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Abstract
This article concerns the composite phrase 'present entitlement to trust income'. Much has been written in respect of present entitlement, but of emerging interest is how the courts will approach the calculation of 'income of a trust estate' when considering whether or not a beneficiary is presently entitled to that income. Of particular interest is the rule in Upton v Brown and its application in recent decisions.

Keywords
Div 6 ITAA 1936, present entitlement, taxation, trusts, reimbursement agreement, prior year losses

PRESENT ENTITLEMENT TO TRUST INCOME AND THE RULE IN *UPTON V BROWN*

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This article concerns the composite phrase 'present entitlement to trust income'. Much has been written in respect of present entitlement,[1] but of emerging interest is how the courts will approach the calculation of 'income of a trust estate' when considering whether or not a beneficiary is presently entitled to that income. Of particular interest is the rule in *Upton v Brown*[2] and its application in recent decisions.[3]

CONCEPT OF PRESENT ENTITLEMENT

The phrase 'present entitlement' is not to be found in the annals of trust law. It is known, however, that the determination of a beneficiary's present entitlement to trust income will be resolved through the application of the principles of equity.[4] Building on earlier decisions,[5] the High Court in *Harmer v Federal Commissioner of Taxation*[6] lays down the starting point of any analysis in relation to a beneficiary's present entitlement. Namely, to be presently entitled:[7]

(a) the beneficiary has an interest in the income which is both vested in interest and vested in possession; and

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1 S Barkoczy, 'The Nature of "Present Entitlement" in the Taxation of Trusts' (1994) (4) *Revenue Law Journal* 3, 65 and also A Everett, 'An Analysis of the Concepts of "Present Entitlement"' (2003) *Revenue Law Journal* 147, 149.

2 (1884) 26 Ch D 588.

3 *Cajkusic v Federal Commissioner of Taxation (No 2)* [2006] FCAFC 164; *Raftland Pty Ltd as Trustee for the Raftland Family Trust v Commissioner of Taxation* [2007] FCAFC 4.

4 *Federal Commissioner of Taxation v Whiting* (1943) 68 CLR 199, 216 (Latham CJ and Williams J).

5 Ibid; *Taylor v Federal Commissioner of Taxation* (1970) 119 CLR 444.

6 (1991) 173 CLR 264.

7 Ibid 271 per Mason CJ and Deane, Dawson, Toohey and McHugh JJ.

(b) the beneficiary has a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant year of income and whether or not the trustee has the funds available for immediate payment.

There is no doubting the importance of determining present entitlement in the context of assessing income tax. It is the only purpose of such an activity.[8] And this highlights significant interpretative issues for the Court; namely, who shall be assessed?

The *Income Tax Assessment Act 1936* (Cth) ('ITAA36') was not the first introduction taxpayers had to a government's attempt to levy tax on beneficiaries. In the original income tax legislation of 1915 the beneficiaries were taxed on amounts actually distributed to them, which were deducted from the net income of the trust estate, leaving the trustee to be taxed on the undistributed income. The gravamen of taxpayer objections against the Commissioner was that progressive rates of taxation unfairly brought home higher rates of income tax merely because amounts remained undistributed, notwithstanding any right to have the income distributed. In other words, any deduction afforded to the trustee for amounts distributed ought to include amounts of income the beneficiary had an immediate right to demand.[9]

Taxation now falls on those persons determined[10] presently entitled to the income of the trust estate by virtue of Division 6 of the ITAA36. When one considers the original state of the law,[11] it can be seen that this Division is primarily concerned with limiting the liability of the trustee, while provisions concerning present entitlement[12] were designed to supplement the ordinary basis for taxation of income in the form of receipt.

The income of a trust estate

When the ITAA36[13] refers to 'income' it means gross income according to ordinary concepts. That is the natural construction of the statute. Therefore, a reference in s 95 of the ITAA36 to the 'income of a trust estate' should, by extension, mean the gross income. The notion that it might refer to net income in some way is the result of contamination by reasoning applicable to the concept of present entitlement.

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8 From Everett, above n 1, 147, 149.

9 The first step in the development of 'present entitlement'.

10 By the Commissioner of Taxation.

11 As stated above.

12 For example, ITAA36 s 97.

13 And the *Income Tax Assessment Act 1997 (Cth)* where relevant.

PRESENT ENTITLEMENT TO TRUST INCOME
AND THE RULE IN *UPTON V BROWN*

In s 97 of ITAA36, when the statute speaks of a present entitlement to a share of the income of the trust estate, it is obvious that the only 'share' in the gross income where present entitlement may exist is the distributable part.[14] It does not follow, as was submitted in *Cajkusic*[15] that for a beneficiary to be presently entitled 'there must be income of the trust estate in the sense of distributable net income'.[16] Present entitlement in certain beneficiaries arises when the trust estate derives gross income and then, after deductions,[17] if a positive amount remains liable for distribution, it is this amount to which the statute will attach liability for income tax.[18] This is not inconsistent with the proposition that 'income' means gross income.

Federal Commissioner of Taxation v Whiting[19] (*Whiting's* case) does not establish a contrary proposition. This case concerned the income of beneficiaries of an unadministered estate. The legal and the beneficial interest in the estate assets were vested in the executor.[20] The Court considered the meaning of the term 'present entitlement' and concluded that, even if it could be said that the remainderman had an entitlement to income because his right to it was vested, he could not be said to have a present entitlement to income because he was not entitled to demand immediate payment.[21] Further, the Court went on to doubt whether the remainderman could be said to have any entitlement to the income which must be applied to meet prior claims.[22]

This statement confirms the purported rule in *Upton v Brown*[23] that there can be no distributable cash for the benefit of the beneficiaries unless and until the prior losses are made good from subsequent profits.[24] However, the joint judgment of Latham CJ and Williams J in *Whiting's* case relied on the authority of *Allhusen v Whittell*[25] in the sense that, the receipt of excessive income during a period of administration of an

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14 See *Commissioner of Taxation v ANZ Savings Bank* (1998)194 CLR 328 ,13–15 (Gleeson CJ).
15 *Cajkusic v Federal Commissioner of Taxation (No 2)* [2006] FCAFC 164.
16 Ibid 14.
17 See ITAA 36 s 95 for definition of 'net income'.
18 For example ITAA36 s 97.
19 (1943) 68 CLR 199.
20 *Commissioner of Stamp Duties (Qld) v Livingston* [1965] AC 694; *Official Receiver in Bankruptcy v Schultz* (1990) 170 CLR 306.
21 Above n 21, 216.
22 Ibid.
23 Above n 2, 590.
24 Heydon JD, Leeming ML *Jacobs Law of Trusts in Australia* (7th Ed, 2006, LexisNexis Butterworths Australia).
25 (1867) LR 4 Eq 295, 303.

estate whereby that amount must be adjusted by crediting the capital account, and a reimbursement made by the life tenant of the appropriate proportion of the income. This was so the life tenant did not unduly benefit at the expense of the capital beneficiary.[26]

Whiting's case has consistently been cited for the proposition that 'present entitlement' exists when a beneficiary has a right to demand immediate payment of income, subject to any legal disability. The false inference to be drawn from this proposition is that the subject of present entitlement – income of the trust estate – must be a net amount. This false inference was refuted in *Federal Commissioner of Taxation v Totledge Pty Ltd*[27] where the Full Court held:

> A beneficiary under a trust who is entitled to income will ordinarily only be entitled to receive actual payment of the appropriate share of surplus or distributable income: the trustee will be entitled and obliged to meet revenue outgoings from income before distributing to a life tenant or other beneficiary entitled to income. Indeed, circumstances may well exist in which a trustee is entitled and obliged to devote the whole of the gross income in paying revenue expenses with the consequence that the beneficiary entitled to income may have no entitlement to receive any payment at all. **This does not, however, mean that a life tenant or other beneficiary entitled to income in a trust estate has no beneficial interest in the gross income as it is derived.** He is entitled to receive an account of it from the trustee and to be paid his share of what remains after payment of, or provision for, the trustee's proper costs, expenses and outgoings. (Emphasis added).[28]

In the earlier decision of *Union Fidelity Trustee Co of Australia Ltd v Federal Commissioner of Taxation,*[29] the application of s 97 was considered and, as Kitto J pointed out, it does not concern present entitlement to net trust income. His Honour said:

> The conclusion treats the three sections, 97, 98 and 99, as giving effect to a harmonious policy, those sections together dealing with three cases: **where a beneficiary has a present title in possession to a share of the income of a trust estate – not be it noticed, to a share of the net income of the trust estate** - and is not under any legal disability (s. 97); where a beneficiary has such a title but is under a legal disability (s. 98); and where no beneficiary has such a title to any

[26] Above n 24, 1900.

[27] (1982) 60 FLR 149.

[28] Ibid 397.

[29] (1969) 119 CLR 177.

> part of that income or there is a part of it to which no beneficiary has such a title (s. 99). (emphasis added)[30]

Now that it is established that certain beneficiaries may be presently entitled to gross income as it is derived by the trustee, the rule in *Upton v Brown*[31] needs to be considered. A beneficiary may also have an interest only in the residue. In such a case, until the residue is ascertained, the interest does not exist. But an interest in net income, however defined,[32] is necessarily an interest in a part of the gross income, that part remaining after some other part is exhausted or consumed or dealt with in some way. It is of course true that the totality of the shares of the gross income to which someone is presently entitled may be less than the total gross income.[33]

THE RULE IN *UPTON V BROWN*

Upton v Brown[34] is a simple case of a dispute between two beneficiaries: the beneficiary entitled to income for life (the life tenant) and the beneficiary entitled to the corpus (the remainderman). The issue was whether a debt of 573 pounds owed by the trustee was to be met out of the capital or out of the subsequent profits of the trust. The action was brought because of the trustee's duty of impartiality between beneficiaries with competing interests.

Pearson J held, 'If the receiver had contracted debts in carrying on the business during the life of the first tenant for life, they 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. I think that this loss must be treated as if it had been a debt incurred by the receiver, and must be paid in the same way'.[35]

So it seems the decision is based on the assumption that the debt is a debt incurred in the ordinary course of the initial receiver's duty. That being so the debt was to be made good out of future profits and not out of the available capital. Does it follow that where the trustee makes the debt good from corpus, notwithstanding a court order of this kind, the future profits are accumulated to make up the loss and therefore endure for the benefit of the capital beneficiary? Moreover, what is the result where a loss trust is purchased for tax purposes and income 'injected' into it?

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30 Ibid 7.
31 (1884) 26 Ch D 588.
32 Income, annuity, residue.
33 Above n 27.
34 (1884) 26 Ch D 588.
35 Ibid 590.

Finally, is the rule one of general application to all trusts? Possible answers arise to these questions when recent decisions are considered.

CAJKUSIC V FEDERAL COMMISSIONER OF TAXATION (NO 2)[36]

This case was an appeal by a husband, his wife and their son (the default beneficiaries), to the Federal Court concerning the meaning of the phrase 'income of the trust estate' in s 97 and 'income of a trust estate' in s 101 of the ITAA36.[37]

The income tax return of the Cajkusic Family Trust (CFT) for 1998 year of income returned nil net income and a carried forward loss of $26,141 based on taxable income for the year of $28,697 and prior year tax losses of $54,838. The trust accounts were identical.

The Commissioner disallowed deductions claimed for contributions made, and incidental costs incurred, in relation to an employee benefit trust arrangement for $197,125, and the prior tax losses claim of $54,838. Amended assessments were issued to each of the default beneficiaries of the CFT by virtue of s 97 of the ITAA36.

It was argued, by the default beneficiaries, that three requirements must be satisfied for a beneficiary to be liable under s 97:

1. There must be income of the trust estate in the sense of distributable net income.
2. A beneficiary must be presently entitled to that income.
3. There must be net income of the trust estate within the meaning of s 95 of the ITAA36.[38]

The Full Court found that the trust did not have any distributable net income in the 1998 year. The Court ignored the claim for a deduction for tax purposes and given no evidence was led as to what the correct amount of trust income was the Court took the financial statements as best evidence. Therefore, as that figure was negative, the Full Court concluded that none of the beneficiaries was entitled to anything. Consequentially the liability for tax on the augmented s 95 income fell wholly on the trustee pursuant to s 99A of the ITAA36.[39]

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36 Above n 15.

37 Decision Impact Statement, *Cajkusic v Commissioner of Taxation*, Australian Taxation Office.

38 Above n 15, 14.

39 Above n 15, 31.

This is a curious result given the analysis above. Clearly, an interest arises in the income beneficiaries as the trustee derives income.[40] Present entitlement, however, does not arise prior to the exercise or failure to exercise a trustee power to distribute, thus it seems anomalous that a positive s 95 amount is attributable to the trustee under s 99A of the ITAA36. Further, if the loss is denied for both accounting and income tax purposes, what part does the rule in *Upton v Brown*[41] play? Moreover, does the denial of a deduction absorb any loss in accordance with this rule?

The Court's analysis that trust expenses reduced trust income thereby impacting upon 'net income' under s 97 of itself would not save the taxpayers in the 1998 year. That is because the distributable income for that year was a positive amount. Using the proportionate approach, the taxpayers would be entitled to a third share each of the distributable net income and thus have to include the same proportion of the net income within s 95 in their assessable income under s 97.

How *Upton v Brown,*[42] a dispute resolving competing interests[43] of a capital and income beneficiary in paying a debt, applies to the facts in *Cajkusic*[44] is not readily apparent. Not only did the terms of the trust deed not give rise to any question of the trustee having to act impartially,[45] the trustee did not make any resolution to accumulate profits for the benefit of a capital beneficiary. Therefore, the question remains whether the rule in *Upton v Brown*[46] has any application to the facts. Notably, the Commissioner's application for special leave to appeal to the High Court was refused on 24 April 2007. The correctness of the view expressed by the Full Court, therefore, is the subject of the appeal to the High Court in *Raftland Pty Ltd v Commissioner of Taxation.*[47]

RAFTLAND PTY LTD V COMMISSIONER OF TAXATION

The Court's analysis in *Cajkusic*[48] was followed by a differently constituted Full Court[49] in *Raftland Pty Ltd v Commissioner of Taxation*[50] (Raftland). This case concerned

40 Above n 24.
41 Above n 2.
42 Above n 2.
43 Via the duty of impartiality of the trustee.
44 Above n 15.
45 As the trust deed allowed the trustee to define what receipts were to be income and what receipts were to be capital.
46 Above n 2.
47 Above n 15.
48 Ibid.
49 Edmonds, Conti and Dowsett JJ.

itself, in relation to the rule in *Upton v Brown*,[51] with whether a trust[52] that was purchased with tax losses, could be effectively utilised to absorb the expected taxable profits derived by the business. To achieve this end, the taxpayers were found to have implemented a reimbursement agreement caught by s 100A of the ITAA36.[53] Of particular importance to the Full Court was whether a beneficiary of the interposed trust[54] estate was presently entitled to any income of the interposed trust estate that is attributable to the relevant trust income.[55] The determination of this issue dictated whether ss 100A(3A) had any application to deny the operation of ss 100A(1).[56]

One of the reasons relied upon by Edmonds J was as follows:

> First and foremost, for the years ended 30 June 1995, 1996 and 1997 the E & M Unit Trust had no net income which it could distribute to the unit holders – by way of payment, application or setting aside – pursuant to cl 22(a) of the E & M Unit Trust deed. I am not referring here to s 95 net income, but to the net income for trust law purposes. Clearly, there was no s 95 net income because of the carry forward tax losses, but equally there was no net income for trust law purposes because of the losses of previous years. The losses of previous years had been incurred by the trustee at the time in carrying on a business of buying and selling real property. The general rule is that such losses in one year must, in the absence of any contrary direction in the trusts instrument, be made up out of profits of subsequent years and not out of capital: *Upton v Brown* (1884) 26 Ch D 588; *Re Reynolds* [1942] VLR 158. [57]

His Honour went on to say: 'In any event, the financial accounts of the E & M Unit Trust were prepared on the basis that the general rule applied…'[58]

So the rule in *Upton v Brown*[59] was used by the Court to avoid the defence that the Commissioner had attacked the wrong taxpayer under s 100A of the ITAA36.[60] But the distinguishing feature of *Upton v Brown*[61] was that it was the same business

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50 Above n 15.
51 Above n 2.
52 E & M Unit Trust.
53 Above n 15, 91 (Edmonds J).
54 E & M Unit Trust.
55 Above n 15, 101 (Edmonds J).
56 ITAA36.
57 Above n 54, 107.
58 Above n 54, 110.
59 Above n 2.
60 Section pertaining to reimbursement agreements.
61 Above n 2.

operated under successive trustees and not two separate businesses that operate in a similar arena.[62]

The High Court will now determine, *inter alia*, whether the rule in *Upton v Brown*[63] is one of general application or alternatively, one confined to a specific factual situation. One should reasonably expect the taxpayers to argue that the rule is not applicable to the facts because, as with *Cajkusic*,[64] the rule, or at least the rationale behind the rule, does not seem to apply to the facts. Moreover, where one class of beneficiary has equal interests in income and capital, or one class of unit holders in a unit trust how does the duty of impartiality of the trustee arise? If one draws an analogy between a unit trust on one hand and a company on another then it can be argued that the role of unit holders and shareholders are also analogous. In this respect guidance can be found in the case of *Re Bridgewater Navigation Co Ltd*[65] where Lindley J said:

> When capital and profits belong to the same persons in the same proportions it becomes unimportant to distinguish the one from the other…But when capital and profits belong to different persons, or the same persons in different proportions, the effect of capitalizing profits is to change their ownership, and an intention to do this must be shown before conversion of profits into capital can be properly inferred.[66]

The obvious intent of this argument would be to defeat the finding of the Full Court in relation to the present entitlement of the unit holders in the E & M Trust and therefore achieve successful operation of ss 100A(3A).

In response to any such allegations before the High Court, one expects the Commissioner to argue the issue of present entitlement on a more fundamental level. This includes applying the test outlined earlier in *Harmer*.[67] This will result in ss 100A(3A) having no application and thus s 100A(1) applies to deem the E & M Unit Trust not to be presently entitled to the trust law income of Raftland. One facet of this argument will be, of course, that given there was no change to the unit holders in the E & M Unit Trust, the intent of the trustee would never have been to distribute nearly $3 million to persons it did not know.[68]

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62 Here, the buying and selling of real property.
63 Above n 2.
64 Above n 15.
65 [1891] 2 Ch 317.
66 Ibid 327.
67 Above n 6.
68 Hence the reimbursement agreement.

CONCLUSION

The Federal Court, on two occasions, has stated that the rule in *Upton v Brown*[69] stands for something the case itself does not contemplate. One must recall that *Upton v Brown*[70] was brought to decide the trustee's duty of impartiality between competing income and capital beneficiaries. It seemed, in that case, to Pearson J, that as long as the business was continuing, albeit under different ends of profitability, prior losses were to be made up from subsequent profits; notwithstanding the change in receiver.[71] How this reasoning translates into the two decisions above is confusing. On one hand, the rule is being applied to support payments made to enter into arrangements[72] that create a loss in the accounts of the trust, therefore abrogating any attempt by the Commissioner to remedy.[73] On the other hand, the rule is being used to defeat the use of loss trusts that are purchased and injected with income to absorb those losses and also falling foul of s 100A.[74] At least the High Court will determine the issue shortly and one only hopes that the High Court also provides guidance on the application of the rule.[75] For the interim, with decisions such as *Cajkusic*,[76] it is to be expected that the Commissioner will find his way back inside the courtroom in the near future to test how, or if at all, taxpayers have been slavishly following trust deeds.

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69 Above n 2.

70 Above n 2.

71 Above n 2, 590.

72 Not effective for tax purposes and usually caught by Part IVA of the ITAA36.

73 Above n 15.

74 Ibid.

75 And not merely whether it applies or not.

76 Above n 15.