

# Continuing controversy post *Cajkusic* – Part II

**FOR MANY TAX PROFESSIONALS THE FULL FEDERAL COURT'S DECISION IN CAJKUSIC APPEARED TO CLARIFY A NUMBER OF CONTENTIOUS ISSUES REGARDING THE TAXATION OF THE INCOME OF TRUSTS. HOWEVER, THE CAJKUSIC DECISION IMPACT STATEMENT HAS AGAIN CLOUDED THE ISSUE.**



## INTRODUCTION

This article is a continuation of the article published in the December/January edition of *Taxation in Australia* which considered the controversial issue of the effect of the trust instrument on the meaning of the phrase “income of the trust estate” for the purposes of trust law.

This article considers the allocation of expenses and the obligation to recoup prior year accounting losses when determining the income of the trust estate. It also discusses the potential application of the general anti-avoidance provision when applying the principles in *Cajkusic*.<sup>1</sup>

Legislative references are to the *Income Tax Assessment Act 1936*.

## SUMMARY OF PART I ARTICLE

### Trust law income

The structure of Div 6, Part III (“Div 6”) is to tax a beneficiary that is presently entitled to the taxable income of a trust estate (ss 97 and 98). If a beneficiary is not presently entitled to part or all of the income, the trustee is taxed on that income (ss 99 or 99A).

Section 95 contains its own definition of “net income” for the purposes of Div 6. However, “income” or the composite phrase “income of a trust estate” is not defined for the purpose of s 97 and are subject to debate concerning their scope. The Commissioner continues to assert that “income of a trust estate” means income according to generally accepted accounting principles (“GAAP”)<sup>2</sup> and not trust law income as understood by trust lawyers.<sup>3</sup>

*Zeta Force*<sup>4</sup> (Federal Court 1998) and *Richardson*<sup>5</sup> (Full Federal Court 2001) unambiguously adopted the proportionate method of construing s 97 and the trust law definition of income in respect of the phrase “income of a trust estate” and the ability of the trustee to reclassify capital as income. The Federal Court has adopted the phrase “distributable income” to refer to the “income of the trust estate”. The Commissioner has challenged this clear statement regarding the ability of the trustee to reclassify capital as income again in *Cajkusic*<sup>6</sup> (Full Federal Court 2006) and the *Cajkusic Decision Impact Statement* (VID 279/2006 – 12 September 2007) (“*Cajkusic DIS*”).

It is clear (at least to the Full Federal Court) that “income” and the composite phrase “income of the trust estate” refers to the well established concepts in trust law for determining what receipts (if any) are distributable to the income beneficiary (often known as a life tenant) or to be accumulated and retained for the future benefit of the capital beneficiary (often known as a remainderman).

### *Cajkusic*

In *Cajkusic* (Full Federal Court 2006) the Full Federal Court:

- confirmed *Zeta Force* that the proportionate approach applies to trust distributions;
- confirmed *Richardson* that the term net distributable income of the trust estate means generally accepted accounting principles as modified by the trust instrument;
- confirmed *Richardson* that a properly drafted trust instrument can permit

the trustee to reclassify capital as income when determining net distributable income;

- confirmed that *ANZ Savings Bank*<sup>7</sup> (High Court 1998) does not prohibit a properly drafted trust instrument from permitting the trustee to reclassify income as capital when determining net distributable income;
- confirmed that a properly drafted trust instrument can permit the trustee to determine the preferred allocation of outgoings against that income or capital; and
- confirmed that a properly drafted trust instrument can permit the trustee to defer the recoupment of prior year losses when determining net distributable income.

The Commissioner’s resistance to these clear statements of principle relates to the potential tax avoidance opportunities that may arise from applying trust law income under the proportionate approach. In the *Cajkusic Special Leave Application*<sup>8</sup> (High Court 2007) Senior Counsel for the Commissioner illustrated his submission by referring to avoidance arrangements involving income distributions to a charity (discussed below).

### Application of trust law income

There is clear and extensive authority regarding the trust law concept of the “income of a trust estate” that concerns the proper administration of a trust which is wholly unrelated to notions of tax planning.

The trustee’s duties to receive receipts, preserve trust property and properly allocate receipts and corpus (“Distribution

Duties”) requires particular receipts to be received and allocated to the benefit of the life tenant (being an income beneficiary) and particular receipts to be received and allocated to the benefit of the remainderman (being a capital beneficiary).

The proposition that a receipt and its proper allocation depends on the terms of the trust instrument as well as the source and nature of the receipt and does not necessarily and is not required to reflect GAAP is supported by numerous authorities including *Hill*,<sup>9</sup> *Hassell*,<sup>10</sup> *Thornley*<sup>11</sup> and *McBride v Hudson*.<sup>12</sup>

The re-characterisation and allocation of receipts as between the income beneficiary and the capital beneficiary concerns the proper exercise of the trustee’s Distribution Duties and is not historically a method to produce particular income tax consequences.

The Commissioner’s views in the *Cajkusic* Special Leave Application (High Court 2007) that the income of the trust estate must refer to ordinary income and the *Cajkusic* DIS (2007) that the trust instrument cannot re-characterise ordinary capital for trust law purposes to alter the share of net distributable income of the trust estate to which beneficiaries are presently entitled is inconsistent with the weight of current authority.

## PART II EXPENSES

### Introduction

In respect of the allocation of expenses, *Cajkusic* (Full Federal Court 2006) relevantly stated:

21 The [Commissioner] 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...

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 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.

Although *Cajkusic* (Full Federal Court 2006) primarily concerned the allocation of income, the Full Federal Court’s statements also apply to the characterisation and allocation of outgoings in determining the “income of the trust estate”. Again there is clear and extensive authority regarding the trust law concept of the “income of a trust estate” that concerns the proper administration of a trust that is wholly unrelated to notions of tax planning.

It is clear (at least to the Full Federal Court) that the trust deed can determine the allocation of expenses as against income and capital in determining the “income of a trust estate”.

The trustee’s Distribution Duties also requires particular expenses to be allocated and borne by the income beneficiary and particular expenses to be allocated and born by the capital beneficiary, unless the trust instrument or the *Trustee Act*<sup>13</sup> otherwise authorises.

For illustrative purposes, consider where a life tenant spouse is entitled to the rents of a rental property and the remainderman children to title to the property intact and the rents after the death of the life tenant spouse.

### Default allocation

The trustee’s duty to preserve property intact for the successor remainderman beneficiary<sup>14</sup> requires ordinary outgoings of a recurrent nature (such as rates, land tax and insurances) to be allocated and born out of the income of the trust estate as the life tenant receives their benefit and if otherwise allocated to the remainderman would diminish the remainderman’s ultimate successor entitlement.<sup>15</sup>

Conversely, the trustee’s duty to preserve property requires costs of effecting permanent improvements (such as structure changes, reroofing and fencing) to be allocated and borne out of the capital

of the trust estate as the remainderman receives their benefit as a permanent improvement of or accretion to corpus and the remainderman’s ultimate successor entitlement.<sup>16</sup>

The allocation of outgoings is complex and the appropriate allocation of particular outgoings may alter. For example, if a mortgagee of the property goes into possession to preserve the property, the payment of rates, land tax and insurances become capital expenses to preserve the property for the remainderman and are payable out of capital.<sup>17</sup>

Further, particular hybrid outgoings that benefit both the life tenant and the remainderman (such as depreciable improvements to property) are apportioned as between them with the initial expense allocated to capital and a portion of that capital recouped from future income.<sup>18</sup>

The *Trustee Acts* in ACT, NSW, Queensland, SA, WA and NT empower the trustee to make improvements out of income or capital.<sup>19</sup> The *Trustee Acts* may also provide other statutory powers of allocation of income and outgoings.

The above default allocations only apply in the absence of specific provisions in the trust instrument. The trust instrument may provide an expressed allocation or a discretion to the trustee to give preference to either the life tenant or the remainderman. For example, a testamentary trust instrument may require the life tenant spouse to make and pay for all capital improvements so as to preserve the ultimate value of the estate to the remainderman children. Alternatively, the testamentary trust instrument may require the payment of rates and insurance out of the capital so as to maximise the income of the life tenant spouse to maintain the spouse’s lifestyle in priority to the remainderman children.

The characterisation and allocation of outgoings as between the income beneficiary and the capital beneficiary concerns the proper exercise of the trustee’s duties and the priorities of the purposes of the trust. However, their characterisation and allocation is not concerned with the production of a particular income tax consequence.

## Statutory expense allocation

Division 2A of Part III contained ss 49 and 50 and required outgoings to be deducted from classes of income in a particular order. Section 50 relevantly stated:

### 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 application of these sections was unclear. For example, arguably a different allocation of expenses for s 95 purposes was required to that permitted for trust law purposes in determining the “share of the income of the trust estate” in s 97. Anomalies could occur where a trust had to set-off a negatively geared property portfolio net loss against the total amount of dividend income for an income year so that there was no distributable dividend income to allow the imputation credits to be passed to the beneficiaries.

The *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* (Cth) has repealed the provisions. Accordingly, the potential anomalies have been removed.

## PART III RECOUPMENT OF LOSSES

### Introduction

Generally, losses in one year must be made up out of profits of subsequent years and not out of the capital of the trust in order to preserve the property for the remainderman.<sup>20</sup> However, the trust instrument may grant the power to the trustee not to use subsequent profits to recoup past losses.<sup>21</sup> This reflects the default trustee’s duty to preserve the trust estate for the capital beneficiary in priority to maintaining the income beneficiary.

“ The Commissioner continues to assert that ‘income of a trust estate’ means income according to generally accepted accounting standards.. ”

As discussed above, the trustee has power to resort to capital for hybrid outgoings. Further, it is common for a modern trust instrument to grant the trustee the power to resort to capital of the trust to pay outgoings when there is insufficient income to do so. Where the trustee has resorted to capital to pay an outgoing, the income beneficiary is not entitled to the profits made in subsequent years until the losses suffered in earlier years are recouped.<sup>22</sup>

The power to require or not require recoupment of losses from income concerns the proper or priority allocation of outgoings as between the income beneficiary and the capital beneficiary and is not historically concerned with the production of a particular income tax consequence.

For example, by exercising the power not to recoup previous year losses out of the income receipts, the trustee can maintain the amount of income of the trust estate for distribution to the income beneficiary to achieve the priorities of the purposes of the trust to maximise the income of the life tenant spouse to maintain the spouse’s lifestyle.

In the income tax context, *Case 7/2001* (AAT 2001)<sup>23</sup> 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* (AAT 2001) and the cases cited do not expressly refer to capital losses, the Tribunal decision infers that capital losses need not be recouped. These statements are consistent with the trust law authorities.

In *Cajkusic* (Full Federal Court 2006) the Commissioner conceded the principle in *Upton v Brown* 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.<sup>24</sup>

However, in the *Cajkusic* DIS (2007) the Commissioner appears to have reserved his position by the following statement:

We note the view expressed by the Full Federal Court 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 (paragraph 31).

The correctness of this view is the subject of the taxpayer’s appeal to the High Court in *Raftland Pty Ltd v Commissioner of Taxation*.

The refusal of the Commissioner to make statements is understandable in the context of a pending appeal to the High Court which will deal with the issue.

### Raftland

In *Raftland P/L v FCT*<sup>25</sup> (Full Federal Court 2007) the Full Federal Court applied the principle in *Upton v Brown* such that the E & M Unit Trust had to recoup previous year losses from current year income so it had no income of the trust estate that

could be appointed to the unit holders. The Full Federal Court rejected the taxpayer's submission that the principle in *Upton v Brown* only applied where the income and capital beneficiaries are different so the principle could not apply to a unit trust where the unit holders had coterminous interests in both income and capital of the trust fund.<sup>26</sup>

In the *Raftland* Special Leave Application<sup>27</sup> (High Court 2007) and the *Raftland* hearing on 30 to 31 January 2008<sup>28</sup> (High Court 2008), Senior Counsel for the taxpayer sought to limit the application of the principle in *Upton v Brown* to a life tenant and remainderman successive estate so that the rule does not apply generally to all trusts, and more particularly does not apply to unit trusts. The decision has been reserved.

Accordingly, the final decision in *Raftland* may significantly impact on the principles for the recoupment of losses, but more broadly, on the determination of income of a trust estate, because the allocation of income and outgoings is based on the same trustee's Distribution Duties. *Raftland* presents the High Court with an opportunity to clarify (at least in *obiter*) the conception of "income of the trust estate".

## PART IV APPLICATION OF PRINCIPLES

### Introduction

The drafters of Div 6 having knowledge of trust law at the time arguably applied the concept of trust law income in the phrase "income of a trust estate". However, the Commissioner continues to resist this interpretation of the authorities.

*Cajkusic* (Full Federal Court 2006) and *Raftland* (Full Federal Court 2007) have applied the life tenant/remainderman trust law authorities regarding the allocation of income and outgoings and recoupment of losses universally to all types of trusts. However, this may be subject to challenge when there is no successive estate or distinction between income and capital beneficiaries or outside the particular share, real estate and pastoral business circumstances.

### GAAP or trust law income

The limited range of authorised trust investments at the time of drafting Div 6 meant that the accounting concept of income and trust law concept of income

were highly consistent. Further, there was no material difference between those concepts and tax law concepts.<sup>29</sup>

A beneficiary's "share of the income of the trust estate" on any of the concepts would be highly consistent and would accord with the recognised allocation of receipts and expenses and the recoupment of losses between the income and capital beneficiaries.

However the increasing incidents of trusts carrying on pastoral and other businesses and the complexity of shares and securitised transactions resulted in trust law income concepts diverging from accounting concepts to provide a proper allocation of receipts and expenses and the recoupment of losses between the income and capital beneficiaries. The tax law concept of income also diverged with the incorporation of statutory income (including capital gains) from accounting and trust concepts of income.

competing entitlements to the income. Legal concepts cannot countenance alternate or multiple answers.

The primary purpose of trust law income, being a legal concept of income, is to provide the proper allocation of receipts and outgoings and recoupment of losses as between beneficiaries with successive estates to resolve conflicts in litigation. How this primary purpose co-exists with the function of present entitlement in Div 6 is unclear.

Division 6 allocates tax liability based on present entitlement or deemed present entitlement. The concept of present entitlement allocates liability to tax by using concepts of vested and indefeasible rights to income.<sup>30</sup>

On one view, present entitlement provides the sole allocation of rights to resolve the conflict of the competing entitlements to the income (however defined) of the trust estate.

“...there is clear and extensive authority regarding the trust law concept of income of a trust estate ... that is wholly unrelated to notions of tax planning.”

The Federal Court has accepted that "income of a trust estate" refers to trust law income. However, a number of interpretation issues arise in respect of Div 6 as a result of these constructions which have not been expressly considered by the Federal Court.

### Trust law income and present entitlement

The economic-accounting concept of income primarily concerns accurate quantification of value rather than predictability and certainty. The indeterminacy or uncertainty of value is recognised by valuation methodologies accepting alternate or multiple methods of calculation which may produce different but acceptable and useful results.

Legal concepts of income primarily concern accurate predictable and certain allocation of rights to resolve conflicts of

If "income of a trust estate" is the trust law concept of income then the phrase imports an additional methodology for allocation of liability to tax into the operation of Division. The additional methodology for allocation of liability is arguably unnecessary and undesirable. Further, the methodology may be inconsistent with the present entitlement allocation. Since present entitlement provides the allocation of rights, the purpose of the concept of income of the trust estate was intended to merely value the receipt. The concept of income can accord and should be limited to GAAP. On this view the courts are incorrect to have held that "income of a trust estate" meant trust law income.

On the second view, the trust law concept of income provides the sole allocation of rights and all the concept of present

entitlement does is determine whether the allocation is sufficient to impose tax on the beneficiary or, if insufficient, tax is imposed on the trustee. The trust law methodology operates concurrently with and is consistent with the operation of present entitlement.

The writer considers the second view is the appropriate construction of Div 6. Accordingly, the operation of present entitlement does not require “income of a trust estate” to be a reference to GAAP.

### Unit trusts

A modern unit trust grants to the unit holders proportionate entitlement to income and capital distributions. All unit holders rank proportionately in respect of annual distributions and vesting day distributions so there is no successive estate.

If the trustee’s Distribution Duties are solely based on the existence of a successive estate, then the life tenant/remainderman authorities may be irrelevant in determining the income of the trust estate for a fixed unit trust.

However, where units are issued with priority or non-proportional entitlement to income or capital or the ability to issue further units to new unitholders there will be a successive trust estate for the purposes of the life tenant/remainderman authorities’ analogy.

entitled to vesting day corpus distributions. The distinction is diluted because the trustee is usually empowered to make capital distributions annually and the class of income beneficiaries is invariably highly similar to the class of capital beneficiaries. However, a successive estate for the vesting day capital beneficiaries does exist.

Regardless of the final decision in *Raftland*, arguably the principles regarding the allocation of income and outgoings and the recoupment of losses may still apply for a discretionary trust because a discretionary trust has successive estates – the income beneficiaries have entitlement to income annually similar to a life tenant and from at the vesting date the capital beneficiaries have a successive estate to the corpus of the trust.

### Drafting trust powers

If the principles regarding the allocation of income and outgoings and the recoupment of losses apply generally or to specific classes of modern trusts, the trust instrument may empower the trustee to effect allocations other than in accordance with the default trust law method.

Care is required to ensure that the trust instrument contains a sufficient power to permit appointment of trust law income in the flexible manner apparently permitted by *Cajkusic* (Full Federal Court 2006) and *Raftland* (Full Federal Court 2007).

reconstruct the scheme and tax the taxpayer on the subsequent basis (Part IVA).

If the trust law authorities in determining the income of the trust estate apply generally or to specific classes of modern trusts, then applying those authorities to allocate income, capital and outgoings and to defer recoupment of losses without more is arguably of itself not a scheme or undertaken for the dominant purpose of the taxpayer obtaining a tax benefit.

Particularly, where the allocation or income, capital or outgoing accords with the default position for shares, real estate and pastoral business for such allocations, then there is ample authority that the dominant purpose of the allocation is in accordance with the Distribution Duties and, without more, is not motivated by a tax avoidance purpose.

### Examples

For illustrative purposes, consider a discretionary trust that has \$1 rental ordinary income and \$99 taxable ordinary capital gain. If the \$1 rental income is distributed to Beneficiary A and the taxable ordinary capital gain is distributed to Beneficiary B, Beneficiary A is taxable on both the \$1 rental income and the \$99 taxable capital gain, producing an inequitable tax liability for Beneficiary A. However, there is generally not a loss of tax revenue as Beneficiary A must pay the tax.

However, subject to the operation of anti-avoidance provisions, tax may be reduced or avoided where, for illustration purposes:

1. Beneficiary A is a tax exempt charity or not-for-profit organisation so no tax is payable on the distribution; or
2. Beneficiary A is a corporate beneficiary related to the trust or Beneficiary B which has sufficient carried forward losses incurred by operating a business of the family group so no tax is payable on the distribution; or
3. Beneficiary A is a special purpose company incorporated for the sole purpose of receiving any adverse income tax assessment and has insufficient assets to pay the increased assessed tax (commonly called a Sump Company).

“ Care is required to ensure that the trust instrument contains a sufficient power to permit appointment of trust law income in a flexible manner...”

If the pending decision in *Raftland* (High Court 2008) limits the authorities to successive estates, the determination of the income of the trust estate may vary based on the type of trust under consideration.

### Discretionary trusts

A modern discretionary trust maintains a distinction between the income beneficiaries entitled to annual income distributions and capital beneficiaries

## PART IVA TAX AVOIDANCE

### Introduction

Where a taxpayer obtains a tax benefit under a scheme and the taxpayer or some other person entered into the scheme for the sole or dominant purpose of the taxpayer obtaining the tax benefit, the Commissioner may disregard and

### Charities and not-for-profits

A charitable purpose is usually included in modern trust instruments to ensure certainty of the establishment of an expressed trust. Accordingly, a wide class of charities will be beneficiaries under the trust. A trust may distribute to a charity with varying motives.

A religious person tithes \$10,000 per year for 10 years to a religious institution indirectly by causing a controlled discretionary trust to distribute the first \$10,000 of the income of the trust to the religious institution. At the start of year 11 the trust sells its only asset, making a substantial taxable capital gain and \$10,000 income for the year, and distributes the \$10,000 tax law income to the religious institution. The non-taxation of the taxable capital gain arises by operation of particular circumstance in year 11. Whether the Commissioner could successfully apply Part IVA in this circumstance is unclear.

However, compare circumstances where the person has never previously tithed or otherwise distributed to a charity, but only does so in the year of the taxable capital gain. Arguably the Commissioner may have a greater prospect of successfully applying Part IVA in this circumstance.

By way of further example a charity acquires preference income units in a unit trust undertaking a commercial property development and leases the property for 10 years. The charity has priority to income to ensure sufficient funds to undertake its charitable objectives. At the start of year 11 the trust sells its only asset, making a substantial taxable capital gain and \$10,000 income for the year and distributes the \$10,000 tax law income to the charity. Again, the non taxation of the taxable capital gain arises by operation of particular circumstance in year 11. Whether the Commissioner could successfully apply Part IVA in this circumstance is unclear.

However, compare circumstances where the charity is only introduced in the year of the taxable capital gain. Arguably the Commissioner may have a greater prospect of successfully applying Part IVA in this circumstance.

### Related loss entity

A discretionary trust conducts a business from leased premises and is a member of a family group for the trust loss provisions. The discretionary trust has a corporate beneficiary which has substantial losses arising from a failed commercial property

Expressed over-simplistically, the greater the commerciality of a transaction the greater the reduction of the Part IVA risk.<sup>32</sup> However, the existence of a rational commercial decision does not preclude there being a dominant purpose to obtain a tax benefit.<sup>33</sup>

“ ... the Commissioner’s continued resistance to applying [Federal Court] authority when favourable to the taxpayer, is unacceptable...”

development. At the commencement of the year the discretionary trust sells its business making a substantial taxable capital gain and distributes all its modest distributable income to the corporate beneficiary. Again, the non-taxation of the taxable capital gain arises by operation of particular circumstance and constitutes recoupment of losses incurred by the same family group. Whether the Commissioner could successfully apply Part IVA in this circumstance is unclear.

Consider the same arrangement but assume the corporate beneficiary is a special purpose company incorporated for the sole purpose of receiving any adverse income tax assessment and has insufficient assets to pay the increased assessed tax. The discretionary trust distributes all its modest distributable income to the corporate beneficiary. Arguably the Commissioner may have a greater prospect of successfully applying Part IVA in this circumstance.

### Part IVA jurisprudence

An analysis of Part IVA and in particular the factors in s 177D(b) is beyond the scope of this paper and will depend on the particular facts of the matter.

Slater<sup>31</sup> considers that the Commissioner has by and large succeeded in his Part IVA claims in cases involving contrived or artificial arrangements but not in relation to what might fairly be described as commercial transactions framed to secure the best tax outcome.

The law is notoriously unpredictable in the middle ground<sup>34</sup> so making general statements which are applicable to specific circumstances is not possible. However, Spence & Haines<sup>35</sup> make the following general observation:

1. Sound technical analysis alone is insufficient and one must consider policy outcomes.
2. Where an arrangement pursues an outcome which is anticipated by government and which is consistent with clear policy objectives, the Commissioner and/or the courts are far less likely to support the application of Part IVA.
3. Where an arrangement pursues a benefit in such a way that the policy outcome is distorted, the application of Part IVA is likely to be supported.

It is unclear whether the trustee’s exercise of the powers in a trust instrument to allocate receipts or outgoings or to defer recoupment of losses, in order to obtain the preferred amount of trust law income to appoint to beneficiaries to achieve or manage the proportionate approach or impose taxation on a particular beneficiary, can colour the arrangement increasing the risk of the Commissioner successfully imposing Part IVA.

Where the exercise of the power is to direct income and capital to the appropriate beneficiaries then exercise of the power does not contain any inappropriate intent and satisfies the Distribution Duties.

However where the exercise is not so explicable, then the exercise will more readily be referable to a dominant purpose of obtaining a tax benefit.

Accordingly, it may be instructive to consider whether the same allocation can be achieved and the Distribution Duties discharged under the terms of the trust instrument without the exercise of the power. If it can, then the inference might reasonably be that the exercise of the power was for the dominant purpose of obtaining a tax benefit.

However, where (as is likely in modern trust instruments) the class of income and capital beneficiaries are homogeneous and the trustee has powers to pay capital on an annual basis and accumulate receipts for the benefit of the capital beneficiaries, there is unlikely to be a clearly preferred allocation as between income and capital beneficiaries. The tax consequences may assume more significance increasing the inference that the exercise of the power was for the dominant purpose of obtaining a tax benefit.

## Conclusion

The Federal Court has since 2001 consistently interpreted “the income of the trust estate” to equate with trust law income as understood by trust lawyers. Trust law income authorities permit allocation of receipts and outgoings and deferral of recoupment of losses in a flexible manner so the trustee can exercise its powers to manage the proportionate approach. Unless the High Court alters the interpretation of Div 6 or the interpretation of “income of the trust estate”, the Commissioner’s continued resistance to applying that authority when favourable to the taxpayer, is unacceptable and further clouds the operation of Div 6.

The determination of whether Part IVA should apply in a particular matter having regard to the surrounding circumstances and the terms of the trust instrument is likely to prove exceedingly difficult and uncertain. It is perhaps for this reason that the Commissioner continues to manage the potential tax avoidance problems arising from the operation of Div 6 by attempting to limit the interpretation of Div 6, rather than relying on Part IVA to disregard the tax benefit or reconstruct the scheme to impose tax differently.

The interpretative difficulties and sometimes incongruent operation of Div 6 are inherent and can only be rectified by legislative change. Blissenden<sup>36</sup> and Taylor<sup>37</sup> have published rewording of Div 6 to correct the interpretation difficulties and incongruent operation of Div 6. Review of Business Taxation, *A Tax System Redesigned* suggested a complete operational redrafting. The appropriateness of the solution is not always obvious or simple. However without legislative change, the operation of Div 6 will continue to be contested by the Commissioner and the taxpayer.

*Ron Jorgensen FTIA*  
*Principal*  
*Accredited Specialist in Tax Law*  
**HARWOOD ANDREWS LAWYERS**

### Reference notes:

- 1 *Cajkusic v FCT* (2006) 62 ATR 1.091 (AAT); (2006) 64 ATR 676; 2006 ATC 4752 (Full Federal Court).
- 2 *Income concept in Statement of Accounting Concepts 4* (SAC 4).
- 3 *Most clearly stated in Cajkusic* [2007] HCA Trans 157 at [line 250] where Young QC counsel for the Commissioner states “We would say income of the trust estate means income on ordinary conceptions”.
- 4 *Zeta Force P/L v FCT* (1998) 39 ATR 277; 98 ATC 4681.
- 5 *Richardson v FCT* (2001) 46 ATR 285; 2001 ATC 4,058 (Federal Court); (2001) 48 ATR 101; 2001 ATC 4,621 (Full Federal Court)
- 6 *Cajkusic v FCT* (2006) 62 ATR 1.091 (AAT); (2006) 64 ATR 676; 2006 ATC 4752 (Full Federal Court).
- 7 *FCT v ANZ Savings Bank* 1997] 36 ATR 230; 97 ATC 4,461 (Full Federal Court), (1998) 39 ATR 419; 98 ATC 4,850 (High Court)
- 8 *FCT v Cajkusic* [2007] HCA Trans 157.
- 9 *Hill v Permanent Trustee Company of New South Wales Ltd* [1930] AC 720 at 729-731.
- 10 *Hassell v Perpetual Executors Trustees & Agency Company (WA) Limited* (1952) 86 CLR 513 at 522-523.
- 11 *Thornley v Boyd* (1925) 36 CLR 526.
- 12 *McBride v Hudson* (1962) 107 CLR 604.
- 13 *Trustee Act 1925 (ACT); Trustee Act 1893 (NT); Trustee Act 1925 (NSW); Trusts Act 1973 (QLD); Trustee Act 1936 (SA); Trustee Act 1898 (TAS); Trustee Act 1958 (VIC) & Trustees Act 1962 (WA).*
- 14 *In re Reid* [1943] SASR 254 at 258.
- 15 *In re Dawes* [1954] VLR 76 at 79.
- 16 *In re Farnham's Settlement* [1904] 2 Ch 561, *In re Cross* [1943] VLR 38; *In re Wentworth* (1915) 15 SR (NSW) 384.
- 17 *Perpetual Trustee Co Ltd v Lassetter* (1934) 34 SR (NSW) 172.
- 18 *Watson v Little* (1921) 38 WN (NSW) 143; *Re Grant* [1933] VLT 263.
- 19 *Section 82-83 Trustee Act 1925 (ACT); s. 18, Trustee Act 1893 (NT); ss. 82-82A Trustee Act 1925 (NSW); s. 33 Trusts Act 1973 (QLD); ss. 25A-25B, Trustee Act 1936 (SA) & s 30 Trustees Act 1962 (WA).*
- 20 *Upton v Brown* (1884) 26 Ch D 588; *Re Reynolds* [1942] VLR 158.
- 21 *Re Mountain* [1934] NZLR 399; *Re Nairn* [1935] NZLR 134.

- 22 *Upton v Brown* (1884) 26 Ch D 588.
- 23 *Case 7/2001* (2001) 48 ATR 1200; 2001 ATC 150.
- 24 *Cajkusic v FCT* (2006) 64 ATR 676; 2006 ATC 4752 at [31] (Full Federal Court).
- 25 *Raftland P/L v FCT* (2007) 65 ATR 336; 2007 ATC 4104 (Full Federal Court)
- 26 *Raftland P/L v FCT* (2007) 65 ATR 336 [108]-[109] (Full Federal Court)
- 27 *Raftland P/L v FCT* [2007] HCA Trans 327 (21 June 2007).
- 28 *Raftland P/L v FCT* [2008] HCA Trans 009 & 010 (30 & 31 January 2008).
- 29 A. Slater QC, “The nature of income: The intersection of tax, legal and accounting concepts”, (2007) 36 AT Rev 138.
- 30 *Harmer v FCT* (1991) 22 ATR 726.
- 31 A Slater QC, “Part IVA in Wonderland: The “New Business Tax System”, Taxation Institute of Australia 2004 Financial Services Taxation Conference, 18 March 2004 at 3.
- 32 G Hill, “The Incremental Expansion of Part IVA”, *Taxation in Australia*, Issue 40, 1 July 2006; B Deutsch, “Today’s Part IVS – a report card”, Taxation Institute of Australia NSW Annual Intensive Conference, 6 November 2004 at [10 and [12]].
- 33 *Hart v FCT* (2004) 55 ATR 712.
- 34 K Spence & S Haines, “Tax advising in practice – where is the line to be drawn and how do you draw it”, Taxation Institute of Australia 44th Victorian Convention, 6n October 2005 at [4.1].
- 35 K Spence & S Haines, “Tax advising in practice – where is the line to be drawn and how do you draw it”, Taxation Institute of Australia 44th Victorian Convention, 6n October 2005 at [4.3].
- 36 M Blissenden, “Taxation of trust income under Div 6: A reflection on Justice Hill’s contribution”, (2006) 35 AT Rev 262 at 271-272.
- 37 C Taylor, “The movement of tax preferences through trusts and the cause of tax law complexity”, (2007) 36 AT Rev 222.