TR 95/29 - Income tax: Division 16 - applicability of averaging provisions to beneficiaries of trust estates carrying on a business of primary production

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

This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

contents para

What this Ruling is about

Class of person/arrangement

1. This Ruling explains the circumstances in which the averaging provisions of Division 16 of the *Income Tax Assessment Act 1936* (the Act), and in particular subsection 157(3), may apply to a taxpayer who is a beneficiary in a trust estate carrying on a business of primary production. This explanation is necessary to clarify the position following the decision in *Case Z35* 92 ATC 326; (1992) 24 ATR 1040.

Previous Rulings

2. The relevant principles from Taxation Ruling IT 286 have been incorporated into this Ruling. Accordingly, Taxation Ruling IT 286 is now withdrawn.

Ruling

3. 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 flows from the provisions of subsection 157(3), subject to subsection 157(3A) of the Act.

4. Subsection 157(3A) is designed to counter schemes of tax avoidance and its application depends on the circumstances of each case. However, beneficiaries in primary production trusts of the traditional kind, for example family trading trusts, will not be affected by this provision.

5. Present entitlement is determined by reference to trust law income of a trust estate rather than net income calculated under section 95. It requires 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 trust (see paragraphs 29-30).

6. If 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.

Existence of trust law income

7. A beneficiary may be presently entitled to trust law income of a trust estate notwithstanding that the trust may have incurred a loss in a year. Provided that some gross trust law income is derived in the relevant year of income by the primary production business conducted by the trustee, it does not matter that there is an overall loss for trust law or income tax law purposes. A beneficiary presently entitled to that income in such a case will be treated as carrying on a business of primary production for the purposes of Division 16.

8. The trust deeds of some discretionary trusts contain clauses which have the effect that if the trustee has not determined to appoint income of the trust to any beneficiary or to accumulate such income before the end of the year of income, the income of the trust will fall to takers in default of appointment. Where such default beneficiaries are entitled to income of the relevant period, they will be presently entitled to that income. Consistent with the situation described in paragraph 7, a presently entitled default beneficiary will be treated as carrying on a business of primary production for the purposes of Division 16.

9. If the discretionary trust deed contains no default or fail-safe clauses and the trustee does not exercise the discretion in favour of a beneficiary, the beneficiary is only contingently entitled to income of the trust estate. In this case, the beneficiary would not be regarded as carrying on a business of primary production for the purposes of Division 16.

10. 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. We accept the correctness of the decision in *Case Z35* on this point.

No trust law income

11. We take the view that were it not for specific income tax law provisions deeming present entitlement, there cannot be present entitlement where there is no trust law income in a year.

12. A beneficiary in a trust estate may have an indefeasible, absolutely vested, beneficial interest in possession in trust law income notwithstanding the trust is not in a position to generate income. This is not sufficient for the beneficiary to be regarded as presently entitled. The further essential requirement is that the beneficiary must be able to demand immediate payment of the trust income; that is, the income must, according to trust law, be legally available for distribution (see *Harmer v. FC of T* (1991) 173 CLR 264; 91 ATC 5000; (1991) 22 ATR 726, wherein the relevant cases were considered).

13. However, in circumstances where a beneficiary (including a default beneficiary) has a vested and indefeasible interest in trust law income but is not presently entitled (for example, where no trust law income has come into the hands of the trustee), subsection 95A(2) deems present entitlement (see paragraphs 40-49).

14. It follows that subsection 157(3) can have application to a beneficiary of a trust estate engaged in a business of primary production and which derives no trust law income in a particular year.

Date of effect

15. 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

16. Following the decision of the Administrative Appeals Tribunal in *Case Z35*, several enquiries have been made concerning the application of Division 16 to a beneficiary of a trust estate carrying on a business of primary production.

17. Taxation Ruling IT 286 outlined the operation of Division 16, in particular subsection 157(3), in relation to a beneficiary of a trust estate engaged in primary production activities. In that Ruling, it was stated that it would be most unlikely that a trustee of a discretionary trust would exercise a discretion in favour of a beneficiary where the business activities resulted in a loss for a particular year. This statement has been interpreted in many quarters to mean that a beneficiary in a trust estate which operated a primary production business at a loss could never receive the benefit of averaging although having a beneficial interest in that trust estate.

18. 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.

19. Subsection 157(3) extends the ambit of the Division beyond people who themselves carry on a business of primary production. Specifically, it enables beneficiaries of a trust estate to benefit from the averaging provisions. 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.

20. The broad effect of subsection 157(3) is to treat a beneficiary, who is presently entitled to a share of the trust law income resulting from the conduct of a business by the trustee of a trust estate, as if he/she were carrying on that business.

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

(a) **a business of primary production** is conducted by the trust estate in the relevant year; and

(b) a beneficiary is **presently entitled** to the whole or part of the trust law income resulting from the conduct of that business.

22. Whether a business of primary production is conducted in a particular year is a question of fact. If a trust is carrying on a business of primary production, a beneficiary presently entitled to share in the trust law income flowing from that business is deemed by subsection 157(3) to be carrying on the business carried on by the trustee.

23. It may well be that a business carried on by a trustee produces income from primary production and other types of income (for example, interest income from investment of surplus funds). Although a beneficiary presently entitled to any of the 'business' income will be eligible to benefit from the deeming provisions of subsection 157(3), this does not necessarily mean that the averaging benefits will apply to that income.

24. In determining whether the beneficiary's share of the 'business' income for the relevant year is subject to averaging benefits, a critical issue is the extent to which income can be said to be derived in consequence of carrying on a business of primary production (subsection 156(1)). This is a question which needs to be answered by reference to the particular circumstances in each instance (see Taxation Ruling IT 225 and *Case X82* 90 ATC 599; (1990) 21 ATR 3708 wherein the issues are discussed).

25. Although all income derived from primary production qualifies for averaging benefits, only a limited amount of non-primary production income may so qualify. For example, non-primary production income up to $5,000 net qualifies for averaging benefits. However, this amount is reduced by one dollar for each dollar over $5,000, so that non-primary production income of $10,000 or more is not subject to any averaging benefit.

26. Prior to 1978, a person was eligible to have the whole of his/her taxable income subject to averaging if he/she was a presently entitled income beneficiary in a trust that carried on a business of primary production, even if the interest in the trust was minimal. However, in the light of the High Court decision in *Cridland v. FC of T* (1977) 140 CLR 330; 77 ATC 4538; (1977) 8 ATR 169, 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.

27. 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 $1,040 or more of the trust's income (i.e., trust law income) in the income year. However a beneficiary, whose entitlement to share in the trust income is less than $1,040, will also

qualify for the application of subsection 157(3) if the Commissioner is satisfied that the person's interest as beneficiary in the trust estate was not acquired primarily for the purpose of having the benefit of the averaging provisions applied to his/her income.

28. 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* at ATC 331; ATR 1046.

Present entitlement to trust law income

29. 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. See for example:

- *FC of T v. Whiting* (1943) 68 CLR 199; 7 ATD 179;
- *Union Fidelity Trustee Co of Australia & Anor v. FC of T* (1969) 119 CLR 177; 69 ATC 4084; (1969) 1 ATR 200;
- *Taylor v. FC of T* (1970) 119 CLR 444; 70 ATC 4026; (1970) 1 ATR 582;
- *FC of T v. Totledge Pty Ltd* 82 ATC 4168; (1982) 12 ATR 830; and
- *Harmer v. FC of T* (1991) 173 CLR 264; 91 ATC 5000; (1991) 22 ATR 726.

30. From these decisions it may be concluded that a beneficiary will be presently entitled to the income of a trust estate if:

- the beneficiary has an indefeasible, absolutely vested, beneficial interest in possession in trust law income; **and**
- the beneficiary has a present legal right to demand and receive payment of the trust law income (or would but for a legal disability), whether or not the precise entitlement can be ascertained before the end of the year of income and whether or not the trustee has the funds available for immediate payment.

Trusts with losses for either or both trust law and tax law purposes

31. 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 paragraph 30

above, present entitlement relates to the income of a trust estate (that is, trust law income).

32. In the *Union Fidelity Trustee Co* case at CLR 185; ATC 4089; ATR 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...'

33. 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...'

34. Accordingly, it is quite consistent with the authorities that, provided there is some gross trust law income, a beneficiary may be presently entitled to income of a trust estate even if the trust:

- has incurred a loss for the year for trust law purposes; or
- has incurred a loss for the year for tax law purposes; or
- has no net income for tax law purposes.

Provided a beneficiary is presently entitled to income from a primary production business carried on by the trustee, the beneficiary in such circumstances will be treated as carrying on a business of primary production for the purposes of Division 16.

35. *Case R28* 84 ATC 255; (1984) 27 CTBR(NS) *Case 82* provides an example of a trust (not discretionary) where the beneficiary had an indefeasible vested interest in the income of the trust. A business of primary production was carried on by the trust at a loss and, in the result, the beneficiary did not receive a distribution for the year. The Commissioner accepted on the facts of the case that subsection 157(3) operated to deem the taxpayer to be carrying on the business of primary production carried on by the trustees.

Discretionary trusts

36. Because of otherwise adverse taxation consequences, many modern discretionary trust deeds contain clauses which have the effect that if the trustee has not determined to appoint income of the trust to any of the objects or to accumulate such income before the end of the year of income, the income of the trust will fall to takers in default of appointment. Such clauses are known as default or fail-safe clauses.

37. The rights of a taker in default and an object of a discretionary trust may be expressed as follows:

- a taker in default has a vested but defeasible interest in the trust fund. The interest may be defeated if the trustee appoints income to the objects. If the trustee fails to exercise the power of appointment or to determine to accumulate income by the end of the accounting year, the default beneficiary's vested interest becomes indefeasible. This is also the result if the trustee's appointment is ineffective (*FC of T v. Marbray Nominees Pty Ltd* 85 ATC 4750; (1985) 17 ATR 93);
- an object has a mere expectancy and therefore has no interest until the trustee appoints income in his/her favour. If the trustee's resolution in this regard is final and irrevocable, it has the effect of vesting the income in the object. The object (beneficiary) may then be said to have a vested and indefeasible interest in income of the trust (*IRC(NZ) v. Ward* 69 ATC 6050; (1969) 1 ATR 287; (1970) NZLR 1).

38. **Provided there is trust law income**, a beneficiary (whether an object or taker in default) whose interest has become indefeasible would be 'entitled' to income and presently entitled. This is so because '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' (*Harmer's* case at ATC 5004; ATR 729,730).

39. It follows that a beneficiary in a discretionary trust who is presently entitled to income from a primary production business

carried on by the trustee will be treated as carrying on a business of primary production for the purposes of Division 16 even if the trust:

- has incurred a loss for the year for trust law purposes; or
- has incurred a loss for the year for tax law purposes; or
- has no net income for tax law purposes.

No trust law income and subsection 95A(2)

40. The point has been made in paragraph 11 that if no trust law income has come into the hands of the trustee, there can be no present entitlement. However, a beneficiary may have an indefeasible, vested beneficial interest in possession in trust income and therefore be 'entitled' to income but not 'presently entitled'.

41. In *Whiting v. FC of T* (1942) 7 ATD 114, Rich J, sitting in the High Court, took the same view as he had expressed in *Executor and Agency Co of SA Ltd v. FC of T* (1932) 2 ATD 35 that the existence of an absolute interest vested in possession was sufficient without more to constitute present entitlement under subsection 97(1). On appeal, the Full High Court disagreed: *FC of T v. Whiting* (1943) 68 CLR 199; 7 ATD 179.

42. In their joint judgment, Latham CJ and Williams J said, at CLR 216; ATD 183:

> 'A beneficiary who has **a vested right to income** (as in this case) but who may never receive any payment by reason of such right, **is entitled to income**, but cannot be said to be "presently entitled" as distinct from merely "entitled" ' (emphasis added).

43. In *Westminister Bank Ltd v. IRC* (1957) 2 All ER 745, the House of Lords considered the question whether there could be a life interest in possession if no income was derived during the life of the settlor. In answering in the affirmative, the House of Lords held that it was immaterial that the trust property does not produce income if the beneficiary would be entitled to the income arising on the sale and reinvestment of the property.

44. We take the view that a beneficiary may have an indefeasible, absolutely vested, beneficial interest in possession in trust income even if the trust is not in a position for the time being to generate income. However, for Australian income tax purposes, the cases show that this is not sufficient for a beneficiary to be regarded as presently entitled. The further essential requirement is that the beneficiary must be able to demand immediate payment of the trust income; that is, the income must be legally available for distribution according to trust law (see *Harmer* wherein the relevant cases were considered).

45. Subsection 95A(2) provides:

> '<u>For the purposes of this Act</u>, where a beneficiary has a vested and indefeasible interest in any of the income of a trust estate but is not presently entitled to that income, the beneficiary shall be deemed to be presently entitled to that income of the trust estate' (emphasis added).

The effect of the underlined words is to deem present entitlement in the circumstances stated for **all** purposes of the Act, including subsection 157(3).

46. The meaning of the words 'vested' and 'indefeasible' in subsection 95A(2) was considered by Hill J in *Dwight v. FC of T* 92 ATC 4192; (1992) 23 ATR 236. Suffice to say for present purposes that 'vested' is used in contradistinction to contingent and an interest is 'indefeasible' where it cannot be brought to an end (ATC 4203; ATR 249).

47. In the circumstances discussed at paragraphs 37-38, **but where there is no trust law income** coming into the hands of the trustee, the object of the trustee's discretion or the default beneficiary, as the case may be, would not be presently entitled to income although having a vested and indefeasible interest in whatever income may be derived by the trust. Subsection 95A(2) would deem present entitlement in these circumstances.

48. It follows that subsection 157(3) can have application to a beneficiary of a trust estate engaged in a business of primary production but deriving no trust law income in a particular year.

49. By reason of the operation of subsection 95A(2), the result contemplated by Division 16 is achieved, thereby placing beneficiaries on the same footing as partners in the case where no income from the primary production business is derived during the year (unless excluded by subsection 157(3A)).

50. It is difficult to imagine a primary production business that would not have some trust law income. For example, if a crop fails it can be cut and sold as hay or the area used for short term agistment. The excise levied on diesel fuel is claimed back through the Australian Customs Service and is an income receipt; drought relief subsidies are income. Interest subsidies under the Rural Adjustment Scheme are income.

51. Nevertheless, in the context of Division 16, any year in which a taxpayer was carrying on business but had no taxable income is capable of being an average year (Section 153). However it is worth noting that, as was shown in *Case R28*; *Case82*, under the averaging provisions as they now stand, a taxpayer who has no primary production income in the relevant year may well have no income to

which the averaging benefits apply (for example, if that taxpayer's non-primary production income is $10,000 or more).

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subject references
- averaging
- beneficiaries
- present entitlement
- primary producers
- trust distributions
- trust estates
- trust income

legislative references
- ITAA 95
- ITAA 95A
- ITAA 95A(2)
- ITAA 97
- ITAA 97(1)
- ITAA 98
- ITAA 153
- ITAA 156
- ITAA 156(1)
- ITAA 157
- ITAA 157(3)
- ITAA 157(3A)
- ITAA Pt AD Div 16

case references
- Case R28 84 ATC 255; (1984) 27 CTBR(NS) Case 82
- Case X82 90 ATC 599; (1990) 21 ATR 3708
- 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
- Dwight v. FC of T 92 ATC 4192; (1992) 23 ATR 236
- Executor and Agency Co of SA Ltd v. FC of T (1932) 2 ATD 35
- FC of T v. Marbray Nominees Pty Ltd 85 ATC 4750; (1985) 17 ATR 179
- FC of T v. Totledge Pty Ltd 82 ATC 4168; (1982) 12 ATR 830
- FC of T v. Whiting (1943) 68 CLR 199; 7 ATD 179
- Harmer v. FC of T (1991) 173 CLR 264; 91 ATC 5000; (1991) 22 ATR 726
- IRC (NZ) v. Ward (1970) NZLR 1; 69 ATC 6050; (1969) 1 ATR 287
- 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
- Westminister Bank Ltd v. IRC (1957) 2 All ER 745
- Whiting v. FC of T (1942) 7 ATD 114