

Distributable trust income

CAJKUSIC HAS CLARIFIED A NUMBER OF CONTROVERSIES CONCERNING A TRUST'S DISTRIBUTABLE INCOME. WE WAIT TO SEE WHETHER THE HIGH COURT WILL TAKE THE OPPORTUNITY TO PROVIDE FURTHER CLARIFICATION.



INTRODUCTION

In 1978 and 1979 Grbich, Munn and Reicher and Mark Leibler published their views regarding the taxation of trusts¹ which addressed whether:

- the “proportionate approach” or “quantum approach” applied to allocating the net income of a trust; and
- the term “net income of the trust estate” referred to “trust accounting income” or “trust income” for the purposes of ss 97 and 98 of the Income Tax Assessment Act 1936 (ITAA 1936).

Since then, *Zeta Force*² has clarified that the proportionate approach applies to allocating the net income of the trust and *Richardson*³ has clarified that the trust instrument may grant the trustee extensive powers to classify and reclassify distributable income.

In substance, a beneficiary is taxed on a share of the **net income** of the trust estate (“net taxable income”) in the same proportion as the beneficiary’s present entitlement to **a share of the income of the trust estate** (“net distributable income”).

Despite *Zeta Force* and *Richardson*, there has continued to be controversy regarding:

- the correct interpretation of the term “share of the income of the trust estate” for the purposes of ss 97 and 98 ITAA 1936;
- the ability of the trustee to classify or reclassify income as capital due to statements in *ANZ Savings Bank*;⁴
- the effectiveness of a trust instrument definition of “net income” which deems net distributable income of the trust to be the same as net taxable income under s 95 ITAA 1936;

- the correct allocation of expenses against income or capital and classes of income or capital; and
- the obligations of trustees to recoup carried forward accounting income or capital losses from subsequent years income and capital receipts.

*Cajkusic*⁵ has discussed and addressed these issues. The Commissioner of Taxation (“Commissioner”) has applied for special leave to appeal the decision. This article discusses the impact of the Full Federal Court’s decision on distributable income.

CAJKUSIC

In *Cajkusic* a discretionary trust claimed a \$205,425 and a \$197,125 income tax deduction for employee benefit trust contributions and implementation costs for the 1996/97 and 1997/98 income years respectively. Due to these deductions, the discretionary trust had a revenue loss of \$54,838 and accumulated revenue loss of \$26,141 for the 1996/97 and 1997/98 income years respectively. If the trustee was not required to recoup the accumulated loss for the 1997/98 income year, then the discretionary trust would have had a \$28,697 net distributable income.

The Court confirmed that:

- the contributions and implementation costs were not allowable deductions for tax purposes;
- the trust had an accounting loss of \$54,838 and an accumulated accounting loss of \$26,141 for the 1996/97 and 1997/98 income years respectively;
- the trust was obliged to recoup accounting income losses before determining if the trust had any net distributable income;

- the trustee had not exercised its discretion to reclassify distributable income to be the same as net taxable income under s 95 ITAA 1936 so that the trust had a net distributable income amount for the 1997/98 income year, before the carry forward losses of the previous year;
- the trust had additional net taxable income of \$205,425 and \$197,127 for the 1996/97 and 1997/98 income years respectively; and
- there being no net distributable income of the trust for either the 1996/97 or 1997/98 income years, the trustee was liable for tax on the net income under s 99A ITAA 1936.

The above result is uncontroversial. However, the Court made several interesting statements regarding the ascertainment of net distributable income for the purposes of s 97 ITAA 1936.

PROPORTIONATE APPROACH

The structure of Div 6 ITAA 1936 is to tax a beneficiary that is presently entitled to the taxable income of a trust (ss 97 and 98 ITAA 1936). Should a beneficiary not be presently entitled to part or all of the income, the trustee is taxed on that income (ss 99 or 99A ITAA 1936).

Section 97 ITAA 1936 states:

97 Beneficiary not under any legal disability

(1) ...Where a beneficiary of a trust estate who ...is presently entitled to a share of the income of the trust estate:

(a) the *assessable income* of the beneficiary shall include:

(i) so much of that share of the *net income* of the trust estate as is attributable to a period when the beneficiary was a resident; and

In substance, a beneficiary is taxed on a share of the net taxable income of a trust in the same proportion as the beneficiary's present entitlement to the trust net distributable income.

Zeta Force settled the position in favour of the proportionate approach differentiating between "net taxable income" and "net distributable income" in the following terms:

The contrast between the expressions "share of the income of the trust estate" and "that share of the net income of the trust estate" shows that the draftsman has sought to relate the concept of present entitlement to distributable income and not to taxable income, which is, after all, an artificial tax amount. Once the share of distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate.

That construction of s 97(1)(a) seems reasonably clear to me, although it may, as I have indicated, result in unfairness to beneficiaries.

Cajkusic has confirmed the proportionate approach.⁶

Practice Statement PS LA 2005/1 (GA): "Taxation of capital gains of a trust" has accepted the proportionate approach, but has sought to provide an administrative quantum approach solution to any anomalous tax results arising from the proportionate approach of interpretation. The validity of the administrative quantum approach is questionable in light of the above clearly stated case law authority.

The NTLG Losses and CGT subcommittee (7 June 2006) minutes notes that the Commissioner has recommended legislative changes to Treasury to reflect the Commissioner's views in PS LA 2005/1 (GA).

Subsequent debate has concerned the concept of "distributable income".

DISTRIBUTABLE INCOME

Timing differences (such as depreciation and prepayments) or permanent differences (such as non-deductible entertainment and fines) and inclusion of statutory income (such as taxable capital gains, imputation credits, deemed distributions under personal exertion rules) will vary taxable income from accounting income under generally acceptable accounting principles (GAAP).

At trust law, receipts are traditionally characterised as "income" or "capital" depending on the class of beneficiaries entitled to receive a distribution. Traditionally, income beneficiaries could only receive income in a non-revenue sense and capital beneficiaries could only receive corpus (capital in a non-revenue sense). Modern trust instruments usually permit corpus to be re-characterised as income to permit distribution of corpus to the income beneficiaries. Similarly, income can be re-characterised as corpus and accumulated to permit distribution of income to the capital beneficiaries.

Accordingly, distributable income could be either ordinary income as detailed in GAAP or GAAP as modified by the trust instrument (such as by allocation of capital to income beneficiaries).

Richardson arguably settled the position that distributable income means GAAP as modified by the trust instrument in the following terms:

30. As Finkelstein J noted, the definition of "income" is an inclusive one. Thus, his Honour observed as follows [at 4062]

"...Accordingly, subject to certain qualifications..., the income of the trust includes that which is regarded as income according to ordinary principles. In addition, the trustee can decide that any other receipt shall form part of the income of the trust, whether or not that amount is income according to ordinary principles."

33. Clause 3 governs the way in which the trustee is to deal with the income of the trust. As Finkelstein J observed [at 4063]:

"...For that purpose income will comprise income according to ordinary principles, except to the extent that a determination under cl 7(m) changes that position, plus any amount determined to be income under cl 1(9), minus any sum that the trustee has determined to be capital gain under cl 6(h)."

Richardson arguably only concerned reclassification of capital as income and did not address reclassification of income as capital or allocation of deductions in determining distributable income.

ANZ Savings Bank may have cast doubt over whether a trustee could reclassify income as capital.

The NTLG Losses and CGT subcommittee (7 June 2006) minutes recognise these uncertainties. The minutes state that the trust consultative group will review the definition of income of the trust estate in s 97 ITAA 1936 and the impact of *ANZ Savings Bank*, *Richardson*, and *Zeta Force*.

Cajkusic has arguably clarified these issues.

In *Cajkusic*, the Commissioner, citing *ANZ Savings Bank* and other cases, argued that a trust instrument could not modify distributable income as to permit this would result in the interpretation of s 97 ITAA 1936 being dependent on the terms of the trust instrument. The Court held:

21 ...The submission is flawed for a number of reasons.

22 First, 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 s 97 purposes – the distributable net income – you can define your way out of the application of the 1936 Act...

28 The passages in the first case relied upon, *ANZ Savings Bank*, is concerned with a totally different matter.

29 The point the Chief Justice was making [in *ANZ Savings Bank*] 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 s 95 "net income", so that part of that receipt was not income in calculating the s 95 "net income". The Chief Justice was not, as the [Commissioner'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 s 97 income, that is, the distributable net income.

Accordingly, *Cajkusic* has clarified that a properly drafted Trust Deed can permit the trustee to reclassify capital as income and income as capital.

Division 2A of Part III ITAA 1936 contained former ss 49 and 50 ITAA 1936 which required outgoings to be deducted from classes of income in a particular order.

49 Successive Deductions

Where by this Act it is provided that any deduction shall be made successively from 2 or more classes of income, the deduction shall be set off against the income of the first of those classes, and if it exceeds the income of that class the excess shall be set off against the income of the second class, and so on until either the deduction or the income of the last of those classes is exhausted.

50 Deductions in case of composite incomes

(1) Where the assessable income is derived from more than one of the following classes of income, that is to say, income from *personal exertion*, income from *property other than dividends*, and *income from dividends*, the following provisions shall apply to all allowable deductions:

(a) where a deduction or part of a deduction relates directly to *income from dividends* (whether of the year of income or of a previous year of income) the deduction or part of the deduction, as the case requires, shall be made successively from *income from dividends*, from *income from property other than dividends* and from income from *personal exertion*;

(b) where a deduction or part of a deduction relates directly to the income from *property other than dividends* (whether of the year of income or of a previous year of income) the deduction or part of the deduction, as the case requires, shall be made successively from income from property other than dividends, from income from dividends and from income from personal exertion; and

(c) *in all other cases*, the deduction or part of the deduction shall be made successively from income from *personal exertion*, from income from *property other than dividends* and from *income from dividends*.

(2) This section applies to a non-share dividend in the same way as it applies to a dividend.

The operation of ss 49 and 50 ITAA 1936 and the terms of modern trust instruments has been unclear. *The Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* (Cth) has repealed the provisions. Accordingly, the trust instrument will determine the procedure for allocating outgoing against income.

Cajkusic has clarified that a properly drafted trust instrument can permit the trustee to determine the preferred allocation of outgoing against that income or capital.

DEEMING DISTRIBUTABLE INCOME TO BE TAXABLE INCOME

Many modern trust instruments define income of a trust estate as follows:

“income” means the net income of the Trust Fund for an Accounting Period calculated in accordance with s 95(1) of the ITAA 1936

This drafting practice is an attempt to reclassify “income” and “capital” for trust purposes to equate net distributable income to net taxable income to avoid any mismatch between the two under the proportionate approach. It has been unclear whether the above clause would be effective to perform the necessary reclassification.

In *Cajkusic* the trustee had a discretion to equate net distributable income with net taxable income, but the provision was not mandatory. On appeal, the Court overturned the Tribunal’s earlier decision that there had been an effective reclassification of capital as income increasing the distributable income so there was an amount to which a beneficiary was presently entitled. However, the Court held that:

18. ... There may be some circumstances where such consequences would follow. For example, where a provision of the relevant instrument pursuant to which a trust estate is constituted mandates that the distributable net income of a year shall be the amount that is the s 95 “net income” of that year (see *Commissioner of Taxation v ANZ Savings Bank Ltd* (1998) 194 CLR 328 at [29] *infra*), but there is no such provision in this case.

Accordingly, *Cajkusic* has clarified that a properly drafted clause would be effective.

RECOUPMENT OF LOSSES

It has arguably been unclear whether prior year accounting losses must be recouped before appointing income for the current year. *Case 7/2001*⁷ held that a revenue loss must be recouped out of profits in subsequent years, subject to any contrary provision in the trust instrument. While *Case 7/2001* and the cases cited do not expressly refer to capital losses, the Tribunal infers that capital losses need not be recouped.

In *Cajkusic* the Court held that losses in one year must, in the absence of any contrary direction in the trust instrument, be made up out of profits of subsequent years and not out of capital so that there can be no income properly distributable until all past losses are paid.

CONCLUSION

Cajkusic is an important case as it has:

- confirmed *Zeta Force* that the proportionate approach applies to trust distributions;
- confirmed *Richardson* that the term share of the income of the trust estate means GAAP as modified by the trust instrument;
- confirmed *Richardson* that a properly drawn trust instrument can permit the trustee to reclassify capital as income when determining distributable income;
- confirmed that *ANZ Savings Bank* does not prohibit a properly drawn trust instrument from permitting the trustee to reclassify income as capital when determining distributable income;
- confirmed that a properly drafted trust instrument can permit the trustee to determine the preferred allocation of outgoing against that income or capital; and
- confirmed that a properly drafted trust instrument can permit the trustee to determine the preferred allocation of outgoing against income or capital.

We await the High Court special leave application in *Cajkusic* to see if the High Court take the opportunity to further clarify the above matters.

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Reference notes

- 1 Y. Grbich, G. Munn and H. Reicher, *Modern Trusts and Taxation, Commercial Law in Context Series*, 1978 and M. Leibler, “Distributions of Trust Income – Some Selected Problems”, *Tax Essays Volume 1*, Butterworths, 1979.
- 2 *Zeta Force* (1998) 39 ATR 277; 98 ATC 4681.
- 3 *Richardson* (2001) 46 ATR 285; 2001 ATC 4,058 (Federal Court); (2001) 48 ATR 101; 2001 ATC 4,621 (Full Federal Court).
- 4 *ANZ Savings Bank* (1997) 36 ATR 230; 97 ATC 4,461 (Full Federal Court), (1998) 39 ATR 419; 98 ATC 4,850 (High Court).
- 5 *Cajkusic* (2006) 62 ATR 1,091 (AAT) [2006] FCAFC 164 (Full Federal Court).
- 6 *Cajkusic*[2006] FCAFC 164 at [22]
- 7 *Case 7/2001* (2001) 48 ATR 1200; 2001 ATC 150.