each other at arm's length.

The amount of income derived from the trust

114. The final requirement for an amount of income to be special income under subsection 273(7) is that the amount of income derived from the arrangement must be greater than the amount of income that might have been expected if the parties were dealing with each other at arm's length in relation to the arrangement.

115. When considering whether the income derived from the arrangement is greater than the income that might have been expected if the parties were dealing with each other at arm's length, the Commissioner will adopt an approach similar to that set out in paragraphs 79 and 80 of this Ruling.

Example 9

116. This example considers the relevance of paying full market value for a fixed entitlement to a trust distribution when considering whether such a distribution is special income.

The facts

117. The members of the Chau Superannuation Fund are Patrice and Tom. The Innovative Investments Trust issues 100,000 units, 10,000 each to 10 different unit holders, including the Chau Superannuation Fund. The units owned by the Chau Superannuation Fund confer a fixed entitlement to the income of the Innovative Investments Trust. The trustees of the Innovative Investments Trust and the members of the Chau Superannuation Fund are unrelated.

118. Although the 9 other unit holders in the Innovative Investments Trust pay $1.00 per unit, a total of $10,000 each, the members of the Chau Superannuation Fund have an agreement with the Innovative Investments Trust whereby the Innovative Investments Trust pay a total of $5,000 (being 50 cents per unit) for it's total unit holding. The Innovative Investments Trust distributes an equal amount of income to all of the unit holders, including the Chau Superannuation Fund, in accordance with the fixed entitlement. Each unit holder receives a distribution of $500. The amount of income

distributed is a market rate of return having regard to the market value of the units.

Application of subsection 273(7)

119. An 'agreement' is an 'arrangement' for the purposes of subsection 273(7) as defined in subsection 273(8). The acquisition of the units in the unit trust, the agreement between the Innovative Investments Trust and the Chau Superannuation Fund whereby the fund pays 50 cents per unit and the distribution of income constitute an arrangement for the purposes of subsection 273(7). The fixed entitlement is acquired and the income is derived under this arrangement.

120. Although the members of the Chau Superannuation Fund and the Innovative Investments Trust are at arm's length, they collude to achieve the result of acquiring units at below market value. The dealing between the two parties in relation to the arrangement was not a matter of real bargaining. Therefore the Chau Superannuation Fund acquired the fixed entitlement under an arrangement the parties to which were not dealing with each other at arm's length. The test in paragraph 273(7)(a) is satisfied.

121. The amount of income that the Chau Superannuation Fund derived is greater than the amount of income that it might have expected to have derived if the Chau Superannuation Fund and Innovative Investments Trust were dealing with each other at arm's length in relation to the arrangement because the units were acquired for $5,000 less than the arm's length amount. The amount of income derived from the arrangement was therefore greater than the amount that would have been derived if the parties were dealing with each other at arm's length. The test in paragraph 273(7)(b) is therefore satisfied.

The decision

122. The $500 distribution from the Innovative Investments Trust is income of the Chau Superannuation Fund that is special income under subsection 273(7).

Example 10

123. This example considers the relevance of a discretionary trust distribution to a fixed trust when considering whether a trust distribution pursuant to a fixed entitlement is special income.

The facts

124. A business is operated by a discretionary trust. A fixed trust is created and the discretionary trust deed is amended to include the fixed trust as a beneficiary. A self managed superannuation fund has a fixed entitlement to income in the fixed trust. The members of the self managed superannuation fund are the trustees of the discretionary trust and are the directors and shareholders of the corporate trustee of the fixed trust. A distribution is made by the discretionary trust to the fixed trust. The fixed trust then distributes income to the self managed superannuation fund in accordance with the fixed entitlement.

Application of subsection 273(7)

125. The amendment of the trust deed of the discretionary trust to include the fixed trust as a beneficiary, the distribution of income from the discretionary trust to the fixed trust and the distribution of income from the fixed trust to the self managed superannuation fund would all fall within the definition of 'arrangement' in subsection 273(8). For the purposes of subsection 273(7) this course of action is an arrangement that relates to the acquisition of the fixed entitlement to the income of the fixed trust and to the derivation of that income.

126. The parties to this arrangement – the discretionary trust, the fixed trust and the self managed superannuation fund – have colluded to achieve a particular result. The parties are not involved in real bargaining in relation to the arrangement. This is demonstrated by the fact that the fixed trust receives a distribution of income for no valuable consideration.

127. The self managed superannuation fund also receives an inflated distribution of income for no valuable consideration. The income of the fixed trust has increased as a result of the distribution received from the discretionary trust under an arrangement the parties to which were not dealing with each other at arm's length. As a result, the fixed trust has more income available to be distributed. If the parties were dealing at arm's length, no distribution to the fixed trust from the discretionary trust could be expected and less income would have been available for distribution from the fixed trust.

128. In these circumstances, the parties to the arrangement were not dealing with each other at arm's length and the amount of income derived by the self managed superannuation fund from the arrangement is greater than might have been expected to have been derived by the fund if the parties had been dealing with each other at arm's length. Both the tests in paragraphs 273(7)(a) and 273(7)(b) are satisfied.

The decision

129. The amount of income derived by the self managed superannuation fund from the fixed trust is special income under subsection 273(7).

Example 11

130. This example considers the relevance of excessive service fees being paid under a service arrangement when considering whether a trust distribution pursuant to a fixed entitlement is special income.

The facts

131. The Kirkpatrick Trust carries on a business of labour hire operation. The trustee is Kiz Pty Ltd. The two shares issued by Kiz Pty Ltd are held by Eddie. Eddie holds 2000 units in the Kirkpatrick Trust. The Kirkpatrick Family Superannuation Fund holds 98,000 units in the Kirkpatrick Trust. The investment in the Kirkpatrick Trust is less than 5% of the Kirkpatrick Family Superannuation Fund's total assets. Both unit holders pay market value for their units. The members of the Kirkpatrick Family Superannuation Fund are Eddie and Katie. The trustee is Kiz Pty Ltd. The trust deed of the Kirkpatrick Trust states that the income of the trust will be distributed in proportion to the units held.

132. The only client of the Kirkpatrick Trust is Edward Kirkpatrick Pty Ltd. All of the income of the Kirkpatrick Trust consists of service fees received from Edward Kirkpatrick Pty Ltd. The income of the Kirkpatrick Trust in the year ended 30 June 2006 was $5,000,000. The Kirkpatrick Trust resolves to distribute all of the income that it has derived in the year ended 30 June 2006 to the unit holders in proportion to the units held. The income derived by the Kirkpatrick Family Superannuation Fund from the Kirkpatrick Trust is $4,900,000. Taking into consideration the operating costs and the net profit achieved by independent suppliers in respect of the provision of similar services in the market, the services fees charged by the Kirkpatrick Trust in the year ended 30 June 2006 are much higher than the market rate of those fees.

Application of subsection 273(7)

133. The income derived by the Kirkpatrick Family Superannuation Fund from the Kirkpatrick Trust in the year ended 30 June 2006 is derived under an arrangement as that term is defined in subsection 273(8).

134. Part of this arrangement is the understanding that service fees would be paid by Edward Kirkpatrick Pty Ltd to the Kirkpatrick Trust at a certain rate. Since the rate of these fees is much higher than the market rate of these fees, the dealing between some of the parties to the arrangement was not a matter of real bargaining. Edward Kirkpatrick Pty Ltd and the Kirkpatrick Trust were not dealing with each other at arm's length in relation to the arrangement. The test in paragraph 273(7)(a) is satisfied.

135. The income of the Kirkpatrick Trust has increased as a result of the excessively high rate of fees charged under an arrangement the parties to which were not dealing with each other at arm's length. As a result, the Kirkpatrick Trust has more income available to be distributed. If Edward Kirkpatrick Pty Ltd and the Kirkpatrick Trust were dealing at arm's length, a much lesser amount of income could be expected from service fees and much lesser income would have been available for distribution from the Kirkpatrick Trust. The amount of income derived by the Kirkpatrick Family Superannuation Fund from the Kirkpatrick Trust in the year ended 30 June 2006 is greater than might have been expected to have been derived if the parties had been dealing with each other at arm's length in relation to the arrangement. The test in paragraph 273(7)(b) is satisfied.

The decision

136. The income is special income of the Kirkpatrick Family Superannuation Fund under subsection 273(7).

Date of effect

137. This Ruling applies to years of income commencing both before and after its date of issue. However, the final Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the final Ruling.

Commissioner of Taxation
2 August 2006

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.

Legislative background

138. Section 273 describes the same class of income as was excluded from the exemption that used to apply to complying superannuation funds. The relevant provisions were sections 23FC and 23FD. These two sections were inserted by the *Taxation Laws Amendment Act (No. 4) 1987* with effect from 18 December 1987. Sections 23FC and 23FD were substantially equivalent to the earlier subsections 23F(16) to (18). These provisions were originally inserted by the *Income Tax and Social Services Contribution Assessment Act (No. 3) 1964*.

139. Section 273 was inserted by the *Taxation Laws Amendment Act (No. 2) 1989* with effect from 30 June 1989. It was amended to include subsections 273(6), 273(7) and 273(8) by the *Superannuation Legislation Amendment Act (No. 2) 1999* with effect from 16 July 1999.[1A] These sections were inserted to tighten subsection 273(4) to rectify a deficiency which allowed certain distributions of trust income to superannuation entities made under non-arm's length arrangements to be taxed at the concessional rate of 15%.[2]

140. The special component of the taxable income of a complying superannuation fund, a complying ADF or a PST is the amount (if any) remaining after deducting from the special income:

a) any allowable deductions that relate exclusively to the special income; and

b) so much of any other allowable deductions as, in the opinion of the Commissioner, may appropriately be related to the special income.

141. Sections 26, 27 and 27A of the *Income Tax Rates Act 1986* apply the top marginal rate of tax to the special component of taxable income.

142. Any amount of normal assessable income that is derived by a complying superannuation fund or a PST from segregated current pension assets or is attributable to current pension liabilities is exempt from tax. The definition of 'normal assessable income' in section 267 specifically excludes special income. Special income that is derived by a complying superannuation fund or a PST from

[1A] Section 273 of the ITAA 1936 was repealed with effect from 1 July 2007 and has been re-written, with some modifications, in section 295-550 of the ITAA 1997.
[2] Paragraph 2.2 of the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 2) 1999.

segregated current pension assets or is attributable to current pension liabilities will be taxed at the top marginal rate of tax.

'Income'

143. The Commissioner's interpretation of 'income' for the purposes of section 273 accords with the object and intent of the provision, as set out in the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 2) 1999, which introduced subsections 273(6), (7) and (8). It states that:

> Section 273 is designed to prevent income from being unduly diverted into superannuation entities as a means of sheltering that income from the normal rates of tax applying to other entities, particularly the marginal rates applying to individual taxpayers.

144. There is no obvious reason why assessable income that is not ordinary income would have been excluded from this anti-avoidance measure. The section attempts to prevent taxpayers from avoiding normal rates of tax, particularly individual marginal tax rates, through the use of a superannuation entity. Statutory income – that is income that is only included in assessable income because of a statutory provision[3] – could be sheltered from marginal rates of tax by the use of a superannuation entity just as ordinary income could be.

145. There is no indication in the Explanatory Memorandum to the Income Tax and Social Services Contribution Assessment Bill (No. 3) 1964, the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 4) 1987, the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 6) 1988, or in the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 2) 1999 that special income does not include statutory income.

146. Section 273 is one example of a provision where the term 'income' is used broadly to cover both ordinary income and statutory income. Another example is the definition of 'foreign income' in subsection 6AB(1). As stated in Taxation Ruling TR 2005/2,[4] the word 'income' in the definition of 'foreign income' in subsection 6AB(1) can include both ordinary income and statutory income.[5] Taxation Ruling TR 2005/2 explains that this interpretation is also in line with the object and intent of the provision.[6]

147. Section 273 would lack the practical application that its words demonstrate it is intended to have if the word 'income' is interpreted to include only ordinary income. If the word 'income' in subsection 273(1) was only to include ordinary income and not statutory income, the whole section could only apply to ordinary

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[3] See subsections 6-10(1) and 6-10(2) of the ITAA 1997.
[4] Taxation Ruling TR 2005/2 Income tax: the meaning of 'foreign income' in subsection 6AB(1) of the *Income Tax Assessment Act 1936* – inclusion of statutory income.
[5] Paragraph 5 of TR 2005/2.
[6] Paragraph 9 of TR 2005/2.

income. This is because subsection 273(1) provides that section 273 only applies to 'income'.

148. The words of section 273 clearly demonstrate that it is intended to apply to dividends in subsection 273(2), income from non-arm's length transactions in subsection 273(4) and trust income in subsections 273(6) and (7).

149. In some circumstances, dividends and trust income may be statutory income. However, if section 273 only applies to dividends and trust income that are ordinary income, it would lack the practical application it is clearly intended to have.

150. The assessable income derived from a non-arm's length transaction would often be a capital gain, which would be included in assessable income as statutory income. The practical application of subsection 273(4) would be limited if it does not apply to capital gains.

151. In addition, there is support for the proposition that for the purposes of applying section 273 to trust income, the phrase 'income derived by a superannuation fund' refers to a share of the 'net income' of the trust. In *AAT Case 9221*[7] the Tribunal interpreted that phrase as it appeared in former subsections 23F(18) and 23FC(4), which are substantially equivalent to subsection 273(4). The Tribunal stated:

> While the Act provides no definition of the word income, the Tribunal is of the opinion that the term should be considered in the context of the precise legislation being reviewed. Subsections 23F(18) and 23FC(4) refer to 'income derived by a superannuation fund'. As the income in question concerns distributions from a trust it is appropriate to turn to Div 6 of the Act which refers to Trust Income. Subsection 97(1) makes it quite clear that a beneficiary of the kind now being considered shall include as assessable income that relevant share of net income. Net income is defined in subs 95(1) … It is the conclusion of the Tribunal that the phrase 'income derived by a superannuation fund', in the context of benefiting from a trust arrangement relates to a share of the net income.[8]

152. This conclusion is significant because it means that the word 'income' in subsections 273(6) and (7) refers to the share of 'net income' included in assessable income under subsection 97(1) for a presently entitled beneficiary. Since the Tribunal interprets the word 'income' in the context of trust income in a way that includes statutory income, this supports the view that the word 'income' for the purposes of section 273 should be interpreted as referring to both ordinary income and statutory income.

153. Therefore, 'income' for the purposes of section 273 should be interpreted to include both ordinary income and statutory income. This interpretation accords with the object and intent of the provision as evident in the words of the section and the Explanatory Memorandum, *AAT Case 9221* and Taxation Ruling TR 2005/2.

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[7] 94 ATC 130; (1993) 27 ATR 1117.
[8] 94 ATC 130 at 135; (1993) 27 ATR 1117 at 1124.

The entire amount of income is special income

154. Section 273 characterises certain amounts of income as special income. The words of the section indicate that once the conditions are met and an amount is characterised as special income, that characterisation applies to the entire amount.

Dividends paid by a private company

Self-assessment

155. Section 357-5 of Schedule 1 to the *Taxation Administration Act 1953* (TAA) establishes that public rulings are a way to find out the Commissioner's view about how certain laws administered by the Commissioner apply so that the risks when self-assessing are reduced. Parts of this Ruling clarify the circumstances in which the Commissioner will exercise the discretion under subsection 273(2) and will bind the Commissioner to the extent that those circumstances apply to you (see section 357-60 and subsection 358-5(2) of Schedule 1 to the TAA).[8B]

Non-share dividends

156. Subsection 273(9) expands the scope of subsection 273(2) so that it applies to non-share dividends. Paragraph 273(9)(a) provides that section 273 applies to a non-share equity interest in the same way as it applies to a share, paragraph 273(9)(b) provides that section 273 applies to an equity holder in the same way as it applies to a shareholder and paragraph 273(9)(c) provides that section 273 applies to a non-share dividend in the same way as it applies to a dividend.

157. The definitions of a 'non-share equity interest', an 'equity holder', and a 'non-share dividend' in subsection 6(1) all refer to subsection 995-1(1) of the ITAA 1997. Subsection 995-1(1) of the ITAA 1997 states that a 'non-share equity interest' in a company means an equity interest in the company that is not solely a share. It also states that an 'equity holder' in a company means an entity that holds an equity interest in the company.

158. The definition of a 'non-share dividend' in subsection 995-1(1) of the ITAA 1997 refers to section 974-120 of the ITAA 1997. Section 974-120 of the ITAA 1997 defines a 'non-share dividend' in relation to a 'non-share distribution'. Section 974-115 of the ITAA 1997 states that a 'non-share distribution' occurs if a taxpayer holds a 'non-share equity interest' in a company and the company distributes money or property to the taxpayer or credits an amount to the taxpayer as the holder of that interest.

[8B] Subsection 295-550(2) of the ITAA 1997 does not confer a discretion on the Commissioner, but contains an objective test.

159. All 'non-share distributions' are 'non-share dividends' except to the extent to which the company debits the distribution against the company's non-share capital account or the company's share capital account.[9] A 'non-share capital account' is the account that a company has under section 164-10 of the ITAA 1997 if the company issues a non-share equity interest in the company on or after 1 July 2001, or the company has issued a non-share equity interest in the company before 1 July 2001 that is still in existence on 1 July 2001.

Matters to be considered by the Commissioner

160. It is the Commissioner's opinion that it would be reasonable not to treat the dividend as special income in accordance with subsection 273(2) when the dividend is derived at arm's length. This view is supported by the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 2) 1999 which introduced subsections 273(6) to (8):

> The assessable income that is included in the special component is termed *special income* and is income derived from certain types of non-arms length transactions (including the payment of certain private company dividends) that fall within the provisions of section 273 of the ITAA 1936.

The Explanatory Memorandum states that special income is income derived from certain types of non-arm's length transactions including the payment of certain private company dividends. The private company dividends that are to be included within subsection 273(2) are intended to be non-arm's length.

161. Section 273 is only aimed at income which is unduly diverted into superannuation entities as a means of sheltering that income from the normal rates of tax.[10] It is not aimed at income which is derived from a genuine investment made on an arm's length basis.

162. If subsection 273(2) is not interpreted as implicitly requiring an assessment of whether or not the income was derived on an arm's length basis, the Commissioner has no basis for determining when it would be reasonable to not treat a dividend as special income. In addition, the matters listed in paragraphs 273(2)(a) to (e) would be meaningless and it would be impossible to determine what is relevant under paragraph 273(2)(f).

163. It is the Commissioner's opinion that the matters listed in subsection 273(2) are matters that indicate whether or not the dividends are derived on an arm's length basis. The Commissioner will consider that a matter is relevant under paragraph 273(2)(f) if it indicates whether or not the dividends are derived on an arm's length basis.

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[9] Section 974-120 of the ITAA 1997.
[10] See paragraph 144 of this Ruling.

164. [Omitted.]

165. Similar provisions to section 273 have existed since 1964.[11] Former subsections 23F(16) to (18) used almost the same words as subsections 273(1) to (4). The main difference is that, while section 273 categorises certain amounts as special income in order to apply a higher rate of tax, subsections 23F(16) to (18) excluded certain private company dividends and certain income from non-arm's length transactions from the exemption from income tax that superannuation funds enjoyed prior to 1 July 1988.

166. Subsections 23F(16) and (18), especially subsection 23F(16), which is virtually equivalent to subsection 273(2), were the subject of several Taxation Board of Review (Board of Review) decisions. Since subsection 273(2) is in the same terms as former subsection 23F(16), the principles to be drawn from those cases remain relevant in interpreting the current provisions.

Value of the shares

167. Paragraph 23F(16)(a) and paragraph 273(2)(a) originally referred to the 'paid-up value of the shares'. Paragraph 273(2)(a) now refers to the 'value of the shares'. This amendment was made by the *Taxation Laws Amendment (Company Law Review) Act 1998* with effect from 1 July 1998. The amendment applies to things done on or after 1 July 1998 where the relevant company has shares with no par value.[12]

168. The Commissioner will consider the paid-up value of shares issued to superannuation entities investing in private companies that issue shares with a par value. This will only occur in rare circumstances.

169. In the ordinary course of events, paragraph 273(2)(a) now obliges the Commissioner to consider the 'value of shares'. The Commissioner will interpret this to mean that regard must be had to the market value of the shares. This becomes especially relevant in comparison to the cost of the shares considered under paragraph 273(2)(b) and the rate of return on investment considered under paragraph 273(2)(f) in determining whether the payment of the dividend is consistent with an arm's length outcome.

[11] See Legislative background at paragraphs 138 to 142.
[12] See history note to subsection 273(2) in *Australian Tax Legislation*, 2005, Thomson ATP, Sydney.

Cost of the shares

170. In many of the cases before the Board of Review under the former provisions, the decision that the dividends were not exempt was based on the fact that the shares were acquired for less than fair value.[13] In the earlier cases, especially *Case A38*,[14] *Case A39*,[15] and *Case A40*,[16] the Board of Review read paragraphs 23F(16)(a) and (b) together and decided that since the cost of the shares in all these cases was far less than the value of the shares, the dividend received from the shares was special income. Paragraphs 23F(16)(a) and (b) are largely similar to paragraphs 273(2)(a) and (b).

171. The interpretation of paragraphs 23F(16)(a) and (b) adopted in these earlier Board of Review cases was challenged by the taxpayer in *Case B40*.[17] In this case, it was argued that the cost of the shares could not be compared with the market value of the shares at the time of acquisition. The Board of Review rejected this argument, unanimously holding that it would not be reasonable to exempt the dividend from income tax having regard to the price at which the fund obtained the shares as distinct from their fair value. This decision was based on an interpretation of the equivalent provisions to both paragraphs 273(2)(a) and 273(2)(b), which understands either both of those paragraphs or at least paragraph (b) to require the Commissioner to compare the cost of the shares with their value.[18] All of the members of the Board of Review decided that even if paragraphs (a) and (b) could not be interpreted in this way, a comparison between the cost of the shares and their value is a relevant matter under paragraph (f).[19]

171A. The essence of the dispute in *Darrelen* was whether, in exercising his discretion under subsection 273(2), the Commissioner is entitled to have regard to a disparity between the cost and the market value at the time of acquisition, or whether, as the taxpayer argued, the inquiry is limited to whether the dividends themselves were paid on a non-arm's length basis. The court agreed that the Commissioner is entitled to have regard to such disparity. The Court observed that 'the policy underlying s 273, and its predecessors, is to enable the Commissioner to deny the concessional taxation of income which has been diverted from taxpayers not enjoying that status.' In the *Darrelen* case, the court considered that 'the income diversion has occurred by recourse to a non-arm's length transaction on the acquisition of the shares.'

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[13] *Case A38* 69 ATC 225 at 226, *Case A39* 69 ATC 227 at 228, *Case A40* 69 ATC 229 at 232-233, *Case B15* 70 ATC 61 at 64 and *Case B40* 70 ATC 202 at 204, 205, 207.
[14] 69 ATC 225 at 226.
[15] 69 ATC 227 at 228.
[16] 69 ATC 229 at 233.
[17] 70 ATC 202.
[18] Compare for example the judgment of Member Dempsey at 70 ATC 202 at 206-7, with the judgment of Chairman Dubout 70 ATC 202 at 203.
[19] 70 ATC 202 at 203-4, per Chairman Dubout; at 205 per Member Thompson; at 207 per Member Dempsey.

172. In accordance with these Board of Review cases and *Darrelen*, and the reasoning found therein, the Commissioner will compare the cost of the shares with the market value of the shares at the time of acquisition. If the market value of the shares at the time of acquisition exceeds the cost of the shares, this will be a significant factor that will weigh heavily in favour of the Commissioner treating any dividends as special income.

Rate of the dividend

173. The Commissioner will take a number of factors into consideration in determining whether the rate of the dividend paid is consistent with an arm's length outcome. These may include how the rate of dividend paid compares to the rate paid on other shares in the company.

174. [Omitted.]

175. [Omitted.]

Other matters that the Commissioner considers relevant

176. The matters that the Commissioner will consider relevant under paragraph 273(2)(f) are set out at paragraphs 53 and 54 of this Ruling.

177. The taxpayer in *Case E56*[20] submitted that paragraphs 23F(16)(a) to (e):

> ... dealt only with matters pertaining to investment, and cl. (f), in spite of its wide terms, should be restricted to an investigation of the 'circumstances which throw light on the conduct of the fund in its role as an investor'.[21]

Although the members of the Board of Review were 'much attracted' to this submission,[22] they observed that the Board of Review had considered paragraph 23F(16)(f) on previous occasions and that a wide interpretation had been consistently adopted.[23] The Board of Review adopted this interpretation, deciding that paragraph 23F(16)(f) should be interpreted broadly.[24]

178. Member Thompson's wide interpretation of paragraph 23F(16)(f) in *Case B40* is a good example of one of the previous occasions when the Board of Review had adopted this interpretation. He states:

> Learned Counsel for the taxpayer frankly conceded that para. (f) could not be construed *ejusdem generis* with the preceding

[20] 73 ATC 442.
[21] 73 ATC 442 at 445 to 446.
[22] 73 ATC 442 at 446.
[23] 73 ATC 442 at 446. The Board of Review quoted the following cases as examples of previous occasions when the Board of Review had adopted a wide interpretation of paragraph 23F(16)(f): *Case A38* 69 ATC 225, *Case A39* 69 ATC 227, *Case A40* 69 ATC 229, *Case A41* 69 ATC 233, *Case B15* 70 ATC 61 and *Case B40* 70 ATC 202.
[24] 73 ATC 442 at 446.

> paras. (a) to (e) of sec. 23F(16). It seems to me, therefore, that para. (f) casts a wide net, and catches all relevant matters.[25]

179. Accordingly, the Commissioner is of the opinion that paragraph 273(2)(f) requires the Commissioner to consider all relevant matters.

179A. One of these matters is whether the rate of return on investment is consistent with an arm's length outcome when compared with both the cost of the shares and the value of the shares. The comparison to value may be appropriate because a comparison to cost may not be informative in all circumstances. These circumstances include when a share is owned for a long time and the value of the shares has increased substantially, or when the value of the shares increases substantially for some other commercial reason. For these reasons, it may be necessary to compare the rate of return with both the cost of the shares and the value of the shares.

179B. It is not possible to provide a set formula for determining the rate of return on investment which, if exceeded, will result in the Commissioner treating the dividend as special income. Such a formula could not account for all of the variables that the Commissioner is required to consider. The higher the rate of return on investment, the more likely that the private company dividend was not derived on an arm's length basis. It is therefore more likely that the dividend will be special income.

179C. One of the variables that the Commissioner may take into consideration is the level of risk. This may be relevant because the higher the level of risk, the more likely it is that a high rate of return is the result of market forces.

[25] 70 ATC 202 at 205. See also the more extensive comments made by Member Fairleigh QC in *Case M63* 80 ATC 440 at 447 to 449.

180. Another of the relevant matters that the Commissioner may consider is the extent to which the fund is being maintained for employees who are at arm's length from the shareholders of the company. The Commissioner considers this to be a relevant matter because it indicates the extent to which the dividends are derived on an arm's length basis. In addition, several Board of Review cases have regarded this to be a relevant matter that the Commissioner should consider under paragraph 23F(16)(f).[26] In most of these cases the fact that the membership of the fund was limited to shareholders of the company weighed in favour of the Board of Review holding that it was reasonable for the Commissioner to treat the dividend as special income.[27] In *Case A40*,[28] however, it was favourable to the taxpayer that all employees, whether shareholders or not, were members of the fund. Either way, the Commissioner will consider this as a relevant matter under paragraph 273(2)(f).

181. The relationship between the superannuation fund, ADF or PST and the private company is also a relevant matter that the Commissioner may consider under paragraph 273(2)(f) because it indicates the extent to which the dividends derived by the superannuation fund, ADF or PST are derived on an arm's length basis.

182. The identity of the entity from which the superannuation fund, ADF or PST acquires the shares is also a relevant matter that the Commissioner may consider under paragraph 273(2)(f) because it indicates the extent to which the dividends derived by the superannuation fund, ADF or PST are derived on an arm's length basis.

Income from a transaction where the parties are not dealing at arm's length

Capital gains

183. The amounts of income that are special income under subsection 273(4) may include capital gains that are included within assessable income under Part 3-1 and Part 3-3 of the ITAA 1997. This is because the term 'income' in section 273 includes both ordinary income and statutory income (see paragraphs 143 to 153 of this Ruling).

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[26] *Case A38* 69 ATC 225 at 226, *Case A39* 69 ATC 227 at 229, *Case A40* 69 ATC 229 at 233, *Case A41* 69 ATC 233 at 235, *Case B15* 70 ATC 61 at 64 and *Case M63* 80 ATC 440 at 446.

[27] *Case A39* 69 ATC 227 at 229, *Case A41* 69 ATC 233 at 235, *Case B15* 70 ATC 61 at 64 and *Case M63* 80 ATC 440 at 446.

[28] 69 ATC 229 at 233. (In *Case A38* 69 ATC 225 at 226 the fact that the shareholder/directors of the private company were the sole members of the fund was a neutral matter because they were virtually the only permanent employees of the company.)

Transaction

184. Subsection 273(5) expands the meaning of 'transaction' for the purposes of subsection 273(4) to include a series of transactions. Aside from this, there is no definition of the word 'transaction' in the ITAA 1936. The courts, tribunals and the Board of Review have not interpreted the word 'transaction' for the purposes of subsection 273(4) or the former subsections 23F(18) and 23FC(4).

185. The word 'transaction' for the purposes of subsection 273(4) takes its ordinary meaning.

186. The *Macquarie Dictionary*[29] defines the word 'transact' as follows:

> **1.** to carry through (affairs, business, negotiations, etc.) to a conclusion or settlement. **2.** to perform.

187. In the context of determining what is a 'transaction' and thus a 'disposition of property' for the purposes of various gift duty and death duty statutes such as the *Gift Duty Assessment Act 1941-1957*, the courts have discussed the ordinary meaning of the word 'transaction'. In this context, the courts developed an interpretation of the word 'transaction' that 'can cover a series of steps linked together to obtain a definite objective'.[30]

188. The word 'transaction' in section 273, however, must be interpreted in accordance with the context in which it appears. As the context is one of dealing between parties, a transaction for the purposes of section 273 must at least involve an element of dealing between two parties.

Not dealing with each other at arm's length

189. The phrase 'at arm's length' has been considered in many courts and used in various legislative contexts. As explained by Davies J in *Re Hains (deceased); Barnsdall v. Federal Commissioner of Taxation*[31] *(Barnsdall)* the term 'at arm's length' was developed in the law with respect to transactions between persons, one of whom, such as a trustee or a solicitor, is in a position of special influence with respect to the other, a beneficiary or client. His Honour referred to the classic statement of principles found in the speech of Lord O'Hagan in *Macpherson v. Watt*.[32]

190. Davies J pointed out, however, that such cases are of little assistance in the interpretation of statutes which are concerned with taxation.[33]

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[29] 3rd edition.
[30] *Robertson v. Commissioner of Inland Revenue* [1959] NZLR 492 at 498, *Gorton v. Federal Commissioner of Taxation* (1965) 113 CLR 604 at 622-623 and *Palmer v. Commissioner of State Taxation (WA)* (1976) 136 CLR 406 at 412 and 417.
[31] (1988) 81 ALR 173 at 176.
[32] (1877) 3 App Cas 254 at 266; (1988) 81 ALR 173 at 176.
[33] (1988) 81 ALR 173 at 176. See also *Re CHK Engineering Pty Ltd and Australian Trade Commission* (1997) 45 ALD 797 at 797.

191. His Honour then went on to set out the interpretation of the phrase 'not at arm's length' that was provided in *Australian Trade Commission v. WA Meat Exports Pty Ltd*.[34] This is the leading case on the meaning of the phrase 'not at arm's length' in the definition of 'prescribed associate' in subsection 4(8) of the *Export Market Development Grants Act 1974*. The Federal Court decided in that case that the ordinary meaning of the phrase applies. After quoting legal dictionaries in order to ascertain the ordinary meaning of 'arm's length',[35] the Federal Court reached the conclusion that the ordinary meaning of the phrase 'not at arm's length' is the circumstance where one party 'has the ability to exert personal influence or control over the other'.[36]

192. Although the ability of one party to influence or control the other party to the transaction is an important issue to consider for the purposes of applying the arm's length requirement in subsection 273(4), it is not the only issue to consider. Subsection 273(4) requires the parties to the transaction to be 'not dealing with each other at arm's length'.

193. The provision with which Davies J was concerned in *Barsndall* was in similar terms:

> If the term were simply 'not at arm's length', *Australian Trade Commission v. WA Meat Exports Pty Ltd* (1987) 75 ALR 287 would apply. … However, s 26AAA(4) [of the ITAA 1936] used the expression 'not dealing with each other at arm's length'. That term should not be read as if the words 'dealing with' were not present. The Commissioner is required to be satisfied not merely of a connection between a taxpayer and the person to whom the taxpayer transferred, but also of the fact that they were not dealing with each other at arm's length. A finding as to a connection between the parties is simply a step in the course of reasoning and will not be determinative unless it leads to the ultimate conclusion.[37]

194. This interpretation of the phrase 'not dealing with each other at arm's length' was adopted for the purposes of interpreting the same phrase in subsection 102AG(3) by the Federal Court in *The Trustee for the Estate of the late AW Furse No. 5 Will Trust v. FC of T*[38] *(Furse)*. Hill J noted:

> The first of the two issues [i.e. whether the parties to the relevant agreement were dealing with each other at arm's length] is not to be decided solely by asking whether the parties to the relevant agreement were at arm's length to each other. The emphasis in the subsection is rather upon whether those parties, in relation to the agreement, *dealt* with each other at arm's length. The fact that the parties are themselves not at arm's length does not mean that they may not, in respect of a particular dealing, deal with each other at arm's length. This is not to say that the relationship between the parties is irrelevant to the issue to be determined under the subsection. The distinction was pointed out by Davies J in

[34] (1987) 75 ALR 287; (1988) 81 ALR 173 at 176.
[35] (1987) 75 ALR 287 at 291.
[36] (1987) 75 ALR 287 at 291.
[37] (1988) 81 ALR 173 at 176.
[38] (1990) 21 ATR 1123; 91 ATC 4007.

> connection with similar words used in sec. 26AAA(4) of the Act in *Barnsdall v. FC of T* 88 ATC 4565 at p. 4568, in a passage which with respect I agree: …
>
> What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining.[39]

195. The point made by Davies J in *Barnsdall* and Hill J in *Furse* is that a relationship between two parties does not necessarily mean that the parties cannot deal at arm's length in relation to a particular transaction. As emphasised by Hill J in *Furse*, however, the relationship between the parties is relevant. It is, in the words of Davies J in *Barnsdall*, 'a step in the course of reasoning'.

196. In line with Hill J's comments in *Furse*, the Commissioner will consider that parties are not dealing with each other at arm's length when they are not involved in real bargaining. This is also the way the phrase 'not dealing with each other at arm's length' is applied in the examples in the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 2) 1999, which introduced subsections 273(6) to (8).

197. Both *Barnsdall* and *Furse* have gained further support from the Federal Court in *Granby Pty Ltd v. Federal Commissioner of Taxation*,[40] this time in the capital gains tax context. For the purposes of determining the cost base of an asset under subsections 160ZH(1), (2) and (3), paragraph 160ZH(9)(c) provides that the taxpayer shall be deemed to have paid market value if, amongst other things, the taxpayer and the vendor were not dealing with each other at arm's length in connection with the acquisition. Lee J followed *Barnsdall* and *Furse* and added:

> … the term 'at arm's length' means, at least, that the parties to a transaction have acted severally and independently in forming their bargain. …
>
> If the parties to the transaction are at arm's length it will follow, usually, that the parties will have dealt with each other at arm's length. That is, the separate minds and wills of the parties will be applied to the bargaining process whatever the outcome of the bargain may be.
>
> That is not to say, however, that parties at arm's length will be dealing with each other at arm's length in a transaction in which they collude to achieve a particular result, or in which one of the parties submits the exercise of its will to the dictation of the other, perhaps, to promote the interests of the other. As in *Minister of National Revenue v. Merritt* 69 DTC 5159 at 5166 where the parties to the transaction were parties at arm's length, the terms of a loan transaction made between them had been dictated by a unilateral

[39] (1990) 21 ATR 1123 at 1132; 91 ATC 4007 at 4014-15.
[40] (1995) 129 ALR 503.

> decision of one of them and no independent will in the formation of that transaction had been exercised by the other.[41]

198. So although Davies J was correct in identifying a connection between the parties as a step in the course of reasoning, it is not a necessary step. As Lee J explains, parties at arm's length may not deal at arm's length when they collude to achieve a particular result or when one of the parties submits the exercise of its will to the dictation of the other.

199. The comments made by Lee J, along with those of Davies J and Hill J, apply equally to subsection 273(4). If the relationship of the parties is such that one party has the ability to influence or control the other, this will suggest that the parties may not be dealing with each other at arm's length, but it will not be determinative. The Commissioner will only be satisfied that the parties are not dealing with each other at arm's length in relation to a transaction if it is established that the independent minds and wills of the parties are not applied to the transaction such that their dealing is not a matter of real bargaining.

Franking credits

200. A franking credit is included in the assessable income of an entity that receives a franked distribution in accordance with section 207-20 of the ITAA 1997. It states:

> If an entity makes a *franked distribution to another entity, the assessable income of the receiving entity, for the income year in which the distribution is made, includes the amount of the *franking credit on the distribution. This is in addition to any other amount included in the receiving entity's assessable income in relation to the distribution under any other provision of this Act.

201. Since franking credits are included in assessable income they are income for the purposes of subsection 273(1) and subsection 273(4). As discussed in paragraphs 143 to 153 of this Ruling, amounts included within assessable income as statutory income are included as 'income' for the purposes of section 273.

202. To fall within subsection 273(4), a franking credit must be derived from a transaction, the parties to the transaction must not have been dealing with each other at arm's length and the amount of income derived from the transaction must be greater than the amount of income that might have been expected if the parties were dealing with each other at arm's length in relation to the transaction.

203. The acquisition of the share in the private company, the payment of the dividend and any other dealings entered into by the private company may constitute a transaction or series of transactions for the purposes of subsections 273(4) and (5). The franking credit may be income derived from this transaction or series of transactions.

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[41] (1995) 129 ALR 503 at 507.

204. The Commissioner's interpretation of subsection 273(2) is that a private company dividend will be special income if it is derived on a non-arm's length basis. If a franked private company dividend is special income and the franking credits are derived from a non-arm's length transaction or series of transactions, the franking credit will also be special income under subsection 273(4).

Trust distributions – 'fixed entitlement'

205. A distribution of trust income obtained 'by virtue of holding a fixed entitlement to the income [of the trust estate]' will be considered under subsection 273(7). If, however, the trust distribution is obtained other than 'by virtue of holding a fixed entitlement to the income [of the trust estate]', it will be special income under subsection 273(6).

206. The term 'fixed entitlement' is not defined for the purposes of section 273. The meaning to be ascribed to these terms must therefore be determined according to the ordinary meaning of the words having regard to the context in which they appear.

207. When inserting subsections 273(6) to (8), Parliament sought to distinguish between investment returns on 'fixed entitlements' in 'unit trusts' and distributions made to persons as beneficiaries of 'discretionary trusts' resulting from the exercise of discretions. Parliament considered it appropriate that the latter should be treated as special income taxed at the non-concessional rate whereas the former should only be treated as special income if the acquisition of the fixed entitlement or the derivation of the income failed to satisfy an arm's length test.

208. Having regard to the statutory context, it is considered that the composite expression 'income derived....by virtue of a fixed entitlement to the income' is designed to test whether an amount of trust income that had been included in the assessable income of a superannuation entity under subsection 97(1) was included because the entity had an interest in the income of the trust that was, at the very least, vested in interest, if not in possession, immediately before the amount was derived by the trustee.

209. To have an interest in the income of a trust estate, a person must have a right with respect to the income of the trust that is susceptible to measurement; a right merely to be considered as a potential recipient of income is not sufficient. An interest in the income of a trust estate will be vested in interest if it is bound to take effect in possession at some time and is not contingent upon any event occurring that may or may not take place. In contrast to a vested interest, a contingent interest will be one which gives no right at all unless or until some future event happens such as the exercise of a discretion by the trustee or some other person.

Trust distributions arising from a fixed entitlement

Not dealing with each other at arm's length

210. The requirement in subsection 273(7) that some or all of the parties to the arrangement were not dealing with each other at arm's length is also present in subsection 273(4). Accordingly, the analysis provided in paragraphs 189 to 199 of this Ruling also explains the Commissioner's interpretation of this requirement of subsection 273(7).

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.

'Income'

211. An alternative interpretation of the word 'income' for the purposes of section 273 is that it only includes ordinary income. According to this view, amounts that are only assessable income because of a statutory provision and are therefore statutory income cannot be special income. Under this view, franking credits and capital gains could never be special income and dividends and trust distributions could only be special income if they were ordinary income.

212. The basis for this view is that the word 'income' is not defined in the ITAA 1936 or the ITAA 1997. It is argued that the ordinary meaning of the word therefore applies. The ordinary meaning of the word 'income' is income according to ordinary concepts or ordinary income.

213. Section 97 has been suggested as an example of a provision in which the word 'income' refers not to 'net income' or 'assessable income' but to ordinary income. *Davis v. FC of T*[42] has been cited as authority for this proposition. The issue dealt with in *Davis v. FC of T* is the distinction for accounting purposes between trust law income and tax law net income and the determination of the appropriate method for calculating 'income' for the purposes of section 97.

214. Although there are similarities between the distinction between ordinary income and statutory income and the one between trust law income and tax law net income, it is considered that the issues are separate. It is therefore considered irrelevant that the reference to 'income' in section 97 has been interpreted to refer to trust law income.

215. Having regard to the intention behind section 273, the way the term 'income' is used and interpreted in other areas of the ITAA 1936, and the consequences that would follow if 'income' were held to only include ordinary income, the term should be interpreted to include both ordinary income and statutory income.

[42] (1989) 20 ATR 548 at 576-7; 89 ATC 4377 at 4403.

'Derived'

216. In support of this alternative view, it is also argued that the words 'income derived' should be read as being limited to ordinary income. This argument is based on the fact that section 6-5 of the ITAA 1997 refers to 'ordinary income that is derived' whilst there is no corresponding requirement in section 6-10 of the ITAA 1997 for statutory income to be derived.

217. The Commissioner disagrees with this interpretation of the word 'derived' for the same reasons that the Commissioner disagrees with the narrow interpretation of the word 'income'. As discussed in paragraphs 143 to 153 and paragraphs 211 to 215 of this Ruling, the intention behind section 273, the way the term 'income' is used and interpreted in other areas of the ITAA 1936 and the consequences that would follow if the word 'income' for the purposes of section 273 were held to only include ordinary income all indicate that the words 'income derived' should be interpreted to include both ordinary income and statutory income.

218. More specifically, the use of the word 'derived' in other areas of the ITAA 1936 suggests that it can be used to refer to ordinary and statutory income.[43] Examples provided include section 79D, in which the word 'derived' refers to assessable income generally, although not capital gains. Section 128B includes the word 'derived' and it applies to dividends and royalties that may not be ordinary income. Similarly, the word 'derived' is also used in subsection 44(1), section 96C and subsection 110-55(7) of the ITAA 1997 to refer to profits that would be beyond what is considered ordinary income.

219. Based on these examples Taxation Ruling TR 2005/2 makes the following conclusion:

> In this particular context, the ATO considers that 'income derived' is a shorthand reference to an amount that is treated as some form of income for the purposes of income tax.[44]

220. The Commissioner considers that this interpretation of the words 'income derived' also applies to section 273.

Franking credits

221. In regard to franking credits, an alternative view is that they can never be special income. This view is supported by the alternative view explained above in relation to the interpretation of the word 'income' for the purposes of section 273. If it is accepted that the word 'income' for the purposes of section 273 does not include statutory income amounts that are only assessable income because of a statutory provision, franking credits cannot be special income.

---

[43] Taxation Ruling TR 2005/2, paragraph 24.
[44] Paragraph 24.

222. Even if it is accepted that the word 'income' for the purposes of section 273 should be interpreted broadly to include both ordinary and statutory income, there is another line of reasoning put forward in support of the alternative view that franking credits can never be special income.

223. This line of reasoning flows from the contention that the words in subsection 273(4) do not apply to franking credits. More specifically, it is contended that a franking credit is not income derived from a transaction.

224. However, as explained in paragraphs 200 to 204 of this Ruling, the Commissioner is of the view that a franking credit may be income derived from a series of transactions for the purposes of subsections 273(4) and (5).

Appendix 3 – Detailed contents list

225. The following is a detailed contents list for this Ruling:

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