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The Nature of 'Present Entitlement' in the Taxation of Trusts

Abstract

Fundamental to the operation of the general 'trust provisions' in the Income Tax Assessment Act 1936 (Cth) is the concept of 'present entitlement'. This article examines the nature of this term in light of a number of cases which have examined both its ordinary meaning as well as its meaning in the deeming provisions of s 95A and s101 of the Act.

Keywords

present entitlement, taxation, trusts

THE NATURE OF "PRESENT ENTITLEMENT" IN THE TAXATION OF TRUSTS



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Fundamental to the operation of the general "trust provisions" in the Income Tax Assessment Act 1936 (Cth) is the concept of "present entitlement". This article examines the nature of this term in the light of a number of cases which have examined both its ordinary meaning as well as its meaning in the deeming provisions of s 95A and s 101 of the Act.

Division 6 of Part III of the Income Tax Assessment Act 1936 (Cth) ("the Act") contains the general provisions of the Act which determine who is assessed in respect of the "net income" of a "trust estate". Central to the operation of Div 6 is the concept of "present entitlement". The Act, however, contains no general definition of this term (although certain provisions exist in Div 6 which deem present entitlement to arise in certain circumstances). It has therefore been necessary for the courts to judicially define what constitutes present entitlement. This article examines the judicial interpretation of this term as well as the operation of the specific provisions of the Act which deem present entitlement to arise.¹

The High Court's interpretation of the meaning of "present entitlement"

The High Court has had the opportunity to consider the meaning of the term "present entitlement" in a number of leading cases. The first of these was *FCT v Whiting*.² In *Whiting* a testator had established a trust under his will. The terms of the trust provided that, after payment of the debts and liabilities of the estate, the residue was to be applied to provide an annuity payable to the testator's widow

¹ This article, however, will not consider the loss of present entitlement under s 100A. For a discussion of this issue see ICF Spry QC, "Reimbursement Agreements" (1990) Aust Tax Rev 4.

² (1942) 68 CLR 199.

and children. Some 10 years after the testator's death, the estate's liabilities had not been finalised. Notwithstanding this fact, certain amounts of income were credited by the trustees of the estate in the books of account in favour of the beneficiaries named under the will.

The Full High Court held that, at the time the amounts of income were credited in favour of the beneficiaries, they were not presently entitled to such income as they were not entitled to call upon the trustees to pay the residue of the estate to them. This was because payment of the liabilities of the estate had not been completely finalised. The Court held that, in order for a beneficiary to be presently entitled to the income of a trust estate, the beneficiary must be able to demand immediate payment of such income from the trustee. The Court found that the beneficiaries in this case were not in such a position. Latham CJ and Williams J stated:

The words "presently entitled to a share of the net income" refer to a right to income "presently" existing - ie, a right of such a kind that a beneficiary may demand payment of the income from the trustee, or that, within the meaning of s 19 of the Act, the trustee may properly reinvest, accumulate, capitalize, carry to any reserve sinking fund or assurance fund however designated or otherwise deal with it or as he directs on his behalf.

A beneficiary who has a vested right to income (as in this case) but who may never receive any payment by reason of such a right, is entitled to income, but cannot be said to be "presently entitled" as distinct from merely "entitled". Indeed, it is difficult to see how he can be entitled at all to income which must be applied in satisfaction of some prior claim³

The decision in *FCT v Whiting* was subsequently examined in *Taylor & Anor v FCT*.⁴ In *Taylor*, there were three trusts. The trustees of these trusts were required to hold the income of each of the trusts for the maintenance and education of a specified child of Leslie Taylor until the child reached 21 years of age. The terms of the trusts provided that any remaining income was required to be accumulated and invested and, rather than being held as an accretion to capital, was required to be held for the child absolutely until the child attained 21 years of age. However, if the beneficiary died before attaining that age, the remaining income was to be held upon trust for the beneficiary's personal representative absolutely.

³ Ibid at 215-216.

⁴ (1970) 119 CLR 444.

In the relevant year in question, in respect of one of the beneficiaries who was still alive but had not yet attained 21, the entire income of the trust had been accumulated and the trustees of the estate were assessed on such income on the basis that the beneficiary was not presently entitled to any part of it.

The trustees objected to the assessment. The trustees argued that the beneficiary was presently entitled to the accumulated income on the basis that, although the beneficiary's right to enjoy the income was postponed, it was nonetheless immediately vested in interest since, if the beneficiary did not reach 21 years of age, the accumulated income would be held on trust for the beneficiary's personal representative.

The Commissioner, however, relied on *FCT v Whiting* as authority for the proposition that, in order to be presently entitled to income, a beneficiary must be able to demand "immediate payment" of the income from the trustee. According to the Commissioner, the beneficiary, as an infant, was not in a position to make such a demand.

Kitto J, sitting as the High Court, noted that s 98 of the Act plainly acknowledges that a beneficiary may be "presently entitled" to income notwithstanding that the beneficiary is under a legal disability and that therefore *Whiting's* case could not be regarded as standing for the proposition that such a person is not presently entitled to the income. According to Kitto J, the term presently entitled:

refers to an interest in possession in an amount of income that is legally ready for distribution so that the beneficiary would have a right to obtain payment of it if he were not under a disability.⁵

Both the decisions in *Whiting* and *Taylor* were referred to in the recent Full High Court decision in *Harmer v FCT*.⁶ This case concerned a dispute between three parties relating to the entitlement to a sum of money. The disputed sum had been paid into Court by one of the parties and it was ordered that the sum be invested in a building society in the names of the parties' solicitors who were to hold the money on trust pending the outcome of the dispute.

⁵ Ibid at 452.

⁶ (1991) 173 CLR 264.

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The Commissioner assessed the parties' solicitors on the interest derived from the building society deposit on the basis that no beneficiary was presently entitled to such income since, pending the outcome of the trial, no beneficiary had "a vested and indefeasible interest" in any part of it. The Full High Court unanimously upheld the Commissioner's assessment. In a joint judgment, Mason CJ, Deane, Dawson, Toohey and McHugh JJ stated:

After payment in, the claimants acquired an interest in the moneys in the sense that they were entitled to insist that they be properly administered and applied for the purposes for which they were paid in. However, no claimant was beneficially entitled to either the whole or any part of the moneys paid into court or of the interest earned thereon... The moneys were received and held...to be applied in accordance with the orders ultimately made by the Supreme Court. The respective interests of the individual claimants were, at best, contingent. None had an entitlement to the capital or the income of the fund which was vested either in interest or possession. A fortiori, none had a present legal right to demand or receive payment of either capital or income. It follows that none of the claimants was "presently entitled" to the income of the fund.⁷

The above cases clearly indicate that the High Court is of the view that in order to be presently entitled to income of a trust estate, a beneficiary:

- (i) must have a vested beneficial interest (as opposed to merely a contingent interest) in the trust income; and
- (ii) must (or would but for a legal disability) be able to demand payment of the trust income from the trustee.

Deemed present entitlement under s 95A

Bearing in mind the second point above, on the view of the High Court, a beneficiary would not be presently entitled to income of a trust estate once the trustee pays or applies such income to, or for the benefit of, the beneficiary, as, once this has occurred, the beneficiary no longer has a right to demand payment. This very point was recognised by Barwick CJ in *Union Fidelity Trustee Co of*

⁷ Ibid at 272-273.

*Australia Ltd v FCT*⁸ where His Honour stated:

In applying the provisions of Div 6 a clear distinction must be maintained between the position of a person who is entitled to receive a share of the estate and one who has been paid the amount of it. When a beneficiary has been paid his share of the income of the estate in respect of a tax year he no longer satisfies the description of a beneficiary who is entitled to a share of the net income of the estate for that year.⁹

This potential limitation on the meaning of present entitlement has now been overcome by the introduction of s 95A(1),¹⁰ which makes it clear that present entitlement to income of a trust estate continues notwithstanding that income has been paid to, or applied for the benefit of, the beneficiary.

Section 95A(2) deems a beneficiary to be presently entitled to so much of the income of a trust estate to which a beneficiary has a "vested and indefeasible interest". There is no definition of the expression "vested and indefeasible interest" in the Act. It is, however, considered that a "vested interest" would be an interest which presently exists as opposed to a "future right" which may only arise at some point in time in the future. An interest could be either "vested in possession," where it confers a present right to possession of a thing (eg the interest of a life tenant in Blackacre), or "vested in interest," where it confers a present right to future possession (eg the interest of a remainderman in Blackacre). An interest is considered to be "indefeasible" where it cannot be taken away as a result of the happening of an event such as the performance of a condition subsequent.¹¹

Owing to the lack of judicial interpretation of s 95A(2),¹² it is difficult to imagine many circumstances in which the provision would expand the ordinary common law meaning of the term present entitlement. However, one circumstance in which s 95A(2) might have potential to expand that meaning is where a beneficiary

⁸ (1969) 119 CLR 177.

⁹ Ibid at 182.

¹⁰ Inserted by Act No 12 of 1979.

¹¹ See further the discussion of what constitutes a vested and indefeasible interest in *CCH Federal Tax Reporter* [50-566] and *Dwight v FCT* 92 ATC 4192 per Hill J at 4202 - 4203.

¹² Although see *Dwight v FCT*, *ibid*, and *Harmer v FCT* (1991) 173 CLR 264 where the provision was argued.

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has a vested and indefeasible interest in income in respect of which the right to demand payment has been deferred.

Section 101 deemed present entitlement

Section 101 provides that a beneficiary, in whose favour the trustee of a discretionary trust exercises his discretion to "pay or apply income", is deemed to be presently entitled to that income. The operation of s 101 was considered in *Case E47*.¹³ In that case, the directors of a company which acted as the trustee of a discretionary trust resolved that the income of the trust:

- (i) "be set aside and apportioned for and shall belong to" various infant beneficiaries in specified shares;
- (ii) be "credited" in the trust's books of account to the respective beneficiaries "as soon as ascertained"; and
- (iii) "be paid" to the beneficiaries or "applied for" their benefit by being paid to the credit of their respective bank accounts.

Part of the income was paid into the beneficiaries' bank accounts before the end of the relevant year of income and part of the income was paid into their bank accounts after the end of that year. Immediately after payment, the funds were loaned back to the trust interest free.

The Commissioner assessed the trustees on the basis that the beneficiaries were not presently entitled to the income since only some of the income had actually been paid to them before the end of the relevant year of income and, in any case, the funds had been loaned back interest free to the trust.

The Taxation Board of Review, however, held that the beneficiaries were presently entitled to the income of the trust estate within the terms of s 101. The members of the Board¹⁴ followed the New Zealand decision in *CIR (NZ) v Ward*,¹⁵ where the Court had held that a declaration by a trustee that income was to be "held for the credit of" infant beneficiaries was an application for their benefit within the meaning of a similarly drafted section in the New

¹³ 73 ATC 385.

¹⁴ Mr Donovan, Mr Thompson and Mr Todd.

¹⁵ 69 ATC 6450.

Zealand legislation. The Board also referred to the United Kingdom decision in *Re Vestey's Settlement*,¹⁶ where the words "paid or applied" as used in a trust deed were considered. In that case, it was held that a resolution by the trustees that income "shall belong to" an infant beneficiary constituted an application of the income for the benefit of the beneficiary and that it was not necessary that income be immediately paid to or applied for the beneficiary's benefit.

Although *Case E47* indicates that it is not necessary that the trustee of a discretionary trust actually physically pay an amount to a beneficiary before the end of a year of income, in order for s 101 to have application the trustee must actually exercise the discretion to pay or apply such income for the benefit of a beneficiary before the end of the year of income. In the case of most trust estates, the precise amount of the income of the trust may not be ascertainable until after the end of the year when the trust accounts have been taken. This might therefore be perceived to cause a practical problem. This problem is, however, easily overcome as it is not necessary that the trustee specify the precise amount of income to be distributed to each beneficiary when exercising the discretion - it is sufficient if the trustee specifies the shares or proportions in which the income is to be distributed.¹⁷

For the purposes of s 101, in exercising the relevant discretion the trustee is required to comply with the terms of the trust deed. In the case of most discretionary trust deeds, the trustee will simply be required to "make a resolution" that the income be paid or applied in favour of a particular beneficiary. Under some deeds, however, the trustee may be required to make the required resolution in writing.

In practice, to avoid the adverse taxation consequences which arise where a trustee has not validly exercised the discretion to distribute the income of a trust estate before the end of a year of income, many discretionary trust deeds have "default distribution clauses" or "fail-safe clauses". These clauses typically provide that, in such circumstances, the trustee is deemed to have exercised the discretion to distribute the income to specified beneficiaries in specified portions. In Income Tax Ruling IT 2356 the Commissioner has accepted that clauses of this kind effectively confer present

¹⁶ [1950] 2 All ER 891.

¹⁷ See *Case 64* 1 CTBR which is authority for the principle that a beneficiary under a trust can be presently entitled to the income thereof notwithstanding that the amount of the beneficiary's entitlement cannot be precisely ascertained as at the end of the year.

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entitlement on the specified beneficiaries.¹⁸

It has been held, in *Vegners v FCT*,¹⁹ that a person was presently entitled to trust income notwithstanding that the person was unaware of the trust. This decision is apparently based on the principle that s 101 operates on the trustee exercising his discretion and is not contingent upon the beneficiary being aware of this. The decision in *Vegners'* case can be taken as having overruled the earlier decision in *Case V22*,²⁰ in which it was held that beneficiaries who were not aware of their entitlements to trust income were not subject to additional tax for omitting to include assessable income in their returns on the basis that they could not be said to have "omitted" assessable income where they did not know or could not have known of the existence of the trust. According to the Administrative Appeals Tribunal, until the beneficiaries assented to their status as such and accepted the distributions, they could not be regarded as being presently entitled to any part of the income.

In Income Tax Ruling IT 2651, the Commissioner expressly rejects the decision in *Case V22* and indicates that he will follow the decision in *Vegners*. In the ruling, the Commissioner also indicates that, if a discretionary beneficiary repudiates the benefit of the trust on becoming aware of his or her entitlement, the disclaimer would have a retroactive effect resulting in the transfer of any property being void ab initio. This would mean that where a disclaimer has been made a beneficiary would not be assessed on the income of the trust. It would appear from IT 2651, however, that, based on the decision in *Case X30*,²¹ in order to be effective, the Commissioner requires that the beneficiary disclaim his whole interest under the discretionary trust and not just his or her interest in the income of a particular year.²²

Present entitlement under the rule in *Saunders v Vautier*

A final circumstance in which it is considered that present entitlement may arise is where the rule in *Saunders v Vautier*²³ is

¹⁸ See also *FCT v Marbray Nominees Pty Ltd* 85 ATC 4750 upon which the ruling is based.

¹⁹ 91 ATC 4213.

²⁰ 88 ATC 224.

²¹ 90 ATC 287 in which Deputy President Bannon QC held that in order to be valid a disclaimer must relate to all interests in a trust.

²² See also *FCT v Cornell* (1946) 73 CLR 394.

²³ (1841) 41 ER 482.

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applicable. Under this rule, where all the beneficiaries of a trust are "sui juris" and are "absolutely entitled" to all the trust property (ie they are of full legal capacity and together have a vested and indefeasible beneficial interest in the whole of the trust estate), the beneficiaries are entitled to terminate the trust and direct that all the trust property be transferred to them by the trustee, regardless of the express terms of the trust. Where the beneficiaries have exercised this right, it is considered that they would be deemed to be presently entitled to the income of the terminated trust.