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RAFTLAND REVISITED: THE HIGH COURT'S VIEW OF PRESENT ENTITLEMENT TO TRUST INCOME

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The High Court deliberated in the *Raftland*[1] appeal on the issue of present entitlement of a trust beneficiary. This note discusses the decision's effect on trust and tax law.

In an article published in the previous issue of the *Revenue Law Journal*,[2] Darren Catherall examined the nature of a trust beneficiary's present entitlement to trust income, as considered in two recent Federal Court decisions, *Cajkusic*[3] and *Raftland*.[4] The article discussed the rule in *Upton v Brown*[5] and its application in the two cases. Catherall concluded that the Federal Court had applied the rule to fact scenarios that did not fall within the ratio of *Upton v Brown* itself, and that it was confusing as to how the reasoning in *Upton v Brown* translated to the decisions in *Cajkusic* and *Raftland*. He noted that the decision of the Full Federal Court in *Raftland* was subject to an appeal to the High Court of Australia,[6] and expressed the hope that the High Court would provide guidance as to the proper application of the rule in *Upton v Brown*.[7]

The High Court delivered its decision in *Raftland* on 22 May 2008. This note recapitulates the rule in *Upton v Brown* and the decisions of the Full Federal Court in *Cajkusic* and *Raftland*,[8] before outlining the judgments of the High Court in *Raftland*, on the issue of present entitlement of a trust beneficiary. It concludes by analysing the effect, on trust and tax law, of the decision.

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1 *Raftland Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation* [2008] HCA 21.

2 D Catherall, 'Present Entitlement to Trust Income and the Rule in *Upton v Brown*', (2008) 18 *Revenue LJ*.

3 *Cajkusic v Federal Commissioner of Taxation* (No 2) [2006] FCAFC 164.

4 *Raftland Pty Ltd v Commissioner of Taxation* [2007] FCAFC 4.

5 (1884) 26 Ch D 588.

6 Above n 2, 7.

7 Above n 2, 10.

8 For a more detailed treatment, see Catherall, above n 2.

UPTON V BROWN

The 'rule' in *Upton v Brown* is usually expressed as follows: Losses in one year must, in the absence of any contrary direction in the trust instrument, be made up out of profits of sequent years and not out of capital.[9] This formulation represents an extension of the ratio of the case itself, which concerned the competing interests in a trust estate of a life tenant and a remainderman. The trustee's duty of impartiality between these two beneficiaries raised the issue of whether a business debt owed by the trustee should be paid from capital or from future trust profits. The business had been run at loss during the life tenancy, but was profitable following the death of the life tenant. Pearson J reasoned that if the receiver had contracted debts in carrying on the business during the life tenancy, those debts would have been treated as contracted on behalf of the business generally and must have been paid out of future profits, if there had been any.[10] Therefore, according to Pearson J, the loss must be treated as if it had been a debt incurred by the receiver, and must be paid in the same way.[11]

CAJKUSIC

On appeal from a decision of the Administrative Appeals Tribunal, the Full Federal Court considered the situation where a trustee involved in the operation of a business made payments to an employee benefit trust scheme. The Commissioner disallowed deductions for these payments and issued amended assessments to the default beneficiaries for the 1996/7 and 1997/8 tax years. The appellants (the beneficiaries) argued that, to be liable for assessment under s 97 of the ITAA 1936:

(a) there must be income of the trust estate in the sense of a distributable net income;

(b) a beneficiary must be presently entitled to a share of that income; and

(c) there must be net income of the trust estate within the meaning of s 95 of the ITAA 1936.[12]

Before the AAT, the respondent had conceded the appellant's position in respect of the 1996/7 tax year on the basis that in that year, no distribution had been made by the trust in favour of the beneficiaries.[13] The financial accounts of the trust for the 1996/7 tax year disclosed a loss of $54,838.[14] As regards the 1997/8 tax year, the Full

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9 See, eg, [2007] FCAFC 4, para 107.
10 (1884) 26 Ch D 588, 590.
11 Ibid.
12 *Cajkusic*, above n 3, para 14.
13 Above n 3, para 7.
14 Above n 3, para 31.

Federal Court held that the rule in *Upton v Brown* was applicable so that no profits were properly distributable in cash until all past losses were paid. Therefore, 'the distributable net income of the Trust for the year ended 30 June 1998 was negative and none of the beneficiaries was presently entitled to anything'.[15]

As Catherall pointed out, the application of *Upton v Brown*, concerning as it does the competition between income and capital beneficiaries, to the facts of *Cajkusic* was not direct and appeared to involve an extension of the rule.[16]

RAFTLAND – FEDERAL COURT

The applicant, Raftland Pty Ltd, was the trustee of the Raftland Trust, part of a group controlled by three brothers involved in the building development industry. Raftland Pty Ltd, as trustee, acquired (for the sum of $250,000) the E & M Unit Trust, whose accounts reflected carried forward tax losses of just over $4 million.

At first instance, Keifel J found that on 30 June 1995 the trustee of another trust within the group resolved to distribute all the year's income of that trust ($2,892,762 but $2,849,467 after allowing for carry forward trust losses of $43,295) to the Raftland Trust.[17] On the same day, the trustee of the Raftland Trust resolved to distribute to the trustee of the E & M Unit Trust the sum of $250,000; and (in a separate resolution) the balance of the income of the Raftland Trust for 1995.[18]

The Commissioner's first contention, that the E & M Unit Trust did not exist as at 30 June 1995, was rejected by Keifel J;[19] however, her Honour accepted the second proposition of the Commissioner – that the purported distributions to the E & M Unit Trust were a 'sham', and that accordingly, there were no distributions to the E & M Unit Trust.[20] (The case was not argued on the basis of ITAA 1936 Part IVA; the Commissioner had advised prior to the hearing that he was not relying on the provisions of Part IVA).

The consequence of the latter conclusion depended on the Court's interpretation of the provisions of s 100A of ITAA 1936. The Commissioner contended that ss 100A(1) and (2) would apply to deem the brothers, as beneficiaries of the Raftland Trust entitled to income arising out of a reimbursement agreement, to be not presently entitled to that income, and therefore the trustee, Raftland Pty Ltd, would be liable to

15 Ibid.
16 Catherall, above n 2, 7.
17 *Raftland Pty Ltd v Commissioner of Taxation* [2006] FCA 109, para 30.
18 Above n 17, para 31.
19 Above n 17, para 73.
20 Above n 17, para 90.

pay tax in accordance with s 99A.[21] The applicant argued that ss 100A(1) and (2) did not apply, as no 'reimbursement agreement' had been identified by the Commissioner and no person or entity could be shown to have been given the benefits provided to the E & M Unit Trust.[22] The applicant submitted in the alternative that, at least with respect to the E & M Unit Trust, s 100A(3A) or (3B) applied so that ss 100A(1) and (2) were not applicable.[23]

Relying on the definitional provisions of s 100A and the decisions in *Commissioner of Taxation v Prestige Motors Pty Ltd*[24] and *Idlecroft v Commissioner of Taxation*,[25] Keifel J accepted that a reimbursement agreement existed and concluded that s 100A(1) applied; accordingly, the present beneficiaries were not presently entitled to the trust income and the trustee was liable to tax pursuant to s 99A.[26] Because there was no distribution to the E & M Unit Trust and because the brothers were not trustees, ss 100A(3A) and (3B) did not apply.[27] Her Honour observed, obiter, that s 100A(3A) would have applied to deny the application of s 100A(1) if the trustee of the E & M Unit Trust had been presently entitled to the income of the Raftland Trust for each of the relevant years of income.[28]

The above line of reasoning did not require consideration of the rule in *Upton v Brown*, which was not referred to by Keifel J.

On appeal to the Full Court, the Commissioner argued that, in terms of s 100A(7) of ITAA 1936, no reimbursement agreement had been identified that provided for the payment of money, transfer of property, provision of services or other benefits to a person other than the beneficiary.[29] The alleged benefits were too remote or alternatively were not benefits within the meaning of the section or within the extended meaning in s 100A(12).[30] The Commissioner also argued that if the E & M Unit Trust was presently entitled or deemed to be presently entitled to the income of the Raftland Trust, whether by reason of the trust resolutions or as a Tertiary Beneficiary under the default provisions of the deed of settlement, then s 100A(3A) or (3B) applied and ss 100A(1) and (2) were not applicable.[31]

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21 Above n 17, para 60.
22 Above n 17, para 61.
23 Above n 17, para 62.
24 (1998) 82 FCR 195.
25 (2005) 144 FCR 501.
26 Above n 17, para 101.
27 Above n 17, para 103.
28 Ibid.
29 Above n 4, para 56.
30 Ibid.
31 Above n 4, para 58.

Edmonds J delivered the primary judgment of the Full Federal Court, and Conti J agreed and Dowsett J substantially agreed. Edmonds J began by concluding, contrary to Keifel J, that the nomination of the trustee of the E & M Unit Trust as a beneficiary of the Raftland Trust was not a sham. Accordingly, the trustee of the E & M Unit Trust was presently entitled to the whole of the income of the Raftland Trust for the relevant years.[32] This conclusion pointed to the result suggested obiter by Keifel J; namely, that s 100A(3A) would apply to deny the application of s 100A(1).[33] That outcome was avoided, however, by the application of the rule in *Upton v Brown*. According to Edmonds J, the E & M Unit Trust had no net income, either for the purposes of ITAA 1936 s 95 or under general trust law principles, because of the carry forward losses of previous years.[34] Accordingly, the trustee beneficiaries of the E & M Unit Trust were not presently entitled to the whole of its income; therefore, s 100A(3A) did not deny the application of s 100A(1) to the income of the Raftland Trust, and thus the trustee of the Raftland Trust was liable to tax pursuant to s 99A.[35] The appeal failed except in respect of an amount of $57,973 relating to the year ended 30 June 1996, which the Full Federal Court held was not the subject of a 'reimbursement agreement' for the purposes of s 100A(1).[36]

RAFTLAND – HIGH COURT APPEAL

The primary judgment was delivered by Gleeson CJ, Gummow and Crennan JJ, with separate judgments by Kirby J and Heydon J. All five judges agreed that the appeal be dismissed, and the cross-appeal by the Commissioner in respect of the $57,973 relating to the year ended 30 June 1996 be allowed. All of the judgments concurred with the reasoning of Keifel J on the existence of a 'sham' transaction and in the application of s 100A(1).

Only the majority considered the rule in *Upton v Brown* although, as their Honours explained, such discussion was not a necessary part of their reasoning.[37] The majority referred to the following statement of the rule from *Lewin on Trusts*:[38]

> Where a business is held in trust for successive life tenants and remaindermen and is carried on by a receiver at a loss during the life of the first life tenant, the loss must be made good out of the profits during the life of the next life tenant and not out of capital, unless payment out of capital is expressly directed. In

[32] Above n 4, paras 83, 84.
[33] Above n 4, para 85.
[34] Above n 4, para 107.
[35] Above n 4, paras 106-114.
[36] Above n 4, para 95.
[37] *Raftland Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation* [2008] HCA 21, 64.
[38] Above, n 37, para 68.

> every case the adjustment of the relative rights of life tenant and remainderman in such a case necessarily depends to some extent on the construction of the particular will.[39]

The majority noted that the above rule was a particular application of the general requirement that a trustee who has two or more beneficiaries is under a duty to deal with each of them impartially.[40] Their Honours distinguished the situation applying to the E & M Unit Trust, because in that case there was one class of unit holders with co-extensive interests in income and capital. Therefore, according to their Honours, the rationale for the application of *Upton v Brown* did not exist.[41]

CONCLUSION

Except for the subject matter of the cross-appeal, the outcomes at all judicial levels were the same, albeit reached by a different path in the Full Federal Court. The High Court preferred the findings of Keifel J at first instance, that the transaction involving the nomination of the E & M Unit Trust as a tertiary beneficiary of the Raftland Trust and the purported distributions to the E & M Unit Trust were 'shams' and that the primary beneficiaries of the Raftland Trust were entitled to the trust income.[42] This indicates that in future the High Court will be readier to favour substance over form when considering the arrangements of taxpayers that appear to have the purposes of reducing their tax liability.

Regarding the rule in *Upton v Brown*, the High Court has elected, albeit in obiter dicta, to adopt a narrower interpretation of the rule, than that applied by the Full Federal Court in *Cajkusic* and *Raftland*.

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39 *Lewin on Trusts* (18th ed 2008) 888.
40 Above n 37, para 69.
41 Ibid.
42 Above n 37, para 53.