

Tax Brief

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Bamford: Taxation of trusts clarified

In its recent decision in *Bamford v Commissioner of Taxation* [2009] FCAFC 66, the Full Federal Court has settled (at least at the level of the Federal Court) two issues in relation to the taxation of trusts that have been the source of debate between taxpayers and the ATO, especially in recent times when the ATO has been developing views partly at odds with the general professional understanding.

Both issues revolve around the words “a share of the income of the trust estate” that appear in section 97(1) of the *Income Tax Assessment Act 1936* and elsewhere in the trust taxing provisions. The first issue decided by the Court concerns whether the so called “proportionate” or “quantum” approach was correct and the Court has come down firmly on the side of the proportionate approach.

The second issue concerns whether income of a trust estate refers to distributable income of the trust and in particular whether the amount of income can be affected by the terms of the trust deed and the exercise of trustee discretions or whether income means ordinary income and cannot be affected by the terms of the trust deed. The Court has clearly accepted that income means distributable income and can be affected by the trust deed and exercise of trustee discretions. We recently issued a Tax Brief discussing this issue at length and taking the same view, see http://www.gf.com.au/477_761.htm.

Facts

P&D Bamford Enterprises Pty Ltd was trustee of the Bamford Trust, a typical discretionary family trust running a business in which the trustee employed Mr and Mrs Bamford. In the 2000 income year the trustee entered into an offshore superannuation scheme in relation to Mr and Mrs Bamford as employees contributing \$175,000 and paying interest of c\$16,000 on money borrowed to fund the contribution. Both amounts were shown as revenue expenses in the trust's accounts and as deductions in the calculation of the net income of the trust. As with other such schemes, the ATO disallowed both deductions which had the effect of more or less doubling the net income of the trust. The trustee pursuant to its discretion in the trust deed resolved to allocate the income for the year in specified amounts to particular persons in order (including \$34,000 each to Mr and Mrs Bamford), with “the balance” to the Church of Scientology. As the income in the trust's accounts was not sufficient to cover all the specified

entitlements in particular amounts, Mr and Mrs Bamford ended up with \$33,872 each.

Before the disallowance of the deductions the tax law net income had been calculated as the same amount as the trust law income. After the disallowance of the deductions which the trustee did not dispute, the tax law net income of the trust (\$379,231) far exceeded the trust law income as calculated in the trust's accounts (\$187, 530). The ATO amended Mr and Mrs Bamford tax assessments so that they included the fraction $\frac{33872}{187530}$ or 18.062% of the net income, that is, \$68,496 each. They claimed that they still should only be assessed on the amounts of \$33,872 each.

The trustee's resolutions regarding beneficiary entitlements for the 2002 income year provided that Mr and Mrs Bamford were entitled to "the first \$60,000 including capital gain, shared equally" with the balance to the Church of Scientology. The trustee had sold an investment property during the year making a gain of \$58,454 which was reflected in the net income of the trust as a net capital gain of \$29,227 (after the CGT discount). The accounts of the trust reflected the full gain in the trust law income (revenue profit) for the year. Under the trust deed the trustee was given power to determine, in its absolute discretion, whether any receipt, profit, gain or payment, loss or outgoing or any sum of money or investment is or is not to be treated as being on income or capital account.

Although the numbers are not fully explained the ATO assessed the trustee on \$16,100 under section 99A on the basis that there was no beneficiary entitled to that amount because it represented (part of) the capital gain. The ATO argued that "income of the trust estate" in section 97 refers to income according to ordinary concepts which does not include a capital gain, that the trust deed cannot change this character and that therefore no beneficiary could be presently entitled to the capital gain. The Bamfords argued that they were presently entitled to that amount as income of the trust estate was to be determined in accordance with the trust deed, and the trustee as it was entitled to do under the deed had treated the gain as part of the trust income.

Proportionate approach preferred

In effect the ATO assessment for the 2000 income year adopted the proportionate approach to the meaning of "share" and the Bamfords' reply relied on the quantum approach, that is, a beneficiary could not be taxed on more income than they could actually demand from the trustee. Though there are some variants on the way the quantum approach has been expressed over the years, the Bamfords limited their argument to cases where specific amounts were allocated to particular beneficiaries and the remainder to another beneficiary, relying in part on the unfairness that could arise under the proportionate approach.

Emmett J (with whom Stone and Perram JJ agreed on this issue) said that the proportionate view was in accord with the natural meaning of the legislation (with share meaning proportion or fraction), and, in relation to the submission about unfairness on behalf of the Bamfords, the quantum view could equally lead to unfair results for the beneficiary allocated with the balance. Accordingly, the proportionate approach was adopted and the ATO's assessment on that basis upheld.

There is only passing reference to the previous case law on this issue in the form of a reference to *Zeta Force v Commissioner of Taxation* (1998) 84 FCR 70 on a particular point. That case had a much broader discussion of the existing case law on the issue which, with one exception, is strongly in favour of the proportionate view so the decision in *Bamford* on this issue is not a surprise.

Income means trust law income including the effect of the trust deed

On the issue of whether income could include a capital gain treated by the trust's accounts as an item entering the calculation of trust law income, Stone and Perram JJ delivered a separate judgment coming to the same conclusion as Emmett J. The judges apparently considered that their reasoning was different but it is not particularly clear what the differences in result are so we will focus first on the important areas of clear agreement among the judges.

All the judges note that the general trust law concept of income developed as part of the duty of the trustee to allocate trust assets among different beneficiaries and that it took the form of presumptions that gave way to the terms of the trust deed. They regard the words "income of the trust estate" in section 97 as a reference to this body of trust law, including alteration of the general presumptions by the trust deed and the exercise of any relevant discretions that the trust deed gives to the trustee in the determination of trust income.

Here the trustee had treated the gain on the investment property as part of trust income and so the Bamfords were presently entitled to that gain. As a result they were entitled to all of the income of the trust estate and so no assessment could be levied on the trustee in respect of income to which no beneficiary was presently entitled.

In his judgment Emmett J came to this conclusion by an analysis of the terms of the legislation and the policy purposes it was designed to achieve. He considered that "liability for tax on receipts of a trust estate should correspond with the enjoyment of those receipts." The trust law rules on income determined what beneficiaries were entitled to. If the trustee in pursuance of a power that enabled it to do so determined that a capital gain was part of the income so that beneficiaries were entitled to it, there was no reason why this result should not follow for tax purposes. This result held even if the character of the gain under tax law was capital or if it would be capital under trust law apart from the operation of the trust deed. He

expressly declined to consider the taxpayer's argument about *Cajkusic v Commissioner of Taxation* (2006) 155 FCR 430 or the argument that Division 115 of the *Income Tax Assessment Act 1997* dealing with the CGT discount clearly contemplated beneficiaries being presently entitled to capital gains.

By contrast Stone and Perram JJ reached their conclusion by a direct application of *Cajkusic*. They specifically rejected the ATO's arguments that the comments on the issue in *Cajkusic* were not part of the decision and that it should not be followed because it misunderstood the High Court decision in *Commissioner of Taxation v Australia and New Zealand Savings Bank* (1998) 194 CLR 328. Although the judges did not consider the policy underlying the legislation in the same way as Emmett J, they rejected an underlying theme of the ATO's arguments that the view in *Cajkusic* somehow thwarted the operation of the income tax legislation. All of the tax law income of the trust was subject to tax; the words "income of the trust estate" were simply part of the mechanism for determining in whose hands that income was taxable. They also did not consider the argument based on Division 115 at any length though they were inclined to the view that it did not help one way or the other.

While the decision in *Cajkusic* was critical to the joint judgment of Stone and Perram JJ, there is no extended discussion in either of the judgments of other case law pertaining to the issue, particularly cases on which the ATO has relied in other contexts in discussing this issue.

Comments

Although there have been varying views expressed about the decision in *Bamford* in the media and elsewhere, we consider that the decision is a welcome clarification of two issues that have been discussed over many years in the trust taxation context. Most observers thought that the first issue on the proportionate versus quantum view had been dealt with fairly extensively and consistently by the Federal Court in previous cases in favour of the proportionate view. Although the ATO has not seemed to regard that issue as settled by the previous cases, it was they who in fact argued the proportionate view in *Bamford*. It is to be hoped that the ATO in future will regard this issue as settled by the unanimous Full Federal Court decision.

On the other hand it was well known from the ATO's decision impact statement on *Cajkusic* that the ATO did not accept what seemed to be a clear decision in that case on the meaning of "income of the trust estate." The judgments in *Bamford* clearly affirm the view that it is trust law income which is described by those words. Trust law income is determined by a combination of the terms of the trust deed, any exercise of relevant trustee discretions, and, only in the absence of provisions in the trust deed or trustee discretions, the trust law presumptions about the meaning of income. Two of the judges in *Bamford* have expressly approved the decision in *Cajkusic* and in doing so have rejected the ATO views of that decision put forward in the decision impact statement. Again it is to be

hoped that the ATO will accept the result of two clear Full Federal Court decisions on the issue and revise its decision impact statement.

Application to public unit trusts (MITs)

Although the decision in *Bamford* concerns a private discretionary business trust, there is nothing in the decision to suggest that the decision is limited to that context and we consider that it is applicable to public unit investment trusts. The decision is thus relevant to the upcoming distribution season for such trusts.

The decision states clearly that the trust deed is paramount in determining what is trust law income for the purposes of section 97. While we agree with this view, we note that this means that it is necessary to consider the issue by reference to the whole of the terms of the relevant deed rather than simply relying on a literal reading of the discretions contained in the income clauses.

First, and most importantly, the whole of the terms of the trust deed need to be considered. If some departure from the default trust income rules is proposed in determining trust income then it must be justified by an explicit provision in the trust deed (or in legislation dealing with trusts). It is apparent from the decision that the court will look at the whole of the trust deed in interpreting particular parts of it. Hence a bare statement in a trust deed in similar terms to the deed in question in *Bamford* about the trustee having an absolute discretion in characterising receipts and outgoings as capital or revenue will need to be considered in the context of any other provisions in the deed concerning the determination of income which may qualify such an apparently unfettered discretion. It is generally not possible for trustees to simply pick a number as trust law income – there must be a process of calculation involved which is justified by the trust deed in cases where the trustee departs from the default rules for determining trust income according to trust law.

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

Thirdly, in *Raftland v Commissioner of Taxation* [2008] HCA 21, the majority of the High Court of Australia suggested that where there is only one class of unit in a unit trust, some of the presumptions about the allocation of trust income among beneficiaries may not be relevant. We note that the unit trust

in question in that case was closely held and that the comment was only made in passing. In a public unit trust where unitholders can enter and exit freely in most cases, the trustee may need to give consideration to the relative treatment of entering and exiting unitholders compared to continuing unitholders and the interests of unitholders may not all be the same, that is, there may be a time dimension to be considered in exercising trustee discretions.

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

- In the case of public unit trusts the constitution of the trust also has effect as a contract between the trustee and unitholders;
- Information (as to intended income distributions) contained in any product disclosure statement;
- The protection of the overall interests of unitholders by not having the trust wound up or forced to sell assets in a way which will produce a substantial reduction in values for unitholders. While a court may have regard to factors such as the constitution, product disclosure statements and consistency in treatment of income over time in considering the exercise of trustee discretions, the current very unusual economic circumstances may justify or require trustees to depart from previous practice in exercising trustee discretions to determine trust income.

As each case will depend on the facts and circumstances, including but not limited to the correct interpretation of the trust deed, trustees will be well advised to obtain confirmation about what courses of action under trust law are possible for upcoming distributions.

Fifthly, trustees seeking to conserve cash resources in public unit trusts may wish to issue new units to unitholders to satisfy rights to income. This is a complex issue and it must not be assumed that a trustee can do this automatically. There must be a clear power in the trust deed and even then it is doubtful that such an issue without any choice on the part of unitholders can satisfy the requirements for present entitlement. Similarly, trustees may be inclined to distribute an amount equal to the tax law net income of the trust. Again this requires considerable caution. The trust deed will need to contain a provision that equates trust law income with tax law net income (or gives the trustee a discretion to make such a determination). There was such a power in the trust deed in the *Bamford* case but the trustee had not exercised the power on the facts. The tenor of the decision is that if the trustee had utilised the power the Court would have given effect to that determination for tax purposes. The ATO has taken the view in the past that it was not possible for deemed tax law income of a trust (such as foreign investment fund income) to be the subject of a present entitlement. Again the tenor of the judgments would support the contrary view if a trustee has power to determine trust income as the same amount as tax law net income or has another power relevant to this issue.

Subject to these cautions, as a result of the two issues decided in *Bamford*, trustees should be able to approach the distribution season with greater certainty than in the past. If trustees properly calculate trust income available for distribution in accordance with the trust deed including relevant discretions, and distribute the full amount of trust income to unitholders again in accordance with the trust deed, then trustees should not be subject to tax under section 99A. Rather as usual the unitholders should be subject to tax under section 97 or MIT withholding tax.

This result should follow even if the trust law income calculated in accordance with the trust deed is less than the tax law net income of the unit trust as a result of the proper exercise of the trustee's discretions in calculation of trust income available for distribution.

Possibility of appeal

The main outstanding tax law question as a result of the *Bamford* decision is whether the ATO will appeal against the decision. We should know the answer to that question shortly.

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

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