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Humpty Dumpty's Rule : income streaming and trusts

Abstract

The article examines the issue of whether the "the conduit theory", which enables trustees of discretionary trusts to stream income, has been overridden by the Income Tax Assessment Act 1936. As the author discovers that there are a number strong arguments that indicate income streaming is not possible under the Act, it is argued that, in order to ensure certainty, the Commissioner of Taxation's administrative practice of permitting income streaming should be legitimised by legislative amendment.

Keywords

Income Tax, Australia, income streaming, tax, law

HUMPTY DUMPTY'S RULE: INCOME STREAMING AND TRUSTS



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The article examines the issue of whether the "the conduit theory", which enables trustees of discretionary trusts to stream income, has been overridden by the Income Tax Assessment Act 1936. As the author discovers that there are a number strong arguments that indicate income streaming is not possible under the Act, it is argued that, in order to ensure certainty, the Commissioner of Taxation's administrative practice of permitting income streaming should be legitimised by legislative amendment.

Introduction

The law which regulates the operation of trusts "is essentially case law which has evolved over a period of many centuries".¹ It is complex, contradictory and abounds with uncertainty. Given this uncertainty, it follows that the application of the Income Tax Assessment Act 1936 ("the Act") to trusts is also complex and can, in many areas, have an uncertain operation. The debate over the last 20 years on whether the proportional or quantum approach applies in respect of s 97 is an example of this uncertainty.²

¹ Leibler MM, "Pitfalls of operating businesses through Trusts" (1978) 7 Aust Tax Review 17.

² Hill J in *Davis v FCT* 89 ATC 4377 at 4403 explains that this debate arose as . . . there has never been a court decision in which it was necessary to decide between the two competing views which have been put forward, although the matter has enjoyed the attention of Boards of Review: (1971) 17 CTBR (NS) *Case 32*; *Case C36*, 71 ATC 156 and (1984) 27 CTBR (NS) *Case 87*; *Case R32*, 84 ATC 298.

The following is a list of some of the articles Hill J cites as having debated this issue: Priddle LG, "Trusts & Income Tax Concepts of Income" (1978) 8 ATR 91; Edmonds RF, "The Taxation of Trusts" (1981) 15 *Taxation in Australia* 398 at 410-411; Magney TW, "Pitfalls in the Future Operation of Trusts in Tax Planning" (1978) 12 *Taxation in Australia* 650 at 797-799; Munn, "Contemporary Issues of Concern" (1983) *Taxation in Australia* 362 at 372-376; and Woellner, Vella and Chippendale, *Australian Taxation Law*

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Despite this complexity, trusts (in particular discretionary trusts) have become one of the most commonly used "entities" in tax planning.³ The popularity of discretionary trusts over the last 30 years is accredited in part to their perceived flexibility⁴ as well as other related advantages.⁵ This flexibility enables a trustee of a discretionary trust to stream income⁶ and tax credits. This article examines the law underlying income streaming by discretionary trusts and evaluates how the Act treats the income streamed.

What is streaming?

Streaming is a process by which income of a particular type (for example, interest, dividends, capital gains or foreign income) or certain tax credits can be distributed in the same form to a specific beneficiary.

(1987 CCH) paras 10-270 to 10-290. The most recent example is Delany TP, "Trust Income: A Taxing Issue" (1994) 6 (5) *The CCH Journal of Australian Taxation* 48.

³ Marks B, *Taxation of Trusts* (1980 CCH) v.

⁴ Adams PR, *Australian Tax Planning with Precedents* (2nd Ed 1967 Butterworths) 114; Clyne P, *Adventures in Tax Avoidance* (1969 Rydge Publications) 123; and "Build trust in the family" *The Weekend Australian* 23-24 April 1994, 37.

⁵ The claimed advantages of trusts include:

- trusts can provide a degree of limited liability through corporate trustees;
- trusts may protect assets from errant spouses and the ability for the asset rich to access social welfare payments. (However, the ability for the asset rich to access social welfare payments is under attack. Refer sections 79, 80, 85 and 85A of the Family Law Act 1975, Division 4A of the Bankruptcy Act 1966 and s 1123 of the Social Security Act 1991 and see Calder G, "All in the Family: Discretionary Trusts as Shelters" (1993) 2 *Taxation in Australia Red* 88;
- trusts can avoid the costs associated with wages to principals (payroll tax, super guarantee, worker compensation) by paying principals via distributions; and
- trusts give the principals complete secrecy.

⁶ Swan AJ, "Streaming trust income" (1995) *Butterworths Weekly Tax Bulletin* para 569.

Why discretionary trusts?

Discretionary trusts are the ideal structure for income streaming as the trustee's flexibility to distribute income amongst beneficiaries is relatively unimpeded. Although there must be a reason for distribution, the Courts are reluctant to interfere in this distribution process. The Courts tend only to interfere in situations where there has been a breach of good faith.⁷ This flexibility means there is no need to adopt artificial means (like the payment of wages) as a means of splitting income and facing the wrath of anti-avoidance provisions like s 109 and s 65.

In recent years the flexibility of trusts to distribute income has been moderated by increases in the rate of tax applicable to trust distributions in favour of minors,⁸ the introduction of the capital gains provisions,⁹ and the introduction of rules regulating the extent to which variations in distribution patterns can affect provisional tax.¹⁰ The 1990s have seen further erosion of that flexibility with the introduction of the transferor trust measures,¹¹ the Foreign Investment Fund measures¹² and the consequential changes to Division 6 of the Act which introduced the deemed entitlement rules.¹³ Despite these changes, trustees still have great flexibility to distribute income.

⁷ *Karger v Paul* (1984) VR 161.

⁸ This happened through a series of enactments. The first was Income Tax Laws Amendment Act 1980 (No 19 of 1980), which first introduced Div 6AA, and Income Tax (Rates) Amendment Act 1980 (No 22 of 1980), which first introduced an income threshold for a minor of \$1040. Next, the Income Tax (Rates) Amendment Act (No 2) 1983 (No 104 of 1983) reduced the threshold to \$416 and finally a \$35,000 step threshold was removed via s 13 and s 14 and schedules 11 and 12 of Income Tax Rates Act 1986 (No 107 of 1986).

⁹ Part IIIA was introduced by Income Tax Assessment Amendment (Capital Gains) Act 1986 (No 52 of 1986).

¹⁰ Sections 221YHAAA to s 221YHAAE were introduced by Taxation Laws Amendment Act (No 4) 1986 (No 154 of 1986).

¹¹ Division 6AAA was introduced by Taxation Laws Amendment (Foreign Income) Act 1990 (No 5 of 1991).

¹² Part XI was introduced by Income Tax Assessment Amendment (Foreign Investment) Act 1992 (No 190 of 1992).

¹³ *Ibid* at s 96A to s 96C.

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Advantages of streaming

By distributing income from a particular source to a particular class of taxpayer, the trustee is able to maximise the available after-tax dollars. Thus, the family or tax planning group has more after tax income with which to increase wealth. This is best illustrated by the following example:

T, the trustee of the K Trust, has determined that the two beneficiaries (A, a non-resident, and C, a charity) should share equally the trust income of \$10,000. The trust income consists of \$5,000 trading income and \$5,000 interest income.

If T gives each beneficiary \$5,000 of trust income, the tax outcomes are that C pays nothing, being tax exempt, while A pays tax of \$975. A's tax liability consists of \$250 of withholding tax (being 10% on A's share of the interest income \$2,500) and \$725 of income tax (being \$2,500 trading income taxed at 29%).

However, if T can stream the income via source (ie, each class of income retains its status in the hands of the beneficiary, eg, interest income remains interest income), the outcome for the beneficiaries as a whole is better. If the interest income is streamed to A, A will only pay withholding tax of \$500 (s 128B(2) and s 128D) and C remains unaffected.

Another example of the advantages of streaming is the approach adopted for non-resident beneficiaries, which involves the trustee ordering distributions of income in the following manner, in order to minimise the tax payable. First, the trustee would distribute all foreign income (not taxable in the hands of non-residents), then all dividend and interest income (subject to withholding tax only) and only then other income (taxed at non-resident rates). Similar favourable tax outcomes can arise where tax credits are streamed only to those taxpayers who can utilise them.

The legal basis for streaming

The only way that a trustee of a discretionary trust can stream income is if discretionary trusts are treated as conduits, that is, the income the trust receives (for example, interest) passes through the trust, and is received in the same form (interest) by the beneficiaries. This is commonly known as "the conduit theory".

The conduit theory has received general judicial support in *Webb v Syme*¹⁴ and *Syme v Commissioner of Taxation (Vic)*.¹⁵ In *Webb v Syme*¹⁶ the High Court considered whether income derived in 1908 from a business (the *Age* newspaper) was still “income from personal exertion” when distributed, or was it “income the produce of property”, under the Income Tax Act 1895 and 1896 (Vic). The High Court found that the income derived in the 1908 income year was all property income. The taxpayer then objected to his assessment for 1910, which was based upon the decision in *Webb v Syme*. The issue was again considered by the Privy Council in *Syme v Commissioner of Taxation (Vic)*.¹⁷ The Privy Council found that the trust was in fact a conduit, and that the income was taxable under the Income Tax Act 1895 and 1896 (Vic) as “income from personal exertion”. Further support for the conduit theory is found in *Charles v FCT*¹⁸ where only the income amounts of a distribution consisting of income and capital receipts was assessable under s 97.

However, there are a number of limitations on the conduit theory. It can be overridden by legislation or by the terms of a trust deed.¹⁹ Also, where there is mixing of funds it will no longer be possible to categorise the trust as a conduit as, by being mixed, the income has lost its identity.²⁰

Is the conduit theory recognised under the Act?

There are a number of arguments against discretionary trusts being conduits under the Act. They can be classified into two broad categories, the fundamental argument and the legislative override arguments.

The fundamental argument

The fundamental argument is that the conduit theory does not apply to discretionary trusts. This argument is based upon the fact that, given that there is a mixing of funds in discretionary trusts, it is not possible to trace the source of each distribution.²¹ Griffith CJ in the

¹⁴ (1910) 10 CLR 482.

¹⁵ (1914) 18 CLR 519.

¹⁶ (1910) 10 CLR 482.

¹⁷ (1914) 18 CLR 519.

¹⁸ (1954) 6 AITR 85.

¹⁹ Above n 3 at 302.

²⁰ *Ibid* at 302-3.

²¹ *Ibid* at 303.

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High Court in *Webb v Syme*, after using the analogy of the income of the estate as a lake fed by several streams, stated that “in the case of mixed funds it is impossible to make such a division of sources”.²² He further stated, in obiter, that had the beneficiary been “put in actual possession, for his exclusive benefit, of any part of the trust estate, the case might be different”.²³ Issacs J, although dissenting, concurred on this point by stating:²⁴

the water of a lake becomes indistinguishable, but the rights of the beneficiaries do not. They may follow the income *eo nomine*, and it is the duty of the trustees to keep accounts which enable them to do so ...

Lord Sumner in the Privy Council in *Syme v Commissioner of Taxation (Vic)*²⁵ also saw the trustee’s obligation to account for income separately as being crucial in determining that a trust was a conduit.

The legislative override arguments

First, the full High Court in *Tindal v FCT*²⁶ held that as the definition of “income from personal exertion” in s 6(1) is defined to include “the proceeds of any business *carried on by the taxpayer*” (emphasis added), any income distributed by a trust to a beneficiary could not be income from personal exertion in the hands of the beneficiary. This arises as it is the trust, not the beneficiaries, which is carrying on the business. Thus, the conduit theory is overridden in this situation as the income (that is “income from personal exertion” in the trust) passes to the beneficiary as income from property.

Secondly, the Act, by the combined operation of s 95 and s 97(1), treats the assessable income distributed to the beneficiaries as being a merger of funds. As the “net income” of a trust estate is calculated under s 95 using the “total assessable income of the trust estate calculated under this Act”, the net taxable income is the total mixed “net income”, not income from source A plus income from source B. This mixing under s 95(1) by itself does not affect the conduit theory, as the s 95 definition merely describes what constitutes net income of a trust, not what type of income is actually distributed to a beneficiary.

²² (1910) 10 CLR 482 at 494.

²³ Ibid.

²⁴ Ibid at 517.

²⁵ (1914) 18 CLR 519 at 525.

²⁶ (1946) 72 CLR 608.

The overriding by the Act occurs due to a combination of s 95 and the application of the proportionate approach to s 97(1). It is clear from *FCT v Totledge*²⁷ that the term “income” in s 97(1) means, in the context of the words “share of income of the trust estate”, the income of the trust as calculated in accordance with the basic principles of the law of trusts. However, what was not clear is how the share of “net income” to which a beneficiary is entitled is calculated under s 97. Hill J in *Davis v FCT*²⁸ concluded, in obiter, that “the proportionate view does seem to me, as a matter of language, to be the better construction of the section” and should be used in conjunction with s 97.

Under the proportionate approach, the beneficiary is deemed to be presently entitled to a portion or percentage of the “net income”, which is determined by the percentage of the “trust income” to which the beneficiary is entitled. In other words, the beneficiary is assessed on the percentage of mixed funds as determined by the percentage of total trust income distributed to the beneficiary. Thus, unlike the discredited quantum approach, there is no scope for the conduit theory, as the beneficiary is assessed under s 97 on a percentage of total income rather than on the actual income distributed from a specified source.

Finally, the fact that the conduit theory is overridden by the Act is evident, as the drafters adopted a number of specific provisions dealing with the transfer of tax credits or income from particular sources.²⁹ This possible legislative override was identified by the Asprey Committee,³⁰ which also noted that the conduit theory may not apply. The Committee stated:

The allocation of net income to a beneficiary should involve the consequence that the character of any item of that net

²⁷ (1982) 12 ATR 830 at 837.

²⁸ 89 ATC 4377 at 4403.

²⁹ For example, imputation credits flow through to the beneficiary assessable under s 97 via s 160AQX, or, where the trustee is assessed under s 98, via s 160AQX (see TD 93/186). Prescribed payment credits also automatically flow where a beneficiary is assessed under s 97, via s 221YHF(3)(a), or, where the trustee is assessed under s 98, the credit attributable to the trustee under s 221YHF(3)(b) flows indirectly to the minor via s 100(1) (see TD 93/193). Foreign tax credits flow by the beneficiary, being deemed by s 6AB(3) and (4) to have paid the foreign tax and being entitled to a credit. Similarly for income, non-excepted income from a trust is assessed to a minor by s 102AG(1) and s 128A(3) deems interest, royalty and dividend income to be included in the income of a beneficiary in that form.

³⁰ Taxation Review Committee (Asprey Chair) *Full Report* (1975 AGPS) 208.

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income is carried through to the beneficiary. The provisions of Div 6 explicitly recognise this as far as exempt income is concerned and it is understood that the Commissioner follows this principle in regard to other items of income. In the Committee's view, the Commissioner's practice should be followed, and supported by express provisions ...

Despite the Asprey committee's recommendation, the Act has not been amended and the process of specifying vertical flow provisions has continued. A recent example is s 160ZM(2), which was enacted to exclude from the scope of s 160ZM the tax-free indexation component of a capital gain distributed to a beneficiary and any distributions attributable to a deduction under Div 10C and/or Div 10D. If trusts were conduits, then such provisions would be unnecessary.

In conclusion, these arguments and other lesser arguments³¹ cast grave doubts on the applicability of the conduit theory to discretionary trust income under the Act.

The Commissioner's practice

Despite these arguments and the inconclusive case law, the Commissioner has continued the practice of treating trusts as conduits. In fact, the Commissioner has stated that streaming will be accepted: if it is authorised by the deed, the accounts separately identify the income to reflect this, and the sole purpose is not for tax avoidance.³² Therefore, in practice, streaming of income and credits can be achieved by careful drafting that provides the trustee with the power to allocate income to beneficiaries by source, and provided the trustee maintains separate records.

³¹ For example, Williams DJ, "Trusts - Treatment of Trustees and Beneficiaries" (1990) *Australian Taxation Office Professional Development Program Paper* at 6, argues that the existence of sections like s 26(b), which catch distributions of income not caught under Division 6, cast doubt on the conduit theory.

³² Taxation Ruling IT 2466, paras 4 and 5; and Taxation Ruling 92/13, paras 8-10.

The future of streaming?

The potential losses to the revenue arising from income streaming were recognised by the Martin committee.³³ The Committee recommended that, pending implementation of its Recommendation 3 that trusts be taxed as if they were companies, the Government should enact legislation which ensures that:

- interest income, streamed to non-residents residing in countries with which Australia does not have a double tax agreement, be taxed at ordinary non-resident rates rather than being subject to withholding tax;³⁴ and
- interest paid by an Australian entity to a trust not be an allowable deduction where the interest is streamed to a non-resident.³⁵

However, the willingness of the Commissioner to argue for such reforms, or the Government to enact them, was always in doubt. On 5 November 1992, a year and half after the Committee's recommendations were made public, the Commissioner issued Taxation Ruling TR 92/13, which gives recognition to the practice of streaming. Its issue came two years before the Government publicly responded to the recommendations. Given this behaviour, the Government's response to the Martin Committee Report (released in December 1994) was, as expected, to either reject the recommendations or suggest on-going monitoring.

Conclusion

In summary, the use of income streaming by discretionary trusts is dependent upon a concessionary course of action by the Commissioner based upon administrative action rather than clear legislative support. If the Commissioner believes that trusts are conduits then the Tax Law Improvement Project provides the ideal opportunity to clarify the legislation. In the meantime, although streaming of income and credits can be done in light of Taxation Ruling TR 92/13, advisers should be aware of the uncertainty of this

³³ The House of Representatives Standing Committee on Finance and Public Administration (Martin Chair), *Follow the Yellow Brick Road: The Final Report on an Efficiency Audit of the Australian Taxation Office: International Profit Shifting* (1991 AGPS).

³⁴ Ibid at Recommendation 4 at xiv, 30 - 35.

³⁵ Ibid at Recommendation 5.

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process in law and that its continuation depends upon the grace and favour of the Commissioner (in other words, the application of "Humpty Dumpty's rule").³⁶

³⁶ Lord Atkin, in his dissenting judgment in *Liversidge v Sir John Anderson* [1942] AC 206, cited the following sentences from Lewis Carroll's *Through the Looking Glass* (Chapter 6) as the only possible authority for the majority's decision. He stated at 245:

"When I use a word", Humpty Dumpty said in a rather scornful tone, "it means just what I choose it to mean, neither more or less." "The question is," said Alice, "whether you can make words mean so many different things." "The question is," said Humpty Dumpty, "which is to be master - that's all."