

Special income

A recent AAT decision reminds us that there are several elements of non-arm's length income that all practitioners must be aware of. This is especially relevant where superannuation fund trustees have invested in related unit trusts.

Superannuation fund income which is non-arm's length income is subject to income tax at 45% (not the usual 15%). Income is non-arm's length income if:

- it is derived from a scheme where the parties were not dealing at arm's length and the amount of the income is more than the amount that would have received if they were dealing at arm's length; or
- it is a private company dividend (unless the Commissioner deems the dividend not be non-arm's length income).

Facts of the AAT decision

In 1995 a superannuation fund trustee acquired 4% of the shares in a private company from Mrs C. There was a 'relationship' between the director of the superannuation fund trustee and Mrs C's husband who controlled the private company. The acquisition price was only 10% of the shares' market value. The superannuation fund trustee conceded that the price at which it acquired the shares was not an arm's length price.

The private company was a passive holding company that held shares in a listed public company. Over the years, the listed public company paid dividends to its shareholders, including the private company. The private company then paid these dividends to its shareholders, including the superannuation fund trustee. All of the dividends paid by the public listed company and the private company were proportional to the shares held.

As these facts arose prior to 1 July 2007, the relevant legislation referred to special income. If the facts arose today, the relevant legislation would refer to non-arm's length income.

As the dividends were from a private company, the dividends received by the superannuation fund trustee constituted special income. However, the Commissioner of Taxation may determine otherwise, having regard to certain factors. Those factors include:

- factor (a): the value of the shares; and
- factor (f): any other matters that the Commissioner considers relevant.

The Commissioner declined to exclude the dividends from being special income. The superannuation fund trustee objected to the AAT.

The Commissioner had stated in a taxation ruling that 'value' in factor (a) means 'market value'. A major argument by the superannuation fund trustee was that the Commissioner was wrong to state in his tax ruling that 'value' in factor (a) means 'market value'. The superannuation fund trustee won on this point, with the AAT stating 'the Ruling is in this particular regard incorrect'. However, market value was still relevant for factor (f).

The superannuation fund trustee argued that if the AAT decided the matter in favour of the Commissioner, the 'tainting effect' arising from the acquisition of assets for less than market value would endure indefinitely, and that this consequence could not have been intended. However, the AAT rejected this argument. They found that the underlying transaction that gave rise to the relevant income could not be divorced from the income itself.

Accordingly, the AAT affirmed the Commissioner's decision and the dividends constituted special income.

Implications: the tainting effect

The decision suggests that if an asset is ever acquired on other than arm's length's length terms, that will taint all associated income forever. Also, this principle applies to other investments that can result in non-arm's length income being derived from investments in trusts.

For example, consider a situation where an SMSF trustee purchases 500,000 units in a brand new unit trust for \$500,000 and an SMSF member also personally purchases 500,000 units for \$500,000. The unit trust trustee uses this money to acquire a \$1 million property. The property increases in value to \$1.5 million. The unit trust trustee needs further cash for repairs. The SMSF trustee wants to invest a further \$50,000 to fund the repairs. The unit trust trustee issues the SMSF trustee 50,000 units for \$50,000 each (ie, \$1 per unit). Because the real estate increased in value, \$1 per unit is no longer an arm's price for a unit. The arm's length price is now \$1.50 per unit.

Because of this, at least some of the income that the SMSF trustee now receives from the unit trust trustee (and arguably all of the income) is non-arm's length income and will be subject to income tax at 45%. This situation could have been overcome if the SMSF trustee had acquired 33,333 units instead of 50,000 in exchange for its \$50,000.

Practical implications

In light of the AAT decision, practitioners should:

- Ensure that all future SMSF transactions are at arm's length.
- Check that any previous SMSF transactions that are still giving rise to income today were at arm's length.
- Ensure that sufficient evidence is retained to prove the above.
- Remember that a transaction can still not be at arm's length even if the other party is not related.

Minimising the risk of non-compliance

A recent AAT decision highlights the risks of an SMSF being issued a notice of non-compliance. In fact recent reports have suggested that there is a substantial increase in the number of SMSFs being rendered non-complying.

The SMSF (with mum and dad members/trustees) lent more than 95% of its assets to a related (dad's) company. The trustees resolved in August 2004 to loan the related company an amount not exceeding \$130,000 for a term up to 5 years, repayable at 10% interest. From 2005 until 2008, no repayment was made, and no arrangement was put in place to reduce the level of in-house assets to below 5%, as required by the in-house asset rules. The loan was eventually repaid in full in March 2009.

The tribunal confirmed the ATO's position that the fund should be rendered non-complying after taking into account the three factors that the decision maker is required to consider, namely the taxation consequences, the seriousness of the contravention, and all other relevant circumstances.

Note, the mum and dad had suffered a number of unforeseeable events, such as health issues and storm damage which adversely impacted their

business, and these were taken into account. However, the members also invested in the purchase of a commercial site and undertook a strata project in 2007 instead of repaying their SMSF loan.

The tribunal after weighing up the above three factors was satisfied that the ATO made the correct decision. In particular, the tribunal was satisfied that the seriousness of the contravention and the length of time taken to redress it weighed most heavily against treating the Fund as complying.

As can be seen from the facts above, where a breach occurs, trustees and members must take timely corrective action to minimise the risk of being rendered non-complying. Moreover, immediate action should be taken as soon as any breach is detected as any breach may need to be reported by the fund's auditor. It is typically an auditor contravention reports ('ACR') that results in follow up activity by the ATO.

DBA is assisting an increasing number of SMSFs in regards to determine whether they have a compliance risk and providing pro active advice on how best to rectify breaches. We have also prepared numerous enforceable undertakings for SMSFs and have considerable experience in the objection and appeals process.

As a result of this experience, we are increasingly being requested to conduct health checks on SMSFs that feel they may benefit from an independent review. We have also noticed that some ACRs that have been lodged with the ATO were not correct at law. Advisers should ensure that ACRs are firmly based on a correct interpretation of law as an incorrect ACR may trigger unnecessary scrutiny. Auditors who are not certain on the law should obtain expert advice.

Advisers must have a sound knowledge of the complying fund rules as early corrective action invariably results in considerable savings.

DBA is covering this topic in detail in its upcoming seminars November 2009 around Australia. For more information regarding these seminars, visit <http://www.dbabutler.com.au/index.php?p=DNW> or call Marie on 03 9092 9400.

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