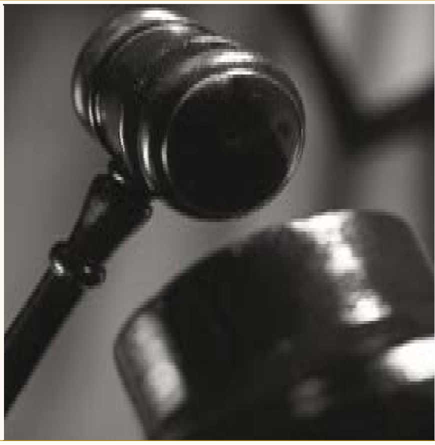
Read the trust deed



CAJKUSIC V COMMISSIONER OF TAXATION [2006] FCAFC 164

INTRODUCTION

Cajkusic v Commissioner of Taxation[1] ("Cajkusic") is the latest in a series of cases[2] dealing with the intersection of trust and revenue law. The case was decided before the Full Federal Court and although it does not deal with any ground-breaking law, it does highlight the importance of the deed of trust and its terms. The case clearly highlights the differences in the calculation of distributable trust income (or accounting income), which is determined according to the terms of the deed and the taxable income of a trust. The revenue implications will, to a great extent, depend on the terms of the deed. In some cases (such as the present case) there may be no distributable trust income pursuant to the terms of the deed to which a beneficiary is presently entitled but there may be taxable income as determined by the tax statutes. In such situations the trustee will be assessed on the taxable income of a trust.

FACTUAL BACKGROUND

This case involved an appeal to the Full Federal Court by Milivoj Cajkusic (Husband), Branka Cajkusic (Wife) and Daniel Cajkusic (Son), (collectively the "taxpayers") from a decision of the Administrative Appeals Tribunal ("Tribunal") in respect of applications by them for the review of objection decisions made by the Commissioner in relation to their assessments for the 1997 and 1998 financial years.

The taxpayers were at all relevant times the principal beneficiaries of the Cajkusic Family Trust ("Family Trust"). The taxpayers were employees of the trustee of the Family Trust; the trustee Intex Coatings Pty Ltd ("Intex") carried on a business as the trustee of the Family Trust. For each of the years ended 30 June 1997 and 30 June 1998 the Family Trust claimed deductions for the contributions to and implementation costs of an employee benefit trust arrangement. The deduction claimed were $205,425 in 1997 and $197,125 in 1998.

The Commissioner issued two fringe benefit tax ("FBT") assessments on Intex on the basis that it had provided a property fringe benefit to the employee taxpayers. Intex did not lodge objections to these assessments, and in December 2001 it went into liquidation. The Commissioner lodged a proof of debt in relation to the FBT assessments but no distribution was made by the liquidator in favour of the Commissioner.

In April 2003 the Commissioner issued amended assessments to each of the taxpayers, increasing their taxable income by the amount of the deduction claimed by the Family Trust. The amended assessments also gave effect to a determination made by the Commissioner under Part IVA of the *Income Tax Assessment Act 1936* ("1936 Act"), cancelling any tax benefit[3] and including the amounts claimed as a deduction by the Family Trust (ie $205,425 for 1997 and $197,125 for 1998) in the assessable income of each of the taxpayers pursuant to s 97 of the 1936 Act[4]. The trust deed of the Family Trust gave Intex a discretion as to what amounts were to be included in the calculation of the trust income for a particular year and further, Intex had a discretion to determine that the distributable trust income was the trust's s 95 or taxable income.

The case before the Tribunal

Before the Tribunal the Commissioner conceded that the amended assessments in respect of the 1997 year should be set aside and the objections allowed, as there was no distribution made by the Family Trust in favour of the taxpayers. The Commissioner also conceded that, in accordance with the terms of the Family Trust deed, in respect of the 1998 year the net income of the trust should be assessed equally among the taxpayers rather than the net income assessed to each of them individually,

The Tribunal treated the amounts of $205,425 and $197,125 as having been paid despite the fact that the evidence was inconclusive as to what amounts were actually contributed to the employee benefit trust. Nevertheless the Tribunal found the contributions and the administrative expenses were not deductible as they served no business purpose and did not meet the deductibility requirements set out in s 51(1) if the 1936 Act or s 8(1) of the *Income Tax Assessment Act 1997* ("1997 Act"). As the contributions and administrative expenses relating to the employee benefit trust were disallowed, the carried forward losses from 1997 were not available, and because Intex did not exercise its discretion to distribute the net income of the Family Trust for the 1998 year, the taxpayers became entitled to the net income of the Family Trust in equal shares as tenants in common pursuant to the deed of the Family Trust. The taxpayers appealed to the Full Federal Court.

ISSUES

Whilst the issues before the Tribunal largely related to whether the contributions made to the employee benefit trust were deductible, the appeal before the Federal Court related to what constituted the distributable income of the Family Trust under s 97 of the 1936 Act.

The taxpayers' submissions

The taxpayers' arguments before the Full Federal Court[5] were that in order for the taxpayers to be assessed on any income from the Family Trust:

1. the Family Trust must have distributable income pursuant to s 97 of the 1936 Act, for the year ended 30 June 1998 and there was no such income.
2. the taxpayers must be presently entitled to a share of that income, and Intex's right of indemnity precluded any of the taxpayers having any entitlement to the income of the Family Trust for the 1998 year.
3. there must be net income within the meaning of s 95 of the 1936 Act, there was no dispute as to this requirement.

The Commissioner's submissions

The Commissioner argued before the Full Federal Court that:

1. the taxpayers objections did not contain sufficient grounds to give the Tribunal jurisdiction to hear the taxpayers' case.
2. income for s 97 purposes cannot be governed by the terms of the trust deed as it would be possible, via the terms of the deed to "define your way out of what the Income Tax Assessment Act provides"[6].
3. because the contributions to the employment benefit trust ultimately ended up in the hands of the taxpayers, the provisions of s 101 of the 1936 Act were triggered so that the taxpayers were deemed to be presently entitled to the amounts paid or applied for their benefit.

RELEVANT LEGISLATION

Section 97 of the 1936 Act provides that where a beneficiary of a trust (not under a legal disability) is presently entitled to **a share of the income** of that trust the assessable income of the beneficiary shall include so much of the share of the **net income** of the trust.

Section 95 of the 1936 Act provides that net income of a trust is the total assessable income less the allowable deductions available under the Act[7] calculated as if the trust was a taxpayer.

It is generally accepted that the reference to "a share of the income" of a trust in s 97(1) refers to the income distributable pursuant to the trust deed (often referred to as accounting income) whereas "net income" refers to the statutory or taxable income[8].

Section 99A provides that where no beneficiary is presently entitled to the income of the trust the trustee is liable for tax on the net income of the trust

THE COURT'S FINDINGS

The Court's findings touched on and highlighted the importance of being familiar with the terms of the trust deed in determining a trust's distributable income.

The validity of the objections

The Court held that the taxpayers' objections were sufficiently explicit in directing the Commissioner attention to their reliance on s 97 of the 1936 Act. It was not necessary that the component arguments under s 97 be articulated at the objection stage. Although the issue of determining the s 97 distributable income was not argued before the Tribunal the grounds raised in the objection allowed the issue to be argued before the Court.

Section 97 – distributable income

The Court found that the Tribunal erred in finding that in disallowing the deductions relating to the employee benefit trust the effect on the Family Trust's distributable income and the Family Trust's s 95 income would be the same[9]. In disallowing the amount of $197,125 for the 1998 year, the tribunal held that both the distributable income pursuant to s 97 and the net income pursuant to s 95 increased by the same amount. Such a conclusion may be valid where the trust deed mandates that the distributable trust income is the same as the s 95 income, but the deed of the Family Trust did not make such provision.

The trust deed of the Family Trust provided Intex with a discretion as to the treatment of receipts and payments by the trust and whether the amounts should be treated as income or capital. Further, the deed provided Intex with a discretion to determine that the income of the Family Trust was equal to the s 95 net income (taxable income), but this was only a discretion and one that Intex did not exercise.

The Court rejected the Commissioner's argument that the s 97 income could not be governed by the terms of the deed because it would allow a taxpayer to define their way out of the provisions of the 1936 Act. The Court found that the passages from two of the cases that the Commissioner relied on[10], when read in the light of earlier and later passages of the judgments, only highlight the importance of the terms of the trust deed in deciding the distributable income of the trust. Further, the "terms of the trust instrument will prevail over any accounting principles that might otherwise be appropriate to the type of business being conducted" . The Commissioner's reliance on the reasoning of Gleeson CJ in the case of *ANZ Savings Bank Ltd*[12] was also rejected because that passage dealt with ability to treat part of a receipt as not being income for the purposes of calculating the s 95 income. The trust deed in that case defined distributable income of the trust fund as the s 95 income.

In adopting the proportional approach[13] of reconciling distributable trust income (accounting income) and taxable income pursuant to s 95 the court held:

> Liability for tax on the s 95 "net income" will fall where it is intended to fall. If there is no s 97 distributable net income to which a beneficiary is presently entitled, any s 95 "net income" will be assessed to the trustee pursuant to s 99A of the 1936 Act. If there is s 97 income to which beneficiaries are presently entitled, the s 95 "net income" (whether greater or smaller than the s 97 income) will be taxed in the hands of the beneficiaries in proportion to the beneficiaries share of the s 97 income[14].

The 1998 accounts for the Family Trust disclosed a distributable income of $28,697 before the carry forward losses of the previous years were accounted for. Although the claims with respect to the employee benefit trust were disallowed in determining the s 95 net income, the claims were properly applied in determining the distributable net income for that year. As the loss in the accounts of the Family Trust for the year ended 30 June 1997 was $54,838, and given that losses must be met from profits and not the capital of the Family Trust (unless the trust provides otherwise)[15] there was no profit that could be properly distributable in the 1998 year. As the income of the Family Trust was negative (ie $28,697 – $54,838) none of the taxpayers were presently entitled to anything, consequently the liability to taxation for s 95 income fell on Intex (being the trustee).

this argument appeared to have its origin from the decision in *CPT Custodians Pty Ltd*[16] and attempted to merge two totally different concepts: the present entitlement to income (not to a specific asset vested in the trustee) and the trustee's right to resort to those assets in order to meet liabilities incurred.

The court's decision

The taxpayers appeal was allowed and the Court held that:

(a) the order made by the Tribunal in relation to the 1998 be set aside:

> There is no substitute for reading and understanding the trust deed. The deed is paramount in determining the distributable income of a trust. It takes precedence over any accounting principles or industry norms.

(b) the objection decisions in relation to the 1998 year be set aside; and

(c) the Commissioner decide the taxpayers objections in accordance with the Court's reasons.

Section 101 of the 1936 Act

The Commissioner's argument for the application of s 101 of the 1936 Act was flawed as it was predicated on the view that the contributions to the employment benefit trust were paid out of gross income. It was held that the reference to "income of a trust estate" in s 101 has the same meaning as s 97 income, that is, distributable net income. Section 101 of the 1936 Act deals with the discretion of a trustee to apply income for the benefit of specified beneficiaries, even where the trust deed allows for the exercise of the discretion there must be distributable income which is the subject of the discretion.

Intex's right of indemnity

As the taxpayers were successful on the first ground the Court did not consider the second submission made, that is, Intex's right of indemnity against the trust precluded any of the taxpayers from having an entitlement to the income for the 1998 year. In passing, the Court commented that need not deal in detail with the constituent elements of the grounds relied on but it must be sufficiently explicit to direct the Commissioner to the issue in question.

CONCLUSION

There is no substitute for reading and understanding the trust deed. The deed is paramount in determining the distributable income of a trust. It takes precedence over any accounting principles or industry norms. Unless there is distributable trust income a beneficiary cannot have a present entitlement to that income, and the taxable income of the trust (if any) will be assessed to the trustee. In the present case the taxpayers avoided the assessment of tax resulting from the disallowance of the claims relating to the employee benefit trust because there was no distributable trust income, and presumably the trustee will avoid the payment of any tax assessed to it as it has entered into voluntary liquidation.

Care should be taken in drawing up the grounds for an objection. The objection

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Reference notes

1. *[2006] FCAFC 164.*
2. *See, for example, Pearson v Commissioner of Taxation [2005] FCA 250.*
3. *Pursuant to section 177F(1)(b) of the 1936 Act.*
4. *Determination made pursuant to section 177F(1)(a) and section 177F (2) of the 1936 Act.*
5. *Above n 1, at [14] and [15].*
6. *Above n 1 at [21].*
7. *This is a simplification of section 95; for example, deductions under Division 16C are not allowable.*
8. *Where the trust income and statutory income are different, the statutory income is distributed in the same proportions as the Trust Income: see Zeta Force Pty Ltd (1998) 84 FCR 70.*
9. *Above n 1 at [18]*
10. *Thornley v Boyd (1925) 36 CLR 52 at 536 and McBride v Hudson (1961) 107 CLR 604 at 623–624.*
11. *See above n 1, at paragraph 27.*
12. *Commissioner of Taxation v Australia and New Zealand Savings Bank Limited (1998) 194 CLR 328.*
13. *See Zeta Force Pty Ltd v FCT (1998) 84 FCR 70.*
14. *See above n 1, at [22].*
15. *The rule in Upton v Browne (1884) 26Ch D 588 refereed to in Heydon JD and Leeming MJ 2006, Jacobs Law of Trusts in Australia, 7th edition, Butterworths.*
16. *CPT Custodians Pty Ltd (previously trading as Sandhurst Nominees (Vic) Ltd) (2005) 221 ALR 196.*