

Tax Brief

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The meaning of income for the purposes of section 97 of *Income Tax Assessment Act 1936*

This tax brief has been written by Professor Richard Vann in consultation with the Directors of Greenwoods & Freehills. A version of the paper will be published separately in an Australian tax journal.

Issue

This paper discusses the operation of trust taxing provisions, specifically the meaning of “income” where that first appears in the introductory words of section 97(1) of the Income Tax Assessment Act 1936, and to what extent the meaning of income can be affected by trust law and the trust deed. That section provides so far as relevant to the subsequent discussion:

Where a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate -

(a) the assessable income of the beneficiary shall include -

(i) ... that share of the net income of the trust estate ...

(b) the exempt income of the beneficiary shall include -

(i) ... the individual interest of the beneficiary in the exempt income of the trust estate ...

...

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate.

The term “**net income**” is defined in section 95(1) as follows:

net income, in relation to a trust estate, means the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions, except deductions under Schedule 2G and except also, in respect of any beneficiary who has no beneficial interest in the corpus of the trust estate, or in respect of any life tenant, the deductions allowable under Division 36 of the Income Tax Assessment Act 1997 in respect of such of the tax losses of previous years as are required to be met out of corpus.

The main positions

The mainstream view in the profession is probably that expressed by the Full Federal Court in *Cajkusic* that income refers to distributable trust income which in turn means the income calculated under trust law, including the provisions of the trust deed and any relevant exercise of a trustee discretion. The Australian Taxation Office (ATO) by contrast had indicated in a number of places that it regards income as referring to gross income according to ordinary concepts (see, for example, the minutes of meetings of the ATO NTLG Trusts Consultation Sub-group minutes for 2008, *Cajkusic* Decision Impact Statement, on the ATO website www.ato.gov.au). The ATO agrees that it is a matter of trust law income but in effect turns this back into income according to ordinary concepts for tax law purposes by saying that the latter is directly derived from (and so seems to correspond exactly to) the former. ATO documents discussing the issue use a mixture of trust law and tax law cases in determining what is meant by gross income according to ordinary concepts. Trust law income is used in what follows to distinguish it from tax law income, but the term is not intended to decide between these views.

Both sides seem to retreat from a completely fixed view. Those advocating the approach favoured in the private profession usually accept that there are some limits imposed on the capacity of the trust deed and/or trustee discretions to determine what is trust law income. The ATO documents seem to accept at various points that the deed, circumstances and/or trustee discretions can affect what is income under ordinary concepts.

There is another important issue often debated under section 97(1) – the proportionate versus the quantum view. The ATO accepts that the weight of authority is currently in favour of the proportionate view but it regards the matter as unsettled and is currently funding test case litigation before the Full Federal Court to test the matter (*Bamford v Commissioner of Taxation* heard in November 2008 with no decision yet released). That case also involves as a separate matter the meaning of income in section 97(1), but judging by the submissions at least this is seen as the subsidiary issue in the case, for example, the issue occupies less than 4 pages in the taxpayers' 33 page written submissions.

Impact of managed investment scheme statutory rules

Managed investment schemes operating as trusts are regulated under the *Corporations Act 2001* as well as trust law. The ATO has recently argued in another test case, *Hance v Commissioner of Taxation* [2008] FCAFC 196 before the Full Federal Court, that the statutory trust created under that legislation has significant impacts on the way that the general trust, contract and commercial law operates in respect of managed investment schemes. The Full Court held that the statutory trust created for an MIS is relatively limited and generally did not affect the operation of normal principles of trust, contract and commercial law. The ATO has indicated by Press Release that it accepts the decision and will not be appealing. A Decision Impact Statement setting out the ATO view of what was decided is expected but not yet published.

For the purposes of this paper it is assumed that the *Corporations Act 2001* does not affect the operation of trust law otherwise so far as it is relevant. It would need to be considered in relation to each particular issue what, if any, effect the *Corporations Act 2001* has for trusts which are MISs but the general view flowing from the decision is that there will be no impact unless the legislation quite clearly changes the result under general trust law.

Policy

The discussions of the meaning of section 97(1) income in ATO documents do not generally consider the policy drivers of the concept of income in trust law or tax law. Trust and tax law cases do discuss the policy of trust and tax law in general terms but without express reference to the issue under consideration. Nevertheless, it is considered that the discussion in the cases and the legislative background are helpful in resolving the issue.

Trust law

In the cases interpreting “present entitlement”, the other main driver of section 97(1), it is accepted that the trust law “rule in *Saunders v Vautier*” is central to the operation of the concept. That rule in a broad sense is one of several designed to prevent accumulations through the use of trusts (the rule against perpetuities being another). To be effective such rules should be self operating and not susceptible to exclusion or change by the terms of the trust deed. Even so the High Court in *CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] HCA 53, 224 CLR 98 seems to have gone some way to allowing trust deeds to modify the operation of the rule though this was in a context where the Court was questioning the continuing policy validity or necessity of the rule.

By contrast when it comes to the relative treatment of beneficiaries, the general statement of principle is that the trustee must treat the beneficiaries fairly. This expression is usually found in the context of competing interests of beneficiaries such as life and remainder interests. The *Corporations Act 2001* section 601FC(1)(d) in the MIS context expresses the duty as “treat the members who hold interests of the same class equally and members who hold interests of different classes fairly.” In determining what is fair between beneficiaries, it is accepted as self obvious in cases, statutes and texts that the wishes of the person who created the trust are to be taken into account (the settlor or deceased in the case of a will trust – the term settlor is used hereafter) . This is why many of the “rules” are expressed as a default fairness position, subject to any contrary intention expressed in the trust deed. The rules are found in case law going back many centuries and the trust/trustee legislation found in the Australian States and Territories (if we confine attention to Australian trusts and trust law).

The income concept in trust law was used traditionally as the primary means for dividing up entitlements to trust assets where there were beneficiaries with different interests and thus was the main area where the duty to act fairly between beneficiaries was applied. The rules developed in the cases constantly have regard to the wishes of the settlor as expressed in the trust deed and those wishes displaced the default rule if the default

rule was inconsistent. In some cases legislation confirmed, expanded, modified or abrogated the decisions in cases and in doing so again generally made the default rule subject to the wishes of the settlor. A perusal of chapter 11 by W A Lee on Income and Capital in Ford and Lee, *Principles of the Law of Trusts* (looseleaf) provides innumerable examples which are not repeated here. The authors summarise the position thus at the end of [11000] under the heading "Contrary intention":

The apportionment requirements [between income and capital] that are about to be described are subject to the expression of contrary intention in the trust instrument. Such expressions of intention may be express or implied and may be in specific or general terms. Occasionally the settlor personally gives the trustee a broad discretion to determine capital and income apportionments. ... Statutes which allude (usually in provisions empowering trustees to effect repairs and improvements) to the apportionment of the costs of repairs and improvements between capital and income, often also refer to the discretion of the trustees and the power of the court to make determinations ...

The income rules could also determine in the case of a single beneficiary what was available for current enjoyment from the trust and what was available for deferred enjoyment, the typical example being a trust created for an infant. The income could be used for current purposes while enjoyment of capital could be deferred until the child attained the age of majority, though as there was often only a single beneficiary concerned, trust deeds, law and legislation have long provided powers of advancement to use the capital of the trust for the infant's benefit during minority.

Income in trust law is generally used in contradistinction to corpus or capital of the trust but it needs to be understood that there was nothing absolute about the concept – it was the means of giving effect to the basic duty to be fair among different beneficiaries and to a lesser extent to separate out current and future claims on trust assets by the same beneficiary. Fairness (including regarding current and future claims) could not be divorced from the wishes of the settlor but on the contrary could only be judged in the light of the settlor's directions or wishes for the trust as expressed in the trust deed having regard to the surrounding circumstances.

Tax law

Tax law raises similar policy considerations to the trust discussion above.

There will be matters where the trust deed cannot generally affect the outcome in the tax area, just as the trust rules on accumulations discussed above are generally regarded as immune from change by the trust deed. The obvious example of this lack of power for the trust deed in relation to tax law is the taxable/net income calculation itself. An attempt by a trust deed to deem for tax purposes that amounts included in assessable income are not assessable income or that exempt income is capital for tax purposes would simply be ineffective for tax law purposes. This is what it is considered that the High Court decided the *ANZ Savings Bank* litigation discussed below. The fact that the trust deed allowed the trustee to recharacterise an amount as capital had no effect for tax calculation purposes in taking away the amount's tax character as exempt income.

There is one clear exception where the trust deed can change the tax calculation elaborated further below in relation to trust tax losses which in effect confirms the general principle that tax calculations at the trust level are not affected by the trust deed.

Similarly there will be matters on which the trust deed can effect tax outcomes. It is considered that the allocation of tax liability among beneficiaries and/or the trustee based on present entitlement is the major example and the reason is that this is the fair outcome between beneficiaries. The original federal income tax of 1915 taxed the trustee on the entire income of the trust but this was quickly felt to be unfair and so in 1918 following a conference of tax commissioners from the Commonwealth and States the legislation was amended to adopt somewhat similar rules to current law which were remodelled in the first consolidation of the legislation in 1922 and the second consolidation in 1936.

The 1918 change (which was similar for partnerships) was explained by the Treasurer as follows (quoted in Harris, *Metamorphosis of the Australasian Income Tax*, Australian Tax Research Foundation, 2004 pp 194-195):

By clauses 20 and 21, the scheme of the principal Act in regard to the assessment of partnerships and trust estates has been remodeled, on the recommendation of the conference of Commissioners of Taxation. At present, a partnership or a trustee is taxable on undistributed income at the rate applicable to the total income of the partnership or the trust estate. This has worked inequitably in many cases, and it is now proposed that the taxable income of a partnership shall be deemed to have been distributed to the partners, and that the whole of the taxable income of a trust estate shall be deemed to have been distributed to the beneficiaries where there are beneficiaries entitled to receive it as income or to have it credited as income.

The last sentence would seem to be referring to trust law treatment of the income and it would seem implausible that it was income according to trust law ordinary concepts. It is clearly based on what the beneficiaries get or can immediately demand from the trustee which will generally be trust income based on a combination of the trust law default rules, the trust deed and any relevant and properly exercised trustee discretion.

That view would seem to be confirmed by an amendment to the 1922 provisions early in their history. The definition of net income was amended in 1930 to provide that net income was not reduced by carry-forward tax losses in cases where a life tenant or other beneficiary without an interest in corpus was entitled to income but losses were to be made up out of corpus. The EM on the issue notes that without this amendment:

the life tenant escapes tax, although actually in receipt of income from the estate. The amendment ... will remedy this defect without injustice to the life tenant.

This amendment and explanation only make sense if income in section 97 means trust law income as modified by the deed, rather than trust income according to ordinary concepts. Under trust law losses are made good out of future income unless the deed provides otherwise – the “rule in Upton v Brown” which as often has a default position and power for the trust deed to provide otherwise. While the High Court has recently suggested in *Raftland*

Pty Ltd v Commissioner of Taxation [2008] HCA 21 that the rule is limited to cases where there are beneficiaries with competing interests, that does not touch the operation of the rule in the kinds of cases with which the amendment dealt where there are such interests *ex hypothesi* (that is, beneficiaries with no interest in capital).

The amendment is dealing with a case where as a result of a provision in the trust deed throwing the loss on corpus contrary to the default rule, the life tenant enjoys future years trust income undiminished by the loss and in effect says in this case that net income is changed to fit better with trust law income as modified by the deed to ensure that the person enjoying the trust income is taxed on net income without reference to the tax loss. The tax loss is enjoyed ultimately, as is fair, by the corpus beneficiary provided the corpus beneficiary comes to enjoy trust income after the cessation of the interest of the life tenant or other beneficiary, for example, if the corpus beneficiary was still a minor (and provided in more recent times the trust tax loss rules do not prevent its use).

This review of the policy and history of the trust taxing provisions suggests that income in section 97(1) is a reference to trust law income as modified by the trust deed and/or any relevant exercise of discretion by the trustee. The discussion now turns to the case law which has been regarded on both sides of the argument as having a bearing on the meaning of that term.

Meaning of income in section 97(1)

The ATO position on the meaning of income in section 97(1) involves several propositions:

1. It is income according to ordinary trust law concepts.
2. It is a gross concept not a net concept.
3. It cannot be altered by the provisions of the trust deed.
4. Trust law ordinary income is the same as tax law ordinary income.

General difficulties in ATO view

Before examining these propositions and the case law claimed to support them in detail, it is worth commenting that they each regard income for this purpose as an immanent or ideal fixed form which exists apart from the circumstances of the case including the provisions of the trust deed and the exercise of trustee discretions. This is an inherently unlikely proposition when actual trust law in Australia is considered. First, this view contradicts the very purpose of the existence of the trust law income concept which is to ensure fairness between beneficiaries, including in some cases to defer enjoyment of trust assets for a particular beneficiary. As already noted to give effect to this purpose trust law recognises that the circumstances including the settlor's wishes as expressed in the trust deed and the exercise of trustee discretions can be critical to determining what is trust law income.

Secondly, the source of the ideal form is unclear. The ATO discussion only seems to refer to case law in determining its meaning. Although there is a

mixture of tax and trust law cases referred to (presumably in reliance on the fourth proposition above), the ATO regards the trust law concept as the relevant one for this purpose. In fact the case law about trust income has been significantly affected by legislation for trustees/trusts in many ways and the modern concept of trust income in trust law texts is regarded as being the result of an amalgam of this case law and statute. The third point which follows from the second point is that trust law is generally a matter of state not federal legislative power and jurisdiction in Australia and state law varies because of different statutory provisions on trust income. Perhaps the ATO does not direct attention to the legislation on trust law income because the result in Australia is to produce at least eight different versions of the trust income ideal form. Case law variation is much less likely to occur though it is possible (an example between the UK and Australia is noted in subsequent discussion). There is nothing to suggest in the income tax cases or elsewhere that it is case law trust income which is the ideal form.

Finally the ATO view assumes that there is always a default trust law income rule and no cases where the very rule states that it is duty of the trustee in some cases to exercise a discretion among two or more possibilities to determine what trust law income is. There are such no-default-rule cases in trust law as again is apparent from a perusal of Ford & Lee chapter 11 (see the quotation from this work above) and the High Court may have created another one in *Raftland* through its treatment of the rule in *Upton v Brown*.

The four propositions involved in the ATO approach to the meaning of income are difficult to separate in their discussion and the cases (and other authorities) relied on in support so they are dealt with together in what follows. The discussion suggests that the ATO has misconstrued the tax cases on these issues often by not paying close attention to the context in which statements are made. None of the Australian court decision relied on seem clearly in support or directly on point for the ATO views and the only one that clearly deals with the issue is to the contrary. The main support for the ATO view currently comes from other sources (a UK case and an article by Professor Parsons) but they are in clear conflict with Australian cases of the highest authority in Australia. This is not to say that the case law in Australia always speaks clearly on the issue under consideration. As the courts in most cases were dealing with other issues, such comments as they make which may be thought to be relevant to that issue do not squarely address it and so do not always make the kinds of distinctions that the ATO and private sector positions involve.

ANZ Savings Bank case

One authority relied on by the ATO is *Commissioner of Taxation v Australia and New Zealand Savings Bank* (1998) 194 CLR 328 where Gleeson CJ in a judgment agreed with by all other members of the Court said:

13. The trust deed defined income to mean the net income of the fund as determined in accordance with section 95 of the Act. Thus the deductible amount was treated under the deed as capital, and dealt with by cl 10 of the trust deed. Income as defined was dealt with by cl 9, and was held on trust for the investors. By cl 10.2 the

capital of the fund was held on trust for the investors in proportion to the number of investment units held by them. Clause 10.3 provided that investment units were to be redeemed “as and when and to the extent that the Trustee receives cash representing capital” of the fund to which an investor was entitled. Redemption was effected by payment by the trustee to the investor of the redemption price of the relevant units. The redemption price was one dollar, which was the purchase price of a unit. Thus, subject to payments to be made to the manager, the unit holders were entitled to the whole of the income and capital as defined.

14. It was argued that the unit holders in the trust, (relevantly, the partnership), had no such individual interest in the amounts in question as would satisfy section 97. However, the relevant provisions of the trust instrument, including those relating to interest in capital, and the procedures concerning redemption, were such that Sundberg J correctly held that the requirements of section 97 were satisfied. He observed that the partnership’s interest in the whole of the annuity income of the trust, which, by reason of the definitions in the deed was treated by the deed partly as income and partly as capital, was vested in interest and possession. The partnership was then presently entitled within the meaning of section 97(1).
15. For the reasons earlier given, the whole of the annuity amounts received by the trustee constituted income of the trust. **The circumstance that the trust instrument, for the purpose of dealing with the entitlements of unit holders, treated the deductible amount as capital, did not alter what was described in *Charles v Federal Commissioner of Taxation* as “the character of those moneys in the hands of the trustees.”**

It is the words in bold that are regarded by the ATO as supporting the proposition that the trust deed cannot alter the character of trust law income. There are a number of reasons suggesting that the ATO view is not supported by the passage. The first 15 paragraphs of the judgment are essentially an account of the facts and the previous decisions in the litigation, together with approval of various parts of previous judgments. It will be noted in paragraph 14 that the Chief Justice refers with approval to the reasoning of Sundberg J. Indeed paragraphs 14-15 effectively track, summarise and approve what Sundberg J said:

Clause 9.2(a) provides that the income of the fund in respect of each financial year is held on trust for the manager to such extent as the trustee determines, and in default of a determination on trust for the investors. Sub-clause (b) provides that subject to sub-clause (a), the income of each year is held on trust for the investors in proportion to the number of investment units held by them. Clause 9.3 requires the trustee promptly to distribute cash representing the income of the fund in accordance with the unit holders’ entitlements as and when the cash is received by the trustee. Clause 10.1 requires the trustee to “retain all moneys being capital of [the fund] pending the investment or redemption of Units”. By clause 10.2 the capital of the fund is held on trust for the investors in proportion to the number of investment units

held by them. Clause 10.3(a) provides that investment units are to be redeemed “as and when and to the extent that the Trustee receives cash representing capital” of the fund to which an investor is entitled. In order to effect any such redemption, the trustee must pay the investor the redemption price of the relevant units, and thereupon the units are redeemed: sub-clause (c). The redemption price is one dollar, which is the purchase price of a unit: clause 6.1. Clause 15.5 requires the manager, when any cash is received by the trustee which is or is to be paid or distributed pursuant to clause 9 or clause 10, to determine the extent to which such cash represents income and the extent to which it represents capital.

Section 95(1) defines “net income” in relation to a trust estate as “the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions ...”. It will be recalled that this definition is picked up by the definition of “income” in the deed.

It was common ground that the deductible amount was treated as “cash representing capital” of the fund within clause 10.3(a) and used to redeem investment units. The submission was that the effect of clause 10 is that the excluded portion of an annuity is in effect added to the trust capital, thus increasing the trust fund in favour of those entitled to capital as against those entitled to income, and that that portion, when received, is to be distributed to the beneficiaries by way of redemption of units. It was said that the beneficiaries become entitled to what is distributed, not as a return on their capital investment but as a return of that capital in pro tanto satisfaction of their interests in the trust fund. An analogy was drawn between the partners’ receipt and that of the shareholder in *Thornett v Federal Commissioner of Taxation* (1938) 59 CLR 787. In that case the receipt by a shareholder of an amount representing three-fortieths of the value of the net assets of the company upon cancellation of her shares, which were three-fortieths of the issued shares, was held to be in satisfaction of, and by way of replacement for, her shares and not as to any part income by way of dividend, notwithstanding that what she received exceeded a full return of her share of the paid-up capital of the company.

Counsel for the taxpayer stressed that they were not suggesting that the provisions of the trust deed could, **for tax purposes**, convert what was truly income into capital. The question, they said, was not whether the excluded portion was exempt income of the trust (which for the purposes of the present submission they accepted it was), but whether it was included in the exempt income of the beneficiary in terms of s97(1)(b)(i). It was not so included because the beneficiary never obtained an individual interest in that income.

Subject to any determination in favour of the manager, the income of the fund is held on trust for the investors absolutely. Upon its receipt by the trustee (as income) the deductible amount is property in which the partners have a beneficial interest, and its character is the same when received by the partners. The provisions of clauses 15.5 and 10.3 cannot alter the character of the receipt for **income tax purposes**. In *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598 at 609

Dixon CJ, Kitto and Taylor JJ said [Charles is then quoted at greater length than by Gleeson CJ].

It is relatively clear, particularly from the words in bold that Sundberg J was holding that the trust deed could not alter the *tax law character* of an amount received by the trustee as such, not that the trust deed could not alter the trust law character of trust income. Gleeson CJ it seems is making exactly the same point. On this view, the case is saying nothing about the meaning of trust law income in section 97(1). To similar effect, although the first sentence of paragraph 15 uses the word income, it seems clear from the cross reference at the start of the sentence that it is picking up what is said in paragraphs 5-11 about the *income tax treatment* of annuities (as is confirmed by reference to the long discussion in the judgment of Hill J which Gleeson CJ refers to with approval in those earlier paragraphs). So again the reference in the first sentence of paragraph 15 is to tax law income not to trust law income. There is nothing clear in either judgment about the trust law income nature of annuities. The second sentence in the last paragraph of the quotation from the judgment of Sundberg J is similar to Gleeson CJ in that it uses the word income without indicating if the tax or trust law nature is in question though it seems that the reference is to its tax character, not its trust law character, in the light of the following sentence.

Moreover, when the issue at stake in the High Court decision is understood, it is clear that the issue of the meaning of income in section 97(1) did not arise. The discussion in paragraphs 1-15 is a prelude to the real issue in the High Court appeal, the meaning of the concluding words of section 97(1)(b) which have been set out earlier. It will be noted that the structure of this provision is different to section 97(1)(a) as it refers simply to the individual interest in exempt income rather than “that share”. The real point of the discussion in both the Full Federal Court and the High Court of the trust deed is that the beneficiary got all the trust law capital (corpus) and trust law income in each annuity payment so there could be no debate that they had the full individual interest in each annuity payment including the tax law exempt income component, however section 97(1)(b) is construed. Even if section 97(1)(b) were construed in a similar way to section 97(1)(a) (which the Court does not address), it would make no difference whether income in section 97(1) refers to trust income according to ordinary concepts or trust law income as affected by the deed and actions of the trustee for the same reason – the beneficiary was entitled to all of the payment and hence all of the trust law income on a current basis. Hence there was no reason for the Court to say anything about the meaning of income in section 97(1).

Within section 97(1)(b), the meaning of the opening words was not the real point at issue either – it was the meaning of the concluding words. For the historical and policy reasons given by the High Court, it was decided that the concluding words did not apply to the case. Overall, either the High Court says nothing on the current point of interest, or, what seems more likely on a fair reading of the case, they accept that the trust deed can affect the meaning of trust law income but hold that the trust deed has no effect in changing the tax law character of income which seems demonstrably correct. This was not a point that troubled the High Court and so it was dealt with very briefly. The Full Federal Court in *Cajkusic* analysed below adopts a similar reading of the High Court judgment to that here.

Totledge

The facts of *Totledge v FCT* (1982) 12 ATR 830 were somewhat unusual. The case concerned a scheme of arrangement involving a company in financial difficulties. Under the scheme a scheme trust was created and a trustee appointed while the creditors of the company gave up their rights as such against the company in exchange for their rights under the scheme as beneficiaries of the scheme trust to payment of amounts equivalent to the original debts plus interest. The business of the company in difficulties was transferred to a second company controlled by the scheme trustee and that company held the assets on trust to operate the business and if necessary to sell it. The amounts realised in this process after paying for the costs of operating the business etc were payable to the scheme trustee, the scheme documents providing for the taxpayer "to carry on manage and conduct the said business as Trustee for the creditors of the company and as and when the same become available to account to and pay the [scheme] Trustee for application in accordance with the provisions of this Scheme all surplus income and other moneys, derived by [the taxpayer] from the carrying on of the said business." If and when the rights of the original creditors under the scheme trust were satisfied the shares in the second company were to be transferred at the direction of the shareholders of the original company for nominal consideration. In fact funds generated by the business were paid direct to the original creditors, their rights were ultimately satisfied and the shares in the second company were transferred back to the control of the shareholders of the original company.

The Commissioner assessed the second company as trustee under section 99(2) as it then was on the net income of the trust of the business on the basis that no beneficiary was presently entitled (nowadays such an assessment would be under section 99A). The second company argued that the scheme trustee was presently entitled to the income and so it was not assessable under section 99(2). It was agreed that the tax law net income of the trust from the business was exactly the same as the trust law income. The real arguments in the case were about the facts (whether one or more trusts were constituted and what the various rights of the parties were). The Commissioner's argument was that the original creditors were simply being paid the debts owed to them and interest so that their rights were contractual in the normal way for debts and not as beneficiaries under a trust.

Although the various documents giving effect to the scheme and transfer of the business to the second company and the actions of the parties under them were not models of clarity, the Full Court held that there were in fact two trusts, one of the business held by the second company and one under the scheme, that the scheme trustee was the beneficiary of the first trust and the former creditors beneficiaries of the scheme trust, that the scheme trustee was presently entitled to all of the income of the business trust and so the trustee of the business trust was not assessable on the net income of that trust. Thus the critical issues in the case had nothing to do with the meaning of income in section 97(1). Along the way the court at first instance (Rogers J in the Supreme Court of New South Wales (1980) 11 ATR 181) and the Full Federal Court made some comments about the taxation of

trusts more generally in response to arguments from the ATO on the meaning of present entitlement.

Thus Rogers J said (at 187):

A further submission which was advanced for the respondent founded on the word “surplus” in cl 7(a). It was submitted that persons could not be said to be “presently entitled” to income within the call of section 97 where the company could appropriate some or all of the income to reserves. True it is that the precise amount of the income to which the beneficiaries may be entitled may not be ascertained until a determination is made by the company as to what amount is to be appropriated to reserves but that does not preclude a present entitlement. Thus A, B and C may be presently entitled to the income of Blackacre when their interest is described as being one third each of the income after payment of all levies and a levy is not quantified until the close of the tax year. So long as the criteria for ascertainment of quantum are prescribed, it is not necessary that quantification should have taken place.

In the Full Federal Court there is a lengthy passage at 836-840 addressed to the issue including the following:

If the words “presently entitled” to a “share of the income” in that subsection were to be construed as meaning entitled to call for an immediate transfer of a share of gross income as derived, they would be inappropriate to refer to the ordinary vested interest of a life tenant or other beneficiary entitled to share in the income of a trust estate which was held other than on bare trust or to the entitlement of the Scheme Trustee under the business trust in the present case. They would, for practical purposes, refer only to the case where the trust estate was vested in the trustee as bare trustee. It is apparent that it could not have been the legislative intent that section 97(1) should be given such a restricted operation: indeed, the section itself, by including in the assessable income of the beneficiary the appropriate share of “net income”, seems to recognize that, in the ordinary case, the beneficiary will not be entitled to require that the trustee distribute gross income as it is derived. Putting to one side questions of legal disability which are not here relevant, the preferable construction of section 97(1) is to treat the requirement of present entitlement to a share of the income of the trust estate as not being concerned with distinctions between gross income as derived and “surplus income” after payment of costs, expenses and outgoings but as referring to a present vested right to demand and receive payment of the whole or part of what has been received by the trustee as income and, retaining that character in his hands, is legally available to be distributed to those entitled to it as beneficiaries under the trusts of the relevant trust estate. Such a right to demand and receive payment represents a present entitlement to receive a share of what retains its character as income of the trust estate regardless of whether, upon closer analysis, it can be seen to reflect a beneficial interest in gross income as derived or whether it represents no more than, for example, the right of an annuitant to be paid a particular amount from surplus or net income. Examination of the

decided cases in which reference has been made to section 97(1) supports this approach. ...

In *Trustees of the I D Taylor Trust v FCT* (1970) 119 CLR 444 at 449-452, Kitto J examined what was said in the judgments in *Whiting's* case, *supra*, and concluded that "the tenor of the judgments is, I think, that 'presently entitled' refers to an interest in possession in an amount of income that is legally ready for distribution so that the beneficiary would have a right to obtain payment of it if he were not under a disability." Kitto J's reference to "legally ready for distribution" was, as is made clear both by his decision in the case and subsequently in his judgment, to income that was available for distribution regardless of whether the accounts necessary to enable its precise ascertainment had been completed at the end of the income year or whether it was actually held in a form ready for immediate payment.

In the present case, the surplus income of the business trust was, in each of the income years, legally available for distribution. In respect of the 1973, 1974 and 1975 income years, the Scheme Trustee was beneficially entitled to the whole of that surplus income and had a right to obtain payment of it from the trustee. During each of those three income years, the taxpayer, as trustee, resolved that the whole of that surplus income be distributed. As regards the 1976 income year, the Scheme Trustee was entitled to be paid the amount of surplus income which is in issue in the present case and that amount was, as has been seen, actually distributed by the taxpayer in the course of that income year. The Scheme Trustee had, under the trusts of the business trust, a present vested right to demand and receive payment of the whole of the relevant surplus income of each income year. In the result, the Scheme Trustee was *prima facie* presently entitled, for the purposes of section 97(1), to the whole of the relevant income of the business trust for the 1973, 1974 and 1975 income years and to the relevant share of the income of the 1976 income year.

These comments seem to be the source of the view that income in section 97(1) means gross income and apparently from the ATO perspective this is seen to provide further support for the views that income in section 97(1) means trust law income according to ordinary concepts and that the trust deed cannot alter the meaning of income. It is clear from the case, however, that the meaning of income as net or gross, as income according to ordinary concepts or as affected by the trust deed and/or trustee discretions was not what the court is discussing in these passages. The ATO, in addition to the issues of whether there was a trust or trusts and whether there were beneficiaries, was arguing that the scheme trustee as beneficiary of the business trust was not presently entitled to the income on the basis that the second company as trustee of the business trust had the obligation to meet expenses and had discretions as to creation of reserves.

This issue has been of concern to the courts on several occasions (see further the discussion of *Cajkusic* below) and the Full Federal Court here goes out of its way to make clear that the existence of such duties or powers in the trustee did not prevent present entitlement arising as otherwise section 97 would hardly ever operate and that clearly was not the intention of the legislation. Along the way the terms "income" and "gross

income” are used to describe the revenue of the trust from its business and the rights of beneficiaries with respect to that revenue are discussed but the whole point of the discussion is that if the beneficiary or beneficiaries can call for all of the distributable income, then it or they are presently entitled to all of the income of the trust estate. There is nothing to suggest that the use of the terms income and gross income in this analysis are more than alternatives to revenue or that the use is intended to say that income in section 97(1) means gross trust law income according to ordinary concepts.

The fact that the scheme trustee was presently entitled to the surplus income as defined in the trust deed was enough to make it presently entitled to all of the income of the trust estate for the purposes of section 97(1). The court clearly regards the surplus income here as equivalent to the distributable income (that is, the income after expenses are paid and reserves are created by the trustee) and so implicit in the decision, although not a point of contention, are views exactly to the contrary of what the ATO seeks to draw from the case. The case indicates that income in section 97(1) is not a gross concept but a net concept and that income can be affected by the terms of the trust deed (here the powers to pay expenses and set aside reserves).

Income from a business operated by a trustee: McBride v Hudson

Indeed the ATO concedes that its view that income in section 97(1) means gross trust income according to ordinary concepts is not to be taken literally. It accepts that the fact that beneficiaries will only get that part of gross income which is not consumed by expenses etc does not mean that the beneficiaries cannot be presently entitled to all the income in the section 97(1) sense.

Relatedly and more importantly, the ATO accepts that the many cases which indicate that when a trust conducts a business the income means the profits of the business, an inherently net concept. The leading case in this area is the High Court decision in *McBride v Hudson* (1962) 107 CLR 604 which concerned the respective rights of a life tenant and remainderman to the profits of a pastoral business (sheep farming for wool) operated by a trustee. The pastoral business had been run down when the trust was created due to drought and the trustee built the business up by increasing the number of sheep in the business from 1850 to 4346 to suit the carrying capacity of the property through the retention of natural increase and purchase of sheep. The question was whether the increase in the number of sheep belonged to the life tenant or remainderman and the court held that it belonged to the latter. In the course of so deciding Taylor J, with whom Dixon CJ and Windeyer J agreed on this point, said at 623-625:

Consideration must be given to the nature of the relevant business activity and to the manner in which it is customarily carried on and, if in the course of carrying on a business pursuant to a direction to do so trustees adopt an appropriate and conventional method of accounting in order to determine the amount of profit to which a life tenant becomes entitled during any accounting period, no exception can be taken. ... These observations must, of course, be understood subject to the

qualification that if in any particular case it appears from the terms of the trust instrument that business profits are to be ascertained upon a cash basis only, or upon any other basis, those terms must prevail. But in the present case no such indication appears, and the testator, as a person conversant with the manner in which pastoral businesses are generally carried on, must be taken to have intended the profits of the business after his death to be ascertained by a process of accounting conventional and appropriate in that type of business. ...

There is, in my view, nothing in the will to indicate that the testator either contemplated or intended that the profits of the business should be ascertained otherwise than by some accounting method conventionally used in the pastoral industry. And, of course, if the testator intended that the net profits should be ascertained by some such appropriate and conventional method of accounting there can be no complaint that the method employed did not do justice as between the life tenants and the remaindermen.

Windeyer J added:

The right of the life tenant was to have the profits of the business considered as a whole, whether it was well managed or ill managed. Whether or not on any given day there were more or less stock running on the property than prudence and proper management might have then dictated, could not make the life tenant the owner of any particular beast or any number of beasts or of the value thereof. ... In this case the annual accounts are compiled in accordance with an appropriate method of accounting. I agree that there is no reason why, so far as they relate to transactions up to the widow's death, they should be rewritten.

I may add that the evidence does not, in my view, support the allegation made in argument that when the trustees entered upon the management of the property they had to restock and restore it after it had been denuded by drought, and that they did so at the expense of the life tenant; or that, in any other way, they failed to hold the scales properly as between life tenant and remainderman.

It is clear from these passages and the case generally that in a business context the income of a trust (that is, the distributable income of the life tenant) is to be determined in accordance with a prudent commercial form of accounting but this is subject to the terms of the trust deed which may prescribe a different form of accounting. In *McBride v Hudson* itself the trust deed in fact had some directions as to employing one of the trustees to run the business and how much he was to be paid which the trustees did. Although it was not material to the issue in question, it is clear that the court saw no difficulty in the accounts treating the amounts so paid as expenses of the business in determining the income available to the life tenant. It will be noted in the passages that the policy underlying the determination of the income, fairness between beneficiaries is identified and that the wishes of the settlor as expressed in the trust deed prevail in that determination. It is also clear from this and the cases referred to in the decision that trustees carrying on a business have considerable discretions in how they run the business and prepare the accounts. In reaching this decision the High Court

applies some previous Australian decisions, including of the High Court, to similar effect and also effectively disapproves of some earlier decisions.

The ATO seeks to confess and avoid so far as this and similar decisions are concerned. It accepts in a business context that income means a net amount but maintains that the accounts must be kept in accordance with accounting standards and is quite prescriptive in what is required in that regard. There is no support in the decisions for this approach and they are to the contrary in the sense that they recognise that the trustee has some discretionary latitude in how they run the business and prepare the accounts (though there are limits) and that the trust deed can require a different form of accounting in determining the income of the life tenant.

Kitto J and income as distributable income

In two decisions in 1969 and 1970 Kitto J expressed the views that income in section 97(1) meant distributable income and that income when first used in section 97(1) was different from net income. In *Taylor v Commissioner of Taxation* (1970) 119 CLR 444 the issue was whether infant beneficiaries were presently entitled to income of a trust under which accumulations went to the estates of the infants if they died before reaching majority. He held that they were presently entitled meaning a vested interest in possession and in doing so linked the issue to the rule in *Saunders v Vautier*. He also explained the somewhat confusing comments in *Whiting v Commissioner of Taxation* (1943) 68 CLR 199 concerning present entitlement. In subsequent cases the analysis of Kitto J has been accepted and often quoted. He said at 449, 452:

The appellants contend for the suggested interpretation of "presently entitled", and they say that by reason of the rule in *Saunders v. Vautier* the son, but for his disability from giving a discharge, could have required the trustees to disregard the trust for accumulation and pay the income in the relevant year to him. ...

The members of the Full Court [in *Whiting*] took a different view. Their Honours held that the provisions of the Act must be construed in the light of the general principles of law applicable to the administration of estates by executors and trustees, and that consequently the crucial question was at what moment of time, having regard to those general principles and to the provisions of the trust instrument, could it be said that a beneficiary had become presently entitled to a share in the income of a trust estate. The answer given was that only when the debts and liabilities, the annuity and the legacies had all been paid or provided for in full would it be possible to say that there was any income to which the residuary beneficiaries would be presently entitled. The point of difference between Rich J and the Full Court was, therefore, that the former thought that a beneficiary is "presently entitled" to the income produced by the trust estate if under the trust instrument he is "presently entitled to income of the estate" whatever be the stage that administration has reached, while the Full Court considered that a beneficiary is not "presently entitled" to any income of the trust estate unless the administration has reached such a point that an amount of income has become identifiable as being the subject of a present

interest in possession vested in him by the trust instrument. When their Honours spoke of the beneficiary having a right to obtain immediate payment, they could not have been referring to his legal capacity to give a discharge for the payment. Having regard to the point of difference from Rich J to which they were addressing themselves, I think it is clear that they were holding only that an admittedly vested interest in possession in the income of an estate does not make the beneficiary “presently entitled” to any income which is **not yet distributable**, and so is not yet specifically caught by the beneficiary’s interest. Notwithstanding a passage in the joint judgment of Latham CJ and Williams J (*Federal Commissioner of Taxation v Whiting* (1943) 68 CLR at 214-215) which I must own I do not altogether understand in view of the recognition by section 98 that a beneficiary may be “presently entitled” to income notwithstanding that by reason of a legal disability he has no right to obtain immediate payment, the tenor of the judgments is, I think, that “presently entitled” refers to an interest in possession in an amount of income that is **legally ready for distribution** so that the beneficiary would have a right to obtain payment of it if he were not under a disability.

It is clear from the decision that Kitto J accepted the view of the taxpayer about the operation of the rule in *Saunders v Vautier* in this context.

In the following year Kitto J made the comment in *Shute’s case* (1969) 119 CLR 177 at 186, 188:

At no time during the year was any beneficiary presently entitled to any part of the income of the estate (though a very small part of the income was in fact distributed to beneficiaries). This is so because “presently entitled to any part of the income of a trust estate” refers, not to the availability of any income for payment to him, but to a present title in possession in respect of any income the estate may produce; and in the present case the executorial duties had not been completed when the year ended. ...

The conclusion treats the three sections, 97, 98 and 99, as giving effect to a harmonious policy, those sections together dealing with three cases: where a beneficiary has a present title in possession to a share of the **income of a trust estate - not, be it noticed, to a share of the net income of a trust estate** - and is not under any legal disability (section 97); where a beneficiary has such a title but is under a legal disability (section 98); and where no beneficiary has such a title to any part of that income or there is a part of it to which no beneficiary has such a title (section 99).

Although the present concern was not in issue in either case, the view of Kitto J was that income is a reference to distributable income and that this was different from net income.

Cajkusic

In contrast to the cases relied on by the ATO which it is considered do not say anything clearly about the meaning of income in section 97(1), the Full Federal Court decision in *Cajkusic v Commissioner of Taxation* [2006]

FCAFC 164 is exactly on point for the current issue. The case involved a discretionary trading trust which entered into an employee benefit scheme under which the trust made large payments to an entity involved in the scheme for which it claimed tax deductions. The deductions meant that in each of the two relevant years there was a tax loss in the trust (that is, no net income). In the accounts of the trust prepared for and adopted by the trustee the payments were treated as expenses so that there was also no distributable trust income. Under the trust deed, the trustee had power:

To determine what amount or amounts shall be treated as income of the Trust Fund and what amount or amounts shall be treated as capital and generally to determine the treatment and characterisation of all receipts and payments by the Fund; and in particular to determine that the income of the Fund for the purposes hereof is an amount equal to “the net income of the trust estate” within the meaning of Section 95 of the Income Tax Assessment Act or some other amount calculated by reference to considerations governing or affecting the incidence of taxation upon the receipts and outgoings of the Fund.

The deductions were denied by the ATO and the taxpayers accepted that position with the result that there was considerable net income of the trust in each of the income years. The ATO claimed that tax on the net income was payable by the default beneficiaries under the trust deed. The default beneficiaries argued that as there was no distributable income, there was no income of the trust estate to which they were presently entitled under section 97(1) and the tax liability for the net income fell on the trustee under section 99A. While normally the ATO would be happy with that result as it collects tax at the maximum individual marginal rate on such income, in this case the trustee was a company that was in liquidation and little or no recovery of that tax was apparently expected.

The Full Federal Court (Kiefel, Sundberg and Edmonds JJ) in a unanimous joint judgment said in response to the ATO submission that allowing the trust deed to determine distributable income would enable taxpayers to define their way out of tax liability:

As evidenced by the financial accounts of the Trust for year ended 30 June 1998 (incorporating the comparative financial accounts for the year ended 30 June 1997), Intex, consistently with the power vested in it by cl 8(u) of the deed, treated the outgoings in question as being on revenue account. By the same clause, it had the power to effectively deny the outgoings that characterisation by determining that the income of the Trust for the year ended 30 June 1998 shall be its section 95 ‘net income’ for that year, but there is no evidence that it exercised that power.

... it does not follow that, because the instrument pursuant to which a trust estate is constituted spells out that the trustee has an absolute discretion as to what receipts are treated as income and what outgoings are treated as outgoings against that income for the purposes of determining the income for section 97 purposes – the distributable net income – you can define your way out of the application of the 1936 Act. Liability for tax on the section 95 ‘net income’ will fall where the 1936 Act intends it to fall. In other words, if there is no section 97 income – no

distributable net income – to which any beneficiary is presently entitled, then liability for the tax on any section 95 ‘net income’ will fall on the trustee under sections 99 or 99A of the 1936 Act. On the other hand, if there is any section 97 income to which beneficiaries are presently entitled, then any section 95 ‘net income’, whether it is greater or smaller than the distributable net income, will fall to be taxed in the hands of those beneficiaries in proportion to their respective shares of the section 97 income: See *Zeta Force Pty Ltd v FCT* (1998) 84 FCR 70 and the cases there referred to.

The ATO also relied on the view about business income discussed under the previous heading referring to *McBride v Hudson* and another High Court decision in similar terms. In response the Court said:

Once again, this case is concerned with the proper determination of the net distributable income – the section 97 income – and, in our view, it is made quite clear [in the High Court decisions on trust law income of a business carried on by the trustee] that in the determination of that amount, the terms of the trust instrument will prevail over any accounting principles that may otherwise be appropriate to the type of business being conducted.

Further the ATO relied on the passage in the *ANZ Savings Bank* case discussed above and in response the Court said:

At [13], his Honour had observed that the trust deed defined income – net distributable income – to mean the net income of the fund as defined in accordance with section 95 of the 1936 Act. Thus, the deductible amount (that part which was exempt income by virtue of the provisions of section 27H(1)(a) of the 1936 Act) was treated under the deed as capital and dealt with by a different clause of the trust deed than that which dealt with income as defined. So understood, the passage from the Chief Justice’s judgment at [15] was dealing with what was income in the hands of the trustee in the calculation of the ‘net income’ of the trust estate for the purposes of section 95 of the 1936 Act. The point the Chief Justice was making was that it was not possible by the terms of the trust deed to bifurcate a receipt in the hands of the trustee which was income according to ordinary principles, and therefore income for the purposes of calculating the section 95 ‘net income’, so that some part of that receipt was not income in calculating the section 95 ‘net income’. The Chief Justice was not, as the respondent’s submission would have it, saying that a provision of the trust deed could not prescribe what was a receipt on revenue account and what was an outgoing on revenue account for the purpose of determining the section 97 income, that is, the distributable net income.

Thus the Court clearly rejects three of the propositions that the ATO maintains in this area – that income in section 97(1) is income according to ordinary trust law concepts, that it is a gross concept not a net concept and that it cannot be altered by the provisions of the trust deed. As with the passages in some of the decisions discussed above, the use of the terms income and net income need to be scrutinised closely to see whether they refer to tax law character or trust law character. Moreover the term “net income” in quotes in the second last sentence seems on each occasion to

be used as a shorthand reference to tax law character rather than directly incorporating the definition of that term in section 95(1) because the deductible part of each annuity, being exempt income in tax law character could not enter "net income" as defined in section 95(1) which only includes assessable income (which is in turn defined not to include exempt income, see *Income Tax Assessment Act 1997* section 6-15(2)).

Finally so far as relates to the present issues of concern the taxpayers relied on a further argument that even if there were trust income, they were not presently entitled to it by reason of the trustee's right of indemnity. This is a variant of the issue that caused much of the discussion in the *Totledge* case above. After that case the issue had been raised squarely in the decision of Hill J in *Dwight v FCT* [1992] FCA 178, 37 FCR 178 which concerned an amount held by trustees as security for costs on behalf of a foreign plaintiff and subject to a charge or lien in favour of the defendant if costs were awarded to the defendant and the plaintiff did not otherwise pay them. The ATO argued that the existence of the lien meant that the plaintiff was not presently entitled to the income in the form of interest earned on the amount held by the trustees. Hill J noted:

Would it then follow that in each case where the trustee has assumed a personal liability for a trust debt not incurred in breach of trust, whether or not the debt is secured upon the trust assets, that no person is presently entitled to the income of the trust estate? The Commissioner's answer, presumably made on instructions, was in the affirmative. This affirmative response, which is contrary to the Commissioner's practice of at least half a century would, if correct, result in most trust estates in the country having no beneficiary presently entitled to the trust law income. Indeed, it would only be those trust estates where the trustee had no borrowings which would qualify. ...

He went on to hold that at the least the plaintiff had a vested and indefeasible interest in the income earned on the amount and that sufficed to satisfy the deemed present entitlement in section 95A(2). Just as in *Totledge*, the judge was not prepared to take a view that would render section 97 more or less superfluous and was somewhat mystified why the ATO wanted to take such a view. In addition to being contrary to 50 years practice, the ATO argument here was clearly contrary to the policy and history of section 97 outlined above.

Some comments made by the High Court in the *CPT Custodian v Commissioner of State Revenue* (2005) 224 CLR 98 were the basis of the argument made by the taxpayers in *Cajkusic* to similar effect. This case concerned Victorian land tax. To be liable to the tax a person had to be the owner of the land and the question was whether the sole holder of units in a unit trust that had legal title to land was the owner for land tax purposes when the trust deed provided that unitholders would not have any specific interest in any particular asset of the trust. The High Court among a number of reasons as to why they considered that the unitholder was not the owner of the land said:

the rule in *Saunders v Vautier* would not meet the case of the Deed considered in this litigation. In the Deed, the Manager covenanted with the Trustee (cl 23.4) to ensure that there were at all times sufficient

readily realisable assets of the Trust available for the Trustee to raise the fees to which the Manager and the Trustee were entitled under cl 23.1 and cl 23.2 respectively. These stipulations made the Trustee and the Manager interested in due administration of the trusts of the Deed, in the sense identified by Kearney J in *Moses Montefiore*. Put somewhat differently, the unit holders were not the persons in whose favour alone the trust property might be applied by the trustee of the Deed. ...

The classic nineteenth century formulation by the English courts of the rule in *Saunders v Vautier* did not give consideration to the significance of the right of the trustee under the general law to reimbursement or exoneration for the discharge of liabilities incurred in administration of the trust. In *Wharton v Masterman*, Lord Davey approached the rule in *Saunders v Vautier* from the viewpoint of the law respecting accumulations of income for an excessive period; if no person had any interest in the trust other than the legatee, the legatee might put an end to the accumulation which was exclusively for the benefit of that person and as a result there was no effective or enforceable direction for any accumulation. However, his Lordship's discussion of the authorities does indicate that the rule in *Saunders v Vautier* could not apply if, by reason of the charging of legacies on the fund and accumulations, the persons seeking to put an end to the accumulations were "only entitled to an undetermined and uncertain surplus (if any) which might be left of the fund after payment of the legacies".

In the present case, the unsatisfied trustees' right of indemnity was expressed as an actual liability in each of the relevant accounts at each 31 December date and rendered applicable the sense of the above words of Lord Davey. Until satisfaction of rights of reimbursement or exoneration, it was impossible to say what the trust fund in question was.

In response to the argument of the taxpayers based on this passage the Full Federal Court in *Cajkusic* said:

In the circumstances, it is not necessary to consider the second of the applicants' arguments ..., namely, that Intex's right of indemnity and exoneration as trustee precluded any beneficiary having any entitlement to any income of the Trust for the 1998 year. However, in passing we would merely observe that this submission, which appears to have its origin in what fell from the High Court in *CPT Custodians Pty Ltd* conflates two totally different concepts – present entitlement to an amount equal to the income of the fund (not to any particular asset vested in the trustee) on the one hand and the trustee's right to resort to such assets to meet liabilities on the other. This latter right of the trustee would not seem to impact on the beneficiary's present entitlement.

The Court did not repeat the comments of *Totledge* and *Dwight* about the effect that this argument would have on the operation of section 97 if successful and did not have to decide the issue but it is clear that they would take a similar view to the earlier cases, and it is considered that the view expressed in the passage just quoted is correct.

The main significance of this passage is, however, the light that it throws on the ATO view of what was decided in *Cajkusic*. The ATO has suggested a contorted, and it is considered untenable, explanation given that the decision is so strongly against the views that the ATO holds on the meaning of income in section 97(1). In its decision impact statement the ATO states

In various places in their reasons their Honours spoke of the '*income of the trust estate*' as being the '*net distributable income*' (eg, paragraph 18, paragraphs 27-30 and paragraph 34). The Commissioner does not understand the Full Court to have meant these comments in the sense that the '*net distributable income*' of the trust was, as a matter of principle, to be substituted directly for the words used in the statute; rather, the '*net distributable income*' was to be used in determining whether the beneficiaries were presently entitled to the '*income of the trust estate*' .

The expression '*presently entitled to a share of the income of the trust estate*' is a composite expression, the meaning of which depends upon the application of authorities concerning '*present entitlement*' and those concerning '*income of the trust estate*'

Notwithstanding some broad observations made by their Honours about the effect of trust instruments (eg, paragraphs 18 and 27 - 30), the question before them did not involve the characterisation of a receipt and, unlike some commentators, the Commissioner does not understand the case to be authority for the proposition that the terms of a trust instrument can govern what is income, for the purposes of subsection 97(1), in the hands of the trustee.

In effect the ATO is saying that the decision as set out above is entirely on present entitlement and says nothing as to the meaning of income in section 97(1). With respect that is simply not correct. The first part of the decision was directly on the meaning of income. It is only the argument that the Full Federal Court felt it did not have to decide which is on the meaning of present entitlement.

One might wonder why the ATO insists so strongly on such an unlikely view of what the court decided. It would not seem to matter to the result under section 97(1) whether the terms of the trust deed are accepted as affecting the "income" or the "presently entitled" part of the section and so achieves nothing in terms of the operation of the section. The reason for this odd ATO view has to do with a matter which was considered in passing by the Full Federal Court in *Cajkusic* but came on the Commissioner's unsuccessful application for leave to appeal to the High Court to be the most important issue.

This issue is the operation of section 101 which provides that if the trustee in accordance with a power to do so applies income of the trust estate for the benefit of a beneficiary, the beneficiary is deemed to be presently entitled to that income. In this section the concepts of income and present entitlement have been separated and the ATO argues that if any of the gross income is in fact paid to a beneficiary (even it seems if it is paid in another capacity), then present entitlement to that income is deemed and section 97 operates accordingly. The argument was rejected in *Cajkusic* as follows:

In his written submissions the respondent submitted that because the contributions to the employment benefit trust ultimately finished up in the hands of some, if not all, of the beneficiaries, the provisions of section 101 of the 1936 Act were triggered and that such beneficiaries were deemed to be presently entitled to the amounts paid or applied for their benefit. This particular submission was not run below and was not, understandably, pressed during the hearing of the appeal. Underlying this submission is the predication that what was contributed to the employee benefit trust was paid out of gross income and that as this finished up, via the employee benefit trust, in the hands of some, if not all, of the beneficiaries, this was sufficient for the purposes of triggering the provisions of section 101. The predication is flawed. ...

The reference to 'income of a trust estate' in this section is a reference to the distributable net income; that is, the same income to which section 97 refers. If, as in the present case, there is no distributable net income then, even where the trust instrument gives the trustee a discretion in terms of the section, there is nothing in respect of which it can be exercised. The only provision of the deed conferring on Intex a discretion in terms of section 101 is cl 3(a)(i), and all the references to 'income' is cl 3 of the deed are clearly references to the distributable net income.

In the application for leave to appeal both the meaning of section 97(1) and section 101 were raised but the main focus was on section 101. By a two to one majority the High Court denied leave and said in a brief ex tempore statement:

The actual decision of the Full Court of the Federal Court is, in our opinion, not attended by sufficient doubt to warrant a grant of special leave. The applicant criticises some particular aspects of the Full Court's expression of its reasons. The particular manner of expression of those reasons presents no point of principle calling for consideration by this Court.

Accordingly it is considered that the present state of authority on the issues under discussion is provided by the Full Federal Court decision in *Cajkusic* and, moreover that decision is consistent with the existing authorities at all court levels in Australia.

Carver v Duncan

In support of its view that the trust deed cannot change the meaning of income in section 97(1), the ATO also draws support from the House of Lords decision in *Carver v Duncan* [1985] STC 356 and comments by the late Professor Parsons on the decision who are also called in aid for the proposition which finds no support in the court cases discussed above that trust law income according to ordinary concepts is the same as tax law income according to ordinary concepts.

The decision concerned the UK higher rate of tax applied to accumulation trusts and the relevant section provided that the tax applied to "income arising to trustees ... so far as it ... (d) exceeds the income applied in defraying the expenses of the trustees in that year which are properly

chargeable to income (or would be so chargeable but for any express provisions of the trust).” It was held by a majority of four to one that various expenses which the trust deed directed to be paid out of income did not reduce the amounts subject to additional tax under the provision. The terms of the section would seem inevitably to lead to that result for if the expenses were otherwise chargeable to capital (which it was held they were), then the trust deed could not affect that result for tax purposes because the section expressly said so. The case is thus distinguishable from the section 97(1) context in a number of ways – the case is dealing with expenses, not income and the section directs the trust deed to be disregarded. Nonetheless some very broad propositions of trust law are stated in the leading judgment of Lord Templeman as follows:

Trustees are entitled to be indemnified out of the capital and income of their trust fund against all obligations incurred by the trustees in the due performance of their duties and the due exercise of their powers. The trustees must then debit each item of expenditure either against income or against capital. The general rule is that income must bear all ordinary outgoings of a recurrent nature, such as rates and taxes, and interest on charges and incumbrances. Capital must bear all costs, charges and expenses incurred for the benefit of the whole estate. ... Now although a settlor may provide that capital expenses shall or may be paid out of income, the settlor cannot alter the nature of those expenses. The exercise of an express power or duty to pay capital expenses out of income, has the effect of taking away income from the income beneficiaries and bestowing it on the capital beneficiaries, so that capital is augmented. ... This only means that a capital expense is paid out of income because the settlor so provided. Similarly, a settlor cannot alter the nature of an income expense by authorising or directing the trustees to pay that expense out of capital. ... This only means that an income expense is paid out of capital because the settlor has so provided.

On this basis he construed the part of the statute quoted above which refers to the trust deed in brackets as simply explanatory of the earlier phrase “properly chargeable to income”. This was too much for Lord Diplock who regarded it as rewriting the statute. He points out that the earlier part of the same provision referring to income which is to be accumulated could only be determined by reference to the trust deed and he thought consistently with that the trust deed could change the nature of an expense and the section ensured that this did not affect the amount of tax payable.

The approach in *Carver v Duncan* has recently been followed as binding in *Revenue and Customs Commissioners v Trustees of the Peter Clay Discretionary Trust* [2008] STC 928 which highlights the problems it causes in a modern trust setting and the kinds of difficulties referred to under the heading above General difficulties in ATO view (such as where this immanent character is derived, and how can it be derived in cases where the law confers some discretion of allocation).

It is very difficult to reconcile the broad absolute propositions of Lord Templeman in *Carver v Duncan* with the Australian cases analysed above, including several in the High Court of Australia. The House of Lords decision seems generally to be ignored in the Australian cases – it seems

only to have been quoted for the unexceptionable proposition that a trustee is entitled to be indemnified for properly incurred expenses which starts the quotation from Lord Templeman above (see *Wendt v Orr* [2004] WASC 28, *O'Brien v McCormick* [2005] NSWSC 619) and for the points on statutory interpretation generally in the dissenting judgment of Lord Diplock.

So far as leading texts are concerned, the general propositions about allocation of expenses in the decision are quoted but it is recognised that the trust deed can change this and the explanation given for such cases by Lord Templeman in the quoted passage does not seem to be adopted, see Ford & Lee, *Principles of the Law of Trusts* [11250], [11260], Underhill & Hayton, *Law of Trusts and Trustees* (17th ed 2006) 51.1, 51.2, 51.16-51.19 where it is treated only as a prima facie rule subject to alteration by the trust deed.

In one sense it might be regarded as merely a matter of language as to whether a discretion in the trustee or direction in the trust deed changes the character of an amount or whether it simply changes the incidence of whether the benefit or burden enures to the income or capital beneficiary. For the issue under discussion, however, the point is critical and as noted above the Australian cases and the major texts are clear that the character of amounts as income may be changed by the trust deed or the exercise of trustee discretions.

Parsons accepts that *Carver v Duncan* stands for the view that the trust deed cannot change the meaning of income but he recognises that that this is a newcomer on the scene and contrary to many previous pronouncements (Parsons, "Income Taxation: An Institution in Decay" (1986) 3 *Australian Tax Forum* 233 at 239-240). In the same article he suggests that the meaning of income in tax law is derived from trust law and may go so far as to say that they are identical, see at 238-239, though he notes at 240 that this was only a matter of assumption in *Carver v Duncan*.

With profound respect to the great professor, the view that income according to ordinary concepts is the same as trust law income according to ordinary concepts is simply incorrect. It is undoubtedly true that trust law has had an influence on the tax law meaning as Parsons shows, but in the UK income is and always has been the subject of detailed description under many schedules which have changed significantly over the years and there is no evidence that they in the past or currently are identical to or reflect the precise meaning of trust law income, see Prebble, "Income Taxation: A Structure Built on Sand" (2002) 24 *Sydney Law Review* 301.

In particular, in the UK profits from a trade or business is taxed on a net basis under Schedule D Case 1 and the meaning of this schedule is drawn largely from accounting profit principles rather than trust law which is ignored entirely in *Carver v Duncan*. Not surprisingly Professor Parsons regards the case of *McBride v Hudson* as revolutionary for drawing trust income concepts for business from flexible accounting principles and the trust deed but that decision reflects the trend in Australia not an isolated exception. It should be noticed that these comments were made in a context where Professor Parsons was pursuing a particular point – that the income concept is incoherent. In such a context expressions about the meaning of

income cannot be taken too seriously given the clear polemical intent of the discussion.

It is considered that the views in *Carver v Duncan* and Professor Parsons' article do not represent the meaning of trust law income in Australia and are not consistent with the Australian authorities on income as used in section 97(1).

Bamford

The AAT decision in this case [2008] AATA 322 is currently on appeal to the Full Federal Court and its outcome may have an effect on the analysis here. The main question in *Bamford* is the long standing issue of whether section 97(1) where it refers to "that share" is adopting what are referred to as the proportionate view or the quantum view. Under the proportionate view the trust law income is used to derive a proportion of income to which a particular beneficiary is presently entitled and then that proportion or fraction is applied to the net income. Under the quantum view as argued in *Bamford* in the Federal Court, if the entitlement of a beneficiary is expressed in terms of a fixed dollar entitlement to trust income, that same amount is all of the net income which can be taxed to the beneficiary.

The case concerns an off-shore superannuation scheme which it was accepted was not successful for tax purposes so that deductions for large contributions to the scheme and related interest expense were not allowable in relation to two income years, thus increasing the net income. In the second year in issue the main assessable income of the trust was a capital gain on a sale of property for which the CGT discount was claimed. The AAT supported the proportionate view and upheld its application to the beneficiaries in relation to the first year.

In relation to the second year the AAT reasoned as follows:

12. It was accepted by the Applicants, in respect of the Trust Deed constituting the Trust, that the term "income" is not a defined term; the Respondent contended, correctly in our view, that it must be construed so as to mean income in accordance with ordinary concepts. ...
38. Clause 7(n) of the Trust Deed furnishes the Trustee with discretion to determine whether a given receipt should be treated as income or as capital. ...
39. As set out previously in these reasons, the evidence before the Tribunal does not indicate that the Trustee did in concrete terms make a determination to that effect. Mr Cammarata referred at some length to AAS 15 and said that in accordance with accounting standards, the capital gain was treated as revenue and for these reasons was not credited to a capital reserve. Mr Cammarata did not in his affidavit indicate whether or not he acted on his instructions from the Trustee and he did not state that he treated the capital gain as income. Income and revenue are different concepts.
40. The relevant resolution referred to a distribution of "income including capital gain". That statement is prima facie ambiguous. It

could be read as indicating a recognition of the fact that the capital gain constituted a separate and distinct item or, in the alternative, it could be construed as indicative of the fact that in accordance with clause 7(n) of the Trust Deed it has been categorised as trust income. Mr Young contended that at least implicitly the Trustee had categorised it as income in accordance with clause 7(n) of the Trust Deed. The wording involved is not clear but on balance we are inclined to the view that the contention by Mr Young should be accepted; the use of the word “including” in this context favours this interpretation, although one might in that event have expected some reference to that determination in the affidavit by Mr Cammarata. His evidence was that the capital gain was revenue, which, as we said previously, is not the same as income.

41. It is important to remember that the term “income” as set out in the Trust Deed is not defined and so it must be construed so as to refer to income according to ordinary concepts. Tax law has for centuries recognised the distinction between a capital gain and income, most often in the context of the respective rights of the life tenant and remainderman in relation to an estate.
42. It is conceivable that if a Trust Deed had contained a definition of “income” which had the effect that trust income and tax income were the same, the term “income” might without reference to clause 7(n) of the Trust Deed include gains of a capital nature. There are comments in the Full Federal Court decision in *Cajkusic* (obiter), which suggest that this may be so. Clause 7(n) of the Trust Deed provided for just such treatment but only in default of a determination and as set out previously we have accepted that the resolution should implicitly be construed as a determination in accordance with that clause. But the fact that pursuant to a deed something which is not income is re-determined as such does not have the effect that it is income (and more particularly trust income) within section 97 of the Act.
43. In *Federal Commissioner of Taxation v Totledge Pty Ltd* (1982) 12 ATR 830 (“*Totledge*”) at page 838 the judges held:

... the preferable construction of section.97(1) is to treat the requirement of present entitlement to a share of the income of the trust estate as not being concerned with distinctions between gross income as derived and ‘surplus income’ after payment of costs, expenses and outgoings but as referring to a present vested right to demand and receive payment of the whole or part of what has been received by the trustee as income and, retaining that character in his hands, is legally available to be distributed to those entitled to it as beneficiaries under the trusts of the relevant trust estate (emphasis added). ...
44. We agree with the Respondent’s contention that a present entitlement to a share of the trust income is a present vested right to demand payment of what has been received by the Trustee with the character of income and, retaining that character, is distributed as such. It is not a present vested right to demand and receive

payment of a capital receipt redefined by the terms of the Trust Deed as income of the Trust Deed and distributed as such.

45. The Respondent's contention, as set out in the preceding paragraph, is supported by the decision in *Commissioner v ANZ Savings Bank Ltd* (1998) 194 CLR 328 ("ANZ"); we refer to (and approve) paragraph 21 of the Respondent's written submissions reading as follows:
 21. This is supported by the reasoning of the High Court in *Commissioner of Taxation v ANZ* (1998) 194 CLR 328. In that case, a partnership borrowed money to invest in units in a unit trust which used the funds to purchase an annuity. Under section 27H of the Act, the amount of an annuity payment included in assessable income is the total amount of the annuity less the 'deductible amount' (ie the purchase price of the annuity) allocated to each annuity payment on a pro-rata basis. The deductible amount is exempt income for the purposes of the Act. The Commissioner disallowed part of the deduction claim on the ground that some of the interest had been incurred for the purpose of gaining or producing exempt income. The taxpayer argued that the terms of the trust deed treated the deductible amount of the annuity as capital held on trust for the unit holders. The High Court expressly adopted what had been held by the Full Federal Court on this issue. The High Court and the Full Federal Court both held that the annuity instalments paid to the trust contained no element of capital although the instalments could be treated as such by the terms of the trust. The income character was retained for the purposes of section 97 – that is, the whole of the annuity amount was income of the trust estate within the meaning of section 97 notwithstanding that part of the amount was treated as capital under the deed. Hence there was a present entitlement to the whole of the annuity amount. Gleeson CJ (with whom all the other members of the Full Court of the High Court agreed) at p 337 line 15 stated that what the trust deed provided for did not alter the law's characterisation of the whole of an annuity payment as constituting income (citing *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598 at 608): ... For the reasons earlier given, the whole of the annuity amounts received by the trustee constituted income of the trust. The circumstance that the trust instrument, for the purpose of dealing with the entitlements of unit holders, treated the deductible amount as capital, did not alter what was described in *Charles v FCT* [(1954) 90 CLR 598 at 608] as "the character of those moneys in the hands of the trustees".
46. We also accept the Respondent's contention that the terms of a trust deed cannot alter the character of a receipt in the hands of a trustee. Put in other words, the fact that a trustee (having the power to do so) elects to treat a capital gain as income in order to distribute it to a beneficiary will not alter its character as capital in

the hands of the trustee. It will be a capital receipt in the hands of the trustee even though the trustee may be entitled to treat it as income for the purposes of distribution. The fact that beneficiaries may have rights against the trustee based on his decision to distribute a capital gain in a particular manner will not have the effect that the provisions of the Act are to be interpreted differently. As set out previously in these reasons, the position might (and see in particular paragraph 47 below) be different if the Trust Deed defined trust income as equivalent to tax income, but it is not necessary for us to decide whether that is so.

47. There was during the hearing considerable discussion of the decision of the Full Federal Court in *Cajkusic*, which suggests, but obiter, that in the determination of income for the purposes of section 97 of the Act the terms of the Trust Deed might take precedence; (see clause 22 at page 437). In *Cajkusic* the Full Federal Court was not concerned with the issues which here concern the Tribunal. In *Cajkusic* deductions were claimed but were not allowed for tax purposes. The effect of that decision was that the deductions claimed were nevertheless deductible in the computation of the trust income. In the result, and because there was no trust income, there were no beneficiaries presently entitled, so that an assessment against default beneficiaries could not be sustained. It does not seem that the Full Federal Court in *Cajkusic* either considered or needed to consider *Totledge* and *ANZ*. The Respondent contends (correctly in our view) that in the factual circumstances of *Cajkusic*, the conclusion reached is consistent with the principles applied in *Totledge*.

It will be apparent that this passage accepts more or less in their entirety the views of the ATO which have been discussed previously. It is considered that the analysis is incorrect for the reasons elaborated above, in particular it misreads the *Totledge* and *ANZ* cases and is not consistent with much of the other case law in Australia on this issue, particularly the decision in *Cajkusic* by which the AAT was bound. Moreover the decision that the trustee did not exercise its power to determine that the receipt was revenue seems directly contrary to the factual finding in *Cajkusic* on the basis of the accounts of the trust as quoted earlier.

When the Full Federal Court releases its decision obviously it may have a significant impact on what the current law on the meaning of income in section 97(1) is in Australia, though it may not be the final word.

General Conclusion

The general conclusion of this analysis is that Australian case law and the income tax statute itself strongly supports the view that income in section 97(1) means trust law income as determined under trust law. Under that law, the concept is a mixture of case law and statutory default rules, the definition of the concept in the trust deed and the exercise of any relevant trustee discretions. It is considered that only the first of the four ATO propositions as to the meaning of the term is correct and then only partially so – that income in section 97(1) is a reference to trust law not to tax law

(on which both sides of the debate agree) while propositions 2-4 are incorrect. Moreover the view preferred here is consistent with the policy and history of both trust and tax law in relation to the taxation of trusts and this is a matter which must be taken in to consideration under modern principles in interpreting a statute like the income tax legislation.

In determining the effect of this conclusion in a particular case it will be necessary to have regard to trust case law, statute law on trusts (including the *Corporations Act 2001* so far as applicable), the trust deed and the exercise of any relevant duties or discretions of the trustee. As this will very much depend on the particular circumstances of the case (for example, what is the governing law of the particular trust, what are the terms of the trust deed, what if anything do trust/trustee statutes or the *Corporations Act 2001* have to say on the issue), it is difficult to go further in the abstract. As a general proposition it may be stated that in the case of public unit trusts, the matter will generally be determined by the trust deed and the exercise of discretions or powers legally available to the trustee, subject to the duty of the trustee to treat the members who hold interests of the same class equally and members who hold interests of different classes fairly and to the general duties imposed on trustees which mean that there will be some broad limits on what trustees can do under apparently unfettered powers.

As a final comment in support of this conclusion it should be noted that the view of the High Court as expressed in the recent cases of *CPT Custodians* and *Raftland* is that the terms of the trust deed have particular significance in resolution of both trust and tax law matters.

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