

## Tax Brief

31 March 2010

### ***Bamford* in the High Court of Australia: Short and Sweet**

In a very short time and judgment, the High Court has disposed of the appeals of both the Commissioner of Taxation and the taxpayers in *Commissioner of Taxation v Bamford* [2010] HCA 10, confirming in a joint judgment the decision of the Full Federal Court. The judgment, which was awaited with both expectation and some trepidation, will be welcomed as generally confirming long standing tax practices in both public unit trusts and private family discretionary trusts.

We have dealt with the issues in two previous tax briefs, one discussing the meaning of “income” written before the Full Federal Court decision in *Bamford*, see [http://www.gf.com.au/829\\_761.htm](http://www.gf.com.au/829_761.htm), and the other commenting on the Full Federal Court decision and its implications, see [http://www.gf.com.au/829\\_771.htm](http://www.gf.com.au/829_771.htm). In broad terms the High Court has taken the same approach as the Full Federal Court to both issues.

The Court was, however, careful to confine itself to the two issues at hand as it was acknowledged on all sides that “examples could readily be given of apparent unfairness in the resulting administration of the legislation” (para 17). The Court felt that it was necessary to resolve only some of the difficulties in the legislation in deciding the appeals (para 26). In making the comment in para 17 of their judgment the Court noted that it was over 20 years since the late Justice Hill had indicated a need for legislative clarification, especially with the advent of the capital gains tax. Inevitably there will still be uncertainty around the edges and some of these uncertainties may be resolved in future litigation.

### **Facts and Issues**

The two issues revolved around the phrase “a share of the income of the trust estate” in the opening words of section 97(1) of the *Income Tax Assessment Act 1936*. One concerned the meaning of “income” in this phrase – did it have a tax law meaning or did it have a trust law meaning. The ATO views on this issue have been difficult to tie down precisely but in the appeal the Commissioner accepted that his appeal should be dismissed “if ‘the income of the trust estate’ within the meaning of section 97(1) includes ‘statutory income’ such as capital gains which are brought in as

'assessable income'" (para 10). The second issue concerned whether "share" means proportion/fraction or has some other meaning.

Both issues are most easily understood on the facts of the case which concerned a fairly standard family discretionary trust which was controlled by Mr and Mrs Bamford and conducted business and investment activities. In one of the years in question, the trust only had capital gains. Pursuant to a power in the trust deed the trustee treated the capital gains as income for trust law purposes and made Mr and Mrs Bamford presently entitled to that income in equal shares. The Commissioner argued that "income" for the purposes of the opening words of section 97(1) could not be altered by the trustee in this way with the result that the capital gain was taxable to the trustee because there was no (ordinary) income of the trust estate to which a beneficiary was presently entitled.

The second issue concerned a disparity in a different year of income between net income calculated under section 95(1) (often referred to as "tax law income" as it involves a fairly standard tax calculation) and income as calculated under trust law (often referred to in this context as "trust law income" to distinguish it from tax law income). The Commissioner applied the so called "proportionate" view so that whatever fraction or proportion of the trust law income to which Mr and Mrs Bamford were entitled, that same fraction was applied to the net income to work out how much they should include in assessable income. Under this view, as net income exceeded trust law income on the facts, the beneficiaries would be assessed on more income than the cash they received (or were entitled to). The taxpayers argued that when a beneficiary was entitled to a specified dollar amount of trust law income (in this case the trustee exercised its discretion to make each taxpayer entitled to \$34,000), that was the amount on which they should be assessed.

## Meaning of "income"

Before dealing with the specific issues the High Court made some general comments, repeating in part what was said by Stone & Perram JJ in the Full Federal Court, four of which link to the first issue (para 17):

the distinction between income and capital in trust law was a product of ... the balancing ... of those with life interests in the receipt of income and those with remainder interests in the conservation and augmentation of capital ...

the "rules" which were developed in Chancery regarding apportionment between capital and income of receipts and outgoings and losses largely took the form of presumptions which would yield to provision made in the trust instrument ...

it was to be expected that the treatment of receipts and outgoings by a trustee would not necessarily correspond with that in a taxing statute ...

the degree to which a revenue statute adopts or qualifies or supplants the general understanding of terms with a particular application in property law will be a matter of statutory construction

...

They also made the important point that the basic approach of Australia's trust taxing provisions is to adopt a conduit approach to taxation of the income of the trust – in other words, taxation of the beneficiary is the primary method, defaulting to the taxation of the trustee as the secondary method.

In view of the Commissioner's conditional concession on the first issue, the Court proceeded mainly by knocking down the various arguments put by the Commissioner for why "income" could not include statutory income. They began by noting that the juxtaposition of the phrases "the net income of the trust estate" and "the income of the trust estate" in section 97(1) suggested that the latter "has a content found in the general law of trusts" as the former is a tax law concept (para 36). They thought the language of the provision referring to a trust estate and a beneficiary "bespeaks the general law of trusts" (para 38) while the phrase "presently entitled to a share of the income" referred to the "processes of trust administration by which the share is identified and entitlement established" (para 39).

Then in just one page the Commissioner's specific arguments get bowled over. First, the Court quotes from *Totledge* to the effect that beneficiaries have a *beneficial interest* in all that comes into the trust in the sense that they are entitled to an account from the trustee for it, but are only *entitled to receive* distributable income from the trustee (that is, after payment of the trustee's proper costs, expenses and outgoings). Although not expressed in terms of rejecting the Commissioner's specific argument, *Totledge* is one of the cases that has been relied on by the ATO for its view that trust income cannot be altered by the deed and that it refers to ordinary income (variously in a trust law or tax law sense). In fact this case was relied on by the AAT in *Bamford* in deciding in favour of the Commissioner on this argument but that seems a very unlikely reading of *Totledge*. Secondly, the Court rejects the application of another decision much relied on by the ATO in this context, the High Court's decision in the *ANZ Savings Bank* case, on the basis that the decision was concerned with other issues entirely. The Court's reading of its earlier decision is an eminently sensible one. Finally, a submission by the ATO that income means tax law income according to ordinary concepts but not statutory income is simply dismissed for its "lack of consistency" – if it is a reference to tax law income, why not all of it? This ATO view was also founded on *Totledge*, *ANZ Savings Bank* and to some extent the English decision in *Carver v Duncan*.

The Court's ready dismissal of the somewhat tortuous arguments that the ATO has tried to construct in recent years on these issues links back to its general comments on trust and tax law quoted above, that trust law income is concerned with division between income and capital beneficiaries and is generally made up of presumptions, not hard and fast rules. The way in which the Court constantly quotes Federal Court decisions in its judgment

might be read as a message to the ATO to follow those decisions and not to seek ingenious ways to circumvent them such as reading the decision in *Cajkusic*, which is patently concerned with the meaning of income and unfavourable to the ATO view, as somehow related to the meaning of present entitlement.

The Court's decision does not spell it out but in our view it is supportive of the Full Federal Court decisions in *Bamford* and *Cajkusic* to the effect that the trust deed can alter what is trust law income by appropriate provision. For example, the Court referred with apparent approval to the statement of Sundberg J in *Zeta Force* that income is to be "ascertained by the trustee according to appropriate accounting principles and the trust instrument".

The specific issue here is the trustee having power to characterise receipts and outgoings as capital or revenue and the Court's decision is clearly in support of the efficacy of such provisions. However, there is no strong reason to think that the same approach would not be adopted for the fairly standard provision in trust deeds of giving the trustee power to equate trust law and tax law income, that is, to treat the net income as the amount of trust law income.

## Meaning of "share"

The second issue gets even shorter treatment than the first issue. It is noteworthy that the Court deals with the two issues in the reverse order to that adopted in the Full Federal Court and the AAT on the basis apparently that once the meaning of income is determined that will have an impact on the meaning of share. The Court noted "On its face the section may appear to postulate the same share of two subject matters which do not correspond." Again it is worth bearing in mind the general comments made earlier in the judgment (para 17) quoted above in relation to the first issue and the Court's recognition that the provisions could operate unfairly in some cases.

The Court quotes Emmett J's summary of the taxpayers' amount argument in the Full Federal Court and simply states the submissions were correctly rejected. The Court then quotes Sundberg J's comments in *Zeta Force* which many thought had finally resolved the issue more than a decade ago in favour of the proportionate approach (given further cases going back in time at least to 1989 with only one significant dissent from this view over that period). The argument is a simple linguistic one that "share" refers to the proportion of the trust law income and the language requires that the same share be applied to the net income of the trust estate. Section 97(1) is to be applied on a formulaic mathematical basis going from the fraction or proportion of trust law income to which a beneficiary is presently entitled to the same fraction or proportion of the tax law net income.

## Implication for MITs and Action by Trustees

Although the decision in *Bamford* concerns a private discretionary business trust, there is nothing in the decision to suggest that it is limited to that context and we consider that it is applicable to public unit investment trusts. As the High Court decision generally supports what was said by the Full Federal Court, our earlier comments on the implications of that decision generally remain relevant and are summarised here.

The decision clearly supports the view that the trust deed is paramount in determining what is trust law income for the purposes of section 97. While we agree with this view, there are several considerations that need to be taken into account, especially the necessity to consider the issue by reference to the whole of the trust deed and the surrounding circumstances, rather than simply relying on a literal reading of the discretions contained in the income clauses.

First, and most importantly, all the provisions of the trust deed need to be considered. If some departure from the trust law presumptions about the meaning of income is proposed in determining trust income then it must be justified by a provision in the trust deed (or in legislation dealing with trusts). Hence a bare statement in a trust deed in similar terms to the deed in question in *Bamford* about the trustee having an absolute discretion in characterising receipts and outgoings as capital or revenue will need to be considered in the context of any other provisions in the deed concerning the entitlements of beneficiaries and the determination of income which may qualify such an apparently unfettered discretion. It is generally not possible for trustees to simply pick a number as trust law income – there must be a process of calculation involved which is justified by the trust deed in cases where the trustee departs from the presumptions for determining trust income according to trust law. The recent Full Federal Court decision in *Forrest* is an example of how a discretion to determine whether an amount is income or capital may be restricted by the context of the deed.

Secondly, trustees are subject to many fiduciary duties and the terms of the trust deed do not generally do away with such duties. In particular they must exercise their powers for a proper purpose and be satisfied that the exercise of the power is in the best interests of the unitholders. What the trust deed may affect is how the duty of the trustee to act fairly among beneficiaries applies in a particular case by specifying how the entitlements of beneficiaries are to be determined, including conferring discretions on the trustee. Such discretions will still need to be exercised in accordance with the general duties of trustees. In the case of public unit trusts that qualify as managed investment schemes under the *Corporations Act 2001* it will be necessary to have regard to the additional duties and obligations imposed on trustees by that Act, for example, s 601FC(1)(d) imposes a duty to “treat the members who hold interests of the same class equally and members who hold interests of different classes fairly.”

Thirdly, in exercising any discretions given by the trust deed, trustees will need to have regard to a variety of factors which might be relevant to them properly carrying out their duties. These might include:

- In the case of public unit trusts, the fact that the constitution of the trust also has effect as a contract between the trustee and unitholders;
- Information (as to intended income distributions) contained in any product disclosure statement;
- The protection of the overall interests of unitholders by not having the trust wound up or forced to sell assets in a way which will produce a substantial reduction in values for unitholders.

While a court may have regard to factors such as the constitution, product disclosure statements and consistency in treatment of income over time in considering the exercise of trustee discretions, the recent very unusual economic circumstances may justify or require trustees to depart from previous practice in exercising trustee discretions to determine trust income.

Subject to these cautions, if a trustee properly calculates trust income available for distribution in accordance with the trust deed including relevant discretions, and distributes the full amount of trust income to unitholders again in accordance with the trust deed, then the trustee should not be subject to tax under section 99A. Rather as usual the unitholders should be subject to tax under section 97 or MIT withholding tax. This result should follow even if the trust law income calculated in accordance with the trust deed is less than the tax law net income of the unit trust as a result of the proper exercise of the trustee's discretions in calculation of trust income available for distribution.

## **ATO Reaction**

The immediate remaining issue from the *Bamford* judgment is the reaction of the ATO to the decision. In our view the ATO should accept that its recent approach to the meaning of income has been roundly rejected by the High Court and that income in this context refers to trust law income as determined under the presumptions in trusts law, modifications of the presumptions in the trust deed and any relevant surrounding circumstances. Recent experience suggests that the ATO may try to limit the decision but we hope that this does not occur as it will simply engender more uncertainty and litigation.

In 2005 the Commissioner issued a Practice Statement, PSLA 2005/1 (GA), stating that as a matter of practical administration, he would tax beneficiaries who had become entitled to receive a distribution of a capital gain if the trustee and the beneficiaries agreed. The ATO will no doubt reconsider this Practice Statement in light of the High Court's decision. Withdrawal of the Practice Statement could adversely impact:

- beneficiaries of trusts where the trust income is income under trust law presumptions without any discretion in the deed for the trustee to determine whether an amount is income or capital;
- unitholders of trusts where an asset is sold to fund a redemption of a particular unit holder, if the trustee is not to be able to stream that capital gain to the redeeming unit holder. In that event the remaining unit holders would be assessed on that capital gain.

The ATO is expected to release a decision impact statement on the case in due course.

## MIT Review

The Board of Taxation has delivered its Report on the taxation of MITs to the Government which is currently considering it, along with the Henry Review. In the medium term it is expected that the Government will proceed with a separate MIT tax regime. Industry and the profession will need to ensure that any remaining problems left over from the *Bamford* decision are addressed in that regime.

For further information, please contact

### Sydney

Andrew Mills

61 2 9225 5966

[andrew.mills@gf.com.au](mailto:andrew.mills@gf.com.au)

Simon Clark

61 2 9225 5957

[simon.clark@gf.com.au](mailto:simon.clark@gf.com.au)

Andrew White

61 2 9225 5984

[andrew.white@gf.com.au](mailto:andrew.white@gf.com.au)

### Melbourne

Adrian O'Shannessy

61 3 9288 1723

[adrian.oshannessy@gf.com.au](mailto:adrian.oshannessy@gf.com.au)

Toby Eggleston

61 3 9288 1454

[toby.eggleston@gf.com.au](mailto:toby.eggleston@gf.com.au)

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Greenwoods & Freehills Pty Limited

ABN 60 003 146 852

Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia

Facsimile (02) 9221 6516 Telephone (02) 9225 5955

Liability limited by a scheme approved under Professional Standards Legislation 510068835