SME TAX & STRUCTURES UPDATE

A paper presented by Michael Bennett for the iCLE

Monday, 8 August 2016

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1 Overview

This paper, and the presentation to which it relates, addresses significant cases and rulings of interest to practitioners advising in the private client and private groups sector. The focus will be the SME space and, within it, recent decisions from courts or pronouncements from the Commissioner of Taxation.

By its nature the topics discussed in the paper, and the presentation, are disparate; the common theme being recent developments across the SME space.

There have been significant developments in recent times. The areas canvassed are:

1. trusts, and in particular the:
    a. mechanism by which a beneficiary can <u>become entitled to capital</u>; and
    b. use of <u>asset revaluation reserves</u>;
2. superannuation, and in particular:
    a. <u>distributions from trusts</u> to related funds;
    b. binding death benefit nominations and the <u>importance of nomenclature</u>; and
    c. the risks of acting as <u>legal personal representative</u> if super payouts are to be derived;
3. the Commissioner of Taxation's approach to a <u>corporate beneficiary wholly owned</u> by the a trust that distributes income to it;
4. Division 7A of Part III of the *Income Taxation Assessment Act* 1936 (Cth) (the '**1936 Act**'), and in particular the <u>recent pronouncements</u> from the Commissioner of Taxation;
5. the small business concessions in Division 152 of the *Income Tax Assessment Act* 1997 (Cth) (the '**1997 Act**'), and in particular <u>issues of valuation</u> that have recently created conflict and the ability to <u>de-risk Dividend Access Shares</u>;
6. the distinction <u>between contractors and employees</u>, and how the superannuation guarantee issues therein must be dealt with through the Commissioner of Taxation; and

7. the <u>different capacities</u> that may apply to an individual within a structure and how to address any conflicts arising therefrom.

The paper will be divided in accordance with the characterisations above.

2 Trusts

There are two aspects of trusts that have been the subject of recent pronouncement by the High Court; both in the same case. I will first set out the background in *Fischer v Nemeske Pty Ltd* [2016] HCA 11 and then consider those two issues.

2.1 Fischer v Nemeske

On 6 April 2016 the High Court handed down its decision in *Fischer v Nemeske Pty Ltd* [2016] HCA 11. By majority[1] the Court dismissed the appeal.

The case concerned 'the power of the trustee of a discretionary trust to advance and apply to two designated beneficiaries, by resolution and entry in the trust accounts, an amount of money representing the value of unrealised trust assets comprising shares in a company'.[2] This gave rise to two issues relevant to this paper:[3]

1. whether the two beneficiaries were made entitled to the funds following resolution and subsequent entry in the trust accounts because of the need to 'advance or raise any parts of the whole of the capital or income of the Trust Funds and to pay or to apply the same…' to effect such an entitlement; and

2. what, if any, effect did the nature of the funds being asset revaluations have for these purposes.

It is convenient to discuss the facts before considering those issues separately.

[1] French CJ and Bell J and, in separate reasons, Gageler J. Justices Keifel and Gordon dissented in separate decisions.

[2] At [1] per French CJ and Bell J.

[3] The answer to the questions this paper considers rendered it unnecessary to answer the other issues of the case, namely whether:

(a) a deed of charge obliged the trustee to pay the amount to the beneficiaries;

(b) the trustee was estopped by that deed or by representations from denying the existence of any such debt; and

(c) the trustee was entitled to an indemnity from trust assets.

2.2 Facts of Fischer v Nemeske

Nemeske Pty Ltd was the trustee of the Nemes Family Trust, a trust with discretion as to appointment of income and capital. The designated beneficiaries were Mr Emery and Mrs Madeleine Nemes.

The trustee owned shares in Aladdin Ltd, the value of which in September 1994 was recorded in an "Asset Revaluation Reserve" in the amount of $3,904,300. It was created as an entry in the trust's accounts, which entry did not describe an asset or a fund from which amounts could be withdrawn or paid.

On 23 September 1994 the trustee passed the following resolution:[4]

> RESOLVED that pusuant [sic] to the powers conferred on the Company as Trustee in the Deed of Settlement of the Nemes Family Trust:-
>
> That a final distribution be and is hereby made out of the asset revaluation reserve for the period ending 30th September, 1995 [sic] and that it be paid or credited to: - the beneficiaries in the following manner and order:
>
> The entire reserve if any, to be distributed to:-
>
> [Mr and Mrs Nemes]
>
> as joint tenants.

The trustee then prepared, or caused to be prepared:

- a "Beneficiaries Accounts" for the period ending 30 September 1994 showing the Asset Revaluation Reserve diminished by a "Capital Distribution" out of that reserve of $3,904,300.
- A balance sheet of the trust, as at 30 September 1994, showing "non-current liabilities" comprising secured loans from EG & M Nemes in the amount of $3,904,300.

That it, the trustee created the loan account to give effect to the distribution by purporting to create an enforceable debt owed by the trustee to the beneficiaries named in the resolution. Justice Stevenson, at first instance, found this was the trustee's intention in so acting.

[4] The reference to 1995 was a typographical error; it should have read 1994.

In passing the resolution the trustee relied on the power in clause 4(b) of the Deed of Settlement. So far as is relevant it provided:

> The Trustee may from time to time exercise any one or more of the following powers that is to say:-
>
> ...
>
> (b) At any time or times to advance or raise any part or parts of the whole of the capital or income of the Trust Funds and to pay or to apply the same as the Trustee shall think fit for the maintenance education advancement in life or benefit of any of the Specified Beneficiaries ...

By Deed of Charge dated 30 August 1995 the trustee purported to charge the Aladdin Ltd shares in favour of Mr and Mrs Nemes.

The appellants, the Fischers, were two other beneficiaries of the trust, who did not benefit from the resolution. However, Mr Nemes, who had survived Mrs Nemes and inherited her estate, purported to bequeath the Aladdin Ltd shares to the Fischers. As the Fischers did not share in Mr Nemes residuary estate, whether they stood to take all or none of the $3,904,300, depending on whether the trustee had validly exercised the power to appoint the amount to Mr and Mrs Nemes.

Justice Stevenson,[5] at first instance, and the Court of Appeal,[6] on appeal, held that the resolution was effective. By majority the High Court agreed.

2.3 Resolution and Book Entry

The significance of *Fischer v Nemeske Pty Ltd* in this regard is its confirmation, by Australia's ultimate court, that a resolution and book entry will effect an advancement and application of trust property to beneficiaries. Indeed, the book entry is supportive but may not be necessary; French CJ and Bell J saying at [26]:

> Barrett JA, in the present case, referred to *Vestey*, *Ward* and *Chianti* as authority for the proposition that a resolution deliberately arrived at and recorded can of itself be sufficient to effect an immediate vesting of a specific part of the trust income. That general proposition may be accepted as also applicable to capital.

[5] [2014] NSWSC 203 at [142].
[6] [2015] NSWCA 6 at [64] and [73]-[74] per Barrett JA (Beazley P and Ward J agreeing).

The Court traced the history of statutory power of trustees referred to as the "power of advancement": at [19]. The power in clause 4(b) of this trust's deed of settlement is broader than the legislative equivalent. Therefore, this case is not conclusive authority for the interpretation of those sections: s 44 of the *Trustee Act* 1925 (NSW); s 38 of the *Trustee Act* 1958 (VIC); s 33A of the *Trustee Act* 1936 (SA); s 62 of the *Trustee Act* 1973 (Qld); s 59 of the *Trustee Act* 1962 (WA); s 29 of the *Trustee Act* 1898 (TAS); s 24A of the *Trustee Act* (NT); and s 44 of the *Trustee Act* (ACT).

Though at [20] French CJ and Bell J did provide the following warning on too ready a reference to those provisions:

> Clause 4(b) uses "advance", "raise", "pay" and "apply" to denote the actions which it empowers the Trustee to take. It uses "maintenance", "education", "advancement in life" and "benefit" to describe the purposes and necessary effects of those actions. It makes a distinction between actions and purposes. Thus, "advance" and "advancement" are used in different senses. One is an action, the other is the purpose it serves defined by reference to its effect. The term "advancement" in common form clauses and statutory provisions conferring powers on trustees to "pay or apply" capital or income for the "advancement" of beneficiaries has been used in judicial exegesis and textbook commentary in a way that sometimes conflates actions taken by the trustee and their effect or purpose. The term "advance", not appearing in the statutory provisions, has nevertheless been used as a synonym for "pay" or "apply", which do appear in those provisions. The use of "advancement" to refer to the actions of a trustee in the exercise of powers conferred by common form and statutory provisions is of some assistance in understanding the application of the terms "advance" and "apply" in cl 4(b). However, the necessary starting point is the ordinary meaning of those words and the logical structure of the provision.

Their Honours also said, at [21], 'It is perhaps of some importance that no particular form of words is required nor any particular mechanism specified for the exercise of the power conferred by clause 4(b).' Despite authority[7] that distinguishes advancing income from capital, they:

> … should not be taken as limiting the means by which an advancement and application of capital can be effected pursuant to a specific provision such as clause 4(b). More particularly, they should not be taken as excluding from the ambit of the power of advancement the creation of a creditor/debtor relationship between trustee and beneficiary by the creation of a vested, absolute equitable interest in capital realised by an action for money had and received or otherwise. (at [25]).

At [98] Gageler J explained it as follows:

[7] *In Re Pilkingtong's Will Trusts* [1964] AC 612 and *Commissioner of Inland Revenue v Ward* [1970] NZLR 1.

> The trustee's power to apply trust property having been held in each of those cases to be available to be exercised by means of an unconditional and irrevocable allocation of trust property, the consequence that the exercise of that power effected an alteration of beneficial entitlements in property which the trustee continued to hold on trust under the terms of the existing settlement was orthodox as a matter of principle. It was also unremarkable as a matter of practice. The power to apply trust property, as interpreted in the cases, was but an example of a power conferred on a trustee by the terms of settlement to bring about an alteration of beneficial entitlements: the power was of such a nature that the exercise of the power was "so to speak, to be read into" the existing settlement with the result that the beneficial entitlements as altered by the exercise of the power were to be recognised and administered by the trustee after the exercise of the power "as if the settlement had actually provided" for them.

On the particular facts the resolution – although poorly worded, as if it had copied a corporate resolution to effect a dividend – was sufficient to create a debt to the beneficiaries. This did not alter the ownership of the Aladdin Ltd shares but provided a basis to apply trust capital to meet that debt. The Chief Justice and Bell J saying at [32]:

> ... There was no fund represented by the Asset Revaluation Reserve from which to make a distribution to give effect to the resolution. The text of the resolution, however, disclosed a clear intention, indicated by the use of a form of words appropriate to the declaration of a dividend, to create a debt due by the Trustee to Mr and Mrs Nemes to the extent of the amount shown in the accounts of the Trust relating to the Asset Revaluation Reserve. The entry in the accounts was an action by the Trustee which further demonstrated and gave effect to its intention. In so doing, the Trustee adopted a mechanism which, without altering the ownership of the Aladdin shares, provided a basis for the application of the trust capital to Mr and Mrs Nemes by sale of the shares to meet the debt. The resolution and the entry in the accounts by creating a creditor/debtor relationship constituted an advance and application within the meaning of cl 4(b). The interest thus conferred on Mr and Mrs Nemes could be realised by the sale of the shares and remittance of the proceeds or by direct transfer of the shares to them. … What is clear is that at the times of the resolution, account entries and covenant, the debt could only have been satisfied out of the assets of the Trust comprising the shares. The Trustee, of course, took the risk that the value of the shares might fall below the amount of the debt acknowledged in its accounts. Given that it was created as a trust company and that its only asset of any substantial value was the shares, it was hardly a risk of any significance.

It is now confirmed, as to income and to capital, that absent peculiar wording in the particular trust instrument a trustee need only resolve to pay or credit an amount to a beneficiary, even where there is no asset set aside to satisfy the amount, to render the beneficiaries so entitled. The crediting in the trust books and records is not necessary, but will support, such a conclusion.

Justices Keifel[8] and Gordon[9] dissented and held the account treatment to a notional sum was not 'paid or credited' to the beneficiaries and that the subject of the resolution was not trust income or capital.

Their Honours considered the lack of an identifiable asset that had been removed from the trust for the beneficiaries was fatal to clause 4(b) having been invoked. This dissent has some weight, but the majority view prevails.

2.4 Asset Revaluation Reserve

Although notoriously disliked by the Commissioner of Taxation, strategies to distribute asset revaluation reserves do not seem to be assessable to the recipient. They are a return of capital: the point to be made is that the asset revaluation reserve 'distribution' is in fact a distribution of capital of the trust estate or an advance of the capital of the trust estate and must be given strict effect to by the rules in the trust deed that allow the trustee to appoint or advance capital of the trust estate to a beneficiary.

If a trustee revalues an asset – a credit to an asset revaluation reserve account and a corresponding debit to the asset account – the gain is ordinarily not assessable income of the trust estate. It is merely the means by which the trustee accounts for the trust assets. A distribution to a beneficiary of an amount from an asset revaluation reserve (either in cash or by way of a journal entry) is ordinarily not assessable income of the beneficiary: *Taxation Ruling* 2005/2 at [30]. However:

(a) a sale of or a dealing with a right to receive such a distribution could result in a receipt of assessable income: *FCT v McNeil* [2007] HCA 5 dealing with the sale of a right by a shareholder of an option to sell back to the company a share.

(b) further considerations – such as repetition of receipt (see *Interpretative Decision* 2011/58) – may treat it as ordinary income.

2.4.1 Section 99B

It is necessary to consider s 99B of the 1936 Act in this context. Although the purpose of s 99B of the 1936 Act was to assess trust income that had been accumulated overseas and not subject to Australian tax (as expressed in *Union Fidelity Trustee Co of Aust Ltd v FCT* (1969) 119 CLR

[8] At [53] to [58], [75] to [79] and at [88].
[9] At [155], [158] to [183].

177), its literal terms are much wider than this. In my experience the Commissioner of Taxation does not apply the provision as widely as its literal terms would permit.

Subsections 99B(1) of the 1936 Act would apply to the distribution of the revaluation reserve. The operation of s 99C of the 1936 Act confirms this position. It is important, however, to set out the relevant passage of s 99B(2) of the 1936 Act in full. It provides:

> The amount that, but for this subsection, would be included in the assessable income of a beneficiary of a trust estate under subsection (1) by reason that an amount, being property of the trust estate, was paid to, or applied for the benefit of, the beneficiary shall be reduced by so much (if any) of the amount, as represents:
>
> (a) corpus of the trust estate (except to the extent to which it is attributable to amounts derived by the trust estate that, if they had been derived by a taxpayer being a resident, would have been included in the assessable income of that taxpayer of a year of income);
>
> (b) an amount that, if it had been derived by a taxpayer being a resident, would not have been included in the assessable income of that taxpayer of a year of income; …

The operation of s 99B(2)(a) of the 1936 Act was recently considered by the Full Court of the Federal Court in *Howard v FCT* [2012] FCAFC 149. The Court[10] held a resident taxpayer received over $6 million from a Jersey-based trust, the Esparto Trust. The Esparto Trust had received this amount as part of a share buy-back from another Jersey trust, the Juris Trust. The taxpayer asserted that the amount was a distribution of the corpus of the trust estate and was therefore a capital receipt. The Commissioner of Taxation did not take issue with this assertion, but said the amount was nevertheless assessable under s 99B of the 1936 Act to the extent that it was not assessable under s 97 of that legislation. The Full Court agreed, finding that the amount was caught by s 99B as it would have been assessable if derived by a resident taxpayer (i.e. the exception to the corpus exception in s 99B(2)(a) applied). This was because the distribution represented the proceeds of an off-market share buy-back, which would have been deemed (by s 159GZZZP of the 1936 Act) to be assessable dividends (under s 44 of the 1936 Act).

The Full Federal Court explained the "simple" application of s 99B(2)(a) to the complex facts of the case as follows (at [41]):

[10] Middleton, Perram and Dodds-Streeton JJ.

> In this case, having penetrated two layers of trusts – first the Esparto Trust; then the Juris Trust – one encounters for the first time a non-trust relationship. The trustee of the Juris Trust received non-trust distributions from another Jersey company called Esparto Ltd. Although the process of conjoining Mr Howard to the amounts paid by Esparto Ltd seems complicated, in reality it is not. Section 99B(2)(a) will simply apply as many times as there are interposed layers of trusts. Each application of s 99B(2)(a) leads to a hypothetical question about whether the amounts received by the trust estate would have been assessable income if they had been earned by a resident taxpayer. Once an answer to that question is known at the level of the deepest trust the answer cascades back up to the original (genuine) resident taxpayer. To unpick that slightly: if the Juris Trust estate had been a resident taxpayer and the amounts received by it had been assessable income, then the amounts received by the Esparto Trust, although corpus, would have fallen within the parenthetic excision in s 99B(2)(a) and would have been assessable income in its hands. This, in turn, provides the affirmative answer to the question posed by s 99B(2)(a) as to whether the amounts received by the Esparto Trust estate would have been assessable income on the hypothesis that the Esparto Trust estate was a resident taxpayer. But it is that answer on that hypothesis which applies to Mr Howard himself. What is revealed therefore is not complexity but repetition.

The issue therefore becomes whether the distribution of the revaluation reserve would be assessable to an Australian resident taxpayer. This is so because it is the question for the exception in s 99B(2)(a) and it is the question itself in s 99B(2)(b).

2.4.2 Two Problems with the Asses Revaluation Proposal

There are two problems with the asset revaluation reserve proposal:

(a) It may cause CGT Event E4 to occur. See the discussion at heading 6 above.

(b) The Trust may have received assessable income in a given year. If the trustee has an amount of taxable income in the year of receipt, it should distribute that amount to beneficiaries lest it pay top marginal tax rates pursuant to s 99A of the 1936 Act.

Private Binding Ruling PBR 90106 confirms that a distribution from the trustee of a unit trust, sourced from an asset revaluation reserve, is not assessable income of the unitholder, but will trigger CGT Event E4 happening. It is akin to the current situations and confirms the Commissioner of Taxation's views that CGT Event E4 would apply to the distributions.

2.4.3 Beyond Doubt Asset Revaluation Reserves are Available for distribution

It is now beyond doubt that subject to the terms of the particular trust instrument, a trustee can apply the accretion in value of assets, on which gains are not yet realised, to beneficiaries. Indeed, this can occur where the:

1. trust comprises nothing but its limited settlement capital and the accretion in value of an asset; and

2. its subsequent books and records show no change in ownership of the asset from which the accretion arises.

In *Fischer v Nemeske Pty Ltd* '[t]he reference to an "asset revaluation reserve" was not to a fund of monies nor to property which had been set aside, as the ordinary meaning of the word "reserve" implies. It was merely the accounting treatment given to an unrealised accretion in the value of the Shares.': at [38] per Keifel J. It was, therefore, an asset revaluation reserve in its most account based form; there being no funds realised at all, and no funds other than the settlement sum, applied to the trust.

However, in dissent Keifel J said at [78]:[11]

> The most that can be said about the Resolution is that it sought to create the appearance of a distribution of something out of the Trust, but that something was not property. The Trustee cannot be taken by the Resolution to have intended to set aside, allocate or otherwise "apply" Trust property. Rather, it was intended at all times that the whole of the property of the Trust continue to be owned by it. This is borne out by the accountant's letter of 26 April 1995, the Charge and entries in the accounts of the Trust concerning trust assets.

The majority view is made clear by Gageler J at [99] and [100]:

> An absolute beneficial entitlement to some part of a fund of property that is held on trust need not be reflected in an absolute beneficial entitlement to the whole or some part of any specific asset within that fund. That must be so whether the absolute beneficial entitlement to some part of a fund of property that is held on trust is defined by the terms of the trust settlement itself, or whether such absolute beneficial entitlement to some part of a fund of property that is held on trust is defined by an exercise of a power conferred on a trustee under the terms of a trust settlement. Whether or not a particular beneficial entitlement to some portion of a trust fund is reflected in a beneficial entitlement to the whole or some part of a specific asset within that fund depends on the terms of the trust settlement.

[11] And see Gordon J at [155] and [158].

> Furthermore, an absolute beneficial entitlement to some part of a fund of property may be defined as an entitlement to be paid a sum of money out of the fund of property that is held on trust, irrespective of whether or not the assets within the fund are currently held in monetary form. Again, it depends on the terms of the trust settlement.

The Commissioner of Taxation would be likely to embrace the minority position, but the majority make clear that it is open to a trustee to record the accretion in value of an asset and make a beneficiary entitled to amount represented by that accretion.

2.4.4 Accounting Treatment Imperative

The following case shows the importance of the accounting and administrative treatment of an 'asset revaluation reserve' amount as it can easily be treated as income if the trustee is not particular to maintain the character of the distribution.

Part of Brereton's J decision in *Wood v Inglis* [2009] NSWSC 601 involved the question of whether movements in the value of assets can be treated as income or otherwise distributed to beneficiaries. In that case it was the movement in value of shares held by the trustee. His Honour held at [14] to [17]:

> I do not accept that it cannot be said that a profit has been made (or "incurred", for the purposes of clause 10 of the Trust Deed), just because it has not been realized. Comparison of the value of the assets of an entity at the end of the relevant period with their value at the beginning of that period is one well-recognised means of ascertaining profit [*Re Spanish Prospecting Co Limited* [1911] 1 Ch 92 at 98; *QBE Insurance Group v ASIC* (1992) 38 FCR 270 at 284-285]. …
>
> That conclusion is only reinforced by clause 6(f). I do not accept that the reference in clause 6(f) to "property or moneys held by the Trustee", coupled with the definition of "property", means that the reach of the clause does not extend to "unrealised capital gains"; the purpose of the clause is plainly to avoid disputation as to whether receipts, profits and distributions received by the trust are capital or income by empowering the Trustee to make that determination. The effect of treating "unrealised capital gains" as income is that so much of the value of a share (which is expressly within the definition of "property") as reflects that gain is treated as income. As has already been observed, the proviso contained in clause 6(f) demonstrates that the Trustee may chose to treat as capital in the Trust accounts what is income for income tax purposes (although a specific declaration to that effect is required); likewise it may (and without any such specific declaration) chose to treat as income in the Trust accounts what is capital for income tax purposes. In that context, submissions that "unrealised capital gains" are not income in the ordinary sense of the word are beside the point.
>
> Accordingly, the Trustee was entitled to treat the movements in the net value of investments as income. Accounts prepared on that basis were nonetheless "proper accounts". Moreover, even if the "unrealised capital gains" were not income, they could

> be distributed as capital under clause 5(a), which gave the Trustee a discretion to apply capital in favour of any eligible beneficiary at any time before the Perpetuity Date.

In that case at [66] Brereton J found that Dr Inglis was the corporate trustee's controlling mind and, therefore, in approving the financial accounts that provided for the unrealized gains being income it was the trustee's determining to so treat those gains. At [67] his Honour also found that Dr Inglis was acting on the corporate trustee's behalf in validly and effectively making distributions to his beneficiary loan account.

In *Clark v Inglis* [2010] NSWCA 144 the Court decided that, for the purposes of the trust deed provision concerning the distribution and allocation of trust 'income' of a year, unrealized gains arising upon revaluation of investments in accordance with a policy of annual 'marking to market' were property treated as part of a year's income.

However, it is clear that the trustee of a trust must properly account for the revaluation reserve – and seek to achieve the outcome of *Fischer v Nemeske Pty Ltd* – lest it run the risk of any accretion in value of the asset being assessable to a beneficiary.

3 Superannuation

The two areas to be discussed in this context are the:

1. currently inconsistent approach the Commissioner of Taxation has taken to distributions from allegedly fixed trusts to regulated superannuation funds; and
2. recent developments on the need for strict adherence to nomenclature in binding death benefit nominations.

They will be separately addressed.

3.1 The Nature of the Interest

The income of a complying superannuation fund[12] is split into two components:[13]

[12] See section 995-1 of 1997 Act and s 45 of the *Superannuation Industry (Supervision) Act* 1993 ("**SIS Act**") as to the definition of a 'complying superannuation fund'.
[13] Subsection 295-545 of the ITAA 1997

1. the non-arm's length component; and

2. the low-tax component.

The non-arm's length component is the fund's non-arm's length income less deductions attributable to that income (see below): s 295-545(2) of the 1997 Act.

The low-tax component is the fund's income other than the non-arm's length component (if any): s 295-545(3) of the 1997 Act. However, certain amounts are specifically excluded from the fund's income, such as non-concessional contributions as outlined above. The low-tax component is taxed at 15%[14] (and capital gains may be entitled to a 33.33% discount reducing the effective tax rate to 10%).[15]

The non-arm's length component is taxed at 45%.[16]

3.1.1 Non-arm's length income

Broadly, by s 295-550 of the 1997 Act, an amount of income is non-arm's length income of a complying superannuation fund if:

1. it is *both*:

    (a) derived from a scheme the parties to which were not dealing with each other at arm's length in relation to the scheme; and

    (b) the amount is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme;

2. if it is *either*:

    (a) a dividend paid to the entity by a private company; or

    (b) ordinary income or statutory income that is reasonably attributable to such a dividend,

    unless the amount is consistent with an arm's length dealing and relevant factors in this regard include:

[14] Paragraph 26(1)(a) of the *Income Tax Rates Act* 1986 ("**ITRA 1986**")
[15] See Subdivision 115-A of the ITAA 1997
[16] Paragraph 26(1)(b) of the ITRA 1986

(a) the value of shares in the company that are assets of the entity; and

(b) the cost to the entity of the shares on which the dividend was paid; and

(c) the rate of that dividend; and

(d) whether the company has paid a dividend on other shares in the company and, if so, the rate of that dividend; and

(e) whether the company has issued any shares to the entity in satisfaction of a dividend paid by the company (or part of it) and, if so, the circumstances of the issue; and

(f) any other relevant matters;

3. income derived by the fund as a beneficiary of a trust other than by virtue of a *fixed entitlement* (see below);

4. income derived by the fund as a beneficiary holding a *fixed entitlement* if:

(a) the fund acquired the entitlement under a scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at arm's length; and

(b) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length.

The Commissioner of Taxation's views on non-arm's length income are outlined in *Taxation Ruling* TR 2006/7. Although the ruling refers to the previous 'special income' regime, the Commissioner's views as to the operation of the relevant provisions have not changed,[17] although it is important to note that the current regime requires taxpayers to self-assess whether income is non-arm's length whereas previously certain amounts were deemed to be special income (and subject to high tax rates) unless the Commissioner exercised his discretion to treat it otherwise: See *Darrelan Pty Ltd (trustee if the Henfam Superannuation Fund) v FCT* [2010] FCAFC 35 where it was held that no single factor decisive, rate of dividend relevant.

[17] See Explanatory Memorandum to the Tax Laws Amendment (Simplified Superannuation) Bill 2006 (Cth) at paragraph 3.14

3.1.2 What is a 'fixed entitlement'?

There has been much confusion surrounding the meaning of the phrase, 'fixed entitlement' in the context of the non-arm's length income rules.

The problem centres on the fact that the term, 'fixed entitlement' is defined in Schedule 2F to the 1936 Act but that definition appears to have a limited application to that particular Schedule.

In *Taxation Ruling* TR 2006/7 at [206] to [208] the Commissioner of Taxation accepts that the term, 'fixed entitlement' for present purposes was separate and distinct to that which applies for the purposes of Schedule 2F to the 1936 Act as follows:

> The term 'fixed entitlement' is not defined for the purposes of section 273. The meaning to be ascribed to these terms must therefore be determined according to the ordinary meaning of the words having regard to the context in which they appear.
>
> When inserting subsections 273(6) to (8), Parliament sought to distinguish between investment returns on 'fixed entitlements' in 'unit trusts' and distributions made to persons as beneficiaries of 'discretionary trusts' resulting from the exercise of discretions. Parliament considered it appropriate that the latter should be treated as special income taxed at the non-concessional rate whereas the former should only be treated as special income if the acquisition of the fixed entitlement or the derivation of the income failed to satisfy an arm's length test.
>
> Having regard to the statutory context, it is considered that the composite expression 'income derived ... by virtue of a fixed entitlement to the income' is designed to test whether an amount of trust income that had been included in the assessable income of a superannuation entity under subsection 97(1) was included because the entity had an interest in the income of the trust that was, at the very least, vested in interest, if not in possession, immediately before the amount was derived by the trustee.

As outlined above, other than the change to a self-assessment model, the replacement of the 'special income' regime with the 'non-arm's length income' regime did not involve a change in underlying policy or legislative operation other than moving to a self-assessment model.

However, if the term, 'fixed entitlement' for present purposes is covered by the definition in Schedule 2F to the 1936 Act the move to self-assessment model would be largely defeated. That is, the Commissioner has discretion to deem a fixed entitlement under Schedule 2F of the 1936 Act where:

1. a beneficiary with an interest in a share of income that the trust derives from time to time, or of the capital of a trust, does not have a fixed entitlement to the share; and

2. the Commissioner considers that the beneficiary should be treated as having the fixed entitlement, having regard to:

   (a) the circumstances in which the entitlement is capable of not vesting or the defeasance can happen; and

   (b) the likelihood of the entitlement not vesting or the defeasance happening; and

   (c) the nature of the trust;

   the beneficiary has the fixed entitlement.

The Commissioner of Taxation's discretion is intended to provide for circumstances where, despite the trust not technically meeting the requirements to be a 'fixed entitlement', the likelihood of the beneficiary's vested interest being defeated is low, and it would be unreasonable in the context of the statutory scheme to treat the beneficiary's interest as not constituting a 'fixed entitlement'.[18]

Further, in the Trust Consultation Sub-Group Issues Register, the Commissioner of Taxation states in this regard:[19]

> For unlisted unit trusts (including those that are not registered managed investment schemes for the purposes of the *Corporations Act* 2001) with a single class of units on issue, it would generally be expected that the Commissioner would exercise the discretion on a year by year basis or for a certain point in time (depending on the relevant legislative provision) provided that, for the relevant year of income:
>
> (a) any issue or redemption of units was actually done at a price determined on the basis of the net asset value at the time of the redemption or issue (that is, the price does not necessarily have to equate precisely to the net asset value, provided that the deviation from that value does not unduly favour or prejudice particular unit holders, is done in the best interests of all unit holders, complies with any relevant ASIC relief, and the Commissioner considers the extent of the deviation to be reasonable in all the circumstances); and
>
> (b) no amendments have been made to the trust's constitution that have had the effect of significantly defeasing a beneficiary's interest in the income or capital of the trust.

[18] See Explanatory Memorandum to the *Tax Laws Amendment (Trust Loss and Other Deductions) Bill 1997* at paragraph 13.13

[19] See https://www.ato.gov.au/General/Consultation/In-detail/Technical-and-special-purpose-working-groups---minutes/Trust-Reform-and-Compliance-Working-Group/Trust-Consultation-Sub-group-issues-register/ (accessed 16 January 2016)

Returning to the non-arm's length income rule, the policy intent of moving to a self-assessment model would be significantly undermined by adopting the position that a fixed entitlement for present purposes was defined by reference to the meaning of that term under Schedule 2F of the ITAA 1936 as taxpayers would have to approach the Commissioner for the exercise of his discretion to treat a trust interest as a fixed entitlement which is not administratively distinguishable to approaching the Commissioner to treat special income as *ordinary* income under the former regime.

However, in *The Trustee for MH Ghali Superannuation Fund v FCT* [2012] AATA 527, Egon Fice SM held that the term was defined in Schedule 2F to the 1936 Act and covered the meaning of that term for the purposes of the (former) special income rules.

In his Decision Impact Statement on *The Trustee for MH Ghali Superannuation Fund v FCT* [2012] AATA 527, the Commissioner of Taxation concluded:

> The Tribunal considered that 'fixed entitlement' in s 273 takes the meaning provided in s 272-5 in Schedule 2F to the ITAA36. This is contrary to, and would be less favourable to taxpayers than, the Commissioner's existing approach.

And further:

> Section 272-5 of Schedule 2F provides that if a beneficiary has a vested and indefeasible interest in a share of income of a trust that the trust derives from time to time, the beneficiary has a fixed entitlement to that share of income. The Tribunal made some observations regarding the nature of that test which are discussed further below. Because of the way the case was argued, the Tribunal did not have the benefit of submissions on the way in which the test operates including relevant case law.

And finally:

> In light of recent authority, it might be said that the fixed entitlement test in Schedule 2F is relatively difficult to satisfy. See, for example, *Colonial First State Investments Ltd v. FCT* , and the Commissioner's Decision Impact Statement in respect of that case. Having regard to the strictness of that test, the Commissioner perceives that the adoption of the Schedule 2F definition for the purposes of s 273 (or its successor, s 295-550) would give rise to adverse and unintended impacts on superannuation funds that hold arm's length trust investments.
>
> The Commissioner proposes to adhere to his existing view that the Schedule 2F definition is inapplicable for the purposes of s 273. Although not considered by the Tribunal, we note that the Commissioner's view is that the Schedule 2F definition also

does not apply for the purposes of s 295-550: see TR 2006/7 and the minutes to NTLG Superannuation Subcommittee meeting of March 2010.

Despite the Commissioner of Taxation's public views on *The Trustee for MH Ghali Superannuation Fund v FCT* [2012] AATA 527 in his Decision Impact Statement, in *Private Ruling* 1012585947911, the Commissioner of Taxation ruled that an amount was non-arm's length income applying the definition of a fixed entitlement under Schedule 2F to the 1936 Act (that is, the complete opposite to what was publicly stated).

I note that Private Rulings are not binding other than in relation to the particular rulee and the Private Binding Rulings Register does contain unfavourable rulings from which taxpayers may have successfully objected.

However, the critical point is that advisers would be loath to advise on the operation of these provisions in the absence of extraordinarily rigid trust deed or a successful Private Ruling, whether in relation to:

1. the meaning of 'fixed entitlement' for present purposes falling outside the scope of the definition in Schedule 2F to the 1936 Act; or

2. if the Commissioner seeks to rely on *The Trustee for MH Ghali Superannuation Fund v FCT* [2012] AATA 527– the exercise of his discretion to treat the relevant interest as a fixed entitlement.

3.2 BDBN - Nomenclature

Through a valid binding death benefit nomination a member can circumscribe the discretion a fund trustee otherwise has to distribute death benefits of that member. I will first set out the legislative regime for those nominations, then discuss their appropriateness and when they are to be used, consider some cases on the effect and effectiveness of certain nominations, then – based on the examples of the cases discussed – consider how to rectify them in case they are currently deficient.

3.2.1 Provisions for a Binding Death Benefit Nomination

Section 59 of the SIS Act provides that:

(1) Subject to subsection (1A), the governing rules of a superannuation entity other than a self managed superannuation fund must not permit a discretion under those rules that is exercisable by a person other than a trustee of the entity to be exercised unless:

(a) those rules require the consent of the trustee, or the trustees, of the entity to the exercise of that discretion; or

(b) if the entity is an employer-sponsored fund:

(i) the exercise of the discretion relates to the contributions that an employer-sponsor will, after the discretion is exercised, be required or permitted to pay to the fund; or

(ii) the exercise of the discretion relates solely to a decision to terminate the fund; or

(iii) the circumstances in which the discretion was exercised are covered by regulations made for the purposes of this subparagraph.

(1A) Despite subsection (1), the governing rules of a superannuation entity may, subject to a trustee of the entity complying with any conditions contained in the regulations, permit a member of the entity, by notice given to a trustee of the entity in accordance with the regulations, to require a trustee of the entity to provide any benefits in respect of the member on or after the member's death to a person or persons mentioned in the notice, being the legal personal representative or a dependant or dependants of the member.

(2) If the governing rules of a superannuation entity are inconsistent with subsection (1), that subsection prevails, and the governing rules are, to the extent of the inconsistency, invalid.

Further, section 31 of the SIS Act provides that regulations may be made so as to provide operating standards for superannuation fund. Relevantly, r 6.17A of the SIS Regulations provides that:

6.17A Payment of benefit on or after death of member (Act, s 59 (1A))

(1) For subsections 31(1) and 32(1) of the Act, the standard set out in subregulation (4) is applicable to the operation of regulated superannuation funds and approved deposit funds.

(2) For subsection 59(1A) of the Act, the governing rules of a fund may permit a member of the fund to require the trustee to provide any benefits in respect of the member, on or after the death of the member, to the legal personal representative or a dependant of the member if the trustee gives to the member information under subregulation (3).

(3) The trustee must give to the member information that the trustee reasonably believes the member reasonably needs for the purpose of understanding the right of that member to require the trustee to provide the benefits.

(4) Subject to subregulation (4A), and regulations 6.17B, 7A.17 and 7A.18, if the governing rules of a fund permit a member of the fund to require the trustee to provide any benefits in accordance with subregulation (2), the trustee must pay a benefit in respect of the member, on or after the death of the member, to the person or persons mentioned in a notice given to the trustee by the member if:

(a) the person, or each of the persons, mentioned in the notice is the legal personal representative or a dependent of the member; and

(b) the proportion of the benefit that will be paid to that person, or to each of those persons, is certain or readily ascertainable from the notice; and

(c) the notice is in accordance with subregulation (6); and

(d) the notice is in effect.

(4A) The trustee is not required to comply with subregulation (4) if the trustee:

(a) is subject to a court order that has the effect of restraining or prohibiting the trustee from paying a benefit in respect of the member in accordance with a notice of the kind described in that subregulation; or

(b) is aware that the member of the fund is subject to a court order that:

(i) requires the member to amend or revoke a notice of that kind that the member has given the trustee; or

(ii) has the effect of restraining or prohibiting the member from giving a notice of that kind.

(5) A member who gives notice under subregulation (4) may:

(a) confirm the notice by giving to the trustee a written notice, signed, and dated, by the member, to that effect; or

(b) amend, or revoke, the notice by giving to the trustee notice, in accordance with subregulation (6), of the amendment or revocation.

(6) For paragraphs (4) (c) and (5) (b), the notice:

(a) must be in writing; and

(b) must be signed, and dated, by the member in the presence of 2 witnesses, being persons:

(i) each of whom has turned 18; and

(ii) neither of whom is a person mentioned in the notice; and

(c) must contain a declaration signed, and dated, by the witnesses stating that the notice was signed by the member in their presence.

(7) Unless sooner revoked by the member, a notice under subregulation (4) ceases to have effect:

(a) at the end of the period of 3 years after the day it was first signed, or last confirmed or amended, by the member; or

(b) if the governing rules of the fund fix a shorter period — at the end of that period.

However, in Self Managed Superannuation Funds SMSFD 2008/3, entitled *Self Managed Superannuation Funds: is there any restriction in the Superannuation Industry (Supervision) legislation on a self managed superannuation fund trustee accepting from a member a binding nomination of the recipients of any benefits payable in the event of the member's death?*, the Commissioner of Taxation observed that:

> 1. … Section 59 of the Superannuation Industry (Supervision) Act 1993 (SISA) and regulation 6.17A of the Superannuation Industry (Supervision) Regulations 1994 (SISR) do not apply to self managed superannuation funds (SMSFs). This means that the governing rules of an SMSF may permit members to make death benefit nominations that are binding on the trustee, whether or not in circumstances that accord with the rules in regulation 6.17A of the SISR.
>
> 2. However, a death benefit nomination is not binding on the trustee to the extent that it nominates a person who cannot receive a benefit in accordance with the operating standards in the SISR. The relevant operating standards are mentioned in Appendix 1 of this Determination.

As a result, before a death benefit nomination is made, regard should be given to the particular constituent documents for the superannuation fund so as to determine what (if any) death benefit nominations can be made. In the event that the constituent documents are silent on the matter, then no nomination can be made.

3.2.2 Binding Death Benefit Nominations – When To, and Not, Use Them

It is common for accountants, financial planners and superannuation administrators to offer pro forma nominations to their respective clients. I caution against this. In its most common form it states '*everything to my spouse and if he/she fails to survive me to the legal personal representative of my estate'*. The issue arises because providing this nomination suggests that (a) some consideration has been given to the appropriateness of it to the particular client, and (b) it carries the suggestion that the nomination is binding. These would suggest legal advice has been given to the client, thereby triggering the provisions of the relevant *Legal Profession Acts.* For non-lawyers a professional indemnity issue may arise.

A further issue relates to the inflexibility of binding death benefit nominations. They circumscribe an otherwise available discretion of the fund trustee. This could cause issues if:

- a member has lost capacity and is unable to amend a binding nomination;
- circumstances change (such as deaths, births, marriages or relationship falling apart);
- the law (in particular the tax law) changes;
- the nomination is to the estate and the prospect of a family provision claim is real.

For these reasons a binding nomination should not be adopted until it is considered, on appropriate material, the right course for the client.

Circumstances where a binding nomination may be appropriate are:

1. a blended family exists and second marriages cause the member to want their superannuation benefits to go to children of a prior relationship;
2. the potential beneficiaries are young adults as the Superannuation Complaints Tribunal has a preference for awarding death benefits to spouses to the expense of young adult children;
3. where a widowed person or recently divorced person wants to ensure their death benefits are not paid to a deemed spouse;
4. where a testamentary trust has been established and s 102AG of the 1997 Act will afford substantial tax benefits going forward through that trust.

A binding nomination, at least so far as they relate to a self manage superannuation fund, is only limited by the payment standards of the SIS Act and SIS Regulations, trust law and the terms of the fund deed and the commercial drivers of any taxation consequences. Therefore, providing the fund deed and the binding nomination are appropriately worded there is no reason by the nomination cannot:

1. direct specific assets to be paid in specie to a particular member;

2. give other direction to the trustee with respect to the payment of death benefits;

3. provide for the form of the payment of a death benefit (for example, by way of a pension on certain terms or by way of a lump sum);

4. contemplating that a member may have more than one spouse (if this happened to be the case);

5. providing the payment of certain assets be subject to life interests or occupancy rights (this commonly occurs in a will).

It is now convenient to considers real life examples, via litigated cases of purportedly binding nominations being challenged. It will be seen that most of these challenges are successful.

3.2.3 Challenging Binding Death Benefit Nominations – Case Law

There have been a number of significant decisions in the last decade dealing with binding death benefit nominations. It is convenient to consider them chronologically, though they deal with issues such as what happens if the nomination is not binding or, if binding, if the trustee nonetheless seeks to ignore it.

From the cases, however, it seems that a binding nomination may be challenged on the following grounds:

1. that the fund deed proscribed how the nomination was to occur and the nomination in question did not confirm to those requirements. A trick to addressing this is ensuring the deeds are permissive in their language rather than mandatory.

2. that the nomination does not specify a 'death benefit dependent'. These would automatically fail as falling foul of the payment standards of the SIS Act and the SIS Regulations.

3. that one of a series of amendments to the fund deed (which occurs over the ordinary life of a fund) such that the operative deed that the trustee and members were applying was not in fact applicable. Thorough and diligent recordkeeping will address this issue.

4. related to the previous issues, is where the fund deed is amended after the nomination is entered and the nomination no longer remains binding due to the rule change. A cross-

check of outstanding nominations at the time of a deed amendment will address this issue.

5. that the fund deed provides that the nominations lapse after a period of time. A common period is three years.

6. the nomination contains the wrong description (see the, possibly, harsh result in *Munro v Munro* below).

7. the member or the trustee lacked capacity at the time the nomination was made. This gives rise to the capacity issues and arguments one normally sees in a probate context.

8. the member or the trustee was subject to undue influence at the time the nomination was made. This gives rise to the equitable issues and arguments one normally sees in a probate context.

9. that although the nomination be binding, the trustees of the fund fail to disclose its existence to the potential beneficiaries. Having the fund's professional advisors aware of the fund's documents or status of its member's nominations will address this issue.

It is now appropriate to consider specific examples in the decisions of the above issues. However, the focus, given the nature of this paper, should be on the decision in *Munro v Munro* [2015] QSC 61 being the most recent development.

3.2.3.1 Katz v Grozman – Breadth of Trustee's Discretion

It should also be noted that if the decision as to who will receive the death benefit is made by the remaining trustee(s) of the self-managed superannuation fund, the death benefit may be paid in a way which is contrary to the deceased member's wishes. Consideration should be given to the decision in *Katz v Grossman* [2005] NSWSC 934, which according to the first sentence of the judgement was: '*…a contest between a brother and a sister over the control of a superannuation trust fund established at the behest of their late father Ervin Katz. The assets of the fund exceed $1 million.*'

Katz v Grossman is authority for the proposition that in the event that binding directions are not provided to the trustee of a self-managed superannuation fund, then the trustee of a fund has complete discretion with respect to dealings with superannuation benefits. Such discretion includes the trustee providing the benefits to themselves, notwithstanding that they are not dependants of the deceased.

Ervin Katz was a member of the E. Katz Employees Trust Fund, which was a self-managed superannuation fund. Both Mr Katz and his daughter, Linda Ann Grossman were trustees of the self-managed superannuation fund. Mr Katz had made a non-binding nomination, in which he expressed the desire for his death benefit to be divided equally amongst his daughter (the co-trustee) and his son.

However, following the death of Mr Katz, Mrs Grossman appointed her husband as a co-trustee. The trustees then resolved to pay the whole of Mr Katz's death benefit to Mrs Grossman.

Mr Katz's son took action in the New South Wales Supreme Court arguing that:

- Mr Katz had not validly appointed Mrs Grossman as a trustee; and
- Mrs Grossman was not validly appointed as a member.

With respect to the first issue, after reviewing the terms of the superannuation fund's deed, the relevant documentation and consideration of the *Trustee Act 1925* (NSW) , Smart AJ held that Ms Grossman had been validly appointed. As a result, Mrs Grossman's decisions were held to be valid, which included the payment of the death benefit referable to Mr Katz's interest in the fund to herself.

With respect to the issue of whether Mrs Grossman was validly appointed as a member of the fund, Smart AJ considered that because the fund's deed required an appointment as a member to be effective the trustee had to consent to it, as there was no documentary evidence which showed that the trustee had consented to Mrs Grossman becoming a member, it was held that Mrs Grossman was not a member of the fund.

As a result, in order to ensure that the wishes of a member with respect to the payment of their interest in a self-managed superannuation fund occurs, either a binding death benefit nomination should be executed, or there should be a trust deed direction which provides for such wishes.

3.2.3.2 Donovan v Donovan – Breadth of Trustee's Discretion

The decision of *Donovan v Donovan* [2009] QSC 26 from the Supreme Court of Queensland highlights the importance of the form a superannuation trust deed and the implications of whether a death benefit nomination is binding on the trustee of a super fund.

In this case, Mr Donovan established a superannuation fund with a corporate trustee, of which Mr Donovan was a member at all material times. Mr and Mrs Donovan (his wife by a second marriage) were also the respective director and secretary of this corporate trustee. The revised trust deed of Mr Donovan's super fund required a corporate trustee to be bound by a binding death benefit nomination, where such binding death benefit nomination satisfies the "Statutory Requirements".

Mr Donovan signed a letter addressed to the corporate trustee, advising that, upon his death, he wished to have his superannuation entitlements distributed to his legal personal representative for inclusion in his estate assets. On Mr Donovan's death, his daughter by his first marriage, Lynda (who was the beneficiary under his will), brought an application to seek the court's determination that Mr Donovan's nomination was binding on the corporate trustee, of which Mrs Donovan had control.

The Court found that the intent of the particular trust deed was to require Mr Donovan's letter to be in the form described in subregulation 6.17A(6) of the SIS Regulations, and so further held that Mr Donovan's letter was not binding on the trustee. As Mr Donovan's letter was a non-binding death benefit nomination, the corporate trustee was not obliged to distribute his superannuation entitlements to his legal personal representative for inclusion in his estate assets.

Further, if the constituent documents provide that binding death benefit nominations may be made under the SIS Act, and because the relevant binding death benefit rules in the SIS Act do not apply to self-managed superannuation funds, such a provision will not allow a member to make such nominations.

It should be noted that the jurisdiction of the Superannuation Complaints Tribunal does not extend to decisions made by trustees of self-managed superannuation funds or certain public sector superannuation schemes. As a result, self-managed superannuation funds are a valuable mechanism to ensure that a death benefit is paid as directed by the deceased member.

Further, because death benefits are not dealt with under a will, legal challenges can be greatly reduced by directing payments from a self-managed superannuation fund upon death directly to a person specified by the deceased, as opposed to having such payments directed to the estate of the deceased.

3.2.3.3 Wooster v Morris – A Rare Win for the Nomination

In *Wooster v Morris* [2013] VSC 594 the Victorian Supreme Court was asked to consider the validity of a binding nomination prepared in respect of a self-managed superannuation funds that allegedly failed to comply with the terms of the fund deed. It also had to consider whether the trustee was entitled to indemnity.

Two years before his death Mr Morris had executed a binding nomination in favour of his daughters from his first marriage. They were to receive all of his death benefits. Mr Morris was survived by his second wife, being the only surviving member and trustee of the relevant fund.

The second wife appointed her son (of another relationship) as co-trustee and member of the fund. A corporate trustee then replaced them both.

The fund deed required that a valid, binding nomination must be delivered to the trustee. It can only be assumed from the judgment that the second wife alleged that the binding nomination was never served on her and therefore was invalid. She and her son exercised the trustee's discretion and resolved to pay, and subsequently paid, the death benefits to the second wife via transfer to her member balance.

The daughters, who were also executrixes of Mr Morris' estate, commenced proceedings seeking a declaration that the binding nomination was in fact valid and, if so, the death benefits should have been paid to them.

The parties agreed that the issue be referred to a referee for determination. The referee filed a report determining that the biding nomination was both valid and binding. Consequently the daughters were to be paid the death benefits and interest.

Interestingly, in seeking to avoid a costs order the second wife relied on the corporate trustee as the entity against whom the order should be made. The Court held that such an outcome would cause the death benefits to be impacted by the order that, in circumstances where the second wife solely benefited from the trustee's actions, was inappropriate.

This case is one of the rare lights in a sea of judicial darkness for binding nominations.

3.2.3.4 Ioppolo v Conti – Breadth of Trustee's Discretion

In *Ioppolo v Conti* [2015] WASCA 45 the Western Australian Court of Appeal confirmed the breadth of the trustee's discretion. In that case the deceased, Mrs Conti, was a fund member and joint trustee with her husband, Mr Conti.

Although she had not prepared a binding death benefit nomination, Mrs Conti's will directed as to the payment of her death benefit to her children. It specifically stated that her husband was not to receive any of the death benefits.

However, during her lifetime Mrs Conti had prepared two binding nominations (29 July 2002 and 10 April 2006). The later of the two lapsed on its third anniversary. Both directed the trustee of the self-managed superannuation fund to pay her death benefits to Mr Conti.

Mr Conti (as director of a corporate trustee appointed to the fund after Mrs Conti's death) caused the death benefits to be paid to himself to the exclusion of the children. The children, who were also executors of Mrs Conti's estate, brought proceedings seeking to clarify:

1. was Mr Conti obliged to appoint one of the executors as trustee of the self managed superannuation fund?
2. whether the corporate trustee, in resolving to pay the death benefits to Mr Conti, do so in a bona fide manner?

The Court held that s 17A(3) of the SIS Act allows for, but does not require, the appointment of an executor as trustee of a self managed superannuation fund. As there is a six month period of grace, and Mr Conti had caused a corporate trustee to be appointed within that grace period, there was no breach of s 17A.

The Court also held that executors' argument, that failure to comply with the direction in the will evidence a lack of bona fides, had no merit. It held that there was no evidence to support the argument. It is to be noted that Mr Conti had sought advice on this issue and complied with that advice.

The case also addressed whether an executor could be appointed as fund trustee under s 77 of the *Trustee Act* 1962 (WA) and whether the trustee's discretion can be reviewed. Both issues were resolved against the executors.

3.2.3.5 Munro v Munro – Technical Breaches are Sufficient

In *Munro v Munro* [2015] QSC 61 Mr Munro died in 2011 survived by his second spouse, her daughter Ms Pooley and Mr Munro's two daughters of his earlier marriage (Vanessa and Elke).

In 2009 Mr Munro had signed a binding death benefit nomination to direct his fund trustee to pay his death benefits to his estate. The deed of that fund required the trustee to pay any benefits in accordance with any binding nominations. One of the provisions of this was that the nomination had to specify who it was to be paid to (reflecting the require of superannuation law). If this requirement was not satisfied, the trustees were not bound by the nomination and could pay the benefits at their discretion (but obviously still subject to the terms of the fund deed and the law).

In 2012 Ms Pooley became a co-trustee with her mother (the second spouse). They gave notice to the two daughters, who were executrixes of Mr Munro's estate, that the trustees intended to exercise their discretion as trustees in paying Mr Munro's death benefits on the basis that they nomination was not binding.

The executrixes sought a declaration of the court that the nomination was binding on the trustees. In doing so they argued the description in the nomination, 'Trustee of Deceased Estate' meant Mr Munro's executrixes.

The Court held the nomination of 'Trustee of Deceased Estate' as the nominated beneficiary was insufficient to direct the trustees to pay the benefits to Mr Munro's 'legal personal representative', being his executrixes. It was noted that while the terms 'executor' and 'trustee' may be used interchangeably in a colloquial sense, the terms are distinct.

The Court held that the nomination was not binding. One may think this outcome both harsh and against the clear factual matrix underpinning the case.

3.3 McIntosh v McIntosh – Capacity of the Receipt

The following case is of significance in the area of disputes over death benefits and the decision to accept, or not, the office of personal legal representative.

In *McIntosh v McIntosh* [2014] QSC 99, in yet another Queensland case, the Supreme Court answers what was (so far as my research has shown) a novel question. It was expressly considered by a court: If a person is eligible to receive a deceased's super both as the deceased's legal personal representative and also in his or her personal capacity, and the person receives the super personally, must he or she transfer it to the estate?

Mr and Mrs McIntosh were married in 1968 and divorced in 1979 with one son of the relationship, James. Mrs McIntosh and James lived together for the bulk of his life. James was killed on 14 July 2013 without a surviving spouse or children. He also died intestate.

Mrs McIntosh applied to be the administrator of James' estate. She stated in an affidavit that she understood that, if she were so appointed, she was required to collect her son's assets and distribute his estate by dividing them equally between herself and the father. She said 'I propose faithfully to do this.' She was granted 'Letters of Administration' (ie, appointed as the administrator).

The net assets of James' estate were about $80,000. However, he had significantly more in various super funds, totaling approximately $454,000.

On 30 September 2013 the mother then applied to James' super funds to have his super death benefits paid to her personally, describing the interdependency relationship that existed between her and her son. Each super fund agreed to do so. This meant that it appeared that all of the super (ie, about $454,000) would be paid directly to the mother and none of it to Mr McIntosh. Mr McIntosh would receive only half of the estate (ie, half of about $80,000).

Mr McIntosh's lawyers wrote to the mother stating:

> As administrator, I note that your client will make her best endeavours to maximise the size of the estate. Bearing this in mind, please advise whether your client intends to seek any or all of the deceased's superannuation entitlements to be paid entirely to her in her personal capacity.

Mrs McIntosh's lawyers wrote back stating:

> … we do not hold any instructions in relation to the superannuation as it does not form part of the estate … If you are able to direct us to the law that requires our client as personal representative to make such an application to the super funds then we will take instructions in this regard

Mr McIntosh's lawyer replied that:

> … as personal representative, your client has a fiduciary obligation to maximise the return for the estate. Clearly your client is in breach of her obligation if she has actively sought payment to herself direct in lieu of the estate.

Mrs McIntosh then filed this application. The Court held that:

> … there was a clear conflict of duty … contrary to her fiduciary duties as administrator. When the mother made application to each of the superannuation funds for the moneys to be paid to her personally rather than to the estate, she was preferring her own interests to her duty as legal personal representative to make an application for the funds to be paid to her as legal personal representative. She was in a situation of conflict which she resolved in favour of her own interests. As such she acted … in breach of her fiduciary duty as administrator of the estate …

Accordingly, the Court held that the mother was required to account to the estate for the super death benefits (ie, 'hand over' the benefits).

This case shows the importance of dovetailing your binding nominations and, possibly, your testamentary dispositions (the will) to ensure the outcome suits. If James' wanted Mrs McIntosh to receive the funds – which may have been the case given their interdependent relationship – these two steps would have assisted.

4 Reimbursement Agreements

Section 100A of the 1936 Act operates where:

(a) a beneficiary of a trust is presently entitled to a share of income from the trust; and

(b) the present entitlement arose out of a reimbursement agreement or arose by reason of any act, transaction, or circumstance that occurred in connection with, or as a result of, a reimbursement agreement.

4.1 Reimbursement Agreements

A 'reimbursement agreement' is an agreement which provides for the payment of money, the transfer of property to, or the provision of services or other benefits for, a person or persons other than the presently entitled beneficiary or the beneficiary and another person or other person: s 100A(7) of the 1936 Act.

For a reimbursement agreement to exist the agreement must be entered into for a tax avoidance purpose: s 100A(8) of the 1936 Act. It is an anti-avoidance provision.

Section 100A of the 1936 Act was introduced to prevent trust stripping arrangements where trust income was diverted to third parties and away from the truly intended beneficiaries of a trust under a scheme where the truly intended beneficiaries or an associate would in return receive a non-taxable amount or benefit. Section 100A operates to prevent these trust stripping schemes by taxing the trustee on the income subject to the present entitlements at the rate of 49.5% under s 99A of the 1936 Act.

4.2 Corporate beneficiary

Conceivably, s 100A could apply to the practice of making unpaid distributions to a corporate beneficiary since the corporate beneficiary is presently entitled to the income of the trust and the present entitlement may be considered to arise out of a reimbursement agreement. That reimbursement agreement being the provision of a benefit to the trustee of the trust in being able to keep the money which is the subject of the present entitlement for an indeterminate period of time. The tax avoidance purpose would relate to the fact that the corporate beneficiary's marginal tax rate is lower than other trust beneficiaries' marginal tax rates.

The critical issue underpinning this interpretation of s 100A is whether the corporate beneficiary's allowing of the trustee to retain the funds which are the subject of the present entitlement can be considered to be the provision of a "benefit".

Prior to the Full Court of the Federal Court decision in *Corporate Initiatives Pty Limited v FCT* [2005] FCAFC 62 one would have thought that there was a reasonable argument to say that a corporate beneficiary who is merely passive and does not seek to call for the payment of an unpaid present entitlement owed to it by a trust, could not be considered to be giving a benefit to the trustee. All that the corporate beneficiary has done is essentially remain passive. In *Corporate Initiatives Pty Limited v FCT*, albeit in the different context of the trust income injection provisions of Division 270 of Schedule 2F of the 1936 Act, the Full Court of the

Federal Court accepted an argument that a beneficiary's failure to call for payment of its unpaid present entitlement constituted the provision of a "benefit" to the trustee since it allowed the trustee to retain use of the funds covered by the present entitlement.

The Commissioner of Taxation in relation to unpaid present entitlements has now applied this argument generally: see *Taxation Ruling* 2010/3 and *Practice Statement* PSLA 2010/4.

Arguments against the application of s 100A of the 1936 Act to the practice of making unpaid distributions are basically twofold:

(a) The first argument relies on the fact that reimbursement agreements that are entered into 'in the course of ordinary family or commercial dealings' are excluded from s 100A's operation: s 100A(13). Arguably, since this practice of providing corporate beneficiaries with unpaid present entitlements is common in the commercial market place and with family groups the practice is shielded by this exception. The term 'in the course of ordinary family or commercial dealings' is, however, very vague and reminds one of John Howard's pronouncement that Part IVA of the 1936 Act is not aimed at such dealings.

(b) The second argument against s 100A applying relies on a purposive approach to interpreting the section rather than a literal approach. The background of s 100A shows that it is aimed at trust stripping arrangements where a third party becomes involved in a trust so as to soak up excess trust income at a lower tax rate and then distributes that income back to the true beneficiaries of the trust after taking out a fee for their services (see Hill's J discussion of trust stripping in *East Finchley Pty Limited v FCT* (1989) 20 ATR 1623 at pages 1637-1638). Arguably, since a corporate beneficiary would have been listed as a beneficiary of the trust since its inception, then no trust stripping has occurred as the corporate beneficiary is one of the truly intended beneficiaries of the trust.

In any event, but subject to heading 4.3 that follows, the Commissioner of Taxation's approach to Division 7A and trusts – set out in *Taxation Ruling* 2010/3 and *Practice Statement* PSLA 2010/4 – has largely overtaken this issue of s 100A.

4.3 Wholly Owned Corporate Beneficiary

Where the Commissioner's Division 7A has not overtaken s 100A is in relation to wholly owned corporate beneficiaries.

Relevant in this regard is the Commissioner of Taxation's publication *Trust taxation – Reimbursement Agreements.* It was issued on 21 August 2015. It says:

> A reimbursement agreement generally involves making someone presently entitled to distributable income of a trust in circumstances where both:
>
> - someone else actually benefits from that income, and
> - a purpose of a party to the agreement is obtaining a tax benefit.

Although a wholly owned corporate beneficiary, to whom the distributions are actually paid and on which tax is assessed by, and remitted to, the Commissioner of Taxation would not fall within this description – because no one else actually benefits from the declaration, other than the company and, in due course, the recipients of is dividend payments – the Commissioner goes so far as to suggest this may be caught by s 100A. In fairness to the Commissioner of Taxation example 5 therein also includes an washing of dividends each year in a non-commercial way, but numerous statements from ATO officers confirms the Commissioner is unlikely to accept a wholly owned corporate beneficiary as escaping s 100A.

The consequence of this in a usual family structure is the establishment of a second trust to hold the shares of the company that is a beneficiary of the first trust. Rules against perpetuity are here relevant as they need to ensure the vesting date of the second trust is not after the perpetuity period of the first trust.

5 Division 7A

Division 7A of Part III of the 1936 Act is an integrity measure seeking to prevent missed tax opportunities that occur when a company distributes its profits as loans or payments to, or forgiveness of debts from, its shareholders or their associates.

Since it was introduced, to replace the former s 108, with effect from 4 December 1997 it has been amended a number of times. The Commissioner of Taxation has also been active in updating his interpretation of the Division, whether at the time of an amendment or not.

5.1 Board of Taxation Review

In the past two years the Board of Taxation has undertaken a post-implementation review of Division 7A. The results of that review, published in a final Division 7A Report released on 4 June 2015, are not flattering to the Division's operation.

The Board of Taxation found reform should be immediate and included the following recommendations:

1. The need for a coherent set of policy principles;
2. Adopting a model to reform the rules relating to complying Division 7A loans to give effect to the policy principles;
3. Supplementing the existing use of company asset rules with safe harbours;
4. Providing a self-correction mechanism;
5. Having the Australian Taxation Office take a new approach to imposing and remitting administrative penalties; and
6. Various other measures.

This is an area to watch.

5.2 Recent Pronouncements

The Commissioner of Taxation has released to *Taxation Determinations* to counter arguments seemingly gaining popularity amongst some advisors.

5.2.1 Dividends Paid by Subsidiary Member of a Consolidated Group

It has been argued by some that Division 7A does not apply where a subsidiary member of a consolidated group has undertaken a transaction which would otherwise amount to a Division 7A deemed dividend, because the subsidiary member does not have a lodgement day and, therefore, Division 7A cannot apply to that subsidiary.

A private company is taken to pay a dividend to a shareholder or an associate of a shareholder at the end of the private company's current income year if the relevant loan is not fully repaid before the lodgement day for the current year: s 109D(1) of the 1997 Act. The relevant 'lodgement day' is the earlier of the due date for lodgement or actual date of lodgement of the private company's tax return: s 109D(6) of the 1997 Act.

On 7 October 2015 the Commissioner of Taxation issued *Taxation Determination* 2015/18 (formerly *Draft Taxation Determination* 2015/D3), in which he expresses the view that the lodgement day for a private company that is a subsidiary member of a consolidated group is taken to be the lodgement day of the head entity of that consolidated group. That is, the lodgement day for the private company's tax return includes amounts attributed to and subsumed within the lodgement obligations of another entity, such as the head company of a consolidated group.

This conclusion is based on an analysis of the consolidation regime rather than on Division 7A. At [15] the Commissioner of Taxation says:

> The Commissioner is of the view that the introduction in 2002 of the tax consolidations measure in Part 3-90 of the *Income Tax Assessment Act 1997* (ITAA 1997) was not intended to alter or disturb the application of Division 7A in so far as it applied to deem a dividend to an entity outside of a consolidated group.

Authorities on statutory construction are then set out and relied on in the Determination. Reliance is also placed on *Pastoral Holdings Pty Ltd v Commissioner of Taxation* [2015] FCAFC 57 where it was held that a subsidiary member of a consolidated group does not cease to exist on consolidation (Allsop CJ at [8]) nor does it stop generating assessable income or gains from that event: Pagone J at [119].

A related point in this regard is that the Commissioner of Taxation does not consider consolidation, and the single entity rule in s 701-1 of the 1997 Act that applies with it, does not affect the calculation of a subsidiary member's distributable surplus: *Taxation Determination* 2004/68.

5.2.2 Release of an Unpaid Present Entitlement

Section 109C of the 1936 Act causes 'payments' by private companies to be deemed dividends in specified circumstances. Practitioners seem to have raised, at least in *Private Binding Ruling*

1012190968124 (which applies for the year ending 30 June 2012), whether a private company beneficiary releasing a trustee from the obligation to pay an unpaid present entitlement would be a payment for s 109C purposes.

On 25 November 2015 the Commissioner of Taxation issued *Taxation Determination* 2015/20 (formerly *Draft Taxation Determination* 2015/D4), in which he expresses the view that the release may be a payment in some circumstances, but not in others; it was said to be a payment to the extent that the release represents a financial benefit to the entity. The Determination says at [29], and then in the footnote to that paragraph:

> Nonetheless, it is considered that the release of a UPE (that ought to be properly reflected by a credit entry in the private company beneficiary's books of account) is a credit of an amount that is typically for the benefit (whether in their own capacity or not) of the entity to whom the UPE is released. Accordingly, the release of a UPE is a payment within the meaning of subparagraph 109C(3)(b)(iii) to the extent it represents a financial benefit to an entity.
>
> [footnote] The financial benefit provided on release will generally be the market value of the UPE. Where the trustee is not in financial distress or otherwise prevented from paying the beneficiary that to which they are entitled, the market value of the UPE will usually be its face value. …

The Commissioner will apply this view if release voluntarily or involuntarily (e.g. a family court settlement order): Determination at [31].

The final view will apply both before and after its issue: Determination at [18]. It may be worth considering what, if any, releases have been made by a corporate beneficiary in light of this position.

6 Small Business Concessions

The focus on the small business CGT concessions, set out in Division 152 of the 1997 Act, will be around issues arising immediately before the time of the relevant transaction. There are two areas in which this issue has received recent attention in the cases:

1. the method of valuing the asset that was subject to the CGT event; and

2. what effect a resolution, suspending rights to dividends on a dividend access share, had on the small business participation percentage immediately before the CGT event.

6.1 Conflicting Valuation Decisions – Maximum Net Asset Value Test

There are now two decisions from the Administrative Appeals Tribunal – as to the basis of valuing assets, immediately before a CGT event happening, for the purposes of the maximum net asset value test in s 152-15 of the 1997 Act – that don't necessarily conflict but show the importance of how to approach question of valuation. This test, which requires your net assets so defined to be less than $6 million[20] in order to access the small business CGT concessions in Division 152.

6.1.1 Excellar Pty Ltd: 2015

On 30 April 2015 Lazanas SM handed down her decision in *Excellar Pty Ltd v Commissioner of Taxation* [2015] AATA 282.

There Excellar Pty Ltd sold a property in Chatswood for $5.5 million and derived a capital gain of $1,866,247. It sought to reduce that gain in the 2006 income tax return by applying the 50% active asset reduction (Subdivision 152-C of the 1997 Act) and the small business retirement exemption: Subdivision 152-D of the 1997 Act.

The maximum net asset value test required Excellar Pty Ltd's net assets to be less than $5 million immediately before the CGT Event A1 happened, from the property's sale.

The parties raised a number of issues regarding the maximum net asset value test, but for the purposes of this paper the basis of valuation is the relevant one. It was described by Lazanas SM at [31] as follows:

> The ***first issue*** concerns the market value of the Chatswood Property as at the relevant date. Was it the price for which the Chatswood Property was sold by Excellar or was its market value different to the sale price?

After quoting from *Spencer v Commonwealth* (1907) 5 CLR 418 at 432 per Griffith CJ and at 441 per Isaacs J, Lazanas SM continued at [34] to [36]:

> In this case, the parties accepted the valuation principles in *Spencer* but sought to

[20] The time of the relevant CGT event in *Excellar Pty Ltd v Commissioner of Taxation* [2015] AATA 282 rendered the limit $5 million in that decision.

interpret and apply them in different ways. Counsel for the Commissioner, Mr O'Brien, argued that it is unnecessary, in the present case, to look any further than the contract price of $5,500,000 agreed between Excellar and the purchaser in respect of the Chatswood Property and that this was the market value of the property just before the CGT event. Mr O'Brien submitted that as the parties were acting at arm's length and were willing, but not anxious to sell or buy and had freely negotiated the price, the contract price was equal to the market value. Therefore, the Commissioner did not need to call any valuation evidence.

On the other hand, Excellar's counsel, Mr Bevan, contended that *Spencer* stands for the proposition that one should not look at the actual selling price of the asset. Mr Bevan put it this way:

> *The Commissioner's thesis is what has been rejected by Sir Samuel Griffith which is to look at what the parties did in that particular transaction.*
>
> *Now, our valuation evidence is that by definition the one thing you can never have regard to when you're valuing Blackacre is what the vendor sold it for or the purchaser paid for it. You have to look at what Whiteacre, Greenacre, Brownacre which are comparable properties sold for because otherwise you're doing what Sir Samuel Griffith said you can't do which is inquiring what price a man desiring to sell could actually have obtained for it on a given day and the reason for this is because you can never trust the vendor or the purchaser to be dispassionate and fully informed ...*
>
> *The vendor and the purchaser are too close to it; that's why you need the valuer to undertake an objective test of what other people have done in more than one transaction ...*

Excellar argued that the market value of the Chatswood Property was $3,720,000 and relied, primarily on the evidence of Mr Ian Handley, a qualified valuer with over 30 years' experience in the Australian property market, to prove the market value of the Chatswood Property. Specifically, Mr Bevan urged me to accept the evidence of Mr Handley as an expert witness in circumstances where the Commissioner did not call any counter veiling expert evidence.

The Senior Member concluded that the report of Handley was not as thorough as it could have been (at [48]), but importantly held that the sale price applicable to the CGT event was the best evidence of value and adopted that as its value: at [49]. She held at [45] and [46], relevantly, the principle to be:

> I do not accept Excellar's contention that the market value of the Chatswood Property was $3,720,000 on the basis that *Spencer* stands for the proposition that the sale price of the subject property is to be ignored and that an expert valuer's evidence of comparable sales is the preferred approach to determining the market value of the subject property. On the contrary, I consider that the actual selling price of the subject property is very

informative as was observed in *Inez Investments Pty Ltd v Dodd* (1979) 26 The Valuer 501. In that case, the issue was different, namely, whether a valuer was negligent in failing to investigate and take into account the existence of a contract for sale of the property when undertaking a valuation for mortgage purposes, but the principles insofar as valuation practice are concerned are equally applicable to the issue here of determining the market value of the subject property. Carmichael J of the New South Wales Supreme Court held at 505:

> *"where a valuation of a piece of real estate is sought as at a particular date the most relevant information is the sale of that very property, if there be one, at or close to that date. The matters requiring analysis are the terms and conditions of the contract, and was it a voluntary sale of a not anxious seller to a not anxious buyer?"*

That is to say, the selling price is *the most relevant information* and the sale has to be analysed to see how it complies with the test of value set out in *Spencer's* case. In the *Inez Investments* case, Carmichael J stated at 505 that "[f]ailure to carry out these functions is to risk ignoring the best evidence of value".

That is, absent expert evidence that is particularly high quality, the Tribunal may take the sale price of property as conclusive proof of its market value immediately before the relevant CGT Event.

6.1.2 Miley: 2016

On 15 February 2016 Frost DP handed down his decision in *Miley v Commissioner of Taxation* [2016] AATA 73.

There Andrew Miley was one of three equal shareholders in AJM Environmental Services Pty Ltd. During the 2008 income year all three sold all their shares in that company to an arm's length purchaser for $17.7 million; this was an amount payable of $5.9 million to each shareholder. The resulting CGT Event A1 caused a capital gain to be derived by Mr Miley. He sought to reduce that gain by applying the 50% active asset reduction: Subdivision 152-C of the 1997 Act.

The maximum net asset value test required Mr Miley's net assets to be less than $6 million immediately before the CGT Event A1 happened, from the share sale.

The Commissioner of Taxation's arguments in this matter were broader than in *Excellar Pty Ltd v Commissioner of Taxation.* He here argued that:

1. Primarily, that s 152-20(1), properly construed and with the assistance of the statutory context of Parts 3-1 and 3-3 of the 1997 Act, requires that:

    a. The amount recognised as the market value of a CGT asset to which the relevant CGT event relates is the same as the amount used in calculating whether the capital gain was made from a particular CGT event and the amount of that gain;

    b. The market value of a CGT asset in respect of which the CGT event happens is to be determined only when one of the four special situations,[21] as described in s 116-30, occurs; and

    c. The market value of all other CGT assets is to be determined by reference to valuation evidence alone.

2. In the alternative, that most reliable evidence of market value of the 100 shares that Mr Miley sold is determined by the price that the unrelated willing purchaser did in fact pay for those shares.

3. In the further alternative, should the Commissioner of Taxation fail on those two arguments, nonetheless his expert evidence should have been preferred to the taxpayers.

Mr Miley submitted relied on *Spencer v Commonwealth* (1907) 5 CLR 418 and the following two cases (per Frost DP at [19] to [21]):

> Mr Miley also refers to the following statement of Williams J in *Abrahams v Commissioner of Taxation* [1944] HCA 32; (1944) 70 CLR 23 at 29:
>
> > *It has been held, however, in the case of other Australian statutes which, like the* Estate Duty Assessment Act*, do not direct any particular method of estimating the value of the assets, that it is proper to estimate the value of shares held by a deceased in a company, the articles of association of which contain restrictions on transfer, in the same manner, and that the court should endeavour to ascertain (as in the case of property compulsorily acquired) the price which a willing but not anxious vendor could reasonably expect to obtain and a hypothetical willing but not anxious purchaser could reasonably expect to have to pay for the shares if the vendor and purchaser had got together and agreed on a price in friendly negotiation ...*
>
> Mr Miley stresses the importance of the word 'hypothetical' in Williams J's statement. He does so because of what the High Court has more recently said in *Commissioner of*

[21] These are (1) no capital procees; (2) capital proceeds not capable of being valued; (3) capital proceeds not equal to market value and parties not dealing with each other at arms length; and (4) capital proceeds not equal to market value and CGT event C2 occurs.

> *State Revenue v Pioneer Concrete (Vic) Pty Ltd* [2002] HCA 43; (2002) 209 CLR 651 at 667:
>
> > *The determination of such an amount [that is, the unencumbered value of property on the open market] is a familiar task, to be carried out in accordance with the principles stated in* Spencer v The Commonwealth*. The subject of the valuation is the unencumbered estate in fee simple. In determining the value there is no warrant, either in the language of the statute or in principle, for departing from the hypothetical inquiry as to the point at which a desirous purchaser and a not unwilling vendor would come together. The purpose of making the inquiry hypothetical is to isolate the value of the estate or interest to be transferred from factors that are extraneous to the purpose for which such a value is to be ascertained. To introduce into the exercise a special condition for which, on a particular occasion, a particular vendor chose to stipulate, and to which a particular purchaser chose to agree, is to depart from the statutory requirement, which is to determine the value of that which was transferred.*
>
> Mr Miley's submission is simply this: the market value of the CGT asset is to be determined by reference to the *Spencer* hypothesis. It is not necessarily equal to the amount paid by the actual purchaser.

The Deputy President took little time to dismiss the Commissioner of Taxation's primary argument. He said at [22] to [24]:

> There is nothing in the text or context of s 152-20(1) of the ITAA to support the Commissioner's submission that the expression 'market value' means one thing for the CGT asset or assets the subject of a CGT event, but something different for other assets owned by a taxpayer.
>
> For that submission to be accepted the drafting would have to be significantly different: instead of requiring a calculation of 'the sum of the market values' of a taxpayer's CGT assets, the provision would have to require a calculation of 'the sum of the capital proceeds of the CGT event plus the market value of all other assets'. That is not what it says, because that is not what it means.
>
> Section 152-20(1) means precisely what it says, namely that you have to calculate the 'market value' of all relevant assets – including the 'market value' of the CGT asset that is the subject of the CGT event.

As to the actual market value of the 100 shares, Frost DP said (at [25]) 'It is often the case, but not always, that the actual selling price of an asset at a particular time represents its 'market value' just before that time.' He cites Lazanas SM's decision above as an example, and one that is 'entirely uncontroversial'.

The critical difference here was that the relevant CGT asset was not the entire asset being sold; they were merely one-third of it. It required the following (at [33] and [34]):

> Mr Halligan's reasoning appears to me to be sound and logical. Mr Samuel's reasoning, on the other hand, seems to proceed on an assumption that the enquiry is one directed towards determining the market value of Mr Miley's shares subject to special circumstances – namely, that the sale of Mr Miley's shares should contemplate the sale of the shares owned by all the other shareholders. I think that is the wrong enquiry. That is an enquiry that suffers from the problem the High Court warned about in *Pioneer Concrete*: see [above].
>
> I think the correct enquiry is directed towards determining the market value of Mr Miley's 100 shares alone – not as part of a package comprising the entire 300 shares in the Company.

The Deputy President concluded that 'while the actual consideration received by Mr Miley should not be ignored as an indicator of the market value of his shares just before the time of the CGT event (*Inez Investments* ...), it is not determinative of that market value.'

The Commissioner of Taxation has appealed this decision to the Full Court of the Federal Court. It is yet to be heard.

6.1.3 Takeaway from these Cases

The takeaway points of these decisions are:

1. There is no basis to distinguish the valuation methods for assets owned by the taxpayer based on whether they are, or are not, subject to the CGT event that gives you cause to consider the maximum net asset value test.

2. Although the sale price is relevant evidence of value, it is not determinative.

3. The sale price is less significant when the asset sold is not the entirety of an asset usually sold (e.g. when a part interest in a private company is sold).

6.2 Suspending Dividend Access Share Rights

On 30 November 2015 the Full Court of the Federal Court (Greenwood, Jagot and Pagone JJ) held that a resolution to suspend the rights to dividends on dividend access shares was effective for the purposes of calculating the company's small business participation percentage in assessing the availability of the small business concessions: *FCT v Devuba Pty Ltd* [2015] FCAFC 168.

On 19 May 2010 Devuba Pty Ltd sold 404,545 ordinary shares in Primacy Underwriting Agency Pty Ltd for $4,381,645. A capital gain of $4,376,896 was made that to be reduced to nil by the small business concessions in Division 152 of the 1997 Act.

The issue here was s 152-10(2)(b) of the 1997 Act, which requires that "CGT concession stakeholders" holding a "small business participation percentage" in Devuba Pty Ltd of at least 90%. That amount comprised the direct small business participation percentage and the indirect small business participation percentage: s 152-650 of the 1997 Act. Item 1(b) in s 152-70(1) of the 1997 Act provided that an entity has a direct small business participation percentage equivalent to the percentage that:

> … the entity has because of holding the legal and equitable interest in shares in the company:
>
> (a) the percentage of the voting power in the company; or
>
> (b) the percentage of any dividend that the company may pay; or
>
> (c) the percentage of any distribution of capital that the company may make
>
> or, if they are different, the smaller or smallest.

The issued share capital of Devuba Pty Ltd immediately before the relevant GCT Event occurred comprised two ordinary shares (both of Mr van der Vegt and a trustee of a family trust holding one share) and one dividend access share held by Ms van der Vegt.

On 1 September 2008 Devuba Pty Ltd resolved that the rights attached to the dividend access share were varied so that the holder of the share had no right to the payment of a dividend until such time as the directors of the company resolved that the holders of the dividend access shares regained the right to dividends. It read:

> Resolved: that pursuant to Article 83 of the company's constitution [sic], the rights attached to Dividend Access Shares are varied so that the holders of the Dividend Access Shares have no right to payment of a dividend until such time as the directors of the company resolve that the holders of the Dividend Access Shares have a right to payment of a dividend.

It was common ground between the parties that the outcome of the appeal – and the availability of the small business CGT concessions – was determined by the proper construction of the Devuba Pty Ltd's Memorandum and Articles of Association. Specifically, did they permit declarations of dividends to Ms van der Vegt on her dividend access share immediately before the relevant CGT Event.

The Full Court held that the 1 September 2008 resolution had restricted Devuba Pty Ltd's ability to pay any dividends on the dividend access share. They said at [9] and [10]:

> Devuba's constitution had effect as a contract between itself and its members, directors and company secretary, and between the members themselves: *Corporations Act 2001* (Cth), s 140. The rights and liabilities under a contract "are determined objectively, by reference to its text, context (the entire text of the document as well as any contract, documentary or statutory provision referred to in the text of the contract) and purpose": *Mount Bruce Mining Pty Limited v Wright Prospecting Pty Limited* [2015] HCA 37, [46], see also [47]-[52], and *Electricity Generation Corporation v Woodside Energy Ltd* [2014] HCA 7; (2014) 251 CLR 640, 656, [35], *Australian Broadcasting Commission v Australasian Performing Right Association* [1973] HCA 36; (1973) 129 CLR 99, 109-10. A fair reading of the Memorandum and Articles of Association, and of the 2007 and 2008 resolutions, is that the ability of Devuba to declare dividends under Article 129 was, and was intended to be, restricted.
>
> … The discretion of the company to declare dividends under Article 129 was not, even from the date of incorporation, without restriction. The Dividend Access Share issued to Mrs van der Vegt pursuant to Article 81 by the 2007 resolution was similarly issued with restriction upon the declaration by the company of dividends. The Dividend Access Shares had been created in 2007 with an entitlement "to receive in respect of such shares, such dividends, [...] as in respect of each class the directors may from time to time determine to pay". Mrs van der Vegt, as the holder of the Dividend Access Share, had an entitlement under the 2007 resolution to be considered for payment of a discretionary dividend by the directors. The 2008 resolution took away that right and deprived the company of an ability to declare a dividend on her shares unless and until the directors first resolved that the holders of the Dividend Access Shares had a right to payment of a dividend. The 2008 resolution expressly limited Devuba's ability to pay a dividend to the holder of the Dividend Access Share by excluding from the holder of the Dividend Access Share any right to a dividend "until such time as the directors of the company resolve[d] that the holders of the dividend access shares have a right to payment of a dividend". Devuba's ability "to pay" any dividend to the dividend access shareholder was made dependent upon the prior determination by the directors. Devuba's ability to declare a dividend was correspondingly restricted. The determination of the directors contemplated by the 2008 resolution was not that the dividend be declared by the directors, but that the holder of the Dividend Access Share should be determined to become entitled to the future exercise of a discretion which had otherwise been removed. No such determination had been made by the directors in respect of the Dividend Access Share and, therefore, as at 19 May 2010 the company could not declare a dividend to the holder of that share.

The take away message is the opportunity to address risks that have long been present in relation to the small business CGT concessions. For years risk has arisen to the small business participation percentage by the effect of Dividend Access Shares. The Full Court's decisions reminds us that the rights arising under a company's constituent documents are a contract and, should the parties agree to govern themselves in a particular way, the company and its members can address the risks otherwise posed by Dividend Access Shares.

A word of warning is required. *FCT v Devuba Pty Ltd* is not a blanket approval that Dividend Access Shares will not affect the small business CGT concessions; it is an answer to the parties in that case on the facts as found. It provides guidance as to how any company, through proper review and planning, can protect their town position.

7 Employees and Contractors

The legal principles of whether someone is an employee or a contractor are of long standing. Leading cases, which are often cited, include:

- *Performing Right Society Ltd v Mitchell and Booker* [1924] 1 KB 762;
- *Stevens v Broadribb Sawmilling Company Pty Ltd* (1986) 160 CLR 16;
- *Vabu Pty Ltd v FCT* (1996) 33 ATR 537;
- *Hollis v Vabu* [2001] HCA 44;
- *On Call Interpreters and Translators Agency Pty Ltd v FCT (No 3)* [2011] FCA 366; and
- *Roy Morgan Research Pty Ltd v FCT* 2011] HCA 35.

The principles are easily recognisable, but their application to the specific fact scenario is where concentration and application is required. It is also for this reason that the authorities are of limited assistance; they can tell you the principles in the abstract, but are unlikely to provide you with factual comparable circumstances.

The principles are also helpfully set out in *Taxation Ruling* 2005/16 and in *Superannuation Guarantee Ruling* 2005/1.

It is the section with which the latter ruling is concerned, s 12 of the *Superannuation Guarantee (Administration) Act* 1992 (Cth), that will be the focus here. Two cases will be discussed that may give taxpayers support should any s 12 issues arise for them.

Section 12(3) of the *Superannuation Guarantee (Administration) Act* 1992 (Cth) provides:

> If a person works under a contract that is wholly or principally for the labour of the person, the person is an employee of the other party to the contract.

By this extended definition of employee many employers are obliged to pay superannuation to workers the common law might otherwise have held to be contractors.

The following case is an examples of taxpayers winning the independent contractor arguments. It is now two years old but should be retained as guidance of examples where the taxpayer eluded the operation of s 12(3) of the *Superannuation Guarantee (Administration) Act* 1992 (Cth).

7.1 Dominic B Fishing Pty Ltd and FCT

The issues in *Dominic B Fishing Pty Ltd v FCT* [2014] AATA 205 before McCable SM was whether crew members of a commercial fishing vessel, operated by the applicant, were employees under the expanded definition in s 12(3) of the *Superannuation Guarantee (Administration) Act* 1992 (Cth).

The vessel would ordinarily be captained by a director of the applicant, would be at sea for ten days at a time and included up to four experienced fishermen. The crew members would be engaged for each particular voyage; that is, they were not engaged on an ongoing basis. During a voyage the vessel would anchor and, from this location, the fisherman would each use a small motorised vessel to head to remote locations for that day's fishing. They would return at the end of each day and unload their catch to the vessel.

Prior to each voyage the particular crew would prepare the vessel for its voyage. The small boats were allocated before the voyage began, and for which the particular fisherman was responsible throughout the voyage, and the fisherman may use their own equipment.

Each crew member operated independently. They were not obliged to fish in particular locations, did not take instructions from the captain or his crewmates.

Each fisherman had to sign a 'joint fishing adventure' agreement prior to the particular voyage that included the following:

- The cost of maintain the vessel was the applicant's but all parties would contribute to the operating costs of the vessel, up to a maximum amount, on a predetermined proportion;
- Each party was required to provide sickness and accident insurance and excluded each other from liability for such events; and
- The catch was to be sold to a buyer at each voyage's conclusion from which each party was entitled to a proportion predetermined in a 'catch schedule'.

The Senior Member said at [29] and [30]:

> As far as the common law is concerned, I think the taxpayer's characterisation of the relationship with the crew members is preferable to that contended for by the Commissioner. The terms of the agreement between the parties contemplates them operating as joint venturers – independent business people who are cooperating for the limited purpose of catching and ultimately selling fish. Individual crew members brought their skills and preferred equipment to the venture, and they could exit the arrangement if they wished (albeit there were some practical limits on their ability to leave the boat while it was at sea). The taxpayer provided equipment – most obviously the boat itself – and the skipper and marketing arrangements. But the equipment was effectively placed at the service of the joint venture, to be managed collectively during the voyage for the common end. The crew members, for their part, were free to fish on their own and they were paid for their output. The crew were not integrated into the taxpayer's organisation; each of the parties had a function that they performed individually, albeit cooperatively.
>
> I do not think the extended definition in s 12(3) of the Superannuation Guarantee (Administration) Act 1992 (Cth) makes any difference to that characterisation. The contract is not wholly or principally for the labour of the crew member. As I have already explained, it is a joint venture agreement that is intended to produce fish for sale. It is true the agreement contemplates the crew members contributing labour, in particular, but they are remunerated on the basis of an outcome. If there was no outcome – if they did not catch any fish – the director said in his evidence there would be no remuneration. Indeed, it was theoretically possible under the agreement the crew might return to port owing money to the taxpayer if there were no fish caught on a voyage (although the director acknowledged that had never occurred).

Senior Member McCabe held that the parties were not employees, but akin to joint venturers. In doing so:

1. He did not accept the Commissioner of Taxation's argument that the fisheries regulations provide that the crew must operate under the direction of a commercial fisher (being the

boat owner or the skipper).

2. The Commissioner of Taxation noted that the taxpayer must have been exercising control over the crew members to get the to comply with the terms of the commercial fishing license, but the McCabe SM noted that this did not reflect how the business was operated.

3. The terms of the arrangement contemplated them acting as joint venturers – independent business people who bought their skills and equipment to the venture, and could generally exist the arrangement as they wished.

4. Although the taxpayer provided equipment (mainly being the boat), the crew members were free to fish and paid for their output and were not integrated into the taxpayer's organisation.

This authority is useful for providing guidance on when clients can elude the operation of s 12(3). It should be retained for that reference purpose.

7.2 Can only deal with Commissioner of Taxation

Further, should a shortfall arise, it is the Commissioner of Taxation with which the employer will have to deal.

Reference can be made to *Akmeemana v Murray* [2009] NSWSC 979 per Davis J and *Cook v Chesterton International Pty Ltd* [2015] NSWSC 283 per Young JA where parties sought relief in the Supreme Court of New South Wales but were unsuccessful, the Court holding it had no jurisdiction to hear such a matter.

Significant adverse costs orders were awarded it those cases. It therefore makes succeeding in the dealings with the Australian Taxation Office – who will usually ask a questionnaire to be completed by the employer and the employee respectively – more significance.

8 Multiple Roles Within Structure

In a timely reminder of the risks associated with forgetting what different capacities an individual can have within a structure, the Court of Appeal (Warren CJ, Neave JA and Garde AJA) of the Victorian Supreme Court have held that the corporate trustee of a superannuation fund was liable to repay another company for monies received from that other company, in circumstances where a director of the corporate trustee knew that the monies had been paid in breach of the director's fiduciary duty to the other company: *Australasian Annuities Pty Ltd (in liq) (recs and mdgrs apptd) v Rowley Super Fund Pty Ltd* [2015] VSCA 9.

It was handed down own 12 February 2015.

8.1 The Facts

The relevant facts were as follows.

Australasian Annuities Pty Ltd carried on a financial planning business and acted as trustee of the Rowley Family Trust. Mr Rowley was the sole director of that company.

Rowley Super Fund Pty Ltd was the trustee of the Rowley Superannuation Fund, a self-managed superannuation fund of which four members of the Rowley family (including Mr Rowley) were members. In accordance with s 17A of the *Superannuation Industry (Supervision) Act* 1993 (Cth) those four members were also directors of Rowley Super Fund Pty Ltd.

Australasian Annuities Pty Ltd borrowed money from a bank under a facility agreement, entered into by Mr Rowley in his personal capacity and on behalf of Australasian Annuities Pty Ltd, who used the money. The money was used to make payments characterised as either employer contributions, eligible termination payments or self-employed contributions, to the Rowley Superannuation Fund. Mr Rowley effected the payments.

Australasian Annuities Pty Ltd failed to repay the money borrowed to the bank, who appointed a receiver and manager to Australasian Annuities Pty Ltd.

8.2 First Instance: Almond J

The receivers and managers, in Australasian Annuities Pty Ltd name, commenced proceedings in the Victorian Supreme Court: see *Australasian Annuities Pty Ltd (in liq) v Rowley Super Fund Pty Ltd* [2013] VSC 543. Australasian Annuities Pty Ltd claimed that the payments by it to the Rowley Superannuation Fund, which Mr Rowley effected, breached fiduciary duties Mr Rowley owed to Australasian Annuities Pty Ltd as its sole director. Australasian Annuities Pty Ltd sought the following relief:

- a declaration of a constructive trust and equitable compensation or an account of profits for knowing receipt of payments made by Mr Rowley under the first limb of *Barnes v Addy* (1874) LR 9 Ch App 244; and
- restitution, either personal or proprietary, by the Rowley Super Fund Pty Ltd on the bases that the Rowley Superannuation Fund received the monies as a volunteer.

Justice Almont held that Mr Rowley, in his capacity as sole director of Australasian Annuities Pty Ltd, breached fiduciary duties owed to that company by facilitating the making of contributions to the Rowley Superannuation Fund and that he failed to act in Australasian Annuities Pty Ltd's interests, exercised his powers and duties for a collateral and improper purpose and did not avoid conflicts of interest. It was a damning view of Mr Rowley.

But it did not provide Australasian Annuities Pty Ltd relief. Justice Almond also held that there was no knowing receipt of trust property by Rowley Super Fund Pty Ltd under the first limb of *Barnes v Addy* because (at [162]):

> Notwithstanding these findings, the plaintiff cannot succeed in its claim against [Rowley Super Fund Pty Ltd], the trustee of the [Rowley] Super Fund, as there was no knowing receipt of trust property by [Rowley Super Fund Pty Ltd] and [Rowley Super Fund Pty Ltd] gave valuable consideration for the contributions made to the [Rowley] Super Fund which it accepted in good faith and without notice of the breaches of fiduciary duty. Accordingly, [Rowley Super Fund Pty Ltd] does not hold the funds or their traceable proceeds on trust for the plaintiff nor is it liable to the plaintiff for money had and received.

The basis of the good consideration being given by a trustee of a regulated superannuation fund in exchange for a contribution is settled law: *Cook v Benson* (2003) 214 CLR 370 where the Court held the consideration is the member balance arising as a consequence of the contribution.

8.3 The Court of Appeal

Australasian Annuities Pty Ltd appealed to the Court of Appeal: *Australasian Annuities Pty Ltd (in liq) (recs and mdgrs apptd) v Rowley Super Fund Pty Ltd* [2015] VSCA 9. It argued the court erred twice in the first instance decision:

1. that there was no knowing receipt of trust property by Rowley Super Fund Pty Ltd; and
2. that Rowley Super Fund Pty Ltd gave valuable consideration for the receipt of monies and thereby were not volunteers.

In relation to the second point Warren CJ and Garde AJA, in separate reasons, applied *Cook v Benson* to hold the contributions were made for valuable consideration. There was no element of being a volunteer.

In relation to the first point, and in separate reasons, Neave JA and Garde AJA held that Rowley Super Fund Pty Ltd knowingly received the funds paid to it as a consequence of Mr Rowley's breach of his fiduciary duty owed to Australasian Annuities Pty Ltd.

Their Honours agreed that Mr Rowley was the 'directing mind and will' of the Rowley Superannuation Fund and of both companies. It was based on:

1. his being the only active or knowledgeable director of Rowley Super Fund Pty Ltd;

2. him being instrumental in all of the transactions; and

3. the fact that there was no evidence to suggest that anyone other than him was the directing mind and will of Rowley Super Fund Pty Ltd or of the Rowley Superannuation Fund.

Judge of Appeal Neave agreed with Garde AJA on this issue: at [136]. Acting Judge of Appeal Garde set out the relevant authorities at [262] to [265] before concluding at [279] to [281]:

> 279 In my view, the evidence clearly demonstrates that Steven Rowley was the directing mind and will of [Rowley Super Fund Pty Ltd] and the [Rowley] Super Fund just as he was of the other Rowley entities involved in the scheme to borrow significant funds from Macquarie in the name of AA and pass these funds to the [Rowley] Super Fund and [Rowley Super Fund Pty Ltd]. As a result, Steven Rowley's knowledge must be imputed to [Rowley Super Fund Pty Ltd]. Ground 2 of the notice of appeal is upheld, as the trial judge was in error in not imputing Steven Rowley's knowledge to [Rowley Super Fund Pty Ltd].
>
> 280 The effect of the imputation of Steven Rowley's knowledge is to impute knowledge to [Rowley Super Fund Pty Ltd] of Steven Rowley's breaches of fiduciary duty to [Australasian Annuities Pty Ltd] both in respect of transactions which preceded the incorporation of [Rowley Super Fund Pty Ltd], and those which occurred subsequent to incorporation. [Rowley Super Fund Pty Ltd] took all of the funds which originated from [Australasian Annuities Pty Ltd], and acted as sole trustee of the Super Fund from 13 February 2008 with imputed knowledge of Steven Rowley's breaches of fiduciary duties to [Australasian Annuities Pty Ltd]. This knowledge extended to both pre-incorporation and post-incorporation transactions.
>
> 281 Steven Rowley was the directing mind and will of [Rowley Super Fund Pty Ltd] on and after its incorporation. The four co-trustees were the conduit through

> whom funds taken from [Australasian Annuities Pty Ltd] prior to the incorporation of [Rowley Super Fund Pty Ltd] passed to [Rowley Super Fund Pty Ltd] following its incorporation and appointment as trustee of the [Rowley] Super Fund. If the four individual Rowley family members had continued as co-trustees and [Rowley Super Fund Pty Ltd] had never existed, their individual liability would stand to be considered in accordance with the principles which apply under the first limb of *Barnes v Addy*.

8.4 Takeaway Point

This decision confirms that a court will look to the commercial reality of the situation, rather than a cursory look at officeholding, to determine what information may be imputed to a company. That Mr Rowley was the controlling mind was sufficient despite there being three other directors of Rowley Super Fund Pty Ltd and three other members of the Rowley Superannuation Fund.

Given the various roles our clients often occupy in a structure the warning is worth consideration.

8.5 Further Interesting Point

Another interesting point raised in this case, though left to another day to be determined, is whether shareholders of a company that acts as corporate trustee can give informed consent to a breach of trust by the company. Acting Judge of Appeal Garde said at [253] to [260]:

> 253 The issue whether shareholders of a company that acts as a corporate trustee can give informed consent to a breach of trust by the company is an important issue that stands to be decided on a future occasion. As a matter of principle, there would appear to be significant difficulties in the way of the proposition that a director of a corporate trustee can be absolved of a breach of fiduciary duty by failing to act in good faith to ensure that the company properly administers the trust merely because shareholders who may have no actual or contingent interest in the affairs of the trust are prepared to give their consent. While Steven Rowley was a beneficiary of the Rowley Family Trust, no informed consent was given by any other beneficiary to any of the transactions. The transactions profoundly and adversely affected the interests of the beneficiaries ultimately resulting in the insolvency of the trustee.
>
> 254 There appears to be little authority on this issue. The trial judge noted the matter of *The Attorney-General for the Dominion of Canada v The Standard Trust Company of New York*. The relevant passage is:
>
>> But whatever may have been the character of this transaction, it was approved, with full knowledge of the facts, by all of those who owned, or were beneficially interested in, the stock of the company at the time. It

> therefore, does not matter, for the purposes of a case such as the present, that these persons were also promoters and vendors.
>
> ...
>
> In this case the interests of the company and of the syndicate were identical. The only persons beneficially interested in the company were the four members of the syndicate. The law gave them the complete control of its action. Under that control the company gave effect to the policy of the only persons who had any beneficial interest in its capital.

255 Senior Counsel for [Rowley Super Fund Pty Ltd] also submitted that the trial judge was wrong when he rejected Barbara Rowley's retrospective approval of the transactions as contained in her witness statement in this proceeding because of the insolvency of [Australasian Annuities Pty Ltd]. He alternatively contended that the fetter on ratification arose only if a company was insolvent at the time of the breach, not at the time of the approval. The fetter on shareholders approving a transaction by the directors arises where the company is insolvent at the time of the breach, and not when it becomes insolvent subsequently.

256 In her witness statement of 6 March 2013, Barbara Rowley purported to consent to the transactions retrospectively. From about November 2008, [Australasian Annuities Pty Ltd] had commenced to default in monthly principal instalments payable to Macquarie leading to the appointment of receivers and managers on 29 June 2009. The witness statement was made years after [Australasian Annuities Pty Ltd's] insolvency, and at a time when [Australasian Annuities Pty Ltd] was in receivership and in liquidation.

257 Contrary to the submissions made on behalf of [Rowley Super Fund Pty Ltd], it is the time of the ratification not the time of the breach that is the relevant time for determining whether the shareholders can give consent to the transactions undertaken on behalf of AA by Steven Rowley as sole director. As Street CJ said in *Kinsela v Russell Kinsela Pty Ltd (in liq)*:

> It is, to my mind, legally and logically acceptable to recognise that, where directors are involved in a breach of their duty to the company affecting the interests of shareholders, then shareholders can either authorise that breach in prospect or ratify it in retrospect. Where, however, the interests at risk are those of creditors I see no reason in law or in logic to recognise that the shareholders can authorise the breach. Once it is accepted, as in my view it must be, that the directors' duty to a company as a whole extends in an insolvency context to not prejudicing the interests of creditors (*Nicholson v Permakraft (NZ) Ltd* and *Walker v Wimborne*) the shareholders do not have the power or authority to absolve the directors from that breach.

258 *In Re New World Alliance Pty Ltd; Sycotex Pty Ltd v Baseler*, Gummow J said:

> Where a company is insolvent or nearing insolvency, the creditors are to be seen as having a direct interest in the company and that interest cannot be overridden by the shareholders.

259 Finally, in *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)*, Owen J said:

> In my view the true state of the law is this. A director has a duty to act in the best interests of the company. The duty is owed to the company and not to any third parties (including creditors). But in an insolvency context (and I will narrow that concept shortly) the duty entails or includes an obligation on the directors to take into account the interests of creditors. Why should this be so? The answer is, as Mason J said in *Walker v Wimborne*, any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for the creditors. What are those consequences? They are many, but they include threats to the very existence of the company: to its ability to continue as a going concern.

260 [Rowley Super Fund Pty Ltd's] defence of ratification by the shareholders of [Australasian Annuities Pty Ltd] of the breaches of fiduciary duty occasioned by the transactions must be rejected.

It seems, at least where creditors or others may be adversely affected, the shareholders are not permitted to ratify a director's breach.