TR 94/D3 - Income tax: Division 16 - applicability of averaging provisions to beneficiaries of trust estates carrying on a business of primary production

Draft Taxation Ruling
Income tax: Division 16 - applicability of averaging provisions to beneficiaries of trust estates carrying on a business of primary production.

other Rulings on this topic

IT 319; IT 328; IT 329; IT 347; IT 348; IT 2680

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What this Ruling is about

1. Following the decision of the Administrative Appeals Tribunal in *Case Z35*, 92 ATC 326; sub nom *AAT Case 8226*; (1992) 24 ATR 1040, several enquiries have been made concerning the application of Division 16 to beneficiaries of trust estates carrying on a business of primary production.

2. Taxation Ruling No. IT 286 outlined the operation of Division 16, in particular subsection 157(3), in relation to beneficiaries of trust estates engaged in primary production activities. In that Ruling it was stated that it would be most unlikely that a trustee of discretionary trust would exercise a discretion in favour of a beneficiary where the business activities resulted in a loss. This statement has been interpreted in many quarters to mean that a beneficiary in a trust which operated a primary production business at a loss could never receive the benefit of averaging through having a beneficial interest in that trust estate.

3. As this is not the case it has been decided to further explain the application of Division 16 averaging provisions, in particular subsection 157(3), to a taxpayer who is a beneficiary in a trust estate carrying on a business of primary production.

Previous Rulings

4. The relevant principles from Taxation Ruling No. IT 286 have been incorporated into this Rulings. Accordingly, Taxation Ruling IT 286 is now withdrawn.

Ruling

5. A beneficiary who is presently entitled, under the terms of a trust deed, to the income or part of the income of a trust estate which carries on a business of primary production may benefit from the averaging provisions. This result is specifically provided for in subsection 157(3), subject to subsection 157(3A) of the *Income Tax Assessment Act 1936* (the Act).

6. Subsection 157(3A) was inserted into the Act to overcome the decision of the High Court in *Cridland v. FC of T* (1977)140 CLR 330; 77 ATC 4538; (1977) 8 ATR 169. The subsection is designed to counter schemes of tax avoidance under which taxpayers become entitled to the benefits of the averaging provisions through having a minimal interest in income from a trust which carries on a business of primary production. Beneficiaries in primary production trusts of the traditional kind, for example family trading trusts, will not be affected by this provision.

7. The application of subsection 157(3) must be considered in the whole context of Division 16. Section 153 provides that any year in which a taxpayer was carrying on a business of primary production but had no taxable income shall be capable of being an average year. It follows that where a beneficiary is presently entitled, under the terms of a trust deed, to the income or part of the income of a trust estate which carries on a business of primary production, any year in which the trust estate incurs a loss is capable of being an average year.

8. It should be noted that subsection 157(3) does not require that a beneficiary be presently entitled to a share of the net income of a trust estate calculated in accordance with section 95. Present entitlement relates to the income of a trust estate and refers 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 is legally available to be distributed to those entitled to it as beneficiaries under the trusts (See paras 22-26).

9. A beneficiary may be presently entitled to income of a trust estate notwithstanding that the trust may have incurred a loss in a year. Provided that income from a business of primary production is derived in the relevant year of income by the business conducted by the trustee it does not matter that there is a loss for income tax purposes. A presently entitled beneficiary in such a case will be

treated as carrying on a business of primary production for the purposes of Division 16.

10. On the other hand in a discretionary trust engaged in a business of primary production, a beneficiary would not, as a general rule, be deemed to be carrying on a business of primary production in any year in which the trustee does not exercise the discretion in favour of the beneficiary. This is because the beneficiary would only be contingently entitled, as opposed to presently entitled to the whole or part of the income of the trust estate as required by subsection 157(3).

11. Should the trustee exercise his discretion in favour of a beneficiary who is contingently entitled under the trust, the interest ceases to be contingent and becomes vested (See *IRC (NZ) v. Ward* 69 ATC 6050; (1969) 1 ATR 287; (1970) NZLR 1). In such a case the beneficiary will be treated as carrying on a business of primary production for the purposes of Division 16.

12. We accept that the decision in *Case Z35* correctly sets out the application of Division 16 to presently entitled beneficiaries of a trust estate which has operated a business of primary production in a year of income at a loss.

Date of effect

13. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Division 16

14. Under Division 16 a person is eligible to have the rate of tax applicable to his/her taxable income determined by reference to averaging provisions, if he/she is a primary producer. The application of averaging is, by section 157, confined to persons carrying on a business of primary production.

15. Subsection 157(3) extends the ambit of the Division beyond people who themselves carry on a business of primary production. The subsection was inserted into the Act to overcome the effect of the decision of the High Court in *Doherty v. FC of T* (1933) 48 CLR 1 where it was held that a beneficiary in a trust estate did not carry on the business of the estate.

16. Subsection 157(3) provides that where the trustee of a trust estate is carrying on a business of primary production a beneficiary who is presently entitled to a share in the income derived by the trust is to be treated, for purposes of the averaging provisions, as if he/she were carrying on the business carried on by the trustee. Prior to 1978 a person was eligible to have the whole of his/her taxable income subject to averaging if he/she was an income beneficiary in such a trust, even if the interest in the trust was minimal.

17. This is still the case but, in the light of the High Court decision in *Cridland's case* , subsection 157(3A) was inserted into the Act. This subsection ensures that the averaging system applicable to primary producers is not available to people who have no real stake in a primary production business and have become a beneficiary in a primary production trust simply to gain the benefits of tax averaging.

18. Subsection 157(3A) acts as a screening mechanism to limit the application of subsection 157(3) in the first instance to those beneficiaries of a primary production trust estate who have a present entitlement to a share of the trust's income in the income year of $1040 or more. However, a beneficiary whose entitlement to share in the trust income is less than $1040, will also qualify for the application of subsection 157(3) if the Commissioner is satisfied that the person's interest as beneficiary in a trust estate was not acquired primarily for the purpose of having the benefit of the averaging provisions applied to his/her income.

19. The provision is aimed at countering tax avoidance arrangements. Beneficiaries in primary production trusts of the traditional kind will not be affected by the provision. See, for example, the family arrangements discussed in *Case Z35* ; 92 ATC 326 at 331; *AAT Case 8226*; (1992) 24 ATR 1040 at 1046.

20. The extension of the averaging provisions under subsection 157(3) to a beneficiary of a trust estate is based upon the requirements that :

(a) <u>income from a business of primary production</u> is derived in the year of income by the business conducted by the trustee; and

(b) a beneficiary is <u>presently entitled</u> to share in the whole or part of that income.

21. Whether income from a business of primary production is derived in the relevant year is a question of fact. If the trust is carrying on a business of primary production a beneficiary presently entitled to share in the income will be deemed to be carrying on the business carried on by the trustee.

Present entitlement to trust income

22. Under a fixed trust, a presently entitled beneficiary has an entitlement in equity in the trust property which is ascertained in accordance with the terms of the trust. The beneficiary may enforce the administration and distribution of the property of the trust. Under a discretionary trust the trustees have an absolute discretion to apply the income and capital of the trust's property to the beneficiaries who can enforce the administration of the trust. A beneficiary's entitlement results from the trustees' exercise of the discretion in favour of the beneficiary.(section 101)

23. The meaning of the expression 'presently entitled' in subsection 157(3) is not defined in the Act but its meaning is well settled by decisions of the courts.

24. A beneficiary of a trust becomes presently entitled to income from the trust if all of the following requirements are met:

- the relevant income is legally available for distribution; and
- the beneficiary has an absolutely vested beneficial interest in possession in the whole of the relevant income; and
- the beneficiary would succeed in an action to recover the income from the trustees ignoring for this point the existence of any legal disability from giving a valid discharge to the trustees (e.g., by being a minor).

(See the High Court of Australia decision in *Taylor v. FC of T* (1970) 119 CLR 444 at 452; 70 ATC 4026 at 4030; (1970) 1 ATR 582 at 586. Taxation Ruling IT 319 further explains the concept of present entitlement.)

25. The conclusion that a beneficiary is presently entitled to a share of the income of a trust estate if, but only if:

(a) the beneficiary has an interest in the income which is both vested in interest and vested in possession; and

(b) the beneficiary has a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant year of income and whether or not the trustee has the funds available for immediate payment

was agreed to by the parties before the Full High Court in *Harmer v. FC of T* (1991) 173 CLR 264 at 271; 91 ATC 5000 at 5004; (1991) 22 ATR 726 at 729-730.

26. The requirement of present entitlement to a share of the income of the trust estate refers 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 the trustee's hands, is

legally available to be distributed to those entitled to it as beneficiaries under the trusts. (see the Full Court of the Federal Court of Australia decision in *FC of T v. Totledge Pty Ltd* 82 ATC 4168 at 4175; (1982) 12 ATR 830 at 838.)

Trusts with no net income or with losses for income tax purposes

27. Under the general trust provisions in the income tax law, a beneficiary's or trustee's assessable income includes the beneficiary's 'share of the net income of the trust estate' (sections 97 and 98). However, subsection 157(3) does not require that a beneficiary be presently entitled to a share of the net income of a trust estate calculated in accordance with section 95. As noted in paragraphs 24 to 26 above, present entitlement relates to the income of a trust estate.

28. In *Union Fidelity Trustee Co. of Australia Ltd & Anor v. FC of T* (1969) 119 CLR 177 at 185; 69 ATC 4084 at 4089; (1969) 1 ATR 200 at 204, *Kitto J* explained present entitlement to the income of a trust estate as follows:

> 'At no time during the year was any beneficiary presently entitled to any part of the income of the estate (though a very small part of the income was in fact distributed to the beneficiaries). This is so because 'presently entitled to any part of the income of a trust estate' refers not to the availability of any income for payment to him, but to a present title in possession in respect of any income the estate may produce;...'

29. Furthermore, in *Totledge's case* at ATC 4173-4174; ATR 837 the Federal Court (*Bowen CJ, Deane and Fitzgerald JJ*) explained a beneficiary's entitlement to income in the following words:

> 'A beneficiary under a trust who is entitled to income will ordinarily only be entitled to receive actual payment of the appropriate share of surplus or distributable income: the trustee will be entitled and obliged to meet revenue outgoings from income before distributing to a life tenant or other beneficiary entitled to income. Indeed, circumstances may well exist in which a trustee is entitled and obliged to devote the whole of gross income in paying revenue expenses with the consequence that the beneficiary entitled to income may have no entitlement to receive any payment at all. This does not, however, mean that a life tenant or other beneficiary entitled to income in a trust estate has no beneficial interest in the gross income as it is derived. He is entitled to receive an account of it from the trustee and to be paid his share of what remains of it after payment of, or provision for, the trustee's proper costs, expenses and outgoings....'

30. Accordingly, it is quite consistent with the authorities that a beneficiary may be presently entitled to income of a trust estate notwithstanding that the trust has no net income for tax law purposes or may have incurred a loss for the year. A presently entitled beneficiary in such a case will be treated as carrying on a business of primary production for the purposes of Division 16.

Trustee resolutions

31. As indicated in paragraph 11, a beneficiary in a discretionary trust has a mere expectancy and, therefore, has no interest until the trustees elect to exercise the discretion in his/her favour. In *Case Z35*, KL Beddoe (Senior Member) referred to *Re Baron Vestey's Settlement, Lloyds Bank Ltd v. O'Meara* [1951] Ch 209; [1950] 2 All ER 891 and *IRC (NZ) v. Ward* [1970] NZLR 1; 69 ATC 6050; (1969) 1 ATR 287 in holding that the trustee had acted in accordance with the relevant clause of the trust deed and its resolutions were therefore effective to apply the primary production income of the business for the benefit of the beneficiary.

32. We accept that the *Ward* decision, which followed the earlier English decision in *Re Vestey's Settlement*, is authority for the proposition that in some cases a resolution or determination of a trustee to apply, divide, set aside, etc trust income for or amongst beneficiaries may have the effect, of itself, of vesting trust income in a beneficiary and thus making him/her presently entitled to that income for the purposes of sections 97 and 98.(See Taxation Ruling IT 347)

33. In practice, present entitlement will be conceded where the Commissioner is satisfied, in the particular circumstances of the case , that the trustee in formally passing the resolution or making the determination in question has acted genuinely and irrevocably in the exercise of the trustee's powers to distribute income of the trust and has intended to vest the income in the beneficiary concerned.

34. If the action of the trustee falls within the requirements previously accepted in connection with the application of trust income for the purposes of section 101 the beneficiary will in any event be deemed to be presently entitled.

35. These requirements are set out in Taxation Ruling IT 329 at paragraph 9. A declaration, resolution or other act of a trustee in an effective exercise of his discretion will amount to an application of income of a trust estate for the benefit of a beneficiary where:

(a) a specific ascertainable portion of the income of the year in question is thereby immediately and absolutely vested in the beneficiary so that even though it might not be immediately paid to the beneficiary it becomes his/her absolute property and would form part of his/her estate in the event of death;

(b) the declaration, resolution, etc is final and irrevocable.

36. It has been a long standing administrative policy to accept that a declaration, resolution, etc which fulfils the above requirements made within two months after the close of the year of income will be effective for the purposes of section 101, ie it will be accepted as an application of the trust income in the year preceding the two months period.

Commissioner of Taxation

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- Case Z35 92 ATC 326; (1992) 24 ATR 1040;
- Cridland v. FC of T (1977) 140 CLR 330; 77 ATC 4538; (1977) 8 ATR 169
- Doherty v. FC of T (1933) 48 CLR 1
- FC of T v. Totledge Pty Ltd 82 ATC 4168; (1982) 12 ATR 830;
- Harmer v. FC of T (1991) 173 CLR 264; 91 ATC 5000; (1991) 22 ATR 726;
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- Re Baron Vestey's Settlement, Lloyds Bank Ltd v. O'Meara (1951) Ch 209; (1950) 2 All ER 891;
- Taylor v. FC of T (1970) 119 CLR 444; 70 ATC 4026; (1970) 1 ATR 582
- Union Fidelity Trustee Co. of Australia Ltd & Anor v. FC of T (1969) 119 CLR 177; 69 ATC 4084; (1969) 1 ATR 200