

***TR 2006/D1 - Income tax: special income derived by a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust in relation to the year of income***

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This document has been finalised by TR 2006/7.



## Draft Taxation Ruling

# Income tax: special income derived by a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust in relation to the year of income

Contents	Para
<b>PROPOSED BINDING SECTION:</b>	
<b>What this Ruling is about</b>	<b>1</b>
<b>Previous Rulings</b>	<b>7</b>
<b>Ruling</b>	<b>8</b>
<b>Date of effect</b>	<b>66</b>
<b>NON BINDING SECTION:</b>	
<b>Appendix 1:</b>	
<b>Explanation</b>	<b>67</b>
<b>Appendix 2:</b>	
<b>Alternative views</b>	<b>232</b>
<b>Appendix 3:</b>	
<b>Your comments</b>	<b>245</b>
<b>Appendix 4:</b>	
<b>Detailed contents list</b>	<b>246</b>

### **🔒 This Ruling provides you with the following level of protection:**

This publication is a draft for industry and professional comment. It represents the Commissioner’s preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

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## What this Ruling is about

1. This Ruling explains what amounts are considered to be ‘special income’ under section 273 of the *Income Tax Assessment Act 1936* (ITAA 1936).
2. Section 273 applies to income derived by a complying superannuation fund, a complying approved deposit fund (ADF) or a pooled superannuation trust (PST). It covers private company dividends, including income derived indirectly from a dividend and non-share dividends, income from a non-arm’s length transaction, income received from a trust in the capacity of beneficiary other than by virtue of holding a fixed entitlement and non-arm’s length income received from a trust in the capacity of beneficiary with a fixed entitlement.
3. The Ruling sets out what amounts are indirectly derived from a dividend and are therefore included within subsection 273(2) by subsection 273(3). It also explains what is meant by a ‘non-share dividend’ in subsection 273(9) and how these amounts are also included within subsection 273(2). The Ruling clarifies the circumstances in which the Commissioner will exercise the discretion under subsection 273(2) to not treat a dividend as special income. This involves an explanation of how the Commissioner will have regard to the matters listed in paragraphs 273(2)(a) to (e) and what

other matters the Commissioner will consider relevant under paragraph 273(2)(f).

4. The Ruling also sets out the circumstances in which income derived from a transaction is special income under subsection 273(4).
5. Finally, the Ruling explains which trust distributions are special income under subsection 273(6) and the requirements for a trust distribution to be special income under subsection 273(7).
6. All legislative references in this Ruling are to the ITAA 1936 unless otherwise indicated.

## Previous Rulings

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7. Draft Taxation Ruling TR 2000/D11 is withdrawn on and from the issue date of this draft Ruling. To the extent that our views in that Ruling still apply, they have been incorporated in this Ruling.

## Ruling

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8. Section 273 sets out four different types of special income. These are:
  - dividends paid by a private company, including income derived indirectly from a dividend and non-share dividends;
  - income from a transaction where the parties are not dealing at arm's length;
  - income received from a trust in the capacity of a beneficiary other than by virtue of holding a fixed entitlement; and
  - non-arm's length income received from a trust in the capacity of a beneficiary holding a fixed entitlement.
9. In order for any amount to be included within special income it must be income derived in a year of income by a complying superannuation fund, a complying ADF or a PST in relation to a year of income.
10. The word 'income' in section 273 is to be interpreted widely. It can include both income according to ordinary concepts and amounts included in assessable income under a statutory provision. This means that franking credits and capital gains could be special income if they satisfy the other requirements set out below.
11. The 'income' referred to in subsections 273(6) and 273(7), which deal with trust distributions, is the amount included within assessable income under Division 6 of Part III.

12. An amount of income either has the character of being special income or it does not. When an amount of income is special income, the whole amount is special income. An amount of income that is characterised as special income cannot be divided between an amount that is special income and an amount that is not special income. The amount of income that is special income is not only the amount by which an amount of income is greater than the amount that might have been derived if the parties had been dealing at arm's length, it is the whole amount of income derived.

#### **Dividends paid by a private company**

13. Subsection 273(2) provides that a dividend that is paid by a private company to a complying superannuation fund, a complying ADF or a PST is special income of the entity unless the Commissioner is of the opinion that it would be reasonable not to treat the dividend as special income, having regard to the matters listed in subsection 273(2).

#### ***Self-assessment***

14. This Ruling sets out the way in which the discretion in subsection 273(2) will be exercised by the Commissioner. A trustee may self-assess as to whether or not to treat a dividend as special income by applying this Ruling to their particular circumstances. This Ruling is not, however, the exercise of the Commissioner's discretion. If the trustee is uncertain as to whether or not the Commissioner will exercise the discretion the trustee should seek clarification by requesting a private ruling.

#### ***Income derived indirectly from a dividend***

15. The application of subsection 273(2) is widened by subsection 273(3). Subsection 273(3) deems that income that is derived by the entity indirectly from a dividend paid by a private company is a dividend paid to the entity by the company. This means that private company dividends that are derived indirectly may also be special income under subsection 273(2). A private company dividend that is derived by a superannuation entity from an interposed entity is indirectly derived from a dividend and will be special income unless the Commissioner exercises the discretion in subsection 273(2).

***Non-share dividends***

16. Subsection 273(9) also widens the scope of subsection 273(2). It ensures that subsection 273(2) applies to distributions that are paid by a private company that are not dividends but are non-share dividends as that term is defined in section 974-120 of the *Income Tax Assessment Act 1997* (ITAA 1997). Non-share dividends are distributions to holders of equity that are not dividends paid to shareholders.

***Matters to be considered by the Commissioner***

17. In order to decide whether the Commissioner will form the opinion that it would be reasonable not to treat a dividend as special income, the Commissioner will have regard to all of the matters in paragraphs 273(2)(a) to (e) and any other matters that the Commissioner considers relevant in accordance with paragraph 273(2)(f). No one matter is determinative. The importance attached to any particular matter may vary depending on the facts of the case. While some matters may be unfavourable to the Commissioner exercising the discretion, others may be favourable.

18. The Commissioner will form the opinion that it would be reasonable not to treat the dividend as special income when the dividends are derived on an arm's length basis. The Commissioner will consider paragraphs 273(2)(a) to (e) as matters that indicate whether or not the dividends are derived on an arm's length basis. The Commissioner will consider a matter to be relevant under paragraph 273(2)(f) if it indicates whether or not the dividends are derived on an arm's length basis.

19. Dividends are only derived on an arm's length basis when the shares are acquired, the investment is maintained, and the dividends are paid on an arm's length basis. If the shares are acquired at market value, the private company is not involved in non-arm's length dealings and the rate of dividend is the same as the rate of dividend paid on other shares in the company or is reasonable having regard to commercial risk, and there are no other matters that the Commissioner will consider relevant, the Commissioner will form the opinion that it would be reasonable not to treat the dividend as special income.

20. The Commissioner will consider the matters listed in subsection 273(2) in comparison to each other. In cases where the dividend paid relates to a share which has a par value, the Commissioner will compare the partly paid value of the share with the paid-up value under paragraph (a). The cost of the shares considered under paragraph (b) will be compared with the market value of the shares at the time of acquisition, which is considered under paragraph (a). The rate of dividend considered under paragraph (c) will be compared to the cost of the shares under paragraph (b) and the market value of the shares under paragraph (a). The rate of dividend will also be compared to the rate of dividend paid on any other shares in the company, which is considered under paragraph (d).

***Value of the shares***

21. The Commissioner will, as required by paragraph 273(2)(a), have regard to the value of the shares.
22. The market value of the shares at the time the superannuation fund, ADF or PST acquires them will be compared to the cost of the shares which is considered under paragraph 273(2)(b) (see paragraphs 26 to 28).
23. The market value of the shares will also be compared to the rate of dividend to determine whether the rate of the dividend is greater than an arm's length amount. This matter is considered under paragraph 273(2)(c) (see paragraphs 29 to 35).
24. Where the shares of a company have a par value, the Commissioner will consider under paragraph 273(2)(a) the paid-up value of the shares. The paid-up value of the shares will be compared with the partly paid value of the shares. The paid-up value of the shares will also be compared with the paid-up value of shares held by other shareholders of the private company. This will be a relevant matter for the purposes of paragraph 273(2)(f).
25. If the shares in the private company are paid-up to different extents, and there are no other matters that the Commissioner considers relevant, the Commissioner will treat the dividend as special income.

***Cost of the shares***

26. The Commissioner will, as required by paragraph 273(2)(b), have regard to the cost to the superannuation fund, ADF or PST of the shares.
27. The cost of the shares will have particular relevance in comparison to the market value of the shares at the time of acquisition.
28. If a superannuation fund, ADF or PST acquires shares in a company for an amount less than the market value of those shares, this will be a significant factor that will weigh heavily in favour of the Commissioner not exercising the discretion. This will especially be the case where other shareholders in the company paid market value for their shares.

***Rate of the dividend***

29. The Commissioner will, as required by paragraph 273(2)(c), have regard to the rate of the dividend paid to the superannuation fund, ADF or PST by the private company on the shares.
30. The rate of dividend will be considered in comparison to the cost of the shares which is considered under paragraph 273(2)(b). It will also be compared to the market value of the shares under paragraph 273(2)(a).

31. The higher the rate of dividend expressed as a rate of return on the investment, the more likely it is that the rate of dividend is not an arm's length rate. If the rate of dividend is not an arm's length rate, the private company dividend will be special income. The Commissioner will take both the original cost of the shares and the value of the shares into consideration when deciding whether the rate of the dividend is excessive.

32. The Commissioner will also take into account whether the rate of return is appropriate given the level of risk. Other commercial factors may also be taken into account.

33. Another relevant factor may be the rate of dividend paid by public companies in the same industry as the private company.

34. Where the shares in the private company are of different classes, differing rates of dividend to shareholders will be an unfavourable factor unless the rate of dividend reflects the level of risk or other relevant commercial factors.

35. The rate of the dividend will also be compared to the rate of any other dividends paid on other shares in the company in accordance with paragraph 273(2)(d).

### ***Whether a dividend is paid on any other shares in the company and the rate of that dividend***

36. The Commissioner will, as required by paragraph 273(2)(d), have regard to whether the company has paid a dividend on other shares in the company and, if so, the rate of that dividend.

37. If the rate of dividend paid to the superannuation fund, ADF or PST for some or all of the shares it holds in a private company is greater than the rate of dividend paid to other shareholders, this will be a significant factor that will weigh heavily in favour of the Commissioner not exercising the discretion.

38. If, however, the differing dividend rates reflect differing underlying commercial risk, the comparative rates of dividends will be a favourable factor towards the Commissioner exercising the discretion.

### ***Whether shares have been issued in satisfaction of a dividend and the circumstances of issue***

39. The Commissioner will, as required by paragraph 273(2)(e), have regard to whether the shares have been issued in satisfaction of a dividend and the circumstances of issue.

40. The Commissioner will not consider the income to be special income just because shares have been issued in satisfaction of a dividend. However, the circumstances of issue will be considered by the Commissioner and may be an unfavourable factor towards the Commissioner exercising the discretion.

41. If the private company has issued bonus shares to all of its shareholders on the same basis, the issue of bonus shares will be a neutral factor towards the Commissioner exercising the discretion.

***Other matters that the Commissioner considers relevant***

42. The Commissioner will consider under paragraph 273(2)(f) any other matters that are relevant to determining whether or not the dividends are derived on an arm's length basis.

43. The matters that the Commissioner may consider relevant include:

- the extent to which members who are at arm's length to the private company have an interest in the superannuation fund, ADF or PST;
- the relationship between the superannuation fund, ADF or PST and the private company; and
- who the superannuation fund, ADF or PST acquires the shares from.

44. The larger the interest that members who are at arm's length from the shareholders of the private company have in the superannuation fund, ADF or PST, the more likely it is that the Commissioner will form the opinion that it would be reasonable not to treat the dividends as special income.

45. The relationship between the superannuation fund, ADF or PST and the company may include any association between any of the members of the superannuation entity and any shareholder or director of the company. Any such relationship may indicate that the superannuation fund, ADF or PST are not at arm's length from the private company and for that reason will be an unfavourable factor towards the Commissioner exercising the discretion. If the relationship between the superannuation fund, ADF or PST and the company is at arm's length this will be a favourable factor towards the Commissioner exercising the discretion.

46. If the entity from which the superannuation fund, ADF or PST acquires the shares is associated to the superannuation fund, ADF or PST, this will be an unfavourable factor towards the Commissioner exercising the discretion.

**Income from a transaction where the parties are not dealing at arm's length**

47. There are three requirements that must be satisfied in order for an amount of income to be special income under subsection 273(4):

- there must be a transaction;
- the parties to the transaction must not have been dealing with each other at arm's length; and

- the income derived from the transaction must be greater than the income that might have been expected if the parties were dealing with each other at arm's length.

48. The types of transactions that subsection 273(4) can apply to include interest on loans, rent from property, and profit on sale of assets. Capital gains that are assessable income may be included as special income under subsection 273(4). Franking credits on a dividend may be included as special income under subsection 273(4).

49. The subsection does not apply to private company dividends or trust distributions.

### ***Transaction***

50. The word 'transaction', for the purposes of subsection 273(4), is defined in subsection 273(5) to include a series of transactions. This means that the Commissioner, when deciding whether or not the parties were dealing at arm's length in relation to a series of transactions, will consider all of the transactions in that series. A series of transactions is a number of transactions linked together to obtain a definite objective.

51. This aside, the word 'transaction' should be interpreted in accordance with its ordinary meaning and the context of the section. A series of transactions for the purposes of section 273 must involve dealing between at least two parties.

### ***Not dealing with each other at arm's length***

52. The Commissioner considers that parties are dealing with each other at arm's length in relation to a transaction if the independent minds and wills of the parties are applied to the transaction and their dealing is a matter of real bargaining. If this is not the case, the Commissioner will consider that the parties are not dealing with each at arm's length in relation to the transaction.

53. If the relationship of the parties is such that one party has the ability to influence or control the other, then this will suggest that the parties may not be dealing at arm's length, but it will not be determinative.

54. Parties that are not at arm's length can deal with each other at arm's length in relation to a transaction and parties that are at arm's length can deal with each other in a way that is not at arm's length. An amount of income can only be special income under subsection 273(4) if, in relation to the particular transaction, the parties are not dealing with each other at arm's length.

***The amount of income derived from the transaction***

55. The final requirement for an amount of income to be special income under subsection 273(4) is that the amount of income derived from the transaction must be greater than the amount of income that might have been expected if the parties were dealing with each other at arm's length in relation to the transaction.

56. This is a question of fact. When considering this issue, the Commissioner will take into account all relevant matters. The commercial risk that the superannuation entity is exposed to will be a relevant matter.

***Franking credits***

57. A franking credit on a private company dividend may be special income under subsection 273(4). If a private company dividend derived by a superannuation entity is special income under subsection 273(2) and is franked, the franking credit needs to be considered under subsection 273(4). The franking credit will be special income under subsection 273(4) if it is derived from a transaction or series of transactions the parties to which were not dealing with each other at arm's length and the amount of income derived from the transaction or series of transactions is greater than the amount of income that might have been expected to have been derived if the parties had been dealing with each other at arm's length in relation to the transaction or series of transactions.

**Trust distributions not arising from a fixed entitlement**

58. If a complying superannuation fund, complying ADF or PST derives income from a trust by way of the trustee or any other person exercising a discretion the income distributed will be special income under subsection 273(6).

**Trust distributions arising from a fixed entitlement**

59. A trust distribution to a complying superannuation fund, complying ADF or PST will fall within subsection 273(7) rather than subsection 273(6) if the entity's entitlement to the distribution does not depend upon the exercise of the trustee's or any other person's discretion.

60. A trust distribution arising from a fixed entitlement will only be special income if three conditions are met:

- the entity must have acquired the fixed entitlement under an arrangement or the income must have been derived under an arrangement;
- some or all of the parties to the arrangement must not have been dealing with each other at arm's length; and

- the amount of the distribution must be greater than the amount of income that might have been expected if the parties had been dealing with each other at arm's length.

***Arrangement***

61. The word 'arrangement' is defined for the purposes of subsection 273(7) in subsection 273(8). The definition is very broad, including any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable. It also includes any scheme, plan, proposal, action, course of action or course of conduct. It follows that to acquire a fixed entitlement to the income of a trust or to derive income from a trust will involve an arrangement. More than two parties may be involved in the arrangement.

***Not dealing with each other at arm's length***

62. Some or all of the parties to the arrangement must not have been dealing with each other at arm's length. Subsection 273(7) does not require that all persons who have entitlements to the trust were not dealing at arm's length. Nor does it require that all members of the superannuation entity benefit from the arrangement.

63. When considering whether some or all of the parties to the arrangement were dealing with each other at arm's length, the Commissioner will adopt an approach similar to that set out in paragraphs 52 to 54 of this Ruling. The only differences are that subsection 273(7) applies to an arrangement rather than a transaction and only requires that some of the parties to that arrangement are not dealing with each other at arm's length.

***The amount of income derived from the trust***

64. The final requirement for an amount of income to be special income under subsection 273(7) is that the amount of income derived from the arrangement must be greater than the amount of income that might have been expected if the parties were dealing with each other at arm's length in relation to the arrangement.

65. When considering whether the income derived from the arrangement is greater than the income that might have been expected if the parties were dealing with each other at arm's length, the Commissioner will adopt an approach similar to that set out in paragraphs 55 and 56 of this Ruling.

## **Date of effect**

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66. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. However, the final Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the final Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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**Commissioner of Taxation**

25 January 2005

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## Appendix 1 – Explanation

**ⓘ** *This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.*

***In finalising this ruling, consideration will be given as to whether the examples contained in this Appendix can be located in the Ruling section.***

### Legislative background

67. Section 273 describes the same class of income as was excluded from the income exemption which used to apply to complying superannuation funds. The relevant provisions were sections 23FC and 23FD. These two sections were inserted by the *Taxation Laws Amendment Act (No. 4) 1987* with effect from 18 December 1987. Sections 23FC and 23FD were substantially equivalent to the earlier subsections 23F(16) to (18). These provisions were originally inserted by the *Income Tax and Social Services Contribution Assessment Act (No. 3) 1964*.

68. Section 273 was inserted by the *Taxation Laws Amendment Act (No. 2) 1989* with effect from 30 June 1989. It was amended to include subsections 273(6), 273(7) and 273(8) by the *Superannuation Laws Amendment Act (No. 2) 1999* with effect from 16 July 1999. These sections were inserted to tighten subsection 273(4) to close a loophole which allowed certain distributions of trust income to superannuation entities made under non-arm’s length arrangements to be taxed at the concessional rate of 15%.<sup>1</sup>

69. The special component of the taxable income of a complying superannuation fund, a complying ADF or a PST is the amount (if any) remaining after deducting from the special income:

- a) any allowable deductions that relate exclusively to the special income; and
- b) so much of any other allowable deductions as, in the opinion of the Commissioner, may appropriately be related to the special income.

70. Sections 26, 27 and 28 of the *Income Tax Rates Act 1986* apply the tax rate of 47% to the special component of taxable income.

71. Any amount of normal assessable income that is derived by a complying superannuation fund or a PST from segregated current pension assets or is attributable to current pension liabilities is exempt from tax. The definition of ‘normal assessable income’ in section 267 specifically excludes special income. Special income that is derived by a complying superannuation fund or a PST from segregated current pension assets or is attributable to current pension liabilities will be taxed at the rate of 47%.

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<sup>1</sup> Paragraph 2.2 of the Explanatory Memorandum to the Superannuation Laws Amendment Bill (No. 2) 1999.

**'Income'**

72. The Commissioner's interpretation of 'income' for the purposes of section 273 accords with the object and intent of the provision as set out in the Explanatory Memorandum for the Superannuation Legislation Amendment Bill (No. 2) 1999, which introduced subsections 273(6), (7) and (8). It states that:

Section 273 is designed to prevent income from being unduly diverted into superannuation entities as a means of sheltering that income from the normal rates of tax applying to other entities, particularly the marginal rates applying to individual taxpayers.

73. There is no obvious reason why assessable income that is not ordinary income would have been excluded from this anti-avoidance measure. The section attempts to prevent taxpayers from avoiding normal rates of tax, particularly individual marginal tax rates, through the use of a superannuation entity. Any type of assessable income could be sheltered from marginal rates of tax by the use of a superannuation entity just as ordinary income could be.

74. There is no indication in the Explanatory Memorandum to the Income Tax and Social Services Contribution Assessment Bill (No. 3) 1964, the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 6) 1988, or in the Explanatory Memorandum to the Superannuation Laws Amendment Bill (No. 2) 1999 that special income does not include statutory income.

75. Section 273 is one example of a provision where the term 'income' is used broadly to cover both ordinary income and amounts that become income under a statutory provision. Another example is the definition of 'foreign income' in subsection 6AB(1). As stated in Taxation Ruling TR 2005/2, the word 'income' in the definition of 'foreign income' in subsection 6AB(1) can include both income according to ordinary concepts and amounts included in assessable income under a statutory provision.<sup>2</sup>

76. Taxation Ruling TR 2005/2 explains that this interpretation is also in line with the object and intent of the provision.<sup>3</sup> It provides section 23L as another example of a provision where the word 'income' must be interpreted to include both ordinary income and statutory income because it applies exclusively to fringe benefits which are statutory income.<sup>4</sup> The Ruling states:

The term 'income' in this context must refer to statutory income if the provision is to have any practical application.<sup>5</sup>

Section 23L would have no practical application if the term 'income' in that section is interpreted to refer only to ordinary income and not statutory income.

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<sup>2</sup> Paragraph 5.

<sup>3</sup> Paragraph 9.

<sup>4</sup> Paragraph 10.

<sup>5</sup> Paragraph 10.

77. Section 273 would also lack the practical application that its words clearly demonstrate that it is intended to have if the word 'income' is interpreted to include only ordinary income. If the word 'income' in subsection 273(1) was only to include ordinary income and not statutory income, the whole section could only apply to ordinary income. This is because subsection 273(1) provides that section 273 only applies to 'income'.

78. The words of section 273 clearly demonstrate that it is intended to apply to dividends in subsection 273(2), income from non-arm's length transactions in subsection 273(4) and trust income in subsections 273(6) and (7). Trust income and dividends are amounts included in assessable income under statutory provisions. In some circumstances they may be ordinary income. If section 273 only applies to dividends and trust income that is ordinary income it would lack the practical application it is clearly intended to have.

79. The assessable income derived from a non-arm's length transaction would often be a capital gain. The practical application of subsection 273(4) would be limited if it does not apply to capital gains.

80. In addition, there is authority for the proposition that for the purposes of applying section 273 to trust income, the phrase 'income derived by a superannuation fund' refers to a share of the 'net income' of the trust. In *AAT Case 9221*<sup>6</sup> the Tribunal interpreted that phrase as it appeared in former subsections 23F(18) and 23FC(4), which are substantially equivalent to subsection 273(4). The Tribunal stated:

While the Act provides no definition of the word income, the Tribunal is of the opinion that the term should be considered in the context of the precise legislation being reviewed. Subsections 23F(18) and 23FC(4) refer to 'income derived by a superannuation fund'. As the income in question concerns distributions from a trust it is appropriate to turn to Div 6 of the Act which refers to Trust Income. Subsection 97(1) makes it quite clear that a beneficiary of the kind now being considered shall include as assessable income that relevant share of net income. Net income is defined in subs 95(1) ... It is the conclusion of the Tribunal that the phrase 'income derived by a superannuation fund', in the context of benefiting from a trust arrangement relates to a share of the net income.

81. This conclusion is significant because it means that the word 'income' in subsections 273(6) and (7) refers to the share of 'net income' included in assessable income under subsection 97(1). Since the Tribunal interprets the word 'income' in the context of trust income as referring to the amount that is included within assessable income under a statutory provision, this adds support to the view that the word 'income' for the purposes of section 273 should be interpreted as referring to both ordinary income and amounts included within assessable income under a statutory provision.

<sup>6</sup> 94 ATC 130; (1993) 27 ATR 1117.

<sup>7</sup> 94 ATC 130 at 135; (1993) 27 ATR 1117 at 1124.

82. 'Income' for the purposes of section 273 should be interpreted to include ordinary income and amounts included within assessable income under a statutory provision. This interpretation accords with the object and intent of the provision as evident in the words of the section and the Explanatory Memorandum, *AAT Case 9221* and Taxation Ruling TR 2005/2.

### **The entire amount of income is special income**

83. Section 273 characterises certain amounts of income as special income. The words of the section indicate that once the conditions are met and an amount is characterised as special income, that characterisation applies to the entire amount.

### **Dividends paid by a private company**

#### ***Self-assessment***

84. Section 14ZAAD of the *Taxation Administration Act 1953* (TAA 1953) permits a public ruling on the way in which a tax law applies to be a ruling on the way in which a discretion of the Commissioner under that law would be exercised. The part of this Ruling that clarifies the circumstances in which the Commissioner will exercise the discretion under subsection 273(2) is in accordance with section 14ZAAD of the TAA 1953.

#### ***Non-share dividends***

85. Subsection 273(9) expands the scope of subsection 273(2) so that it applies to non-share dividends. Paragraph 273(9)(a) provides that section 273 applies to a non-share equity interest in the same way as it applies to a share, paragraph 273(9)(b) provides that section 273 applies to an equity holder in the same way as it applies to a shareholder, and paragraph 273(9)(c) provides that section 273 applies to a non-share dividend in the same way as it applies to a dividend.

86. The definitions of a 'non-share equity interest', an 'equity holder', and a 'non-share dividend' in subsection 6(1) all refer to subsection 995-1(1) of the ITAA 1997. Subsection 995-1(1) of the ITAA 1997 states that a 'non-share equity interest' in a company means an equity interest in the company that is not solely a share. It also states that an 'equity holder' in a company means an entity that holds an equity interest in the company.

87. The definition of a 'non-share dividend' in subsection 995-1(1) of the ITAA 1997 refers to section 974-120 of the ITAA 1997. Section 974-120 of the ITAA 1997 defines a 'non-share dividend' in relation to a 'non-share distribution'. Section 974-115 of the ITAA 1997 states that a 'non-share distribution' occurs if a taxpayer holds a non-share equity interest in a company and the company distributes money or property to the taxpayer or credits an amount to the taxpayer as the holder of that interest.

88. All 'non-share distributions' are 'non-share dividends' except to the extent to which the company debits the distribution against the company's non-share capital account or the company's share capital account.<sup>8</sup> A non-share capital account is the account that a company has under section 164-10 of the ITAA 1997 if the company issues a non-share equity interest in the company on or after 1 July 2001, or the company has issued a non-share equity interest in the company before 1 July 2001 that is still in existence on 1 July 2001.

### ***Matters to be considered by the Commissioner***

89. It is the Commissioner's opinion that it would be reasonable not to treat the dividend as special income in accordance with subsection 273(2) when the dividend is derived at arm's length. This view is supported by the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 2) 1999 which introduced subsections 273(6) to (8):

The assessable income that is included in the special component is termed *special income* and is income derived from certain types of non-arm's length transactions (including the payment of certain private company dividends) that fall within the provisions of section 273 of the ITAA 1936.

The Explanatory Memorandum states that special income is income derived from certain types of non-arm's length transactions including the payment of certain private company dividends. The private company dividends that are to be included within subsection 273(2) are intended to be non-arm's length.

90. Section 273 is only aimed at income which is unduly diverted into superannuation entities as a means of sheltering that income from the normal rates of tax.<sup>9</sup> It is not aimed at income which is derived from a genuine investment made on an arm's length basis.

91. If subsection 273(2) is not interpreted as implicitly requiring an assessment of whether or not the income was derived on an arm's length basis then the Commissioner has no basis for determining when it would be reasonable to not treat a dividend as special income. In addition the matters listed in paragraphs 273(2)(a) to (e) would be meaningless and it would be impossible to determine what is relevant under paragraph 273(2)(f).

92. It is the Commissioner's opinion that the matters listed in subsection 273(2) are matters that indicate whether or not the dividends are derived on an arm's length basis. The Commissioner will consider that a matter is relevant under paragraph 273(2)(f) if it indicates whether or not the dividends are derived on an arm's length basis.

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<sup>8</sup> Section 974-120 of the ITAA 1997.

<sup>9</sup> See paragraph 72.

93. There is little judicial guidance on how the Commissioner should exercise the discretion in subsection 273(2) and how the Commissioner should have regard to the matters listed in paragraphs 273(2)(a) to (f).

94. Similar provisions to section 273 have existed since 1964.<sup>10</sup> Former subsections 23F(16) to (18) used almost the same words as subsections 273(1) to (4). The main difference is that, while section 273 categorises certain amounts as special income in order to apply a higher rate of tax, subsections 23F(16) to (18) excluded certain private company dividends and certain income from non-arm's length transactions from the exemption from income tax that superannuation funds enjoyed prior to 1 July 1988.

95. Subsections 23F(16) and (18), especially subsection 23F(16), which is virtually equivalent to subsection 273(2), were the subject of several Taxation Board of Review (Board of Review) decisions. Since subsection 273(2) is in the same terms as former subsection 23F(16), the principles to be drawn from those cases remain relevant in interpreting the current provisions.

### **Value of the shares**

96. Paragraph 23F(16)(a) and paragraph 273(2)(a) originally referred to the 'paid-up value of the shares'. Paragraph 273(2)(a) now refers to the 'value of the shares'. This amendment was made by the *Taxation Laws Amendment (Company Law Review) Act 1998* with effect from 1 July 1998. The amendment applies to things done on or after 1 July 1998 where the relevant company has shares with no par value.<sup>11</sup>

97. The Commissioner will consider the paid-up value of shares issued to superannuation entities which invest in private companies that issue shares with a par value. This will only occur in rare circumstances.

98. In the ordinary course of events the paragraph now obliges the Commissioner to consider the 'value of the shares'. The Commissioner will interpret this to mean that the Commissioner must have regard to the market value of the shares. This becomes especially relevant in comparison to the cost of the shares considered under paragraph 273(2)(b) and the rate of dividend considered under paragraph 273(2)(c).

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<sup>10</sup> See Legislative background.

<sup>11</sup> See history note to subsection 273(2) in *Australian Tax Legislation 2005*, Thompson ATP, Sydney.

**Cost of the shares**

99. In many of the cases before the Board of Review, the Board based their decision that the dividends were exempt on the fact that the shares were acquired for less than fair value.<sup>12</sup> In the earlier cases, especially *Case A38*,<sup>13</sup> *Case A39*,<sup>14</sup> and *Case A40*,<sup>15</sup> the Board of Review read paragraphs 23F(16)(a) and (b) together and decided that since the cost of the shares in all these cases was far less than the value of the shares, the dividend received from the shares was special income. Paragraphs 23F(16)(a) and (b) are largely similar to paragraphs 273(2)(a) and (b).

100. The interpretation of paragraphs 23F(16)(a) and (b) adopted in these earlier Board of Review cases was challenged by the taxpayer in *Case B40*.<sup>16</sup> In *Case B40* it was argued that the cost of the shares could not be compared with the market value of the shares at the time of acquisition. The Board of Review rejected this argument, unanimously holding that it would not be reasonable to exempt the dividend from income tax having regard to the price at which the fund obtained the shares compared with their fair value. This decision was based on an interpretation of both paragraphs (a) and (b), which understands either both of those paragraphs or at least paragraph (b) to require the Commissioner to compare the cost of the shares with their value.<sup>17</sup> All of the members of the Board of Review decided that even if paragraphs (a) and (b) could not be interpreted in this way, a comparison between the cost of the shares and their value is a relevant matter under paragraph (f).<sup>18</sup>

101. In accordance with these Board of Review cases and the reasoning found therein, the Commissioner will compare the cost of the shares with the market value of the shares at the time of acquisition. If the market value of the shares at the time of acquisition exceeds the cost of the shares, this will be a significant factor that will weigh heavily in favour of the Commissioner treating any dividends as special income.

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<sup>12</sup> *Case A38* 69 ATC 225 at 226; *Case A39* 69 ATC 227 at 228; *Case A40* 69 ATC 229 at 232-233; *Case B15* 70 ATC 61 at 64; *Case B40* 70 ATC 202 at 204, 205, 207.

<sup>13</sup> 69 ATC 225 at 226.

<sup>14</sup> 69 ATC 227 at 228.

<sup>15</sup> 69 ATC 229 at 233.

<sup>16</sup> 70 ATC 202.

<sup>17</sup> Compare for example the judgment of Member Dempsey at 70 ATC 202 at 206-7, with the judgment of Chairman Dubout 70 ATC 202 at 203.

<sup>18</sup> 70 ATC 202 at 203-4, per Chairman Dubout; at 205 per Member Thompson; at 207 per Member Dempsey.

***Rate of the dividend***

102. In order to properly assess whether the rate of dividend is an arm's length rate, the Commissioner must compare the rate of dividend with both the cost of the shares and the value of the shares. This is because the cost of the shares may be misleading in some circumstances. These circumstances include when a share is owned for a long time and the value of the shares have increased substantially, or when the value of the shares increase substantially for some other commercial reason. For these reasons it may be necessary to compare the rate of dividend with both the cost of the shares and the value of the shares.

103. It is not possible to provide a set formula for determining a rate of dividend which, if exceeded, will result in the Commissioner treating the dividend as special income. Such a formula could not account for all of the variables that the Commissioner is required to consider. The higher the rate of the dividend expressed as a rate of return on the investment the more likely that the private company dividend was not derived on an arm's length basis. It is therefore more likely that the dividend will be special income.

104. One of the variables that the Commissioner may take into consideration is the level of risk. This may be relevant because the higher the level of risk the more likely it is that a high rate of dividend is the result of market forces.

105. The rate of dividend paid by public companies in the same industry may be useful because this will indicate what the rate of dividend paid by the private company would be if the parties were dealing at arm's length.

***Other matters that the Commissioner considers relevant***

106. The matters that the Commissioner will consider relevant under paragraph 273(2)(f) are explained at paragraphs 89-92.

107. The taxpayer in *Case E56*<sup>19</sup> submitted that paragraphs 23F(16)(a) to (e):

... dealt only with matters pertaining to investment, and cl. (f), in spite of its wide terms, should be restricted to an investigation of the 'circumstances which throw light on the conduct of the fund in its role as an investor'.<sup>20</sup>

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<sup>19</sup> 73 ATC 442.

<sup>20</sup> 73 ATC 442 at 445-446.

Although the members of the Board of Review were ‘much attracted’ to this submission,<sup>21</sup> they observed that the Board of Review had considered paragraph 23F(16)(f) on previous occasions and that a wide interpretation had been consistently adopted.<sup>22</sup> The Board of Review adopted this interpretation, deciding that paragraph 23F(16)(f) should be interpreted broadly.<sup>23</sup>

108. Member Thompson’s wide interpretation of paragraph 23F(16)(f) in *Case B40* is a good example of one of the previous occasions when the Board of Review had adopted this interpretation. He states:

Learned Counsel for the taxpayer frankly conceded that para. (f) could not be construed *ejusdem generis* with the preceding paras. (a) to (e) of sec. 23F(16). It seems to me, therefore, that para. (f) casts a wide net, and catches all relevant matters.<sup>24</sup>

109. Accordingly, the Commissioner is of the opinion that paragraph 273(2)(f) requires the Commissioner to consider all relevant matters.

110. One of these matters is the extent to which the fund is being maintained for employees who are at arm’s length from the shareholders of the company. The Commissioner considers this to be a relevant matter because it indicates the extent to which the dividends are derived on an arm’s length basis. In addition, several Board of Review cases have regarded this to be a relevant matter that the Commissioner should consider under paragraph 23F(16)(f).<sup>25</sup> In most of these cases the fact that the membership of the fund was limited to shareholders of the company weighed in favour of the Board of Review holding that it was reasonable for the Commissioner to treat the dividend as special income.<sup>26</sup> In *Case A40*,<sup>27</sup> however, it was favourable to the taxpayer that all employees, whether shareholders or not, were members of the fund. Either way, the Commissioner will consider this as a relevant matter under paragraph 273(2)(f).

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<sup>21</sup> 73 ATC 442 at 446.

<sup>22</sup> 73 ATC 442 at 446. The Board of Review quoted the following cases as examples of previous occasions when the Board of Review had adopted a wide interpretation of paragraph 23F(16)(f); *Case A38 69 ATC 225*; *Case A39 69 ATC 227*; *Case 40 69 ATC 229*; *Case A41 69 ATC 233*; *Case B15 70 ATC 61*; *Case B40 70 ATC 202*.

<sup>23</sup> 73 ATC 442 at 446.

<sup>24</sup> 70 ATC 202 at 205. See also the more extensive comments made by Member Fairleigh QC in *Case M63 80 ATC 440* at 447-449.

<sup>25</sup> *Case A38 69 ATC 225* at 226; *Case A39 69 ATC 227* at 229; *Case A40 69 ATC 229* at 233; *Case A41 69 ATC 233* at 235; *Case B15 70 ATC 61* at 64; *Case M63 80 ATC 440* at 446.

<sup>26</sup> *Case A39 69 ATC 227* at 229; *Case A41 69 ATC 233* at 235; *Case B15 70 ATC 61* at 64; *Case M63 80 ATC 440* at 446.

<sup>27</sup> 69 ATC 229 at 233. (In *Case A38 69 ATC 225* at 226 the fact that the shareholder/directors of the private company were the sole members of the fund was a neutral matter because they were virtually the only permanent employees of the company.)

111. The relationship between the superannuation fund, ADF or PST and the private company is also a relevant matter that the Commissioner may consider under paragraph 273(2)(f) because it indicates the extent to which the dividends derived by the superannuation fund, ADF or PST are derived on an arm's length basis.

112. The identity of the entity from which the superannuation fund, ADF or PST acquires the shares is also a relevant matter that the Commissioner may consider under paragraph 273(2)(f) because it indicates the extent to which the dividends derived by the superannuation fund, ADF or PST are derived on an arm's length basis.

### ***Example 1***

#### *The facts*

113. A private company, Maz Pty Ltd, is in the biotechnological industry and has two shareholders. Both of the shareholders are self managed superannuation funds. The Tifco Superannuation Fund has two members, Tiffany and Colin. The Jubri Superannuation Fund has two members, Judy and Brian. Each self managed superannuation fund has acquired 500,000 shares at \$1.00 a share. The market value of each share in Maz Pty Ltd is \$1.00.

114. Brian and Tiffany are employees of Maz Pty Ltd. Judy and Colin are directors of Maz Pty Ltd. All employees and directors are paid a salary at the market rate. The Tifco Superannuation Fund owns the business premises from which Maz Pty Ltd runs its business. The Tifco Superannuation Fund leases the business premises to Maz Pty Ltd at a market rate. The business premises is less than 5% of the Tifco Superannuation Fund's total assets. Judy's father, Jose, loans money to Maz Pty Ltd at a market interest rate and on bona fide commercial terms.

115. Maz Pty Ltd makes a biotechnological breakthrough and thereby makes large profits. It pays the same amount of dividends to both the Tifco Superannuation Fund and the Jubri Superannuation Fund. The dividends paid by Maz Pty Ltd are larger than dividends paid by public companies in the biotechnological industry. They are a reflection of the large profits made by the private company as a result of the biotechnological breakthrough.

#### *Consideration of the matters under subsection 273(2)*

116. The members of the Tifco Superannuation Fund and the Jubri Superannuation Fund are employees and directors of Maz Pty Ltd. The relationship between the funds and the private company is not at arm's length. This is an unfavourable factor that will be considered under paragraph 273(2)(f) and will weigh in favour of the Commissioner not exercising the discretion in subsection 273(2) to exclude the private company dividend from being treated as special income.

117. The matter to be considered under paragraph 273(2)(e) is not relevant as there is nothing to consider under it.

118. The cost of the shares is the market value. This fact is relevant under paragraphs 273(2)(a) and (b). This is a favourable factor that will weigh in favour of the Commissioner exercising the discretion.

119. In addition, the rate of dividend paid to the Tifco Superannuation Fund and the Jubri Superannuation Fund is the market rate, having regard to the bona fide commercial reason for the large profits. The rate of dividend is therefore a favourable factor, under paragraphs 273(2)(c) and (d), to the Commissioner exercising the discretion.

120. Although Maz Pty Ltd and the Jubri Superannuation Fund are not at arm's length they deal with each other at arm's length in relation to the lease of the business premises. Although Maz Pty Ltd and Jose are not at arm's length they deal with each other at arm's length in relation to the loan agreement. Although Maz Pty Ltd is not at arm's length with Judy, Brian, Colin and Tiffany, they deal with each other at arm's length in relation to their employment arrangement. These are relevant factors that the Commissioner will consider favourable to the exercise of the discretion under paragraph 273(2)(f).

### *The decision*

121. On the whole, having regard to the matters listed in paragraphs 273(2)(a) to (f), the Commissioner is of the opinion that it would be reasonable not to treat the dividends as special income of the Tifco Superannuation Fund and the Jubri Superannuation Fund.

### **Example 2**

#### *The facts*

122. On 1 June 2001 a self managed superannuation fund, the Toby Superannuation Fund, acquires 100,000 shares for 50 cents each in a private company, Extension Products Pty Ltd. The Toby Superannuation Fund pays a total of \$50,000. At the time of the acquisition of the shares, the market value of one share in Extension Products Pty Ltd is \$1.00. Also on 1 June 2001 nine other entities acquire 100,000 shares each in Extension Products Pty Ltd. The nine other entities pay \$1.00 for each share, paying a total of \$100,000 each. The members of the Toby Superannuation Fund are unrelated to the directors and the other shareholders.

123. On 1 June 2003 Extension Products Pty Ltd pay dividends on all of its shares at the market rate of 5 cents per share. All ten shareholders are paid a dividend of \$5,000. In the following year no dividends are paid on the shares. On 1 June 2005 Extension Products Pty Ltd pay dividends on all of its shares at the market rate of 5 cents per share. All shareholders are paid a dividend of \$5,000.

*Consideration of the matters under subsection 273(2)*

124. The rate of dividend paid on 1 June 2003 and on 1 June 2005 is the market rate and all of the shareholders are paid the same rate. These factors weigh in favour of the Commissioner forming the opinion that it would be reasonable not to treat the dividends as special income having regard to paragraphs 273(2)(c) and 273(2)(d) respectively.

125. The matter to be considered under paragraph 273(2)(e) is not relevant as there is nothing to consider under it.

126. The arm's length relationship between the Toby Superannuation Fund and Extension Products Pty Ltd is a favourable factor considered under paragraph 273(2)(f) in favour of the Commissioner exercising the discretion.

127. The cost to the Toby Superannuation Fund of the shares in Extension Products Pty Ltd is 50 cents for each share. The market value of the shares at the time of acquisition is \$1.00 per share. The cost of the shares is less than the market value of the shares. This unfavourable factor, considered under paragraphs 273(2)(a) and (b), will weigh heavily in favour of the Commissioner not exercising the discretion.

*The decision*

128. On the whole, having regard to the matters listed in paragraphs 273(2)(a) to (f), the Commissioner is not of the opinion that it would be reasonable not to treat the dividends paid on 1 June 2003 and on 1 June 2005 as special income of the Toby Superannuation Fund. The dividends are special income under subsection 273(2).

**Example 3***The facts*

129. A private company, Debvin Pty Ltd, was established in 2001 for the purpose of acquiring a parcel of land for development and resale. The company was to be wound up on completion of the project and sale of the lots. Ten separate entities unrelated to each other subscribed for 100,000 ordinary shares. Nine of the original investors were issued shares for \$1.00 per share, including the Ebony Superannuation Fund (a self managed superannuation fund). There were four directors of Debvin Pty Ltd being individuals related to four of the investor entities. The directors were not involved in the day to day management of the property development and did not receive any director's fees or other remuneration from Debvin Pty Ltd. The development and sale of the land was undertaken by unrelated parties on normal commercial terms.

130. Debin Pty Ltd acquired a parcel of land recommended by Jasmine Lee, a director of the company, at the fair market value of \$2.5 million from an unrelated party. Debin Pty Ltd obtained additional finance from commercial lenders to fund the purchase of the land and the initial stages of the development. The profits from sales of the redeveloped land were initially used by Debin Pty Ltd to repay the loans and fund future stages of the development. In February 2006 Debin Pty Ltd paid a dividend of \$3.85 per share and was wound up by returning \$1.00 capital per share to each shareholder.

*Consideration of the matters under subsection 273(2)*

131. With respect to the dividend received by the Ebony Superannuation Fund the following factors are taken into consideration.

132. The matter to be considered under paragraph 273(2)(e) is not relevant as there is nothing to consider under it.

133. The fact that the Ebony Superannuation Fund paid the same price as the majority of the other shareholders who originally subscribed for shares provides a strong indication the shares were acquired for market value which is a favourable factor, under paragraphs 273(2)(a) and (b), for the Commissioner to exercise the discretion.

134. While the rate of dividends paid on the shares under paragraphs 273(2)(c) and (d) is considered to be high it generally reflects the commercial risk undertaken by the investors at the time and the growth in the property market, with the same dividend being declared on all shares. These are favourable factors to the Commissioner exercising the discretion.

135. Under paragraph 273(2)(f) factors favourable to the Commissioner exercising the discretion are that no parties related to the fund were involved with or had dealings with the company. It is an unfavourable factor that there are no arm's length members of the fund. On balance, the factors indicate the Ebony Superannuation Fund invested in and received dividends on an arm's length basis.

*The decision*

136. The Commissioner considers it reasonable to exercise the discretion so that the dividends are not treated as special income of the Ebony Superannuation Fund.

***Example 4 (incorporates the facts in paragraphs 129-130 from Example 3)****Additional facts*

137. The Jasmine Superannuation Fund (a self-managed superannuation fund) was the other original investor in Debvin Pty Ltd. The sole member of the Jasmine Superannuation Fund is Jasmine Lee (a director of Debvin Pty Ltd). Jasmine Lee had undertaken a considerable amount of research and feasibility testing in locating a suitable site for development and preparing the original investment proposal. Shares were issued to the Jasmine Superannuation Fund for \$0.75 per share.

*Consideration of the matters under subsection 273(2)*

138. With respect to the dividend received by the Jasmine Superannuation Fund the following factors are taken into consideration.

139. The matter to be considered under paragraph 273(2)(e) is not relevant as there is nothing to consider under it.

140. The fact that the Jasmine Superannuation Fund paid less than the other shareholders who subscribed for shares at the same time provides a strong indication the shares were acquired for less than market value. Under paragraphs 273(2)(a) and (b) this is a factor which weighs heavily against the Commissioner exercising the discretion.

141. While the rate of dividends paid on the shares under paragraphs 273(2)(c) and (d) is considered to be high it generally reflects the commercial risk undertaken by the investors at the time, with the same dividend being declared on all shares. These factors can be considered favourable in exercising the discretion. However, because the Jasmine Superannuation Fund paid less than the other original shareholders the actual rate of return on its investment was higher than the other original shareholders.

142. Under paragraph 273(2)(f) factors unfavourable to the Commissioner exercising the discretion are that Jasmine Lee undertook the initial preparatory steps to establish the investment, is a director of the company and has not received any remuneration for any of those services. It is also unfavourable that there are no arm's length members of the fund. On balance, the factors would indicate the Jasmine Superannuation Fund invested on terms more favourable than a party dealing at arm's length would have.

*The decision*

143. The dividends received by the Jasmine Superannuation Fund will be special income under subsection 273(2) as the Commissioner does not consider it appropriate to exercise the discretion.

***Example 5 (incorporates the facts in paragraphs 129-130 from Example 3)***

*Additional facts*

144. Cameron Rinny was one of the original investors in Debin Pty Ltd. On 1 June 2005 Cameron Rinny sold his shares in Debin Pty Ltd to his self managed superannuation fund, the Camaleon Superannuation Fund for \$4.86 per share. The financial accounts of Debin Pty Ltd for the year ended 30 June 2005 show net assets of \$4.86 million consisting primarily of cash and three unsold lots of land. The sale of the three remaining lots occurred in July 2005 for slightly less than the carrying value.

*Consideration of the matters under subsection 273(2)*

145. With respect to the dividend received by the Camaleon Superannuation Fund the following factors are taken into consideration.

146. The matter to be considered under paragraph 273(2)(e) is not relevant as there is nothing to consider under it.

147. Under paragraphs 273(2)(a) and (b) it could be argued the cost of the shares to the Camaleon Superannuation Fund represented the market value as it was based on the net assets of the company, however this does not take into account the lack of commercial risk on the investment. Therefore, this would be considered an unfavourable factor in the Commissioner exercising the discretion.

148. The rate of dividend paid on the shares under paragraph 273(2)(c) is considered to be high and does not reflect any commercial risk undertaken by the fund at the time that it invested. This would be considered an unfavourable factor. As the same dividend was paid on all shares this would be considered a favourable factor under paragraph 273(2)(d).

149. Under paragraph 273(2)(f) factors unfavourable to the Commissioner exercising the discretion are that the Camaleon Superannuation Fund acquired the shares from a member of the fund. It is also unfavourable that there are no arm's length members of the fund. On balance, the factors would indicate the Camaleon Superannuation Fund did not undertake the investment on an arm's length basis.

*The decision*

150. The dividends received by the Camaleon Superannuation Fund will be special income under subsection 273(2) as the Commissioner does not consider it appropriate to exercise the discretion.

**Example 6***The facts*

151. The Abrooks Estate Pty Ltd ('Abrooks') was established in July 1998 by issuing two fully paid \$1.00 ordinary shares to two self managed superannuation funds. One share was acquired by the Joshaye Superannuation Fund. The members and trustees of the fund are Josh Mack and Shaye Tayla who are related. Josh Mack is the principal of a property development business trading as Mack Constructions. Shaye Tayla is a licensed real estate agent with a family owned and run entity trading as Tayla Rural Realty. The other share was acquired by the Banker Superannuation Fund. The members and trustees of the fund are Graeme Ross and Le My Ross who are related. Graeme Ross and Le My Ross are not related to either Josh Mack or Shaye Tayla. Graeme Ross is an accountant and local councillor. He is the accountant for Josh Mack, Shaye Tayla and their businesses. The directors of Abrooks are Shaye Tayla and Graeme Ross.

152. Abrooks became aware of some rural properties for sale and based on the experience and knowledge of the trustees of the funds believed the properties offered an excellent investment opportunity. The trustees thought that because of the rapid population growth occurring in the region the possibility existed for the properties to be rezoned to allow for residential development. A number of commercial lenders were approached to provide the finance for Abrooks to purchase the properties but none were willing to lend the required funds to Abrooks. As commercial finance was not available the shareholders decided to lend the funds to Abrooks. Each shareholder through other related entities, controlled by the trustees of the funds, made unsecured loans of \$275,000 to Abrooks. It was decided that an interest rate of 10.5%, being the current overdraft interest rate plus two percent, represented a fair market rate. Repayment of the principal or interest was not required until such time as Abrooks had sufficient funds and working capital. The related entities have never provided loans to arm's length parties.

153. In early 2000 the properties were rezoned to allow for residential development. The development of the properties was undertaken by Mack Construction on their normal commercial terms. Sales were handled by Tayla Rural Realty on their usual terms. Accounting services were provided by Graeme Ross on his standard terms. Each of the loans with total interest payments of \$84,000 had been repaid by 30 June 2002. In the year ended 30 June 2003 the Banker Superannuation Fund sold their share in Abrooks to the Davis Unit Trust for \$38,000. Jurgen Davis replaced Graeme Ross as a director of Abrooks. Jurgen Davis, the unit holders in the Davis Unit Trust and the trustee of the trust are not related to any of the members of the Banker Superannuation Fund or the Joshaye Superannuation Fund or their associated entities. In the year ended 30 June 2004 Abrooks paid a dividend of \$43,000 per share.

*Consideration of the matters under subsection 273(2)*

154. With respect to the dividends received by the Joshaye Superannuation Fund the following factors are taken into consideration.

155. The matter under paragraph 273(2)(d) is favourable as both shares are fully paid up and the same dividend was paid on each share.

156. The matters under paragraphs 273(2)(a) and (b) are favourable because at the time the fund acquired its share both shares were issued for the same price on the establishment of the company.

157. Under paragraph 273(2)(c) the rate of the dividend is considered to be extremely high and does not reflect the level of risk undertaken by the fund, accordingly this factor weighs against the Commissioner exercising the discretion.

158. An additional factor considered under paragraph 273(2)(f) that indicates the return on the investment was greater than an arm's length amount was the fact parties related to the shareholders provided loans when commercial lenders would not provide finance. Even if commercial finance was available the terms and conditions of the loan are also considered to be more favourable than what would be available to an arm's length borrower, particularly given the nature of the investment. A further factor under paragraph 273(2)(f) that weighs against the Commissioner exercising the discretion is that there are no arm's length members of the fund. There is nothing to consider in respect of paragraph 273(2)(e). On balance, the factors indicate the dividend received by the Joshaye Superannuation Fund was not the result of an investment undertaken and maintained on an arm's length basis.

*The decision*

159. The dividend received by the Joshaye Superannuation Fund will be special income of the fund as the Commissioner does not consider it appropriate to exercise the discretion.

**Income from a transaction where the parties are not dealing at arm's length**

***Capital gains***

160. The amounts of income that are special income under subsection 273(4) may include capital gains that are included within assessable income under Part 3-1 and Part 3-3 of the ITAA 1997. This is because the term 'income' in section 273 includes both income according to ordinary concepts and amounts included in assessable income under a statutory provision (see paragraphs 72 to 82).

**Transaction**

161. Subsection 273(5) expands the meaning of ‘transaction’ for the purposes of subsection 273(4) to include a series of transactions. Aside from this, there is no definition of the word ‘transaction’ in the ITAA 1936. The courts, tribunals and the Board of Review have not interpreted the word ‘transaction’ for the purposes of subsection 273(4) or the former subsections 23F(18) and 23FC(4).

162. The word ‘transaction’ for the purposes of subsection 273(4) takes its ordinary meaning.

163. The *Macquarie Dictionary*<sup>28</sup> defines the word ‘transact’ as follows:

1. to carry through (affairs, business, negotiations, etc.) to a conclusion or settlement.
2. to perform.

164. In the context of determining what is a ‘transaction’ and thus a ‘disposition of property’ for the purposes of various gift duty and death duty statutes such as the *Gift Duty Assessment Act 1941-1957 (Cth)*, the courts have discussed the ordinary meaning of the word ‘transaction’. In this context, the courts developed an interpretation of the word ‘transaction’ that ‘can cover a series of steps linked together to obtain a definite objective’.<sup>29</sup>

165. The word ‘transaction’ in section 273, however, must be interpreted in accordance with the context in which it appears. As the context is one of dealing between parties, a transaction for the purposes of section 273 must at least involve an element of dealing between two parties.

**Not dealing with each other at arm’s length**

166. The phrase ‘at arm’s length’ has been considered in many courts and used in various legislative contexts. As explained by Davies J in *Re Hains (deceased); Barnsdall v. Federal Commissioner of Taxation*<sup>30</sup> (*Barnsdall*) the term ‘at arm’s length’ was developed in the law with respect to transactions between persons, one of whom, such as a trustee or a solicitor, is in a position of special influence with respect to the other, a beneficiary or client. His Honour refers to the classic statement of principles found in the speech of Lord O’Hagan in *Macpherson v. Watt*.<sup>31</sup>

167. Davies J points out, however, that such cases are of little assistance in the interpretation of statutes which are concerned with taxation.<sup>32</sup>

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<sup>28</sup> 3<sup>rd</sup> edition.

<sup>29</sup> *Robertson v. Commissioner of Inland Revenue* [1959] NZLR 492 at 498; *Gorton v. Federal Commissioner of Taxation* (1965) 113 CLR 604 at 622-623; *Palmer v. Commissioner of State Taxation (WA)* (1976) 136 CLR 406 at 412 and 417.

<sup>30</sup> (1988) 81 ALR 173 at 176.

<sup>31</sup> (1877) 3 App Cas 254 at 266; (1988) 81 ALR 173 at 176.

<sup>32</sup> (1988) 81 ALR 173 at 176; see also *Re CHK Engineering Pty Ltd and Australian Trade Commission* (1997) 45 ALD 797 at 797.

168. His Honour then goes on to set out the interpretation of the phrase ‘not at arm’s length’ that was provided in *Australian Trade Commission v. WA Meat Exports Pty Ltd*.<sup>33</sup> This is the leading case on the meaning of the phrase ‘not at arm’s length’ in the definition of ‘prescribed associate’ in subsection 4(8) of the *Export Market Development Grants Act 1974*. The Federal Court decided in that case that the ordinary meaning of the phrase applies. After quoting legal dictionaries in order to ascertain the ordinary meaning of ‘arm’s length’,<sup>34</sup> the Federal Court reached the conclusion that the ordinary meaning of the phrase ‘not at arm’s length’ is the circumstance where one party ‘has the ability to exert personal influence or control over the other’.<sup>35</sup>

169. Although the ability of one party to influence or control the other party to the transaction is an important issue to consider for the purposes of applying the arm’s length requirement in subsection 273(4), it is not the only issue to consider. Subsection 273(4) requires that the parties to the transaction were ‘not dealing with each other at arm’s length’.

170. The provision with which Davies J was concerned in *Barsndall* was in similar terms:

If the term were simply ‘not at arm’s length’, *Australian Trade Commission v. WA Meat Exports Pty Ltd* (1987) 75 ALR 287 would apply. ... However, s 26AAA(4) [of the ITAA 1936] used the expression ‘not dealing with each other at arm’s length’. That term should not be read as if the words ‘dealing with’ were not present. The Commissioner is required to be satisfied not merely of a connection between a taxpayer and the person to whom the taxpayer transferred, but also of the fact that they were not dealing with each other at arm’s length. A finding as to a connection between the parties is simply a step in the course of reasoning and will not be determinative unless it leads to the ultimate conclusion.<sup>36</sup>

171. This interpretation of the phrase ‘not dealing with each other at arm’s length’ was adopted for the purposes of interpreting the same phrase in subsection 102AG(3) by the Federal Court in *The Trustee for the Estate of the late AW Furse No. 5 Will Trust v. FC of T*<sup>37</sup> (*Furse*). Hill J noted:

The first of the two issues [ie whether the parties to the relevant agreement were dealing with each other at arm’s length] is not to be decided solely by asking whether the parties to the relevant agreement were at arm’s length to each other. The emphasis in the subsection is rather upon whether those parties, in relation to the agreement, *dealt* with each other at arm’s length. The fact that the parties are themselves not at arm’s length does not mean that they may not, in respect of a particular dealing, deal with each other at arm’s length. This is not to say that the relationship between the parties is irrelevant to the issue to be determined under the subsection. The distinction was pointed out by Davies J in connection with similar words used in sec. 26AAA(4) of the Act in

<sup>33</sup> (1987) 75 ALR 287; (1988) 81 ALR 173 at 176.

<sup>34</sup> (1987) 75 ALR 287 at 291.

<sup>35</sup> (1987) 75 ALR 287 at 291.

<sup>36</sup> (1988) 81 ALR 173 at 176.

<sup>37</sup> (1990) 21 ATR 1123; 91 ATC 4007.

*Barnsdall v. FC of T* 88 ATC 4565 at p. 4568, in a passage which with respect I agree: ...

What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining.<sup>38</sup>

172. The point made by Davies J in *Barnsdall* and Hill J in *Furse* is that a relationship between two parties does not necessarily mean that the parties cannot deal at arm's length in relation to a particular transaction. As emphasised by Hill J in *Furse*, however, the relationship between the parties is relevant. It is, in the words of Davies J in *Barnsdall*, 'a step in the course of reasoning'.

173. In line with Hill J's comments in *Furse*, the Commissioner will consider that parties are not dealing with each other at arm's length when they are not involved in real bargaining. This is also the way the phrase 'not dealing with each other at arm's length' is applied in the examples in the Explanatory Memorandum to the Superannuation Legislation Amendment Bill (No. 2) 1999, which introduced subsections 273(6) to (8).

174. Both *Barnsdall* and *Furse* have gained further support from the Federal Court in *Granby Pty Ltd v. Federal Commissioner of Taxation*,<sup>39</sup> this time in the capital gains tax context. For the purposes of determining the cost base of an asset under subsections 160ZH(1), (2) and (3), paragraph 160ZH(9)(c) provides that the taxpayer shall be deemed to have paid market value if, amongst other things, the taxpayer and the vendor were not dealing with each other at arm's length in connection with the acquisition. Lee J followed *Barnsdall* and *Furse* and added:

... the term 'at arm's length' means, at least, that the parties to a transaction have acted severally and independently in forming their bargain. ...

If the parties to the transaction are at arm's length it will follow, usually, that the parties will have dealt with each other at arm's length. That is, the separate minds and wills of the parties will be applied to the bargaining process whatever the outcome of the bargain may be.

That is not to say, however, that parties at arm's length will be dealing with each other at arm's length in a transaction in which they collude to achieve a particular result, or in which one of the parties submits the exercise of its will to the dictation of the other, perhaps, to promote the interests of the other. As in *Minister of National Revenue v. Merritt* 69 DTC 5159 at 5166 where the parties to the transaction were parties at arm's length, the terms of a loan transaction made between them had been dictated by a unilateral decision of one of them and no independent will in the formation of that transaction had been exercised by the other.<sup>40</sup>

<sup>38</sup> (1990) 21 ATR 1123 at 1132; 91 ATC 4007 at 4014-15.

<sup>39</sup> (1995) 129 ALR 503.

<sup>40</sup> (1995) 129 ALR 503 at 507.

175. So although Davies J was correct in identifying a connection between the parties as a step in the course of reasoning, it is not a necessary step. As Lee J explains, parties at arm's length may not deal at arm's length when they collude to achieve a particular result or when one of the parties submits the exercise of its will to the dictation of the other.

176. The comments made by Lee J, along with those of Davies J and Hill J, apply equally to subsection 273(4). If the relationship of the parties is such that one party has the ability to influence or control the other, then this will suggest that the parties may not be dealing with each other at arm's length, but it will not be determinative. The Commissioner will only be satisfied that the parties are not dealing with each other at arm's length in relation to a transaction if it is established that the independent minds and wills of the parties are not applied to the transaction such that their dealing is not a matter of real bargaining.

### ***Franking credits***

177. A franking credit is included in the assessable income of an entity that receives a franked distribution in accordance with section 207-20 of the ITAA 1997. It states:

If an entity makes a \*franked distribution to another entity, the assessable income of the receiving entity, for the income year in which the distribution is made, includes the amount of the \*franking credit on the distribution. This is in addition to any other amount included in the receiving entity's assessable income in relation to the distribution under any other provision of this Act.

178. Since franking credits are included in assessable income they are income for the purposes of subsection 273(1) and subsection 273(4). As discussed in paragraphs 72 to 82, amounts included within assessable income under a statutory provision should be included as 'income' for the purposes of section 273.

179. To fall within subsection 273(4) a franking credit must be derived from a transaction, the parties to the transaction must not have been dealing with each other at arm's length, and the amount of income derived from the transaction must be greater than the amount of income that might have been expected if the parties were dealing with each other at arm's length in relation to the transaction.

180. The acquisition of the share in the private company, the payment of the dividend and any other dealings entered into by the private company may constitute a transaction or series of transactions for the purposes of subsections 273(4) and (5). The franking credit may be income derived from this transaction or series of transactions.

181. The Commissioner's interpretation of subsection 273(2) is that a private company dividend will be special income if it is derived on a non-arm's length basis. If a franked private company dividend is special income and the franking credits are derived from a non-arm's length transaction or series of transactions the franking credit will also be special income under subsection 273(4).

***Example 7 (facts as per paragraphs 151-153 of Example 6)***

*Application of subsections 273(4) and (5)*

182. The capital gain included in the assessable income of the Banker Superannuation Fund from the sale of its share in Abrooks falls for consideration under subsection 273(4) in determining if it is special income. The sale of the share by the Banker Superannuation Fund to an unrelated party was made on an arm's length basis and prima facie this would indicate the income will not be special income. However, it must be kept in mind that the reference to a transaction in subsection 273(4) includes a reference to a series of transactions as provided in subsection 273(5). Other transactions that led up to the sale of the share included the acquisition of the share by the fund upon the establishment of Abrooks and the provision of finance by entities related to the shareholders.

183. Abrooks, the shareholders and the entities that provided the finance are not at arm's length from each other. With respect to the finance provided, the shareholders decided that because commercial finance was not available they would provide the finance through the related entities. The parties did not act severally and independently and it cannot be said that the parties were involved in any real bargaining. The provision of the finance on a non-arm's length basis allowed Abrooks to undertake the development which increased the value of its shares. The capital gain included in the assessable income of the Banker Superannuation Fund from the sale of the share is greater than the amount that would be reasonably expected if the transactions had been conducted on an arm's length basis.

*The decision*

184. The capital gain included in the assessable income of the Banker Superannuation Fund is special income of the fund under subsection 273(4).

**Example 8***The facts*

185. Ben and Sandra Wardell are the members and trustees of the Wardell Superannuation Fund, a self managed superannuation fund. The fund had previously purchased a property from an unrelated party on an arm's length basis. The Wardell Superannuation Fund leases the property to Stevros Shipwright Services ('Stevros'). The parties are not related or associated in any other way. For the past fifteen years Stevros has conducted a boat repair business from the property owned by the Wardell Superannuation Fund by entering into five year leases. Negotiations for a new lease were recently entered into by both parties. The agent acting on behalf of the trustees of the Wardell Superannuation Fund advised that a reasonable market rent for a five year lease would be \$24,000 per annum. During negotiations the representatives of Stevros raised issues with repairs and improvements to the property and fixtures. This included the possibility of Stevros paying for improvements to the slipway and jetty in return for a reduced rental and longer lease. The trustees of the Wardell Superannuation Fund were reluctant to accept a lower rent.

186. The agent advised the trustees that if the improvements were made to the property a reasonable market rent for a five year lease would be \$30,000 per annum. The preference of the trustees was to pay for the improvements and have Stevros enter into a fifteen year lease for \$30,000 to increase each five years by the rate the consumer price index (CPI) had risen. For a variety of reasons the principals of Stevros were reluctant to accept the terms proposed by the trustees of the fund and instead agreed to enter into a five year lease for \$8,500 per annum more than the market rent of \$30,000. The lease also contained an option for Stevros to enter into two further five year leases upon the expiration of the new lease. The rental payable would revert back to the market rent applicable at the time of taking up the option. The trustees of the Wardell Superannuation Fund engaged an unrelated party to carry out the improvements to the property on normal commercial terms.

*Application of subsections 273(4) and (5)*

187. The rental income derived by the Wardell Superannuation Fund from the new lease of the property falls for consideration under subsection 273(4) in determining if it is special income. The rental income received by the Wardell Superannuation Fund from entering into the new lease of \$38,500 per annum is higher than the reasonable market rent as advised by the agent. Prima facie this could indicate the income will be special income. The first issue for consideration is determining if the dealings between the parties were at arm's length, that is, did the parties act severally and independently in forming their bargain. It should also be kept in mind that a reference to a transaction in subsection 273(4) includes a reference to a series of transactions.

188. In this case the transactions for consideration include the purchase of the property, the improvements made to the property and entering into the new lease. Both the purchase of the property and the improvements were entered into by the trustees of the fund with unrelated parties on an arm's length basis. With regard to the new lease, Stevros and the trustees of the fund are not related parties. Each of the parties entered into genuine negotiations regarding the terms of the new lease. These negotiations were a matter of real bargaining. There is nothing to suggest the parties colluded to achieve a particular result or that the representatives of Stevros submitted the exercise of their will to the dictation of the trustees of the fund. The parties dealt with each other at arm's length in negotiating the new lease. The fact that the rental under the new lease is above the amount regarded as a market rent by the agent does not alter the fact the parties dealt at arm's length.

*The decision*

189. The rental amount received by the Wardell Superannuation Fund is not special income of the fund.

**Example 9**

*The facts*

190. A self managed superannuation fund, the Amti Superannuation Fund, forms an incorporated limited partnership with a private company, Tiam Pty Ltd. The members of the Amti Superannuation Fund are Amanda and Tim. Amanda and Tim are the only shareholders and directors of Tiam Pty Ltd. In the incorporated limited partnership, the Amti Superannuation Fund is the limited partner and is entitled to 99% of the income of the incorporated limited partnership. Tiam Pty Ltd is a general partner, only entitled to 1% of the income of the incorporated limited partnership. Tim and Amanda are also the trustees of the Tim and Amanda Family Trust. The beneficiaries of the Tim and Amanda Family Trust are Tim, Amanda and their two daughters Marion and Jodi. On the same day as the incorporated limited partnership is formed, the trust deed of the Tim and Amanda Family Trust is amended to include the incorporated limited partnership as a beneficiary. One month later, Tim and Amanda, as trustees of the Tim and Amanda Family Trust exercise their discretionary trust powers by distributing \$200,000 to the incorporated limited partnership. The incorporated limited partnership distributes 99% of this amount, \$198,000, to the Amti Superannuation Fund.

*Application of subsections 273(4) and (5)*

191. The formation of the incorporated limited partnership, the amendment of the trust deed of the Tim and Amanda Family Trust to include the incorporated limited partnership as a beneficiary, the distribution of income from the Tim and Amanda Family Trust to the incorporated limited partnership, and the distribution of income from the incorporated limited partnership to the Amti Superannuation Fund are all transactions in a series of transactions. In accordance with subsection 273(4), a transaction includes a series of transactions through the operation of subsection 273(5).

192. The parties to these transactions are all controlled by the same two individuals, Tim and Amanda. This suggests that the parties may not be dealing at arm's length but it is not determinative. The series of transactions is not a matter of real bargaining because it involves the distribution of \$200,000 for nothing in return. For this reason the parties to the series of transactions are not dealing at arm's length.

193. The amount of income that the Amti Superannuation Fund derived is \$198,000. The income of the incorporated limited partnership increased as a result of the distribution received from the Tim and Amanda Family Trust. As a result the incorporated limited partnership had more income available to be distributed to the partners. If the parties were dealing at arm's length no distribution to the incorporated limited partnership from the Tim and Amanda Family Trust could be expected and much less income would have been available for distribution to the partners. Accordingly, the amount of income derived by the Amti Superannuation Fund from the transaction is greater than might have been expected to have been derived by the fund if the parties had been dealing with each other at arm's length.

*The decision*

194. The income derived by the Amti Superannuation fund will be treated as special income under subsection 273(4).

**Example 10***The facts*

195. Steve and Mary are the only members and trustees of the Vale Superannuation Fund, a self managed superannuation fund. Steve and Mary are the directors of Vale Enterprises Pty Ltd, a private company. Steve and Mary hold 1 share each in Vale Enterprises Pty Ltd. After trading successfully, Vale Enterprises Pty Ltd makes a profit of \$1 million in December 2004. At this time Vale Enterprises also has \$500,000 credit in its franking account. In January 2005 Vale Enterprises Pty Ltd issues 99,998 shares to the Vale Superannuation Fund for 1 cent per share. The Vale Superannuation Fund pays a total of \$1,000 for their shares. In April 2005 Vale Enterprises Pty Ltd distributes all of its profits to its shareholders in proportion to their shareholding. It pays fully franked

dividends at the rate of \$10 a share. Vale Enterprises Pty Ltd pays a \$10 dividend each to both Steve and Mary. Vale Enterprises Pty Ltd pays a fully franked dividend of \$999,980 to the Vale Superannuation Fund. The dividend of \$999,980 and the attached franking credits will be included in the assessable income of the Vale Superannuation Fund.

*Application of subsection 273(2)*

196. The Commissioner will consider all of the matters listed in paragraphs 273(2)(a) to (e) and any other relevant matters under paragraph 273(2)(f). The fact that the shares are acquired for far less than market value will be of particular importance under paragraphs 273(2)(a) and (b).

197. The dividend received by the Vale Superannuation Fund will be special income under subsection 273(2) as the Commissioner does not consider it appropriate to exercise the discretion.

*Application of subsections 273(4) and (5)*

198. The acquisition of the shares in Vale Enterprises Pty Ltd and the payment of the dividend are a series of transactions for the purposes of subsections 273(4) and (5). The franking credit is income derived from this series of transactions.

199. Since the shares were acquired for less than market value the parties in relation to that transaction were not dealing with each other at arm's length. The amount of franking credits derived from the series of transactions was greater than the amount of franking credits that would have been derived if the parties were dealing at arm's length because if the parties were dealing at arm's length the Vale Superannuation Fund would have received less shares for their outlay and would not have been entitled to as many franking credits. The franking credits are special income under subsection 273(4).

*The decision*

200. The franked dividend is special income of the Vale Superannuation Fund under subsection 273(2). The franking credits on the dividend are special income of the Vale Superannuation Fund under subsection 273(4).

**Trust distributions – 'fixed entitlement'**

201. A trust distribution that is derived by virtue of holding a fixed entitlement will be considered under subsection 273(7). If the trust distribution is derived other than by virtue of holding a fixed entitlement it will be special income under subsection 273(6).

202. The phrase ‘fixed entitlement’ is not defined for the purposes of section 273. It takes its meaning from the context of the section.

203. The terms ‘fixed trust’ and ‘discretionary trust’ were defined by Gummow J, sitting as a single judge in the Federal Court, in *Federal Commissioner of Taxation v. Vegners*.<sup>41</sup>

A fixed trust is used to describe a species of express trust where all the beneficiaries are ascertainable and their beneficial interest [sic] are fixed, there being no discretion in the trustee or any other person to vary the group of beneficiaries or the quantum of their interests. The expression ‘discretionary trust’ is used to identify another species of express trust, one where the entitlement of beneficiaries to income, or to corpus, or both, is not immediately ascertainable. Rather, the beneficiaries are selected from a nominated class by the trustee or some other person and this power may be exercisable from time to time.

204. A ‘fixed entitlement’ for the purposes of section 273 is an entitlement to income in a trust that does not depend upon the exercise of the trustee’s or any other person’s discretion.

205. So for the purposes of subsection 273(7), income derived by an entity in the capacity of beneficiary of a trust estate by virtue of holding a fixed entitlement is a trust distribution that does not depend upon the exercise of the trustee’s or any other person’s discretion.

206. For the purposes of subsection 273(6), income derived in the capacity of beneficiary, other than by virtue of holding a fixed entitlement, is a trust distribution that does depend on the exercise of the trustee’s or any other person’s discretion.

## **Trust distributions arising from a fixed entitlement**

### ***Not dealing with each other at arm’s length***

207. The requirement in subsection 273(7) that some or all of the parties to the arrangement were not dealing with each other at arm’s length is also present in subsection 273(4). Accordingly, the analysis provided in paragraphs 166-176 also explains the Commissioner’s interpretation of this requirement of subsection 273(7).

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<sup>41</sup> (1989) 90 ALR 547 at 551-552.

**Example 11***The facts*

208. A self managed superannuation fund, the Salbo Superannuation Fund, acquires 10,000 units in the Bosa Trust. The members of the Salbo Superannuation Fund are Bobby and Sally. The corporate trustee of the Bosa Trust is Bruce Industries Pty Ltd. Sally's brother Bruce has a 75% shareholding and is a director of Bruce Industries Pty Ltd. The Bosa Trust issues 100,000 units, 10,000 each to 10 different unit holders, including the Salbo Superannuation Fund. The investment in the Bosa Trust is less than 5% of the Kirkpatrick Family Superannuation Fund's total assets. The units in the Bosa Trust confer a fixed entitlement to the income of the Bosa Trust. The Salbo Superannuation Fund and all of the 9 other unit holders pay \$1.00 per unit, each paying a total of \$10,000. The market value of a unit in the Bosa Trust is \$1.00.

209. The Bosa Trust carries on a storage business. Bobby and Sally are employees of the Bosa Trust. They are paid a salary at the market rate. The Salbo Superannuation Fund owns the business premises from which the Bosa Trust runs its business. The Salbo Superannuation Fund leases the business premises to the Bosa Trust at a market rate. The business premises is less than 5% of the Salbo Superannuation Fund's total assets. Bruce loans money to the Bosa Trust at a market interest rate and on bona fide commercial terms. The Bosa Trust distributes an equal amount of income to all of the unit holders, including the Salbo Superannuation Fund, in accordance with the fixed entitlement. The amount of income distributed is a market rate of return, having regard to the market value of the units.

*Application of subsection 273(7)*

210. The acquisition of the units in the unit trust and the distribution of income constitute an arrangement for the purposes of subsection 273(7). Other arrangements and dealings have occurred between the Salbo Superannuation Fund, the Bosa Trust and other parties who are not at arm's length with each other.

211. The relationship between some of these parties is such that one party has the ability to influence or control the other. The crucial issue, however, is that in all of these arrangements, the dealing between the parties is a matter of real bargaining. The units are acquired at market value, the distributions are paid at a market rate, the lease of the business premises is on commercial terms as is the loan agreement between Bruce and the Bosa Trust. All of the parties involved in these arrangements are therefore dealing with each other at arm's length.

212. Accordingly, the facts of this example do not satisfy the test in paragraph 273(7)(a). Furthermore the amount of income derived by the Salbo Superannuation Fund is not greater than an arm's length amount. The facts of this example do not satisfy the test in paragraph 273(7)(b).

## *The decision*

213. The trust distribution derived by the Salbo Superannuation Fund from the Bosa Trust is not special income.

## **Example 12**

### *The facts*

214. A self managed superannuation fund, the Chau Superannuation Fund, acquires 10,000 units in the Innovative Investments Trust. The members of the Chau Superannuation Fund are Patrice and Tom. The Innovative Investments Trust issues 100,000 units, 10,000 each to 10 different unit holders, including the Chau Superannuation Fund. The units owned by the Chau Superannuation Fund confer a fixed entitlement to the income of the Innovative Investments Trust. The trustees of the Innovative Investments Trust and the members of the Chau Superannuation Fund are unrelated.

215. Although the 9 other unit holders in the Innovative Investments Trust pay \$1.00 per unit, a total of \$10,000 each, the members of the Chau Superannuation Fund have an agreement with the Innovative Investments Trust whereby the Innovative Investments Trust pay 50 cents per unit and only pay a total of \$5,000 for their total unit holding. The Innovative Investments Trust distributes an equal amount of income to all of the unit holders, including the Chau Superannuation Fund, in accordance with the fixed entitlement. Each unit holder receives a distribution of \$500. The amount of income distributed is a market rate of return having regard to the market value of the units.

### *Application of subsection 273(7)*

216. An 'agreement' is an 'arrangement' for the purposes of subsection 273(7) as defined in subsection 273(8). The acquisition of the units in the unit trust, the agreement between the Innovative Investments Trust and the Chau Superannuation Fund whereby the fund pays 50 cents per unit, and the distribution of income constitute an arrangement for the purposes of subsection 273(7). The fixed entitlement is acquired and the income is derived under this arrangement.

217. Although the members of the Chau Superannuation Fund and the Innovative Investments Trust are at arm's length they collude to achieve the result of acquiring units at below market value. The dealing between the two parties in relation to the arrangement was not a matter of real bargaining. Therefore the Chau Superannuation Fund acquired the fixed entitlement under an arrangement the parties to which were not dealing with each other at arm's length. The test in paragraph 273(7)(a) is satisfied.

218. The amount of income that the Chau Superannuation Fund derived is greater than the amount of income that it might have expected to have derived if the Chau Superannuation Fund and Innovative Investments Trust were dealing with each other at arm's length in relation to the arrangement because the units were acquired for \$5,000 less than the arm's length amount. The amount of income derived from the arrangement was therefore greater than the amount that would have been derived if the parties were dealing with each other at arm's length. The test in paragraph 273(7)(b) is therefore satisfied.

*The decision*

219. The \$500 distribution from the Innovative Investments Trust is income of the Chau Superannuation Fund that is special income under subsection 273(7).

**Example 13**

*The facts*

220. A business is operated by a discretionary trust. A fixed trust is created and the discretionary trust deed is amended to include the fixed trust as a beneficiary. A self managed superannuation fund has a fixed entitlement to income in the fixed trust. The members of the self managed superannuation fund are the trustees of the discretionary trust and are the directors and shareholders of the corporate trustee of the fixed trust. A distribution is made by the discretionary trust to the fixed trust. The fixed trust then distributes income to the self managed superannuation fund in accordance with the fixed entitlement.

*Application of subsection 273(7)*

221. The amendment of the trust deed of the discretionary trust to include the fixed trust as a beneficiary, the distribution of income from the discretionary trust to the fixed trust and the distribution of income from the fixed trust to the self managed superannuation fund would all fall within the definition of 'arrangement' in subsection 273(8). For the purposes of subsection 273(7) this course of action is an arrangement that relates to the acquisition of the fixed entitlement to the income of the fixed trust and to the derivation of that income.

222. The parties to this arrangement, the discretionary trust, the fixed trust and the self managed superannuation fund have colluded to achieve a particular result. The parties are not involved in real bargaining in relation to the arrangement. This is demonstrated by the fact that the fixed trust receives a distribution of income for no initial expense.

223. The self managed superannuation fund also receives a distribution of income for no initial expense. The income of the fixed trust has increased as a result of the distribution received from the discretionary trust under an arrangement the parties to which were not dealing with each other at arm's length. As a result, the fixed trust has more income available to be distributed. If the parties were dealing at arm's length, no distribution to the fixed trust from the discretionary trust could be expected and less income would have been available for distribution from the fixed trust.

224. In these circumstances, the parties to the arrangement were not dealing with each other at arm's length and the amount of income derived by the self managed superannuation fund from the arrangement is greater than might have been expected to have been derived by the fund if the parties had been dealing with each other at arm's length. Both the tests in paragraphs 273(7)(a) and 273(7)(b) are satisfied.

#### *The decision*

225. The amount of income derived by the self managed superannuation fund from the fixed trust is special income under subsection 273(7).

#### **Example 14**

##### *The facts*

226. The Kirkpatrick Trust carries on a business of labour hire operation. The trustee is Kiz Pty Ltd. The two shares issued by Kiz Pty Ltd are held by Eddie. Eddie holds 2000 units in the Kirkpatrick Trust. The Kirkpatrick Family Superannuation Fund holds 98,000 units in the Kirkpatrick Trust. The investment in the Kirkpatrick Trust is less than 5% of the Kirkpatrick Family Superannuation Fund's total assets. Both unit holders pay market value for their units. The members of the Kirkpatrick Family Superannuation Fund are Eddie and Katie. The trustee is Kiz Pty Ltd. The trust deed of the Kirkpatrick Trust states that the income of the trust will be distributed in proportion to the units held.

227. The only client of the Kirkpatrick Trust is Edward Kirkpatrick Pty Ltd. All of the income of the Kirkpatrick Trust consists of service fees received from Edward Kirkpatrick Pty Ltd. The income of the Kirkpatrick Trust in the year ended 30 June 2000 was \$5,000,000. On 1 July 2000, the Kirkpatrick Trust distributes all of the income that it has derived in the year ended 30 June 2000 to the unit holders in proportion to the units held. The income derived by the Kirkpatrick Family Superannuation Fund from the Kirkpatrick Trust in the year ended 30 June 2001 is \$4,900,000. Taking into consideration the operating costs and the net profit achieved by independent suppliers in respect of the provision of similar services in the market, the services fees charged by the Kirkpatrick Trust in the year ended 30 June 2000 is much higher than the market rate of those fees.

*Application of subsection 273(7)*

228. The income derived by the Kirkpatrick Family Superannuation Fund from the Kirkpatrick Trust in the year ended 30 June 2001 is derived under an arrangement as that term is defined in subsection 273(8).

229. Part of this arrangement is the understanding that service fees would be paid by Edward Kirkpatrick Pty Ltd to the Kirkpatrick Trust at a certain rate. Since the rate of these fees is much higher than the market rate of these fees, the dealing between some of the parties to the arrangement was not a matter of real bargaining. Edward Kirkpatrick Pty Ltd and the Kirkpatrick Trust were not dealing with each other at arm's length in relation to the arrangement. The test in paragraph 273(7)(a) is satisfied.

230. The income of the Kirkpatrick Trust has increased as a result of the excessively high rate of fees charged under an arrangement the parties to which were not dealing with each other at arm's length. As a result, the Kirkpatrick Trust has more income available to be distributed. If Edward Kirkpatrick Pty Ltd and the Kirkpatrick Trust were dealing at arm's length, a far less amount of income could be expected from service fees and much less income would have been available for distribution from the Kirkpatrick Trust. The amount of income derived by the Kirkpatrick Family Superannuation Fund from the Kirkpatrick Trust in the year ended 30 June 2001 is greater than might have been expected to have been derived if the parties had been dealing with each other at arm's length in relation to the arrangement. The test in paragraph 273(7)(b) is satisfied.

*The decision*

231. The income is special income of the Kirkpatrick Family Superannuation Fund under subsection 273(7).

## Appendix 2 – Alternative views

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❶ ***This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.***

### **‘Income’**

232. An alternative interpretation of the word ‘income’ for the purposes of section 273 is that it only includes income according to ordinary concepts. According to this view, amounts that are only assessable income because of a statutory provision cannot be special income. Franking credits and capital gains could never be special income. Trust distributions and dividends could only be special income if they were income according to ordinary concepts.

233. The basis for this view is that the word ‘income’ is not defined in the ITAA 1936 or the ITAA 1997. It is argued that the ordinary meaning of the word therefore applies. The ordinary meaning of the word ‘income’ is income according to ordinary concepts or ordinary income.

234. Section 97 has been suggested as an example of a provision in which the word ‘income’ refers not to ‘net income’ or ‘assessable income’ but to income according to ordinary concepts. *Davis v. FC of T*<sup>42</sup> has been cited as authority for this proposition. The issue dealt with in *Davis v. FC of T* is the distinction for accounting purposes between trust law income and tax law net income and the determination of the appropriate method for calculating ‘income’ for the purposes of section 97.

235. Although there are similarities between the distinction between ordinary income and statutory income and the one between trust law income and tax law net income, it is considered that the issues are separate. It is therefore considered irrelevant that the reference to ‘income’ in section 97 has been interpreted to refer to trust law income.

236. Having regard to the intention behind section 273, the way the term ‘income’ is used and interpreted in other areas of the ITAA 1936, and the consequences that would follow if ‘income’ were held to only include ordinary income, the term should be interpreted to include ordinary income and statutory income.

### **‘Derived’**

237. In support of this alternative view it is also argued that the words ‘income derived’ should be read as being limited to ordinary income. This argument is based on the fact that section 6-5 of the ITAA 1997 refers to ‘ordinary income that is derived’ whilst there is no corresponding requirement in section 6-10 of the ITAA 1997 for statutory income to be derived.

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<sup>42</sup> (1989) 20 ATR 548 at 576-7; 89 ATC 4377 at 4403.

238. The Commissioner disagrees with this interpretation of the word ‘derived’ for the same reasons that the Commissioner disagrees with the narrow interpretation of the word ‘income’. As discussed in paragraphs 72-82 and paragraphs 232-236, the intention behind section 273, the way the term ‘income’ is used and interpreted in other areas of the ITAA 1936, and the consequences that would follow if the word ‘income’ for the purposes of section 273 were held to only include ordinary income, all indicate that the words ‘income derived’ should be interpreted to include ordinary income and statutory income.

239. More specifically, the use of the word ‘derived’ in other areas of the ITAA 1936 suggests that it can be used to refer to statutory and ordinary income. This point is made in Taxation Ruling TR 2005/2 at paragraph 24. Examples provided include section 79D, in which the word ‘derived’ refers to assessable income generally, although not capital gains. Section 128B includes the word ‘derived’ and it applies to dividends and royalties that may not be ordinary income. Similarly, the word ‘derived’ is also used in subsection 44(1), section 96C and subsection 110-55(7) of the ITAA 1997 to refer to profits that would be beyond what is considered ordinary income.

240. Based on these examples Taxation Ruling TR 2005/2 makes the following conclusion:

In this particular context, the ATO considers that ‘income derived’ is a shorthand reference to an amount that is treated as some form of income for the purposes of income tax.<sup>43</sup>

241. The Commissioner considers that this interpretation of the words ‘income derived’ also applies to section 273.

### **Franking credits**

242. In regard to franking credits, an alternative view is that they can never be special income. This view is supported by the alternative view explained above in relation to the interpretation of the word ‘income’ for the purposes of section 273. If it is accepted that the word ‘income’ for the purposes of section 273 does not include amounts that are only assessable income because of a statutory provision, then franking credits cannot be special income.

243. Even if it is accepted that the word ‘income’ for the purposes of section 273 should be interpreted broadly to include both income according to ordinary concepts and amounts included in assessable income under a statutory provision, there is another line of reasoning put forward in support of the alternative view that franking credits can never be special income.

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<sup>43</sup> Paragraph 24.

# TR 2006/D1

244. This line of reasoning flows from the contention that the words in subsection 273(4) do not apply to franking credits. More specifically, it is contended that a franking credit is not income derived from a transaction. As explained in paragraphs 177-181, the Commissioner is of the view that a franking credit may be income derived from a series of transactions for the purposes of subsections 273(4) and (5).

## **Appendix 3 – Your comments**

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245. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date. (Note: The Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

**Due date:** 10 March 2006

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**Appendix 4 – Detailed contents list**

246. The following is a detailed contents list for this Ruling:

	<b>Paragraph</b>
<b>What this Ruling is about</b>	<b>1</b>
<b>Previous Rulings</b>	<b>7</b>
<b>Ruling</b>	<b>8</b>
Dividends paid by a private company	13
<i>Self-assessment</i>	14
<i>Income derived indirectly from a dividend</i>	15
<i>Non-share dividends</i>	16
<i>Matters to be considered by the Commissioner</i>	17
<i>Value of the shares</i>	21
<i>Cost of the shares</i>	26
<i>Rate of the dividend</i>	29
<i>Whether a dividend is paid on any other shares in the company and the rate of that dividend</i>	36
<i>Whether shares have been issued in satisfaction of a dividend and the circumstances of issue</i>	39
<i>Other matters that the Commissioner considers relevant</i>	42
Income from a transaction where the parties are not dealing at arm's length	47
<i>Transaction</i>	50
<i>Not dealing with each other at arm's length</i>	52
<i>The amount of income derived from the transaction</i>	55
<i>Franking credits</i>	57
Trust distributions not arising from a fixed entitlement	58
Trust distributions arising from a fixed entitlement	59
<i>Arrangement</i>	61
<i>Not dealing with each other at arm's length</i>	62
<i>The amount of income derived from the trust</i>	64
<b>Date of effect</b>	<b>66</b>
<b>Appendix 1 – Explanation</b>	<b>67</b>
Legislative background	67
'Income'	72
The entire amount of income is special income	83

Dividends paid by a private company	84
<i>Self-assessment</i>	84
<i>Non-share dividends</i>	85
<i>Matters to be considered by the Commissioner</i>	89
<i>Value of the shares</i>	96
<i>Cost of the shares</i>	99
<i>Rate of the dividend</i>	102
<i>Other matters that the Commissioner considers relevant</i>	106
<i>Example 1</i>	113
<i>The facts</i>	113
<i>Consideration of the matters under subsection 273(2)</i>	116
<i>The decision</i>	121
<i>Example 2</i>	122
<i>The facts</i>	122
<i>Consideration of the matters under subsection 273(2)</i>	124
<i>The decision</i>	128
<i>Example 3</i>	129
<i>The facts</i>	129
<i>Consideration of the matters under subsection 273(2)</i>	131
<i>The decision</i>	136
<i>Example 4 (incorporates the facts in paragraphs 129-130 from Example 3)</i>	137
<i>Additional facts</i>	137
<i>Consideration of the matters under subsection 273(2)</i>	138
<i>The decision</i>	143
<i>Example 5 (incorporates the facts in paragraphs 129-130 from Example 3)</i>	144
<i>Additional facts</i>	144
<i>Consideration of the matters under subsection 273(2)</i>	145
<i>The decision</i>	150
<i>Example 6</i>	151
<i>The facts</i>	151
<i>Consideration of the matters under subsection 273(2)</i>	154
<i>The decision</i>	159
Income from a transaction where the parties are not dealing at arm's length	160

<i>Capital gains</i>	160
<i>Transaction</i>	161
<i>Not dealing with each other at arm's length</i>	166
<i>Franking credits</i>	177
<i>Example 7 (facts as per paragraphs 151-153 of Example 6)</i>	182
<i>Application of subsections 273(4) and (5)</i>	182
<i>The decision</i>	184
<i>Example 8</i>	185
<i>The facts</i>	185
<i>Application of subsections 273(4) and (5)</i>	187
<i>The decision</i>	189
<i>Example 9</i>	190
<i>The facts</i>	190
<i>Application of subsections 273(4) and (5)</i>	191
<i>The decision</i>	194
<i>Example 10</i>	195
<i>The facts</i>	195
<i>Application of subsection 273(2)</i>	196
<i>Application of subsections 273(4) and (5)</i>	198
<i>The decision</i>	200
<i>Trust distributions – 'fixed entitlement'</i>	201
<i>Trust distributions arising from a fixed entitlement</i>	207
<i>Not dealing with each other at arm's length</i>	207
<i>Example 11</i>	208
<i>The facts</i>	208
<i>Application of subsection 273(7)</i>	210
<i>The decision</i>	213
<i>Example 12</i>	214
<i>The facts</i>	214
<i>Application of subsection 273(7)</i>	216
<i>The decision</i>	219
<i>Example 13</i>	220
<i>The facts</i>	220
<i>Application of subsection 273(7)</i>	221
<i>The decision</i>	225

<i>Example 14</i>	226
<i>The facts</i>	226
<i>Application of subsection 273(7)</i>	228
<i>The decision</i>	231
<b>Appendix 2 – Alternative views</b>	<b>232</b>
‘Income’	232
‘Derived’	237
Franking credits	242
<b>Appendix 3 – Your comments</b>	<b>245</b>
<b>Appendix 4 – Detailed contents list</b>	<b>246</b>

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TR 92/20; TR 2005/2

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