

TD 2005/34 - Income tax: what are the results for income tax purposes of entering into a profit washing arrangement as described in Taxpayer Alert TA 2005/1?

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Taxation Determination

Income tax: what are the results for income tax purposes of entering into a profit washing arrangement as described in Taxpayer Alert TA 2005/1?

Preamble

*The number, subject heading, date of effect and paragraphs 1 to 20 of this document are a 'public ruling' for the purposes of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner.*

[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (<http://law.ato.gov.au>) to check its currency and to view the details of all changes.]

1. Taxpayer Alert TA 2005/1 ('the Alert') was issued on 2 May 2005. It described an arrangement where the business of a taxpayer is structured so that the income of the business passes through a chain of trusts and on to a loss company, and the income, less an amount for promoter fees, remains effectively under the control of the taxpayer or associates of the taxpayer. The Alert indicated that we are examining the arrangement.
2. The arrangement exhibits some or all of the following features:
 - a) a trading entity (the 'taxpayer') derives an income from a business that it carries on. The business is structured so that a hybrid trust (the 'new trust') receives the income. The promoter derives a fee for establishing the new trust;
 - b) the new trust has a number of classes of units. Each class of units has different rights attached. The taxpayer or associates hold units with income, capital and voting rights in the new trust (class A units). A trust which is unrelated to the taxpayer (the 'promoter trust') holds units in the new trust with either income rights only, or income and capital rights (class B units);
 - c) the trustee of the new trust has discretion as to the distribution of income to unit holders;
 - d) the promoter trust has a number of classes of units. Each class of units has different rights attached. The promoter holds units with income, capital and voting rights in the promoter trust. A company with carry forward losses (the 'loss company') holds units in the promoter trust with income rights only;
 - e) the new trust distributes a large proportion of the trust income to the promoter trust. A smaller proportion may be distributed to the class A unit holders;

- f) a small proportion (for example, 10%) of the distribution to the promoter trust is paid in cash. This amount represents the fee paid by the taxpayer for the use of the arrangement. The remaining amount (that is, 90%) is never paid to the promoter trust, and by agreement (usually verbal) between the parties, is never intended to be paid; and
 - g) the promoter trust then distributes all of the income distribution from the new trust to the loss company. The promoter claims that the loss company has carry forward losses that offset the distribution from the promoter trust.
3. The arrangement may also include the use of a joint venture formed between the new trust and the promoter trust whereby the new trust contributes as capital to the joint venture the amount of the distribution made to the promoter trust. This allows the new trust to maintain effective control of the funds.
4. Our view on the arrangement is as follows.

The distribution of income to the promoter trust – intention of the parties

5. A sham transaction is essentially a transaction which involves a common intention between the parties to the apparent transaction that it be a disguise for some other and real transaction or for no transaction at all (see *Richard Walter Pty Ltd v. Commissioner of Taxation* (1996) 67 FCR 243; (1996) 96 ATC 4550; (1996) 33 ATR 97).

5A. However sham is only one of various situations in which a court may take an agreement or other instrument, such as a settlement on trust, as not disclosing, or disclosing fully, the legal rights and entitlements for which it provides on its face (that is, by way of exception to the parol evidence rule).

6. The High Court in *Raftland Pty Ltd as trustee of the Raftland Trust v. Commissioner of Taxation* [2008] HCA 21 explained that:^{1A}

[33] ...The apparent discrepancy between the entitlements appearing on the face of the documents and the way in which the funds were applied gave rise to a question whether the documents were to be taken at face value. In various situations, the court may take an agreement or other instrument, such as a settlement on trust, as not fully disclosing the legal rights and entitlements for which it provides on its face...

[34] One such case is where other evidence of the intentions of the relevant actors shows that the document was brought into existence 'as a mere piece of machinery' for serving some purpose other than that of constituting the whole of the arrangement. That, in essence, is the respondent's case with respect to the alleged existence of the 'present entitlement' of the trustee of the E & M Unit Trust to the income of the Raftland Trust.
[footnotes deleted]

7. In the arrangement described in paragraph 2, it is agreed between the parties that only a small proportion of the distribution to the promoter trust ever be paid in cash. Further, the amount paid in cash is effectively the fee paid by the taxpayer for the use of the arrangement. There is no intention by either party for the promoter trust to receive the benefit of the income of the new trust. There is simply an attempt to create the appearance of the promoter trust having present entitlement to the income of the new trust so as to avoid tax being payable by the taxpayer and associates of the taxpayer who ultimately receive the benefit of the trust income.

^{1A} Per Gleeson CJ, Gummow and Crennan JJ. Kirby J in separate reasons likewise concluded purported trust distributions may be a sham. See also the Decision Impact Statement relating to *Raftland* dated 24 October 2008 and AAT cases *Case 10,796* (1996) 96 ATC 296; (1996) 32 ATR 1168, *Case 11,115* (1996) 96 ATC 443; (1996) 33 ATR 1128 and *Case 11,125* (1996) 96 ATC 453; (1996) 33 ATR 1140.

8. The purported distribution of income from the new trust to the promoter trust is considered to be of no legal effect. The trust deed and resolutions of the new trust determine if any other unit holder is presently entitled to the trust income. If no unit holder is presently entitled to the trust income, the trustee will be assessed on this income under section 99A of the *Income Tax Assessment Act 1936* (ITAA 1936).

Part IVA of the ITAA 1936 applies

9. The application of Part IVA depends on a careful weighing of all the relevant circumstances of each case and the relative weight that should be attached to each of those circumstances. Therefore, in the absence of all relevant information, it is not possible to state definitively whether a particular scheme will attract Part IVA.¹

10. It is considered however that the whole or some part of the arrangement described in paragraph 2 constitutes a scheme under section 177A. Should the purported distribution of income from the new trust to the promoter trust be held to have legal effect, this scheme would give rise to a tax benefit under paragraph 177C(1)(a) in that but for the scheme the income which was distributed from the new trust to the promoter trust would have been included in the assessable income of the taxpayer or associates of the taxpayer.

11. It is also considered that it would be reasonable to conclude, having regard to the matters set out in section 177D, that the sole or dominant purpose of the taxpayer (and the promoter) in entering into or carrying out the scheme was for the taxpayer or associates of the taxpayer to obtain the tax benefit.² In this context the following general observations can be made:

- the manner in which the scheme was entered into or carried out will demonstrate that the steps taken to bring the income into the new trust and to distribute it to the promoter trust are undertaken only to avoid the taxpayer and associates of the taxpayer from being assessable on this income;
- the form of the scheme is to confer ultimate beneficial entitlement to income of the new trust to a company with substantial carry forward losses. The substance of the scheme is that the income of the new trust remains under the control of the new trust and is used for the ultimate benefit of the taxpayer and associates of the taxpayer without being reduced by the payment of income tax;
- but for the operation of Part IVA, the distributions made from the new trust to the promoter trust and then on to the loss company, would be effective. The result would therefore be that no tax is payable by any entity on the income earned by the new trust, as the ultimate beneficiary of this income is a company with carry forward losses; and
- by entering into the scheme, the taxpayer or associates avoid any liability to tax on the income of the new trust for which they receive the benefit. The promoter generally derives a fee for establishing the new trust as well as a fee for each distribution made by the new trust to the promoter trust. The loss company derives a fee for enabling the promoter trust to utilize its carry forward losses.

¹ There have been a number of decisions of the High Court and Federal Court concerning the operation of Part IVA. A useful summation of the principles emerging from these decisions can be found in the judgement of Hill J in *Commissioner of Taxation v. Sleight* (2004) 136 FCR 211; (2004) 2004 ATC 4477; (2004) 55 ATR 555.

² The question posed by section 177D concerning purpose is one that is objectively determined and does not depend on why the taxpayer or any of its agents acted as they did (see *FCT v. Hart* (2004) 217 CLR 216; (2004) 2004 ATC 4599; (2004) 55 ATR 712).

12. The Commissioner is therefore likely to exercise his powers under section 177F to cancel the tax benefit and include in the assessable income of the taxpayer or associates of the taxpayer the income of the new trust that was purported to be distributed to the promoter trust.

Section 100A of the ITAA 1936

13. Section 100A is an anti-avoidance provision designed to counter trust stripping schemes. Subsection 100A(1) states that where a beneficiary of a trust is presently entitled to income of the trust and the present entitlement arose out of a reimbursement agreement, the beneficiary shall be deemed never to have been presently entitled to the trust income.

14. A reimbursement agreement is an agreement entered into otherwise than in the course of ordinary family or commercial dealing that provides for the payment of money (including the payment of money by way of loan) or the transfer of property to, or the provision of services or other benefits for, a person or persons other than the beneficiary.

15. In the arrangement described in paragraph 2, there is an agreement between the parties that only a small proportion of the income distributed to the promoter trust would ever be paid in cash and that the remaining monies are to be retained by the new trust for the ultimate benefit of the taxpayer and associates. This constitutes a reimbursement agreement. It is considered that the present entitlement of the promoter trust to the income of the new trust, if having legal effect, arose out of this reimbursement agreement, and as such section 100A must be considered.

16. Subsection 100A(3A) provides that where a trustee of a trust (the 'interposed trust') is the beneficiary of another trust and subsection 100A(1) would otherwise operate to deem the interposed trust not to be presently entitled to income of the other trust, subsection 100A(1) does not apply to so much of that income to which a beneficiary of the interposed trust is in turn presently entitled.

17. Therefore, in those cases where present entitlement of the loss company to income of the promoter trust is validly established and this income is attributable to income of the new trust to which the promoter trust is presently entitled, subsection 100A(3A) will be relevant. It will preclude subsection 100A(1) from applying to deny present entitlement of the promoter trust to income of the new trust.

CGT event may occur

18. Where the business of the trading entity is restructured into the new trust, a CGT event may occur which gives rise to an assessable net capital gain. The circumstances of each restructure will need to be considered to determine whether a CGT event occurs and whether a capital gain arises.

Carry forward losses may not be deductible

19. No deduction is available for prior year losses unless the loss company satisfies the continuity of ownership test or the same business test as outlined in Division 165 of the *Income Tax Assessment Act 1997* (ITAA 1997) (previously sections 80A and 80E of the ITAA 1936).

20. If the loss company satisfies the continuity of ownership test, the Commissioner may still disallow the relevant losses pursuant to Subdivision 175-A of the ITAA 1997 (previously section 80DA of the ITAA 1936). Subdivision 175-A applies where income is channelled or injected into a loss company in order to take advantage of its losses, or where a person has obtained a tax benefit in connection with a scheme which would not have been entered into if the loss had not been available for deduction.

Date of effect

21. This Determination applies to years commencing both before and after its date of issue. However, it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Commissioner of Taxation

17 August 2005

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:
TR 92/20

Subject References:

- company losses
- Part IVA
- scheme
- sham
- trusts

Legislative References:

- TAA 1953 Pt IVA
- ITAA 1936 80A
- ITAA 1936 80DA
- ITAA 1936 80E
- ITAA 1936 99A
- ITAA 1936 100A
- ITAA 1936 100A(1)
- ITAA 1936 100A(3A)
- ITAA 1936 Pt IVA
- ITAA 1936 177A
- ITAA 1936 177C(1)(a)
- ITAA 1936 177D
- ITAA 1936 177F

- ITAA 1997 Div 165
- ITAA 1997 Subdiv 175-A

Case References:

- AAT Case 10,796 (1996) 96 ATC 296; (1996) 32 ATR 1168
- AAT Case 11,115 (1996) 96 ATC 443; (1996) 33 ATR 1128
- AAT Case 11,125 (1996) 96 ATC 453; (1996) 33 ATR 1140
- Commissioner of Taxation v. Sleight (2004) 136 FCR 211; (2004) 2004 ATC 4477; (2004) 55 ATR 555
- FCT v. Hart (2004) 217 CLR 216; (2004) 2004 ATC 4599; (2004) 55 ATR 712
- Raftland Pty Ltd as trustee of the Raftland Trust v. Commissioner of Taxation [2008] HCA 21
- Richard Walter Pty Ltd v. Commissioner of Taxation (1996) 67 FCR 243; (1996) 96 ATC 4550; (1996) 33 ATR 97

Other References

- Decision Impact Statement B39/2007: Raftland Pty Ltd as trustee of the Raftland Trust v. Commissioner of Taxation
 - Taxpayer Alert TA 2005/1
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ATO references

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