

TR 93/D1 - Income tax: treatment of a trust distribution made to an exempt body for services it provides to beneficiaries or their associates



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Draft Taxation Ruling

Income tax: treatment of a trust distribution made to an exempt body for services it provides to beneficiaries or their associates

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What this Ruling is about

1. This Ruling considers whether the anti-avoidance provision, section 100A of the *Income Tax Assessment Act 1936*, applies to an arrangement where:

- (a) a beneficiary of a trust estate is an exempt body presently entitled to a share of the net income of that trust estate; and
- (b) the exempt body provides a benefit or service to a beneficiary or to an associate of a beneficiary of the trust estate; and
- (c) the exempt body accepts the income as payment for the service provided.

An example is a distribution of trust income to a school in lieu of the payment of fees for the education of a child of a beneficiary of the trust estate.

2. The Ruling does not consider the possible application of Part IVA to the arrangement. Nor does it consider the fringe benefits tax consequences should an employment relationship exist between the trustee and beneficiary.

3. Key terms used in this Ruling are defined in paragraph 8.

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Ruling

4. We consider an arrangement to be a reimbursement agreement as defined in subsections 100A(7), (8) and (13) if all the following conditions are satisfied:

- (a) an exempt body is a beneficiary of a trust estate;
- (b) the exempt body is presently entitled or deemed to be presently entitled to a share of the net income of the trust;
- (c) the exempt body accepts the amount as full or part payment for a benefit provided or a service rendered by it to a beneficiary or an associate of a beneficiary;
- (d) the arrangement is not explained by ordinary family or commercial dealing; and
- (e) any party to the arrangement has a purpose of avoiding tax.

This is so if the exempt body is a beneficiary on creation of the trust or is introduced as a beneficiary later. If the above conditions are met it does not matter whether or not the body is aware of its status as a beneficiary.

5. Such an arrangement attracts the anti-avoidance provisions of section 100A.

6. It is important to distinguish between income distributed by a trustee to an exempt body as a gift and the type of arrangement where the distribution is connected with a service or benefit provided by the body to a beneficiary or associate. A gift by a trustee to an exempt body, where the body provides no advantage of a material character, will not attract section 100A.

Date of effect

7. This Ruling has both a past and future application (see Taxation Ruling TR 92/20). However, it does not have a past application for a taxpayer who has agreed to a settlement of a dispute to the extent that the Ruling is less favourable than the settlement terms. To the extent that the Ruling is more favourable, it does not have a past application for the taxation years the subject of the settlement.

Definitions

8. The following definitions of key terms apply for this Ruling:

associate

in relation to a person has the same meaning as in subsection 26AAB(14);

exempt body

means a non-profit body which is exempt from income tax. For example, a school, a hospital and a sporting association may be exempt under paragraphs 23(e), (ea) and (g) respectively;

fee

means an amount of money charged for a benefit, privilege or service.

Explanations

Reimbursement agreement

9. Section 100A requires that a 'reimbursement agreement' exist. The scope of section 100A is determined largely by the manner in which the definitions of 'reimbursement agreement' in subsection 100A(7) and of 'agreement' in subsection 100A(13) are interpreted and applied. The terms of the latter definition ensure that the type of arrangement described in paragraph 4 of this Ruling can be a reimbursement agreement even when it is nothing more than an informal understanding. That definition also provides that an arrangement, agreement or understanding cannot be a reimbursement agreement if it is entered into in the course of ordinary family or commercial dealing.

10. We consider that the words 'entered into in the course of' require a particular isolated arrangement to be viewed in the context of a wider dealing. If this wider dealing is regarded as ordinary family or commercial dealing, section 100A does not apply.

Ordinary family or commercial dealing

11. We consider that an arrangement of the type examined in this Ruling could not be regarded as a commercial dealing.

12. Whether a particular payment by a family trust is 'in the course of ordinary family dealing' can be determined by looking at how this phrase has been interpreted by the courts. This phrase comes from the

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Privy Council's opinion in *Newton v FC of T* (1958) 98 CLR 1; 11 ATD 442 dealing with the former general anti-avoidance provision, section 260. Lord Denning's statement is referred to as the predication test:

'In order to bring the arrangement within the section you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section'.

13. Since *DFC of T v Purcell* (1921) 29 CLR 464 the courts have held that a transfer of business assets to a trust for the benefit of a taxpayer's family is explicable as ordinary family dealing. The courts have also held that the adoption of a trust structure to ensure that financial benefits generated by a business would go to family members could, in some circumstances, be explained as ordinary family dealing.

14. However, in our view the distribution to an exempt beneficiary of a family trust in lieu of a payment for a benefit or service goes beyond ordinary family dealings of the kind mentioned in paragraph 13. The exempt body may be providing benefits to family members but we consider it is placing too wide an interpretation on the term to regard the arrangement as made 'in the course of ordinary family dealing'.

Purpose of reducing tax liability

15. A 'reimbursement agreement' also requires that the agreement be entered into for the purpose of reducing the tax liability of any person (subsection 100A(8)). If the liability for fees rests on a beneficiary or an associate, distribution of net income by the trustee to the exempt body in satisfaction of those fees results in a reduction of the tax liability of the beneficiary or the trustee. If the amount had not been distributed to the exempt body the fees would have been paid from the assessable income of a beneficiary or the trustee.

16. It is clear from the terms of subsection 100A(9) that if the trustee (or a director of a corporate trustee) entered into the arrangement with a purpose of avoiding the payment of tax on the income used to pay the fees, section 100A applies. It is not necessary that the exempt body have the same purpose.

Knowledge of arrangement and consent by exempt body

17. The exempt body may be unaware of its status as a beneficiary or that the payment it receives is a distribution made by the trustee. For example, fees may be paid by a cheque written in the business name of the trust. This has no effect on the school's entitlement to the trust income. It was held in *Vegners v FC of T* 91 ATC 4213; (1991) 21 ATR 1347 that it is not necessary for a taxpayer to consent to the status of beneficiary for income distributed by a trustee to be assessable income of that beneficiary.

18. In *East Finchley Pty Ltd v FC of T* 89 ATC 5280; (1989) 20 ATR 1623 the Federal Court of Australia (Hill J) in *obiter dicta* considered whether a 'reimbursement agreement' required that the relevant beneficiary be a party to an agreement. In that case, if present entitlement arose, it was in circumstances where the trustee hoped that he might be able to enter into an arrangement with the beneficiary in the future. Hill J observed that in such a situation it was difficult to see how the requisite purpose of entering into an arrangement to reduce the liability of some person to income tax could be established. His Honour considered that subsection 100A(8) would require: 'the hypothesis to be formulated as to what income tax *would* become payable if the relevant agreement had not been entered into'.

19. Hill J also said he had 'great difficulty in conceiving in the context of sec. 100A of the Act, how an arrangement could be constituted by the directors of a trustee company alone or for that matter by them and the trustee without the beneficiary being also a party'. However he qualified these comments as applying in particular to a 'reimbursement agreement' requiring payment by the beneficiary to the trustee.

20. The facts in *East Finchley* are very different to the circumstances being considered in this Ruling. The relevant beneficiary here is providing a service or other benefit rather than the payment of money (as was the case in *East Finchley*) or the transfer of property. The lack of knowledge of the arrangements by the exempt body has no influence on whether it provides the service or benefit for which payment is made.

21. Moreover the comments of Hill J referred to in paragraph 19 were not accepted by the Administrative Appeals Tribunal on re-hearing *East Finchley* as *Case X40* 90 ATC 342; AAT Case 5813, 21 ATR 3352. The Tribunal expressed the opinion that an alternative reimbursement agreement, not involving the beneficiary, could be identified. The Tribunal found that there was an arrangement or understanding between the taxpayer (the corporate trustee of a

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discretionary family trust) and its two directors that income of the trust be distributed among non-resident beneficiaries on the basis that each non-resident would be expected to lend such money back to the taxpayer. That arrangement was held to be a 'reimbursement agreement' even though the non-resident beneficiaries were not parties to the arrangement.

22. Generally speaking for an agreement to exist there have to be two or more consenting parties, and some adoption of the agreement. It follows from paragraphs 19 to 21 that the parties to an arrangement necessary to constitute a reimbursement agreement must depend on the circumstances of each particular case.

23. It is relevant also that the passage of a resolution at a directors' meeting of a corporate trustee may effectively constitute the adoption of an arrangement (*FC of T v. Lutovi Investments Pty Ltd* (1978) 140 CLR 434; 78 ATC 4708). We consider that an arrangement where the relevant beneficiary provides a service or benefit does not require that beneficiary to be a consenting party for the arrangement to constitute a reimbursement agreement.

24. In our view, therefore, in an arrangement of the type examined in this Ruling, there would normally exist an agreement or understanding, other than one made with the relevant beneficiary, which would be a reimbursement agreement.

Who is assessable?

25. If the present entitlement of the exempt body is linked to a reimbursement agreement, section 100A deems the body not to be presently entitled to the distribution. Subsection 100A(4) requires that the relevant trust income be included as assessable income of the trustee under section 99A.

Example

26. Mr Richard Daddee decides he will conduct his trading business using a discretionary trust structure. He includes as beneficiaries of the trust, his family, the private school that his children attend and the golf club of which he is a member. Mr and Mrs Daddee are appointed directors of the corporate trustee.

27. As the school and club fees become payable Mr Daddee pays them by trust cheque drawn in the business name. The trust accounts show these amounts as loans by the trust estate until the end of the financial year when the trustee resolves to distribute to each body an amount equal to the fees paid. The school and golf club are not aware

of their status as beneficiaries or that the payments are made to them as distributions of trust income.

28. If the distributions to the school and golf club had not been made, the amounts would have formed part of the assessable income of Mr Daddee, another family member or the corporate trustee.

29. Section 100A applies to the arrangements with the result that the income distributed to the school and golf club is assessed to the trustee under section 99A at the maximum rate of personal tax.

Commissioner of Taxation

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case references

- East Finchley Pty Ltd v. FC of T 89 ATC 5280; (1989) 20 ATR 1623
- Lutovi Investments Pty Ltd; FC of T v. (1978) 140 CLR 434; 78 ATC 4708
- Newton v. FC of T (1958) 98 CLR 1; 11 ATD 442
- Purcell; DFC of T v. (1921) 29 CLR 464
- Vegners v. FC of T 91 ATC 4213; (1991) 21 ATR 1347
- Case X40 90 ATC 342; AAT Case 5813, 21 ATR 3352