National Superannuation Conference

Non-arm's length income – how does it apply and where is it at?

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1 How the non-arm's length income rules apply (and don't apply) to related party dealings, dividends from private companies and distributions from trusts?

1.1 Introduction, mischief and purpose

Although the non-arm's length income provisions are rightly receiving an increasing amount of attention, I suspect they still remain either obscure or unknown amongst parts of the wider tax, legal and accounting professions. This is unfortunate (and can be perilous) since, as is apparent from the steady trickle of litigation that involves these provisions, their operation results in dire tax consequences. Shortly stated, the non-arm's length component of the taxable income of a complying superannuation fund, complying approved deposit fund (**ADF**) and a pooled superannuation trust (**PST**) is taxed at non-concessionary rates (45%) instead of 15% or 0%. The non-arm's length component is the entity's non-arm's length income less any deductions to the extent they are reasonably attributable to that income. Odiously, once an amount is non-arm's length income, the whole amount is non-arm's length income (not just, for example, the amount that might be considered to be in excess of an arm's length dealing).

The non-arm's length income provisions are an anti-avoidance measure. The mischief to which s 273 of the *Income Tax Assessment Act 1936* (**ITAA36**), the predecessor to the current provisions was directed was identified in the explanatory memorandum to a Bill that expanded the application of s 273 in 1999:

> "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".[1]

In relation to superannuation funds that received trust distributions, the Full Court of the Federal Court in *Allen (As Trustee of the Allen's Asphalt Staff Superannuation Fund) v Federal Commissioner of Taxation* [2011] FCAFC 118 stated at [62]:

> "The mischief at which both s 273(6) and (7) ITAA 1936 were evidently aimed is the movement of assessable income, which would otherwise be taxed at the rate of 47% in the hands of the person who derived it, into a CSF [complying superannuation fund] by the mere exercise of a discretion (in the case of a discretionary trust) or by non-arm's length dealing in the case of a fixed trust entitlement".

[1] *Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 2)* 1999, para [2.13].

Similarly, the Full Federal Court in *Darrelen Pty Ltd v Commissioner of Taxation* [2010] FCAFC 35 at [31], in relation to dividends paid to a complying superannuation fund from a private company observed that the provisions (former s 273(2)) had the policy:

> "...of enabling the Commissioner to deny the concessional taxation of income where the income had been diverted from taxpayers not enjoying that concessional basis, through a non-arm's length acquisition of the shares".

1.2 The law

Prior to 1 July 2008, the relevant law was contained in s 273 of the ITAA36; a copy of s 273 is provided at the end of this paper (Appendix 1). Income that answered the requirements of s 273 was classified as "special income".

Since 1 July 2008, the law has been contained in Subdivision 295-H of the *Income Tax Assessment Act 1997* (**ITAA97**). The expression "special income" has been replaced with "non-arm's length income". Since the applicable law is now contained in Subdivision 295-H, it will be those provisions and "non-arm's length income" that are referred to, unless otherwise indicated. The pivotal provision, s 295-550 is in the following terms:

> (1) An amount of *ordinary income or *statutory income is ***non-arm's length income*** of a *complying superannuation fund, a *complying approved deposit fund or a *pooled superannuation trust (other than an amount to which subsection (2) applies or an amount *derived by the entity in the capacity of beneficiary of a trust) if:
>
> (a) it is derived from a *scheme the parties to which were not dealing with each other at *arm's length in relation to the scheme; and
> (b) that amount is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme.
>
> (2) An amount of *ordinary income or *statutory income is also ***non-arm's length income*** of the entity if it is:
>
> (a) a *dividend paid to the entity by a *private company; or
> (b) ordinary income or statutory income that is reasonably attributable to such a dividend;
>
> unless the amount is consistent with an *arm's length dealing.
>
> (3) In deciding whether an amount is consistent with an *arm's length dealing under subsection (2), have regard to:
>
> (a) the value of *shares in the company that are assets of the entity; and
> (b) the cost to the entity of the shares on which the *dividend was paid; and
> (c) the rate of that dividend; and
> (d) whether the company has paid a dividend on other shares in the company and, if so, the rate of that dividend; and
> (e) whether the company has issued any shares to the entity in satisfaction of a dividend paid by the company (or part of it) and, if so, the circumstances of the issue; and
> (f) any other relevant matters.
>
> (4) Income * derived by the entity as a beneficiary of a trust, other than because of holding a fixed entitlement to the income, is ***non-arm's length income*** of the entity.

(5) Other income * derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust is ***non-arm's length income*** of the entity if:

(a) the entity acquired the entitlement under a * scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at * arm's length; and
(b) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length.

(6) This section:

(a) applies to a * non-share equity interest in the same way as it applies to a * share; and
(b) applies to an * equity holder in a company in the same way as it applies to a shareholder in the company; and
(c) applies to a * non-share dividend in the same way as it applies to a * dividend.

It is apparent from the legislation that there are three categories of non-arm's length income as follows:

a. non-arm's length dealings;

b. private company dividends; and

c. trust distributions (s 295-550(4) and (5)).

This paper discusses each category in further detail. Almost every category of non-arm's length income contains a reference to either "dealing with each other at arm's length" or "an arm's length dealing". Accordingly, it is convenient to begin a discussion of these provisions by considering the meaning of the expression "arm's length".

1.3 Meaning of "arm's length"

The term "arm's length" is not defined in the ITAA36. It is defined in s 995-1 of the ITAA97 as follows:

> "in determining whether parties deal at arm's length, consider any connection between them and any other relevant circumstance".

The statutory definition does not explain the term; rather it contains a direction of how to determine whether the parties are dealing with other at arm's length rather than a definition or explanation of the term. As Lee J stated in *Granby Pty Ltd v FCT* 95 ATC 4240 at 4243:

> "The expression "dealing with each other at arm's length" involves an analysis of the manner in which the parties to a transaction conducted themselves in forming that transaction. What is asked is whether the parties behaved in the manner in which parties at arm's length would be expected to behave in conducting their affairs".

The nature of a non-arm's length dealing has been described by the courts. In *Re Hains (deceased); Barnsdall v FCT* 88 ATC 4565 at 4568, Davies J stated:

> "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".

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The comments of Davies J were endorsed by Hill J in *The Trustee for the Estate of the late AW Furse No. 5 Will Trust v. FC of T* 91 ATC 4007, by Lee J in *Granby* and by the Full Federal Court in *Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134 at [15].

In *Australian Prudential Regulation Authority v Derstepanian* [2005] FCA 1121, Weinberg J stated that the expression "at arm's length" plainly implied a dealing carried out on commercial terms. His Honour suggested that a useful test to apply was (at [18]):

> "... whether a prudent person, acting with due regard to his or her own commercial interests, would have made such an investment".

The Full Federal Court in *AXA* noted that there is no presumption that parties at arm's length deal with each other at arm's length: at [107]. Further, it is clear, from the comments of both Davies J in *Re Barnsdall* and Hill J in *Furse* that parties that are not at arm's length may still deal with each other at arm's length (and vice versa).

A useful summary of the principles that emerge from the cases on arm's length was provided by Dowsett J (dissenting) in *AXA* at [26] as follows:

- in determining whether parties have dealt with each other at arm's length in a particular transaction, one may have regard to the relationship between them;
- one must also examine the circumstances of the transaction and the context in which it occurred;
- one should do so with a view to determining whether or not the parties have conducted the transaction in a way which one would expect of parties dealing at arm's length in such a transaction;
- relevant factors which may emerge include existing mutual duties, liabilities, obligations, cross-ownership of assets, or identity of interests which might enable either party to influence or control the other, or induce either party to serve a common interest and so modify the terms on which strangers would deal;
- where the parties are not in an arm's length relationship, one may infer that they did not deal with each other at arm's length, and that the resultant transaction is not at arm's length;
- however related parties may, in some circumstances, so conduct a dealing as to displace any inference based on the relationship;
- un-related parties may, on occasions, deal with each other in such a way that the resultant transaction may not properly be considered to be at arm's length.

Careful regard should be given to the issue of collusion. Courts have readily accepted that parties at arm's length will not deal with each other at arm's length where they collude to achieve a particular result: *Granby*. However, the plurality in AXA noted that the pursuit of one party, for its own benefit, of a "collateral advantage" cannot, without more lead to a conclusion that the parties to the transaction were not dealing with each other at arm's length: at [117]. Further, the majority warned (at [119]):

> "...there may be real risks in approaching the question of whether two parties are dealing with each other at arm's length by "dissecting" the dealing into segments or aspects and submitting that the parties "colluded" or "yielded judgment" one to the other on some aspect of the dealing".

That is, a dissection of the transaction into segments may inaccurately colour the overall assessment of whether the parties dealt with each other at arm's length.

1.3.1 How the non-arm's length income rules work in relation to dividends from private companies

The way in which the non-arm's length income rules operate in relation to dividends from private companies will now be considered; the way in which the non-arm's length income rules operate in relation to distributions from trusts is considered below (at heading 2).

A dividend or an amount of ordinary or statutory income that is reasonably attributable to a dividend that is paid by a private company to a complying superannuation fund will be non-arm's length income unless the amount is consistent with an arm's length dealing: s 295-550(2). In distilling whether the dividend amount paid was consistent with an arm's length dealing, primacy is to be given to the factors enumerated in s 295-550(3).

The Full Federal Court in *Darrelen* has provided some guidance as to how substantially the same factors contained in s 273(2) of the ITAA36, (the predecessor) should be construed. In *Darrelen*, the Full Court upheld assessments which treated private company dividends as "special income" (equivalent to non-arm's length income). Foremost amongst the court's reasoning was that the cost of the shares to the fund was significantly less than their market value. The fact that the fund had derived a distribution at a rate equal to the rate per share paid on all shares did not alter or impede the court's conclusion. The court also found that:

- the reference to "value" in para (a) (of s 273(2)) was a reference to the market value of the shares at the time of their acquisition (at para [30]; and
- the "rate of the dividend" under para (c) (of s 273(2)) was not a reference to the rate of return or yield (at para [29]) – however, there was "no doubt" that the rate of return on investment was a factor that could be considered under para (f).

In relation to the price at which the shares had been sold to the fund (effectively s 295-550(3)(a)), the court said at [34]:

> "If the price at which the four shares in Vercot were sold to the Fund had been set at their market value, the price at which they were sold would not have secured the sale of even one share; the dividends on those four shares would have continued to accrue to the transferor, a non-concessional taxpayer. So understood, the income diversion has occurred by recourse to a non-arm's length transaction on the acquisition of the shares".

The matters referred to in s 295-550(3)(a) to (f) speak largely for themselves in terms of what factors a court will consider in adjudicating whether a dividend derived by a complying fund is consistent with an arm's length dealing. However, note the expansive provision in sub-para (f) – "any other relevant matters". In *Darrelen* the Full Federal Court regarded the rate of return on investment, or the "yield" as a factor that could be considered pursuant to para (f), but not para (c) (of s 273(2)). A similar conclusion was reached in relation to the market value of the shares, which may be considered under either paras (b) or (f), or in combination with each other.

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In relation to para (f), the Commissioner, in para [54] of TR 2006/7, lists the matters that he will consider relevant as follows:

a. 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;

b. the relationship between the superannuation fund, ADF or PST and the private company;

c. the relationship between the superannuation fund, ADF or PST and any party with which the private company has dealings;

d. who the superannuation fund, ADF or PST acquires the shares from and the circumstances of that acquisition; and

e. the rate of return on the superannuation fund's investment.

1.3.2 Amounts derived from non-arm's length dealings

The Commissioner in his ruling, TR 2006/7, correctly articulates that three things are required for the operation of s 295-550(1):

a. there must be a "scheme" ("transaction" under s 273);

b. the parties to the transaction must not have been dealing with each other at arm's length; and

c. 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.

The items above are discussed in more detail elsewhere in this paper. The expression "scheme" is also a requirement for non-arm's length income derived by a fund through holding a fixed entitlement to the income of a trust (see heading 2). So too is the requirement that 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. The expression "arm's length" (and dealing with each other at arm's length) is considered above. In relation to the requirement of a "scheme" (see below), it may be that the exact parameters of the scheme identified by the Commissioner will be a contested issue.

The provisions relating to non-arm's length dealings in s 295-550(1) do not apply to private company dividends or trust distributions. In my experience, this leaves little practical operation for the operation of s 295-550(1). Nonetheless, the Commissioner considers that s 295-550(1) can apply to include interest on loans, rent from property, profits on sale of assets, capital gains and franking credits.

2 What is a fixed entitlement in a trust for the non-arm's length income rules?

The answer to this question has become unsettled. The issue is relevant because both the former s 273 and the current Subdivision 295-H draw a distinction between a fund that derives income as a

beneficiary of a trust "through holding a fixed entitlement to the income of the trust" on the one hand and "other than because of holding a fixed entitlement to the income" on the other.

Income derived by a fund as a beneficiary of a trust other than because of holding a fixed entitlement will automatically be non-arm's length (formerly special) income. Conversely, income derived by a fund as a beneficiary of a trust through holding a fixed entitlement to the income of the trust will only be non-arm's length income if other conditions are satisfied: ss 295-550(5) and (6) of the ITAA97. As was the scenario in *The Trustee for MH Ghali Superannuation Fund and Commissioner of Taxation* [2012] AATA 527, the sudden death result of a non-fixed holding to income of the trust will likely remain an agitated threshold issue in litigation involving alleged non-arm's length income and trusts.

The expression "fixed entitlement" was not defined in s 273; nor is it asterisked as a defined term in Subdivision 295-H of the ITAA97. Unhelpfully, the ITAA97 provides that "most" defined terms are identified by an asterisk appearing at the stat of the term: s 2-10(2). The general definition provisions in s 995-1 of the ITAA97 do define "fixed entitlement" by reference to Division 272 in Schedule 2F of the ITAA36. However, until recently, no suggestion had ever been made that the definition in s 995-1 was applicable to the undefined reference to "fixed entitlement" in the non-arm's length income provisions.

The Commissioner's position, as contained in his ruling TR 2006/7 (which was drafted prior to s 273 being repealed) was well settled. At the very least, the Commissioner considered that the interest in the income of the trust had to be "vested in interest, if not possession" immediately before the amount was derived by the trustee: at para [208]. The Commissioner articulated his views of what "vested in interest" meant as follows, para [209]:

> "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".

2.1 The decision in *Ghali*

In *Ghali*, a threshold issue was whether the fund had a fixed interest in the income of the relevant unit trust since the answer to this would dictate whether s 273(6) or (7) was applicable. The taxpayer contended that it had a fixed interest, that s 273(7) was applicable and that consequently there were other conditions to be satisfied. The Commissioner contended that the fund held no fixed interest and that the income was automatically special income by virtue of s 273(6).

It was common ground between the taxpayer and commissioner that a fixed entitlement for the purposes of s 273 meant an interest (in the income of the trust) that was "vested in interest". So far as relevant, the facts in *Ghali* involved a complying superannuation fund that was a unit holder of a the Ghali Unit Trust (the **unit trust**). The unit trust deed, at clause 2.7, provided that the Trust Fund shall initially be divided into a number of $1 units and classified as A Class, B Class, C Class and D Class units. A Class units carried an entitlement to a share in the capital of the Trust Fund upon the termination of the trust, the distribution of the income of the trust in accordance with the provisions of clause 12, the right to one vote in respect of each unit held and the right to resolve by unanimous agreement with other A Class unit holders the amount of the income to be distributed to the holders of B, C and D Class units.

The distribution of income of the unit trust was regulated by clause 12.3. So far as is relevant, it provided:

12.3.1 *The Trustee may subject to the provisions in this clause and subject to any special rights or restrictions provided in clause 2.7 in relation to units of any class distribute at any time to any one or more of the classes of Unitholders or to any one or more of the unitholders within a particular class to the exclusion of other Unitholders such of the income of the Trust Fund as the Trustee may in its absolute and uncontrolled discretion decide.*

12.3.11 The Trustee shall in its absolute discretion determine which class of Unitholder shall be presently entitled to such Income of the Trust Fund as is agreed upon in accordance with the requirements of clause 12.3.1 and in default of such determination the Unitholders in the same proportions as they hold units in the Trust Fund shall notwithstanding classification be presently so entitled.

The taxpayer in *Ghali* agitated that the expression "vested in interest" is one where the holder has an "immediate fixed right of present or future enjoyment": *Glenn v Federal Commissioner of Land Tax* (1915) 20 CLR 490 at 496; see also *Walsh Bay Developments Pty Ltd v Federal Commissioner of Taxation* (1995) 31 ATR 15 at 27; (1995) 95 ATC 4378. As stated by Beaumont and Sackville JJ in *Walsh Bay Developments*, before a beneficiary is entitled to a vested interest two things must be established (13 ATR 15 at 27):

a. his identity must be established; and

b. his right to the interest (as distinguished from his right to possession) must not depend upon the occurrence of some event.

The taxpayer acknowledged in *Ghali* that ordinarily, the existence of a substantive condition precedent will preclude the relevant interest being vested. However, the taxpayer agitated that a distinction was to be drawn between a contingent interest and a defeasible interest. A defeasible interest is a vested interest, which is liable to be divested by a supervening event: see *Walsh Bay Developments* at (31 ATR 15 at 27). As Hill J stated in *Dwight v Federal Commissioner of Taxation* (1992) 23 ATR 236 at 249; (1992) 37 FCR 178:

> "...a beneficiary with an interest which is not contingent but which interest may be brought to an end by the exercise of a power of appointment, would be said to have a vested but defeasible interest: cf *Queensland Trustees Limited v Commissioner of Stamp Duties* (1952) 88 CLR 54 at 63 and *Re Kilpatrick's Policies Trusts* [1966] Ch 730."

The taxpayer advanced that an entitlement that is vested in interest, but which is defeasible will be taken to constitute a fixed entitlement to income for the purposes of s 273(6) and (7).

In relation to the facts before the Tribunal, the primary submission put by the taxpayer was that although the trustee did have discretion to determine which class of unit holders were presently entitled to income of the trust (subject to clause 2.7.1), unit holders were presently entitled to income in the same proportions as their unit holdings in default of a determination being made. In this regard, the identity of the taxpayer (and other unit holders) was established, as was the taxpayer's right to the interest. Significantly, the entitlement to that interest did not depend on the occurrence of some event; to the contrary, no discretion was required to be exercised. The taxpayer's interest existed unless a determination was made to defeat its existence.

The Commissioner submitted that the fund did not hold a fixed entitlement in the income derived from the unit trust as it was contingent upon a number of matters including (but not limited to) a unanimous agreement by A Class unit holders resolving the amount of income to be distributed to B, C and D unit holders. On this basis, the entitlement was not vested in interest at the relevant time.

The taxpayer succeeded on the issue of fixed entitlement. The Tribunal found that to fall within the definition of the expression "fixed entitlement", a beneficiary's interest need only be vested, not vested in interest and in possession: at [35]. The Tribunal said further at [39]:

> "...clause 12.3.11 of the Unit Trust Deed makes it abundantly clear that a unit holder's interest in the income or capital of the trust is vested irrespective of whether the trustee exercises its absolute discretion to determine which class of unit holder is presently entitled to income of the Trust Fund. It is not contingent upon the trustee making a determination or on any other event".

However, unexpectedly, the Tribunal found that the expression "fixed entitlement" took its meaning from the same expression in the trust loss provisions in Schedule 2F of 272 of the ITAA36. Section 272-5 provides that a beneficiary has a fixed entitlement to a share of income or capital if:

> "...under a trust instrument, a beneficiary has a vested and indefeasible interest in a share of income of the trust that the trust derives from time to time, or of the capital of the trust".

The question, according to the Tribunal, was whether the unit trust deed granted a beneficiary of that trust a vested *and* indefeasible interest in a share of the income or capital of the trust. Ultimately, the Tribunal in *Ghali* found that the deed did grant such an interest: at [43]-[44]. The Tribunal found that clause 8 of the unit trust deed, which dealt with the question of forfeiture of units, was the only clause that was relevant to the question of defeasibility. That is, although A Class units (held by the taxpayer) could be allotted upon the payment of at least 1 cent per unit, failure to make the rest of the payment of the payment at call may result in the forfeiture of the units if the trustee so resolved. Since the evidence in *Ghali* was that the A Class units held by the taxpayer were fully paid, the units held by the taxpayer were not subject to a call or forfeiture. Accordingly, the Tribunal concluded that the taxpayer held a fixed entitlement to the income of the trust.

The unexpected aspect of *Ghali* was that the definition of "fixed entitlement" in the trust loss rules was found to be applicable to the meaning of the same expression in s 273. No argument was advanced by the taxpayer or Commissioner that such a construction was open to the Tribunal. So far as I am aware, this contention has not been made before. The view that the trust loss definition of "fixed entitlement" was applicable to the same expression in s 273 is unchartered territory.

The decision in *Ghali* was not appealed. The Commissioner released a Decision Impact Statement (**DIS**) in which he acknowledged that the Tribunal had not had the benefit of submissions on the issue; indeed that neither party had advanced the argument in the first place. The Commissioner opined, correctly in my view, that the application of the fixed entitlement definition for the trust loss purposes would amount to a more stringent test that would give rise to adverse and unintended impacts on superannuation funds. In his DIS, the Commissioner states that notwithstanding the decision in *Ghali*, he did not consider the trust loss definition of fixed entitlement to be applicable to s 273 (or s 295-550 of the ITAA97).

The DIS gave the profession some comfort that the status quo would be maintained – at least for the being. That is, that what was required for a fixed entitlement was an interest that was vested in

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interest, being an entitlement that did not depend upon the trustee's discretion. The more stringent definition of fixed entitlement in the trust loss provisions would not be applied by the Commissioner unless or until the issue was further tested in the courts or Tribunal. In the DIS, the Commissioner stated that he did not propose to amend TR 2006/7 as a result of the decision in *Ghali*.

2.2 The current state of affairs

Here the saga may have ended but for the recent release of a private ruling that rightfully, has caused some unrest. The private ruling in question (authorisation number 1012585947911) is one of a series of private rulings released in 2014 that deals with a limited recourse borrowing arrangement (**LRBA**) and which are considered in more detail below. A copy of the ruling is provided at Appendix 2 at the end of this paper.

In the ruling, the second question asked is whether income received by the fund from the custodian trusts will be non-arm's length income (if the fund enters into an LRBA with a related party with a nil interest rate). The Commissioner concludes such income would be non-arm's length income. Intriguingly, the Commissioner in considering the meaning of non-arm's length income states as follows:

> "In accordance with subsection 995-1 of the ITAA 1997, an entity has a fixed entitlement to a share of the income or capital of a company, partnership or trust if the entity has a fixed entitlement to that share within the meaning of Division 272 in Schedule 2F to the *Income Tax Assessment Act 1936* (ITAA 1936)".

The definition contained in s 272-5 in Schedule 2F is then quoted, requiring both a vested and indefeasible interest in a share of income of the trust or of the capital of the trust. A discussion of the meaning of the terms "vested" and "indefeasible" is provided and consider many of the authorities that were raised in *Ghali* – including *Glenn*, *Walsh Bay Developments* and *Dwight*. Unlike the decision in *Ghali* however, the ruling also contains some of the Explanatory Memorandum to the *Taxation Laws Amendment (Trust Loss and Other Deductions) Bill* 1998, which accompanies the enactment of s 272-5 to Schedule 2F. The contents are contained in the ruling (see Appendix 2).

The ruling concludes that, on the facts as presented, the fund would have a fixed entitlement to all of the income of the custodian trusts the subject of the LRBA for the purposes of s 295-550(5).[2] The ruling states:

> "...assessing the circumstances holistically, it is clear that, in respect of the LRBA's, the parties will not be dealing with each other as arm's length parties would do".

Further, the ruling concludes that the amount of income that would be derived is more than the amount that the entity might have been expected to derive if the parties had been dealing with each other at arm's length. The reasons for this conclusion mirror those applicable to private ruling authorisation number 1012582301006 (set out below). On the ruling's reasoning, the income of the fund would accordingly be non-arm's length income.

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[2] The ruling notes that it is conclusion is wrong, any income derived by the fund would be non-arm's length income pursuant to s 295-550(4) of the ITAA97.

The private ruling does not, in my view, express any new concepts about what the meaning of the expressions "vested" or "indefeasible". However, the significance of the ruling is that it endorses the trust loss definition of fixed entitlement when the Commissioner espoused in the *Ghali* DIS that this would not be the adopted approach.

The question becomes what, if anything, should be done given the current climate? The private ruling is only applicable to the taxpayer(s) to whom they relate. TR 2006/7 has not been withdrawn or amended at the time of writing and accordingly affords protection to some taxpayers. However, what remains unknown is whether the private ruling above heralds a change in view by the ATO which could lead to the amendment of TR 2006/7. Currently, I would be reluctant to form the view that the private ruling amounts to a change in official ATO view. I would expect that if a change of view is emerging within the ATO, this view would be tested in litigation, ideally in a superior court and TR 2006/7 ultimately amended.

In terms of precautions, it would be prudent to have deeds reviewed to ensure that under the approach taken in the private ruling (applying the Schedule 2F of the ITAA36 definition), they do not create non-fixed entitlements. In that context, the sorts of provisions that will offend a fixed entitlement include:

- a power to issue units otherwise than at market value;
- a power by the trustee to distribute income or capital by discretion or disproportionately to unit holdings;
- a power by the trustee to amend the deed without the consent of all unit holders;
- a power to redeem units for less than their market value or net asset value; and
- a power to make gifts.

The Commissioner, in his DIS in relation to the decision in *Colonial First State Investments Ltd v Commissioner of Taxation* [2011] FCA 16 states that the ATO has considered issuing a public ruling about the fixed entitlement test in the trust loss provisions in Schedule 2F to the ITAA36. However, the ATO does not propose to "prioritise" the fixed arrangement issue whilst a government review of the fixed trust rules (recommended by the Board of Taxation as part of its review of the Managed Investment Trusts) is in place.[3]

Finally, if a trust deed is to be amended, careful regard should be given to the (unwanted) prosect of a resettlement for CGT purposes.

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[3] The previous government released a discussion paper in July 2012 and submissions closed in September 2012. No announcement has been made about any changes to the meaning of fixed trust.

3 Whether a nil interest loan under a limited recourse borrowing arrangement will trigger the non-arm's length income rules?

Frequently, in my view, a nil interest loan under a LRBA will be suggestive of a non-arm's length dealing; however it will need to be viewed with other aspects of the loan. At the very least, a nil interest loan will be a significant factor to consider in terms of whether the non-arm's length income rules are triggered. The real question is whether the parties to the LRBA are dealing with each other at arm's length when all the circumstances of the LRBA, including the nil interest loan are considered. If the answer is yes, then the non-arm's length rules will be triggered.

The issue has been simmering away for some time. It should be acknowledged that the legislation creates something of a vacuum in relation to LRBA's; the provisions, regulated by s 67A of the *Superannuation Industry Supervision Act 1993* (**SIS Act**) are silent as to interest rates, loan to value ratios and terms.

In 2010, the Commissioner released ID 2010/162 in which he concluded that in that instance, a complying superannuation fund would not breach s 109 of the SIS Act if it borrowed money from a related party under an LRBA on terms favourable to the fund. Section 109 of the SIS Act essentially provides that a fund must not invest unless:

- the trustee of the fund and other party to the relevant transaction deal with each other at arm's length; or
- if the parties are not dealing with each other at arm's length (in respect of the transaction), the terms and conditions of the transaction are no more favourable to the other party than those that would reasonably apply if the parties were dealing with other at arm's length.

A discussion of the meaning of the expression "arm's length" is contained above.

Similarly, at the National Tax Liaison Group (**NTLG**) Superannuation Technical Sub-group in June 2012, the ATO acknowledged that a lower than market interest rate or the absence of a requirement to pay interest on money loaned to the fund by a related party will not prevent the arrangement from being a "borrowing" for the purposes of s 67A. Although interest may evidence the existence of a borrowing, it was not a feature of the borrowing itself.

Although the Commissioner's distinction between a borrowing and the interest on a borrowing is acknowledged, ID 2010/162 concluded that although the interest rate under the borrowing arrangement was lower than the rate that would be available to the SMSF under an arm's length lender, s 109 was not contravened. This was because the terms and conditions of the borrowing were not more favourable to the other party than if the parties were dealing with other at arm's length. Notably, ID 2010/162 did not identify or canvass whether any other parts of the SIS or tax legislation would be breached by the arrangement in question.

At the NTLG meeting in December 2012 the ATO's position on low rate loan arrangements and LRBA's was:

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"...that that they do not generally invoke a contravention of the SISA, do not give rise to non-arm's length income under section 295-550 of the *Income Tax Assessment Act 1997* (ITAA), do not invoke Part IVA of the *ITAA 1936* and are not considered to give rise to contributions to the SMSF *just from that one fact alone*" [italics added].

At that meeting, it was noted that the commissioner's views in ID 2010/162 and the NTLG Superannuation Technical Sub-group minutes from June 2012 had made it appear there were "no issues from a legal or tax perspective" in entering an interest free or low interest LRBA and that there was a "temptation" for this to be exploited. Some private rulings were also seen to endorse the position that nil interest loans would not trigger the non-arm's length rules.[4]

In April 2014, any complacency was removed by a private ruling (the **2014 PR**) which concluded that in that instance, a superannuation fund will derive non-arm's length income where it enters into an LRBA with a nil interest rate and a loan to value ratio of 100%.[5] A copy of the private ruling is provided at Appendix 3 of this paper.

The facts of the 2014 PR followed a common trajectory. A superannuation fund was proposing to borrow funds from a related family trust. The corporate trustee of the fund and trust were one and the same. The directors of the trustee were the only members of the fund. Both members were receiving pensions from the fund.

The sample loan agreement provided referred to an interest rate of "0% or such other rate as agreed between the lender and borrower in writing from time to time". The fund was to repay the loan as a single lump sum at the end of the loan terms – which was not specified in the agreement. In fact, the applicants advised that the loan would have a term of several decades. The trust was proposing to lend 100% of the value of the assets to be acquired to the fund. The lender would be granted a first mortgage or charge over the asset acquired with the funds borrowed. The lender's rights would be limited to the rights relating to the acquired asset.

The asset acquired (listed ASX shares) with the borrowed amount would be held through a custody trust for the fund by a custodian. The fund would have a vested and indefeasible interest in and be absolutely entitled to, the acquired asset(s) held by the custody trust.

Amongst the questions asked of the Commissioner was whether income derived by the fund from the "nil interest rate arrangement" would be non-arm's length income pursuant to s 295-550 of the ITAA97. The answer to this was "yes". The reasoning of the 2014 PR is instructive.

It appeared to be common ground between the applicant and the Commissioner that the Declaration of Custody Trust established a fixed trust and that accordingly s 295-550(5) was applicable. Unsurprisingly, the 2014 PR also concluded that the proposed arrangement amounted to a "scheme". Of interest however, is that the scheme identified by the Commissioner included more than the derivation of the income by the fund. It included:

"...the series of steps undertaken by the parties that results in the Fund's acquisition of its fixed entitlement to the income of the Custody Trust and any derivation of income by the Fund through holding that entitlement".

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[4] See Authorisation numbers 1012396819768 and 1012414213139.

[5] Authorisation number 1012582301006.

That is, for the purposes of s 295-550(5), the proposed scheme involved the series of steps undertaken that results in the fund's acquisition of its fixed entitlement; the Commissioner did not consider the "scheme" to be limited to the derivation of income.

That established, the issue central to the non-arm's length income aspect of the ruling was whether the parties to the scheme dealt with each other at arm's length. In this regard, the authority relied on by the Commissioner was the decisions of the Full Federal Court in *AXA* and *Allen*. The 2014 PR states that, assessing the circumstances holistically, it was clear that the parties would not be dealing with each other in respect of the LRBA as arm's length parties would do. Factors which supported that conclusion included the following:

- no interest was being charged and the lender was not compensated for the opportunity cost in lending the principal;
- only a single lump sum repayment was being made at the end of the loan (which could be years away);
- 100% of the value of the assets to be acquired would be lent (rather than a lower loan to value ratio (**LVR**)); and
- no insistence by the lender on the giving of personal guarantees by the members of the fund was made.

The Commissioner also concluded that the amount of income that would be derived by the fund is greater than the amount that the fund might have been expected to derive if the parties had been dealing with each other at arm's length. According to the Commissioner, in the event the parties did deal with each other at arm's length, the amount of income the fund might be expected to derive though the custody trust would be either:

- nil – on the basis that no lending on the proposed terms by the family trust would occur (and consequently no income might be expected to be derived); or
- less than under the proposed arrangement - on the basis that the family trust might be expected to lend on commercial terms that involve lower than 100% LVR's (lower borrowed amounts might be expected to generate less income to be derived by the fund through the custody trust).

Either way, the 2014 PR concluded that the final element of s 295-550(5)(b), that the amount of income is more than the amount that the fund might have been expected to derive if those parties dealt with each other at arm's length would be satisfied.

This aspect of the Commissioner's reasoning has attracted some controversy. The borrowing interest rate is at the fund level and doesn't affect the gross income from the custody trust; that is, since the fund will have a vested and indefeasible interest in the acquired asset and all income of the custody trust, the amount of income received from the trust will not be affected by the absence of the fund paying interest. The Commissioner's argument that the fund is receiving income it wouldn't ordinarily receive either because it wouldn't acquire the asset at all or would have to purchase an asset of lesser value has not persuaded segments of the profession.

The result of the 2014 PR is that it has created uncertainty about the Commissioner's position. The 2014 PR is a private ruling only and cannot be relied on by other taxpayers. However it has rightly

occasioned controversy and suggestions of a change in view by the ATO. In my view some of the controversy generated by the 2014 PR is a result of a misunderstanding (or misconceiving) the Commissioner's previous position. ID 2010/162 was directed at s 109 of the SIS Act and notably did not address the non-arm's length income provisions. These are couched in different language and relevantly deal with the expansive definition and concept of a "scheme". The distinction between a borrowing on the one hand and the interest payable on that borrowing would assume less (if any) relevance when one considers that both would likely be included in a scheme for s 295-550(5) purposes. Further, the NTLG minutes should not have been seen as the panacea that some considered them to be; the minutes state that the Commissioner's position that the low rate loan arrangements and LRBA's do not offend s 295-550 was based "just from that one fact alone".

Regardless, the 2014 PR should not be seen as prohibiting LRBA's per se from being entered into with related entities. What can be distilled is that dealings between the fund and the family trust/lending entity must be at arm's length. This is the common theme that may be discerned from the legislation and cases that deal with non-arm's length income.

One question now frequently asked is whether a non-interest loan, of itself, is enough to taint the income of a fund as non-arm's length income if it is derived from an investment made through an LRBA with a related entity. I consider that frequently, this factor, of itself, will be suggestive of a non-arm's length dealing. However, as is apparent from the 2014 PR, there are other factors that the Commissioner will examine. Some, such as the LVR ratio are significant. In my view, a non-interest bearing loan, coupled with a 100% LVR ratio will make the conclusion that the parties to the scheme did not deal with each other at arm's length and that the income derived is non-arm's length income even more compelling. Ultimately however, what is required is a holistic assessment of the LRBA to determine whether the parties, even if they are not *at* arm's length, *dealt* with each other at arm's length.

A further question commonly asked is what, if anything, to do with an LRBA that may offend the non-arm's length rules. If it is clear that the LRBA in question will result in non-arm's length income being derived, ideally, it is best to amend the terms of the LRBA or refinance. Interest should be charged at market rates and loan repayments should be made over the (realistic) term of the LRBA. An LVR of less than 100% would also likely assist.

Amending the terms of an LRBA (or refinancing) may prevent non-arm's length income being derived going forward. However, the die may be cast for past income years. If it is clear that non-arm's length income has been derived, reporting the income as non-arm's length income would reduce penalties and interest if the fund was later audited.

The other issues considered in the 2014 PR have not attracted as much controversy. The other questions asked of the Commissioner were essentially:

- if a fund enters into a LRBA, whether the discount amount of interest (the difference between interest calculated using an arm's length interest rate and a nil interest rate) be considered a superannuation contribution by the fund?
- if the income derived from the nil interest rate is non-arm's length income, would this be treated as a contribution to the fund?

- if the asset was sold at a loss, would the value of the shortfall in the loan repayments be considered a contribution to the fund as a result of the debt forgiveness provisions?

All of these questions were answered "no".

Finally, the 2014 PR provides a salient reminder of the requirements imposed by s 109 of the SIS Act. These are set out above. A breach of s 109 carries civil and criminal consequences.

4 Whether the non-arm's length income rules apply to capital gains and distributions?

The position, shortly stated, is that the non-arm's length income rules include capital gains. This is the case regardless of whether the facts involve Subdivision 295-H or the former s 273. In relation to the 1936 provisions, this remains the position until and if either the Full Federal Court finds the decision in *Allen* to be "plainly wrong" or the High Court overrules it. In the latter scenario, the taxpayer's application for special leave to the High Court was refused.[6]

To date, the contention that the non-arm's length income rules do not apply to capital gains has been made in relation to s 273 of the ITAA36. For the reasons set out below, I am of the view that the same argument cannot be made with merit in relation to the re-written non-arm's length income provisions in Subdivision 295-H of the ITAA97.

The genesis for debate about whether special income for s 273 purposes included capital gains was the expression "income derived" in that section. The expression "income" in the context of s 273 was not defined in the ITAA36. Those who contended that "income derived" did not extend to capital gains reasoned that s 273 only applied to income according to ordinary concepts, not assessable income or statutory income.

Other tenets of statutory interpretations were relied on to the same (ultimately inglorious) end. They included the contention that the requirement that income be "derived" supported the construction that "income" meant income according to ordinary concepts. On that premise, there was no compelling reason to construe the reference to "income derived" as a reference to statutory or assessable income derived. It was also observed that s 273 had been repealed (and re-written as s 295-550 of the ITAA97). That s 295-550 expressly includes statutory income as non-arm's length income was seen as advancing the contention that "income" in the context of s 273 meant ordinary income and was not intended to encompass both ordinary and statutory income.

The Full Federal Court in *Allen* rejected the arguments that income in s 273(7) did not include assessable income. In so doing, the court has, for the time being, substantially put to rest the argument that capital gains were not included in "income" for s 273 purposes.

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[6] [2012] HCA Trans 25.

The court in *Allen* sought to distil the context and mischief of s 273[7]; in so doing it applied the High Court's well known remarks in *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue* (2009) 239 CLR 27 at 46-47:

> "This Court has stated on many occasions that the task of statutory construction must begin with a consideration of the text itself. Historical considerations and extrinsic materials cannot be relied on to displace the clear meaning of the text. The language which has actually been employed in the text of legislation is the surest guide to legislative intention. The meaning of the text may require consideration of the context, which includes the general purpose and policy of a provision, in particular the mischief it is seeking to remedy".

In distilling the context and mischief at which s 273 was aimed, the Court found that special income was intended to refer to assessable income. The court reasoned that pursuant to s 97(1) of the ITAA36, the income of the superannuation fund as the sole beneficiary of the Allen's Asphalt Fixed Trust included their share or proportion of the net income of the trust estate in accordance with s 95. By virtue of s 6-10 of the ITAA97, that share or proportion was assessable income of the fund. As the court stated at [52]:

> "...if it is assumed that the trustees of the Super Fund are themselves the beneficiaries of a trust, any income which comes home to them will be assessable income by reasons of ss 95 and 97(1)(a) of the ITAA 1936. This assumption may properly be made in this case because s 273(7) of the ITAA 1936 is expressly predicated upon a state of affairs in which the trustee of the complying superannuation fund (CSF) receives the putative income by virtue of a fixed entitlement, that is to say a situation in which s 97(1)(a) operates".

The court identified that s 273 attached a particular consequence in terms of the rate of tax to that income which is special income. According to the court, s 273 disclosed "an unmistakable intention to deal comprehensively with trust income", including amounts included in assessable income otherwise than from an income earning activity. If the income derived by the complying superannuation fund did not include trust distributions, s 273(6) could have no operation at all. Further, the court concluded, there could be "no doubt" that the phrase "income derived" had the same operation in ss 273(6) and 273(7).

Finally, in response to the taxpayer's argument that the relevant explanatory memorandum's failure to refer to assessable income supported their case, the court concluded that a more compelling explanation was that that the drafter of s 273(7) proceeded on the assumption that to speak of income in s 273(7) in context was to speak of assessable income.

The taxpayer in *Allen* sought special leave but was unsuccessful. Chief Justice French said in dismissing the application:

> "This application for special leave involves the construction of section 273(7) of the 1936 Act and, in particular, the term "income derived by the entity in the capacity of beneficiary of a trust estate" which appears in that subsection. A key question raised by the applicants is whether the term "income" there refers to income according to ordinary concepts. The application for special leave raises a question of statutory construction in a particular context. The Full Court adopted the construction which it did by reference to both purpose and context. In so doing, in our opinion, it applied correct principle. The decision is unattended with sufficient doubt to warrant the grant of special leave. Special leave will be refused with costs".

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[7] See Heading 1.1 above.

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More recently, other decisions have implicitly taken the same view as *Allen*. In *SCCASP Holdings as trustee for the H & R Super Fund v Commissioner of Taxation* [2012] FCA 1052, Logan J in the Federal Court observed at [28]:

> "...However moot the answer to the question which divides the parties might have been prior to the High Court's refusal of special leave to appeal, that did not then (much less now) make the judgment of the Full Court in *Allen* any less binding on me as a judge exercising original jurisdiction in hearing SCCASP's taxation appeal. At least at first blush, one might have thought, in light of the Full Court's judgment in *Allen*, that the question had been decided adversely to SCCASP, ie that the word "income" in s 273 was to be construed as meaning assessable income and thus both ordinary income and statutory income such as the net capital gain such that that gain constituted income derived by SCCASP for the purposes of s 273".

His Honour found that the net capital gain in *SCCASP* was, for the purposes of s 273, income derived" by the fund. In addition to rejecting the submission of the taxpayer that the Full Court's ,remarks in *Allen* about derivation were obiter, His Honour noted the High Court's decision in *Commissioner of Taxation v Bamford; Bamford v Commissioner of Taxation* [2010] HCA 10 and stated that:

> "...Once it is appreciated, as it must be in light of what the High Court stated in *Bamford* at [12], quoted above, in relation to capital gains and the taxation of trusts, that a net capital gain forms part of the net income of the trust estate within the meaning of s 95(1) of the ITAA36, then it necessarily follows that the share of that gain which is included in the beneficiary's assessable income pursuant to s 97 is included in the same way as any other part of the net income of the trust estate".

In *SCCASP*, the taxpayer's appeal to the Full Court was dismissed. In rejecting the taxpayer's argument that "income derived" meant income received for the purposes of s 273 (and that *Allen* was wrongly decided), the Full Court in *SCCASP* noted that the taxpayer faced a "formidable task" in persuading the court that the Full Court in *Allen* was wrong. It concluded it had failed to do so. As was the case with *Allen*, the taxpayer's application for special leave was refused.

In *Ghali*, although an argument was made that a capital gain should not be included until a change in ownership occurred, it was ultimately not contended, given the decision in *Allen*, that s 273 did not include capital gains.

Since 1 July 2008, the relevant law has been contained in Subdivision 295-H of the ITAA97. In so far as the issue of capital gains and assessable income will be relevant, it will be in relation to s 295-550(4) and (5). This is because, as was the case with ss 273(2) and (3), subsections 295-550(2) and 295-550(3) are concerned with dividends paid by a private company. Unlike its predecessor in s 273(4), s 295-550(1) makes clear that it applies to "an amount of ordinary income or statutory income".

The re-written provisions in s 295-550(4) and (5) concerning income derived by trusts contain some differences to their predecessors. The rewritten provisions refer to income derived by the entity as a beneficiary (instead of in the capacity of beneficiary), trust (rather than trust estate), scheme (instead of arrangement) and non-arm's length income (not special income). Both the re-write and s 273 still refer to "income derived". However, given the common law authority and the context of the re-write, there can be no doubt that income derived in either provision includes assessable income and capital gains.

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5 What principles come out of the recent cases on special/non-arm's length income?

As is apparent from the discussion above, there are now several recent decisions of superior courts that deal with the non-arm's length income provisions. The Commissioner has won all of them, save for a partial loss in relation to the fixed entitlement issue in *Ghali*.

The common thread amongst the cases that, in my view, is attributable to the taxpayer's loss is the presence of non-arm's length dealings. However, the basis for this conclusion varies according to the facts and which limb of s 273 has been before the Court or Tribunal.[8] The umbrella principle that should direct transactions involving complying superannuation funds must be this: ensure that all dealings involving the fund are at arm's length.

Where assets are acquired in a company or units acquired in a trust, they must be acquired at market value. The fund should not receive any special treatment. Where it acquires assets, it should do so on the same terms as any other investor. In *Darrelen*, the fund in question indirectly (through a passive holding company) acquired shares in another company for 10% of their market value and between 1/10th and 1/6th of their true value. The Full Court noted that the market value of the shares acquired was "far in excess" of the amount paid: at [7]. The fact that the fund derived a distribution at a rate equal to the rate per share paid on all shares did not remove the "tainting effect" of the acquisition: at [24].

Given the uncertain state of the law in relation to fixed entitlements, the prudent approach must be to ensure as best as possible that all future deeds create a fixed entitlement, as defined in Schedule 2F to the ITAA36. This should be the approach, at least until the view of the Tribunal in *Ghali* is tested by a superior court or the Commissioner clarifies his approach by amending TR 2006/7.

There are no court or tribunal decisions which have tested the Commissioner's views that are set out in the 2014 PR. As with the fixed entitlement, the prudent approach is to err on the side of caution. The terms of new LRBA's should mirror loans available from banks and other financial institutions. That is, market rate interest should be a term of the LRBA and paid over the (realistic) term of the arrangement. A LVR that is consistent with the market is highly advisable.

In relation, to capital gains, the decisions in *Allen* and *SCCASP* appear to have put to rest any argument that capital gains are somehow excluded from being non-arm's length income. The terms of the disposal of capital assets that generate capital gains should be considered in the same way as other types of income in considering whether the non-arm's length income provisions will be invoked.

Other important principles that have emerged from recent cases are:

- in relation to dividends derived by a complying fund, the expression "any other relevant factors" in s 295-550(3)(f) is expansive: see *Darrelen*; and
- in relation to fixed entitlements, the "scheme" in s 295-550(5) is not limited to the derivation of income; rather it includes the acquisition of a fixed entitlement: *Allen*.

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[8] There are no decisions yet which have involved s 295-550 of the ITAA97.

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A final but important message that emerges is that the documentation that surrounds a transaction is critical. Accounting records and other evidence about the transaction must be accurately produced and kept. In *Ghali*, the Tribunal observed that:

- no resolutions were made as to how income would be distributed;
- there was no evidence that unit certificates were ever issued;
- units recorded in the fund balance sheet did not correspond with the balance sheet of the unit trust;
- units of another superannuation fund were recorded as belonging to the fund in question; and
- reference to some income years had been whited out on the unit register and replaced with other income years.

The effect of some of the alterations led Senior Member Fice to note (at [59]) that "...it does not give me great confidence in the accuracy of the register". In relation to accounting records, the Tribunal observed (at [62]) that accounting records are produced to record the transactions which have in fact taken place rather than "constituting the transaction itself". The records, the Tribunal found:

> "...amplifies the fact that the issue and redemption of units were not at arm's length. This is not the conduct one would expect where parties were dealing with each other at arm's length".

It is sobering to remember that if a fund is audited and amended assessments issued, the onus will be on the fund to prove its case. It will be up to the trustee to call witnesses and produce what documentary evidence exists to support its case.

4 August 2014

S A Tisher

Owen Dixon Chambers West

Appendix 1

Section 273 - Special income

(1) This section applies to income derived in a year of income by a fund or unit trust (in this section called the ***entity***) that is a complying superannuation fund, a complying ADF or a PST in relation to the year of income.

(2) A dividend paid to the entity by a company that is a private company in relation to the year of income of the company in which the dividend was paid 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 of the entity, having regard to:

(a) the value of the shares in that company that are assets of the entity;

(b) the cost to the entity of the shares on which the dividend was paid by the company;

(c) the rate of the dividend paid to the entity by the company on the shares in the company that are assets of the entity;

(d) whether the company has paid a dividend on other shares in the company and, if so, the rate of that dividend;

(e) whether any shares have been issued by the company to the entity in satisfaction of, or of a part of, a dividend paid by the company and, if so, the circumstances of the issue of those shares; and

(f) any other matters that the Commissioner considers relevant.

(3) For the purposes of subsection (2), income that, in the opinion of the Commissioner, was derived by the entity indirectly from a dividend paid by a company, being a private company in relation to the year of income of the company in which the dividend was paid, shall be deemed to have been a dividend paid to the entity by the company.

(4) Income (other than a dividend to which subsection (2) applies or income derived by the entity in the capacity of beneficiary of a trust estate) derived by the entity from a transaction is special income of the entity if the parties to the transaction were not dealing with each other at arm's length in relation to the transaction and that income is greater than the income that might have been expected to have been derived by the entity from the transaction if those parties had been dealing with each other at arm's length in relation to the transaction.

(5) A reference in subsection (4) to a transaction includes a reference to a series of transactions.

(6) Income derived by the entity in the capacity of beneficiary of a trust estate (other than by virtue of holding a fixed entitlement to the income) is special income of the entity.

(7) Income derived by the entity in the capacity of beneficiary of a trust estate by virtue of holding a fixed entitlement to the income is special income of the entity if:

(a) the entity acquired the fixed entitlement under an arrangement (see subsection (8)), or the income was derived under an arrangement, some or all of the parties to which were not dealing with each other at arm's length in relation to the arrangement; and

(b) the amount of the income is greater than might have been expected to have been derived by the entity if those parties had been dealing with each other at arm's length in relation to the arrangement.

(8) In subsection (7), ***arrangement*** means:

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(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and

(b) any scheme, plan, proposal, action, course of action or course of conduct.

(9) This section:

(a) applies to a non-share equity interest in the same way as it applies to a share; and

(b) applies to an equity holder in the same way as it applies to a shareholder; and

(c) applies to a non-share dividend in the same way as it applies to a dividend.

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Ruling

Subject: Limited recourse borrowing arrangements

Questions

1. If the Fund enters into a limited recourse borrowing arrangement (LRBA) with a related party, will the interest saving achieved by the Fund from refinancing loans from the Existing Lender with new loans from the New Lender on the terms which include an interest rate of 0% be treated as a contribution for a member of the Fund?

2. If the Fund enters into an LRBA with a related party, will the income received by the Fund from the custodian trusts be considered non-arm's length income of the Fund in accordance with section 295-550 of the *Income Tax Assessment Act 1997* (ITAA 1997)?

Answer

1. No

2. Yes

This ruling applies for the following period:

Income year ending 30 June 2014

The scheme commences on:

During the income year ending 30 June 2014

Relevant facts and circumstances

The Fund is a self-managed superannuation fund (SMSF).

The trustee of the Fund (the Trustee) is a corporate entity.

Taxpayer A and Taxpayer B are the members of the Fund and also the directors and shareholders of the Trustee.

A few years ago, the Fund purchased two business real properties (Property 1 and Property 2).

Property 1 was purchased from an unrelated party of the Fund. Property 2 was purchased from Company A as trustee for the Taxpayer A Family Trust.

The properties were purchased using LRBAs and are held on behalf of the Fund as follows:

- Property 1 - Bare Trust 1
- Property 2 - Bare Trust 2

The Custodian Trust Deed of the Bare Trust 1 provides that:

- The Custodian holds/will hold the Asset and any income from the Asset for the Beneficial Owner (the Fund);
- The Custodian acknowledges and declares that it has and will have no beneficial interest in the Asset;
- The Fund may collect and retain the Income in respect of the Asset;
- Bare Trust 1 must, if requested by the Fund, pay any Income or other payments in respect of the Asset to the Fund;
- *Income* means all and any entitlements arising out of ownership of the asset including dividends, interest, rent, licence fees, hire fees and similar entitlements;
- *Asset* means any item of property (whether or not presently identified) as may be purchased by Bare Trust 1 on behalf of the Fund, including, but not necessarily being or remaining Property 1.

The Terms of the Bare Trust 2 provide that:

- On the purchase of any Asset by the Custodian, the Fund has a beneficial interest in the Asset that is vested and indefeasible as against the Custodian;
- The Fund is presently entitled to all income arising from any Asset (and/or is entitled to any accretion in the value of any Asset;
- *Asset* means asset agreed from time to time between the Custodian and the Fund if and as permitted under sections 67A and 67B of the *Superannuation Industry (Supervision) Act 1993*.

To finance the property purchases, the Fund borrowed from Company A as trustee for the Taxpayer A Family Trust (Existing Lender).

The terms of the loan agreements provided for:

- repayment in monthly instalments
- payment of interest at a specific percentage (and a higher percentage in certain circumstances); and
- termination on the tenth anniversary.

It is estimated that during the 2013-14 income year, a significant amount of the loans that represent a major portion of the properties' value was still outstanding.

Taxpayer A and Taxpayer B are both directors and shareholders of:

- the trustee of the Bare Trust 1
- the trustee of the Bare Trust 2; and
- the Existing Lender.

Taxpayer A and Taxpayer B wish to refinance the existing loans and have established a new family trust (the New Lender) for that purpose.

Taxpayer A and Taxpayer B are directors and shareholders of the trustee of the New Lender.

To enable the New Lender to refinance the existing loans, Taxpayer A and Taxpayer B intend to gift money to the New Lender either personally or from other entities they control.

The terms of the draft loan agreements provide that:

- � the repayment is on the tenth anniversary;
- � the borrower may repay the outstanding amount or any part of it at any time; and
- � interest rate of 0%

Relevant legislative provisions

Income Tax Assessment Act 1936	Division 272
Income Tax Assessment Act 1936	Section 272-5
Income Tax Assessment Act 1936	Subsection 272-5(1)
Income Tax Assessment Act 1936	Subsection 273(7)
Income Tax Assessment Act 1997	Division 292
Income Tax Assessment Act 1997	Section 295-550
Income Tax Assessment Act 1997	Subsection 295-550(5)
Income Tax Assessment Act 1997	Paragraph 295-550(5)(a)
Income Tax Assessment Act 1997	Paragraph 295-550(5)(b)
Income Tax Assessment Act 1997	Subsection 995-1(1) of the ITAA 1997

Reasons for decision

Summary

The absence of a requirement to pay interest on money loaned to the trustee of the Fund does not increase the capital of the Fund. Therefore, the interest saving achieved by the Fund from refinancing loans from the Existing Lender with new loans from the New Lender on the terms which include an interest rate of 0% will not be a contribution for a member of the Fund.

Income received by the Fund from Bare Trust 1 and Bare Trust 2 will be non-arm's length income of the Fund.

Detailed reasoning

Meaning of 'contribution'

Division 292 of the ITAA 1997 limits the superannuation contributions made in a financial year for a person that receive concessionally taxed treatment. It sets out rules to determine a taxpayer's liability to 'excess contributions tax' on superannuation contributions exceeding specified 'contribution caps'.

The term '*contribution*' is not defined in the ITAA 1997. Therefore, consistent with basic principles of statutory interpretation, the term 'contribution' is to be given its ordinary meaning having regard to the context and underlying purpose of the legislative provisions in which the term appears.

The Commissioner's view on the meaning of 'contribution' in the superannuation context is set out in Taxation Ruling TR 2010/1. Paragraph 4 of TR 2010/1 states:

> In the superannuation context, a contribution is anything of value that increases the capital of a superannuation fund provided by a person whose purpose is to benefit one or more particular members of the fund or all of the members in general.

Where an arrangement is put in place to ensure that a superannuation fund does not incur a liability to meet certain expenses, as illustrated by the examples in paragraphs 75; 76; 81 and 82 of TR 2010/1, there is no increase in the capital of the superannuation fund because no forgiveness or extinguishment of any liability is involved. Consequently, no superannuation contribution is made to the superannuation fund under the arrangement.

Where, under the terms of a loan, no interest is charged on the borrowings of a superannuation fund, no liability to pay interest is incurred. As there is no liability to pay interest in the first instance, there can be no forgiveness or extinguishment of any such liability. As such, the absence of a requirement to pay interest on borrowings does not increase the capital of the superannuation fund.

This view is confirmed by the 'ATO initial response' to issues raised by members of the NTLG Superannuation Technical Sub-Group in relation to related party loans under limited recourse borrowing arrangements where it was said:

> The absence of a requirement to pay interest on money loaned to the trustee does not increase the capital of the fund. A saving on an expense of an SMSF in the circumstances described is analogous to the circumstances outlined in examples 2 and 5 in Taxation Ruling TR 2010/1 Income tax: superannuation contributions. The purpose of a person in offering a low interest loan to an SMSF does not fall for consideration if there has been no increase in the capital of the fund.

Based on the above, it is considered that interest savings achieved by the Fund by refinancing the loans from the Existing Lender with loans from the New Lender on the terms which include interest rate of 0%, will not be treated as a contribution for the purposes of Division 292 of the ITAA 1997.

Meaning of 'non-arm's length income'

The phrase 'non-arm's length income' has the meaning given by section 295-550 of the ITAA 1997. Subsection 295-550(5) of the ITAA 1997 provides that:

> Other income *derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust is ***non-arm's length income*** of the entity if:
>
> (a) the entity acquired the entitlement under a *scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at *arm's length; and
>
> (b) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length.

In accordance with subsection 995-1(1) of the ITAA 1997, an entity has a *fixed entitlement* to a share of the income or capital of a company, partnership or trust if the entity has a *fixed entitlement* to that share within the meaning of Division 272 in Schedule 2F to the *Income Tax Assessment Act 1936* (ITAA 1936).

Subsection 272-5(1) in Schedule 2F of the ITAA 1936 states:

> If, under a trust instrument, a beneficiary has a vested and indefeasible interest in a share of income of the trust that the trust derives from time to time, or of the capital of the trust, the beneficiary has a fixed entitlement to that share of the income or capital.

Meaning of 'vested and indefeasible'

The terms 'vested' and 'indefeasible' are not defined in the ITAA 1997. Therefore, the meaning to be given to these terms must be determined according to the ordinary meaning of the words having regard to the context in which they appear.

In *Dwight v. Commissioner of Taxation* Justice Hill of the Federal Court made the following comments concerning the meaning of the terms 'vested' and 'indefeasible':

> The words "vested" and "indefeasible" in the context of trust law are technical legal words of limitation, which have a well understood meaning to property conveyancers. Estates may be vested in interest or vested in possession, the difference being between a present fixed right of future enjoyment where the estate is said to be vested in interest and a present right of present enjoyment of the right, where the estate is said to be vested in possession: *Glenn v Federal Comr of Land Tax* (1915) 20 CLR 490 at 496 per *Griffith* CJ at 501 per Isaacs J
>
> An interest is said to be defeasible where it can be brought to an end and indefeasible where it can not. Thus, a beneficiary with an interest which is not contingent but which interest may be brought to an end by the exercise of a power of appointment, would be said to have a vested but defeasible interest: *cf Queensland Trustees Ltd v Comr of Stamp Duties* (1952) 88 CLR 54 at 63, and *Re Kilpatrick's Policies Trusts* [1966] Ch 730.

In *Walsh Bay Developments Pty Ltd v. Federal Commissioner of Taxation*, Justices Beaumont and Sackville of the Federal Court referred to the distinction between vested but defeasible interests and an indefeasible interest as stated in *Cheshire's Modern Law of Real Property*, where the author said:

> An defeasible interest is an interest that is to be defeated by the operation of a subsequent or mixed condition.
>
> An indefeasible interest, or an absolute interest as opposed to a defeasible interest, is one that is not subject to any condition.

The Explanatory Memorandum to the *Taxation Laws Amendment (Trust Loss and Other Deductions) Act 1998*, which accompanied the enactment of section 272-5 of the ITAA 1936 states at paragraphs 13.4 to 13.7:

> 13.4 A person has a vested interest in something if the person has a present right relating to the thing. Stated simply, a vested interest is one that is bound to take effect in possession at some point in time. A vested interest is to be contrasted with a 'contingent' interest which may never fall into possession. If an interest of a beneficiary in income or capital is the subject of a condition precedent, so that an event must occur before the interest becomes vested, the beneficiary does not have a vested interest to the income or capital since such an interest is instead 'contingent' upon the event occurring.
>
> 13.5 In traditional legal analysis, a person can be said to be either 'vested in possession' or 'vested in interest'. A present interest, i.e. one that is being enjoyed, is said to be 'vested in possession'; a future interest, i.e. one which gives its holder a present right to future enjoyment, is said to be 'vested in interest'. A person is vested in possession where the person has a right to immediate possession or enjoyment of the thing in question. In the definition of fixed entitlement, 'vested' includes both vested in possession and vested in interest.
>
> 13.6 Because vested interests include future interests, a person can have a vested interest in a thing even though the person's actual possession and enjoyment of the thing is delayed until some time in the future.
>
> 13.7 A vested interest is indefeasible where, in effect, it is not able to be lost. A vested interest is defeasible where it is subject to a condition subsequent that may lead to the entitlement being divested. A condition subsequent is an event that could occur after the interest is vested that would result in the entitlement being defeated, for example, on the occurrence of an event or the exercise of a power. For example, where a beneficiary's vested interest is able to be taken away by the exercise of a power by the trustee or any other person, the interest will not be a fixed entitlement.

It is an essential element of subsection 272-5(1) in Schedule 2F to the ITAA 1936 that in order to have a fixed entitlement to a share of income or capital there must be a vested or indefeasible interest 'under a trust instrument'. In all cases, the determining factor in deciding if fixed entitlements exist will be the terms of the trust instrument under which the trust is constituted.

After considering the terms of the Custodian Trust Deed of the Bare Trust 1 and the Bare Trust 2, it is our view that the Fund holds a fixed entitlement to all the income of these two [custodian] trusts for the purposes of subsection 295-550(5) of the ITAA 1997. This view is based on facts as stated above in the '*Relevant facts and circumstances*'. If that conclusion were wrong, any income derived by the Fund as beneficiary of these trusts would be non-arm's length income of the Fund in accordance with subsection 295-550(4).

Meaning of 'scheme'

The term '*scheme*' is defined in subsection 995-1(1) of the ITAA 1997 to mean:

> (a) any *arrangement; or
>
> (b) any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise.

The term '*arrangement*' is also defined in subsection 995-1(1) of the ITAA 1997 to mean:

> ... any arrangement, agreement, understanding, promise or undertaking, whether expressed or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings.

The Full Federal Court in *Allen v Federal Commissioner of Taxation* considered the term 'arrangement' as defined for the purposes of former subsection 273(7) of the ITAA 1936 - the immediate predecessor of subsection 295-550(5) of the ITAA 1997. That term was defined in terms almost identical to a combination of the definitions of 'scheme' and 'arrangement' in the ITAA 1997. The court held that the series of steps undertaken by the parties that resulted in the acquisition of a fixed interest in the trust estate and the relevant distribution of income from that trust estate were readily seen to be an 'arrangement' to which the various entities were parties, and those results were readily seen to be the consequence of that arrangement.

Applying subsection 295-550(5) of the ITAA 1997 to the present case, it is considered that the 'scheme' would be series of steps undertaken by the parties that would result in an fixed entitlement to the income of the Bare Trust 1 and the Bare Trust 2 (and any derivation of income by the Fund through holding that entitlement) including:

> � the establishment of the New Lender;
>
> � the establishment of the trustee for the New Lender;
>
> � discharging the existing loans which include interest charges and replacing them with interest free loans from the New Lender;
>
> � the gifting of money by Taxpayer A and Taxpayer B (either personally or through the entities they control) to enable the New Lender to refinance the existing loans.

As such, it is readily concluded that, for the purposes of paragraph 295-550(5)(a) of the ITAA 1997, the Fund would acquire its fixed entitlement to the income of the Bare Trust 1 and the Bare Trust 2 under a scheme, and any income derived through holding that entitlement would be derived under a scheme.

Dealing at 'arm's length'

In accordance with subsection 995-1(1) of the ITAA 1997, in determining whether parties are dealing at arm's length, consideration is to be given to any connection between them and any other relevant circumstances.

In *Federal Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* Justice Dowsett of the Full Federal Court summarised propositions which emerge from the numerous cases in which the expression 'not dealing with each other at arm's length' or similar expressions have been considered, as follows:

> � in determining whether parties have dealt with each other at arm's length in a particular transaction, one may have regard to the relationship between them;
>
> � one must also examine the circumstances of the transaction and the context in which it occurred;

� one should do so with a view to determining whether or not the parties have conducted the transaction in a way which one would expect of parties dealing at arm's length in such a transaction;

� relevant factors which may emerge include existing mutual duties, liabilities, obligations, cross-ownership of assets, or identity of interests which might enable either party to influence or control the other, or induce either party to serve a common interest and so modify the terms on which strangers would deal;

� where the parties are not in an arm's length relationship, one may infer that they did not deal with each other at arm's length, and that the resultant transaction is not at arm's length;

� however related parties may, in some circumstances, so conduct a dealing as to displace any inference based on the relationship;

� un-related parties may, on occasions, deal with each other in such a way that the resultant transaction may not properly be considered to be at arm's length.

In that case Justices Edmonds and Gordon further stated that:

> Any assessment of whether parties were dealing at arm's length involves 'an assessment [of] 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': ...

It is clear that the parties in this case are not in an arm's length relationship. This is because Taxpayer A and Taxpayer B are:

� the only members of the Fund (the borrower);

� the directors and shareholders of the trustee for the Fund;

� the directors and shareholders of the trustee for the Bare Trust 1 (the custodian for Property 1);

� the directors and shareholders of the trustee for the Bare Trust 2 (the custodian for Property 2); and

� the directors and shareholder of the trustee for the New Lender.

Further, the Full Federal Court in *Allen* held that former paragraph 273(7)(a) of the ITAA 1936 - the immediate predecessor of paragraph 295-550(5)(a) of the ITAA 1997 - does not require that the 'dealing' consist only of the actual derivation of the income in question by 'the entity', but that the evident legislative intention of the provisions is to permit regard to be had to the totality of the steps that result in the entity's acquisition of its fixed entitlement to the income of the trust and any derivation of income by the entity through holding that entitlement.

In this case, assessing the circumstances holistically, it is clear that, in respect of the LRBAs, the parties will not be dealing with each other as arm's length parties would do. Aspects which, taken together, the Commissioner considers lead to that conclusion include:

� Taxpayer A and Taxpayer B are to gift the money (either personally or through entities they control) to the New Lender for the purposes of providing the relevant loans;

� the New Lender is not by way of the charging of interest under the loan agreements, or by any other means, compensated for the opportunity cost in lending the principal or for the additional risk assumed in relation to recovery of the principal in the event of the borrower's default under a loan given the limited recourse nature of the loans;

� rather than regular periodic repayments of the principal sum, a single lump sum repayment is to be made on the tenth anniversary of the loan agreement; and

� no insistence by the New Lender on the giving of personal guarantees by the members of the Fund as security for the borrower's performance under the loan terms.

Amount of income greater than might be expected if dealing at arm's length

The final requirement of subsection 295-550(5) of the ITAA 1997, which is set out in paragraph 295-550(5)(b), is that the amount of the income (derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust) is more than the amount that the entity might have been expected to derive if the parties had been dealing with each other at arm's length.

If the parties in this case were dealing with each other at arm's length, the amount of income the Fund might be expected to derive through the relevant trusts is either:

- nil - on the basis that no lending on the proposed terms by the New Lender might be expected and therefore no income might be expected to be derived by the Fund through Bare Trust 1 and Bare Trust 2; or
- is less than under the proposed arrangement - on the basis that the New Lender might be expected to lend on commercial terms given the limited recourse nature of the loans. The income that might be expected to be derived by the Fund through Bare Trust 1 and Bare Trust 2 would be reduced by the amount of interest payable in respect of the loans.

Either way, the final requirement of subsection 295-550(5) of the ITAA 1997 is satisfied. As such, the income to be derived by the Fund through Bare Trust 1 and Bare Trust 2 will be non-arm's length income of the Fund in accordance with subsection 295-550(5).

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Appendix 3

Australian Government
Australian Taxation Office

Edited version of your private ruling

Authorisation Number: 1012582301006

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Ruling

Subject: Non-arm's length income and limited recourse borrowing arrangement

Questions

1. If a superannuation fund (the Fund) enters into a limited recourse borrowing arrangement (LRBA) and borrows at a nil interest rate, will the discount amount of interest (that is, the difference between interest calculated using an arm's length interest rate and a nil interest rate) be considered a superannuation contribution received by the Fund?

2. Will income derived by the Fund from this nil interest rate loan arrangement as described in the facts, be non-arm's length income of the Fund pursuant to section 295-550 of the *Income Tax Assessment Act 1997* (ITAA 1997)?

3. If the income derived from this nil interest rate loan arrangement is considered non-arm's length income pursuant to section 295-550 of the ITAA 1997, would this non-arm's length income' be considered a contribution to the Fund?

4. If the asset used as security is sold at a loss thereby reducing the amount due under LRBA, would the value of the shortfall in the loan repayments be considered a contribution to the Fund as a result of the debt forgiveness provisions?

Answers:

1. No

2. Yes

3. No

4. No

This ruling applies for the following periods

Year ended 30 June 2014, 2015, 2016 and 2017

The scheme commenced on

1 July 2013

Relevant facts

The Fund was established several years ago. The Fund is a regulated self managed superannuation fund (SMSF).

A private company (the Company) is the corporate trustee of the Fund. The trustee of the Fund is also the trustee of a family trust (the Family Trust), will lend between a significant amount to the Company, in its capacity as trustee of the Fund.

The directors of the Company are Taxpayer A and Taxpayer B.

The Family Trust is controlled by the members of the Fund.

Taxpayer A and Taxpayer B are the only members of the Fund.

Each member of the Fund is receiving two pensions from the Fund.

Neither member of the Fund has a superannuation interest in the Fund that is an accumulation interest.

The Fund is a 'complying superannuation fund' within the meaning of section 45 of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act).

At 30 June 2012, the Family Trust had total assets of a specific amount and total liabilities of almost equal value. It is stated that the Family Trust has sufficient liquid assets to make the loans to the Fund.

The amount lent will be advanced as two or more separate loans, but each loan will be made on the same terms (apart from the amount of the particular Advance and the asset purchased using that Advance).

The borrower must repay the loan as a single lump sum at the end of the loan term, or earlier as agreed between the borrower and lender (specific clauses 10 and 11 of the sample loan agreement).

No term has been specified in the sample loan agreement provided. However, the applicant's advisers have stated that the loan agreement under which the relevant monies will be advanced will have a term of several decades. They explained that the term of several decades would be a maximum period and not all money will be advanced at once.

The borrower may prepay all, or some, of the loan without any penalty on any date agreed between the lender and borrower (clause 12 of the sample loan agreement). The applicant's advisers stated that this will usually occur as particular investment opportunities arise. They indicated that most of the borrowed money would be repaid as the Fund chooses to realise particular investments.

Although the sample loan agreement contains clauses for the payment of interest on the amount borrowed (clauses 6 to 9 of the sample loan agreement) and Schedule 1 to the loan agreement refers to the interest rate as '0% or such other rate as agreed between the Lender and Borrower in writing from time to time', paragraph D of the Background recitals in the sample loan agreement states that the Lender has agreed to a nil interest rate and the applicant's advisers have stated that the loan 'would have a 0% interest rate'.

It is stated that the loan will be made on terms that ensure it satisfies the requirements of the SIS Act to be a LRBA. Clauses 28 to 29 of the sample loan agreement, however, refer more broadly to the 'Superannuation Law' as defined in that agreement.

The lender will be granted a first ranking mortgage or charge over the asset acquired with the amount borrowed (clause 14.1.1 of the sample loan agreement). The asset acquired with the borrowed amount will be held on trust for the Fund by an entity (the Custodian) that is not yet in existence (sample Declaration of the Custody Trust, paragraph C of the Background recitals in the sample loan agreement and clauses 3.2 and 3.3 of the sample loan agreement).

The lender's rights against the borrower or the Custodian in relation to any default on the borrowing (or the borrowing and charges related to the borrowing) are limited to rights relating to the acquired asset (clauses 16 and 17 of the sample loan agreement).

Although there is the ability under the sample loan agreement for the lender to require the borrower to procure the provision of a personal guarantee from each member of the Fund (in their personal capacity) as security for the borrower's performance under the loan agreement, the applicant's advisers stated that no such guarantees will be required by the lender.

The Fund will have a vested and indefeasible interest in the acquired asset and any other assets comprising the Custody Fund (which includes all the income of the Custody Trust). The Fund will be absolutely entitled to the acquired asset and any other assets comprising the Custody Fund as against the Custodian (clause 8 of the sample Declaration of Custody Trust).

The Custodian will deposit any interest, income or other proceeds that the acquired asset generates, or any accretions or accruals attributable to the acquired asset, into a bank account or accounts designated by the Fund (clauses 5 and 6 of the sample Declaration of Custody Trust).

The Custodian will be a new company. The members of the Fund will be the directors and shareholders of the trustee company.

Listed ASX shares will be acquired with the borrowed money. To comply with section 67A of the SIS Act a separate loan will be made in respect of the shares acquired in each particular company (or in each different class of shares acquired in a particular company).

All of the units to be issued by a unit trust which is to be established as part of this arrangement will be acquired with another amount of the borrowed money. The unit trust will invest the money paid to acquire the units in cash and interest bearing securities. All the units in the unit trust will be held by the Fund.

The Family Trust will lend 100% of the value of the assets to be acquired and held for the benefit of the Fund.

Relevant legislative provisions

Income Tax Assessment Act 1997 Section 295-545.

Income Tax Assessment Act 1997 Subsection 295-545(2).

Income Tax Assessment Act 1997 Section 295-550.

Income Tax Assessment Act 1997 Subsection 295-550(4).

Income Tax Assessment Act 1997 Subsection 295-550(5).

Income Tax Assessment Act 1997 Paragraph 295-550(5)(a).

Income Tax Assessment Act 1997 Paragraph 295-550(5)(a).

Income Tax Assessment Act 1997 Paragraph 295-550(5)(b).

Income Tax Assessment Act 1997 Subsection 995-1(1).

Reasons for decision

Summary

The discounted amount of interest is not considered a superannuation contribution.

The income to be derived by the Fund through the Custody Trust will be non-arm's length income of the Fund.

The non-arm's length income derived by the Fund from this loan arrangement is not considered a superannuation contribution.

In regard to the debt forgiven, it is the Commissioner's view that the capital of the fund has not been increased. The outstanding debt amount forgiven is equal to the asset value lost. Therefore, the forgiveness of the debt does not result in a contribution.

Detailed reasoning

Whether the discounted amount of interest is a superannuation contribution?

The Commissioner has set out his view of the meaning of contribution as it is used in relation to superannuation funds in Taxation Ruling TR 2010/1 titled *Income tax: superannuation contributions*. At paragraph 4 the Commissioner states:

> In the superannuation context, a contribution is anything of value that increases the capital of a superannuation fund provided by a person whose purpose is to benefit one or more particular members of the fund or all of the members in general.

Therefore, for a contribution to be made to a superannuation fund the transaction must have two features. Firstly, that the transaction must increase the capital of the superannuation fund and secondly that it was the purpose of the person to benefit one or more of the members of the fund.

In this case, it needs to be determined if the capital of the fund has been increased as a result of there being no obligation to pay interest on the money borrowed under the loan contract.

The Commissioner discusses his view of the ordinary meaning of 'borrow' and 'loan' in Self Managed Superannuation Funds Ruling SMSFR 2009/2 titled *Self managed superannuation funds: the meaning of 'borrow money' or 'maintain an existing borrowing of money' for the purposes of section 67 of the Superannuation industry (Supervision Industry (Supervision) Act 1993.* At paragraph 48 of that ruling the Commissioner recognises that while the obligation to pay interest may evidence the existence of a borrowing or loan of money it is not a necessary feature.

The fact that there is no interest payment obligation under the loan or borrowing arrangement between the Fund trustee and the related party does not result in an increase in the assets of the Fund. Therefore the discounted amount of interest (that is, the difference between interest calculated using an arm's length interest rate and a nil interest rate) is not considered to be a superannuation contribution received by the Fund.

In addition, a saving on expense of an SMSF in the circumstances described in this case appears to be similar to the circumstances outlined in examples 2 and 5 in TR 2010/1:

Example 2 - no contribution made by a free service

� Jasmine has a self-managed superannuation fund of which she is the sole member. She is a chartered accountant and has significant experience in general accounting, taxation and superannuation matters. Jasmine prepares the accounts and income tax and regulatory return for her self-managed superannuation fund each year without remuneration.

� By ensuring the fund does not incur a liability in having the fund accounts prepared, Jasmine does not increase the capital of the fund and there is no contribution.

Example 5 - no contribution made by employer sponsor

� Mega Pty Ltd is the employer sponsor of the Mega Staff Superannuation Fund. The vast majority of Mega's current employees are members of the Mega Staff Superannuation Fund. Mega pays the wages of five individuals who are employed to provide assistance to the trustees and administrators of the fund and to assist other Mega employees with questions concerning the fund and their benefits as members. Mega Pty Ltd does not seek to recover from Mega Staff Superannuation Fund the wages paid to these individuals.

� As with Example 2, by ensuring the fund has not incurred these liabilities in operating the fund, Mega Pty Ltd does not increase the capital of the fund and there is no contribution.

Consequently, the purpose of a person in offering a low interest loan to an SMSF does not fall for consideration if there has been no increase in the capital of the Fund.

Whether the income derived from this nil interest rate loan arrangement is considered non-arm's length income pursuant to section 295-550 of the ITAA 1997

Section 295-545 of the ITAA 1997 provides that the taxable income of a complying superannuation fund is split into a non-arm's length component and a low tax rate component. The note to subsection 295-545(1) explains that a concessional rate of tax applies to the low tax component, while the non-arm's length component is taxed at the highest marginal rate. These rates are set out in the *Income Tax Rates Act 1986*.

Subsection 295-545(2) of the ITAA 1997 provides that the non-arm's length component for an income year is the entity's non-arm's length income for that year less any deductions to the extent that they are attributable to that income. The phrase 'non-arm's length income' has the meaning given by section 295-550. Subsection 295-550(5) provides that:

> Other income *derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust is non-arm's length income of the entity if:
>
> (a) the entity acquired the entitlement under a *scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at *arm's length; and
>
> (b) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length.

Fixed entitlement to trust income

Clauses 5, 6 and 8 of the sample Declaration of Custody Trust together clearly demonstrate that the Fund holds a fixed entitlement to the income of the Custody Trust for the purposes of subsection 295-550(5) of the ITAA 1997. Further, the applicant's advisers agree with that conclusion. If that conclusion were wrong, any income derived by the Fund as beneficiary of the Custody Trust would be non-arm's length income of the Fund pursuant to subsection 295-550(4).

Scheme

The term 'scheme' is defined in subsection 995-1(1) of the ITAA 1997 to mean:

> (a) any arrangement; or
>
> (b) any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise.

The term 'arrangement' is also defined in subsection 995-1(1) of the ITAA 1997 to mean:

> any arrangement, agreement, understanding, promise or undertaking, whether expressed or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings.

The Full Federal Court in *Allen v Federal Commissioner of Taxation* (2011) 195 FCR 416; [2011] FCAFC 118; (2011) 2011 ATC 20-277; [2012] ALMD 3059; (2011) 84 ATR 853. (*Allen*) considered the term 'arrangement' as defined for the purposes of former subsection 273(7) of the *Income Tax Assessment Act 1936* (ITAA 1936) - the immediate predecessor of subsection 295-550(5) of the ITAA 1997. That term was defined in terms almost identical to a combination of the definitions of 'scheme' and 'arrangement' in the ITAA 1997. The court held that the series of steps undertaken by the parties that resulted in the acquisition of a fixed interest in the trust estate and the relevant distribution of income from that trust estate were readily seen to be an 'arrangement' to which the various entities were parties, and those results were readily seen to be the consequence of that arrangement . See (2011) 195 FCR 416, at 433 - 434.

Similarly, for the purposes of applying subsection 295-550(5) of the ITAA 1997 in the present case, the scheme involves the series of steps undertaken by the parties that results in the Fund's acquisition of its fixed entitlement to the income of the Custody Trust and any derivation of income by the Fund through holding that entitlement. These steps include the establishment and operation of the LRBA between the Fund and the Family Trust (which includes the establishment and operation of the Custody Trust in favour of the Fund in respective of each of the assets acquired with the borrowed money).

Similarly further, those results are readily seen to be the consequence of the scheme. As such, it is readily concluded that, for the purposes of paragraph 295-550(5)(a) of the ITAA 1997, the Fund would acquire its fixed entitlement to the income of the Custody Trust under a scheme and any income derived through holding that entitlement would be derived under a scheme.

Not dealing at arm's length

Subsection 995-1(1) of the ITAA 1997 provides that in determining whether parties deal at arm's length, consider any connection between them and any other relevant circumstances.

In *Federal Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134; (2010) 189 FCR 204; (2010) 2010 ATC 20-224; [2011] ALMD 2345; (2010) 81 ATR 180, Justice Dowsett of the Full Federal Court summarised propositions which emerge from the numerous cases in which the expression 'not dealing with each other at arm's length' or similar expressions have been considered, as follows:

� in determining whether parties have dealt with each other at arm's length in a particular transaction, one may have regard to the relationship between them;

� one must also examine the circumstances of the transaction and the context in which it occurred;

� one should do so with a view to determining whether or not the parties have conducted the transaction in a way which one would expect of parties dealing at arm's length in such a transaction;

� relevant factors which may emerge include existing mutual duties, liabilities, obligations, cross-ownership of assets, or identity of interests which might enable either party to influence or control the other, or induce either party to serve a common interest and so modify the terms on which strangers would deal;

� where the parties are not in an arm's length relationship, one may infer that they did not deal with each other at arm's length, and that the resultant transaction is not at arm's length;

� however related parties may, in some circumstances, so conduct a dealing as to displace any inference based on the relationship;

� un-related parties may, on occasions, deal with each other in such a way that the resultant transaction may not properly be considered to be at arm's length. (See (2010) 189 FCR 204, at 213. Although Justice Dowsett dissented in the application of those propositions in that case, the other judges, Justices Edmonds and Gordon, did not disapprove of his summary of those propositions.)

In that case Justices Edmonds and Gordon further stated that:

> Any assessment of whether parties were dealing at arm's length involves 'an assessment [of] 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': (See (2010) 189 FCR 204, at 231.) It is clear that the parties in this case are not in an arm's length relationship. Both members of the Fund are:
>
> (a) the directors and shareholders of the private company - the corporate trustee of both the Family Trust (the lender) and the Fund (the borrower);
>
> (b) to be the directors and shareholders of the Custodian;
>
> (c) the only members of the Fund;
>
> (d) objects of the Family Trust; and
>
> (e) said to control the Family Trust.

Further, the Full Federal Court in *Allen* held that former paragraph 273(7)(a) of the ITAA 1936 - the immediate predecessor of paragraph 295-550(5)(a) of the ITAA 1997 - does not require that the 'dealing' consist only of the actual derivation of the income in question by 'the entity', but that the evident legislative intention of the provisions is to permit regard to be had to the totality of the steps that result in the entity's acquisition of its fixed entitlement to the income of the trust and any derivation of income by the entity through holding that entitlement. (See (2011) 195 FCR 416, at 434). In this case that means that regard may be had to the establishment and operation of the LRBA between the Fund and the Family Trust (which includes the establishment and operation of the Custody Trust in favour of the Fund in respective of each of the assets acquired with the borrowed money).

Assessing the circumstances holistically, it is clear that the parties will not be dealing with each other in respect of the LRBA as arm's length parties would do. Aspects which, taken together, the Commissioner considers lead to that conclusion include:

� the lender is not by way of the charging of interest under the loans or by any other means compensated for the opportunity cost in lending the principal or for the additional risk assumed in relation to recovery of the principal in the event of the borrower's default under a loan given the limited recourse nature of the loans and lack of other security;

� rather than regular periodic repayments of the principal sum, only a single lump repayment at the end of a loan term, which could be as much as several years, is required;

� 100% of the value of the assets to be acquired will be lent, rather than a lower loan to value ratio given the nature of the assets to be acquired with the borrowed funds, namely shares and units in a unit trust, and given the limited recourse nature of the loans;

� no insistence by the lender on the giving of personal guarantees by the members of the Fund as security for the borrower's performance under the loans; and

� the absence of mechanisms in the lender's favour to protect the underlying value of the units in a private unit trust to be acquired with the borrowed funds, particularly given the limited recourse nature of the loans, lack of other security, and the kind of 'cash' assets in which the unit trust proposes to invest.

Amount of income greater than might be expected if dealing at arm's length

The final requirement of subsection 295-550(5) of the ITAA 1997, which is set out in paragraph 295-550(5)(b), is that the amount of the income (derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust) is more than the amount that the entity might have been expected to derive if the parties had been dealing with each other at arm's length.

If the parties in this case were dealing with each other at arm's length, the amount of income the Fund might be expected to derive through the Custody Trust is either:

Ÿ nil - on the basis that no lending on the proposed terms by the Family Trust might be expected and therefore no income might be expected to be derived by the Fund through the Custody Trust; or

Ÿ is less than under the proposed arrangement - on the basis that the Family Trust might be expected to lend on commercial terms that involve lower than 100% loan to value ratios given the nature of the assets to be acquired with the borrowed money and the limited recourse nature of the loans. Therefore, the substantially lower borrowed amounts available to be invested might be expected to generate less income to be derived by the Fund through the Custody Trust than under the proposed arrangement.

Either way, the final requirement of subsection 295-550(5) of the ITAA 1997 is satisfied.

If the income derived from this loan arrangement that has a nil interest rate is considered a non-arm's length income pursuant to section 295-550 of the ITAA 1997, would this non-arm's length income' be considered a contribution for the Fund?

As discussed previously, whether an amount is considered to be a contribution depends on whether the capital of the superannuation fund is increased and whether the person's intention in increasing the capital of the fund is for benefiting one or more particular members or all of the members in general.

Paragraphs 6 to 9 of TR 2010/1 explains that:

> 6. Not every increase in the capital of a fund is a superannuation contribution as a person who increases a fund's capital must have the purpose of benefiting one or more particular members of the fund or all of the members in general.
>
> 7. A person's purpose is the object which they have in view or in mind. Generally, a person will be said to intend the natural and probable consequences of their acts and likewise their purpose may be inferred from their acts. This is a determination of a person's objective purpose, not their subjective intention.
>
> 8. A person will not normally have a purpose of benefiting a member of the fund if the transaction they carry out is in no way dependent upon the identity of the other party as a superannuation provider or they are simply fulfilling the terms of a contract or arrangement entered into on a commercial or arm's length basis.
>
> 9. By contrast, an objective determination of a person's purpose may in some cases lead to the conclusion that the person's purpose is to benefit one or more particular members of the fund or all of the members in general. This may occur when a transaction or arrangement is entered into because of a connection or relationship between the person and the superannuation provider or cannot be explained by reference to commercial or arm's length dealings.

On the facts, the transactions that increase the value of the Fund's asset are the payments resulting from the investments in the shares and the related unit trust. An objective determination of a person's purpose is that the payments made in relation to these assets has no purpose other than to provide a commercial based return on the investment made.

As mentioned previously, the Fund holds a fixed entitlement to the income of the Custody Trust for the purposes of subsection 295-550(5) of the ITAA 1997. Consequently, the income received would be an amount that is distributed from a fixed trust under the terms of the deed and the actual distributable income would be the earnings from the arm's length underlying investment. Therefore, it could not be said that it is something paid for the purposes of providing superannuation benefits to the members. It is the Commissioner's view that the income derived, simply a receipt of income from an investment and would therefore not be a contribution.

If the asset used a security is sold at a loss reducing the amount due under LRBA, would the value of the shortfall in the loan repayments be considered a contribution to the Fund as a result of the debt forgiveness provisions?

Generally, the SIS Act prohibits a trustee of a superannuation fund from borrowing money, there are a few limited exceptions. A question has arisen as to whether a contribution would be made if a lender were to forgive the debt of a trustee, particularly in relation to the LRBA covered by subsection 67(4A) of the SIS Act.

For the LRBA exception in section 67A of the SIS Act to apply, the money borrowed is applied for the acquisition of a single acquirable asset and that asset is held in a holding trust. Under the arrangement the Fund trustee acquires a beneficial interest in the asset. Pursuant to paragraph 67A(1)(d), in the event that the Fund trustee defaults on the loan any recourse that the lender has under the arrangement against the Fund trustee is limited to rights relating to the acquirable asset.

In the LRBA case described, the single acquirable asset is sold and the proceeds applied to reduce the amount of the loan outstanding, but did not extinguish it completely. Nevertheless, the LRBA between the Fund trustee and the related party lender, the lender is unable to take any further recovery action to recover the outstanding amount from the Fund trustee. Consequently, by operation of the LRBA contract the loan amount outstanding after the proceeds from the sale of the asset is offset against the amount outstanding is forgiven.

In this case, the rights of the lender in the event of default by the borrower are set out in section F in the terms of the sample loan agreement. To satisfy the section 67A of the SIS Act these must limit the rights of the lender to the single acquirable asset held in the holding trust.

In the event that the Fund trustee defaults and the lender receives less from the sale of the asset in the holding trust than the outstanding loan balance, they have not forgiven the loan, they have pursued their rights to the full extent available under the loan arrangement. Therefore, the capital of the fund has not been increased. The outstanding debt amount forgiven is equal to the asset value lost. In this instance, the forgiveness of the debt does not result in a contribution. This circumstance described is specifically covered in paragraph 180 of TR 2010/1 which states:

> Similarly, the capital of the fund would not be increased when a lender exercises their right of recourse against the asset in circumstances where the value of the asset is less than the amount outstanding on the loan. This will be so even if the lender exercises both the right of recourse against the asset and requires a guarantor to satisfy any difference between the value of the asset and the outstanding loan amount.

However, the above answer would be different if the lender actually did forgive the loan without pursuing its right to the asset.

Other relevant Comments

Legislative intent

This conclusion is entirely consistent with the legislative intent of section 295-550 of the ITAA 1997 and its predecessors.

The earliest predecessor of section 295-550 of the ITAA 1997 - former section 23F of the ITAA 1936 - was introduced in 1964 as a result of the *Report of the Commonwealth Committee on Taxation, 1961* (the Ligertwood Report) which recommended legislative amendments to counter the numerous ways identified by the Committee in which a taxpayer could constitute a superannuation fund with income, that would have accrued to the taxpayer in the ordinary course of events, and thus be received virtually tax free. See Ligertwood Report [740] & [741].

Of particular relevance to the circumstances of this case was the second example given in the Ligertwood Report of a situation which the recommended legislation was to address:

> "A director-controlled superannuation fund is set up by a private company, primarily for the benefit of those employees who are also shareholders and directors. The directors then cause the company to make interest-free loans to the fund which invests the proceeds. The income derived by the fund from its investments is exempt under Section 23(j) and when this income is eventually paid to the directors in a lump sum on their retirement, only 5 per cent thereof will be taxed in the hands of the beneficiaries or alternatively the amount may be wholly free from tax". See Ligertwood Report [740(2)].

Further, the Full Federal Court in *Darrelen Pty Ltd v Federal Commissioner of Taxation* [2010] FCAFC 35; (2010) 2010 ATC 20-180; (2010) 183 FCR 237; [2010] ALMD 4701; (2010) 78 ATR 916 stated that the policy underlying former section 273 of the ITAA 1936, 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.

Similarly, the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No.2) 1999 which inserted former subsections 273(6) and (7) of the ITAA 1936 - the immediate predecessors of subsections 295-550(4) and (5) of the ITAA 1997 - explained at paragraph 2.13 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.

The main effect of the scheme in this case, being the movement of income producing capital through a non-arm's length dealing from entities who would pay marginal or company tax rates on such income into the concessionally taxed superannuation fund is clearly intended to be addressed by section 295-550 of the ITAA 1997 and its predecessors.

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