

# Special income: The Commissioner's discretion

**DARRELEN PTY LTD V COMMISSIONER OF TAXATION [2010] FCAFC 35**



On 30 April 2010, the Full Federal Court (Stone, Edmonds and Jagot JJ) handed down its decision in *Darrelen Pty Ltd v Commissioner of Taxation* [2010] FCAFC 35.

This case relates to the classification as 'special income' for income tax purposes of income received by a superannuation fund.

The consequences for a superannuation fund of income being classified as 'special income' is that the income so classified ceases to be taxed at the usual concessional rate in the hands of the superannuation fund and is taxed at a higher rate.

## FACTS

On 10 October 1995, Darrelen Pty Ltd as trustee of the Henfam Superannuation Fund (**Darrelen**) purchased from an existing shareholder four of the 100 shares on issue in a private company, Vercot Pty Ltd (**Vercot**), for \$51,218. Vercot was a passive investment company which held 25,609,520 shares in Abigroup Limited (**Abigroup**), an ASX listed company. The market value of the Abigroup shares was \$0.58 per share.

The purchase of the shares in Vercot by Darrelen had the effect that Darrelen indirectly held 1,024,373 shares in Abigroup, the market value of which was \$594,136 on the date of purchase. Thus, the value of the Vercot shares, both at the time of purchase and subsequently, was far in excess of the price actually paid by Darrelen for those shares. Abigroup paid substantial dividends to Vercot, which in turn paid dividends *pari passu* to its shareholders (including Darrelen) in the proportion that the number of shares held

by the shareholder bore to the total number of shares on issue.

Against a purchase price of \$52,218 paid in October 1995, Darrelen received the following dividends:

Year End	Amount
30 June 1996	\$26,400
30 June 1997	\$208,136
30 June 1998	\$140,000
30 June 1999	\$125,200
30 June 2000	\$143,720
30 June 2001	\$143,720
30 June 2002	\$86,320
30 June 2003	\$76,640

## RELEVANT LEGISLATION

During the relevant years of income, ss 273(1) - (4) ITAA 1936 provided:

- "(1) This section applies to income derived in a year of income by a fund ... (in this section called the **entity**) that is a complying superannuation fund ... in relation to the year of income.
- (2) A dividend paid to the entity by a company that is a private company in relation to the year of income of the company in which the dividend was paid is special income of the entity unless the Commissioner is of the opinion that it would be reasonable not to treat the dividend as special income of the entity, having regard to:
- the value of the shares in that company that are assets of the entity;
  - the cost to the entity of the shares on which the dividend was paid by the company;

- the rate of the dividend paid to the entity by the company on the shares in the company that are assets of the entity;
  - whether the company has paid a dividend on other shares in the company and, if so, the rate of that dividend;
  - whether any shares have been issued by the company to the entity in satisfaction of, or of a part of, a dividend paid by the company and, if so, the circumstances of the issue of those shares; and
  - any other matters that the Commissioner considers relevant.
- (3) For the purposes of subsection (2), income that, in the opinion of the Commissioner, was derived by the entity indirectly from a dividend paid by a company, being a private company in relation to the year of income of the company in which the dividend was paid, shall be deemed to have been a dividend paid to the entity by the company.

- (4) Income (other than a dividend to which subsection (2) applies or income derived by the entity in the capacity of beneficiary of a trust estate) derived by the entity from a transaction is special income of the entity if the parties to the transaction were not dealing with each other at arm's length in relation to the transaction and that income is greater than the income that might have been expected to have been derived by the entity from the transaction if those parties had been dealing with each other at arm's length in relation to the transaction.

In each of the years of income, Vercot was a private company and Darrelen was trustee of a complying superannuation fund. The Court found that, in the absence of the Commissioner declining to exercise his discretion under s 273, the effect of s 273 was that the dividends paid to Darrelen in each of the years of income were special income.

## THE COMMISSIONER'S DECISION ON OBJECTION

The Commissioner failed to exercise his discretion in favour of Darrelen.

Darrelen objected.

On objection, the Commissioner refused to exercise his discretion. In reaching this decision, the Commissioner considered each of the matters in paras (a) to (f) of subs 273(2). A summary of the Commissioner's conclusion and process of reasoning follows.

### Paragraph (a) The value of the shares which are an asset of Darrelen.

The Commissioner considered that the reference to "value" was a reference to market value of the Vercot shares at that time of purchase. However, there was no finding of market value under this head. The Commissioner noted that the shares were all fully paid and that the same dividend amount was paid to the holder of each share. The Commissioner concluded, "[i]t is considered the facts for this matter do support the Commissioner exercising his discretion under subsection 273(1) ...".

### Paragraph (b) The cost to the entity of the shares on which the dividend was paid.

The Commissioner considered that this entitled him to consider the cost of the shares with their market value at the date of acquisition. The actual cost was significantly less than market value, which the Commissioner found to be \$594,136 at the date of purchase.

The Commissioner's position was:

"Where shares are acquired at less than market value, an implication may be drawn that one of the intentions of the entity in acquiring the shares was to enable the entity to derive dividend income greater than would be the case if all parties were dealing at arm's length and dividends paid are likely to be considered as special income ... A conclusion to be drawn from the above is that the transaction has provided an opportunity for concessional taxation treatment to income that would otherwise be attributed to a high rate taxpayer ... the cost of the shares in the private company does not reflect the true value or full market value of the shares. Therefore, it is considered the facts for this matter do not support the Commissioner exercising his discretion under subsection 273(2) ..."

Paragraph (c) The rate of the dividend paid to the entity on the shares that are assets of the entity.

The Commissioner took the position that he was entitled to look not only at the rate of dividend, but also to the rate of return of investment and, as such, he was entitled to have regard to the original cost of the shares and their value in deciding whether the rate of the dividend is consistent with an arm's length outcome. The Commissioner found the rate of return to be exceptionally high and, taking imputation credits into account, concluded this was a factor unfavourable to him exercising his discretion.

### Paragraph (d) Whether the company has paid a dividend on other shares in the company and, if so, the rate of that dividend.

As all shareholders received the same rate of dividend per share, the Commissioner regarded this as a neutral factor.

### Paragraph (e) Whether shares have been issued in satisfaction of a dividend and the circumstances of issue.

No shares were issued by Vercot. The Commissioner considered that this did support an exercise of discretion.

### Paragraph (f) Other matters the Commissioner considers relevant.

The Commissioner noted the following:

- the extent to which members who are at arm's length to the private company have an interest in the superannuation fund;
- the relationship between the superannuation fund and the private company;
- the relationship between the superannuation fund and any party with which the private company had dealings;
- from whom the superannuation fund acquired the shares and the circumstances of that acquisition; and

"a further matter to be considered is whether the fund is dealing at arm's length with Vercot ... the answer to this appears to be no. If the funds were dealing at arm's length with Vercot, the fund would have paid market value for the shares it acquired.

This factor would be unfavourable to the exercise of the Commissioner's discretion."

The Commissioner concluded:

"The matters under paragraphs (a) and (e) ... [are] favourable, while the matter under paragraph (d) is neutral. The matters in paragraphs (b) and (c) and a part of (f) were unfavourable ... these were sufficient to outweigh those in the former paragraphs. Accordingly, the private company dividends paid to [Darrelen] from Vercot ... for the years ended 30 June 2000 to 30 June 2003 are to be treated as special income of the fund."

## TRIBUNAL DECISION

The taxpayer appealed to the AAT.

The taxpayer argued effectively that s 273 is not concerned with non-arm's length arrangements concerning the purchase of the shares, but only with arm's length arrangements concerning derivation of dividend income: if dividends are paid on all shares in Vercot, including those owned by Darrelen, on a *pari passu* basis without preference of any kind, the policy underlying the exercise of the Commissioner's discretion not to treat the dividend as special income of Darrelen necessarily is satisfied.

The Tribunal did not accept the argument.

In short, the Tribunal considered that the underlying transaction which gave rise to the relevant dividends cannot be divorced from the dividends themselves in the manner for which Darrelen contends and must form part of the factual matrix to be considered in relation to the question of whether discretion can be exercised.

In relation to matters to which regard is to be had under s 273(2), the Tribunal found:

1. The reference to "value" in para (a) was, for "historical" reasons, a reference to "paid up value or par" not market value.
2. The reference to "cost" in para (b) "means that it must be taken into account as a relevant factor and as part of the overall deliberation". That required comparison with, *inter alia*, market value.
3. The rate of dividend was such that "all shareholders in the private company were treated on a *pari passu* basis". Further, the term "rate" can refer to the rate of return and the rate of return was enormous.

4. The relevance of para (d) is limited even though it must be compared with para (c) given that all shareholders, in Vercot received dividends at the same rate.
5. Paragraph (e) is not apposite.
6. In relation to para (f), the board of review cases were correctly decided even though there was, in some instances, a lack of detailed reasoning.

## ISSUES BEFORE THE FULL FEDERAL COURT

The thrust of Darrelen's argument in the Federal Court was similar to its argument in the Administrative Appeals Tribunal: the circumstances of the acquisition of the Vercot shares, including cost and value, are not required to be ignored. However, they will be relevant only if they assist with the proper enquiry. If the dividends are found to be at arm's length, the proper (ie permissible) inquiry under the statute

(c) could have regard to the "yield", or "rate of return received". The paragraph referred to the "rate of dividend paid", not the "rate of return received" or "yield". But the Court found the error was not an error of consequences because the Commissioner can have regard to rate of return on the investment under para (f).

2. The Court found that, in relation to para (f), the words "[i]f the fund were dealing at arm's length with Vercot, the fund would have paid market value for the shares it acquired", was predicated upon erroneous facts. Darrelen, as trustee, did not acquire four shares in Vercot by allotment, but by transfer from an existing shareholder in Vercot; Vercot was not a party to the transaction. Darrelen could not be said to be not dealing with Vercot at arm's length. However, the Court did not see this as an error of consequence because

- The Tribunal also erred in its consideration in relation to para (c), namely, on entitling the Commissioner to take into account rate of return as well as rate of dividend. This was a similar error to that identified in relation to para (a), but for similar reasons was without consequence.

## FEDERAL COURT DECISION

The Federal Court<sup>2</sup> found that the thrust of Darrelen's argument, namely, that if in the year of income Darrelen derives income from a private company which represents distributions at a rate per share equal to the rate per share paid on all shares in the private company, then that is the end of the enquiry, the Commissioner cannot be concerned with other matters referred to in subs 273(2) and should, or must, therefore exercise his discretion not to treat the dividends as special income, is flawed on at least two bases.

First, the text<sup>3</sup> of subs 273(2) gives no support.

The Court found the text of subs 273(2) to be clear. It does not support a limitation of the type suggested by Darrelen. None of the matters in paras (a) to (f) inclusive is given precedence over the others. The Court held that to suggest that if one matter is to be answered favourably in support of the exercise of the discretion, consideration of the other matters is irrelevant, was not supported by the wording of the legislation.

Second, the underlying policy behind subs 273(2), namely enabling the Commissioner to deny the concessional taxation of income where the income had been diverted from taxpayers not enjoying that concessional basis, through a non-arm's length acquisition of the shares, rather than through non-arm's length distributions by dividend would be undermined.

The Court found<sup>4</sup> (and Darrelen accepted) that the policy behind s 273 is to enable the Commissioner to deny the concessional taxation of income which has been diverted from the taxpayer not enjoying that status. Darrelen appeared to adopt the position that the only way in which this can occur, in the context of dividends paid on shares in a private company, is where differential dividend rates are paid on those shares so that dividends paid on shares held by the concessional taxpayer are greater than

“ The policy behind s 273 is to enable the Commissioner to deny the Concessional taxation of income which has been diverted from the taxpayer not enjoying that status. ”

is at an end. In such a case, the fact that the shares were acquired as a gift, or for market value, does not assist the inquiry.

Based on that argument, in the circumstances of this case, namely, that the Vercot shares were effectively a gift many years before the dividends were paid, and the other circumstances surrounding the payment of the dividends, the answer to the s 273(2) enquiry is that there was no undue diversion of income in any of the relevant years of income. In other words, on the facts of this case, the circumstances of the acquisition of the shares in 1995 did not in any way affect the arm's length derivation of the dividends in any of the relevant years of income.<sup>1</sup>

The Court found errors in the Commissioner's reasoning:

1. The Court could not see any basis on which the Commissioner under para

there was no dispute that Darrelen and the transferor of the shares were not dealing at arm's length with each other in relation to the purchase of the shares, and the Commissioner can have regard to that under para (f). It is a relevant matter for the Commissioner to consider when exercising his discretion.

The Court also found errors in the Tribunal's process of reasoning:

- The Tribunal's conclusion that the reference to "value" in para (a) was, for historical reasons, a reference to "paid up or par" value not market value was incorrect. The Court was not persuaded that the word "value" used in para (a) meant anything other than market value. The Court found the error of no consequence because the Commissioner was entitled to consider market value under either para (b) or (f).

the dividends paid on shares held by the non-concessional taxpayers. But the Court found that is not the only way such income diversion can occur, as the facts of this case should.

The income diversion has occurred by recourse to a non-arm's length transaction on the purchase of shares.<sup>5</sup>

The Court found that the Commissioner was entitled to have regard to this matter in declining to exercise his discretion not to treat the dividends as special income, even where dividends are paid rateably by reference to the number of shares held. Thus, the Court found that the Tribunal had not erred in affirming the Commissioner's objection decision not to exercise his discretion not to treat the dividends received from Vercot in the relevant years of income as special income, and dismissed the appeal.

## CONCLUSION

The Commissioner and the Full Federal Court appeared to adopt a different approach to the interpretation of s 273. The Commissioner adopted a subparagraph by subparagraph analysis and reached his decision by balancing those elements of his analysis which supported the exercise of his discretion against those which did not support the exercise of his discretion, coming to the conclusion, on balance, that he should be guided by those factors which militated against the exercise of his discretion.

The Full Federal Court, while considering the subparagraph by subparagraph analysis, also looked at the underlying policy behind the section and concluded that Darrelen's action in buying shares in a private company at a substantial discount to market value breached that policy.

So the Court found that the Commissioner was correct in not exercising his discretion, in favour of Darrelen.

In Darrelen, the different approaches between the Commissioner and the Full Federal Court led to a similar result.

However, the different approaches leaves open the possibility of different results on a different set of facts.

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Madgwicks*

### Reference notes

1. Paragraph 27-28.
2. Paragraph 31.
3. Paragraph 32.
4. Paragraph 33.
5. Paragraph 34.

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