

# Commissioner attacks “trust stripping scheme”

**WHILE FAILING ON THE SHAM ARGUMENT, THE COMMISSIONER HAS SUCCESSFULLY ARGUED THAT THE DISTRIBUTION OF TAXABLE INCOME TO A LOSS TRUST IS A REIMBURSEMENT AGREEMENT PURSUANT TO S100A.**



In *Raftland Pty Ltd v Commissioner of Taxation* [2007] FCAFC 4, the Full Federal Court has found that the nomination of a “loss trust” as a beneficiary and distributions to that loss trust was not a sham but that the trust stripping provisions of s 100A of the *Income Tax Assessment Act 1936* (ITAA36) applied.

The case demonstrates the effectiveness of s 100A in preventing taxpayers from using loss trusts to receive distributions of assessable income in an attempt to absorb losses and minimise tax. The case is also a reminder of the difficulties the Commissioner of Taxation (Commissioner) faces when arguing that a transaction is a sham where the parties intend the legal consequences of their actions (even where that intention is to minimise tax).

## FACTS

Various building and property related businesses owned by the Heran brothers (the Heran businesses) were projected to make substantial taxable profits for the 1995 and subsequent financial years. The Heran brothers sought the advice of their accountants who arranged for the Heran brothers to “buy”, for \$250,000, the E & M Unit Trust (the Unit Trust) which had losses from previous years in the order of \$4 million. The trustee of the Unit Trust (subsequently replaced by Raftland Pty Ltd (Raftland)) and the trustee of the unit holding discretionary trusts were initially third parties but were replaced with the Heran brothers’ lawyer before the end of the 1995 financial year.

In the 1995 financial year the Heran brothers established two discretionary

trusts including the Raftland Trust of which Raftland was the trustee. Both discretionary trusts included the Unit Trust as a “tertiary” beneficiary. According to the deeds of the discretionary trusts if the trustees of those trusts did not determine to accumulate or distribute to a beneficiary the income of those trusts, then that income was to be held in trust for the tertiary beneficiary who was to have an indefeasible vested interest in that income. If there was no tertiary beneficiary then the income was to be held on trust for the Heran brothers as primary beneficiaries.

On 30 June 1995 a trust associated with the Heran brothers (Associated Trust) resolved to distribute approximately \$2.8 million to the Raftland Trust from the Heran businesses, which in turn resolved to distribute \$250,000 to the Unit Trust and the balance to the Unit Trust. The \$250,000 was paid at the direction of the Heran brothers’ lawyer as trustee of the Unit Trust to the accountants and to third parties. The balance of the distribution was unpaid. Similar unpaid distributions were made during the 1996 and 1997 years from associated trusts to the Raftland Trust who in turn made unpaid distributions to the Unit Trust.

## FEDERAL COURT DECISION

The Court found that both the nomination of the Unit Trust as a tertiary beneficiary of the Raftland Trust and the distributions by the Raftland Trust to the Unit Trust were shams. As a result the Heran brothers as primary beneficiaries were presently entitled to the income distributions. The Court further found that s 100A applied so that Raftland as trustee of the Raftland Trust was liable

to tax pursuant to s 99A ITAA36 on the amounts purportedly distributed.

## FULL FEDERAL COURT DECISION

### Was the nomination of the Unit Trust as a beneficiary a sham?

The Full Court quoted, with approval, case law that found that for a transaction to be a sham there must be an intention common to the parties to it, that the transaction is a cloak or disguise for some other and real transaction or no transaction at all.

The Full Court found that it was clear that it was deliberately intended that the Unit Trust was to be the tertiary beneficiary of the Raftland Trust so that it would receive distributions of income, including as a default beneficiary, to absorb the losses of the Unit Trust. Therefore the nomination of the Unit Trust as a tertiary beneficiary of the Raftland Trust was not a sham but rather at the forefront of the intentions of those who established the Raftland Trust.

### Were the distributions to the Unit Trust a sham?

The Full Court declined to expressly decide whether the trustee of the Raftland Trust’s determinations to distribute income to the Unit Trust were shams as, even if they were found to be shams (and therefore ineffective), as the Unit Trust was the default beneficiary for any undistributed or unaccumulated income, it would have received those distributions in any event.

The Full Court did acknowledge that it was objectively inconceivable that the Raftland Trust intended to confer an entitlement to \$4 million to complete strangers but

found that it was the intention to pass the income of the Raftland Trust to the Unit Trust to absorb the Unit Trust's losses for tax purposes, whether that be by express distributions or through the default income provisions of the Raftland Trust's deed.

#### Were the distributions reimbursement agreements pursuant to s 100A?

If subs 100A(1) applies to a distribution to a beneficiary, the distribution is taken not to occur and the trustee of the trust is attributed with the income. In order for subs 100A(1) to apply there must be a reimbursement agreement arising out of the present entitlement of a beneficiary (i.e. the Unit Trust) to the income of a trust (i.e. the Raftland Trust). A transaction will not be a reimbursement agreement if it is in the course of ordinary family or commercial dealings.

The Full Court found that the arrangements involving the unpaid distribution from the Raftland Trust to the Unit Trust in the 1995 financial year was a reimbursement agreement as those arrangements involved the provision for the payment of money to a person other than the Unit Trust (i.e. the Associated Trust retained the money from the first unpaid distribution to the Raftland Trust). The Full Court further found that the reimbursement agreement arose out of the unpaid present entitlement to the Unit Trust as the distribution would not have been made without the reimbursement agreement and that the distributions were for the purposes of tax minimisation rather than in the course of ordinary family or commercial dealings.

All of the unpaid distributions in the 1996 and 1997 financial years were also found to involve reimbursement agreements, other than a distribution of rental and interest income from an associated trust.

#### Did the exemption in subs 100A(3A) apply?

Subsection 100A(1) does not apply to a distribution from a trust (original trust) if that distribution is made to a trust (beneficiary trust) as a beneficiary of the original trust and one or more beneficiaries of the beneficiary trust are presently entitled to the "trust stripping" income from the original trust.

It was argued on behalf of the Raftland Trust that the subs 100A(3A) exemption should apply. The trust deed of the Unit Trust provided that the trustee was required to pay, apply or set aside the net income of the Unit Trust for the unit holders in their proportion of units, with such amounts to be held on trust for the unit holders. It was argued that the unit holders of the Unit Trust were therefore presently entitled to the income distributed to the Unit Trust by the Raftland Trust.

The Full Court rejected this argument for three reasons. First it found that during the years in question, for trust law purposes, there was no net income that the trustee of the Unit Trust could distribute as the income was absorbed by the previous losses of the Unit Trust.

Secondly, there was no payment, application or setting aside of any income to the unit holders. This was supported by the Unit Trust's financial accounts which showed no distributions to the unit holders. This is an interesting finding as it suggests that even where the trust deed requires amounts to be set aside for unit holders of a unit trust, if the trustee fails to set aside that income or accumulate it, the unit holders will not be presently entitled to that income.

Thirdly, until the income is paid, applied or set aside, the unit holders right to the income is defeasible at the discretion of the trustee of the Unit Trust due to its power to redeem or cancel the issued units on such terms and conditions and for such consideration that it shall determine.

#### IMPLICATIONS OF THE CASE FOR THE COMMISSIONER AND TAXPAYERS

This case shows yet again the great difficulties that the Commissioner has in arguing that a transaction is a sham, even if that transaction has a tax minimisation purpose. As most arrangements are set up deliberately and have been structured to create legal rights and obligations, it will only be the most poorly documented transactions that will be found to be a sham. The case also highlights the need for taxpayers to consider the potential application of s100A when making distributions of assessable income to a loss trust.

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