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"*Oh, that way madness lies.*" Some reflections on the arguments in the *Bamford* case

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Reading the transcripts of the recent oral arguments presented on 2 and 3 March 2010 in *Bamford v FCT* (S310 of 2009: *FCT v Bamford* and S311 of 2009: *Bamford v FCT* [2010] HCATrans 037 and 038), one is reminded of the abovementioned quote from Act 3, Scene 4 of Shakespeare's King Lear.

The issues

Bamford is about who pays tax on what, when Div 6 of Pt III of the ITAA 1936 is engaged. Essentially, the issues to be resolved are:

1. What is meant by the expression "so much of that share of the net income of the trust estate"?
2. What is meant by the expression "is presently entitled to a share of the income of the trust estate"?

Bamford concerns 2 income years, the 2000 income year and the 2002 income year. In the Full Federal Court (*Bamford v FCT* (2009) 73 ATR 49), the Commissioner succeeded in the dispute concerning the 2000 income year (Question 1) and the taxpayers succeeded in the dispute concerning the 2002 income year (Question 2).

Question 1

There was a time when the answer to the question rested on a choice between the "proportionate approach" and the "quantum approach". See, for example, *Davis v FCT* (1989) 20 ATR 548.

To date, the Commissioner has successfully argued that the "proportionate approach" was the right way to interpret the phrase "so much of that share of the net income" so that if a beneficiary received 50% of the "income of the trust estate", whatever that last amount might be (see the appeal regarding the 2002 income year), the beneficiary is assessed on 50% of the net income, regardless of how much the beneficiary receives and regardless of the process by which the 50% came about.

The taxpayers (Mr and Mrs Bamford, but not the Church of Scientology), contrary to what one might expect (in a simple world), are not arguing that the beneficiary is assessed on the quantum amount. The approach argued for by Tony Slater QC appears to be an amalgam of both the proportionate and quantum views and depends for its outcome on how the income of the trust estate is allocated. Gummow J calls it the "prescription approach". It was expressed by Tony Slater QC as follows:

"If the share in the income of the trust estate is the whole of the income, then the whole of the net income is assessed to the beneficiary.

If the beneficiary's share is one-third of the income of the trust estate then one-third of the net income is assessed.

If the share is all the income in excess of $50,000 or some other denominated sum then the net income assessed to the beneficiary is all of the net income in excess of the $50,000.

But – this is the point material to the present appeal – if the share is $50,000 and no more then in our submission it is $50,000 and no more which is that share of the net income for the purposes of section 97."

Trying to read between the lines, it seems that Tony Slater QC's preferred approach may not win the judges over. Nevertheless, his clients may succeed in their appeal because the High Court may conclude that the "quantum approach" is the preferred basis for assessing beneficiaries. This may be because it follows from a simple reading of the words and the meaning to be given to the expression "to that share". Alternatively, it may be because the High Court concludes that s 97 of the ITAA 1936 is simply a timing rule from the perspective of a beneficiary that brings forward the point of taxation if there is present entitlement.

In seeking an answer to how Division 6 works, particularly s 97, one must focus on a number of matters, including the different language in the various sections where phrases such as "individual interest" (s 97(1)(b)) and "that part of the net income" in s 99(3) and s 99A(4A) are also used. One particularly important issue arises out of the fact that "net income" can be 2 different amounts in respect of the same "trust estate", yet neither party appears to have successfully dealt with that issue in putting forward views on how to interpret s 97.

Question 2

The second matter in issue is the meaning to be given to the expression "income of the trust estate" in s 97.

The Commissioner’s position (not always clearly elucidated by senior counsel) is that the expression means income derived by the trustee that is income according to ordinary usage (net of expenses), although that argument has it’s own uncertainty – is it income according to ordinary usage from a trust law perspective or from an income tax perspective, in particular s 6-5, as it is possible that there is a lack of identity between the 2?

The taxpayers are arguing that, in the context of this matter, the expression means that which is distributable as income from a trust law perspective and that which is distributable as income depends on the terms of the trust deed which may prescribe what is to be distributed as income or allow the trustee a power to effectively determine what is to be distributed as income regardless of its character from a trust law perspective.

Neither side appears to have addressed the implications, if any, arising out of the recent decision of the Full Federal Court in *Forrest v FCT* [2010] FCAFC 6 (reported at 2010 WTB 6 [256]). In that case, the Full Federal Court (Spender, Sundberg and McKerracher JJ) reversed the decision of the AAT (*AAT Case [2008] AATA 325* (2008) 68 ATR 717) on the issue of whether the taxpayer was presently entitled to the income of a “hybrid” trust (income depended on unit holdings, capital was discretionary).

The AAT had found that the taxpayer was not presently entitled to the income of the trust as a unit holder because the trustee had the power to re-characterise the receipts and gains made and could effectively divest the taxpayer of his interest in the income of the trust.

The Full Federal Court held that a power given to the trustee to classify receipts as capital or income:

“[27] ... cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee’s unconfined discretion.

[28] The words used in cl 12 do not have the literal and broad meaning which the Tribunal gave to them. The respondent to this appeal accepts that no effect can be given to cl 12.1 to the extent that it purports to make the trustee’s determination "conclusive and binding" to the exclusion of the courts. Clause 12.1 is a power to make an honest administrative determination whether receipts are on capital account or income account. It is not a power to determine, in the trustee’s unconfined discretion, whether a receipt "represents realised or unrealised capital gains". It is that fact which determines whether components of the trust fund are held on trust for the discretionary beneficiaries or the Unit Holders. (See the definitions of "Discretionary Component", "Fixed Income", and "Unit Component", and cl 3.2).

[29] Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force as a power honestly to classify income or distributions according to law, as the appellant contended to this Court."

The Full Federal Court emphasised the limitations any such clause would have; one cannot by the terms of a trust convert capital into income or vice versa. This would suggest that the power given to a trustee to "characterise" receipts and gains made is limited (as the case law has always said it was) and the concern that the Commissioner has about the terms of a trust being used as a means for avoiding tax through alchemy is significantly overstated.

The case appears to conflict with the position taken by the Full Federal Court in *Bamford* which is that the deed in question allowed such a re-characterisation to occur.

Bumps in the road

The judges have struggled with some of the arguments, a matter that will no doubt be put right when their Honours have an opportunity to study the matter in detail.

The difficulty, of course, is that there is no sensible way to deal with the failure of Parliament to construct an appropriate and comprehensible approach to the taxation of trusts and any interpretation of the current legislation must, it is suggested, result in someone somewhere being taxed inappropriately.

Is Division 6 a Code?

A proper reading of Division 6 may well result in chaos. Underlying the arguments put by both sides is the view that Division 6 is a "code". As Tony Slater QC said:

"Division 6 appears to operate as a code for the assessment of the amounts which fall within net income as defined in section 95."

Justin Gleeson SC for the Commissioner never uses the word "code", but it is an unstated assumption. If the amount received by a beneficiary as income from the trust is greater than the amount that is assessed under s 97, Justin Gleeson SC says that the excess is not assessable under s 6-5:

“In the pure quantum approach the problem that was thought to be perceived was this, that if trust income is greater than net income – that is the reverse of the example I have given – if trust income is $400 and each beneficiary is entitled to one half of it, $200, that is their amount or quantum and I somehow have to apply that to a trust income, which is less than that $200. ***It would be bizarre if I put $200 into each beneficiary’s assessable income, because I am then collecting more tax than I was ever meant to collect****. Therefore, the quantum type approach needs some more additional sophistication, at least in that circumstance*.” [Emphasis added]

But why is that outcome “bizarre”? Why should a beneficiary of a trust not be taxed on his income from the trust?

It may be recalled that in *FCT v McNeil* [2007] HCA 5; (2007) 229 CLR 656; (2007) 64 ATR 431, the majority (Gummow ACJ, Hayne, Heydon and Crennan JJ) rejected an argument put by the taxpayer that s 44 and its related sections in the ITAA 1936 constituted a code for the taxation of distributions from companies:

“[39] The taxpayer also submitted what was said to be a "code" argument. This was that s 44 and companion sections in subdiv D of Div 2 of Pt III of the 1936 Act together constitute a complete code with respect to the taxation of receipts by shareholders from companies.”

In rejecting the argument, the majority said:

“[43] The exercise must fail. The taxpayer gave many examples of the inclusion in the dividend provisions of measures to deem as assessable income that which would not be income according to ordinary concepts. But that does not support the implicit exclusion from s 6-5 of the 1997 Act of other items of income according to general concepts.”

The same 4 judges, together with French CJ, have heard the appeals in *Bamford* and one might wonder, from the transcript of the oral argument, whether the outcome in *Bamford* will involve a touch of déjà vue.

The assumption that Division 6 is a code appears to be based in part on the amendments made in 1979 in response to *Union Fidelity Trustee Co of Australia Limited v FCT* [1969] HCA 36; (1969) 119 CLR 177; (1969) 1 ATR 200. However, as Gummow J suggests, there may have been a “wrong turning” as regards the role of Division 6.

The suggestion of a wrong turning is reinforced by the judgment of the Full Court of the High Court in *FCT v Prestige Motors Pty Limited* [1994] HCA 39; (1994) 181 CLR 1; (1994) 28 ATR 336. The case concerned the income years from 1979 through to 1990 and is generally considered to be a case dealing solely with the question of when is the service of a notice of assessment validly made on a trustee.

However, in *Prestige Motors*, the Full Court (Mason CJ, Brennan, Deane, Gaudron and McHugh JJ) said:

"[8] Under Div.6 of Pt III of the Act, liability to pay tax upon the net income of a trust estate may fall ultimately ((1) See s.100.) either upon the trustee or upon the beneficiary. Whether a liability to pay tax falls immediately upon the trustee or upon a beneficiary depends upon the operation of the several provisions of that Division which follow s.96. That section provides that there is no liability on a trustee to pay income tax upon the income of the trust estate except as elsewhere provided in the Act. Unless the Act expressly provides ((2) Federal Commissioner of Taxation v. Belford (1952) 88 CLR 589 at 597.), as it does in ss.98, 99 and 99A, that the trustee "is liable to pay tax", income tax is either payable by the beneficiary or none is payable ((3) Tindal v. Federal Commissioner of Taxation [1946] HCA 26; (1946) 72 CLR 608 at 619 per Latham CJ dissenting.). Sections 97, 98 and 99 deal with three cases: (1) where a beneficiary is presently entitled to a share of the income, as distinct from a share of the net income, of the trust estate, and is not under any legal disability (s.97); (2) where a beneficiary is so entitled but is under a legal disability (s.98); and (3) where no beneficiary is so entitled to any part of that income or there is a part of it to which no beneficiary is presently entitled (s.99). ***The operation of the three sections does not define the tax liability of beneficiaries in respect of distributions of income of a trust estate because income which beneficiaries receive from a trust estate is taxable in their hands under the general provisions of s.25*** *((4) See Union-Fidelity Trustee Co. of Australia Ltd. v. Federal Commissioner of Taxation [1969] HCA 36; (1969) 119 CLR 177 at 187-188 where Kitto J discusses the general framework of the provisions in Div.6 relating to liability to pay tax and states the effect of ss.97, 98 and 99 as set out above.)."* [Emphasis added]

Some might say these remarks are incidental to the decision. However, a close reading of the case suggests that the passage is fundamental to the decision.

There are, of course, other reasons why Division 6 is not a code as regards "net income". For example, Div 6AAA of Pt III of the ITAA 1936 refers to "net income" as defined in s 95 and, if applicable, assesses by reference to that definition as modified by the Division. The soon to be repealed Pt XI is another reason why Division 6 is not a code.

The role of s 96

The other issue that may surprise practitioners is the role of s 96 of the ITAA 1936. It also uses the expression "income of the trust estate", but does so in the context of limiting the trustee's liability. The section says:

"Except as provided in this Act, a trustee shall not be liable as trustee to pay income tax upon ***the income of the trust estate***." [Emphasis added]

How are we to read the expression in this section? Everyone clearly says or assumes that "income" means "net income" as defined in s 95 and it makes sense to read the section as if "net" is added. But what does that expression do for the arguments about the expression "income of the trust estate" in s 97?

The High Court has consistently said that "income of the trust estate" in s 97 does not mean "net income of the trust estate". But what if it does? We all recognise that "net income" is a statutory construct that is ever increasingly removed from "income" for trust law purposes, but in trying to make sense of Division 6, rethinking the meaning to be given to the expression "income of the trust estate" in s 97 may help unlock the key to the taxation of trusts. Doing that may also require some reconsideration of what is meant by "presently entitled".

Conclusion

In trying to resolve the 2 appeals, the High Court may choose to consider the issues in the context of a wider review of the relevant rules and decide the case by way of reasoning that takes one back to the underlying principles and that may, of course, lead to a few surprises. If that were to occur, the Commissioner and taxpayers will need to rethink how the net income of a trust is taxed.

More significantly, the case must lead to reform of the rules as it is certain that the current arrangements are unworkable. Regardless of who wins and why, new rules will need to be introduced as a matter of urgency so that the taxation of income derived and gains made by trustees and distributions to beneficiaries are taxed appropriately and not randomly.