IT 2121 - Income tax: family companies and trusts in relation to income from personal exertion

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TAXATION RULING NO. IT 2121

INCOME TAX: FAMILY COMPANIES AND TRUSTS IN RELATION TO INCOME FROM PERSONAL EXERTION

F.O.I. EMBARGO: May be released

REF H.O. REF: J209/75 P1 DATE OF EFFECT: Immediate

B.O. REF: Sydney AF 2058 P9 DATE ORIG. MEMO ISSUED:
Parramatta K-T95-102/1/1
Melbourne VJ172/1 P9
Brisbane COR 2070
Adelaide C 221 C/1/13 P3
Perth J 8/70
Hobart 2A H 5/3/1
ACT AC 75 P2

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1122290	INCOME TAX: FAMILY COMPANIES AND TRUSTS IN RELATION TO INCOME FROM PERSONAL EXERTION.	260 PART IVA

RULING

This ruling sets out official views in the light of a decision of the Federal Court of Australia handed down on 21 November 1984 in the case of Tupicoff v. Commissioner of Taxation. This decision was reported as 84 ATC 4851 and 15 ATR 1262.

2. In recent times there has been a significant increase in the creation of family companies and trusts designed to obtain the income tax advantages flowing from the splitting of income derived from the personal exertion of a family member. The practice has extended to most industries and many taxpayers who were formerly deriving income from the rendering of personal services in the mining, computer, insurance, motor vehicle, real estate and entertainment industries are now purporting to be employees of a family company or trust. In a number of cases drawn to the attention of this office a taxpayer has ceased employment on one day and arrived at the former employer's premises the following day to do the same work, not as an employee of the former employer but as an employee of a family trust that has contracted to provide the taxpayer's services to the former employer.

3. A form of the arrangements commonly encountered involves a taxpayer who had been deriving salary and wage income forming a family company of which he and his wife are directors and the company becoming a trustee of a family trust of which the taxpayer's wife and children are beneficiaries. The family company, in the capacity of trustee, engages the taxpayer as an employee. The trustee will then negotiate with the

taxpayer's former employer for the provision of the taxpayer's services to the former employer. The amount which would otherwise be paid to the taxpayer as salary and wages will be paid to the trustee who, in turn, will pay the taxpayer a salary which is generally much lower than he had previously received and distribute the balance to family members according to the trust arrangements.

4. In other arrangements of this nature a company will be incorporated with the taxpayer and other family members as shareholders and directors. The taxpayer will become an employee of the company and, thereafter, much the same procedure is followed as in the family trust situation. The company negotiates with the former employer for the provision of the taxpayer's services. The amount which would otherwise be paid to the taxpayer as salary and wages will be paid to the company which will in turn pay the taxpayer a salary - again generally much lower than the taxpayer might otherwise have received - and pay the balance to family members as directors fees, etc.

5. It is a feature of these sorts of arrangements that there is very little, if any, outward sign of change in the method by which the income is derived from the former employer. The taxpayer continues to work for the former employer and performs the same functions for the same overall remuneration. Many of the arrangements of this nature examined in this office indicate that the former employer retains control over the performance of the taxpayer's work, that the taxpayer is required to attend at the former employer's premises during normal working hours, that the former employer has to reimburse the taxpayer for out-of-pocket expenses and that the taxpayer may be absent for periods which might generally be equated with normal annual leave and sick leave entitlements. In many cases the former employer, rather than having a right to terminate the agreement with the family company or trust, retained a direct right of dismissal in relation to the taxpayer.

6. There are said to be advantages to the former employer in these types of arrangements in as much as there is no longer any obligation to take out workers compensation insurance and to make tax instalment deductions. In some cases the former employer has also sought to escape the obligations for providing recreation and sick leave.

7. It is also a common feature of this sort of arrangement that income tax deductions are claimed in the family company or trust return of income for a wide variety of expenditures which would not be allowable as deductions had the taxpayer not entered into the arrangement.

8. Typical of this sort of arrangement is the situation which existed in the case of Tupicoff v. FCT, 84 ATC 4367 : 15 ATR 655. The taxpayer in that case was a life assurance agent who restructured his activities so as to become an employee of a family trust. Thereafter, the trust received the commissions formerly paid to the taxpayer who was paid a salary by the trustee. The balance of the income in the trust was

distributed to family members. In the Supreme Court of Queensland, Shepherdson J. held that section 260 of the Income Tax Assessment Act operated to nullify the arrangements for income tax purposes. In the course of his judgment, he described the principal effect of the arrangement in these terms:

> "Before the transactions the taxpayer was an agent of NML selling life assurance on its behalf. The sales were made purely as a result of his selling ability. After the transactions the taxpayer sold life assurance on behalf of NML - as he had done before - save that he was then an accredited agent and an employee of the company. In the 1980 year all the gross earnings of the company were derived from the taxpayer's selling ability. The taxpayer, so far as dealings with clients and potential clients were concerned, operated in exactly the same way both before and after the transactions. There were admittedly minor differences - e.g. the business cards, the letterheads and NML paying commission to the company and the company acquiring certain assets. These differences do not, in my view, cause me to believe that from the clients' viewpoint there was any substantial change in the taxpayer's operations after the transactions were completed."

In a decision given on 21 November 1984 the Federal Court upheld the decision of Shepherdson J. In the course of his judgment, Fisher J. said:

> "... it is not possible objectively to discern any significant business or commercial purpose in the taxpayer's arrangements. Indeed careful attention seems to have been given to the retention of as much as possible of the pre-existing arrangements. The taxpayer retained his status as an accredited representative approved by National Mutual Life Association of Australia Limited ("National Mutual") and as such he preserved for himself his existing benefits in superannuation, medical, accident and sickness funds conducted by National Mutual. Likewise he appears to have retained for the company the benefit of his exisiting bonus entitlements. On the other side of the coin he was required personally to indemnify National Mutual in relation to his company's activities."

9. A large number of cases of this general nature that have come under notice would, it is believed, call for the same sort of comment. Notwithstanding the interposition of a family company or trust there is no apparent substantial change in the taxpayer's operations. It is only the taxpayer's services that are the subject of the arrangement with the former employer and the remuneration for those services is much the same albeit that it is paid to a different taxpayer entity.

10. Moreover, looking at the substance of these

arrangements, the interposed entity is not itself carrying on a business. The income which it purports to derive comes wholly, or almost wholly, from the work done by the taxpayer and that work is largely confined to work for the employing firm. In a practical sense, to say nothing else, the taxpayer works as an employee of the former employer. In this vein the practical nature of the arrangements that existed in the Tupicoff case was recognised in the Federal Court. Fisher J. commented:

> "Even though as a matter of law the taxpayer was employed by the trustee company, which held the agency from National Mutual, the source of the company's revenue and of the income distributed by it as trustee was the personal exertion and expertise of the taxpayer."

Beaumont J. also observed:

> "As has been said, the practical, although not the legal, source of the income of the trust is the personal exertion of the taxpayer and, as Fisher J. has pointed out in his reasons, that exertion continued to be applied after the making of the arrangements now attacked by the Commissioner."

11. In the view of this office all of these arrangements may be characterised as arrangements entered into primarily or principally or predominantly to avoid liability for income tax by means of the splitting of income. They are not explicable as ordinary business or family dealings. To the extent that the arrangements were entered into prior to 28 May 1981 section 260 will operate to nullify them for income tax purposes. The tax benefit arising out of arrangements entered into on or after 28 May 1981 will be removed through the application of Part IVA. In both cases, the practical result will be that the taxpayer doing the work will be liable to tax on the amount paid by the former employer to the interposed entity.

12. In the Tupicoff case, Shepherdson J. said, in relation to section 260:

> "In the view which I take of the matter and on all the evidence before me I find the transactions entered into and on which the Commissioner relied plainly had as their central feature the alteration of the incidence of tax on income earned by the taxpayer from his personal exertions as an insurance salesman ... I am satisfied that the transactions had as their main purpose and effect the splitting of the taxpayer's income between himself and his family."

In the Federal Court, Fisher J. said:

> "In my opinion the only significant discernable purpose was that of income splitting. The contention of the taxpayer that he avoided the application of s.260 on the ground of ordinary business dealing was thus

correctly rejected by the trial judge."

13. Insofar as Part IVA is concerned, it would of course be necessary to consider the question in the light of all the reference matters listed in section 177D. The situation being that the interposed entity is not in substance engaged in carrying on business (see paragraph 10 above) it would be expected that, in arrangements entered into on or after 28 May 1981, Part IVA would be applied so that the income paid by the former employer would be assessed to the taxpayer doing the work.

14. The above views have been expressed in relation to situations where a family company or trust is interposed between a taxpayer and a former employer and the taxpayer continues to work for the former employer. The same view would be taken if, when arrangements are made for a taxpayer's personal employee-like services to be provided to a firm, the taxpayer has in, or brings into existence and works through an interposed company or trust that is a vehicle by which the resulting remuneration is split with family members.

15. In all of these situations it is most commonly to be found that:

(a) The taxpayer performs the same tasks as employees might ordinarily perform and generally works under the same physical conditions as other employees.

(b) The taxpayer attends throughout normal business hours the premises of the firm for which personal services are rendered through the interposed entity.

(c) The basis of payment of the income is akin to that normallly paid for the personal services.

(d) In the performance of the duties the taxpayer is subject to a measure of control by the firm for which personal services are rendered.

(e) The firm has the right to dismiss the taxpayer.

This is not, of course, an exclusive list.

16. The emphasis on the views expressed so far has been on arrangements for the splitting of income and associated avoidance of liability for income tax where the income affected by the arrangements comes from the provision, through an interposed entity, of personal services in an employee-like way. It should not be taken that the views apply solely to income from salary and wages. They apply to any arrangement for the splitting of income and consequent avoidance of liability for income tax where:

(a) the income involved is income arising from a taxpayer's personal exertions; and

(b) the arrangements operate solely in respect of that income.

17. It is mentioned at this point that references in this ruling to income from personal exertion are not at all made in the sense in which the term "income from personal exertion" is defined in section 6 of the Income Tax Assessment Act. The meaning of that technical definition is irrelevant for present purposes. This ruling is concerned with the reward to a person for his or her personal services or, as Beaumont J. said in the Tupicoff appeal, for the efforts of the taxpayer. This ruling is thus capable of application to income arising under a contract wholly or principally for the labour or services of a person, e.g. income payable under a fencing contract where the payment under the contract related wholly or principally to the labour of the individual concerned. Similarly it has application to the income derived by a professional sportsman or entertainer from the exercise of his or her particular attributes or skills, e.g. the income derived by a professional football player from the actual playing of football or public appearances etc. On the other hand this ruling does not apply to income derived by a professional sportsman from the endorsement of products. In the context of this ruling income from this source would not represent income from personal exertion.

18. Taking up a point of contrast, in a true business situation, whether it be that of a sole trader or an individual professional practice, there will be many cases where arrangements are made to conduct the business or practice for the benefit of family members. The assets of the business, e.g. plant and machinery, trading stock, goodwill etc., will be transferred to a family company or trust and the business will be carried on thereafter for the benefit of family members. This ruling does not extend to this situation because the income splitting does not operate solely in respect of income flowing from the taxpayer's personal exertions - it flows at least in part from the ownership of the business assets. (See also paragraphs 23 and 24 below.)

19. Whether or not the transfer of the income producing assets of a business to a trust and the subsequent conduct of the business for the benefit of family members is affected by section 260 or Part IVA can only be determined in the light of the circumstances of each case. Accordingly that matter is not addressed in this ruling. It should be remembered there is no inherent reason to deny that a business undertaking, be it carried on by an individual, partnership or company can be made the subject of a trust. It is not uncommon for a trustee under a will to be authorised under the terms of the will to hold the assets of a business and carry it on for the benefit of beneficiaries named in the will. Similar trusts may be created inter vivos. The case of D.F.C. of T. v. Purcell (1920-21) 29 CLR 464 is an example. In that case the taxpayer, the owner of certain farming properties, live-stock, etc. executed a declaration of trust in respect of the various assets on behalf

of himself, his wife and his daughter equally. The High Court held that the then counter-part of section 260 did not operate to strike down the declaration of trust on the grounds that a bona fide sale or gift of assets producing income was not affected by the relevant provision.

20. The decision in the Purcell case has generally been followed in this office and it has been indicated officially that the outcome in that case is one that could be expected to occur in the context of Part IVA. In his reasons for judgment in the Tupicoff case, Beaumont J. referred to Purcell's case in these terms.

> "The taxpayer further argues that the reasoning in Purcell's Case (Deputy Federal Commissioner of Taxation v Purcell (1921) 29 CLR 464) demonstrates that s.260 cannot apply here. But that was a case of an out and out gift of a portion of certain property to members of the taxpayer's family under a declaration of trust. The beneficial interest in the property passed absolutely, and, despite the retention of wide powers of management, it was possible to characterise the transaction as no more than an 'ordinary family dealing'."

21. By way of aside, section 260 has been held to be applicable in three business/professional practice cases that had income splitting features - Hollyock v. FCT, 71 ATC 4202 : 2 ATR 601, Peate v. FCT, 11 CLR 553 and Millard v. FCT 108 CLR 336. The High Court has now granted special leave to appeal in a number of cases involving similar fact situations to the Peate case and the position can be expected to be further clarified in the decisions of the High Court on those appeals.

22. Before arrangements for the conduct of a business in trust form could have the tax consequences intended for them it would need to be established that a trust in respect of the business is operating according to the formal arrangements. That is, it would be necessary for the documentation creating the trust to have been carried out, there would need to be no bar to the particular business activity being carried on other than by an individual or individuals, and the trustee would in fact need to hold the trust property, i.e. the business and its assets, absolutely and be carrying on the business activities for the benefit of beneficiaries.

23. The Tupicoff appeal proceeded on the basis that the taxpayer's activities constituted the carrying on of a business. Against this background the question may be asked - what is it that distinguishes the situation referred to in paragraphs 18, 19 and 20 from those to which this ruling applies? As to that the business structure in the Tupicoff case was the agency appointment. Because it was personal to the taxpayer it had no goodwill value as the business of a sole trader or individual professional practice might have. The only assets which the taxpayer was able to transfer to the trustee

company were incidental items of office furniture. They were not income producing assets in the sense referred to in the Purcell case. The factual situation in the Tupicoff case was that the income of the business was produced solely by the personal efforts of the taxpayer - the amounts paid by National Mutual Life Association of Australiasia Ltd to the family trust were paid solely in respect of the activities of the taxpayer in selling policies of assurance, etc.

24. To put it another way, the principles which have been applied in the Federal Court and which form the essence of this ruling are applicable where there are no income producing assets or goodwill to be transferred to the interposed entity and where the particular income of the interposed entity is derived wholly from the personal efforts of the taxpayer. This situation will exist in clearest form where a taxpayer renders personal services in an employee-like way (paragraph 14 above) and the income of the interposed entity comes wholly, or almost wholly, from work done for the employing firm and the personal exertions which produce that income are those of the taxpayer in question.

25. Where, in the application of the general views expressed in this ruling, income that purports to have been derived by an interposed entity is assessed instead to the taxpayer whose personal exertions produced the income, the taxpayer is to be allowed deductions on the basis that he or she incurred the expenditure that the interposed entity purported to expend. However, it will be necessary to ensure that expenses which represent private or domestic outgoings, should not be allowed as deductions.

26. An associated question that has arisen concerning arrangements to which this ruling applies relates to the provision of superannuation benefits by the interposed family company or trust. On the basis that the taxpayer is an employee of the family company or trust, a section 23F superannuation fund would have been established to provide superannuation benefits for the taxpayer and income tax deductions sought for the contributions made to the superannuation fund by the family company or trust.

27. Against the background that section 260 or Part IVA operate to nullify the effectiveness of the family company or trust arrangements for income tax purposes or to cancel out any tax benefit arising from the arrangements, it is considered that the contribution to the superannuation fund in respect of the taxpayer is neither allowable as an income tax deduction nor does it qualify as concessional expenditure for rebate purposes. For assessment purposes, the superannuation fund should be treated as a trust estate to which Division 6 applies and the income of the fund assessed to beneficiaries according to their interest in it, i.e. according to contributions made to the fund on behalf of each beneficiary involved.

28. In arrangements entered into on or after 28 May 1981, i.e. those to which, in accordance with this ruling, Part IVA will apply, it will be necessary to make a determination in

terms of section 177F as part of the process of making the assessment. Deputy Commissioners may authorise appropriate officers for this purpose.

29. Subject to any modifications that might be necessary in particular circumstances the following adjustment sheet should accompany notices of assessment:

"The attached notice of assessment has been made on the basis that section 260 (or Part IVA) of the Income Tax Assessment Act 1936 applies to require that the gross income

commission (whichever is appropriate)
fees

disclosed in the return of income of the .....
XYZ Trust ..... from ..... ABC Pty Ltd .....
for the year ended ....., $,
should be included in your assessable income.

To be used only where Part IVA is applied.

It has been determined in terms of section 177F that the whole of the above amount should be included in your assessable income and it is deemed to be so included by virtue of the operation of sections 17, 19 and 25.

Your taxable income has been calculated as follows:

Taxable income as returned		$
Gross income disclosed in XYZ Trust from ABC Pty Ltd	$	
Less: Allowable deductions	$	
Less: Amount already disclosed in your return	$	
Add		$

"

30. The amount added to the taxpayer's taxable income will be subject to provisional tax.

31. This ruling is to be applied in the assessment of unassessed returns and in the determination of any out-standing objections or appeals. Insofar as the re-opening of the assessments is concerned, where the information now available to Deputy Commissioners in any case makes it clear that the case is one to which this ruling applies, and the requirements of section 170 are met, assessments issued within three years of the date of this ruling may be amended to give effect to this ruling.

32. In the generality of cases the taxpayer rendering the personal services will only include in his or her personal return of income the amounts derived under the family company or trust arrangements, i.e. the amounts payable to the taxpayer by the interposed entity. To the extent that, in accordance with this ruling, additional income is to be added to the income returned there will be liability for additional tax in terms of sub-sections 226(2) or 226(2A), now sub-section 223(1) and section 226 respectively.

33. In the light of all the circumstances, including the fact that the proper treatment for income tax purposes of arrangements of this nature was not wholly clear, it has been decided that additional tax under sub-sections 226(2) and (2A) should be remitted in full in assessments made on the basis of this ruling where the assessments are based on returns that have been lodged or are lodged not later than one month subsequent to the date of this ruling. Where returns involving interposed entity arrangements are lodged later than one month from the date of this ruling, additional tax under sub-sections 226(2) or (2A) should be remitted having regard to the matters in Taxation Ruling No. IT 2012. The calculation should be made by reference to the net income omitted, i.e. the amount remaining after taking into account allowable deductions.

34. As indicated in the preceding paragraph, the remission of additional tax under sub-sections 226(2) or (2A) will apply to assessments made which have issued prior to this ruling. Where formal objection has been taken to the imposition of additional tax under sub-sections 226(2) or (2A), the objection should be allowed to this extent. Where no formal objection has been lodged sub-section 170(8) may be used as authority for re-opening assessments to give effect to the full remission of the additional tax.

35. As a result of the decision of the Federal Court in the Tupicoff case it may be expected that numbers of taxpayers will accept assessments that accord with the approach outlined in this ruling. Some, however, may seek to press a view that their arrangements are effective for income tax purposes. In situations, for example, where a family trust has been interposed returns of income will have been lodged including in beneficiaries' returns the shares of the trust income to which they claim to be presently entitled. In these situations assessments issued to beneficiaries should include the income. The assessments would need to be maintained for so long as the taxpayer whose personal exertions are involved disputes full assessment of the income to himself or herself. To the extent that there is income to which no beneficiary is presently entitled, an assessment should be issued to the trustee.

36. It may be that some assessments have issued in relation to arrangements entered into on or after 28 May 1981, i.e. arrangements to which Part IVA applies, where a specific determination under Part IVA has not been made. The assessments would have been made on the basis that, notwithstanding the arrangements, the income involved was at all times derived by

the taxpayer and assessable to him under the general provisions of the income tax law. The decision of the Federal Court in the Tupicoff appeal has rejected this argument. It follows, therefore, that, if the arrangements are to be contested beyond the objection stage, an amended assessment should be issued to the taxpayer based on a determination under Part IVA - see section 177G.

37. It is likely that the issue of assessments to the taxpayer and the beneficiaries or trustees will result in the lodgment of objections and applications for extension of time for payment pending the ultimate resolution of the matter. The objections should be disallowed except in relation to the remission of additional tax under sub-sections 226(2) or (2A) as indicated above.

38. Care must be taken in determining applications for extension of time for payment. Clearly it would not be proper to seek to obtain payment in full from both the taxpayer to whom all the income has been assessed and beneficiaries and/or trustees. If the taxpayer to whom all the income has been assessed pays the tax assessed to him no action should be taken to recover payment from the beneficiaries pending resolution of the matter.

39. In other cases recovery action may be deferred pending determination of objection or subsequent consideration by a Taxation Board of Review or Court, provided appropriate arrangements for payment are made having regard to the nature and the basis of assessment. It would be acceptable, for example, if the taxpayer providing the personal services were to pay 50% of the tax in dispute. Alternatively, payment of amounts by all the parties involved of amounts based on returns as lodged by them may be accepted. The deferment of recovery action in these circumstances would be subject to additional tax for late payment on any amount ultimately found to be owing when the matter was finally resolved taking into account payments by the parties.

40. It has been the practice in arrangements of this nature to endeavour to require employers to make tax instalment deductions from the gross amounts paid to the interposed entity. This practice stemmed from the belief that the amount paid by the employer to the interposed entity represented income derived by the taxpayer and not by the interposed entity. In cases where the arrangements are not a sham, it was considered that they represented an agreement by the taxpayer to hand over the income after it had been derived by the taxpayer. In effect, the taxpayer was an employee of the former employer.

41. This view was not dealt with by Shepherdson J. at first instance. It has been rejected by the Federal Court. However, the Court has said that, because the arrangements were not a sham, the gross income was technically the income of the interposed entity and, apart from the operation of section 260, it was never the taxpayer's income.

42. It follows, therefore, that unless any arrangements of this nature can be said to be a sham, attempts to require employers to make tax instalment deductions from the gross payments to interposed entities should be discontinued.

43. If the payment is of a type covered by the prescribed payments system, then the deduction at source requirements of that system would of course have to be observed.

COMMISSIONER OF TAXATION
12 December 1984