

Part IVA, discretionary trust distributions and the CGT small business concessions

THIS ARTICLE CONSIDERS THE ALTERATION OF INCOME/CAPITAL APPOINTMENTS FROM A DISCRETIONARY TRUST TO ACCESS THE CGT SMALL BUSINESS CONCESSIONS IN LIGHT OF THE PART IVA REGIME.



This article considers the potential application of the general income tax anti-avoidance regime, Part IVA, to the alteration of income or capital appointments from a discretionary trust such that access to the capital gains tax (CGT) small business concessions¹ (small business concessions) would be available in circumstances that they otherwise would not. Specifically, the alteration is carried out so that at the time of a relevant CGT event, the necessary small business participation percentage requirements are met.

The small business concessions take the form of an exemption, discount or deferral of CGT that would otherwise be payable. Therefore altering the appointment of income/capital for the primary purpose of ensuring that the necessary small business participation requirements are satisfied could, on the face of it, be considered to trigger a Part IVA scheme as the structuring is directed at achieving a tax benefit.

In these circumstances a tax practitioner should advise with Part IVA in mind. The eight factors identified in s 177D(b) of the *Income Tax Assessment Act 1936 (ITAA36)* should be considered in determining whether a Part IVA scheme exists. Following the reasoning applied by Gummow and Hayne JJ in *Commissioner of Taxation v Hart² (Hart)*, Part IVA should not apply in the writers' view, so long as the distribution of income/capital made to the beneficiary by the trustee corresponds with any appointment.

This article considers when such structuring will be effective tax planning and when it may attract the adverse attention of Part IVA.

All legislative references in this article are to ITAA36.

PART IVA

Part IVA applies to a scheme where a taxpayer obtains a tax benefit in connection with the scheme if, after having regard to the eight factors identified in s 177D(b), it can be concluded that the scheme was entered into to obtain a tax benefit.³ The test is an objective one that is applied to the individual circumstances of each case. The Commissioner has the discretion to cancel a tax benefit that has been obtained in connection with a Part IVA scheme.⁴

A Part IVA scheme is defined broadly and includes any agreement, arrangement, understanding or undertaking⁵ and has been held to encompass not only a series of steps which together are considered to be a scheme but also the taking of one of the steps.⁶

The eight factors the Commissioner must consider in determining whether to cancel a tax benefit are, broadly, the manner in which the scheme was entered into or carried out, the form and substance of the scheme, the time and length of the scheme, the tax result of the scheme if Part IVA did not apply, the change in financial position of the taxpayer and any other person connected with the scheme that resulted from the scheme, the connection between the parties to the scheme and the other relevant consequences to the taxpayer.⁷

Deriving a tax benefit must be the dominant purpose of the scheme.⁸ In its ordinary meaning, dominant indicates that purpose which is "the ruling, prevailing, or most influential purpose."⁹

SMALL BUSINESS CONCESSIONS

In broad terms, where certain basic conditions are satisfied an entity that is liable to pay CGT on the transfer of an asset is entitled to a tax concession under the small business concessions regime. The concession can take the form of:

- a full exemption if the "15 year exemption"¹⁰ applies; or
- a reduction of the CGT liability if the "50 per cent active asset reduction" applies;¹¹ and/or
- a reduction of the CGT liability if the "retirement exemption"¹² applies; and/or
- a deferral of the CGT liability if the "replacement active asset rollover"¹³ applies.

The basic conditions that are required to be met are that the taxpayer is a small business entity (or the net asset value of the business and its connected entities is \$6 million or less) and the asset disposed of is an active asset.

Where the CGT asset is a share in a company (**target company**) or an interest in a trust (**target trust**) an additional basic condition must be satisfied, being that:

- the taxpayer is a CGT concession stakeholder in the target company or target trust, that is, the taxpayer being an individual has a small business participation percentage in the target entity of at least 20 per cent (also defined as a "significant individual") (s 152-10(2)(a)); or
- CGT concession stakeholders in the target company or target trust together have a small business participation

percentage in the taxpayer entity of 90 per cent (s 152-10(2)(b)).¹⁴

For the purposes of this article it will suffice to note that a small business participation percentage in a trust is the percentage of any distribution of income (or capital)¹⁵ that an individual beneficiary is beneficially entitled to. The definition of the small business participation percentage in relation to a company is not considered nor the definition of a CGT concession stakeholder in relation to a spouse of a significant individual.

DISCRETIONARY TRUST STRUCTURING

Consider the following example:

The trustee of a discretionary trust proposes to dispose of or transfer three units in a unit trust on 30 June 2008. The units are three of ten units on issue constituting a 30% interest. The discretionary trustee holds the three units on trust for a class of beneficiaries comprising Bill and June and their relatives and related entities. In planning for the transfer of the interest in the unit trust, on 30 June 2008, the discretionary trustee varies the appointment of income in favour of Bill from 20% for that income year to 90% so that the additional basic condition of relief is satisfied (that is, Bill holds a small business participation percentage in the discretionary trust of 90% and a small business participation percentage of 27% (30% multiplied by 90%) in the unit trust) at the time of the transfer of the units (specifically in satisfaction of section 152-10(2)(b)).

Will the alteration of the appointment of income on 30 June 2008 from 20 per cent to 90 per cent trigger a cancellation of the tax benefit under Part IVA?

In determining whether the alteration is a Part IVA scheme entered into or carried out for obtaining a tax benefit entails consideration of the eight factors set out in s 177D(b). In applying s 177D(b), Gummow and Hayne JJ held in the Hart decision that:

...the inquiry directed by Part IVA requires comparison between the scheme in question and an alternative postulate. To draw a conclusion about purpose from the eight factors identified in s 177D(b) will require a consideration of what other possibilities existed.¹⁶

In other words, the inquiry necessitates a consideration of how else the economic objective of the scheme might have been achieved in determining whether the scheme was entered into for a dominant tax purpose.

In Hart, the taxpayers elected to split a loan advance into a home loan account for the purchase of a primary residence and an investment loan account for the refinance of an investment property. They subsequently directed the lender, under the terms of the loan agreement, to allocate their monthly principal and interest payments in reduction only of the home loan amount. The interest on the investment loan amount accrued without being serviced and was capitalised. The Commissioner of Taxation (**Commissioner**) denied interest deductions and issued a Part IVA determination.

manner in which the trustee could have distributed 90 per cent of the income of the discretionary trust to Bill.

Therefore whilst, objectively, it may be concluded that the alteration of the patterns of income appointment was directed towards a tax purpose, the change in the financial position and economic circumstances of Bill (his entitlement to 90 per cent and not 20 per cent of the income of the discretionary trust) would not, in the writers' view, lead to the conclusion that the scheme was one to which Part IVA applies.

“ It is therefore necessary to determine whether the economic substance of the transaction could have been achieved in a more ‘straightforward or commercial’ manner ... ”

The High Court unanimously concluded that Part IVA did apply to the particular transaction. In their decision, Gummow and Hayne JJ determined that there were other ways in which the commercial objective of the scheme, the borrowing of the funds to finance and refinance properties, might have been achieved. Their Honours were left with no doubt that the terms on which the split loan was made available “were explicable *only* by the taxation consequences”.¹⁷

In applying s 177D(b) to the discretionary trust example above, the alteration of the income appointment could be said to have been made so that the discretionary trust and Bill could gain access to the small business concessions on the subsequent transfer of the units, however, the economic rationale of any appointment of income is the subsequent distribution of that income to the beneficiary who had become entitled to it. The “alternative postulate” reasoning of Gummow and Hayne JJ requires a determination of how else the economic objective of the appointment (or variation to it) might have been achieved. In these particular circumstances, on the basis that the distribution of income follows the appointment, there is no other discernable

It is fundamental to this conclusion that the form and substance of the scheme correspond. In the example, the creation of the entitlement in Bill to 90 per cent of the income is not an entitlement in legal form only. Its dominant purpose was its commercial objective of distributing income.

The tax benefit to the discretionary trust and Bill could be cancelled under Part IVA if in substance there was an arrangement in place so that Bill had no entitlement to the economic benefit of the distribution in the discretionary trust. For example, this could be achieved through an understanding that Bill disclaim his income entitlement or gift it to a person who had previously been receiving appointments of income from the discretionary trust prior to the appointment of 90 per cent of the income.¹⁸

PSLA 2005/4 summarises the Commissioner's position on the interrelationship between the guiding alternative postulate principle and the form/substance factor:

The second factor, which examines “the form and substance of the scheme”, requires that substance, rather than form, be the subject of inquiry. Put simply the factor directs attention to whether there is a discrepancy between the form of the scheme and its substance, meaning

its commercial and economic substance.

A discrepancy between the business and practical effect of a scheme on the one hand, and its legal form on the other, may well indicate the scheme has been implemented in a particular form as the means to obtain a tax benefit if the substance of the scheme may be achieved or available by some other more straightforward or commercial transaction or dealing.

It is therefore necessary to determine whether the economic substance of the transaction could have been achieved in a more “straightforward or commercial” manner and the existence of a more appropriate manner could demonstrate, in the Commissioner’s view, a discrepancy between the “business and practical effect” of a scheme and its legal form.

Whilst the Commissioner has not officially clarified his view on this issue, it appears that the Commissioner will not be concerned with deliberate alterations to income/capital appointment where it is conducted or followed through in a fashion where substance corresponds with form.¹⁹

The discretionary trust structuring example is one that could, like many other tax planning initiatives, be considered at face value to be a Part IVA scheme. The example was employed to demonstrate that tax planning can be effective in passing the Part IVA hurdle if a purpose of the transaction²⁰ is the obtaining of an economic benefit²¹ and the transaction is completed in substance. From applying the alternative postulate principle, it would also appear that, where an economic benefit is delivered by a transaction and there is no other manner in which the same economic benefit could be achieved in a less tax effective form, Part IVA would not apply.

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Reference notes:

- 1 Division 152 of the Income Tax Assessment Act 1936.
- 2 [2004] HCA 26.
- 3 Section 177D.
- 4 Section 177F.
- 5 Subsection 177A(1).
- 6 *FCT v Hart* (2004) HCA 26 at 43.
- 7 Subsection 177D(b).
- 8 Subsection 177A(5).
- 9 *FCT v Spotless Services Ltd* 141 ALR 92 at 98.
- 10 Subdivision 152-B.
- 11 Subdivision 152-C.
- 12 Subdivision 152-D.

- 13 Subdivision 152-E.
- 14 Subsection 152-10(2).
- 15 Specifically the lower of the percentage of the actual distributions of income or actual distributions of capital.
- 16 [2004] HCA 26 at 66.
- 17 [2004] HCA 26 at 68.
- 18 Additionally this may also draw into question whether the present entitlement was made and invalidate or void the distribution.
- 19 *Nick Oliver and Peter Walmsley, Part IVA, 16th National Tax Intensive Retreat*, at 10.
- 20 *Being one or more critical steps or the entire transaction.*
- 21 *That is assessed independent of the tax benefit obtained.*