

# ***TR 2001/D16 - Income tax: Simplified Tax System: eligibility - grouping rules (\*STS affiliate, control of non fixed trusts)***

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This document has been finalised by TR 2002/6.



## **Draft Taxation Ruling**

### **Income tax: Simplified Tax System: eligibility – grouping rules (\*STS affiliate, control of non fixed trusts)**

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#### ***Preamble***

*Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.*

#### **What this Ruling is about**

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1. This Ruling considers the application of:
  - (a) the non-fixed trust control rule in paragraph 328-380(4)(c) of the *Income Tax Assessment Act 1997* ('ITAA 1997'); and
  - (b) the \*STS affiliate<sup>1</sup> definition in subsection 328-380(8) of that Act.
2. These rules affect whether an entity is eligible to be an \*STS taxpayer for the purposes of the Simplified Tax System ('STS') in Division 328.
3. Specifically, the ruling considers:
  - (a) when a trustee of a non-fixed trust is accustomed or might reasonably be expected to act in accordance with an entity's directions, instructions or wishes for the purposes of paragraph 328-380(4)(c); and
  - (b) the role and scope of the \*STS affiliate definition in subsection 328-380(8).
4. Special consideration is given to the following aspects of the \*STS affiliate definition:
  - (a) when an entity could reasonably be expected to act in accordance with a second entity's directions or wishes or in concert with the second entity; and

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<sup>1</sup> Terms that are defined in the *Income Tax Assessment Act 1997*, and identified with an asterisk in that Act, are similarly identified in this Ruling and have the same meaning as in that Act.

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- (b) when two entities will be viewed as acting 'in concert'.

## **Class of person/arrangement**

5. This Ruling applies to an entity that satisfies the STS eligibility rules in Subdivision 328-F for a relevant income year and has made an election in the \*approved form to become an \*STS taxpayer for that year under Subdivision 328-G of the ITAA 1997.

## **Legislative framework**

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### **Introduction to Division 328 – Simplified Tax System**

6. The STS arose as a result of the Government's adoption of Recommendation 17.1 of the Ralph Committee's report, *Review of Business Taxation: A Tax System Redesigned*. This recommended the introduction of a simplified tax system to reduce the income tax compliance costs faced by small business.

7. Division 328 of the ITAA 1997 provides the legislative framework for the STS. In implementing the recommendation of the Ralph Committee, Division 328 offers eligible small businesses the choice of using modified accounting, capital allowance and trading stock regimes. An entity that chooses to become an \*STS taxpayer will also be able to claim a full deduction for certain prepaid expenditure through the combined operation of section 8-1 of the ITAA 1997 and section 82KZM of the *Income Tax Assessment Act 1936* ('ITAA 1936').

### **Outline of the STS eligibility rules**

8. Before the rules in Division 328 can apply to an entity, the entity must be an \*STS taxpayer for the relevant income year. Section 328-435 requires that to be an \*STS taxpayer, the entity must:

- (a) be eligible to be an \*STS taxpayer under Subdivision 328-F; and
- (b) notify the Commissioner in the \*approved form of its choice to be an \*STS taxpayer for the income year.

9. Under Subdivision 328-F, an entity is eligible to be an \*STS taxpayer for an income year if:

- (a) it carries on a \*business in that year; and
- (b) it has an \*STS average turnover for that year of less than \$1 million; and

- (c) the sum of the \*adjustable values of the \*depreciating assets held by it and other entities with which it is grouped is less than \$3 million at the end of that year: section 328-365.

10. Subsection 328-50(2) describes the purpose of these eligibility rules as being to prevent entities other than eligible small businesses from taking advantage of the benefits offered by the STS.

### **Outline of the STS grouping rules**

11. The STS is directed towards small business, with particular focus on the smallest business sector. In recommending the introduction of the STS, the Ralph Committee's report, *Review of Business Taxation: A Tax System Redesigned* identified the need for the STS to contain rules preventing larger businesses from gaining access to the benefits of the STS. Of particular concern was the potential for a larger business to be structured or restructured into several smaller operations, one or more of which would be eligible to be an \*STS taxpayer.<sup>2</sup>

12. Subdivision 328-F addresses these concerns through the grouping rules in section 328-380 which operate to group 'related' entities. Section 328-365 then applies so that the turnover and depreciating assets of the broader group are taken into account when determining whether an individual member of the group is eligible to enter the STS.

13. Section 328-380 operates by grouping entities that can be seen as related because of transparent connections such as shareholding or fixed entitlements under a trust deed. It also operates to group entities which may superficially appear unrelated but which in substance cannot be viewed as independent of each other. This is achieved through the \*STS affiliate concept in subsection 328-380(8). The \*STS affiliate concept looks to the underlying relationship between two entities to determine whether in substance, one can properly be viewed as carrying on a business independently of the other. Similarly, the grouping test for trusts that are not \*fixed trusts in paragraph 328-380(4)(c) examines the underlying relationship between an entity and the trustee.

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<sup>2</sup> Ralph Committee's report, *Review of Business Taxation: A Tax System Redesigned*, page 576.

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## **Eligibility as an STS taxpayer - STS average turnover less than \$1 million**

14. To be eligible to be an \*STS taxpayer for an income year, an entity must have an \*STS average turnover for the income year of less than \$1 million: paragraph 328-365(1)(b).

### ***Calculating STS average turnover for a year***

15. Under the general rule in subsection 328-370(1), an entity's \*STS average turnover for an income year is the average of its \*STS group turnovers for any three out of the four previous income years (not including the current year). This is known as the 'look back' method of calculating \*STS average turnover for a year.

16. However, an entity may not satisfy the \*STS average turnover test under the look back method, or it may find that it cannot use this method because it did not carry on a business in any of the four previous income years. In either case, under subsection 328-370(3) it can instead calculate its \*STS average turnover for an income year using the average of its \*STS group turnover for the current income year and reasonable estimates of its \*STS group turnovers for the following two income years. This is known as the 'look forward' method of calculating \*STS average turnover.

17. To work out its \*STS average turnover for an income year, an entity's first step therefore is to identify which income years it is going to take into account in working out this average under section 328-370.

18. The next step is to work out its \*STS group turnover for each of those years.

### ***STS group turnover***

19. The term \*STS group turnover is defined in section 328-375. Under this definition, an entity's \*STS group turnover for an income year is the sum of the \*value of the business supplies made by the entity in the income year and the \*value of the business supplies made in that year by the entity's 'grouped entities'. This figure is reduced by the \*value of the business supplies made between the entity and its grouped entities, and between the grouped entities themselves.

20. To work out its \*STS group turnover for an income year, an entity will therefore need to know which entities, if any, are its grouped entities for that year.

21. For example, if the entity is working out its \*STS average turnover for a year using the average of its \*STS group turnovers for three out of the four past income years, the entity will need to work

out which entities (if any) were its grouped entities in each of those previous three income years.

22. This is done by applying the grouping rules in section 328-380 to the entity and to the relevant surrounding circumstances, as they existed in each of those years.

23. An entity working out its \*STS average turnover using the average of its \*STS group turnovers for the current and following two income years will need to work out which entities are its grouped entities in the current year and which entities will be its grouped entities in the following two income years. This is done by applying the grouping rules in section 328-380 to the entity and to the relevant surrounding circumstances as they exist in the current year and as they are reasonably expected to exist in each of the following two income years.

#### ***Grouped entities under section 328-380***

24. Under paragraph 328-365(1)(c), an entity's 'grouped entities' for an income year are the entities whose \*value of the business supplies is grouped with its own under section 328-380.

25. The \*value of the business supplies made by an entity will be grouped with that of another under section 328-380 if:

- (a) either entity controls the other in the way described in section 328-380: paragraph 328-380(1)(a);
- (b) both entities are controlled in that way by the same third party: paragraph 328-380(1)(b); or
- (c) the entities are \*STS affiliates of each other: paragraph 328-380(1)(c).

#### ***Role of the STS affiliate definition***

26. The term \*STS affiliate is defined in subsection 328-380(8) as follows:

‘An entity is an STS affiliate of yours if the entity acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the entity's \*business.’

27. The definition of \*STS affiliate plays a two-fold role in identifying which entities were the entity's grouped entities in a previous income year or which entities will be its grouped entities for the current and following two income years.

28. The first role is in relation to the rule in paragraph 328-380(1)(c). Under that paragraph a grouped entity will be one that

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is an \*STS affiliate of you, if you are also an \*STS affiliate of it. (e.g., two entities in what might loosely be called a 'joint venture'.)

29. The second rule relates to the rules in paragraphs 328-380(1)(a) and 328-380(1)(b). Under these rules, a grouped entity will be one that 'controls' you or is 'controlled' by you, or one where you both are 'controlled' by the same third entity. Subsections 328-380(3), (4), (5) and (6) set out certain of the rules under which it is determined whether one entity 'controls' another. Under these rules, an entity 'controls' another if it *and/or its* \*STS affiliate(s) 'control' that other entity in one of the ways specified in section 328-380.

30. To work out its grouped entities in a previous income year, an entity will therefore firstly need to consider which entities, if any, were its \*STS affiliates in that past year. To determine this, the \*STS affiliate definition needs to be applied to the entity and to the relevant surrounding circumstances as they existed in that past year. To work out its grouped entities for the current and each of the following two income years, the entity will need to determine which entities, if any, are or will be its \*STS affiliates in each of those years. To determine this, the \*STS affiliate definition will need to be applied to the entity and to the relevant surrounding circumstances as they exist and are reasonably expected to exist in the current and following two income years.

## Ruling

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### The scope of the STS affiliate definition

31. The \*STS affiliate definition in subsection 328-380(8) does not apply where the potential \*STS affiliate acts or could reasonably be expected to act as another directs or wishes, or in concert with it, only in relation to isolated transactions or on an irregular, *ad hoc* basis. For the definition to apply, the potential \*STS affiliate must act in accordance with the entity's directions or wishes or in concert with it, or could reasonably be expected to so act, in relation to all or a substantial part of the affairs of the potential \*STS affiliate's business.

32. This reflects the intended effect of the \*STS affiliate definition. This is to group entities that may superficially appear unrelated but which in substance have a high degree of connection and involvement with each other. The \*STS affiliate definition is intended to apply where that degree of connection is such that, in substance, one business cannot be seen as being carried on independently of the other. (See paragraphs 2.38 and 2.40 of the Explanatory Memorandum to the *New Business Tax System (Simplified Tax System) Act 2001*.)

33. Significantly, it follows from the definition that an entity that does not carry on a business cannot be an \*STS affiliate.

#### ***Non resident entities***

34. The \*STS affiliate definition applies to both resident and non-resident entities. Neither this definition, nor the definition of 'entity' in subsection 960-100(1), contain any restrictions that would operate to preclude a non-resident entity being an \*STS affiliate. This means that in determining which entities it is grouped with, an entity will need to consider its relationship, and the relationships of its \*STS affiliates, with both resident and non-resident entities.

#### ***Partnerships***

35. Subsection 328-380(9) ensures that partners in a partnership are not \*STS affiliates of each other simply because they act in concert with each other in relation to the affairs of the partnership business. To be \*STS affiliates of each other, the partners would need to act in the relevant way in relation to a business activity external to the partnership business.

36. However the question of whether the partnership itself is an \*STS affiliate of the individual constituent partners is not affected by the rule in subsection 328-380(9). The partnership will be an \*STS affiliate of a partner in that partnership if the partnership acts in accordance with the individual partner's directions or wishes, or in concert with it or could reasonably be expected to do so in relation to all or a substantial part of the partnership's business affairs.

37. A partner or other entity may also be taken to control the partnership and be grouped with it on that basis under subsection 328-380(5). The partnership itself may be grouped with another entity if the partnership controls it under subsection 328-380(6).

#### **Applying the two limbs of the STS affiliate definition – 'acts' or 'could reasonably be expected to act'**

38. The first limb of the \*STS affiliate definition looks at the actual acts of the potential \*STS affiliate to see if it acts, or has acted, in accordance with the entity's directions or wishes or in concert with the entity in relation to the potential \*STS affiliate's business affairs (i.e., 'acts in the relevant way').

39. Where the STS affiliate definition is being applied to a past income year, the second limb of that definition looks at whether the potential \*STS affiliate '***could reasonably be expected***' to have acted in the relevant way in that year despite not actually having done so.

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40. Where the \*STS affiliate definition is being applied to the current or a future income year, the second limb of that definition looks at whether the potential \*STS affiliate ***'could reasonably be expected'*** to act in the relevant way in any of those years.

41. The three categories of behaviour caught by the \*STS affiliate definition (i.e., acting according to the directions, wishes or in concert with an entity) represent alternatives in terms of control, influence or cooperation. Only one of these alternatives needs to be present for the definition to apply.

### ***Applying the STS affiliate definition to past years – the first limb***

42. For an entity to determine whether another entity was its \*STS affiliate in a previous income year (eg., in calculating its \*STS group turnover for that year), it needs to consider whether the potential \*STS affiliate acted in the relevant way during that year.

43. Whether the potential \*STS affiliate did act in the relevant way in the past year will be a matter of historical record for the purposes of the first limb of the definition.

### ***Applying the STS affiliate definition to past years – the second limb***

44. Even if the potential \*STS affiliate did not act in the relevant way in that past year, it still needs to be considered, for the purposes of the second limb of the definition, whether it could reasonably be expected to have acted in the relevant way in relation to that past year.

45. Whether it could reasonably have been expected to act in that way is to be determined based on evidence of events, transactions or relationships present in that earlier year. It can also be determined by reference to evidence of this kind from years before the past year in question where the effect of those events, transactions or relationships could reasonably be expected to have continued into the year in question. The process of arriving at a reasonable expectation that a potential \*STS affiliate will act in a relevant way is explained below at paragraphs 49 to 56.

### ***Applying the STS affiliate definition to current or future years***

46. Where an entity is working out its \*STS average turnover for the current income year using the average of its \*STS group turnovers for the current and following two income years, it will need to determine:

- (a) whether the potential \*STS affiliate acts or has acted in the relevant way in the current year;

- (b) if it has not, whether it could reasonably be expected to have done so; and
- (c) whether it could reasonably be expected to act in the relevant way in each of the following two income years.

47. Again, whether the potential \*STS affiliate acts or has acted in the current year in the relevant way will be a matter of historical record.

48. Whether the potential \*STS affiliate could reasonably be expected to have acted in that way in the current year even though it did not actually do so, and whether it can reasonably be expected to do so in either or both of the following income years is examined below.

#### ***Meaning of ‘could reasonably be expected’***

49. In *FC of T v. Peabody* (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344 the full High Court, in considering the meaning of the phrase ‘might reasonably be expected’ as it appears in section 177C of the ITAA 1936, held<sup>3</sup> that ‘[a] reasonable expectation requires more than a possibility’. In its view the phrase involves a prediction that must be sufficiently reliable for it to be regarded as reasonable.<sup>4</sup>

50. The requirement that the expectation as to the entity’s actions be capable of description as ‘reasonable’ was also adopted in *News Corporation Ltd v. National Companies and Securities Commission* (1984) 5 FCR 88; (1984) 57 ALR 550 and *A G’s Dept v. Cockcroft* (1986) 10 FCR 180; (1986) 64 ALR 97; (1986) 12 ALD 468.

51. It can reasonably be expected that a potential \*STS affiliate will act, or would have acted, in the relevant way where the entity stands in a relationship of control or influence over the potential \*STS affiliate in the relevant income year.

52. The conclusion that such a relationship exists or existed in the relevant year may be based on:

- (a) inferences drawn from events, transactions or patterns of behaviour which show that the entity has been, is, or will be able to direct or influence the potential \*STS affiliate’s behaviour; and

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<sup>3</sup> *FC of T v. Peabody* (1994) 181 CLR 359 at 385; 94 ATC 4663 at 4671; (1994) 28 ATR 344 at 353

<sup>4</sup> See also Woodard J’s consideration of this phrase in *News Corporation Ltd v. National Companies and Securities Commission* (1984) 5 FCR 88, (1984) 57 ALR 550 where his Honour held at FCR 101, ALR 561: “A reasonable expectation of an event requires more than a possibility, risk or chance of the event occurring.”

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- (b) the presence of a relationship between the two entities which enables or has enabled the entity to influence or direct the potential \*STS affiliate.

53. The types of relationships that may constitute a relationship of control or influence include:

- (a) family or other close personal relationships;
- (b) financial relationships and dependencies; and
- (c) relationships created through links such as common directors, partners or shareholders.

54. However even where such a relationship is present, it must be of sufficient strength to enable the entity to direct or influence the potential \*STS affiliate's actions in relation to all or a substantial part of the affairs of the latter's business. If, having regard to the full facts and circumstances of the particular case, it is evident that, despite that relationship the potential \*STS affiliate cannot reasonably be expected to act in the relevant way, then it will not come within this particular part of the \*STS affiliate definition.

55. The kinds of considerations which may show that a potential \*STS affiliate cannot reasonably be expected to act in the relevant way, notwithstanding the strength of a particular relationship include:

- (a) a pattern of conduct which shows that despite the presence of a relevant relationship, it is the entities' practice not to involve themselves in each other's business affairs;
- (b) a pattern of conduct which shows that despite the presence of a relevant relationship and attempts to influence or direct the potential \*STS affiliate, it is the potential \*STS affiliate's practice not to act as the other entity wishes or directs;
- (c) whether the potential \*STS affiliate has an overriding relationship with another entity that will prevent it from acting as the entity directs or wishes;
- (d) whether the potential \*STS affiliate is bound by obligations which prevent it from acting as the other entity wishes in relation to the overall affairs of the business;
- (e) whether to act as the other entity wishes would be inconsistent with the interests of the potential \*STS affiliate.

56. This is discussed further at paragraphs 103 to 139 in the Explanations and Examples part of this Ruling.

*Meaning of 'in concert'*

57. Under the definition of \*STS affiliate, an entity will be your \*STS affiliate if it acts in concert with you, or could reasonably be expected to do so, in relation to the affairs of its \*business.

58. The term 'in concert' is not defined in Division 328 or elsewhere in the ITAA 1997. It therefore needs to be interpreted according to its ordinary meaning and legislative context.

59. To ensure that the 'in concert' test in the \*STS affiliate definition only operates to group entities that are sufficiently related to warrant grouping, a potential \*STS affiliate will only be regarded as acting 'in concert' with another entity for the purposes of subsection 328-380(8) where:

- (a) it is acting together with the other entity in pursuit of a common goal or objective; and
- (b) that common goal or objective is the carrying on of a business by the potential \*STS affiliate with a substantial degree of connection with or dependence on the business carried on by the other entity.

60. The overall degree of that connection must be such that the potential \*STS affiliate cannot be viewed as operating independently of the other entity.

*Franchises*

61. The term 'in concert' does not automatically operate to group franchisees and franchisors.

62. To be grouped with each other as \*STS affiliates under paragraph 328-380(1)(c) it is necessary that each entity is the \*STS affiliate of the other. A franchisee and a franchisor will therefore not be grouped under that provision where only one of those entities is the \*STS affiliate of the other. Whether a franchisee acts in concert with the franchisor in the conduct of the franchisee's business, or whether a franchisor's business is conducted in concert with a franchisee will in each case depend on the nature of the franchise agreements between the two parties and any other relevant factors such as those described in the table at paragraph 65.

*Determining if two entities are acting in concert*

63. The following table describes some factors that are relevant to determining whether the potential \*STS affiliate's business has the required degree of dependence and/or connection with the other entity's business.

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64. Under the \*STS affiliate definition it is sufficient if the potential \*STS affiliate’s business has the required degree of connection with or dependence on the other entity’s business. It is not necessary for the other entity’s business to also have a substantial degree of connection with, or dependence on, the potential \*STS affiliate’s business.

65. No factor is necessarily decisive, nor does each one necessarily have to be given the same weight. Rather, determining whether the potential \*STS affiliate is acting in concert with the entity in relation to the business affairs of the former will be a matter of overall impression. Nonetheless, factors (G) to (I) inclusive will not be sufficient in themselves, to conclude that two entities are relevantly acting in concert with each other.

<b>Factor</b>	<b>‘for’ there being a substantial connection</b>	<b>‘against’ there being a substantial connection</b>
A. Nature and extent of commercial dealings between the two entities	Goods and/or services supplied by the potential *STS affiliate to the other entity account for a large percentage of the potential *STS affiliate’s business and/or a large proportion of its income.	No or a low level of supplies from the potential *STS affiliate to the other entity.
B. Common resources, facilities or services	The two entities share a number of facilities or services necessary for the operation of the businesses. For example, the entities share business premises, or staff, or management and accounting services, or income producing assets. The more facilities or resources that are shared, the stronger the indication that the two businesses have a substantial	The two entities share no or few common resources and operate from separate business premises, use different assets, employ different staff, are managed by different individuals and/or use different accounting services.

	connection.	
C. Involvement in managerial decisions and day to day management	The entity actively participates in the potential *STS affiliate's day to day management and/or decision making processes. For example, it actively takes part in meetings of a company's board of directors or a partnership's partners' meetings.	The entity plays no part in the management of the potential *STS affiliate's business.
D. Financial interdependencies	The potential *STS affiliate is dependant on the other entity for access to loans or guarantees. Alternatively, the two entities could share common banking facilities such as a joint accounts or the same account signatories.	The potential *STS affiliate obtains its financial support from other sources. The entities maintain separate banking arrangements.
E. Common flow of profits	The profits from the businesses carried on by the two entities are ultimately received by the same entities.	The profits from the businesses carried on by the two entities are received by unconnected entities.
F. Common ownership/capital	The entities share the same owners, for example the same shareholders. The source of the capital underpinning the two entities is the same. For example, two partnerships sharing the same partners.	The ownership or capital backing of the two businesses can be traced to different sources.
G. Shared purchasing of goods or services	The two entities coordinate their orders for goods or services. Alternatively, the potential *STS	The two entities purchase goods or services independently of each other.

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	affiliate is under an obligation to order through the other entity. A further alternative is where the entity determines which goods or services the potential *STS affiliate should order and/or orders on its behalf.	
H. Common customers	The entities agree to share a customer's overall business. The entity directs customers to the potential *STS affiliate or uses it to obtain custom.	The entities maintain a separate client base. The entities do not seek to pursue marketing opportunities through each other.
I. Similar kind of business	The entities provide identical or similar goods or services.	The nature of the business carried on by the potential *STS affiliate is inherently different to that of the other entity.

**The non-fixed trust control rule**

66. Paragraph 328-380(4)(c) provides that an entity will control a trust that is not a \*fixed trust where a trustee of the trust is accustomed, or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the entity, its \*STS affiliates or the entity together with its \*STS affiliates.

***Accustomed to act***

67. For the purposes of this test, a trustee will only be regarded as accustomed to act in accordance with the other entity's directions, instructions or wishes where it has done so on a recurrent basis. Isolated instances of such behaviour will not be a sufficient basis on which to conclude that an entity is accustomed to act as another directs, instructs or wishes. The relative importance of the matters in relation to which the trustee has acted as directed or instructed are also relevant to determining whether the trustee can be regarded as accustomed to act as another directs, instructs or wishes. The more important the matter the stronger the grounds for concluding that the

trustee is accustomed to act as the other entity directs, instructs or wishes. (*Case 29/96*, 96 ATC 330; *Case 10,898* (1996) 32 ATR 1259).

***Might reasonably be expected to act***

68. For the purposes of determining whether a trustee ‘might reasonably be expected to act’ as directed, the approach outlined at paragraphs 51 to 55 for the \*STS affiliate definition should be taken. The entity will need to determine whether it stands in a position of control or influence over the trustee.

69. In the context of paragraph 328-380(4)(c), this will involve considering the past or current actions of the trustee together with any relevant dealings or transactions involving the entity and the trustee. This may show that the entity has been or is able to direct or influence the actions of the trustee.

70. The relationship between the entity and the trustee also needs to be examined. The trustee may be a relative or associate of the entity, or an independent professional advisor, or a professional trustee. The differing nature of the relationship will affect whether it can be viewed as of sufficient strength to enable the entity to direct or influence the trustee’s actions in relation to all or a substantial part of the trust’s business. For example, if the trustee is a corporate trustee and the entity controls that company, the inference of control or influence will be stronger than if the trustee is an arm’s length professional trustee.

71. The entity’s own standing in relation to both the trustee and the trust will also be relevant. For example, under the trust deed the entity may be the settlor and/or a beneficiary of the trust or it may act as an appointor.

72. The use by an entity of a ‘memorandum of wishes’ such as that discussed in *Wily v. Fuller* [2000] FCA 1512, or a similar document, to formalise its relationship with the trustee of a trust will also be relevant. In that case, a ‘memorandum of wishes’ had been sent to the trustee with its agreement requesting it wherever possible to exercise its powers and discretions in accordance with the wishes of the other entity.

73. When considering if the relationship with the trustee alone constitutes a reasonable basis for expecting the trustee to act as the entity directs, instructs or wishes, it will be relevant to consider whether to act in that way would cause the trustee to breach any of its obligations as trustee at law and/or under the trust deed.

74. Generally, an arm’s length professional trustee would not be expected to act in accordance with the other entity’s directions,

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instructions or wishes if to do so would breach its obligations as trustee. (See for example Hill J's remark in *Wily v. Fuller* at paragraph 66 of the decision.)

75. However, in cases where the trustee is closely related to or controlled by the entity, it may be that because of that relationship and/or the motives of those parties, for example the obtaining of a tax benefit, the trustee may more readily be expected to act in breach of its obligations as trustee. See, for example, the arrangements considered in *Case X58* 90 ATC 430; *Case 6021* (1990) 21 ATR 3466 where a corporate trustee was held to have acted in excess of power and in breach of trust in pursuit of a tax benefit with another entity. In that case each of the entities involved, including the relevant corporate trustee, were all ultimately controlled and/or owned by one individual or members of his family.

76. Where the trustee is a professional advisor it will also be relevant to consider, among other things, whether the professional advisor is financially dependent on fees derived from providing trustee services, together with whether a failure to act in accordance with the entity's directions, instructions or wishes would jeopardise the continuation of that fee income.

77. The presence in the trust deed of a requirement that the trustee should have no regard to such directions, instructions or wishes will not remove the need for the entity to consider the actual circumstances of the case to determine whether the trustee acts, or could reasonably be expected to act, in the relevant way.

78. Under paragraph 328-380(4)(c) an entity needs to determine whether or not the trustee of a trust is accustomed, or under an obligation (whether formal or informal), or might reasonably be expected to act in accordance with the entity's directions or wishes, as set out in the paragraphs above. However, paragraph 328-380(4)(c) will also apply to say that the entity exercises control over the trust where this behaviour, or expected behaviour, on the part of the trustee occurs in relation to the directions or wishes of any of the entity's \*STS affiliates, or in relation to the combined directions or wishes of any of the entity's \*STS affiliates, or in relation to the combined directions or wishes of the entity together with its \*STS affiliates. In considering the relationship between its \*STS affiliates and the trustee, the entity should take into account the same range of considerations as taken into account for itself under paragraphs 69 to 77.

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## Date of effect

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79. This Ruling applies to assessments for income years starting on or after 1 July 2001 to which Division 328 applies.

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## Explanations and Examples

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### STS average turnover

80. To be eligible to be an \*STS taxpayer for an income year, an entity must have an \*STS average turnover for that income year of less than \$1 million.<sup>5</sup>

81. The way in which the entity must work out its \*STS average turnover for an income year is explained above at paragraphs 14 to 30.

82. As those paragraphs explain, an entity's \*STS average turnover for a year will be worked out by reference to its \*STS group turnovers for a number of years.

83. An entity's \*STS group turnover for an income year is made up of the \*value of the business supplies it has made during that year and the \*value of the business supplies its grouped entities made in that year.

84. To work out its \*STS group turnover for a year an entity therefore needs to know:

- (a) which entities (if any) are its grouped entities for that year; and
- (b) the \*value of the business supplies made by those entities in that year.

85. To work out which entities are its grouped entities for a particular year, an entity will need to apply the STS grouping rules in section 328-380. Importantly, those rules will need to be applied to the entity and to the relevant surrounding circumstances as they exist or existed in that particular year.

86. This means that where the entity is working out its \*STS group turnover for a past income year, the STS grouping rules will need to be applied to the entity and to the relevant surrounding circumstances as they existed in that past income year. If the entity is working out its \*STS group turnover for the current or a future income year, the STS grouping rules will need to be applied to the entity and to the relevant surrounding circumstances as they exist in the current year and are reasonably expected to exist in the future year.

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<sup>5</sup> paragraph 328-365(1)(b).

***Non-resident entities***

87. The STS grouping rules, including the \*STS affiliate definition, apply to both resident and non-resident entities. This is because no aspect of the wording of these rules, or of the definition of 'entity' in subsection 960-100(1), restricts their application to resident entities. Where it is grouped with a non-resident entity, an entity will need to include the \*value of the business supplies made by that non resident entity when working out its own \*STS group turnover for the relevant year.

**The STS grouping rules**

88. To work out its grouped entities for an income year under the STS grouping rules, the entity needs to determine which entities, if any, are its \*STS affiliates for that year.

89. This is because of the twofold role the \*STS affiliate concept has in the STS grouping rules. This twofold role is explained above at paragraphs 27 to 30.

**STS affiliate**

90. The term \*STS affiliate is defined in subsection 328-380(8). Under this definition, an entity will be your \*STS affiliate if it acts, or could reasonably be expected to act, as you direct or wish, or in concert with you, in relation to the affairs of its business.

91. The definition does not however specify when an entity could reasonably be expected to act as another directs or wishes or in concert with it.

***Meaning of 'could reasonably be expected'***

92. In *FC of T v. Peabody* (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344 the full High Court held that '[a] reasonable expectation requires more than a possibility'.<sup>6</sup> In its view, the phrase involves a prediction that must be sufficiently reliable for it to be regarded as reasonable.

93. Hill J in the Federal Court decision of *Peabody v. FC of T*<sup>7</sup> also considered the reasonable expectation test in the context of section 177C of the ITAA 1936. His Honour held that the word

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<sup>6</sup> *FC of T v. Peabody* (1994) 181 CLR 359 at 385; 94 ATC 4663 at 4671; (1994) 28 ATR 344 at 353

<sup>7</sup> *Peabody v. FC of T* (1993) 40 FCR 531, at 541; 93 ATC 4104, at 4112; (1993) 25 ATR 32, at 40

‘reasonable’ must be understood as distinguishing what is required from an expectation that is ‘unreasonable, irrational or absurd’. He further held that the word ‘expectation’ requires the hypothesis to be one that proceeds beyond the level of a mere possibility to become one which is the expected outcome.

94. The requirement that the expectation be reasonable, as distinct from something irrational, absurd or ridiculous was also emphasised by the Full Federal Court in *A-G’s Dept v. Cockcroft* (1986) 10 FCR 180, at 190; (1986) 64 ALR 97, at 106; (1986) 12 ALD 468, at 470 when considering subsection 43(1) of the *Freedom of Information Act 1982 (Cth)* and the phrase ‘could reasonably be expected to prejudice’. Bowen CJ and Beaumont J held, at FCR 190; ALR 106; ALD 470, that the proper inquiry is whether the expectation claimed was reasonably based.

95. The Courts considered these principles to accord with both the ordinary meaning of the words ‘might reasonably be expected’ and the purpose of the legislative schemes in which they appeared. These principles are equally applicable when considering the reasonable expectation test in the \*STS affiliate definition.

96. As explained above at paragraphs 38 to 48, the second limb of the \*STS affiliate definition looks at whether the potential \*STS affiliate **could reasonably be expected** to act in the relevant way in the income year in question.

97. Where the entity is applying the \*STS affiliate definition to a past income year, the potential \*STS affiliate can reasonably be expected to have acted in the relevant way in that year, despite not actually having done so, if the entity stood in a relationship of influence or control over the potential \*STS affiliate in that past year.

98. Where the entity is applying the \*STS affiliate definition to the current or a future income year, it will be reasonable to expect that the potential \*STS affiliate will act in the relevant way in one or more of those years if the entity stands or expects to stand in a relationship of influence or control over the potential \*STS affiliates in any of those years.

99. To determine if the entity stands in a position of control or influence over the potential \*STS affiliate in a year, the past or current actions of the potential \*STS affiliate should be considered together with any relevant transactions or dealings it and the entity have entered into. In the context of the definition of \*STS affiliate, relevant actions will be those to do with the interaction between the entity and the potential \*STS affiliate concerning the operation of all, or a substantial part of, the potential \*STS affiliate’s business. These may support or rebut the inference that the entity stands in a position of control or influence by showing that the potential \*STS affiliate acts, has acted, or will act as the entity directs or wishes.

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100. The entity should also consider the nature of any relationships between the entity and the potential \*STS affiliate to determine whether the entity stands in a position of control or influence over the potential \*STS affiliate by virtue of that relationship.

101. In considering the relationship between the two, the entity should examine whether there are other factors present which indicate that the potential \*STS affiliate cannot reasonably be expected to act in the relevant way despite the presence of that relationship. The entity must evaluate whether the relationship is of sufficient strength to outweigh any other circumstances which might cause the potential \*STS affiliate to act contrary to its wishes or instructions or in concert with it in relation to the affairs of the potential \*STS affiliate's business.

102. Where there is such a relationship between the entity and the potential \*STS affiliate, and no overriding circumstances are present, there will be more than a chance or possibility that the potential \*STS affiliate will act as the other entity directs or wishes or in concert with it. As a result, there is a sufficient basis on which to conclude that the potential \*STS affiliate could reasonably be expected to act in the relevant way.

## ***The relationship between the entities***

### *Family or other close personal relationships*

103. In considering whether it can direct or influence the actions of the potential \*STS affiliate, the entity will need to consider whether it has a familial or other close personal relationship with the potential \*STS affiliate. This is because that relationship may give the entity the ability to influence or direct the way in which the potential \*STS affiliate conducts its business. This is due to the emotional ties and sense of duty, obligation or loyalty that are commonly seen as flowing from familial or other close personal relationships. Similarly, the potential \*STS affiliate may reasonably be expected to comply with the entity's wishes or directions because of this sense of duty, obligation or loyalty. The strength of this expectation will be affected by matters such as:

- (a) whether the two parties enjoy trusting and harmonious relations; and
- (b) whether the potential \*STS affiliate is subject to a more powerful source of influence or control.

*Financial relationships*

104. Any financial relationships or dealings between the two entities should also be taken into account, particularly where these render the potential \*STS affiliate financially dependent on the entity on an on-going basis. A finding that the potential \*STS affiliate is financially dependant on the entity is a factor that would support a conclusion that the potential \*STS affiliate might reasonably be expected to act as the entity wishes or directs. This is because it can reasonably be expected to comply with these directions or wishes to avoid jeopardising the financial support it needs to maintain its profitability or simply to continue in business. Typically, arm's length loans from unassociated third party lenders do not carry with them this sort of control.

*Relationships based on other common links*

105. The entity should also consider any other relevant relationships or links between it and the potential \*STS affiliate that may support a conclusion that the potential \*STS affiliate will act as the entity directs or wishes. Examples of such links include common directors, shareholders or partners. This type of relationship is relevant because it may reveal that each entity is ultimately controlled or owned by the same group of individuals. Depending on the circumstances of the case, this may provide a mechanism by which one entity can seek to direct or influence the activities of the other entity in the relevant way.

*What type of entity is the potential STS affiliate?*

106. In considering its relationship with the potential \*STS affiliate, the entity should take into account whether the potential \*STS affiliate is a company, individual, partnership or trust. This may affect whether the entity stands in a position of control or influence over the potential \*STS affiliate. The entity should also take into account its own entity type.

*Companies*

107. If the potential \*STS affiliate is a company, whether or not it can reasonably be expected to act as the entity directs or wishes will depend on whether the majority shareholders and/or directors of the company can reasonably be expected to act as the entity wishes or directs. This requires an examination of the nature of the relationships between the entity and the majority shareholders and/or directors, together with the nature of the relationships between those shareholders/directors.

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108. It then needs to be determined whether the nature of these relationships suggest that the entity has a relationship with the majority shareholders/directors on the basis of which it can seek to direct or influence the actions of the company.

## *Individuals*

109. Where the potential \*STS affiliate is an individual, the entity will only need to consider the nature of its relationship with that individual. The question to be determined remains the same: is the relationship between the two such that the entity can direct or influence the actions of the potential \*STS affiliate?

## *Partnerships*

110. Where an entity that is not a partner in a partnership is determining whether that partnership is its \*STS affiliate, it will need to examine its relationship with each of the partners in the partnership, together with the relationships between the partners, to determine whether it has a relationship with the partnership whereby it is able to influence or direct the activities of the partnership.

111. The entity will need to have such a relationship with a sufficient number of partners able to control, either formally or informally, the partnership, before it could reasonably be expected that the partnership will act as the entity wishes or directs.

## *Trusts*

112. Where the potential \*STS affiliate is a trust, the entity will need to have a relationship with a trustee of the trust on the basis of which it could reasonably be expected that the trustee would act as the entity directs or wishes.

## ***Other considerations***

113. A consideration of the full facts and circumstances of the case may show that despite the presence of a particular kind of relationship between the entity and the potential \*STS affiliate, the entity cannot be shown to be in a position of control or influence over the potential \*STS affiliate.

114. The following are examples of the kinds of considerations which may show that a potential \*STS affiliate cannot reasonably be expected to act in the relevant way notwithstanding its relationship with that entity.

*Independent business affairs*

115. The manner in which the two entities have conducted their respective businesses in the past may show that despite the relevant relationship between them, the entity does not take an interest in the affairs of the business conducted by the potential \*STS affiliate.

116. Past conduct may also show that while the entity has sought to direct or influence the business affairs of the potential \*STS affiliate on the basis of its relationship with the potential affiliate, the potential affiliate's practice is to ignore or disregard those wishes or instructions notwithstanding the relationship.

117. If a review of the previous behaviour of the entities shows that either of the situations above exists, it will not generally be reasonable to expect that the potential \*STS affiliate will act as the other entity wishes, directs or in concert with it notwithstanding the relevant relationship. This is so provided the entity has no reasonable cause to believe or expect that:

- (a) it will depart from its past practice of not seeking to direct or influence the potential \*STS affiliate's business affairs during the relevant income year; or
- (b) the potential \*STS affiliate will change its past practice of ignoring the entity's wishes or directions during that income year.

*Other relationships*

118. While the entity may have a relationship with the potential \*STS affiliate which could reasonably be expected to enable that entity to direct or influence the potential \*STS affiliate's business affairs, the potential \*STS affiliate may also have a relationship with another entity which can be expected to prevent it acting in accordance with the first entity's wishes or directions or in concert with it.

119. For example, the first entity may have a close familial relationship with the potential \*STS affiliate. However the potential \*STS affiliate may also be commercially dependent on continuing financial support from a second entity. Depending on the facts of the particular case, it may be reasonable to expect that the potential \*STS affiliate will ignore the first entity's wishes or directions if these are inconsistent or incompatible with the wishes or directions of the second entity upon which it is financially dependent.

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## *Other obligations*

120. While the entity may have a relationship with the potential \*STS affiliate that would enable the entity to direct or influence the potential \*STS affiliate's business, the potential \*STS affiliate may be prevented from acting in accordance with the entity's wishes or directions because of its other obligations.

121. For example, where the potential \*STS affiliate is the trustee of a trust estate its duty as a trustee to avoid a conflict of duty and interest or its duty of impartiality may prevent it from acting as the other entity wishes or directs in relation to the business affairs of the trust where following those wishes or directions will cause breaches of the trustee's legal or fiduciary obligations.

## *Competing interests*

122. An entity may have a relationship with a potential \*STS affiliate that would enable it to direct or influence the business affairs of that potential \*STS affiliate. However where the business interests of that entity conflict with the business interests of the potential \*STS affiliate, it may not be reasonable to expect that the potential \*STS affiliate will act as the other entity wishes or directs. This is because, on the facts of the case, it is reasonable to expect that the potential \*STS affiliate will act according to its own best interests rather than the other entity's.

## **Example 1 - \*STS affiliates of the one entity**

123. Nick owns three snack bars. During the 2001-2002 income year, he decided to sell two of these snack bars to two of his children. Nick now owns just one of the snack bars. It has an average annual turnover of \$200,000. Nick also owns a wholesale food business.

124. Nick wants to know if either of the children he sold his snack bars to will be his \*STS affiliates for the 2001-2002, 2002-2003 and 2003-2004 income years.

125. A review of the children's actions during the 2001-2002 year show that they usually act as Nick directs or wishes in relation to a substantial part of their respective business affairs. During that year, Nick's practice was to tell his children the quantities and lines of stock they were to order, together with the prices to be paid. The children did not source stock from suppliers other than Nick's wholesale business without first consulting him. Occasionally each of the children have ignored Nick's instructions and sourced stock from more competitive suppliers.

126. Overall however, it can be seen that during the 2001-2002 income year Nick's children are acting in accordance with Nick's directions and wishes in relation to a substantial part of their respective business affairs. On this basis, the children will be \*STS affiliates of Nick for the 2001-2002 year.

127. The children's business practices in relation to stock during the 2001-2002 year will also be relevant to deciding if the children can reasonably be expected to act in accordance with Nick's directions or wishes or in concert with him in the 2002-2003 and 2003-2004 income years. This past practice shows that Nick actively seeks to influence the affairs of his children's businesses and that his children are accustomed to following his directions and wishes in this regard. The fact that Nick is the father of the individuals carrying on these businesses is also relevant to deciding if they can reasonably be expected to act in the relevant way.

128. A review of Nick's past behaviour in relation to his children's businesses shows that he has consistently sought to influence or direct a significant aspect of their affairs, namely the purchase and pricing of stock. There is nothing in the facts to suggest that Nick's active interest in these affairs is likely to cease in the near future. However, it also seems that in the past the children have sometimes been prepared to go against Nick's wishes where this has been to their commercial benefit. It is unclear whether this practice will increase.

129. Despite these uncertainties, it can be concluded that:

- (a) in the past each of the children have generally complied with Nick's wishes or directions;
- (b) none of the children appear to have a relationship with another entity which may also wish to influence the affairs of their respective businesses;
- (c) Nick's interests generally do not appear to be inconsistent with those of his children's businesses or incompatible with his children's financial interests.

130. On balance, Nick's familial relationship with these individuals, together with the other considerations above support the conclusion that his children can reasonably be expected to act as Nick wishes or directs or in concert with him in relation to the affairs of their respective businesses in the 2002-2003 and 2003-2004 income years. Therefore, they will also be his \*STS affiliates for those years.

### **Example 2 – no \*STS affiliates**

131. Assume the same facts as in Example 1, except in this case a review of the children's actions during the 2001-2002 year shows that

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they are increasingly ignoring Nick's instructions in relation to their businesses.

132. Nick has regularly told his children which stock they should be ordering from his wholesale business and the prices they will be paying for this stock. While Nick's children have continued to source particular types of stock from Nick at the prices he has set, they have also begun to source the bulk of their supplies from other sources. This is because it is more profitable for the businesses to do so. They have also begun to change the range of food offered by their snack bars and Nick's wholesale business is unable to supply some of the new lines they require.

133. Against the background of this familial relationship are the actions of the children during the year. These show that while Nick has tried to govern a significant aspect of his children's businesses, the children have chosen when they will act in accordance with these wishes and when they will not. They have only chosen to act as Nick directs in relation to a limited aspect of their stock purchasing. As a result, the children cannot be described as acting as Nick directs or wishes in relation to all or a substantial part of their business affairs. On this basis, they will not be his \*STS affiliates for the 2001-2002 year.

134. This pattern of behaviour also suggests that despite their familial relationship, Nick does not stand in a position of control or influence over the children in relation to their business affairs. It also appears that his children's commercial interests are better served by not acting as he directs or wishes. On this basis, assuming that they do not act, or could not reasonably be expected to act, in concert with him, in relation to the affairs of their respective businesses, they will not be his \*STS affiliates for the 2002-2003 or 2003-2004 years.

### **Example 3 – no reasonable expectation of acting in accordance with directions or wishes**

135. Felicia and her younger sister Rosa run a market gardening business with an average annual turnover of \$350,000. They operate this business in partnership with each other and their husbands. Their older sister, Ileana, owns and manages an office stationery business with an average annual turnover of \$800,000.

136. The partnership has suffered from severe cash flow problems. To assist her sisters' business, Ileana has made several large informal loans to their partnership. These are repaid at a non commercial rate of interest whenever a repayment can be managed. Ileana does not actively pursue the repayment of the amounts loaned. Ileana also advanced her sisters much of the start up capital needed to establish their partnership.

137. Ileana has taken an active interest in the affairs of the partnership business throughout the three years in which it has been carried on. She regularly expresses firm views as to the way in which things should be run, demands to see the partnership's accounts and expresses dismay at the decisions made by Felicia and Rosa together with their husbands. However Ileana's views are unsolicited and are usually not followed by Felicia and Rosa. Despite the continued failure to act in keeping with her views, Ileana has continued to support the partnership financially.

138. In this example, there is a family connection between the parties. On the basis of that relationship, Ileana has been a continuing source of funds for the business carried on by Felicia and Rosa in partnership with their husbands. She has also sought to influence the way in which the partnership's business is run. However, notwithstanding their financial dependency on Ileana, the usual practice of Felicia and Rosa has been to disregard Ileana's views on the partnership.

139. Accordingly, while the partnership has a significant degree of financial dependence on Ileana, the past conduct of the sisters shows that it cannot reasonably be expected that the partnership's business will be carried on as Ileana directs or wishes either because of its financial dependence on her or because it is run by her sisters. As a result, neither Ileana nor the partnership are \*STS affiliates of each other, and so will not be grouped entities on this basis. If Ileana does not formally control the partnership under subsection 328-380(5), then none of the grouping rules apply. Neither she nor the partnership have to take into account the turnover of the other, when calculating their \*STS average turnover.

### ***Meaning of 'in concert'***

140. Under the definition of \*STS affiliate, an entity can be your \*STS affiliate if it acts or could reasonably be expected to act in concert with you in relation to the affairs of its business.

141. The term 'act in concert' is not defined in Division 328 or elsewhere in the income tax law. In the absence of any definition, the term must be interpreted both according to its ordinary meaning and in keeping with the purpose and scope of Subdivision 328-F.

142. The *Macquarie Dictionary* (Second Edition) defines the term 'in concert' to mean:

'in a coordinated or organised way; together'.

143. This ordinary meaning suggests that the term 'in concert' is used in the \*STS affiliate definition to describe an entity that cannot be seen as independent of another because of the degree to which its

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business activities are combined or organised together with those of another.

144. The term ‘in concert’ has not been considered judicially in an income tax context. However in *IPT Systems v. MTIC Corporate Pty Ltd* (2000) 158 FLR 349; (2000) 36 ACSR 454; (2001) 19 ACLC 386, Owen J considered the meaning of the term ‘acting in concert’ for the purposes of paragraph 15(1)(a) of the *Corporations Act 1989*. This provides that the definition of ‘associate’ in that Act includes a person in concert with whom the primary person is acting, or proposes to act. His Honour referred to his earlier consideration of this term in *Bank of Western Australia v. Ocean Trawlers Pty Ltd* (1995) 13 WAR 407; (1995) 16 ACSR 501 and the decision in *Adsteam Building Industries Pty Ltd v. Queensland Cement & Lime Co Ltd (No 4)* [1985] 1 QdR 127; (1984) 14 ACLR 456; (1984) 2 ACLC 829. His Honour identified the following key principles from those cases:

- (a) the words “in concert” take their meaning from the context and the scope and the purpose of the legislative framework they appear in;
- (b) the term “acting in concert” involves at least an understanding between the parties as to a common purpose or object”; and
- (c) the common purpose or object can be established by inference as much as by direct evidence.

145. Further support for the principles described above can be found in the decisions of the Federal Court in *National Union of Workers v Davids Distribution Pty Ltd* (1999) 91 FCR 463; (1999) 165 ALR 550; *J-Corp Pty Ltd v Australian Builders Labourers Federated Union of Workers (WA)* (1992) 111 ALR 502; (1993) ATPR 46-099; (1992) 46 IR 263 at ALR 535-536; *Re Australasian Meat Industry Employees Union and Allied Trades Federation of Australia* (1991) 32 FCR 318; (1991) 104 ALR 199; (1991) ATPR 41-151, at ALR 208 and 215.

146. Consistent with these views and the ordinary meaning of this term, an entity will only be viewed as acting in concert with another entity for the purposes of the \*STS affiliate definition where it and the other entity act together in pursuit of a common goal or purpose.

147. In the context of the \*STS affiliate definition, that goal or purpose must be that all or a substantial part of the potential \*STS affiliate’s business is carried on with a substantial degree of connection with or dependence on the business of the other entity. The degree of that connection must be such that the business carried on by the potential \*STS affiliate cannot be viewed as separate or independent from the business carried on by the other entity. This degree of connection and/or dependence is necessary to ensure that the

\*STS affiliate definition does not apply to group unrelated businesses that genuinely operate in isolation, or independently, of each other.<sup>8</sup>

148. The table under paragraph 65 sets out some factors which should be considered when determining whether the potential \*STS affiliate conducts its business with a substantial degree of connection with the business carried on by the other entity.

#### **Example 4 – acting in concert with each other**

149. Bill and Maria are married. Bill and his father are equal shareholder/directors of a company which runs a milk bar attached to Bill and Maria's house. The company has an average annual turnover of \$700,000. Maria and her sister are equal shareholder/directors in another company which operates a separate milk bar several suburbs away. This second company has an average annual turnover of \$750,000. The capital used to start up the milk bar run by Maria's company came from the profits of the milk bar run by Bill's company. Each company maintains a separate bank account although both use the same accountant who prepares the accounts of each business at the same time each year. Each company employs a different shop assistant to help serve customers during the busiest part of the day. Maria is responsible for hiring the staff for both companies. She also arranges the wages for the staff of both companies. The companies want to know whether they are \*STS affiliates of each other and therefore grouped with each other.

150. Bill and Maria always make decisions about the business affairs of each milk bar in consultation with each other. For example, they usually place joint orders for stock with various suppliers although sometimes they will source stock from different suppliers. They also transfer stock between the milk bars where one is short of a particular line and the other has an excess. They also make joint decisions about the stock each shop should carry, the mark up for each line of goods and any expansions into new types of goods.

151. The overall conclusion is that the two companies are operating in concert with each other. While they are separate companies with different director/shareholders and employ different staff, an examination of the day to day management and operation of the business affairs of the two companies shows there is a high degree of connection between the companies' businesses. For example, they generally place joint orders and there is a regular exchange of stock between the businesses. There also appears to be a high degree of consultation on the range of goods to be stocked and the profit margins to be set for each company. Maria is also responsible for the

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<sup>8</sup> Paragraphs 2.38 and 2.40 of the Explanatory Memorandum to the *New Business Tax System (Simplified Tax System) Act 2001*.

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staffing affairs of Bill's company. As they are \*STS affiliates of each other, each company will need to include the turnover of the other when working out its \*STS average turnover.

## **Example 5 – two partnerships not acting in concert**

152. Simon and Judy are married. Simon runs a dry cleaning business in partnership with his sister. They have equal shares in the partnership business. The average annual turnover of the partnership is \$500,000. Judy runs a dry cleaning business in partnership with her friend Won. Judy and Won also have equal shares in their partnership business. The average annual turnover of their partnership is \$600,000. The businesses carried on by each partnership are located in the same suburb and each is operated under a franchise agreement with the same national dry cleaning franchise chain. Each partnership maintains its own bank accounts although the accounts for each are handled by Won's sister who is an accountant. Simon and Judy discuss business with each other and each understands the financial position of the other's partnership. However, decisions affecting the affairs of each partnership are made separately by the partners in each partnership. The partnerships have never made joint decisions about their respective business affairs. They do not share stock, equipment or staff, although some customers use both dry cleaning shops as the promotional vouchers offered by the franchise chain are redeemable at either shop. There are no financial interdependencies between the two.

153. On these facts, the two partnerships are not acting in concert. There are a number of features common to both partnerships. They both offer dry cleaning services, are part of the same franchise chain, are located in the same suburb and to an extent have shared customers. However, despite these links the partnerships are in substance still operated as distinct and independent businesses. They are operated through differently constituted partnerships, each of which maintains separate financial affairs. It is also clear that business decisions affecting each partnership are taken separately and that the day to day management of each partnership's business is independent from that of the other. As they are not \*STS affiliates of each other, the two partnerships will not be grouped and will not need to include each other's turnover when calculating their respective \*STS average turnovers.

## **Example 6 - ostensibly independent businesses acting in concert with each other**

154. Ross' Trading Trust ('RTT') is a fixed unit trust which carries on a business supplying and installing minibars to hotels and motels.

It has an average annual turnover of \$600,000. Ross' Refrigerators Pty Ltd ('RR') acts as the trustee of RTT. Ross and David are the only two directors and shareholders of RR, holding 50% of the shares each. Three quarters of the units in RTT are held by Ross' Family Trust ('RFT') which is a discretionary trust. The potential beneficiaries of RFT are Ross, his wife and their children. The remaining quarter of the units are held by David's Family Trust ('DFT'). DFT is also a discretionary trust, the potential beneficiaries being David, his wife and their children.

155. Nufridg Trading Trust ('NTT') is a fixed unit trust that carries on a business providing maintenance and upgrade services for commercial refrigeration units. It has an average annual turnover of \$600,000. Nufridg Pty Ltd ('NPL') is trustee of the NTT. Ross and David constitute one half of the board of NPL and each holds 25% of the issued shares in that company. The other two directors are David's wife and Ross' wife, who each hold 25% of the remaining shares. Three quarters of the units in NTT are held by DFT. The remaining quarter are held by RFT.



156. The business carried on by NTT was established without any capital of substance. It was originally funded by loans from RTT that are still being repaid. Ross and David have also made additional loans of smaller amounts to help NTT acquire critical items of new plant for the business. Since it started trading, NTT has made use of its connection with Ross together with RTT's name and goodwill and has regularly called on the services of two experienced employees of RTT to assist with complex maintenance and upgrade work.

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157. NTT trades from the same premises as RTT, sharing reception and administrative staff, warehouse facilities and work vans. David is responsible for the day to day management of NTT's business, but key business decisions are put to NPL as trustee for formal approval. NPL as trustee has never gone against the recommendations of David or Ross.

158. In return for the shared premises and facilities, and the use of two of its employees, NTT pays a fee to RTT each year. The amount of this fee is determined at the time RTT accounts for the year are prepared. In years where NTT's income has been higher than RTT's income, the fee has been increased.

159. NTT agrees to feature the name of RTT prominently in its promotional material and RTT does the same for NTT. Both endeavour to obtain business for each other. Approximately a quarter of RTT's sales are from customers referred through NTT. However, the customers of one are not always the customers of the other. Although both work in the same market-place, they are regarded by the market-place as distinct businesses.

160. The two trusts share the services of one accountant. They maintain different bank accounts but Ross and David are the joint signatories of each business's accounts.

161. A consideration of the factors in the table under paragraph 65 shows that:

- (a) while the two entities do not supply goods or services to each other, each actively promotes the services of the other to potential customers;
- (b) NTT trades out of RTT's business premises and uses the services of RTT's reception and administrative staff, warehouse and transport vans, and regularly uses two experienced employees of RTT;
- (c) NTT's accounts are attended to at the same time and by the same individual as RTT's and the two signatories of RTT's bank accounts are also the signatories of NTT's bank accounts;
- (d) NTT's capital backing is sourced from the same individuals that provide the capital backing behind RTT;
- (e) NTT has looked to those individuals rather than a commercial banking institution for any loans it has required in the past;
- (f) David and Ross hold all of the shares in RTT's corporate trustee RR and 50% of the shares in NTT's

corporate trustee NPL. Their wives hold the remaining 50% of the shares in NPL;

- (g) The directors of RR comprise half of NPL's board of directors, the wives of those directors making up the other half;
- (h) The day to day management of NTT is performed by one of the two directors of RR; and
- (i) 25% of NTT's profits flow to the same individuals as ultimately receive 75% of the profits of RTT.

162. Viewed together, these factors suggest that there is a substantial connection between the ownership, management and business infrastructure of NTT and that of RTT to the degree that NTT cannot be seen as genuinely independent of and separate from the business carried on by RTT. Accordingly, NTT will be RTT's \*STS affiliate.

163. Whether RTT is the \*STS affiliate of NTT will depend on whether there is a substantial connection between RTT's business and the business carried on by NTT.

164. In determining this, the following considerations are relevant:

- (a) RTT uses the business activities of NTT to promote itself and obtains approximately a quarter of its business from customers referred through NTT;
- (b) RTT shares its business premises, warehouse, transport vehicle and staff with NTT;
- (c) The signatories to RTT's bank account are the same as the signatories to NTT's bank account. The accounting for the two businesses is also done by the same individual at the same times;
- (d) The two shareholder/directors of RR also own 50% of the shares in NPL and comprise half of NPL's board;
- (e) One of RTT's directors is responsible for the day to day management of NTT's business;
- (f) RTT has made significant loans to NTT with substantial amounts still to be repaid;
- (g) The two businesses operate in a similar market offering services that can be seen as complementary to each other.

165. When viewed overall, these factors indicate that there are sufficient common threads and links between these two businesses to conclude that a substantial connection exists between them. As a result, RTT will be an \*STS affiliate of NTT. Given that each of these

businesses is the \*STS affiliate of the other, they will be grouped under paragraph 328-380(1)(c). RTT will therefore need to include NTT's turnover when working out its \*STS average turnover for an income year. NTT will need to include RTT's turnover when working out its \*STS average turnover for the year.

166. Even if RTT and NTT were not \*STS affiliates of each other, it would be necessary to determine whether they were grouped entities as a result of the operation of the grouping rules in subsections 328-380(3) and (4). In this example, they would not be because neither 'controls' the other under those rules, nor are they both 'controlled' by the same third entity.

### **The non-fixed trust control rule**

167. Paragraph 328-380(4)(c) provides that an entity will control a trust that is not a \*fixed trust where a trustee of the trust is accustomed, or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the entity, its \*STS affiliates or the entity together with its \*STS affiliates.

168. In *Case 29/96*, 96 ATC 330; *Case 10,898* (1996) 32 ATR 1259 the Administrative Appeals Tribunal considered whether a trustee of a trust estate was accustomed to acting as directed by a non-resident for the purposes of subsection 159GZE(3) of the ITAA 1936. Under that provision, a non resident was a foreign controller of a trust if (*inter alia*) the trustee of the trust was accustomed, or under an obligation, or might reasonably be expected, to act in accordance with the directions or wishes of the non resident or associates of the non resident.

169. The Tribunal held that a trustee cannot be viewed as "accustomed" to act in the relevant way where the conduct in question is isolated, or even occasional. In its opinion, the term required recurrent conduct on the part of the trustee. The Tribunal also considered that the question of recurrence could be linked to the importance or the relevant behaviour. Where the behaviour was in connection with relatively important matters affecting the affairs of the trust it was more likely that the trustee could be viewed as acting in the relevant way.

170. These principles also apply when determining whether a trustee is accustomed to act as directed for the purposes of the control test in paragraph 328-380(4)(c).

171. The test in paragraph 328-380(4)(c) also requires the entity to consider whether a trustee of the relevant trust estate might reasonably be expected to act as it directs, instructs or wishes. To decide this question, the entity should take the same approach as outlined at paragraphs 51 to 54 for determining if an entity could reasonably be

expected to act in the relevant way for the purposes of the \*STS affiliate definition.

172. Unlike the \*STS affiliate definition, however, paragraph 328-380(4)(c) requires an examination of not only the relationship between the entity and the trustee, but also the relationship between the \*STS affiliates of the entity and the trustee.

### **Example 7 – no control of non-fixed trust**

173. The Benevolent Family Trust has an average annual turnover of \$2 million. Its potential beneficiaries are George, his brother, sister, mother and any company in which either of those individuals holds at least 25% of the issued shares. George holds 50% of the shares in Widgets Pty Ltd which has an average annual turnover of \$200,000. George wants to know if either he or Widgets Pty Ltd will be considered to control the Benevolent Family Trust. If he does, Widgets Pty Ltd will be grouped with the trust as both entities will be controlled by him. Widgets Pty Ltd would then need to include the trust's turnover with its own when working out its \*STS average turnover for the year.

174. The trustees of the trust are Ann, the solicitor of George's late father, and Jenni, a close family friend of George and his late father. When he settled the trust shortly before his passing, George's father told Ann and Jenni that they were only to distribute the trust monies when they considered it to be prudent and necessary to do so. Over the past few years Ann and Jenni have been cautious when making distributions and have regularly declined to distribute moneys to any of the potential beneficiaries, even when direct requests have been made. However, on a handful of occasions in the past they have made substantial distributions to another company of which George is a majority shareholder following a request from him.

175. In this scenario, George has known the trustees for many years, is a beneficiary of the trust, and is a 50% shareholder of a company that is also a beneficiary. In this sense, he has both a personal relationship with the trustees and a financial relationship as a potential beneficiary. However, the past conduct of the trustees shows that despite these relationships they have maintained an arm's length relationship in relation to the trust affairs with all the potential beneficiaries including George and Widgets Pty Ltd throughout the life of the trust.

176. The conclusion that the trustees have exercised an independent mind as to whether or not the trust should make any particular distributions is supported by the fact that they have declined direct requests for distributions on numerous occasions. Nothing in the facts suggests that this practice could be expected to change over the course

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of the relevant year. On this basis, it cannot reasonably be expected that the trustees of the trust will act in accordance with the directions or wishes of Widgets Pty Ltd or George.

177. Accordingly, neither George or Widgets Pty Ltd will be taken to control the trust and Widgets will not need to include the trust's turnover when working out its \*STS average turnover for the year.

## **Detailed contents list**

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## Your comments

179. If you wish to comment on this draft Ruling, please send your comments promptly by 15 February 2002 to:

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### Commissioner of Taxation

19 December 2001

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Not previously released in draft form	- ITAA 1936 159GZE(3)
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<i>Related Rulings/Determinations:</i>	- ITAA 1997 8-1
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