



# Cover sheet for: IT 2330-TEST

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 Note: Paragraph 19 of this Ruling does not apply to assignments entered into after 30 June 2015 and certain other assignments. ATO guidance on the potential application of Part IVA to the assignment of a partnership interest is set out in [Everett assignments](#).

TAXATION RULING NO. IT 2330

INCOME TAX : INCOME SPLITTING

F.O.I. EMBARGO: May be released

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F.O.I. INDEX DETAIL

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| I 1209568     | INCOME SPLITTING | 260<br>PART IVA |

OTHER RULINGS ON TOPIC : IT 25, IT 276, IT 2121

PREAMBLE                   The purpose of this Ruling is to restate the official approach to be followed in determining the income tax consequences attaching to arrangements which seek to avoid income tax through the splitting of income. This topic was the subject of recent decisions of the High Court of Australia in C. of T. v. Gulland, Watson v. FCT and Pincus v. FCT 85 ATC 4765 : 17 ATR 1 (the doctors' cases). It was also involved in the decision of the Federal Court in Tupicoff v. FCT 84 ATC 4851 : 15 ATR 1262. The High Court has refused the taxpayer's application for special leave to appeal against the decision of the Federal Court.

2.           Largely because trusts are the vehicle usually employed in arrangements designed to split income this Ruling is concerned essentially with trust arrangements and the extent to which the general anti-tax avoidance measures, i.e. section 260 and Part IVA, operate to nullify them for income tax purposes or to cancel out any tax benefits in them. There are of course other provisions which may also require consideration in appropriate circumstances, e.g. section 102, Division 6A.

The Doctors' Cases

3.           The facts in the doctors' cases were substantially the same. Each case involved a medical practitioner who had conducted a medical practice either alone or in partnership. The medical practitioner established a unit trust the units in which were held by the trustee of his family trust. The trustee of the unit trust acquired the medical practice and thereafter employed the medical practitioner on an agreed salary.

4.           As a result of the arrangements fees which would otherwise have been paid directly to the medical practitioner or to the partnership were paid to the unit trust. The trustee of the unit trust paid the medical practitioner an agreed salary and was then in a position to distribute the remainder to unitholders, i.e. effectively to the families of the medical practitioner. The arrangements had the effect of splitting with

family members the income upon which the medical practitioners might otherwise have been liable to tax with a consequent reduction in the amount of tax payable.

5. By majority the High Court held that section 260 operated to render the arrangements void for income tax purposes. The majority found that the arrangements were not capable of explanation by reference to ordinary business or family dealing without necessarily being labelled as a means to avoid tax, i.e. avoidance of tax was an essential feature of the arrangements.

6. In the course of their decisions the judges in the majority made reference to the following factors:-

- (1) The nature of the income involved in the arrangements, i.e. it was income derived from the personal exertion of each of the medical practitioners.
- (2) The trustee of each family trust had a discretion to distribute the income of the trust between the medical practitioner and family members. The medical practitioner had power to remove the trustee of the family trust, i.e. he had power to control the family trust.
- (3) The trustee of the unit trust, i.e. the medical practice trust, did not actively engage in the conduct of the medical practice.
- (4) The medical practices were carried on in much the same way as they had been before the arrangements were entered into. The arrangements did not result in any limitation of liability nor did they assist in the provision of medical services by each of the medical practitioners.

It does not appear from the decisions if any of the factors appeared crucial to the majority. Rather, the decisions represented a conclusion to be drawn from the whole of the facts. As Dawson J. said:

"The very complexity of the arrangements pointed to their contrived nature and took them beyond the range of transactions ordinarily encountered in the organisation of affairs for business or personal reasons."

#### Section 260 Generally

7. Although section 260 is often referred to as a "dragnet" or "catch all" tax avoidance measure, earlier decisions of the High Court have indicated that its operation is subject to certain limitations. The doctors' cases confirm the limitations. Shortly stated they are:-

- (1) The operation of section 260 is essentially a matter of statutory interpretation, i.e. it is a matter of

construing the Income Tax Assessment Act as a whole and seeing where section 260 fits. While the section has an obvious role in protecting the general provisions of the Income Tax Assessment Act it does not override specific and particular provisions.

- (2) It is not possible to formulate a general rule for the operation of section 260 which will operate across the board. Whether the section applies in the particular case must be determined in the light of all the facts of the case.
- (3) For section 260 to apply to any transaction, arrangement, etc. there must be an avoidance of tax. It is not necessary that tax avoidance should be the sole or dominant purpose of it. It is sufficient if the purpose of tax avoidance is a main or substantial purpose as contrasted with tax avoidance which arises as an inessential or incidental feature.
- (4) A simple disposition of income producing assets does not attract the operation of section 260.
- (5) An arrangement which results in tax avoidance will not be caught by section 260 if it is capable of explanation by reference to ordinary business and family dealing and the avoidance of tax is incidental.
- (6) There is a qualification to be placed on what is meant by the expression "ordinary business or family dealing". The expression is intended to convey the notion of normal or regular rather than common or prevalent.
- (7) An arrangement which is struck down by section 260 will be struck down notwithstanding that there may not have been any tax avoided in the year; see the decision in the Gulland case.
- (8) Notwithstanding that an arrangement may not be capable of explanation by reference to ordinary business or family dealing and even though it may be entered into to avoid tax, it will not attract the operation of section 260 if its purpose is to take advantage of a specific or particular provision in the Income Tax Assessment Act and complies in every respect with the requirements of the specific or particular provision, i.e., the choice principle.
- (9) Section 260 is an annihilating provision only. It does not permit reconstruction. This means, for example, that where section 260 renders an income splitting arrangement void for income tax purposes, the general law of income tax must be able to operate to say that the taxpayer who formerly derived the income has derived an amount of income upon which he or she is liable to tax.

8. It has been said in some of the cases involving section 260 that the section cannot operate unless there is an antecedent transaction or situation which is affected by a subsequent arrangement. It has also been stated that the section does not strike at a new source of income or restrict the right of a taxpayer to arrange his or her affairs in relation to income from a new source in such a way as to attract the least liability to tax. Whatever may be the extent of the operation of these propositions their application to income from the rendering of personal services or from salary and wages is far from clear.

9. For many years it has been understood officially that income from the rendering of personal services cannot be so dealt with as to make it liable to income tax to any person other than the person who rendered the personal services. In the Report of the Commonwealth Committee on Taxation in June 1961, for example, it is stated at paragraph 715 that "it is a well established principle that income from salary and wages cannot be alienated for taxation". There have been judicial observations to the same effect - they are referred to in F.C. of T. v. Everett 80 ATC 4076 : 10 ATR 608 and in the decision of Beaumont J. in the Federal Court in the Tupicoff case. While it is true that there are statements in both decisions which cast doubt upon the validity of the long held official understanding as a general proposition of law, it is equally true that arrangements for the alienation of income from the rendering of personal services are in a special position in relation to the operation of section 260. As Fisher J. said in the Tupicoff case:-

"Moreover sec. 260, on its application to dealings with income produced by personal exertion, operates in a manner markedly different from that when a disposition of income producing property is under consideration (contrast D.F.C. of T. v. Purcell (1921) 29 CLR 464 with Peate's case, Hollyock v. FCT (1971) 125 CLR 647 and Millard v. FCT (1962) 108 CLR 336)."

10. It would be a curious result if a medical practitioner who commenced practice for the first time and structured the practice along the same lines as the arrangements which were nullified in the doctors' cases were free of section 260. To take another example, it would be an odd result if a salary and wage earner changed employers and was able to structure the new employment along the same lines as the medical practitioners in the doctors' cases without attracting the operation of section 260. Until such time as it is shown by court decisions that the position is otherwise it is proposed to adopt the view that section 260 applies in cases of this nature.

11. Although this Ruling is directed at the operation of section 260 and Part IVA in relation to income splitting arrangements there appears much in the Court's reasoning in the doctors' cases to support the operation of section 260 in a number of other tax avoidance schemes. Section 260 has been

argued in a number of situations involving claims for income tax deduction in circumstances which, in the view of this Office, are artificial and contrived and, apart from income tax considerations, have no independent commercial character. As a number of cases have been heard and are awaiting decision it is not appropriate to discuss them further.

#### Income Splitting

12. It is necessary to repeat, as Dawson J. said, that the reconciliation of section 260 with other provisions of the Income Tax Assessment Act means that a decision can only be made in individual cases and it requires an examination of all the features of the particular arrangement.

13. Notwithstanding the admonition of Dawson J. it is possible to point to some situations which may be said to involve income splitting but which do not attract adverse income tax consequences. For example, a taxpayer in business may employ family members in the business - provided the employment is bona fide and the wages reasonable in amount, an income tax deduction is allowable for the wages. A taxpayer in business may take his or her spouse into partnership in the conduct of the business and, provided a genuine partnership exists, it is accepted for income tax purposes. There are not any adverse income tax consequences where, for normal business or commercial reasons, a trading enterprise is incorporated and the business is conducted along normal commercial lines. The operation of a service company or trust, where the charges are commercially realistic, does not attract the operation of section 260.

14. Furthermore, in the doctors' cases the Chief Justice and Dawson J. have clearly signalled that they do not see an arrangement under which a structure is set up to cover a professional practice, but which operates only to allow employer-level deductions for superannuation contributions, as being struck at by section 260. This accords with the view that the Commissioner has long adopted.

#### Transfer of Income Producing Assets

15. It has been stated earlier that a simple disposition of income producing assets does not attract the operation of section 260. Income producing assets in this context extend to the assets of a business and it is in this area that the efficacy of arrangements which have the effect of income splitting are frequently called into question, i.e. where a business enterprise is conducted per medium of a trust structure and the income is distributed to family members. There are two aspects to the question. In the first place it is necessary to decide whether the particular arrangements represent a simple disposition of income producing assets or whether they ought to be characterised as arrangements for the splitting of income beyond the range of transactions ordinarily explicable as normal commercial or family dealing. In the second place it is necessary to consider the implications where the income of a

business does not flow predominantly from income producing assets but from the rendering of personal services by the "principal" in the business.

16. As is stated in Taxation Ruling No. IT 2121, 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 counterpart 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.

17. The decision in the Purcell case was specifically upheld in the doctors' cases. It 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. There are two observations which should be made about the effect of the decision. It is not limited to the income producing assets of a business of primary production but extends to comparable income producing assets. It also illustrates that a measure of control over the conduct of a business by the former owner or owners normally does not detract from the notion of a simple disposition of the income producing assets. In the Purcell case the fact that the taxpayer retained possession of the property and the sole right to continue to manage and carry on the businesses for as long as he should think proper did not prevent the High Court from concluding that the transfer was absolute and the transaction bona fide.

18. The decision in the Purcell case has been and will continue to be followed in comparable cases where it is established that the trust in respect of a 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.

19. A recent situation where a disposition of income producing assets was not considered to attract the operation of section 260 occurred in FCT v. Everett 80 ATC 4076 : 10 ATR 608. There, a partner in a legal firm assigned part of his share in the firm to his wife absolutely. The question at issue revolved around the effectiveness of the assignment for

income tax purposes, i.e. whether the share of partnership income attributable to the assigned share was taxable to the partner or to his wife. Principles of equity law were involved. The possible operation of section 260 was not advanced in argument for the Commissioner because it was considered that the situation was one to which the decision in the Purcell case applied, i.e. it was a "no strings" attached disposition of an income producing asset. It is still the approach of this office that neither section 260 nor Part IVA applies to "no strings" attached assignments of partnership interests of the same nature as the interest assigned in the Everett case.

20. The doctors' cases are an illustration of the sorts of factors which must be taken into account in determining whether or not there has been a simple disposition of income producing assets. They illustrate that it is not possible to determine whether section 260 applies in any particular case simply by reference to the documentation establishing the arrangement - an examination of the arrangement in operation is necessary.

21. To further illustrate the point, reference is made to two other decisions of the High Court of Australia, Millard v. C. of T. (1962) 108 CLR 336 and Hollyock v. FCT (1971) 125 CLR 647. In the Millard case the taxpayer was a registered bookmaker. He entered into an agreement with a private company to conduct the bookmaking activities on behalf of the company as its agent. He was to be paid certain amounts for his services during the existence of the agreement. The shares in the private company were owned by the taxpayer and his family. In the year under appeal, i.e. the year ended 30 June 1958, the taxpayer disclosed as income the amount paid to him by the private company for his services in conducting bookmaking activities as agent for the company. The Commissioner, however, included in the taxpayer's income the total proceeds from the bookmaking activities. The taxpayer disputed the Commissioner's action.

22. The matter came before Taylor J. His Honour found that the bookmaking business was conducted precisely as it had been conducted before the agreement was entered into, that no advice of the agency agreement had been given to relevant authorities, e.g. racing clubs, that the bookmaking business had not been assigned and was never intended to be assigned to the company and that it was not possible for the company to obtain registration as a bookmaker. All of these factors led to the conclusion that the whole purpose and effect of the agreement was to split the taxpayer's income into a number of parts in order to minimise the amount of tax which would become payable. The agreement was clearly within the provisions of section 260 and, in the result, was void for income tax purposes.

23. The Millard case has added significance in as much as it is an illustration of a situation where a company has been used as a mechanism for the avoidance of tax through the splitting of income. It is stated in paragraph 13 that the incorporation of a trading enterprise and the subsequent conduct



of the business along normal commercial lines would not attract the operation of section 260. Without departing from what is said in paragraph 13, the Millard case illustrates in this context the need for incorporation of trading enterprises to be a genuine business arrangement.

24. The Hollyock case concerned a pharmaceutical chemist who created a trust of his business for himself and his wife. The arrangement provided that the taxpayer would sell to his wife a half-share in the business but the purchase price was not to become payable so long as the business existed and the wife did not sell or assign her half share. The wife's share of the income from the business was to be applied in payment of the purchase price. The taxpayer was to carry on the business himself.

25. In actual fact Gibbs J. found that, although the accounts of the business showed equal drawings of profits by the taxpayer and his wife, the wife did not draw any profits from the business nor was any amount set off towards payment of the purchase price. The taxpayer alone operated the business bank account and he made regular withdrawals which he paid to his wife for household expenses as he had done before the arrangements were entered into. Furthermore, the nature of the business was such that it could only lawfully be carried on by a pharmaceutical chemist - the wife could not lawfully join in carrying it. In the result, Gibbs J. concluded that section 260 operated to nullify the arrangement for income tax purposes.

26. Not all business undertakings conducted in trust form are structured in the same way as the trust which existed in the Purcell case. The trust arrangement there was relatively straightforward. Purcell declared that he held the assets of his primary production business in trust in equal shares for himself, his wife and his daughter. Thenceforward he carried on the business as he had always done but distributed the profits equally between himself, his wife and his daughter.

27. There are other situations, however, where the business proprietor may sell or transfer to a trustee the income producing assets of his business on trust for the trustee to carry on the business and hold the assets and income for the benefit of family members either absolutely or at the discretion of the trustee. The terms of the arrangement provide for the trustee to employ the former business proprietor to carry on the business, probably in much the same way as it had always been conducted.

28. Although the trust arrangement outlined in the preceding paragraph is not the same as that in the Purcell case there does not seem to be any reason to suggest that it should be regarded any differently from the Purcell case. Where the arrangements satisfy the matters referred to in paragraph 18, as they apply in the changed circumstances, and do not present any of the disqualifying features illustrated in paragraphs 20-25, they would not be affected by section 260.

29. In the circumstances outlined in paragraphs 27 and 28, i.e. where a trustee employs a former proprietor of a business to continue to conduct the business, the level of salary paid to the former proprietor could well be indicative of a purpose of tax avoidance in the arrangements. Accordingly, the payment of a salary to the former proprietor considerably lower than the profits which he or she formerly derived from the business, accompanied by a corresponding diversion of income to family members, would require examination. There may be good and valid reasons for the particular level of salary, e.g. reduction in duties and responsibilities, contraction in business activities, payment that adequately enough compensates for the work that is done, participation by beneficiaries in the business activities, etc. As a general proposition the level of salary paid to the former proprietor should be no less than commensurate with his or her continuing duties and responsibilities.

30. Another feature which may arise in trust arrangements involving the transfer of income producing property is the existence of a power in the former owner to revoke or alter the trust arrangements so as to acquire a beneficial interest in the income or property of the trust, or to otherwise alter their destination. Such a power is in a different category to the power retained by a former owner of income producing property to control the income producing activities and which is recognised in paragraph 17 as not destroying the effectiveness of trust arrangements for income tax purposes.

31. The power now under discussion - the power to alter beneficial enjoyment - may or may not have an adverse effect in terms of section 260. If the power could not be explained by reference to ordinary business or family dealing, but was to be seen as a technique by which the former owner exerted influence so that the use or enjoyment of the income that is currently formally diverted to another person is really that of the former owner, then the power would have tax avoidance connotations.

32. If, on the other hand, the power were to be explicable by reasons such as provision for a possible marriage break-up, or a need to maintain and support parental control and upbringing of children, then it would not count against the arrangements in terms of section 260.

#### Income from the Rendering of Personal Services

33. Taxation Ruling No. IT 2121 deals particularly with the use of family trusts and companies as a means of splitting income from the rendering of personal services and of reducing the amount of income tax which might otherwise have been payable. It is stated in the Ruling that arrangements of this nature would attract the operation of either section 260 or Part IVA depending upon whether the arrangements were entered into prior to or subsequent to 27 May 1981.

34. The decisions in the doctors' cases provide strong support for the views expressed in the Ruling. Gibbs C.J. has made it clear that the Income Tax Assessment Act does not permit

a taxpayer the opportunity to have his own income from personal exertion taxed as though it were income derived by a trust and held for the benefit of a number of beneficiaries, i.e. the choice principle does not extend to arrangements for the splitting of income from personal services. Furthermore, the doctors' cases and the Millard and Hollyock cases illustrate that, where the income of a business is produced predominantly by the personal services of one person, any arrangement entered into for the splitting of the income will not involve a simple disposition of income producing assets in the sense contemplated in the Purcell case. The reason for this is, of course, that where a person's remuneration is the product of his or her personal services, all that can be disposed of are future receipts - there are not any income producing assets of the nature of those in the Purcell case.

35. In the light of the various decisions there appears to be only one test for determining whether arrangements entered into for the splitting of income from personal services attract the operation of section 260, i.e. whether the arrangements are explicable by reference to ordinary business or family dealing and any avoidance of tax is an inessential or incidental feature of the arrangements. The various decisions indicate, however, that it is not possible in the generality of arrangements for the pre-tax splitting of income from personal services to discern any significant business or commercial purpose for them and that, in fact, the one significant discernible purpose for them is the reduction or avoidance of tax which follows from the splitting of the income.

36. In this context income derived from the rendering of personal services means what it says, i.e. it is income which flows directly or predominantly from skills, services, etc. personally rendered. The use of the word "predominantly" is necessary to provide for the situation where the personal services involve the use of some equipment, e.g. the drawing board of an architect. The equipment involved in these cases is not of the same significance as the income producing assets in the Purcell case. Salary and wages is the clearest example of income derived from the rendering of personal services. Income derived by a professional person who practises on his or her own account without professional assistance is another example.

37. Not all income derived by professional people from the conduct of their professions can be said to be derived from the rendering of personal services. There are many large professional firms, e.g. accountants, engineers, architects, solicitors, etc. whose income is produced by the staff employed by them. In *Henderson v. FCT* 70 ATC 4016 : 1 ATR 596, for example, Barwick C.J. drew a distinction between the income of a professional practice carried on by a taxpayer personally and the professional firm of which Henderson was a partner and which employed some 295 persons. In *FCT v. Everett* 80 ATC 4076 : 10 ATR 608 the majority of the High Court expressed the view that the income of the taxpayer from a large legal partnership was not income from personal exertion in the same sense as the expression has been used in cases such as the

doctors' cases, etc. Whether or not arrangements for the conduct of large professional firms under a trust structure are to be accepted for income tax purposes will depend upon whether they satisfy the matters referred to in paragraphs 18-32 above.

38. The Court went on to say in the Everett case that it is not true of partners in general that they derive their income from personal exertion. On the other hand, in the doctors' cases the Court was clearly of the view that the character of the income involved in each case was income from personal exertion notwithstanding that there were partnerships involved. For the purposes of this Ruling partnership income will be treated as income from the rendering of personal services where it results from the personal services of the partners and not from the efforts of employees and/or income producing assets of the type illustrated by the Purcell case. In practice it is expected that it will be partnerships providing professional services which will be affected by this Ruling.

39. It is not practicable at this time to state with any greater precision the circumstances in which a taxpayer may be said to be in receipt of income from the rendering of personal services. It cannot be said, for example, that the income of a business or profession will be considered to be income from the rendering of personal services if there are less than x number of employees or if there is a certain ratio between proprietorship and staff. Questions of degree, the nature of the business activity, etc. must enter into consideration.

40. There is nothing in the cases to suggest that a person who is carrying on business, the income of which is derived from the person's personal services, cannot incorporate the business. Where incorporation is explicable as an ordinary commercial or business step to take and does not result in any splitting of the income from personal services, and the incorporated business activity is conducted along normal business lines (see paragraph 13), it will be acceptable for income tax purposes. The fact that the company may be able to obtain greater income tax concessions in providing superannuation benefits than would have been the case if the business had not been incorporated would not attract the operation of section 260 or Part IVA.

#### Part IVA

41. As is apparent from this Ruling, and also from Taxation Ruling No. IT 2121, the decisions of the Courts in relation to income splitting have been concerned with their effectiveness in the context of section 260. Part IVA has not been in issue. And, of course, the question of whether Part IVA would apply in a particular case has to be considered on the basis of the language of those provisions, and of the specific reference matters set out in them. The approach of the Commissioner to the application of Part IVA has been set out on previous occasions. Nevertheless, in the situations where the Courts have decided that section 260 operated to nullify particular income splitting arrangements for income tax purposes, it is to

be expected that Part IVA would operate to cancel out any tax benefits if the case were a post-27 May 1981 one. Conversely, in the situations where an income splitting arrangement survives the operation of section 260, it may be expected that it would not be affected by Part IVA.

42. Beyond saying that, it is not necessary to analyse Part IVA for the purposes of this Ruling. Part IVA has been designed to express in statutory form the approach to section 260 expressed by the Privy Council in *Newton & Others v. FCT* (1958) 98 CLR 1. The decisions of the High Court in the doctors' cases follow the same approach to section 260 as that of the Privy Council subject to the effect of the "choice principle" which does not apply in income splitting arrangements. As a practical matter, therefore, the views expressed earlier as to the impact of section 260 have broadly the same application in relation to Part IVA.

#### Application

43. This Ruling will apply in the determination of all presently outstanding objections and in the consideration of existing requests for reference to a Taxation Board of Review and appeals to Courts. Apart from that it will also apply generally in the assessment and/or examination of returns of income for the year ended 30 June 1986 and subsequent years. Cases falling within Taxation Ruling No. IT 2121 are of course to be dealt with on the basis of paragraph 31 of that Ruling.

COMMISSIONER OF TAXATION  
30 June 1986