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Abstract
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Keywords
tax law, income, income tax assessment act

Cover Page Footnote
I wish to thank Michael Kobetsky of the Faculty of Law, Australian National University for his helpful comments and encouragement in writing this article which was originally presented as part of the Master of Taxation Law program in the School of Law at Deakin University. The views expressed in this article, however are mine alone.

LIEDIG AND THE LIMITS OF SECTION 96

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INTRODUCTION

In the Federal Court case of *Liedig v FCT*,[1] Hill J, sitting as a single judge, considered the following question: is there a principle of tax law which holds that a trustee in receipt of income from his personal exertion must be deemed to derive that income beneficially so that he is not protected from personal assessment by s 96 of the *Income Tax Assessment Act* 1936 (Cth) (the Act)? Dr Gerber, Deputy President of the Administrative Appeals Tribunal (the AAT), had held such a principle to exist in reaching his decision[2] in favour of the Federal Commissioner of Taxation (the Commissioner) on this question. Hill J could not find such a principle in the authorities and said that it would be up to an appellate court to propound any such principle. His Honour stated:

> I am unable to discern from any binding case law or any provision of the Act a principle of the width and uncertainty propounded for by the Commissioner. If such a principle exist, it must need be propounded

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1 94 ATC 4269.

2 *Case* 36/93, 93 ATC 402.

> by an appellate court dealing with the facts of a case apart from tax avoidance. It is not for a single judge to propound.[3]

However, the Commissioner, in withdrawing his appeal to the Full Federal Court, has decided not to go through with the suggestion made by Hill J. This action may be taken to imply that either the Commissioner has concluded that Hill J's decision is correct or that he will consider taking this issue to a superior court in another case. The purpose of this article is to examine whether there is compelling authority for his Honour's decision or whether, on the other hand, a persuasive case could have been made for the Commissioner on appeal to the Full Court. In other words, what do the authorities say about the principle[4] enunciated by the Commissioner? In examining this issue, consideration will be given also to matters of tax avoidance and policy.

LIEDIG v FCT

The facts and the AAT's decision

The facts of this case as presented before the AAT by the witnesses, including the taxpayer, were quite convoluted and at times contradictory.[5] The essential facts as found by the AAT, however, involved the taxpayer, a licensed landbroker, in acquiring a landbroking business from his parents-in-law, on the understanding that the taxpayer's wife would have an equal share in that business. But, as the wife was not licensed as a landbroker, she was not permitted at law[6] to operate the business in partnership with the taxpayer. Therefore, the taxpayer purported to pay his wife wages, apparently for little or no work, for the years 1986 to 1990 and accordingly claimed these amounts as deductions in the income tax returns lodged by him as a sole trader. The Commissioner disallowed these claims and the taxpayer objected

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3 94 ATC 4269 at 4279.

4 This will be referred to as "the principle".

5 The taking of evidence was made difficult, it seems, by the fact that the taxpayer and his wife had divorced since the years in question and were not on good terms. These two, together with the taxpayer's former father-in-law, were the main witnesses. The former father-in-law denied in evidence that he had intended the wife (his daughter) to benefit from the business, but Dr Gerber found him to be indifferent to the truth and rejected this evidence. He was equally as dismissive of the wife's evidence, finding that her "true position can be likened to a ventriloquist dummy mouthing her father's utterances" (93 ATC 402 at 423). Thus, in his view, Dr Gerber was left with the taxpayer's evidence that he had acquired the business for the benefit of his wife and himself equally as the most credible. This finding, however, was made in the face of the taxpayer's doubtful performance in this affair, including forgery of his wife's signature on various documents.

6 Real Property Act 1886 (SA).

on the interesting grounds that the amounts of wages disallowed were, in fact, amounts derived by him as trustee for the benefit of his wife, and thus she was assessable on them as distributions of income pursuant to s 97 of the Act. The objections, having been disallowed by the Commissioner, were referred to the AAT for review.

Notwithstanding the doubtful nature of the evidence, the AAT found on the facts that the taxpayer had acquired the business as trustee for both his wife and himself as beneficiaries, but held that he could not divest himself of income for tax purposes by this means. Dr Gerber of that tribunal said:

> I am satisfied that there are limits to what can be achieved by the use of a trust. "Picking up the position in the law", it seems to me that, for tax purposes, one cannot use a trust in this case, whether express, implied or constructive, in order to divert income from this taxpayer's personal exertion; the income remains his income, irrespective of the method that may be adopted to dispose of it, and even if there was no intention to reduce the incidence of tax. It follows that such income cannot constitute trust income, not subject to tax in the hands of the trustee in reliance on sec 96 of the Act ... .
>
> I have therefore concluded that as I understand the law, T [the taxpayer, Mr Liedig] cannot create a right to receive future income from his personal exertion. Whilst he *can* bind himself to hand over future income, it remains his income for tax purposes.[7]

Hill J's judgment

His Honour rejected Dr Gerber's approach in finding for the taxpayer on the basis of a trust created by the taxpayer's father-in-law for the benefit the taxpayer's wife. It is the reasoning that led to this decision which now becomes important. But at the outset it is interesting to note that Hill J expressed some reservations about the AAT's finding of fact that the taxpayer had acquired the business as a trustee. Given the contradictory and generally unsatisfactory nature of the evidence, his Honour observed that "a reader might well form the view that the Tribunal would have been uncertain whom to believe and have ultimately concluded that Mr Liedig had not satisfied the onus of showing the assessment to be excessive".[8] Nevertheless, as the AAT did make this finding, and as it was not challenged by the Commissioner, Hill J was required to proceed on this basis.

His Honour opened his deliberations thus:

> Underlying the Commissioner's submissions and indeed the decision of the Tribunal is the theory that there is some principle of income tax

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7 *Case* 36/93, 93 ATC 402 at 424.

8 94 ATC 4269 at 4272.

> law which brings about the result that a person acting in the capacity of a trustee and carrying on a business which involves the trustee in performing services derives that income beneficially or, at least is not protected from the obligation to pay income tax upon it by force of s 96 of the Act.[9]

Hill J noted that the basis of this proposed principle was to be found in New Zealand cases and dicta from certain High Court cases,[10] and further noted that the Commissioner conceded in the face of this questionable authority that there was no Australian case which supported a principle as broad as the one submitted in this case. In fact, his Honour indicated that "in the Australian cases it had been unnecessary to decide whether such a principle existed, let alone the boundaries of such a principle".[11] Nonetheless, he recognised some argument on the question had occurred before the Full High Court in *FCT v Everett*[12] and that Murphy J had accepted such a principle in his dissenting judgment. But the majority in that case had declined to consider the "true and precise limits" of the principle because they held it not to be applicable to the facts of the case involving the assignment of an interest in a share of a partnership. The majority held that a partner's share of partnership income was not a product of his personal exertion,[13] but rather a result of sharing in accordance with an entitlement set down in the partnership agreement.

Hill J referred also to the Privy Council's decision in *Hadlee & Sydney Bridge Nominees Limited v CIR (NZ)*[14] where, in a situation similar to that in *Everett*, it was held that a person who derives personal exertion income cannot alienate it by way of assignment, contrary to the Australian High Court's view of the law. Underpinning *Hadlee* is the principle held in New Zealand that the income of a person derived by his personal exertion is always his income, regardless of how he disposes of it. (This principle is

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9 94 ATC 4269 at 4274.

10 The NZ cases were *Spratt v IRC (NZ)* and *Kelly v IRC (NZ)* and the Australian High Court cases were *Stewart Dawson Holdings Pty Ltd v FCT*, *Peate v FCT* and *Hollyock v FCT*. In addition, the Federal Court case of *Tupicoff v FCT* was cited. Full citations of these cases appear later in the article.

11 94 ATC 4269 at 4274.

12 80 ATC 4076.

13 Throughout the cases and this article, the terms "personal exertion" and "personal services" are generally used interchangeably and are intended to mean the direct personal activities of the taxpayer or trustee. In this sense, "personal exertion" should be distinguished from the definition of "income from personal exertion" in s 6(1) of the Act; this definition covers a broad range of incomes with a personal exertion source, including business income of a partner. As indicated in *Everett*, however, the source of partnership income is not the direct personal exertion of the partner. Unless stated specifically to the contrary, it is not the formal definition in s 6(1) which is being referred to when the term "personal exertion" is used, but the informal meaning concerning the source of income arising from direct personal services or activities.

14 93 ATC 4099.

discussed later in respect of other New Zealand cases cited in *Liedig*.) Hill J pointed out that *Everett* bound him on this point.

As to the significance of s 96, Hill J referred to comments by Dixon CJ in *FCT v Belford*[15] and Barwick CJ in *Union-Fidelity Trustee Company of Australia Limited v FCT*.[16] The essence of these comments is that s 96 and Div 6 as a whole operate to provide an exclusive source of tax liability for trust income, separate from the general provisions of the Act. Thus a trustee is only assessable on trust income in a representative capacity; beyond that, in accordance with s 96, the trustee has no liability for tax.

Hill J also gave recognition to the distinction between income of a trust estate and the trust estate itself as enunciated by Kitto J in *Stewart Dawson Holdings Pty Ltd v FCT*[17] and approved of in *Everett*. The importance of this distinction lies in the fact that where a person assigns his income alone, that income constitutes the trust estate and therefore cannot also be the income of that trust estate. Thus the assigned income would fall outside the provisions of Div 6, rendering the assignment ineffective for tax. As a consequence, his Honour said:

> That explanation suffices to deal with the great majority of cases which have been cited in support of a proposition that a person cannot assign personal exertion income. It does not deal with other cases, such as the present, where income may be derived by a person as a trustee of a trust estate. Many were ultimately dealt with by s 260 of the Act.[18]

At this point, his Honour reviewed a series of cases[19] involving businesses operated through trusts where the income was generated exclusively or substantially by the personal exertions of the taxpayer. In each of these cases, the trust arrangement was in fact accepted as valid and then voided for tax by s 260, as indicated in the passage above. As a consequence of such acceptance, Hill J was led to the conclusion that there was no principle as submitted by the Commissioner and applied by the AAT that would require Mr Liedig to be assessed in his own right as the beneficial recipient of the trust income in question.

Finally, before proceeding to the next part, reference should be made to an example Hill J gave of a situation "outside the field of tax avoidance" where the principle clearly should not apply. The example involved the case of a

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15 (1952) 88 CLR 589.

16 69 ATC 4084.

17 (1965) 10 AITR 113.

18 94 ATC 4269 at 4277.

19 *FCT v Gulland; Watson v FCT; Pincus v FCT* 85 ATC 4765 (HC); *Gulland v FCT* 83 ATC 4352 (WA Sup Ct at first instance); *Tupicoff v FCT* 84 ATC 4851 (FC).

solicitor in sole practice who dies and another solicitor as executor carries on the deceased solicitor's practice for the benefit of the estate until it can be sold. His Honour said, most reasonably, that the Act should not operate to assess the executor beneficially on the income derived during the executorship, with s 96 clearly operating to exonerate the executor, as the trustee of trust estate in the form of the practice, from personal liability. That this is a correct reading of the tax implications of such a situation can hardly be challenged. And from this situation, his Honour suggested that:

> there can exist no general law doctrine, applicable only for tax purposes, to be found somewhere outside the scope of the Act to the effect that in no case can income, which is "personal service or personal exertion income", be derived by a person as trustee in such a way as to exonerate that person from a personal liability to tax arising under the Act outside Div 6.[20]

However, as his Honour has indicated, this example does no more than cast doubt on the existence of any "general law doctrine" of taxation; in view of its rather specific nature involving a deceased estate, it cannot be taken alone to resolve the issue.

THE NEW ZEALAND CASES

Two New Zealand cases were cited as examples containing comments in support of the Commissioner's submission, namely *Spratt v IRC(NZ)*[21] and *Kelly v IRC(NZ)*.[22] In *Spratt*, Henry J said:

> No taxpayer can, by way of assignment, escape assessment of tax on income resulting from his personal activities - such income always remains truly his income and is derived by him irrespective of the method he may adopt to dispose of it.[23]

His Honour stated this to be a principle from decided cases and as such accepted by the parties before him. However, as the taxpayer in this case had assigned interests in income from a deceased estate, there was no question of this principle having any application. Nonetheless, it must be taken as a principle of New Zealand income tax law and it was in fact applied in the next case.

In *Kelly*, the taxpayer and his partner each executed a deed to assign his share of the partnership business income to the other as trustee for his (the assignor's) child. The intention was to alienate their income to their children

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20 94 ATC 4269 at 4278.
21 (1963) 9 AITR 277.
22 (1969) 1 ATR 380.
23 (1963) 9 AITR 277 at 280.

(and two nieces also, in one case). The Inland Revenue Commissioner refused to accept these arrangements as effective alienations and assessed the taxpayers accordingly. Woodhouse J upheld the assessments on several grounds, including that the partnership income depended on the personal services of the taxpayers and thus could not be alienated. His Honour relied upon the above principle espoused by Henry J in *Spratt* and cited the following text book passage as correctly stating the law:

> Income from personal exertion such as salary, wages, income from business or income from a partnership cannot be assigned so that it is not first received as income by the assignor. ... All an assignor can do is bind himself to earn the income and to hand it over, ie, apply it, when he receives it. When he receives it he receives it as owner. It is his income.[24]

These two cases clearly reveal the law of New Zealand with regard to assignments of income from personal exertion. But, of course, these have no necessary application in Australia, and may well be inconsistent to some extent with decided authority here, particularly the High Court's majority decision in *Everett*. Furthermore, it may be argued that they are not strictly relevant to the facts of *Liedig*, an issue which will be explored later.

As mentioned earlier, the Privy Council in *Hadlee & Sydney Bridge Nominees* had upheld the decision of the New Zealand Court of Appeal in holding that a partner in a professional partnership could not effectively assign for tax purposes an interest in his partnership share. This case does no more, of course, than to clearly re-affirm the law in New Zealand regarding the assignment of personal exertion income. Contrary to the position of the Australian High Court, partnership income in New Zealand is seen as a direct product of the partners' personal exertions. This is a difficult position to maintain, it is submitted, because the facts of most cases would indicate that there is no necessary connection between the personal exertions of a partner and his share of income from the partnership. This was the view taken by the High Court in *Everett,* where the majority[25] said:

> The respondent's entitlement under the partnership agreement was to a proportionate share of the partnership profits as disclosed by the partnership accounts. The relevant proportion of the partnership profits was payable to the respondent because he was a partner and the owner of a share in the partnership. The respondent was entitled before the assignment to his proportionate share of the partnership profits, however much or however little energy he devoted to the practice, so long as the partnership remained on foot. Accordingly, it

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24 (1969) 1 ATR 380 at 384. (Quoted from Cunningham and Thompson, *Taxation Laws of New Zealand* vol 3 (6th edn) 3059).

25 Barwick CJ, Stephen, Mason and Wilson JJ.

> is a misnomer to speak of the respondent's share of the income as having been gained by his personal exertion.[26]

This is the view to be preferred. It accords with both the legal situation regarding a partner's entitlement under the partnership agreement and with the usual factual situation where in a partnership the income is also earned by the efforts of other partners and by employees where relevant.[27] It might well be the case that a partner who is perceived not to be contributing his or her share of effort to the partnership would be removed from the partnership as a result. Nonetheless, as indicated by the High Court, while the partnership agreement remained in place, the recalcitrant partner would remain entitled to his or her share of the income in accordance with the agreement.

THE AUSTRALIAN CASES

Of the Australian judgments supporting the contended principle, *Stewart Dawson Holdings* has already been mentioned with regard to the fundamental distinction between income of a trust estate and the trust estate itself. The second judgment referred to was that of Menzies J at first instance in *Peate v FCT*.[28] It is assumed that the dictum which the Commissioner's counsel had in mind was Menzies J's comment that "it is established [that a family man] cannot achieve taxation immunity by the simple expedient of assigning his earnings to his wife and family".[29] Apart from this, *Peate* has little to offer this debate.

However, the third judgment, that of Gibbs J in *Hollyock v FCT*,[30] is relevant. In this case, the taxpayer who had carried on a pharmaceutical business as a sole trader declared henceforth to hold and carry on the business as trustee for the equal benefit of himself and his wife. Accordingly, for each of the years in question, the taxpayer included only one-half of the business's net income

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26 80 ATC 4079 at 4083.

27 The fact that in partnerships, particularly larger ones, there is no necessary connection between a partner's share of partnership income and his contribution to the earning of the income was recognised by McInerney J of the Victorian Supreme Court in *FCT v Firstenberg* 76 ATC 4141 in distinguishing the situation of a sole practitioner with no professional employees in that case from the situation of the earnings of a partner in *Henderson v FCT* 70 ATC 4016 (Full HC) where there were 19 partners and about 150 professional employees. His Honour said at 4153:

> I am not ... dealing with return of assessable income of a member of a large partnership carrying on a practice of the type considered in *Henderson's* case where a considerable amount - possibly the great bulk - of the work done by and in the name of the partnership was done by employees.

28 (1962) 10 AITR 3.

29 Ibid at 5. His Honour cited *Parkins v Warwick* (1943) 25 TC 419 in support of this view.

30 71 ATC 4202.

in his return. The other half was included in his wife's. The Commissioner, however, assessed the taxpayer on the whole of the business income for each of these years. The first argument used by the Commissioner in support of his assessments was that the arrangement was void as a result of illegality under legislation[31] which required a licensed pharmacist to carry on a pharmaceutical business. The wife was not a pharmacist, but his Honour was inclined toward the view that there was no contravention of the governing legislation in the arrangement because the appellant taxpayer himself continued to carry on the business. The second argument raised by the Commissioner was that even if the arrangement was valid, it "was not effectual to divest the appellant of his right to receive the income from the pharmacy business".[32] The third argument, relied upon most strongly, was that the arrangement was voided by s 260.

It is the second argument which is of most interest here. Gibbs J indicated that it had some merit, but unfortunately he opted to apply s 260 and thus did not consider the argument in depth. His Honour said:

> *There is something to be said for the view that quite apart from sec. 260 the entire income derived from the business was income derived by the appellant and that the trust only operated on the income after he had earned it and had become liable to pay tax on it.* In *Peate v. FCT* ... Menzies J said that it is established that a family man "cannot achieve taxation immunity by the simple expedient of assigning his earnings to his wife and family ...". The present case is not one in which there was an assignment of income earned but it presents obvious analogies. However, like Menzies J ... "I see no point in attempting to decide this matter independently of sec. 260 if the case falls within its scope, for in that event that section, without the Commissioner or Court 'invoking' its operation, is part of the law that has to be applied and, so far as the Commissioner is concerned and in these proceedings, its operation would require some things that were done to be disregarded notwithstanding that for other purposes their legal effect would remain unimpaired". I shall therefore assume that apart from sec. 260 the deed is valid and effectual and that the provisions of Div. 6 of Pt. III of the Act would be applicable.[33]

Thus Gibbs J sought cover behind s 260 and left unanswered the critical question. Perhaps one should not blame him for this; an applicable general anti-avoidance provision obviously offers a ready alternative approach in a case such as this and the same approach has been taken by other judges in cases referred to in this article. Nonetheless, the emphasised first sentence in the above passage leaves the door slightly ajar to the recognition of the

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31 Pharmacy and Poisons Act 1910-1962 (WA).

32 71 ATC 4202 at 4204.

33 Ibid. Emphasis added.

principle. It remains to be seen whether the door can be prised open further by a superior court.

The final case cited in support of the Commissioner's submission was the Full Federal Court's decision in *Tupicoff v FCT*[34] and comments by Beaumont J. In this case, the taxpayer had been an agent for an insurance company but had substituted a family company as agent instead, with the taxpayer being employed by this company to act as its sole representative in selling insurance on behalf of the insurance company. The family company was the trustee of a discretionary family trust. While the issue of assignment of personal exertion income was considered in Beaumont J's judgment, it was found not to apply because the income was, in fact, held to be the product of the contract of agency between the insurance company and the trustee company and not the direct product of the taxpayer's exertions. This point was made by Hill J in dismissing the relevance of *Tupicoff* in his judgment in *Liedig*. As with a number of other cases referred to in this article, the arrangement was voided by s 260.

THE ARGUMENT AGAINST THE PRINCIPLE

Much of this argument appears in the judgment of Hill J in *Liedig*. Nonetheless, for the purpose of an examination of the argument, key cases will be considered again.

DFCT v Purcell

A logical starting point in mounting this argument is the early Full High Court decision in *DFCT v Purcell,*[35] a case of such apparent relevance to *Liedig* that it is noteworthy that it was not raised in argument before Hill J.

The taxpayer, Purcell, was a grazier who, as the owner of a business comprising certain pastoral holdings and livestock, executed a deed of trust declaring that the business would henceforth be the subject of a trust for the benefit of himself, his wife and his daughter in equal shares with himself as trustee. The trust deed vested unusually wide powers of management and control in the trustee to the extent that the validity of the trust was argued before the Full High Court in an earlier case reported as *Purcell v DFCT.*[36] Notwithstanding the unusual nature of the deed, a majority found that a valid trust had been created.[37]

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34 84 ATC 4851.

35 (1920-1921) 29 CLR 464.

36 (1920) 28 CLR 77.

37 The essence of the question before the Full Court was whether the declaration of trust was valid, given that it had not been registered under the Bills of Sale Act 1891 (Qld). The majority comprising Knox CJ, Gavan Duffy and Rich JJ found

The hearing in *Purcell* was before a Full Court of the High Court consisting of Gavan Duffy, Starke and Rich JJ on appeal from a decision of Knox CJ of that Court. The Chief Justice at first instance had been required to consider the following three contentions by the Deputy Commissioner:

(1) that s 53 of the *Income Tax Assessment Act* 1915-1916 (Cth) (the predecessor to s 260 of the Act) voided the trust for income tax purposes;
(2) that the declaration of trust was void and of no effect; and
(3) that in any event no part of the income from the trust property had been distributed to any beneficiary within the meaning of s 27(2) of the 1915-1916 Act.[38]

In response to the first contention, his Honour found that s 53 had no application to this type of situation where a bona fide disposition of property had taken place. The second contention had been dealt with by a Full Court in the meantime in *Purcell* and had been rejected. Finally, in response to the third contention, his Honour held that the income derived from the property in question was derived by him as trustee and accordingly the appropriate deductions should be made from the tax assessed to him to take account of distributions to the other beneficiaries as provided for in s 27(2).

In the Full Court, the following pertinent comments were made by Gavan Duffy and Starke JJ in their joint judgment:

> According to the provisions ... of the *Income Tax Assessment Act*, ... every person who in any financial year derives any taxable income from sources within Australia is liable to income tax; and, if such person derives it as trustee, he is liable in respect of the tax as if he were beneficially entitled to the income, subject to the provision that in the assessment of a trustee there shall be deducted from the tax assessable to him so much of the total tax as bears to the total tax the

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that lack of registration did not affect the validity of the trust. But Isaacs J in dissent found the deed to be a "most extraordinary production" which at best required registration to make it valid.

38 The summary at the head of *Purcell* provides the following explanation of the mechanism for assessing trust income:

> By secs. 26(1) and 27(2) of the Income Tax Assessment Act 1915-1916 it is provided that any person who derives income as a trustee shall be assessed and liable in respect of income tax as if he were beneficially entitled to the income, and that in the assessment of a trustee there shall be deducted from the tax assessable to him so much of the total tax as bears to the total tax the proportion which that part (if any) of the whole income which is distributed to the beneficiaries bears to the whole income.

Thus, while the mechanism for assessing trust income in this earlier Act differed from the current Act, the effect was essentially the same; the trustee ultimately was not responsible for tax on distributions of income to beneficiaries.

> proportion which that part (if any) of the whole income which is distributed to the beneficiaries bears to the whole income ... .[39]

Neither these two judges, nor Rich J in a separate judgment, considered that s 53 operated to void this otherwise valid trust. Hence, apart from some minor adjustment to the amounts distributed, the decision of Knox CJ was affirmed.

The important matter for the purpose of this article is the acceptance of the trust arrangement in respect of income derived by a trustee from business activities. In terms of the different but equivalent provisions of the earlier Act, the taxpayer in *Purcell* was absolved of personal liability for income tax on income distributed in accordance with the trust as would be the case under s 96 of the current Act. While it is not clear from the facts of the case how much of the trust income was the product of the taxpayer's personal exertions, it may be inferred from details in the deed of trust that he played a significant part in the running of the business. Thus it may be proposed that there is sufficient factual similarity between *Purcell* and *Liedig* for the former, as a Full High Court decision, to bind the latter. The acceptance of the trust by the High Court, in spite of its unusual features, could be interpreted as laying down a principle contrary to the one which is the subject of this article. That principle is that a trustee is protected from personal tax liability by s 96, even where the trust income is the product of his personal exertions.

Can Purcell be distinguished?

A significant distinction between the two cases might revolve around the different natures of the businesses. In *Purcell*, there were significant physical assets including livestock which, of course, were an important part of the income earning activities, as well as the personal exertions of the taxpayer and others, such as employees. On the other hand, in *Liedig*, the main source of the business income consisted of the professional landbroking services performed by Mr Liedig personally; assets such as client contracts, office equipment and goodwill, as well as the services of office staff, would also have played their part, but a business of this nature depends heavily on the personal services of the professional principal. However, this analysis begs the question whether such a distinction should be drawn between different types of business. Hill J alluded to this question in *Liedig* and asked, "Where is the line to be drawn?"[40] The Commissioner's answer was that the proposed principle applied to cases where the income was the result "substantially" of the personal exertion of the taxpayer. His Honour's response was that such a submission is difficult to square with the Full Court's decision in *Tupicoff* and

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39 (1920-1921) 29 CLR 464 at 470-471.

40 94 ATC 4269 at 4279.

with examples of trustees carrying on business as tradesmen and the like.[41] The obvious implication to be drawn from this response is that his Honour considered that no line should be drawn; this view, of course, is fundamental to his decision in this case. And this question forms the essence of the issue under consideration.

FCT v Everett

Reference has already been made to the Full High Court's decision in *Everett*. The majority's decision in this case does not necessarily exclude the contended principle because the judges saw fit in their ratio to find that partnership income is not the product of personal exertion.[42] However, some obiter dicta are of interest, if not of direct relevance, to the issue at hand. Of the Commissioner's submission that income from personal exertion cannot be assigned for income tax purposes, they said, inter alia:

> The appellant's argument did not succeed in identifying the origin of the proposition or, indeed, the precise area of its operation.
>
> One thing at least is clear, and that is that the principle is one of taxation law, not of equity. Even an equitable assignment for value of future property gives the assignee a right to the subject matter as soon as it comes into existence.
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> ... Whatever be its true and precise limits, we do not consider that the principle applies here. The income of the respondent from the partnership was not income from personal exertion in the sense in which that expression has been used in the cases. There, with the exception of *Kelly*, it has been usually employed to signify income by way of wages or salary under a contract of employment where the contractual right to receive the income has been incapable of present assignment. It would also apply to the income earned by a sole trader who operates a business and a professional man who practises on his

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41 In this regard, his Honour said: "It has never been suggested that income earned by the trustee of a trust carrying on business as a milkman or plumber or an electrician is derived by the person pursuing the respective occupation, yet each involves significant personal service or personal exertion." (94 ATC 4269 at 4279). Later his Honour said: "Only where no trust property was involved could the distinction become meaningful." (Ibid). But taken literally this would mean that no trust would be in existence in the first place, thus it is difficult to see the relevance of such an observation.

42 It is interesting to note that the majority referred to *Kelly* and distinguished it on the basis that it involved an assignment of future income dissociated from the underlying partnership interest. However, in the light of the majority's view that "a partner's entitlement to participate in profits is not separate and severable from the interest of the partner" (80 ATC 4076 at 4081), this seems a curiously contradictory approach to take. Rather, it might be preferable to recognise New Zealand law as taking a different view of the origin and nature of partnership income.

> own account. In this context it is correct to say that the taxpayer's remuneration is the product of his personal exertion and all he has to assign are his future receipts as distinct from any right to receive those receipts.[43]

These observations of the law make it clear that a person cannot alienate his income for tax where that income is the product of personal exertion. In making these observations, the majority was prepared to distinguish the situation of a partner from that of a salary or wage earner and from that of a sole trader in business. But what, if anything, do they say about the principle under consideration? That is, if a person operates a business as trustee rather than for his own benefit exclusively and in that role earns income by his personal exertions, as in *Liedig*, does that constitute a proscribed form of income alienation? Is s 96 precluded from operating in such a case? *Everett* does not provide definite answers to these questions and therefore they must be sought elsewhere. The following cases involving the operating of professional services businesses through trusts may enlighten this debate. The notable feature of all of these cases, and one that has been referred to before, is that the trust arrangement was accepted as legitimate in the first place and then the arrangement was struck down for tax purposes by s 260.

The "Doctors' Cases"

The so-called "Doctors' Cases" are a trio of appeals cases heard together by the Full High Court and reported as *FCT v Gulland; Watson v FCT; Pincus v FCT*.[44] The taxpayers in each case were medical practitioners who ceased to practise as principals and instead set up trusts which acquired the practices and employed them to provide their medical services to the patients of the newly structured practices. The trustees of the practice trusts thereby became the recipients of the medical income previously received by the practitioners who then received salaries. Watson and Pincus had practised in partnerships and Gulland had been a sole practitioner. While specific details differed between the individual cases, they were similar enough to be heard together by the High Court. The appeals concerned the application of s 260.[45] With perhaps particular pertinence to *Liedig*, Dawson J made reference to the fact that the primary judge had accepted the arrangement in *Gulland* "although many of the steps taken to implement the arrangement were artificial and carelessly executed".[46]

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43 80 ATC 4076 at 4082-4083.

44 85 ATC 4765.

45 In each case, a majority comprising Gibbs CJ, Wilson, Brennan and Dawson JJ (with Deane J dissenting) held that s 260 applied to void the trusts and leave the doctors in receipt of the income.

46 85 ATC 4765 at 4793.

The acceptance of these arrangements is a cogent case against the principle. Nowhere do these judgments indicate any support for such a principle and, if anything, they strongly militate against it in their willingness to find, in spite of technical shortcomings,[47] the arrangements legally valid and thus, aside from s 260, effective for tax.

Other cases

Several other cases also militate against the principle by typically accepting the trust arrangements and then considering the application of s 260. The previously mentioned Full Federal Court's decision in *Tupicoff* is a prime example. Two decisions handed down by Bray CJ of the Supreme Court of SA, *Bayly v FCT*[48] and *Jones v FCT*,[49] were referred to by Hill J to underline the approach taken in *Tupicoff* on the question of whose was the income involved. In each of these cases, the taxpayer was a pharmacist whose business was acquired by his wife who was not a qualified pharmacist. The taxpayer was employed by the wife to manage the pharmacy and provide the necessary professional services. Notwithstanding the fact that the wife in each case was not a qualified pharmacist, it was held that the business income was that of the wife as proprietor. However, as no trusts were involved in these two cases, their relevance to the issue at hand is limited.

In *Bunting v FCT*,[50] the Full Federal Court was required to consider the case of a computer consultant who provided his services through the medium of a discretionary trust, in a manner similar to that of *Tupicoff*. This hearing was an appeal from a decision of a single judge of the Federal Court,[51] who considered the application of s 260 only on appeal from an AAT decision[52] in which it was held that s 260 did not apply. A majority of the Full Court upheld the primary judge's decision that s 260 applied. Again, s 260 voided what was otherwise accepted as a legitimate business structure.[53] This is yet

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47 In addition to his comments regarding *Gulland*, Dawson J had the following to say about *Watson*: (85 ATC 4765 at 4799).

> Whilst the arrangement was effected in a somewhat haphazard fashion, involving the use of fictitious minutes, pre-dated documents and the substitution in some instances of formal written documents for oral agreements which were already in operation, the primary Judge found that it was not a sham and that the legal changes which it purported to make were intended to be and were effective.

48 77 ATC 4045.

49 77 ATC 4058.

50 89 ATC 5245.

51 89 ATC 4358 (Lockhart J).

52 *Case* V62, 88 ATC 467.

53 The AAT had considered the structure and found it to be legally effective. Further, that tribunal had considered the question of alienation of personal exertion income and had found that it was the trustee company which had derived the income and not the taxpayer (cf *Tupicoff*). It is interesting to note that the dissenting judge of the Full Court, Hill J, was of the opinion that the AAT had made insufficient findings of fact for him to reach a firm conclusion

another case where, while the income was earned by the personal exertions of the taxpayer, it was legally derived by the trustee as a result of contracts which it made with clients. Thus its relevance is also limited.

THE ARGUMENT FOR THE PRINCIPLE

Having adduced a supposedly strong case against the principle, what can be raised in favour of it?

The New Zealand cases

Spratt, *Kelly* and *Hadlee & Sydney Bridge Nominees* stand for a clear principle that personal exertion income, including partnership income, cannot be alienated by assignment in the New Zealand jurisdiction. However, as authority in support of the principle, there are two main problems with these cases. The first problem that these decisions do not constitute binding authority in Australia, is a point already made. The second problem involves the factual relevance of the cases; that is, the situation in *Liedig* may well be distinguishable from the assignment situations which applied in the New Zealand cases. In *Liedig*, of course, there was no assignment of income as such. Rather, the income was derived by the taxpayer in the capacity of trustee in the first place. Consequently, it is debatable whether this would amount to a proscribed alienation, even in New Zealand, on the basis of these decisions.

FCT v Everett

Obiter comments of the Full High Court case of *Everett* may be used by both sides in support of their respective cases.

Murphy J's judgment

As recognised by Hill J in *Liedig*, Murphy J in his dissenting judgment in *Everett* accepted the principle precluding the diversion of personal exertion income enunciated in the New Zealand cases and found them applicable to the taxpayer's situation. This decision required Murphy J to take the view, contrary to the majority, that partnership income is earned by the personal exertion of the partner. On this matter, his Honour said:

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on the application of s 260. However, his Honour did not question the legitimacy of the trust arrangement. In a final sequel, the High Court refused an application for special leave to appeal the Full Federal Court's decision on s 260, partly on the basis of the absence of clear findings of fact by the AAT (see *Bunting v FCT* 90 ATC 4109).

> The taxpayer, by his personal exertion, earned his share of profits as a member of the partnership; he remained a partner but transferred certain limited rights to his wife. In regard to the share of profits, what Mrs Everett obtained depended upon her husband's personal exertion to earn his share of profits. ... His assignment to her of 6/13ths of his share of the profits was an attempt to divest himself of income from his personal exertion before that income was derived. In my opinion, the provision dealing with income derived from personal exertion [ie the definition in s 6(1)] should be read with those dealing with trust income so that what in reality is income from personal exertion is not able to be diverted for tax purposes by a device such as that adopted here.[54]

The majority's view of partnership income is to be preferred from both a legal and realistic viewpoint because partnership income may be earned also by the exertions of others, such as other partners and employees. What the partner is entitled to is the share of income provided for in the partnership agreement, a share which need not bear any direct relationship to his own exertions.[55]

Earlier, Murphy J had said that taxation law should not be construed according to the technicalities of other bodies of law such as partnership and property and, further, that "the tax laws should be applied in the light of the commercial and economic realities".[56] Coupled with this opinion were the following views of the policy of the tax legislation, invoking notions of equity:

> The Act is based on graduation of tax for individual taxpayers and the evident legislative policy is to require those who are more financially able (as measured by their income) to pay at a higher rate than those less able. It would be remarkable if Parliament had intended its policy to be so easily defeated by a device or loophole capable of widespread application. ...
>
> The *Income Tax Assessment Act* should not be construed to impute an intention to Parliament to have its main purpose defeated by an income-splitting device which tends to defeat its policy of graduated tax rates, is available only to the professional and commercial classes,

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54 80 ATC 4076 at 4084.

55 However, it might be argued also that the direct source of an employee's income in the form of salary is strictly his employment contract rather than his personal exertions. Furthermore, an individual in business might in similar vein be said to derive his income from client or customer contracts. Could rights under these contracts be assigned to divest a person of income in a manner similar to *Everett*? If this were so, Australian law would depart even further from that of New Zealand in respect of alienation of personal exertion income. But this is a question which the majority in *Everett* found that it did not have to decide.

56 80 ATC 4076 at 4084.

> and allows the burden of taxation to be shifted increasingly from those taxpayers most able to afford it to those less able.[57]

Murphy J's judgment would appear to represent "a cry from the heart" for an equitable and policy-conscious approach to the legislative interpretation of tax law. Without debating the merits of this approach, it must be questioned whether this particular judgment has much to say about the principle. While the majority gave effect to the assignment by determining the creation of a trust by which the taxpayer derived the relevant share of his partnership income as trustee for the assignee, Murphy J did not recognise such an arrangement in the first place. Accordingly, it may be argued that his Honour's views would not be inimical to the type of arrangement in *Liedig* and therefore the principle at issue. And to return to his Honour's concern for the recognition of commercial realities in the application of tax laws, it must be said that operating businesses through trusts is a reality and perhaps as a consequence he would not support the principle on this basis. Finally, it can be argued that the general anti-avoidance provisions of Part IVA, and previously s 260, are available to prevent the defeat of the Act's intentions, as was the approach taken in the "Doctors' Cases", for example.

The majority's judgment

The essential ambiguity of this judgment in respect of the principle has already been discussed. While granting at least qualified recognition of a principle that personal exertion income cannot be assigned, the judgment remained silent on the application of the particular principle that personal exertion income derived by a trustee must be deemed to be derived beneficially by that trustee.

Hollyock v FCT

The dictum of Gibbs J, which gave some direct support for the principle, has been discussed earlier, including the fact that his Honour saw fit to rely on s 260, rather than the principle, in reaching his decision to ignore the trust for tax.

CONCLUSION

There is no clear support in the authorities for the principle. The best that can said for the principle is that there is not, on the other hand, any specific denial of it. However, the presence of the general anti-avoidance provision in s 260 would appear to have rendered its application unnecessary, a point explicitly made by Gibbs J in *Hollyock*. And, as Hill J noted in *Liedig*, "There is no reason to doubt that Part IVA of the present Act, replacing s 260 ..., would

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57 Ibid at 4085.

have the same result"[58] in appropriate circumstances. Thus the need for the principle as an anti-avoidance measure may be rendered permanently redundant by Part IVA.

Aside from Part IVA, any justification for the principle would need to be based on policy considerations such as those enunciated by Murphy J in *Everett.* But with the presence of Part IVA, such legislative policy should be protected without the need for recourse to the principle. And, unless there is evidence of tax avoidance, what end would such a principle serve? The running of many businesses through the medium of trusts, even where the income is earned by the personal exertions of the trustees, has become commonplace and acceptable. Accordingly, it would reasonably be expected that the application of Part IVA would be precluded in these cases on the basis of finding that they satisfy the "ordinary business or family dealing" test.[59] If such arrangements were to be proscribed in the future, therefore, it would seem more appropriate to enact specific provisions to achieve that result, rather than seek to rely on a principle of doubtful pedigree.

So, finally, was the Commissioner right to withdraw his appeal on the question of the principle? On the basis of the preceding conclusions, it is submitted that he was, on balance. Furthermore, the somewhat questionable nature of the finding of fact by the AAT that a trust existed could have made it an unacceptable case for the determination of a matter of general principle.[60]

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58 94 ATC 4269 at 4278.

59 This test was given expression by the Privy Council in *Newton v FCT* (1958) 98 CLR 1 at 8 where it was said:

> In order to bring the arrangement within the section [s 260], you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to *ordinary business or family dealing*, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section." (Emphasis added.)

It has been stated by the Treasurer and the Commissioner that this test is to be applied also to the operation of Part IVA.

60 This was part of the reason given by the High Court in refusing to hear the question of s 260 in *Bunting*. Refer above n 53.