

Continuing controversy post *Cajkusic*

For many tax professionals the Full Federal Court's decision in *Cajkusic* followed by the High Court's rejection of the Commissioner's application for special leave to appeal appeared to clarify a number of contentious issues regarding the taxation of the income of trusts. However the decision impact statement released by the Commissioner on 12 September 2007 has again clouded the issue.

INCOME-CAPITAL DICHOTOMY

Introduction

This article considers the controversial issue of the effect of the trust deed on the meaning of the words "income of the trust estate" for the purposes of the tax law.

The first issue to consider in any such analysis is the income-capital dichotomy. That in itself is a very complicated subject and as such it is beyond the scope of this article to extensively discuss the dichotomy. In this article legislative references are to the *Income Tax Assessment Act 1936 (ITAA 1936)* and the *Income Tax Assessment Act 1997 (ITAA 1997)*.

Income according to ordinary usage (**ordinary income**) and capital according to ordinary usage (**ordinary capital**) is that recognised by generally acceptable accounting principles (**GAAP**). Ordinary income and ordinary capital retain their character in the hands of the recipient and that objective character cannot be modified or varied.

Income for trust law purposes (**trust law income**) and capital for trust law purposes (**trust law capital**) apply those terms of ordinary usage, but permits the trust instrument to modify them for the sole purpose of ensuring the proper allocation of the ordinary income and ordinary capital to the correct beneficiaries.

Income for revenue law purposes (**tax law income**) and capital for revenue law purposes (**tax law capital**) apply those terms of ordinary usage, but ITAA 1936 and ITAA 1997 modify them for the sole

purpose of ensuring the proper statutory taxation of the ordinary income and ordinary capital.

The characterisation of income and capital depends on the relevant accounting, trust or revenue context employed.

Parsons¹ makes the following relevant observations:

1.30 The word income is used by economists and lawyers. Economists tend to argue about what income "is". The argument is obviously sterile... Lawyers argue about what the word means in a particular legal context. Trust law has a meaning for the word. Income tax law has another, perhaps two others, for purposes of tax by assessment... The income tax law meaning or meanings owe a good deal to trust law. But income tax law is fundamentally statute law, and the concern of this Volume is with the meaning of income as the word is used in the Assessment Act in relation to tax by assessment.

The construction of the correct usage of income and its scope is central to the debate concerning a number of aspects of the trust provisions in Div 6, Part III ITAA 1936.

Ordinary income

A definition of ordinary income is elusive.

Parsons² makes the following relevant observations:

2.6 A description of ordinary usage income which will bring together all the propositions that follow would be:

An item is income of a taxpayer, in the amount of its realisable value, if it has been derived by him and the item is a gain

derived in circumstances which give it in other respects an income character.

2.7 This description summarises a number of propositions:

Proposition 1: An item of income character is derived when it has "come-home" to the taxpayer. The presence of illegality, immorality or ultra vires does not preclude derivation.

Proposition 2: An item of an income character that has been derived will be income in the amount of its realisable value.

Proposition 3: The character of an item of income must be judged in the circumstances of its derivation by the taxpayer, and without regard to the character it would have had if it had been derived by another person.

Proposition 4: To have the character of income an item must be a gain by the taxpayer who derived it.

Proposition 5: There is not gain unless an item is derived by the taxpayer beneficially.

Proposition 6: There is not gain if an item is derived by the taxpayer himself: the principle of mutuality.

Proposition 7: There is not gain if an item is derived by the taxpayer as a contribution to capital.

Proposition 8: A gain which is a mere gift does not have the character of income.

Proposition 9: A mere windfall gain does not have the character of income.

Proposition 10: A capital gain does not have the character of income.

Proposition 11: A gain which is one of a number derived periodically has the character of income.

Proposition 12: A gain derived from property has the character of income.

Proposition 13: A gain which is a reward for services rendered or to be rendered has the character of income.

Proposition 14: A gain which arises from an act done in carrying on business, or from the carrying out of an isolated business venture, has the character of income.

Proposition 15: A gain which is compensation for an item that would have the character of income had it been derived, or for an item that has the character of a cost of deriving income, has itself the character of income.

Under the income-capital dichotomy, what is not ordinary income must be ordinary capital.

Proposition 3 precludes the re-characterisation of an ordinary income receipt as ordinary capital and vice versa.

*ANZ Savings Bank*³ (High Court 1998) represents the application of proposition 3 to an arrangement where an interest deduction was claimed by a partnership in respect of units acquired in a unit trust that received an annuity part of which was exempt income under s 27H ITAA 1936. The High Court stated:

[5] At common law the instalments of an annuity have the character of income. However, purchased annuities include an element representing a return to the purchaser of the purchase price paid for the annuity...

[15] For the reasons earlier given, the whole of the annuity amount received by the trustee constituted income of the trust. The circumstances that the trust instrument, for the purposes of dealing with the entitlements of unit holders, treated the deductible amount as capital, did not alter what was described in *Charles v FCT* as “the character of those moneys in the hands of the trustees”.

However, the Commissioner has controversially attempted to apply proposition 3 in a trust law and revenue law context to preclude a re-characterisation of income and capital for trust law and revenue law purposes (discussed below).

Proposition 4 requires the character of a receipt to be determined not only by its source, but also by the nature of the recipient’s interest. For example a trustee shareholder in a company may own some shares as trading stock and/or some as a capital investment. The disposal proceeds will be a mix of income and capital. The objective source and nature is not affected by the intentions of the purchaser.

*Hill*⁴ (Privy Council 1930) concerned a payment by a company to its shareholders expressed to be a payment of capital and not a dividend. The Privy Council stated:

From this it would appear that moneys paid in respect of shares in a private company may be income or corpus of a settled share according to the procedure adopted, ie, according as the moneys are paid by way of dividend before liquidation or are paid by way of surplus assets in a winding up....

“dividend”, “bonus”, or any other name, it still must remain a payment on division of profits.

... No statement by the company or its officers that moneys which are being paid away to shareholders out of profits are capital, or are to be treated as capital, can have any effect upon the rights of the beneficiaries under a trust instrument which comprises shares in the company.

Proposition 3 precludes the re-characterisation of an ordinary income receipt as ordinary capital and vice versa, but importantly, for the reasons stated below, does not prevent re-characterisation for trust law purposes.

TAXATION LAW INCOME

Introduction

The structure of Div 6, Part III 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
 - (ii) ...
 - (b) the exempt income of the beneficiary shall include:
 - (i) so much of individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and
 - (i) ...

Conventional dogma contends that income throughout ITAA 1936 has two possible meanings – income according to ordinary usage and assessable income (being income according to ordinary usage and deemed income or statutory income for taxation purposes) (called parallel provision analysis by Parsons).

“ Zeta Force coined the phrase “distributable income”. The adjective “distributable” infers that the income is available for distribution. *Cajkusic* also adopted that phrase. ”

[8] ...There is, however, a difference between recognising that an instalment of a purchased annuity contains a component reflecting the need to return to the purchaser the price paid for the annuity, and a conclusion that an instalment of an annuity bears, at least in part, the character of capital.

A limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorised reduction of capital. Any other payment made by it by means of which it parts with money to its shareholders must and can only be made by way of dividing profits. Whether the payment is called

Section 95 ITAA 1936 contains its own definition of “net income” which adopts the assessable income meaning with modifications for the purposes of Div 6, Part III ITAA 1936. However, “income” and its composite phrase “income of a trust estate” are not defined and are subject to debate concerning their scope.

Trust law income adopted

“Income” or “income of a trust estate” in Div 6, Part III ITAA 1936 could be interpreted as:

- ordinary income (being only income according to ordinary usage);
- assessable income (being income according to ordinary usage and other amounts deemed income by revenue law);
- ordinary income as modified for trust law purposes (being income according to ordinary usage and other amounts deemed income by trust law).

*Zeta Force*⁵ (Federal Court 1998) concerned whether the proportionate method, quantum method or purposive method (discussed below) should apply in construing s 97 ITAA 1936. The Federal Court stated:

279 ...I will describe a trust estate's net income for tax purposes as its “taxable income” and its net income for trust purposes as its “distributable income”.

282 The words “income of the trust estate” in the opening part of s 97(1) refer to distributable income, this is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument.

Zeta Force adopted the trust law definition of income in respect of the phrase “income” or “income of a trust estate” in s 97(1) ITAA 1936.

Zeta Force coined the phrase “distributable income”. The adjective “distributable” infers that the income is available for distribution. *Cajkusic*⁶ also adopted that phrase.

*Richardson*⁷ (Full Federal Court 2001) made the following statement unambiguously to the same effect:

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.”

“

It would appear clear (at least to the Federal Court) that section 97 ITAA 1936 applies the trust law definition of income.

”

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).”

The Commissioner sought to challenge this clear statement again in *Cajkusic*⁸ (Full Federal Court 2006) where the following statements were made:

- 21 The respondent submitted that: “... *what [is] income for trust law purposes, s 97 purposes, cannot be governed by what is said in the trust deed.*” That, so the submission went: “... would be remarkable. You could just define your way out of what the *Income Tax Assessment Act 1936* (Cth) provides.” ... *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 ITAA 1936. Liability for tax on the s 95 “net income” will fall where the ITAA 1936 intends it to fall. In other words, if there is no s 97 income – no distributable net income – to which any beneficiary is

presently entitled, then liability for the tax on any s 95 “net income” will fall on the trustee under s 99 or s 99A of the ITAA 1936. On the other hand, if there is any s 97 income to which beneficiaries are presently entitled, then any s 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 s 97 income: see *Zeta Force Pty Ltd v FCT* (1998) 84 FCR 70; 39 ATR 277; 98 ATC 4681 and the cases there referred to.

It would appear clear (at least to the Federal Court) that s 97 ITAA 1936 applies the trust law definition of income.

The Commissioner continues to resist these statements. The Commissioner in the *Cajkusic* Decision Impact Statement (VID 279/2006) provides the following views:

Effect of trust instrument on “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.

The Commissioner considers he must continue to follow what he understands to be the reasoning of the High Court in the *ANZ Savings Bank* decision (see per Gleeson CJ, paragraphs 14 and 15; cf/ Full Court in *Cajkusic* at paragraph 29).

Given, however, the observations made by the Full Court in *Cajkusic* have created some uncertainty in relation to this issue the Commissioner will seek to further test the issue in the appellate courts as soon as the opportunity arises.

The Commissioner has sought to distinguish *Cajkusic* in respect of future matters on the basis the statements referred to allocation of expenses and were obiter in respect of re-characterisation of receipts.

With respect, while the statements may on one view be considered obiter, the Commissioner is effectively ignoring unambiguous statements that are consistent with statements that are not obiter in *Zeta Force* and *Richardson*.

The Commissioner's resistance to this principle relates to the consequences of applying trust law income under the proportionate approach.

Proportionate approach

The references to "share of the income of the trust estate" and "share of the net income of the trust estate" may be interpreted as meaning a proportion or a specific amount.

Zeta Force provides the following illustration of the difference in approaches:

279 An example will assist in the description of the competing approaches. A trust estate's distributable income is \$60,000. An amount of \$30,000, being a gain on the sale of property acquired after 19 September 1985, has been treated as an accretion to corpus and is not included in the distributable income. The \$30,000 is however assessable for income tax purposes, so that the taxable income is \$90,000. The trustee resolves to distribute 30% of the distributable income to X and 70% to Y.

One method is to assess X on 30% of \$90,000 (\$27,000) and Y on 70% of \$90,000 (\$63,000). This is appropriately described as the proportionate method. It treats the words "that share" in the phrase "that share of the net income of the trust estate" in s 97(1) as meaning a "fraction" or "proportion" and not an "amount". Because X is entitled to 30% of the distributable income, he will be taxed in respect of 30% of the taxable income. This method distributes the tax between X and Y proportionally, and there will be no amount upon which the trustee will be liable to pay tax under s 99 or s 99A. The proportionate method may appear to operate unjustly, in that X and Y are taxed on amounts greater than they have received from or can demand of the trustee.

The alternative method is to assess X on 30% of \$60,000 (\$18,000) and Y on 70% of \$60,000 (\$42,000). The \$30,000 balance is assessed to the trustee under s 99 or

s 99A. This method taxes the beneficiaries on what they receive from or can demand of the trustee. It treats "that share" as meaning the share of the net income to which the beneficiary is presently entitled.

Zeta Force concluded that the proportionate approach was the correct construction:

“

The proportionate method is now the settled view. *Cajkusic* has confirmed the proportionate approach.

”

282 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.

The proportionate method is now the settled view. *Cajkusic*⁹ has confirmed the proportionate approach.

Perceived structuring problem

For illustrative purposes, consider a discretionary trust has \$1 rental ordinary income and \$99 taxable ordinary capital gain. The rental income is distributed to Beneficiary A and the taxable ordinary capital gain is distributed to Beneficiary B. Under the proportionate approach, Beneficiary A has received 100 per cent of the trust income so is taxable on 100 per cent of the net income of the trust, which included the \$99 taxable capital gain. Beneficiary A will be taxed on the rental income and taxable capital gain even though Beneficiary B receives the money (effectively tax free). Although there is

arguably unfairness to Beneficiary A, tax is effectively allocated.

However, assume that Beneficiary A is a tax exempt charity. Beneficiary A will receive \$1 for its charity work (for which it will be grateful). However, but for its tax exempt status, Beneficiary A would have been taxable on the \$99 capital gain. Tax on

the \$99 has been avoided (subject to the operation of anti-avoidance provisions). Beneficiary B is not taxable on the capital gain. As the trust has only appointed and distributed \$1 to Beneficiary A, Beneficiary A cannot call for the \$99 capital gain, so Beneficiary B's position is secure.

Further, assume that the discretionary trust has no ordinary income but has a \$100 taxable ordinary capital gain. As there is no ordinary income, the trustee cannot make an appointment and distribution so that a beneficiary has a present entitlement to the taxable capital gain under s 97 ITAA 1936. In these circumstances, the trustee could re characterise the \$100 taxable ordinary capital gain as trust law income creating an amount that can then be distributed to a beneficiary to create the necessary present entitlement to the taxable capital gain.

TRUST LAW INCOME

Introduction

A trust is the relationship between trustee and beneficiary in respect of certain property with legal title vested in the trustee for the beneficial enjoyment of the beneficiary.¹⁰ Scott states:¹¹

The trust is the whole judicial device: the legal relationship between the parties with respect to the property that is its subject matter, including not merely the duties that the trustee owes to the beneficiary and to the rest of the world, but also

the rights, privileges, powers and immunities that the beneficiary has against the trustee and against the rest of the world.

The trustee's duties include the equitable duties to get the trust property in, preserve the trust property, ascertain and administer the trust in accordance with the terms of the trust and act fairly between beneficiaries entitled to income and those entitled to capital.¹²

The duty to act fairly between beneficiaries requires the impartial and proper disposition and application of trust property so as to avoid benefiting one beneficiary over another by properly distinguishing between income and capital as to receipts and expenditure.¹³

The duty to act fairly between beneficiaries prescribes that income is payable only out of amounts actually received by those beneficiaries entitled to that income and to preserve the capital of the trust and augmentation that accrues to the capital of the trust to those beneficiaries entitled to that capital.¹⁴

The terms "income beneficiary" and "capital beneficiary" reflect the difference in entitlement to income and capital. An income beneficiary is entitled to income receipts and a capital beneficiary is entitled to corpus and capital receipts (subject to the terms of the trust).

It is the trustee's duty to receive receipts, preserve trust property and properly allocate receipts that is central to understanding the continuing debate over interpreting s 97 ITAA 1936.

Simple life estate trust

The trustee's duty to receive receipts, preserve trust property and properly allocate receipts and corpus is most simply illustrated and analysed by the life estate.

Under a life estate, property is given to someone for the person's life (**life tenant**) and the remaining interest in that property is given to another person (**remainderman**) such that the life tenant obtains use of and the net receipts produced by that property and the remainderman is entitled to the corpus of that property, less the life tenant's net income derived from that property. Upon the death of the life tenant, the remainderman becomes the absolute owner of the property and the net income derived from that property.

The trustee's duties to receive receipts and properly allocate those receipts requires certain receipts to be received and allocated to the benefit of the life tenant and certain receipts to be received and allocated to the benefit of the remainderman. The receipt and its proper allocation depends on the terms of the trust as well as the source and nature of the receipt and does not necessarily and is not required to reflect ordinary concepts of income or capital.

A receipt and its proper allocation is illustrated by distributions in respect of company shares owned by a trustee. In summary:

- a distribution by dividend of profits by a company not in liquidation to its trustee shareholder constitutes a receipt by the trustee shareholder belonging to the life tenant;
- a distribution by return of capital and a share of surplus assets by a company in liquidation to its trustee shareholder constitutes a receipt by the trustee shareholder belonging to the remainderman despite it being swollen because the company has undivided profits.

Hill (Privy Council 1930) states:¹⁵

From this it would appear that moneys paid in respect of shares in a private company may be income or corpus of a settled share according to the procedure adopted, ie, according as the moneys are paid by way of dividend before liquidation or are paid by way of surplus assets in a winding up. Each process might appear to involve some injustice, the former to the remainderman, the latter to the tenant for life.

In truth the only method by which the rights of the respective cestuis que trust can be safeguarded and made incapable of being varied or affected by the conduct of the company, is by the insertion of special provisions in the trust instrument clearly defining the respective rights of income and corpus in regard to money received by the trustee from limited companies, in respect of shares therein held by him as part of a trust estate.

Money so paid to a shareholder will (if he be a trustee) prima facie belong to the person beneficially entitled to the income of the trust estate. If such moneys or any part thereof are to be treated as part of the corpus of the trust estate there must be some provision in the trust deed which brings about that result. No statement by the company or its officers that moneys which are being paid away to shareholders out of profits are capital, or are to be treated as capital, can have any effect upon the rights of the beneficiaries under a trust instrument which comprises shares in the company.

“ The receipt and its proper allocation ... does not necessarily and is not required to reflect ordinary concepts of income or capital. ”

The objective source and nature of the dividend receipt is income according to ordinary concepts and of the return of capital receipt is capital according to ordinary concepts. However, for the purpose only of delineating the rights to a receipt between the life tenant and the remainderman, a receipt which is objectively capital may be treated as income and vice versa pursuant to a specific provision in the trust instrument.

To prevent unfairness to the life tenant, the receipt from capital return or liquidation could be reallocated to the life tenant by re-characterising the receipt as trust law income.

A similar issue arises in respect of livestock on pastoral properties (*Hassell*¹⁶; *Thornley*¹⁷ and *McBride v Hudson*¹⁸). Proceeds from the sale of natural increase of livestock constitutes ordinary income to be allocated to the life tenant and the proceeds from the sale of the original livestock producing the natural increase constitutes ordinary capital to be allocated to the remainderman.

To prevent the flock from decreasing by natural attrition and to maintain the value of the remainderman's interest, the receipt from the sale of progeny could be reallocated to the remainderman by re-characterising the receipt as trust law capital.

The re-characterisation allocation as between the income beneficiary and the capital beneficiary concerns is in accordance with the trustee's duty to act fairly between the beneficiaries rather than to produce income tax consequences.

Varying complexity of trusts

The complexity of modern trust instruments result in difficulties in extrapolating the principles applicable to life estates and applying those principles to modern factual situations.

The re-characterisation of income and capital to properly allocate receipts is usually of less importance because:

- modern trust instruments usually authorise the trustee to distribute a capital receipt or corpus (or both) to an income beneficiary and to accumulate an income receipt for the benefit of a capital beneficiary; and
- the class of income beneficiaries is largely the same (if not identical) to the class of capital beneficiaries.

The following is an example of such power to resort to and distribute capital receipts to the income beneficiary:

The Trustee may (in the Trustee's absolute and unfettered discretion), in each Accounting Period appoint, pay, apply or set aside part or all (if any) of the income and capital of the Trust Fund of that Accounting Period for the benefit of all or any one or more exclusive of the other or others of the General Beneficiaries living from time to time in such proportions and in such manner as the Trustee determines.

Where the trust deed provides the trustee with power to pay receipts of ordinary capital to income beneficiaries, it is not strictly necessary to re-characterise the ordinary capital as trust law income to effect the proper and fair allocation to the income beneficiary. For example, the capital receipt from a return of share capital or company liquidation could simply be allocated to the income beneficiary under the trustee's power to resort to

capital to pay the income beneficiary. Similarly, the trustee could accumulate the income receipt from progeny sales for the remainderman.

Modern trust deeds with the power to resort to and apply ordinary capital receipts for the income beneficiaries circumvents the need to reclassify ordinary income and ordinary capital to satisfy the trustee's duty of fair allocation as between beneficiaries.

Accordingly, the re-characterisation cannot be explained simply by the trustee's duty of fair allocation as between beneficiaries. One possible reason for re-characterisation is to create the necessary present entitlement for s 97 ITAA 1936 and obtain a desired tax treatment (or benefit) otherwise not available without the re-classification. If that is the case, the anti-avoidance provisions in Part IVA 1936 may apply to the re-classification.

Cajkusic decision impact statement

As noted above the Commissioner has expressed the view that the income of the trust estate must refer to ordinary income and the trust deed cannot re characterise ordinary capital for trust law purposes to alter the share of net income of the trust estate to which beneficiaries are present.

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*".

In *FC of T v Totledge* 40 ALR 385 at 394 a differently constituted Full Court of the Federal Court held that the composite expression "*present entitlement to a share of the income of the trust estate*" was a reference 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*". This view was in our opinion endorsed by the High Court in *Harmer v F CoF T* [1991] 173 CLR 264 at 271 and is fully consistent with the decision of the High Court in *Commissioner of Taxation v Australia and New Zealand Savings Bank* (1998) 194 CLR 328.

The Commissioner appears to contend that the phrase "present entitlement" preceding the words "a share of the income of the trust estate" in s 97(1) colours those later words. In so doing, with respect, the Commissioner appears to be interpreting the quotation taken from the decision in *Totledge* as making a finding on a matter of law rather than a statement of fact. There is no comment made in the decision that the relevant trust deed attempted to define income for the purpose of the trust instrument.

“ The current debate concerning the interpretation of the words “the income of the trust estate” continues the controversy that has seemingly always surrounded Div 6, Part III of the ITAA 1936. ”

Cajkusic (Full Federal Court 2006):

- 21 The respondent submitted that: "... what [is] income for trust law purposes, s 97 purposes, cannot be governed by what is said in the trust deed."

The Commissioner in the *Cajkusic* Decision Impact Statement (VID 279/2006) provides the following views:

Where the deed does not otherwise contain some provision defining income for the purpose of the trust estate, income will have its ordinary meaning. It is submitted that the quote taken from *Totledge* by the Commissioner does no more than simply record the fact that in the circumstances of that case trust law income and ordinary income were the same, such that a present entitlement to the income

of the trust estate was as a matter of fact in this case a present entitlement to the ordinary income derived by the trust estate. As noted above, a very different conclusion has been reached in those cases where the trust deed does permit the re-characterisation of the ordinary income and ordinary capital of the trust for the purpose of determining the trust law or distributable income.

Conclusion

Recent judicial authority supports the need to consider income as defined by three different methodologies; ordinary income, trust law or distributable income and tax law income; in order to determine which, if any, of the beneficiaries is to be entitled to the income and capital of the trust and which of those beneficiaries or the trustee is liable to tax on the tax law income derived by the trust.

It is clear that the Commissioner disputes that conclusion and through his decision impact statement issued in respect of *Cajkusic* he has attempted to downplay the judicial authority as nothing more than statements in obiter, “broad observations” and not binding authority. Based upon the Commissioner’s interpretation of the nature of the relevant statements he considers it open to further test the issue in the appellate courts. It is an interesting approach and somewhat surprising given the criticism the Commissioner faced when he last attempted to continually challenge a line of judicial authority based on his alternative interpretation of the law.¹⁹

The current debate concerning the interpretation of the words “the income of the trust estate” continues the controversy that has seemingly always surrounded Div 6, Part III of the ITAA 1936. Comments made by the late Hill J nearly two decades ago in *Davis*²⁰ (Federal Court 1989) that “the scheme of Div. 6 calls out for legislative clarification” remain as relevant today as they were when they were first made.

We can only hope that the Commissioner reflects on those statements and attempts to clarify Div 6 through agitating for legislative amendment rather than to continue to release ambiguous decision impact statements or through testing the matter through the judicial system using unsuitable cases.

*Ron Jorgensen, Special Counsel
Accredited Specialist in Tax Law
Harwood Andrews Lawyers*

*With thanks to Daniel Smedley, Principal
Accredited Specialist in Tax Law
Harwood Andrews Lawyers*

Reference notes:

- 1 *R. Parsons, Income Taxation in Australia, Principles of Income, Deductibility and Tax Accounting, University of Sydney Library, electronic format, 2001.*
- 2 *R. Parsons, Income Taxation in Australia, ibid.*
- 3 *FCT v ANZ Savings Bank Ltd (1998) 39 ATR 419; 98 ATC 4,850 (High Court).*
- 4 *Hill v Permanent Trustee Company of New South Wales Ltd [1930] AC 720 at 729-731.*
- 5 *Zeta Force P/L v FCT (1998) 39 ATR 277; 98 ATC 4681.*
- 6 *Cajkusic v FCT (2006) 62 ATR 1.091 (AAT); (2006) 64 ATR 676; 2006 ATC 4752 (Full Federal Court).*
- 7 *Richardson v FCT (2001) 46 ATR 285; 2001 ATC 4,058 (Federal Court); (2001) 48 ATR 101; 2001 ATC 4,621 (Full Federal Court).*
- 8 *Cajkusic v FCT (2006) 62 ATR 1.091 (AAT); (2006) 64 ATR 676; 2006 ATC 4752 (Full Federal Court).*
- 9 *Cajkusic v FCT (2006) 64 ATR 676 at [22].*
- 10 *S. Ong, Trusts Law in Australia, 2nd ed., The Federation Press, 2003 at p. 4.*
- 11 *A. Scott and W. Fratcher, The Law of Trusts, 4th ed., Aspen Publishers, 1998, Vol 1, at [2.4].*
- 12 *J. Heydon and M. Leeming, Jacobs' Law of Trusts in Australia, 7th ed., LexisNexis Butterworths, 2006, at Ch. 17.*
- 13 *J. Heydon and M. Leeming, Jacobs' Law of Trusts in Australia, ibid, at [1703] and [1920], [1926] and [1932].*
- 14 *J. Heydon and M. Leeming, Jacobs' Law of Trusts in Australia, ibid, at [1932].*
- 15 *Hill v Permanent Trustee Company of New South Wales Ltd [1930] AC 720 at 729-731.*
- 16 *Hassell v Perpetual Executors Trustees & Agency Company (WA) Limited (1952) 86 CLR 513 at 522-523.*
- 17 *Thornley v Boyd (1925) 36 CLR 526.*
- 18 *McBride v Hudson (1962) 107 CLR 604.*
- 19 *Commissioner of Taxation v Indooroopilly Childrens Services Pty Ltd [2007] FCFCA 16.*
- 20 *Davis & Anor v Federal Commissioner of Taxation (1989) 86 ALR 195.*