

Connected entities: double-edged sword

Capital gains tax liability can depend on who controls a trust.

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The small business capital gains tax (CGT) concessions are notoriously complex, especially when applied to trusts and companies. Where there is more than one entity in a family group, the connected entity rules apply. The connected entity rules use a 'control' test. And these rules are a two-edged sword.

Why? Because on the one hand, connecting two or more entities may mean the \$2 million turnover and \$6 million net asset tests cannot be satisfied, as turnover and net assets are aggregated; and on the other hand, connecting entities may help you to satisfy the active asset test.

In *Gutteridge & Anor v FC of T [2013] AATA 947*, the control of a discretionary trust was in issue. The Administrative Appeals Tribunal found that the trust and company in question were not connected by a common controller and the trust was able to claim small business CGT concessions, as its turnover and assets did not exceed the \$2 million and \$6 million thresholds. If the company and trust had been connected, both these would have been exceeded.

The facts

Mr and Mrs G were beneficiaries of the trust. Mr G's daughter, Ms M, was the sole director and shareholder of the trust. Mr C was the appointer of the trust. Ms M was the sole director and shareholder of the company. The trust secured and let out properties

to clients for use as childcare centres. The company operated the childcare centres on behalf of the clients.

The issue

Connection of entities is based on common control. The issue to be determined was whether Ms M controlled the trust; it was clear that she controlled the company.

The decision

Section 328-125(3) of the ITAA 1997 provides that one of the ways an entity (controller) controls a discretionary trust is where the trustee of the trust acts, or could reasonably be expected to act, in accordance with the wishes of the controller (controller test).

The Commissioner argued that Ms M was the controller of the trustee, not because she was the director of the trustee but because she was the public face of the trust and because of the decisions she

took in relation to the trust and the company.

The tribunal found on the evidence before it that Mr G controlled the trust behind the scenes and decisions would not be made in respect of the trust if they did not accord with his wishes. Mr C, the appointer, gave unchallenged evidence that Mr G controlled the trust behind the scenes and that Mr C would exercise his appointer powers in accordance with the directions of Mr G and disregard any instructions from Ms M.

The tribunal found that the controller test had parallels with the definition of 'director' in the Corporations Act. The definition of 'director' includes the words 'accustomed to act in accordance with' the wishes of a person; and a reasonable expectation to act in a particular way in the controller test can be determined if a person is 'accustomed to act in that way'. ¹

Lessons learned

- Evidence is critical. No matter how good a family group structure is in terms of tax effectiveness, what actually happens on the ground will impact on that effectiveness.
- The small business CGT concessions give taxpayers a 'free kick', but with that come complex hurdles that must be overcome. Falling on one of those hurdles may mean that the taxpayer misses out on the small business CGT concessions.

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