# *IT 328 - Trusts : interpretation of section 101 in relation to sections 99 and 99A under 1964 amending legislation.*



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# TAXATION RULING NO. IT 328

TRUSTS : INTERPRETATION OF SECTION 101 IN RELATION TO SECTIONS 99 AND 99A UNDER 1964 AMENDING LEGISLATION.

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OTHER RULINGS ON TOPIC IT 329

PREAMBLE In response to a number of queries from tax agents and other tax advisers, this Office has given consideration to the manner in which the provisions of Division 6 of Part III of the Income Tax Assessment Act would be applied under the 1964 amending legislation. Particular attention has been given to the manner in which enquiries regarding the effect of section 101 should be answered.

FACTS 2. The enquiries generally appear to come from firms of accountants or solicitors which have been active in arranging for their clients to set up multiple trusts so that income from the client's business or investments would be taxed in a series of section 99 assessments, so as to bear little or no tax while still remaining substantially within the client's control. In the typical arrangement, the nominal beneficiaries had no more than a contingent right to receive the income at some remote future time and often there were special provisions which might well be used by the person in control of the trust to ensure that the rights of the beneficiaries to enjoy the income could be postponed indefinitely.

3. The broad effect of the 1964 remedial legislation which was directed against these schemes was that income to which no beneficiary was presently entitled would be taxed at the flat rate of 10/- in the /, except where the Commissioner of Taxation was of the opinion that it would be unreasonable to apply the flat rate. The circumstances in which the Commissioner is prepared to exercise his discretionary powers have been stated in Public Information Bulletin No. 4 and other instructions and, generally speaking, the 10/- rate does not apply so long as :-

(a) there has been no unwarranted duplication of trusts; and

(b) use is not being made of such arrangements as direct or indirect

loans to the trustees or the attachment of variable dividend rights to shares owned by the trustees.

4. Generally speaking, the enquiries which are now being received would come from tax agents acting for trustees who have previously been taxed under section 99 and who cannot, unless some action is taken to alter existing circumstances, anticipate exercise of the discretion under section 99A.

RULING

5. It is quite consistent with the objectives of the 1964 legislation that the trustee should, in such cases, avoid a liability under section 99A by exercising whatever powers they may have to make beneficiaries presently entitled to income.

6. It has been decided for assessment purposes that where a trustee claims that beneficiaries are presently entitled, the claim should be accepted (at least in the first year of operation of section 99A) unless the information supplied by the trustee or available in official papers indicates otherwise. The absence of complete information demonstrating that section 101 applies need not, in the early years of the operation of section 99A, be the grounds for a query. On the other hand, examination of the position will be appropriate when the available information throws a real doubt on the correctness of the claim or the beneficiary disputes liability for tax.

7. The position is different, however, if a tax agent or trustee asks for advice regarding the application of section 101. Because taxpayers may arrange their affairs on the basis of whatever advice is given, it will be necessary to ensure that no rulings are given, regarding the interpretation of the section, which are likely to be proved incorrect by later decisions of the Courts or Boards of Review.

8. The persons making such enquiries would probably know the circumstances in which a beneficiary is regarded as being "presently entitled" to income within the primary meaning of that expression in sections 97 and 98 (cf. Taxation Ruling IT 348 on this question). They would also be aware that it has always been accepted without question that, pursuant to section 101, a beneficiary is deemed to be presently entitled to income which the trustee, in the exercise of a discretion granted to him under the trust deed, has expended for the beneficiary's immediate personal benefit - as where the trustee pays for the beneficiary's education or maintenance, pays his debts or makes cash payments to him (10 C.T.B.R. Case 116).

9. It seems, therefore, that the enquiries will be mainly concerned with whether, in view of the rather broad terms in which section 101 is expressed, it will be accepted that income is "paid or applied" for the benefit of a beneficiary, so that he will be deemed to be presently entitled to it, if the trustee continues to accumulate the income as before but takes some formal steps which could be regarded as an application of the income for the beneficiary's benefit. Typical suggestions have

been that the trustees might -

(a) make book entries or declarations attributing income to particular beneficiaries;

(b) pay income into a bank account in the name of a beneficiary and then lend it back to the trust; or

(c) pay the income to a new trust expressed in similar terms to the original trust in which the beneficiary would still not be presently entitled to either income or capital.

10. It appears that the originating point for many of the enquiries is to be found in a note on section 99A in the service to Challoner and Greenwood's "Income Tax Law and Practice" which pointed to the decision of the House of Lords in Pilkington v I.R.C., (1962) 3 All E.R. 622, as showing how trustees might take advantage of statutory powers granted to them under the Trustee Act to re-settle property so as to avoid the application of section 99A.

11. In essence, Pilkington's case decided that a provision in the Trustee Act authorizing trustees to "pay or apply" part of the capital of a trust fund for the advancement or benefit of a person contingently entitled could be used to re-settle trust property in which an infant had merely a contingent interest in a new trust. The main purposes of the re-settlement was to reduce the incidence of death duties and, after the change, the beneficiary still had only a contingent interest, although it was of a different kind. The House of Lords nevertheless decided that the re-settlement was a valid exercise of the trustees' statutory power to "pay or apply" capital.

12. It is important to recognise that Pilkington's case was concerned with the interpretation of a particular statutory provision and that, in reaching their decision, their Lordships took into account the history of the provision and the conveyancing precedents on which it was based. The decision does not mean that the words "pay and apply" always have the same meaning or that they must be interpreted as having the same meaning in section 101 of the Income Tax Assessment Act as they do in the Trustee Act. In accordance with the accepted principles of statutory interpretation, a court interpreting section 101 would have to determine its meaning in the light of the context in which section 101 appears in the Assessment Act.

13. If the words "pay or apply" in section 101 were given the same broad meaning as in Pilkington's case, this could mean that an adult beneficiary with only a contingent interest in the income of a trust estate would become liable to bear the tax on income which he might never actually receive simply because a trustee, over whom he had no control, had re-settled the income on a new trust under which the beneficiary still had no guarantee of ever receiving the income. Trustees seeking to reduce the incidence of tax could probably take advantage of such an interpretation - if it became established - by making a

series of infants the nominal beneficiaries in respect of whom assessments should be raised under section 98, while intending that the income should in the long run pass, through the happening of some contingency, to some other person.

14. An even stronger ground for not applying the "Pilkington" interpretation to section 101 is that there could be many cases in which a trustee could "apply" income, by re-settling it on a new trust under which the income could eventually pass to any one of several named people. Such an application of income would seem to be for the benefit of each of those people (in the Pilkington sense) as they may eventually receive the income. The legislature could hardly have intended that all of them should be taxed, and there is no basis on which the liability could be shared between them.

15. Because such consequences would flow from a broad interpretation of the critical words in section 101, a court could reasonably infer that the legislature must have intended the words "pay or apply" to have a narrower meaning in section 101 than the corresponding words in the Trustee Act as interpreted by the House of Lords. In the absence of decided cases, it is difficult to predict what limits a court would place on section 101 but it is at least arguable that the section, as a provision helping to impose tax on the income of beneficiaries, should be construed as deeming a beneficiary to be presently entitled to income only where :-

(a) the income is paid to the beneficiary;

(b) the income is expended by the trustee in some way which immediately and irrevocably confers some personal benefit on the beneficiary (e.g. payment of his living or educational expenses or payment of premiums on a life policy owned by the beneficiary);

(c) the trustee has validly exercised a power granted to him under the trust deed which has the effect of making the beneficiary "presently entitled" (in the primary sense of that term as explained in Taxation Ruling IT 348) even though his infancy makes him incapable of demanding payment from the trustee; or

(d) the income is re-settled by the trustee on some new trust in which the beneficiary has an immediate and indefeasible entitlement to both capital and income, subject only to such limitations as may arise from his personal status as an infant.

16. Difficult questions of law can sometimes arise in connection with cases falling into category (c). If, for example, the trust deed provides that the trustee may, in his discretion, pay or apply the income of the trust to such of the settlor's infant children as the trustee selects, it would not

necessarily be sufficient if the trustee merely makes a book entry allocating the income to particular beneficiaries : cf. Montgomerie v. I.R.C., (1965) 9 A.I.T.R. The book entries may not be binding on the trustee and, in any event, they may amount to no more than a declaration of intention to accumulate the income.

17. Paying cash into a bank account held by the trustee in the name of a beneficiary would be inconclusive if the effect of the trust deed is that the trustee has power to take the money out again at will and eventually pay it to someone else. Written advice by the trustee to the beneficiaries could be equally inconclusive, particularly if it is expressed in ambiguous terms.

18. Particular care will be needed in handling enquiries regarding such proposals. The situation is complicated by the fact that many of the trusts which were established for tax-saving purposes have been set up by tax agents using standard forms of trust deed the implications of which they do not always understand.

19. To explain this office's view of what is needed to ensure present entitlement in cases where the trustee purports to apply income without distributing or expending it, the enquirer should be told that the trustee has to take some formal action which, having regard to the terms of the paticular trust instrument, has the legal effect of giving the beneficiary an immediate and irrevocable vested interest in the income - that is, the beneficiary has to be put in a position where he would be able to demand immediate payment if not for the fact that he is an infant.

20. It would not be appropriate for taxation officers to attempt to give legal advice to accountants or trustees as to the actions that the trustee should take in order to give a beneficiary an immediate and indefeasible vested interest in the income. In cases of doubt, the enquirers will have to seek guidance from their own advisers.

21. Where, however, the trustee has decided upon the action he proposes to take and an examination of the trust deed as a whole leads to the conclusion that the proposed action would make the beneficiary presently entitled, there would be no objection to telling the enquirer that, under the current assessing practices, it would be accepted that the beneficiary is presently entitled. Borderline cases could, if desired, be referred to this office in the interests of uniformity.

22. Caution will also be needed in advising persons who are seeking to bring about present entitlement by paying trust income into bank accounts in the names of beneficiaries. Trust income is always paid into some bank account and the fact that a bank account controlled by a trustee bears the name of a particular beneficiary does not establish that the beneficiary is presently entitled. This question would have to be determined by considering the terms of the provision in the

trust deed which authorised the trustee to pay the money into the bank account, the manner in which the application of income was made and the arrangements that were made with the bank.

23. If, for example, a trustee, in the exercise of a discretionary power to make a distribution out of the net income of the trust estate to an infant beneficiary, gives effect to the distribution by paying the amount involved into a bank account which a parent of the beneficiary (not being a trustee) has opened in the beneficiary's name, it would be conceded that this was a payment to the beneficiary which would make him presently entitled pursuant to section 101 (provided, of course, that there was no reason to doubt that the infant was the beneficial owner of the money in the bank account). In cases of doubt, however, the onus should be placed on the trustee to satisfy that either the bank account is the absolute property of the beneficiary or that the bank account is held under a new trust, under the terms of which the beneficiary is presently entitled to both capital and income.

24. In particular, it is doubtful if these requirements will be satisfied in cases where the trustee proposes to remove the money from the bank and lend it back to the original trust estate. He could not do this if the money belonged outright to the beneficiary and, if there is a new trust, a loan to the old trust would probably be found not to be an authorized trustee investment in the particular case. The lending of the money back to the original trust would seem to raise a presumption that the money has at all times been held under the original trust and that the beneficiary is not presently entitled. Until the position is clarified by further decisions, the effectiveness of such arrangements should not be conceded without prior reference to this office.

25. In the present state of the law, it has been decided not to concede that section 101 would apply where income is re-settled on a new trust unless the trust is constituted in such a way as to make the beneficiary presently entitled to both the income and the capital of the new trust - i.e. the beneficiary's rights to claim both income and capital must not be restricted except by the fact that the beneficiary's personal status as an infant renders him incapable of calling on the trustee to pay over the capital and income.

26. In dealing with these enquiries it should be explained, in appropriate cases, that borderline questions of law are involved and that, in raising assessments in the future, it will be necessary to apply section 101 in the light of any further decisions of the courts that may be given on the application and interpretation of section 101.

27. In the light of the Pilkington decision, it is not certain that the Commissioner will be able to maintain all the propositions stated in paragraphs 15 to 25 but it will be safer to adhere to them in advising taxpayers rather than accept a broader interpretation of section 101 which would, in some cases, impose liabilities that seem to be quite inappropriate,

and which would no doubt be challenged on appeal sooner or later.

28. It is stressed, however, that the comments in paragraphs 15 to 25 are designed to assist in answering specific enquiries or in dealing with cases in which there are definite grounds for challenging returns prepared on the basis that beneficiaries are presently entitled. They do not in any way modify the decision, referred to in paragraphs 5 and 6, that such returns may be accepted without query where there is no reason to doubt their correctness.

29. Some support for the placing of a narrower interpretation on the words "pay or apply" in section 101 is to be found in the decision of the Supreme Court of New Zealand in Montgomerie v. I.R.C. (1965) 9 A.I.T.R. 577. The judge in that case interpreted a section in the N.Z. income tax law which is similar in effect to section 101 and held that income could not be said to be "applied" within the meaning of that provision, merely because it was credited to an account of a beneficiary.

30. Tax agents enquiring generally about the interpretation of section 101 could be informed, in appropriate cases, that the approach of the New Zealand court is considered to provide an indication of the manner in which section 101 would be interpreted by an Australian court, and that the Commissioner accepts that section 101 applies in the circumstances outlined in paragraph 15 of this Ruling.

Period in which Application of Income Should be made

31. Where a trustee is carrying on a business, it will often be impossible to determine the amount of the net income of the trust estate until after the close of the year of income.

32. Enquirers may be told that, although a strict application of the law may possibly require that income be paid or applied prior to the close of the year of income if section 101 is to be relied on, it will be accepted that a payment or application made within two months of the close of the year of income is effective for purposes of section 101 - provided, of course, that the other requirements of the section are complied with and the assessments raised under section 97 or 98 are accepted. A longer period may be allowed for this purpose, on application being made to a Deputy Commissioner, if the amount of the net income of the trust estate cannot conveniently be determined within two months.

COMMISSIONER OF TAXATION