Full Federal Court upholds Commissioner's assessments in Raftland appeal

RAFTLAND PTY LTD V COMMISSIONER OF TAXATION [2007] FCAFC 4

In January 2007, the Full Federal Court heard an appeal from the decision of Keifel J in the Federal Court in the case of *Raftland Pty Ltd v Commissioner of Taxation [2007] FCAFC 4*. The Federal Court had upheld an amended assessment issued by the Commissioner of Taxation ("Commissioner") to include $4.205 million in the assessable income of the taxpayer, after the Commissioner disallowed the taxpayer's purported distributions of income to a unit trust with accumulated losses because it was a sham. The Full Federal Court confirmed the Federal Court's earlier decision, save for an amount of $57,953, despite finding that the taxpayer's distributions to the unit trust were effective. The decision of the Full Federal Court again reinforces that taxpayers must be cautious in their decision to make use of accumulated tax losses, as it is the taxpayer that must prove the transaction was not a sham.

FACTUAL BACKGROUND

The facts of the case, as provided in our case note in May 2006 issue, surround the taxpayer who is the corporate trustee of the Raftland Trust ("R Trust"). The R Trust operates a building business through various companies and is controlled by three brothers, Brian, Martin and Stephen Heran. The building business was expected to derive approximately $3 million in profit for the year ended 30 June 1995. In light of that forecast, one of the brothers sought to acquire a trust with accumulated tax losses in an attempt to absorb some or all of the expected profits.

The brothers acquired the E&M Unit Trust ("EM Trust") for $250,000. The EM Trust held approximately $4 million in accumulated tax losses. It was agreed that, upon acquisition, the existing trustee of the EM Trust, Mr Carey, would resign as trustee.

In June 1995, the taxpayer settled the R Trust and entered into a sales rights agreement with the associated building companies, combined with various loan arrangements. The EM Trust was then made a tertiary beneficiary of the R Trust. The trust deed of the R Trust provided that if the trustee has not done so by 30 June, then the trustee holds the income on trust for the tertiary beneficiaries, and if these are not then in existence, for the primary beneficiaries (the three brothers).

On 30 June 1995, the R Trust resolved to distribute $250,000 to Mr Carey as trustee of the EM Trust, together with the balance of the R Trust's $2.6 million income for 1995. These amounts were recorded as debts in the accounts of the R Trust. Although the $250,000 was paid to Mr Carey by entities associated with the brothers, no amount was actually paid to the EM Trust. Mr Carey then resigned as trustee and the taxpayer was appointed in his place. There was, however, no change made to the unit holders of the EM Trust.

For the 1996 and 1997 income years, the taxpayer resolved to distribute to the EM Trust $779,705 and $385,035, respectively. The R Trust did not include these amounts in its taxable income for the 1995 to 1997 income years and the EM Trust used its losses to offset the distributions, recording a nil taxable income for the relevant years. The taxpayer, as trustee of the EM Trust, did not seek to recover the amounts owed to it by the R Trust.

In July 2002, the Commissioner made a Part IVA determination and issued the taxpayer with an amended assessment of $2.974 million (including $1.595 million for penalties and interest) in respect of the 1995 income year. Amended assessments of $837,610 and $393,692 for the 1996 and 1997 years, respectively, were also issued. The assessments were made pursuant to a finding that the distributions to the EM Trust were ineffective. Objections to the assessments were disallowed and the taxpayer appealed.

PROVISIONS OF THE INCOME TAX ASSESSMENT ACT 1936

Part 3 Div 6 of the *Income Tax Assessment Act 1936 (Cth)* ("ITAA36") addresses the taxation of trust estates. Generally a trustee is not liable to pay income tax on the income of the trust estate (s 96). It is for resident beneficiaries of the trust to include a share of the trust income in their taxable income, provided they are presently entitled to that income and are not under a legal disability (s 97(1)). However, where trust income has not been included in a beneficiary's assessable income pursuant to s 97, s 99A(4) provides that the trustee is liable to pay tax on that net trust income.

Section 100A relates to the circumstance where a beneficiary of a trust estate who is not under a legal disability is presently entitled to a share of the income of the trust estate by virtue of a "reimbursement agreement" or of any act, transaction or circumstance that occurred in connection with, or as a result of a reimbursement agreement. In such circumstances the beneficiary is deemed not to be presently entitled to that trust income. Section 100A(7) defines a reimbursement agreement as an agreement which provides for the payment of money or the transfer

of property to, or the provision of services or other benefits for, a person or persons other than the beneficiary or the beneficiary and another person or persons.

FEDERAL COURT'S DECISION

The Commissioner argued before the Federal Court that the distributions made by the R Trust to the EM Trust were ineffective because either the EM Trust did not exist at 30 June 1995 or that the distributions were a sham. Furthermore, the Commissioner argued that the default beneficiaries under the R Trust were not presently entitled to the relevant income because their present entitlement arose out of a reimbursement agreement for the purposes of s 100A of the ITAA36. Accordingly, the taxpayer was assessable on the relevant income under s 99A.

The taxpayer submitted to the Federal Court that the assessments were excessive because the resolutions of the R Trust were effective according to their terms and there was no reimbursement agreement in place as no person had been identified by the Commissioner as having benefited from such an agreement. In the alternative, the entitlement of the default beneficiaries under the R Trust arose out of the default clause in the relevant trust deed rather than any reimbursement agreement. The taxpayer also argued that the penalties imposed by the Commissioner were excessive.

Keifel J dismissed the taxpayer's appeal, maintaining the purported distributions were in fact "shams" and ineffective. However, contrary to the Commissioner's contention, her Honour held that the EM Trust was and continued to be in existence as at 30 June 1995. Further, Keifel J held that s 100A(1) did apply to make the three brothers not presently entitled to the income and thus pursuant to s 99A, the income was assessable to the trustee. Having regard to Raftland's recklessness in understating its income, Keiffel J upheld the penalties and interest imposed by the Commissioner.

ISSUES ON APPEAL

The taxpayer appealed to the Full Federal Court on the following grounds:

- Finding that the distributions were a "sham" was erroneous because there was little substantive evidence to support this conclusion. Furthermore, the resolutions to distribute $250,000 and the balance of the income of the R Trust to Mr Carey, as trustee of the EM Trust, created present entitlements to that income, even if payments were not made. In any event, all parties intended the instruments in question to operate according to their contents.
- Although the burden of proving that an assessment was excessive lay upon the taxpayer, an evidentiary onus lay upon the person making the allegation of sham to prove as such. There was no evidence before the Court that the parties intended to mislead anyone and "mere circumstances of suspicion" could not, by themselves, establish that a transaction was a sham. It was not open to the Federal Court to recharacterise the agreement between the parties because the intention of the parties was clear.
- If the EM Trust was presently entitled or deemed presently entitled by reason of the trust resolutions or as tertiary beneficiary, the reimbursement provisions were not applicable. In the alternative, there was no reimbursement agreement as the alleged benefits were either too remote or otherwise were not benefits within the meaning of the section or extended meaning in s 100A(12).

The Commissioner then submitted to the Court that:

- the taxpayer did not show that the assessments were excessive and prove, on the balance of probabilities, that the net income should have been assessed to another person under s 97 ITAA36 because the distributions were effective;
- the taxpayer had no intention of creating a relationship of trustee and beneficiary between the R Trust and the EM Trust, and such a finding did not require a "recharacterisation" of the agreement between the parties; and
- neither s 100A(3A) nor s 100A(3B) applied where the taxpayer held income on trust for the primary beneficiaries (the three brothers).

Were the distributions effective?

Edmonds J upheld the proposition accepted in the case of *Faucilles Pty Ltd v FCT (1989) 90 ATC 4003 which stated that, while a provision contained within a trust deed of a trust can be a sham, the trust deed itself cannot as, "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 sometimes … for no transaction at all".*[1]

His Honour found that in the present case, it was clearly intentional that the EM Trust be a tertiary beneficiary of the R Trust in order for it to receive distributions of, or otherwise be entitled in default of such distributions to, income of the R Trust, which were to be absorbed by the losses of the EM Trust. The brothers' advisors were well aware that the income of the R Trust would be sheltered by the losses in the EM Trust only to the extent that the EM Trust was presently entitled to the income of the R Trust. The objective of the parties was to use the losses of the EM Trust and, if this objective was not achieved by a resolution to pay, apply or set aside the income of the R Trust to the EM Trust pursuant to the R Trust deed, it was to be achieved by the default provisions therein.

His Honour considered the reasoning of Lehane J in *Richard Walter Pty Ltd v FCT* (1996) 67 FCR 243 at 267-268 that:

> '[I]t must be borne in mind that it is of the essence of a structure intended to be effective to minimise tax that it be created by means of real transactions, giving rise to real rights and obligations, however 'artificial' they may be, in the sense of being incapable of rational explanation except on the basis of their tax consequences…one expects, in a case such as this, that transactions are intended to have their apparent legal effect because it is only if they do that they are efficacious to achieve the desired consequences.'

In light of this, Edmonds J was of the view that the nomination of the EM Trust as a tertiary beneficiary was not a sham, but rather was the very intention of those responsible for establishing the R Trust. In other words, the R Trust income was intended to be passed to the EM Trust so as to be sheltered by the losses of that trust, if not by distribution, then by the default provisions in the trust deed. His Honour concluded that in each of the relevant income years, the EM trust was presently entitled to the whole of the income of the R Trust, if not by reason of

the resolutions to distribute the income, then by virtue of the default provisions.

Was there a reimbursement agreement?

In applying the definition of "reimbursement agreement" in subs 100A(7), Edmonds J concluded that the agreement made between Heran Projects and Maggside (entities associated with the brothers), was a "reimbursement agreement" in relation to a beneficiary of the R Trust (the EM Trust) given that it provided for the payment of money to a person other than that beneficiary namely, Maggside. Therefore, the present entitlement of the EM Trust to the R Trust income in the 1995 income year, arose out of that reimbursement agreement, such that without that agreement there would have been no income of the R Trust to which the EM Trust would have been presently entitled. For these reasons, Edmonds J concluded that s 100A(1) applied to the whole of the income of the R Trust for the year ended 30 June 1995, leaving aside at this stage the operation of s 100A(3A).

With respect to the income of the R Trust for the income years ending 30 June 1996 and 1997, his Honour noted that none of those streams of income were sourced in the "reimbursement agreement" as referred to above. However, a second agreement made in June 1995 and reduced to writing in June 1996, in which Heran Developments (one of the building companies) took over the assets and liabilities of Heran Projects, was also found to be a reimbursement agreement. Edmonds J considered that the whole of the income which came into the R Trust for the income years ending 30 June 1996 and 1997, was sourced, except for an amount of $57,953, in that reimbursement agreement. The $57,953 was totally unrelated to that agreement and was instead founded in rental and interest income. His Honour therefore concluded that subs 100A(1) also applied to all of the income of the R Trust in the 1996 and 1997 income years, save for the amount sourced in rental income.

The EM Trust was therefore not presently entitled to the income as distributed in each of the relevant income years, unless s 100A(3) applied to deny the operation of that provision.

Did section 100A(3) apply?

His Honour found s 100A was applicable because the R Trust did not satisfy the exemption to s 100A set out in s 100A(3). The R Trust failed because although Mr Carey and later, the taxpayer, in their capacities as trustee of the EM Trust were presently entitled to the whole of the income of the R Trust and both were deemed not to be presently entitled by virtue of s 100A(1), the unit holders of the EM Trust were not presently entitled to the whole of the income of the EM Trust, which was attributable to the relevant R Trust income in each of the relevant income years.

Edmonds J based his finding on the fact that as the EM Trust had accumulated losses from previous years, in the absence of any contrary direction in the trust deed, these losses were required to be made up out of profits of subsequent years and not out of capital; see *Upton v Brown (1884)* 26 Ch d 588; *Re Reynolds [1942]* VLR 158. Applying the general rule, Edmonds J concluded that the extent of the losses of the EM Trust resulted in there being no trust income to be distributed in each of the relevant income years. In the alternative, there was no evidence to suggest that the Trustee of the EM Trust had paid, applied or set aside such income for the benefit of the unit holders, and therefore the beneficiaries were not presently entitled.

The application of s 100A resulted in the EM Trust not being presently entitled to the trust income in each of the relevant income years. Accordingly, the trust income fell to be assessed against the trustee of the R Trust pursuant to s 99A.

FULL FEDERAL COURT'S DECISION

The Full Federal Court dismissed the taxpayer's appeal and upheld the Commissioner's objection decisions in respect of each of the relevant income years, save for an amount of $57,953 in respect of the income year ended 30 June 1996. The penalties imposed were also upheld and ordered only to be disturbed to give effect to the above saving.

Justices Dowsett and Conti agreed with the reasons and orders of Edmonds J, in dismissing the appeal. Edmonds J held with respect to the primary judge's decision, that the distributions to the EM Trust in each of the relevant income years were in fact effective and not "shams". His Honour maintained that the provisions of s 100A applied to each of the distributions, save for an amount of $57,953, thereby deeming the primary beneficiaries of the EM Trust not presently entitled to the trust income. The taxpayer therefore was assessed on that income pursuant to s 99A ITAA36.

CONCLUSION AND COMMENT

The Full Federal Court reinforced the decision of the Federal Court to uphold the Commissioner's amended assessment to include $4.205 million in the assessable income of the taxpayer after it disallowed the taxpayer's purported distributions of income to the EM Trust with accumulated losses, despite finding that the taxpayer's distributions were effective. The Court maintained that the provisions of s 100A applied to each of the distributions, save for an amount of $57,953, thereby deeming the primary beneficiaries of the R Trust not presently entitled to the trust income. The taxpayer therefore was assessed on that income pursuant to s 99A ITAA36.

The decision of the Full Federal Court has reinforced the need for taxpayers to think carefully about the way in which they intend to use accumulated trust losses. Firstly, any arrangement set up to access trust losses, which is not intended to have any legal effect, is liable to be found a sham and any purported transactions as per such arrangements will be deemed ineffective. Further, where the Commissioner alleges that the transaction is a sham, the onus lies with the taxpayer to show otherwise. The taxpayer will have to demonstrate that the parties intended that legal or equitable rights and obligations be created by the various transactions into which they entered, to avoid a finding of a sham and the imposition of tough penalties.

In addition, where the income to be distributed to the trust with losses arises out of an agreement whereby the benefit is provided to an entity other than the beneficiary, the distributions may be captured by s 100A. Where this is the case, the particular income will be assessed against the trustee pursuant to s 99A and not the beneficiary. To avoid such an outcome, taxpayers need to think carefully about the source of the income purported to be distributed to a trust in order to access losses.

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Reference notes

1 *per Hill J at 4025*