

Income injection out to sting taxpayers

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The AAT has recently considered the issue of whether a complex trust loss scheme was caught by the income injection test in Div 270 of Sch 2F to *ITAA 1936*. The issue arose in the case of *Eldersmede & Ors v FC of T* 2004 ATC 2129.

The AAT's decision highlights the broad operation of the income injection provisions. Surprisingly perhaps, the provisions potentially apply to what on their face would seem to be ordinary commercial arrangements. Significantly, the case evidences the unexpected sting the income injection provisions can give taxpayers.

Facts

The facts of the case are complex and to make them easier to understand we had to simplify them significantly.

Parties

The case involved a number of different parties. However, the main parties involved were the following:

- Eldersmede Pty Ltd (Corporate Trustee – CT1) was the trustee of both the Eldersmede Unit Trust (T1) and the Eldersmede Distribution Trust (T2); and
- Southern Business Supplies Pty Ltd (CT2) was the trustee of Citytrak Unit Trust (T3).

Importantly, each income year, the net income of T1 was distributed to T2.

Events

In the 1996 income year, the taxpayer, CT1 as trustee for (atf) T1 initially conferred a present entitlement to just over \$1.2m of its net income to CT1 atf T2. This was followed by a second resolution with T2 conferring a present entitlement to \$859,806 of its net income to CT2 atf T3 that had carry-forward losses of exactly \$859,806. Neither amount was paid in cash or invested on commercial terms.

The order of events was as follows.

- T2's trust deed was varied to redirect assessable income and the directors of CT1 and CT2 were standardised.
- There was a re-arrangement of unit holders in T1, T2 and T3 so that all units were held by the same parties.
- A resolution was passed by CT1 atf T1, to pay income to itself atf T2.
- The accounts of T2 reflected the distribution from T1.
- Immediately after the resolution distributing T1's income to T2, CT1 atf T2, resolved to make an interim distribution of income to CT2 atf T3 for an amount totalling the accumulated losses of the unit trust with the amounts allocated remaining unpaid.
- The above income allocations remained unpaid but were recorded by journal entry in the books of account of T1, T2 and T3.
- CT2 atf T3 took no steps to recover the above allocations to it (or the balance of that allocation after allowing for the amount of the set off) from CT1 atf T2 or to require CT1 atf T2 to invest on commercial terms for the benefit of T3 the amount of allocation to it.
- CT1 atf T2 took no steps to recover the above allocation to it (or the balance of that allocation after allowing for the amount of the set off) from itself atf T1 or to require the investment of the amount of the allocation (or the balance of it) on commercial terms, for the benefit of T2.

- CT2 atf T3 passed a "fail safe" resolution in favour of its unit holders to ensure that if it had net income in the relevant year, it would be distributed to beneficiaries of that trust and would not be taxed in the hands of CT2.

Issues for consideration

Before the AAT, the parties agreed that:

- CT2 atf T3 received a distribution from CT1 atf T2 and that this was an amount of assessable income (sec 270-10(b)(i)); and
- CT1 atf T2 was an outsider to CT2 atf T3 – in that capacity CT1, directly or indirectly, provided a benefit to CT2 atf T3 (sec 270-10(1)(b)(ii)).

The main issues to be considered by the AAT were:

- whether there was a "scheme";
- if so, whether CT1 atf T2 provided a benefit to CT2 atf T3 under the scheme; and
- whether CT2 atf T3, directly or indirectly, provided a benefit to CT1 atf T2 or one of its associates (sec 270-10(b)(iii)).

The law - What is income injection?

Where the income injection is met, the sting for taxpayers is that no deduction will be allowed. The conditions for the disallowance of deductions are set out in sec 270-10.

The requirements in sec 270-10(1) are cumulative, being the following:

- there must be a scheme;
- a person not connected with the trust (the outsider) must provide a direct or indirect benefit to the trustee or a beneficiary (or an associate of the trustee or beneficiary);
- a return benefit must be provided to the outsider; and

- it is reasonable to conclude that the benefit was provided, or scheme assessable income was derived, wholly or partly (but not merely incidentally) because the loss or deduction was allowable.

Where the conditions in sec 270-10 are met, the assessable income derived under the scheme ("scheme assessable income") will be included in the net income of the trust, taking no account of any tax losses and deductions that might otherwise have been taken into account (sec 270-15). Accordingly, even if the net income of the trust, calculated in the ordinary way, were less than the scheme assessable income, or even if the trust has no net income (calculated in the ordinary way), the net income of the trust for the income year will be increased so that it equals the scheme assessable income.

AAT decision

The AAT held that there had been a course of conduct and therefore a scheme. Further, the AAT concluded that all of the conditions in sec 270-10 for the income injection test were met. Accordingly, the stinging consequences in sec 270-15 followed for the taxpayer.

AAT's interpretation of the elements - Requirements 1 and 4: was there a scheme?

The term "scheme" was given its ordinary meaning being "any plan, proposal, action, course of action or course of conduct". In the case before the AAT, the scheme comprised the course of events that happened over time as discussed above.

The AAT found that a course of action or conduct happened over time, concluding on the date of the third distribution and was part of a scheme within the meaning of sec 272-140. In particular, the AAT was satisfied that there was a scheme to direct assessable income to the loss trust, ie T3.

Requirements 2 and 3: direct or indirect benefit/return benefit

The AAT interpreted the elements in sec 270-10(1)(ii) as follows:

- "directly or indirectly" – the AAT noted that if a party's actions are either the proximate cause or a contributory cause, then they will be taken to have provided the benefit directly or indirectly;
- "benefit or advantage" – both these terms were given their ordinary meaning being "anything that is for the good of a person or thing or that puts him, her or it in a better or more favourable position"; and
- "provide" – was also given its ordinary meaning of "furnishing, supplying or making available".

Were T1 and T2 associates?

The AAT found that CT1 atf T2 was an associate of itself atf T1 within the meaning of sec 318(3) of ITAA 1936.

The benefits

AAT concluded that the following occurred under a scheme:

- CT2 atf T3 derived an amount of scheme assessable income in the income year;
- CT1 atf T2, directly or indirectly, provided a benefit to CT2 atf T3. There was no issue between the parties that CT1 atf T2 provided a benefit to CT2 atf T3 by a resolution to distribute its income; and
- CT2 atf T3, directly or indirectly, provided a benefit to CT1 atf T2.

The AAT's findings on the benefits provided under the scheme are summarised in the table below.

Benefit provider and recipient	Action	Benefit provided
CT2 atf T3 to CT1 atf T2	T3 not calling upon T2 either to pay the amount allocated to it or to invest that amount on its behalf on commercial terms.	CT2 atf T3 by not calling for payment of the distributed funds permitted CT1 atf T2 to retain the use of those funds.
		T2 did not have to source the funds necessary to meet the demands of T3 calling upon the payment. Further, there was no requirement to pay interest on the amount remaining unpaid.
		T2 did not enter into an agreement to invest the amount of the distribution, or the balance outstanding, on a commercial basis for the benefit of T3.
CT2 atf T3 to CT1 atf T1 (indirect benefit)	T3 not demanding payment it was entitled to from T2.	If its demands had been made, T2 would have been obliged to make a corresponding demand on T1 in order to obtain the funds necessary to meet the demand by T3. As no such demand was made by T3, T1 continued to have the use of the funds equivalent to the amount of its distribution.
		As a result, by not calling up the distribution, or the balance of the distribution from T2, T3 indirectly conferred a benefit on T1.
CT2 atf T3 to CT1 atf T2	Delay in transferring amounts to T2.	When an amount of the distribution is paid to T3, that amount will be worth less in real terms.
CT2 atf T3 to T2 CT2 atf T3 to T1 (indirect benefit)	Agreement between CT1 and CT2 to extinguish T3's liability to T2 in circumstances in which it would not otherwise have done so.	CT2 atf T3 by enabling CT1 atf T2 to extinguish CT2's liability to CT1 atf T1, directly or indirectly, provided a benefit to an associate of CT1 atf T2. T1 was an associate of T2.
		T2 assumed the liability of T3 to make the payment of \$487,809.05 to T1. The result was T3's liability to T1 was extinguished and the amount payable to T3 by T2 was correspondingly reduced by that same amount.

Conclusion

In the *Eldersmede case* , the AAT took a wide approach to interpretation of the income injection provisions. As a result, the provisions can now potentially apply to ordinary commercial arrangements. Ill-advised parties with multiple trusts may therefore find themselves in the unfortunate situation of the income injection provisions applying to their fact scenario. When they are least expecting the application of the provisions, then they will really feel the sting of their implications.