Are asset revaluation reserve distributions ‘ordinary income’ for discretionary beneficiaries?

Brett Freudenberg*

This article will analyse whether an asset revaluation reserve distribution made by a trustee of a discretionary trust could be regarded as ordinary income for the receiving beneficiary. This is important as normally only the capital gains tax treatment is considered, with the resultant conclusion that such a distribution is not assessable. Through this article’s analysis, the accepted position that asset revaluation reserve distribution has no adverse income tax consequences for a beneficiary of a discretionary trust will be challenged. In particular, it will be submitted that the receipt of such a distribution by a discretionary beneficiary could be assessable as ordinary income.

The article will initially consider whether an asset revaluation is ordinary income for the trust estate itself. Then the conduit theory’s application to asset revaluation reserve distributions by trustees of discretionary trusts will be considered. Following this analysis, the article will consider whether the receipt of an asset revaluation reserve distribution is ordinary income for the beneficiary of a discretionary trust.

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Tax-preferred amounts

A perceived abuse of the tax system is the ability of tax-preferred amounts to flow through to discretionary beneficiaries, and the fact that there is no effective mechanism to ensure that trust income is brought to tax in a timely manner.\(^1\) Tax-preferred amounts describe amounts that are not included in the trust estate’s calculation of net income pursuant to section 95 of the *Income Tax Assessment Act 1936* (‘ITAA36’). These tax-preferred amounts may arise due to a number of reasons, including asset revaluations, capital gains concessions,\(^2\) accelerated depreciation for plant and equipment purchased prior to 21 September 1999,\(^3\) and the small business 15-year exemption amount.\(^4\) A detailed list of tax-preferred amounts is contained in the table below.

<table>
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<th>Table 1 Tax-preferred amounts</th>
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<td>Tax-preferred amounts may arise because of:</td>
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<td>• Asset revaluations;</td>
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<td>• Capital gains concessions (such as the CGT asset being acquired prior to 20 September 1985);(^5)</td>
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<td>• Division 43 capital works;(^6)</td>
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<td>• Accelerated depreciation for plant and equipment purchased prior to 21 September 1999;(^7)</td>
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<td>• Small business 15 year exemption amount;(^8)</td>
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<td>• Small business further 50 per cent reduction amount;(^9)</td>
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<td>• Depreciation concessions for small businesses electing to be part of the simplified tax system;(^10)</td>
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<td>• Amounts sheltered because of carried forward losses;(^13)</td>
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<td>• Amounts sheltered because of indexation of CGT assets’ cost bases;(^14) and</td>
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<td>• Capital gains discount amounts.(^15)</td>
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2. Such as the CGT asset being acquired prior to 20 September 1985: Sub-section 104-10(5) *Income Tax Assessment Act 1997*.
3. Division 42 *ITAA97*.
4. Section 152-105 *ITAA97*.
5. Section 104-10(5) *ITAA97*.
6. Division 43 *ITAA97*.
7. Division 42 *ITAA97*.
8. Section 152-105 *ITAA97*.
9. Section 152-205 *ITAA97*.
As may be observed, one of the tax-preferred amounts is asset revaluation reserve distributions made by a trustees of discretionary trusts. In the absence of statistical information the true extent of such distributions is not fully known. While some regard the extent of such distributions as being limited, it may be staggering. Findings by the Tax Office’s High Wealth Individual Taskforce revealed that for the 236 taxpayers reviewed during the 1995 income tax year alone, the total amount of tax-free distributions from reserves to beneficiaries amounted to $50 million. In one case, $19 million was distributed to one wealthy individual, while in another, an individual received distributions of $5 million per year over at least three years.

The mischief presented by discretionary trusts performing asset revaluation reserve distributions is that beneficiaries of a discretionary trust lack any proprietary interest in the assets held by the trust. Through an asset revaluation reserve distribution a discretionary beneficiary is able to access the increase in value of the asset without being exposed to the risk of ownership, nor with any taxation implications.

This article will consider whether the unrealised gain arising from a revaluation is ‘income’ for the discretionary trust estate, as well as the receiving beneficiary. This analysis is timely, in light of the Board of Taxation’s recommendation to keep the flow-through treatment of non-assessable amounts, as well as the Government’s recent amendments to

10 Division 328 ITAA97.
11 Section 43-20 ITAA97.
12 Sub-division 388-A ITAA97.
13 Division 36 ITAA97.
14 Division 114 ITAA97. Note indexation is now frozen from September 1999.
15 Division 115 ITAA97.
16 Due largely to the lack of disclosure requirements for trusts.
17 The Board of Taxation. (2002). Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer, AGPS, Canberra. While the Board of Taxation considered these to be limited examples, unfortunately it did not provide any statistical information to support this conclusion.
19 Gartside v IRC [1968] 1 All ER 121 and Chief Commissioner of Stamp Duties (NSW) v Buckle 98 ATC 4103.
20 The Board of Taxation, supra note 17.
Division 7A to encompass unrealised profits distributions by a trust when there is a private company with an unpaid present entitlement.21

What is an asset revaluation reserve distribution?

For accounting purposes, the balance sheet is generally a historical document showing assets at cost, less any decline in value. However, a trustee of a discretionary trust is likely to have the power to revalue an appreciating asset pursuant to the trust instrument, and if not, the relevant trustee legislation generally provides such a power.22 It could also be the case that the trust instrument provides for an obligation on the trustee to actually perform valuations. This could be the circumstance when the trustee is about to make a corpus distribution.

When a trustee performs such a revaluation, there is no legislative requirement that accounting standards must be complied with.23 However, because of the trust instrument and the trustee’s fiduciary obligations, it is likely that due regard would be had of the relevant accounting standards.

The relevant accounting standard concerning revaluations of non-current assets provides that either the cost basis, or fair value basis, can be adopted.24 The standard states in recognising fair value, a credit is created to the asset revaluation account,25 and that the reserve may be utilised by a transfer to retained profits.26 After such a transfer, it appears that it is up to a trustee, subject to the trust instrument, to determine whether such a revaluation represents distributable profits.27 Indeed, companies in Australia are able to distribute profits sourced from unrealised gains, as recently

21 Schedule 8 of the Tax Laws Amendment (2004 Measures No 1) Act 2004 (Cth), receiving Royal Assent on 29 June 2004 and Sch 8 commenced on the date of Royal Assent.
22 Trusts Act 1973 (Qd) sub-section 51(1), Trustee Act 1958 (Vic) section 26, Trustee Act 1925 (NSW) section 52, Trustee Act 1936 (SA) no section, Trustee Act 1898 (Tas) no section, Trustee Act 1962 (WA) section 50, Trustee Act 1957 (ACT) section 52, and Trustee Act 1893 (NT) no section.
25 Id, at paragraph 5.5.
26 Id, at paragraph 5.5.3. Again the amount transferred must be net of any related recognised current tax or deferred tax AASB 1020.
27 McBride v Hudson (1961-1962) 107 CLR 604, per Dixon CJ., Windeyer and Taylor JJ.
illustrated by the declaration of a $150 million dividend by ENERGEX Limited.  

Once transferred to retained profits, it is possible for the unrealised gain resulting from an asset revaluation to be distributed to a discretionary beneficiary. However, this raises the tax issue of whether an unrealised gain is ‘income’ of the trust estate? In particular, is it assessable income of the discretionary trust for Australian income tax purposes? Also, is it possible for the conduit theory to apply to the distribution of cash to a beneficiary in the utilisation of this unrealised gain? This article will consider these pivotal issues, which are important in determining whether the receipt of such an asset revaluation reserve distribution by a discretionary beneficiary is ordinary income for the beneficiary.

**Trusts’ taxation**

Division 6 of the *ITAA36* provides the general framework to determine the tax liability for a trust estate, involving the key concepts of net income, present entitlement and income of the trust.

For taxation purposes, the initial step for each income year is to determine the taxable income of the trust estate, known as the ‘net income’. Net income is essentially the assessable income of the trust estate less all allowable deductions, calculated as if the trustee was a resident individual.

After calculating net income, the next step is to ascertain whether there are any beneficiaries presently entitled to the income of the trust estate, as opposed to the net income.

To the extent that a resident beneficiary not under a legal disability is presently entitled to income of the trust estate, then the beneficiary is assessable on its share of the net income. If a beneficiary is presently entitled but under a legal disability, then the trustee is liable to pay tax on the beneficiary’s share of net income in a representative capacity.

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29  Depending upon the precise terms of the trust instrument and the availability of cash.

30  Section 95 *ITAA36*.

31  Richardson v FCT 99 ATC 2198, per Dr Gerber at 2206: the concept of present entitlement under that subsection only relates to the income of the trust estate.

32  Section 97 *ITAA36*.

33  Such as being a minor (less than 18 years of age), bankrupt or insane.

34  Section 98 *ITAA36*. 
To the extent that there is some or all of the net income to which no beneficiary is presently entitled to, then the trustee is liable to be assessed on that amount.\textsuperscript{35} Generally, the trustee is taxed at the highest marginal rate plus Medicare levy (currently 48.5 per cent),\textsuperscript{36} though relief can be provided when the trust involved is one that arises under a will, an intestacy or bankruptcy.\textsuperscript{37}

Accordingly, central to the taxation of trusts are the concepts of present entitlement, income of the trust estate and net income. These concepts will be analysed in relation to how they might apply to a trustee’s recognition of an unrealised gain on an appreciating asset held by a discretionary trust.

\textbf{Present entitlement}

Present entitlement has been interpreted as meaning that the beneficiary has an immediate right to the payment of a share of the income of the trust. In that:

\begin{quote}
“An interest in possession in an amount of income that is legally ready for distribution so that the beneficiary would have a right to obtain payment of it if he were not under a disability.”
\end{quote} \textsuperscript{38}

A resolution by a trustee to distribute an amount of cash to a beneficiary in recognition of an asset revaluation reserve distribution would mean the recipient beneficiary was presently entitled. Indeed, present entitlement is deemed to exist for a beneficiary in whose favour a trustee exercises a discretion to pay or apply trust income, and the trustee actually pays

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\textsuperscript{35} Sections 99 and 99A ITAA36. This could occur in circumstances where the trustee had no power to appoint a particular entity as a beneficiary, and a default provision had not been triggered so as to entitle a default beneficiary, such as in the decision of \textit{BRK (Bris) Pty Ltd v Federal Commissioner of Taxation} 2001 ATC 4111.


\textsuperscript{37} In such circumstances, normal individual progressive rates will apply: Section 99 ITAA36.

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the amount.\(^{39}\) Note this determination of present entitlement needs to be made each tax year.\(^{40}\)

It is possible that a beneficiary’s entitlement to an asset revaluation reserve distribution may arise because of a power of advancement such as:

“At any time (before vesting of the trust) the Trustee out of the capital of the Trust Fund raise any sum and pay it to Eligible Beneficiary in the absolute discretion of the Trustee as s/he thinks fit.”

In light of the preceding analysis, it is submitted that the exercise of a power of advancement would create present entitlement.

**Income of a trust estate**

The term ‘income of a trust estate’ is a concept taken from the law of trusts, referring to the distributable income. Pursuant to this income is ascertained by the trustee according to appropriate accounting principles and the trust instrument.\(^{41}\)

Therefore to determine whether an unrealised gain is income of the trust estate, appropriate accounting principles and the trust instrument itself would need to be considered.

**ACCOUNTING PRINCIPLES**

**Income**

Accounting principles, as specified in accounting standards, state that revenue items, synonymous with income\(^{42}\):

\(^{39}\) Sections 101 and 95A ITAA36. *Case M45* 80 ATC 36 and *Case M46* 80 ATC 322. Note there is an issue in relation to unpaid trust distributions, where a beneficiary does not actually receive an income distribution from a trust. The amount may be either regarded as a loan back from the beneficiary to the trust estate, or the amount may be treated as being held under a separate trust for the beneficiary: Pascall, T. (2002). *Get a grip!* Trusts, Taxation in Australia, Vol 36, No 7, 347, at 348.


\(^{41}\) *Zeta Force Pty Ltd v Federal Commissioner of Taxation* 98 ATC 4681, per Sundberg J at 4686, and *Davies and Another v Federal Commissioner of Taxation* 89 ATC 4377. Compared to the quantum approach favoured by Merkel J in *Richardson v Federal Commissioner of Taxation* 97 ATC 5098, at 5111 when taxable income exceeded the distributable income, though Merkel J did consider the proportional approach was appropriate when the distributable income exceeded taxable income.

\(^{42}\) Note there is a difference in that income is generally used to refer to ‘net’ of expenses, whereas revenue is ‘gross’.
‘are inflows and other enhancements, or saving in outflows, of future economic benefits in the form of increases in assets or reduction in liabilities of the entity, other than those relating to contributions by owners, that result in an increase in equity during the reporting period.’

For a transaction or event to give rise to revenue it must have the effect of increasing equity.

While the bringing to account of an unrealised gain on an asset held by the trust estate would be revenue as it would be regarded as ‘other enhancements of future economic benefits in the form of increases in assets that result in an increase in equity during the reporting period’, the issue of at what time this revenue should be recognised is critical.

**Time of recognition**
The accounting standards specify that revenue should be recognised in the operating statement when and only when:

(a) it is probable that the inflow or other enhancement or saving in outflows of future economic benefits has occurred; and
(b) it can be measured reliably.

It is submitted that an unrealised gain on an appreciating asset, while meeting the definition of revenue, should not be actually recognised as revenue until a later date as it cannot be measured reliably. Accounting standards are emphasising more and more the desirability of the qualitative characteristic of reliability, rather than conservatism, accordingly if the gain was recognised as revenue it would not be reliable.

The conclusion that the unrealised gain should not be recognised as revenue until a later date can be seen as consistent with the approach

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44 Australian Accounting Research Foundation and Australian Accounting Standards Board, supra note 43, at paragraph 122.

45 Id, at paragraph 125.


47 This can lead to a deliberate bias towards understatement of revenues or assets.
adopted in the Australian Accounting Standards Board’s *AASB 1041: Revaluation of Non-Current Assets*. AASB 1041 provides that most of the accounting entries for a revaluation only affect the balance sheet.\(^{48}\) Pursuant to *AASB 1041* the only times an asset revaluation affects the profit and loss\(^{49}\) is when:

(a) there is a later decline in value of an asset and there does not exist a credit balance for the asset revaluation reserve (for the same class of asset), then the decrement is an expense;\(^{50}\) and

(b) an increment can be directly recognised as revenue if the increment reverses a decrement previously recognised as an expense.\(^{51}\)

Accordingly, accounting principles generally specify that the recognition of an unrealised gain by a trust is potentially income, though it should not be recognised as such until a later date. It is submitted that this is consistent with the accounting standard’s desirability of relevance and reliability as being the primary characteristics of financial information.\(^{52}\)

**Trust instrument**

The trust instrument itself may prescribe that unrealised gains can be regarded as ‘income of the trust’. Whether this is the case will vary from trust to trust.

The decision of *Richardson v Federal Commissioner of Taxation*\(^{53}\) provides a recent example of a trust instrument providing that an unrealised gain could be regarded as income for a trust estate. In that decision, trust income was defined in the trust instrument as:

“*Income* shall include any amounts which the Trustee shall in its absolute discretion determine to form income of the Trust Fund whether or not: —

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48 Known more recently as the Statement of Financial Position.
49 Known more recently as the Statement of Financial Performance.
50 Australian Accounting Standards Board, supra note 24, at paragraph 5.5.
51 Ibid.
52 Australian Accounting Research Foundation and Australian Accounting Standards Board, supra note 46, at paragraph 7.
53 *Richardson v FCT* 2001 ATC 4621.
(a) such amounts constitute income for the purposes of the Income Tax Assessment Act (or any other legislation relating to taxation of any form) or not;
(b) such amounts arise from investments or personal exertion;
(c) such amounts constitute gains of a capital nature (which have accrued actually or notionally) for the purposes of any legislation relating to taxation of any form” 54 (Emphasis added)

Accordingly, the trust instrument itself may determine that income of the trust estate includes unrealised gains. However, even if an unrealised gain is regarded as ‘income of the trust estate’ that does not necessarily mean that the trustee or a beneficiary will be assessable on the unrealised gain. This is because Division 6 55 only includes ‘net income’ amounts in assessable income, as compared to ‘income of the trust estate’. 56 This is because neither trust law nor the provisions of the trust instrument can alter the character of a receipt for tax purposes. 57

**Net income**

For the determination of what amounts are included in ‘net income’ regard must be had to section 95 of the ITAA36 which defines net income to mean:

“The total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions, except the concessional deductions and deductions under Division 16C and except also, in respect of any beneficiary who has no beneficial interest in the corpus of the trust estate, or in respect of any life tenant, the deductions allowable under section 80, 80AAA or 80AA in respect of such of the losses of previous years as are required to be met out of corpus.” 58

54 Id at 4628 quoting clause 1(9) of the trust instrument.
55 ITAA36.
56 Sections 97(1) and 98 ITAA36 for the beneficiary, and sections 99 and 99A ITAA36 for the trustee.
57 Federal Commissioner of Taxation v Australian and New Zealand Savings Bank Limited 98 ATC 4850, per Gleeson CJ at 4854.
58 Section 95 ITAA36.
Assessable income includes ordinary income and statutory income, and it is these concepts that need to be analysed to determine whether they incorporate an unrealised gain recognised by a discretionary trust. Also, the concept of derivation for tax purposes needs consideration.

**Ordinary income**

Ascertaining income according to ordinary concepts can be difficult, a fact recognised by the Commissioner. He identified the difficulty of establishing a definition of income as one of the five factors which explained the tax laws complexity.

To determine whether an amount is income, the character of the amount in the hands of the recipient, here initially the trustee needs to be considered, with the test being applied objectively. While the entitlement of the beneficiaries could be dictated by the accounting records and accounting standards, those considerations could not apply to the characterisation of the money in the hands of the trustee. However, this determination provides little clarity in relation to asset revaluations that are transferred to retained profits, as nothing has actually come into the trust estate.

**Economist interpretation**

To an economist, income denotes increments to an individual’s economic power, by looking to the changes in wealth of the individual plus spending. Pursuant to this ideology, unrealised gains on appreciating assets are as much gains as dollars in a pay packet. However, such a system that

59 Sections 6-5(1) and 6-10(1) and (2) ITAA97.
63 Richardson, supra note 32.
65 Ibid.
67 Id at 95. Such as how are assets to be valued? What about fluctuating markets? What if the taxpayer has no funds besides the asset from which to pay the tax?
includes unrealised gains presents particular economic and administrative problems.\(^{67}\)

Even though some commentators conclude that no concept of income can be really equitable if the definition does not embrace all receipts that increase an individual’s command over the use of society’s scarce resources,\(^{68}\) judicial decisions concerning income have generally formulated a narrower concept.

Notwithstanding this, a court in a recent decision adopted an apparent economic definition of income. This occurred in the case of *Sun Alliance Investments Pty Ltd (In liquidation) v Commissioner of Taxation.*\(^{69}\) This decision involved the interpretation of sub-section 160ZK (5),\(^{70}\) which concerns attributing an amount to profits derived by a company before a new shareholder acquired shares in the company. In the initial decision by Stone J, she accepted that the rebateable dividends pursuant to this sub-section could be attributable to realised or unrealised profits of the company at the time of the acquisition of the shares by the new shareholder.

The company in that decision did revalue its assets,\(^{71}\) via increments and decrements to the asset revaluation reserve. However, the company had a policy of only declaring dividends out of retained profits and realised gains, and not out of unrealised amounts.

In interpreting the legislation, Stone J noted as a matter of plain English the term ‘profits’ would seem to include both realised and unrealised profits, and that there did not seem any requirement to draw a distinction between these.\(^{72}\)

Stone J in coming to her decision referred to the following statement of Lockhart J:

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\(^{68}\) [2003] FCA 75, 13 February 2003, Federal Court of Australia, per Stone J.

\(^{69}\) ITAA36. A provision that reduces the cost base of shares by the amount of certain rebateable dividends.

\(^{70}\) In accordance with the relevant accounting standard at the time of *AASB 1010*.

\(^{71}\) *Sun Alliance Investments Pty Ltd (In liquidation) v Commissioner of Taxation* [2003] FCA 75, 13 February 2003, Federal Court of Australia, at paragraph 43.

“The statement of principle that profit should be calculated by reference to changes in value of assets of a business during the relevant financial period in Spanish Prospecting is as valid today as it was in 1911 when it was expounded.” 73

Additionally, Stone J noted decision of Read, where it was stated:

“‘Profit’ must be assessed in terms of whether they resulted in any consequential financial gain to the appellant.

In our opinion a mere increase in the value of an asset does not amount to a capital profit. A profit connotes an actual gain and not mere potential to achieve a gain. Until a gain is realized it is not ‘earned, derived or received’. A capital gain is realized when an item of capital which has increased in value is ventured, either in whole or in part, in a transaction which returns that increase in value.” 74 (Emphasis added)

However Stone J in Sun Alliance 75 distinguished the decision of Read as the purpose of the legislation under her consideration was to preclude a taxpayer from claiming a capital loss where there was no economic loss to the taxpayer. 76 Accordingly looking at the purpose of the legislation, she held that the term profits used in sub-section 160ZK (5) included both realised and unrealised profits.

On appeal Lee, Sundberg and Conti JJ overturned in part the decision of Stone J. 77 The Full Federal Court focused on the word ‘derived’ as they quoted the long standing dictum of Lord Herschell in Russell v Town and Country Bank. 78

74 Sun Alliance, supra note 72, at 57.
75 This reasoning of referring to the economic substance of the transaction is in congruence with a number of recent legislative reform provisions that look more to the economic substance, such as the 45-day holding rule, and the trust loss measures.
77 (1888) 13 App Cas 418, at 424.
78 Sun Alliance, Full Federal Court, supra note 77, at 37.
“The profit of a trade or business is the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning those receipts….Unless and until you have ascertained that there is such a balance nothing exists to which the name ‘profits’ can properly be applied” (Emphasis added)

Therefore, in addressing the assets which the unrealised gains were attributed to — being a share portfolio and land — the court noted that in respect of the shares that increments in value emerging from valuations could not realistically be characterised as having been derived pending their ultimate realisation. Their justices noted that the evidence did not appear to travel beyond circumstances of a mere process of valuation. In contrast, in relation to the land holding, the court concluded that an unrealised gain had been derived, because it had been ‘locked-in’. The court held that this gain had been derived, as there was a put option, as another company would make up the short fall if the properties were sold at less than valuation to which the unrealised gain related.

The Full Federal Court in determining whether the unrealised gains were profits derived considered that such gains had to be of a permanent character, and must have come home during the relevant accounting period, in a realised or realisable form.

If the reasoning of Sun Alliance Insurance is adopted by analogy, then for a trustee that has not locked in the unrealised gain, it is unlikely that an unrealised gain would be regarded as ordinary income for the trust.

Of course Sun Alliance Insurance may not have general application because it was considering a particular statutory provision where the explanatory memorandum of the Bill that introduced the provision, referred to economic principles, not requiring any distinction between realised and unrealised profits. Stone J found this legislative purpose as paramount, requiring her to distinguish the decision in Read, albeit on appeal.

79 Id at 38.
80 QBE Insurance Group, supra note 73.
81 Commissioner of Taxes (SA) v Executor Trustee and Agency Co of SA Ltd (1938) 63 CLR 108
82 Sun Alliance, Supra note 72.
83 Ibid.
84 Taxation Laws Amendment Bill (No 2) 1994 (Cth).
85 Sun Alliance, Supra note 72, at paragraphs 41 to 43.
86 Id at paragraph 57.
87 Cooper, G. supra note 43, at 424.
It is submitted that the principles of Read have more general application, and are relevant in considering whether asset revaluations by discretionary trusts are ordinary income.

Additionally, criticisms of the model of comprehensive income tax as espoused by the Haig-Simmons model include that it is not as comprehensive as one may consider. This model would include income from gambling and unrealised gains, but would exclude employee fringe benefits. In addition to these inconsistencies, how would such a model deal with less tangible increments in net wealth such as social welfare payments, government education, government health care, and roads? Also tax on observed incomes as espoused by such a model can often operate as a poor measure of economic welfare.

Judicial Consideration

The judicial theme as to what is income, generally involves the notion that income is what comes in, though it has been recognised that income itself is not a term of art.

Business and commerce principles have also been relied upon in determining income, unless the legislature has itself made some specific provisions. The accounting basis that has been employed in calculating profits and losses for the purposes of the assessment acts is generally historical cost not economic equivalence. However business principles have never been fully determinative, as the Taxation Act at times clearly intends a different tax treatment.

Also some judges have drawn inspiration from trust law, where income is a long time recognised concept. This is notwithstanding that it is used in a very different sense in that field, in determining entitlements between income and capital beneficiaries.

88 Id at 426.
89 Id at 424.
90 Id at 423.
91 Waincymer, J. supra note 64, at 96.
92 Ibid: Scott v FCT (1966) 117 CLR 514, per Jordan CJ.
93 Ibid: Commissioner of Taxes (SA) v Executor Trustee and Agency Co of SA Ltd (1938) 63 CLR 108, at 155 per Dixon J.
94 Federal Commissioner of Taxation v Myer Emporium Ltd (1987) 163 CLR 1999 per Mason ACJ, Wilson, Brennan, Deane and Dawson JJ.
95 Waincymer, J. supra note 64, at 97.
96 Ibid.
97 Id at 110: Doyle v Mitchell Bros Co 247 US 179 (1918).
Income has been determined as:

“Not a gain accruing to, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital, however invested or employed, and coming in, being ‘derived’, that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit, and disposal; that is income derived from property.” 98 (Emphasis added)

It is submitted that the recognition of an unrealised gain on an asset held by a discretionary trust is at best regarded as capital in nature and not income, as the gain has not proceeded ‘from the property’. However, even if the unrealised gain could be regarded as revenue in nature, 99 the income has not yet been derived by the trust for taxation purposes. 100

**Derivation**

A trustee carrying on a business must use generally accepted accounting principles, including accrual accounting. 101 In determining when income is derived what can be gleaned from the case law is ‘realisation’. The statement of Lord Justice Clerk in *Californian Copper* highlights this:

“It is equally well established that enhanced values obtained from realization on conversion of securities may be also assessable, where what is done is not merely a realization or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business.” 102 (Emphasis added)

Though pursuant to *Evans’ case* 103 the word ‘derived’ does not connote that the profit must be realised profit. To be derived it is enough if it is an ascertained profit, ascertained by proper account.

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98 In that, the asset held was trading stock, for a profit to be made on its resale: *Federal Commissioner of Taxation v Whitfords Beach Pty Ltd* (1982) 150 CLR 355.

99 Section 6-5(2) ITAA97. The concept of realisation is used in the legislation extensively, even in the exposure draft for the *New Business Tax System (T axation of Financial Arrangements) Bill 2002*, which ensures that foreign currency gains and losses are brought to account when realised.

100 *Zeta Force Pty Ltd v Federal Commissioner of Taxation* 98 ATC 4681.

101 *Californian Copper Syndicate Ltd and Reduced v Harris* (1904) 5 TC 159, at 165-66.


103 *BHP Billiton Petroleum (Bass Strait) Pty Ltd and Another v Federal Commissioner of Taxation* [2002] FCAFC 433.
In the recent decision of *BHP Billiton*\(^{104}\) the court relied on expert evidence that it was only appropriate to treat amounts as income when, amongst other things, it was capable of being measured with sufficient reliability. In doing so, their Honours considered that on questions involving the derivation of income the court may have regard to the concepts of business and the principles of commercial accountancy.

Stone J in *Sun Alliance*\(^{105}\) observed that the Assessment Acts do not contain any definition of ‘derived’. She stated that it was not a technical word and there was no reason why it should not bear its ordinary English meaning. The ordinary meaning has been expressed as ‘obtained’ or ‘got’ or ‘acquired’,\(^{106}\) or as, ‘arising or accruing or coming in by way of income, not necessarily actually received’\(^{107}\). On appeal, their justices in *Sun Alliance* provided that the notion of derivation was paramount in generally excluding an unrealised gain which had not been ‘locked-in’\(^{108}\).

In the assessment of income the aim is to discover what gains have during the period of account come home to the taxpayer in a realised or immediately realisable form.\(^{109}\) In the circumstances of a discretionary trust revaluing an appreciating asset, neither is it likely that the increment in value is income, nor is it in an immediately realisable form. Therefore, it is submitted that, an asset revaluation is neither ordinary income, nor has it been derived by the discretionary trust. The only qualification is if the trustee has been able to ‘lock-in the unrealised gain, for example by holding a put option, then the principles of *Sun Alliance Insurance* may determine that it is ordinary income.

As noted earlier, in addition to ordinary income, assessable income includes statutory income.\(^{110}\) Is it therefore necessary to consider whether it is possible for an asset revaluation to be regarded as statutory income under the Assessment Acts?

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104 *Sun Alliance*, supra note 72, per Stone J at paragraph 50.
105 *Federal Commissioner of Taxation v Clarke* (1927) 40 CLR 246, per Isaacs ACJ at 261.
107 *Sun Alliance*, supra note 77, at 37.
108 *Executor Trustee*, supra note 82, per Dixon J at 155.
109 Sub-section 6-10(2) *ITAA97*.
110 Sub-section 6-10(2) *ITAA97*. 
Statutory income

Whether the unrealised gain could be assessable as statutory income, particular regard must be had to the CGT provisions. The bringing to account of an asset revaluation increment is not likely to be assessed as a capital gain to the trustee, as there has not been a disposal of property. This is because most CGT events require for their operation the passing of property from one entity to another. For example CGT event A1 happens if a taxpayer disposes of a CGT asset, in that a change of ownership occurs from the taxpayer to another entity.

Neither are any of the CGT events in Sub-division 104-E likely to cause the trustee to be liable for taxation on an asset revaluation, and its subsequent distribution. This is because CGT event E1 would not occur for an asset revaluation reserve distribution, as there has not been a creation of a trust over a CGT asset by declaration or settlement.

Nor has CGT event E2 occurred, as there would be no transfer of a CGT asset to an existing trust. CGT events E3 and E4 are not relevant for the trustee, as these events only potentially tax the beneficiary on a capital gain.

There is likely to be a nil capital gain for the trustee under CGT event E5, as the market value of the asset revaluation reserve distribution will equal its cost base. CGT events E6 and E7 will not apply to an asset revaluation, or its subsequent distribution, since an asset revaluation as contemplated is not effected to end an income or capital right of the beneficiary. Neither would CGT event E9 apply as it only occurs if a taxpayer agrees for consideration that when property comes into existence the taxpayer will hold it on trust, and at that time of agreement no potential

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111 Note there are some CGT events that do not require a disposal for them to operate, such as CGT Event E4 in section 104-70 ITAA97 that is discussed later in this chapter.
112 Section 104-10(2) definition of ‘dispose of’ ITAA97.
113 ITAA97.
114 Section 104-55 ITAA97.
115 Section 104-60 ITAA97.
116 Sub-sections 104-65(3) and 104-70(4), respectively ITAA97.
117 Sub-section 104-75(3) ITAA97. This provision is explored in greater detail in Chapter Five.
118 Sub-sections 104-80(1) and 104-85(1), respectively ITAA97.
119 Sub-section 104-105(1) ITAA97.
beneficiary under the trust has a beneficial interest in the rights created by the agreement.\textsuperscript{120}

However, CGT event D1 may occur for the trustee as it has created a legal or equitable right in another entity by making an asset revaluation reserve distribution.\textsuperscript{121} Though for the trustee there is likely to be neither a capital gain or capital loss, as the capital proceeds would be nil, and the incidental costs either minimal or nil.\textsuperscript{122} Note the market value substitution rule does not apply to CGT event D1, so the capital proceeds of nil will not be replaced with the market value of the entitlement to the asset revaluation reserve distribution.\textsuperscript{123}

**UNREALISED GAIN NOT INCOME**

Consequently, it is submitted that the unrealised gain on the revaluation of an appreciating asset will not be included in the calculation of the net income of the trust estate. This is because it is neither ordinary income derived, nor statutory income of the trust estate. This conclusion is not affected by the decision of the trustee to utilise the asset revaluation by transferring it to retained profits, and then subsequently distributing it to a beneficiary.

Therefore, even if a beneficiary is presently entitled to a share of the income of the trust estate, which may include the unrealised gain, the beneficiary only has to include in its assessable income its share of net income.\textsuperscript{124} The ‘net income’ calculation will not include the asset revaluation. Also the trustee is not liable for tax on the unrealised gain, as the trustee’s liability is limited to amounts of the net income to which no beneficiary is presently entitled to.\textsuperscript{125}

\begin{flushleft}
\textsuperscript{120} Section 104-35 \textit{ITAA97}.  \\
\textsuperscript{121} Sub-section 104-35(4) \textit{ITAA97}.  \\
\textsuperscript{122} Sub-section 116-30(3) \textit{ITAA97}.  \\
\textsuperscript{123} Zeta Force, supra note 101, per Sundberg J at 4686, and \textit{Davies and Another v Federal Commissioner of Taxation} 89 ATC 4377. Compared to the quantum approach favoured by Merkel J in \textit{Richardson v Federal Commissioner of Taxation} 97 ATC 5098, at 5111 when taxable income exceeded the distributable income, though Merkel J did consider the proportional approach was appropriate when the distributable income exceeded taxable income.  \\
\textsuperscript{124} Sections 99 and 99A \textit{ITAA36}.  \\
\textsuperscript{125} Section 95 \textit{ITAA36}. 
\end{flushleft}
Accordingly, it is submitted that neither the trustee nor the beneficiary of a discretionary trust will be assessable on an asset revaluation reserve distribution under Division 6 ITAA36. This is because the calculation of ‘net income’ does not include the asset revaluation, or its distribution. However, whether the subsequent distribution to a discretionary beneficiary of an asset revaluation subject to tax under a provision outside Division 6 for the receiving beneficiary, in particular as ordinary income still needs consideration? Before considering this, the character of the payment to the receiving beneficiary will be reflected upon; in particular, whether the cash amount received by a beneficiary because of an asset revaluation reserve distribution could continually be referrable to the source that created it?

**Conduit theory’s application**

If the conduit theory applies to an asset revaluation reserve distribution, the money would maintain its character and identity as it passes through the trust to the beneficiary. The conduit theory is based upon the premise that, as the trust is not a separate legal entity, an amount received by the trustee and paid to a beneficiary maintains its identity and character as it passes through the trust. Therefore, if a receipt were capital in nature in the hands of the trustee, when paid out to a beneficiary, it would still be regarded as capital in the hands of the beneficiary.

In the United States of America, trusts are expressly provided with conduit taxation under Sub-chapter J of the *Internal Revenue Code* when the trust distributes its income to the beneficiaries, which are taxed directly on the income.

**Non-receipt by the trustee**

How the conduit theory applies when a trustee of a discretionary trust makes an asset revaluation reserve distribution is problematic, as the trust has not actually derived any receipt. In contrast, the trustee has just brought to account an unrealised gain, which may or may not eventuate in the

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future. In reality any money distributed to a beneficiary because of the revaluation does not originate from the appreciating asset itself. This is because the appreciating asset is still held by the trust, and the money paid out to the beneficiary is probably traceable to either prior trading profits of the trust estate, tax-preferred amounts, or money borrowed by the trustee to pay for the distribution.

In relation to a trust borrowing money to fund an asset revaluation reserve distribution the Commissioner considers that the interest on the borrowings is not deductible for the trust.129 However, if the trustee specifies that the distribution is in recognition of the increment in value of an appreciating asset, this raises the issue of whether that is enough to stamp the identity of the distribution?

It is submitted that it is impossible for such an identity to be stamped on an asset revaluation reserve distribution. The following statement in AASB 1041 supports this conclusion:

“Once an amount has been transferred from an asset revaluation reserve to another reserve, it is not available for offsetting against future revaluation decrements. That is, a transfer from an asset reserve is not merely a matter of display; and an amount transferred from an asset revaluation reserve does not retain its character as a balance of an asset revaluation reserve.”130 (Emphasis added)

Accordingly, it is doubtful whether a beneficiary in receipt of an asset revaluation reserve distribution can point to the appreciating asset as the source of the payment, and therefore determinative of the payment’s character.

**Application to discretionary trusts**

In addition to this ambivalence about the conduit theory’s application to an asset revaluation reserve distribution, is the acknowledgment that a number of cases have cast doubt on the application of the conduit theory to discretionary trusts generally.131

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129 Australian Accounting Standards Board, supra note 24, at paragraph 5.5.3.
131 *Baker v Archer-Shee* [1927] AC 844.
INTEREST IN TRUST PROPERTY

Decisions have concluded that the conduit theory applies to a sole beneficial owner of interest and dividends, and a trust with a sole beneficiary. Another decision applied the conduit theory to a distribution to a unit holder of a unit trust. The High Court in that decision observed that a unit under the trust instrument was conferred a proprietary interest in all the trust property. This proprietary interest meant the character of the money in the hands of the trustee must be considered to determine whether money distributed to unit holders formed part of their income or capital.

The interest in trust property of a unit holder and of a sole beneficiary is considerably different to that of a discretionary beneficiary and a default beneficiary of a discretionary trust. A unit holder under a trust instrument would normally be conferred a proprietary interest in all the property that is subject to the trust. Whereas for discretionary beneficiaries it has been held that they do not hold an interest in the trust estate. In that, they have no vested interest in corpus, but have rights to the due administration of the trust that a court of equity would protect. A default beneficiary has a similar lack of proprietary interest in the trust property. This determination of a beneficiary’s interest is important, as this distinction appeared to influence the High Court’s decision in Syme, as the court held in that case that the income could not be traced. Though Griffith CJ noted that:

“If the circumstances were such that the beneficiary could be, and had been, put in actual possession, for his exclusive benefit, of any part of the trust estate, the case may be different.”

133 Baker supra note 132.
135 Ibid.
136 Ibid.
137 Gartside supra note 19.
138 Chief Commissioner of Stamp Duties (NSW) v Buckle 98 ATC 4103.
140 Webb v Syme (1910) 10 CLR 482.
141 Id, at 494.
142 Australian and New Zealand Savings Bank Ltd v Federal Commissioner of Taxation 97 ATC 4461.
The *ANZ case* concerned unit holders of a trust, where the trust received income through holding annuities. The Full Federal Court held that the trustee held the income of the trust fund on trust for the investors absolutely, and on receipt of the income, the income was property in which the unit holders had a beneficial interest. Consequently, it was held that the unit holders’ receipts from the trust had the same character as when received by the trustee.\(^{143}\)

According to the Court, the question of whether money distributed to the unit holders formed part of their income or capital must be answered by considering the character of the money in the hands of the trustee before the distribution was made. This was because a unit holder’s interest in the income was vested in possession, and the unit holder was entitled to demand payment.\(^{144}\) *Charles’ case* was cited as authority for the proposition that the character of money coming to the trustee before a distribution is made, is the character of the money in the unit holder’s hands after the distribution.\(^{145}\)

The High Court on appeal in the *ANZ case* noted that the whole of the annuity amounts received by the trustee constituted ordinary income of the trust. When considering entitlements of the unit holders, while the trust instrument treated certain amounts of the annuity as capital, this did not alter the character of the receipt for the beneficiaries.\(^{146}\) Chief Justice Gleeson\(^{147}\) cited *Charles’s case* as authority that the character of the receipt depended upon ‘the character of the moneys in the hands of the trustees.’\(^{148}\)

It is submitted that this citation of *Charles’ case* by the High Court cannot be seen as a general acceptance of the conduit theory, as the decision there too related to a unit trust.

Indeed, there appears to be no Australian decisions decisively considering whether the conduit theory applies to distributions by discretionary trusts. In the recent decision of *Richardson*,\(^{149}\) which involved a discretionary

\(^{143}\) Ibid.

\(^{144}\) Id, at 4469.

\(^{145}\) *Australian and New Zealand Savings Bank*, supra note 57, at 4854.

\(^{146}\) With McHugh, Gummow, Kirby and Callinan JJ agreeing.

\(^{147}\) *Australian and New Zealand Savings Bank*, supra note 57, at 4854.

\(^{148}\) *Richardson*, supra note 31.

\(^{149}\) Id, at 2211.
trust, there appeared some indirect references to the conduit theory by Dr Gerber. Dr Gerber did not consider the lack of distribution of specific money to Mr Richardson as being fatal.\(^{150}\) This was because while present entitlement of the beneficiaries may be dictated by the accounting records and accounting standards, these same considerations cannot apply to the characterisation of the money in the hands of the trustee.\(^{151}\) On the facts, Dr Gerber was satisfied that the sale of the properties constituted ordinary income in the hands of the trustee. Consequently, the discretionary beneficiary, Mr Richardson, was to be assessed on the balance on the net income of the trust after the payment of $47,000 in accordance with the Trustee’s resolution.\(^{152}\) This was even though Mr Richardson’s present entitlement dissipated, not through distribution of the income to him, but through the transfer of the profit by the trust to the capital reserve instead. By such a transfer the profit was to be held for the benefit of the corpus beneficiaries, which Mr Richardson was not.\(^{153}\)

In Richardson’s case, Dr Gerber appeared to focus on the characterisation of the receipts in the hands of the trustee, and did not consider whether the nature of the trust as a discretionary trust, compared to a unit trust, affected the character of the receipt for the beneficiary. It is submitted that the application of the conduit theory was not fundamental to the determination of the Richardson’s decision, nor directly relied upon. This is because it was determined on the facts that the net income of the trust included the profit on the sale of the two proprieties. Since the Mr Richardson was presently entitled to income of the trust estate under the trustee’s resolution of the 24th of June, Mr Richardson had to include his share of this net income in his assessable income pursuant to section 97. Dr Gerber’s dicta concerning Charles’ case and the ANZ case, was not considered on appeal by the Federal Court.\(^{154}\)

Instead, on appeal to the Full Federal Court,\(^{155}\) it was stated that the critical question was not whether, before sale, the property was part of the

\(^{150}\) Ibid.

\(^{151}\) Ibid.

\(^{152}\) Ibid.

\(^{153}\) Richardson v Federal Commissioner of Taxation 2001 ATC 4058.

\(^{154}\) Richardson, supra note 53.

\(^{155}\) Id, per Kenny J with Beaumont and Lindgren JJ agreeing at 4632.
trust corpus, but whether the proceeds received on sale had the character of income or capital in the hands of the trustee. The decisions of Charles and ANZ were cited as comparison to this statement.\textsuperscript{156} It is not clear on the reasoning why these cases were cited as comparisons. It may be that these cases concerned the characterisation in the hands of beneficiary rather than the trustee. Other than this comment by the court no further reference was made to these decisions. The Full Federal Court held that the profits did represent income to the trust, and that Mr Richardson was presently entitled to income of the trust.

In support of the proposition that the conduit theory does not apply to discretionary trusts is the following obiter statement by Latham CJ in \textit{Re: Executor Trustee}. His Honour stated the following as a reply to an argument based upon the conduit theory:

\begin{quote}
\textit{“In view of the fact that such a discretion exists, and that the exercise of it is interposed between the receipt of rents and profits of the land by the trustee and the payment of income to the beneficiaries, it seems to me to be impossible to hold that the latter are entitled specifically to the rents and profits.”}\textsuperscript{157}(Emphasis added)
\end{quote}

This reasoning is supported by the recent decision of \textit{Memec},\textsuperscript{158} where Walker J stated:

\begin{quote}
\textit{“Transparency is normally associated with a situation where the ultimate recipient of the income in question has a beneficial interest in it from the start, and moreover the income is not transmuted at some intermediate stage by the need for the trustees to exercise a discretion or by its being packaged so as to reach the ultimate recipient in the form of a fixed annuity.”}\textsuperscript{159}(Emphasis added)
\end{quote}

These observations have led some commentators to conclude that unless there is a specific contrary statutory intention,\textsuperscript{160} the trust conduit principle

\textsuperscript{156} \textit{Re Executor Trustee}, supra note 82, per Latham CJ at 557-558.
\textsuperscript{157} \textit{Memec PLC v IRC} [1996] BTC 590 (ChD).
\textsuperscript{158} Id, at 605.
\textsuperscript{159} Such specific contrary statutory intention in Australia can be found in sections 6B (1), 6B (2), 45Z, 160AQX of \textit{ITA A36}.
\textsuperscript{160} Schabe, D. supra note 131.
does not hold for discretionary trusts. 161 This is even so when the trustee keeps separate accounts for different types of trust income and purports to allocate different types of income to particular objects or classes of objects. 162

It is interesting to note that the Asprey Committee stated that while the Commissioner appeared to apply the conduit theory not only to exempt income but also other forms of income, it was the view of the Committee that the Commissioner’s practice had no legislative support. 163

PURELY TECHNICAL LEGISLATIVE INTERPRETATION

Another limitation to the general application of the conduit theory is that some cases, which have been referred to as demonstrating the conduit theory, on analysis, can be limited to a purely technical interpretation of the taxation legislation involved. 164

One such decision is Syme. 165 This decision concerned an amount received by a beneficiary under a testamentary trust. Under the trust a widow was entitled to an annuity with the residue to be divided equally amongst five sons. The issue was whether the income derived by one of the sons was from personal exertion or from the produce of property within the terms of the *Income Tax Acts 1895 and 1896* (Vic). Under the testamentary trust, the trustees conducted a newspaper business. Under the relevant legislation ‘income derived by any person from the produce of property’ was defined as all income derived in or from Victoria and not derived from personal exertion. Therefore if income was personal exertion income, by necessity it would not be income from property. ‘Income derived by any person from personal exertion’ was defined as income arising or accruing from any trade carried on in Victoria.

The majority of the High Court 166 considered that the different types of income derived by the trust estate could not be traced to the income distributed to the beneficiaries. However, the Privy Council held on appeal that in saying ‘any trade carried on in Victoria’ the definition did not say by

161 Ibid. Though some consider a default beneficiary is able to utilise the conduit theory as they have interests vested in interest and possession but subject to divestment.


163 Schabe, D. supra note 131.

164 *Syme v Commissioner of Taxation (Victoria)* (1914) 18 CLR 519.

165 *Webb v Syme* (1910) 10 CLR 482.

166 *Syme*, supra note 165, at 522.
whom such trade was carried on by. Additionally, when a trade is carried on by a trustee there is no doubt that they carry it on for the beneficiaries. The Privy Council held that what the beneficiary obtained was income arising from a trade carried on in Victoria by trustees for the benefit of himself and others. Accordingly, the court held that the interposition of the trustee between the property and the trust beneficiaries did not prevent the beneficiaries from saying that their income was still derived from the property.

In addition to these statements, the Privy Council stated that what was the produce of personal exertion in the trustee’s hands does not in the instant of transfer to the hands of the cestui que trust, suffer a change, and become the produce of property and not of personal exertion.

 has been distinguished by a number of cases by the express words of the Assessments Acts. The decision of concerned income coming from the trustee’s ownership of a pastoral property on which it carried on business, as well as a share in a grazing business that it carried on with another person in partnership. A beneficiary was entitled to an annuity charged on both capital and income, and the question arose as to whether this was income derived from property for the beneficiary.

In this determining this, Dixon J stated:

“The second question presents no difficulty. What is income from personal exertion is defined in s. 6. All other income is income from property. The income derived by the taxpayer, as stated in the reference, does not fall within the definition from personal exertion. Syme v. Commissioner of Taxes (Vic.) (supra) is inapplicable because, no doubt with that decision in mind, the draftsman of the definition introduced the words ‘carried on by the taxpayer’ after the words ‘proceeds of any business’. The taxpayer did not carry on the business. She was a beneficiary, not a partner. The trustee did carry on the business, that is as a partner.”

167 Id, at 522.
168 Id, at 523.
170 Syme, supra note 165, at 526.
171 Tindal, supra note 107, and Case V152 88 ATC 962.
172 Tindal, supra note 107.
173 Id, at 629. Stark J made a statement in similar terms at 625.
174 ITAA36.
Indeed the notion of Syme being limited to statutory interpretation can be re-enforced by the consideration of sub-section 157(3),\footnote{As referred to Case 235 92 ATC 326, by KL Beddoe at 330.} which deems a beneficiary to be carrying on a business of primary production.\footnote{For example section 97 ITAA36 seems to expressly acknowledge the retention of character of exempt income of the trust estate to the beneficiary, and by sub-section 102AG ITAA36 the Commissioner is required in certain circumstances to attribute to each prescribed minor beneficiary amounts categorised by reference to source of income as excepted trust income and non-excepted trust income.} This deeming allows beneficiaries to take advantage of primary production provisions in the Assessment Acts, and without it is unclear whether otherwise they would be entitled to do so.

**Non-application of conduit theory**

It is submitted that conduit theory does not have general application to the receipt by a beneficiary of an asset revaluation reserve distribution from a discretionary trust. This is because the cash distribution is not sourced from the appreciating asset, and additionally it is uncertain whether the conduit theory has general application for discretionary trusts in any event.

This is even though a number of provisions of the ITAA36 and ITAA97 seem to acknowledge certain limited forms of attribution in the context of trusts.\footnote{Aust. supra note 1, at 113.}

The implications of the conduit theory’s non-application will now be examined in determining the taxation treatment of the asset revaluation reserve distribution for the receiving beneficiary. Through this analysis, possible flaws in the accepted view that an asset revaluation distribution is non-assessable for the receiving beneficiary will be highlighted.

**Accepted view**

It is the current accepted view that tax-preferred income, including asset revaluation increments, can be distributed tax-free to beneficiaries of discretionary trusts.\footnote{Commissioner of Taxation. supra note 129, at paragraph 29.} The Commissioner, as recently stated in Taxation Ruling TR 2003/9, also accepts this view.\footnote{ITAA36.}

There are a number of provisions that potentially tax a discretionary beneficiary on receipt of an asset revaluation reserve distribution, extending
from Division 6’s core provisions, to sections 26(b), 6-5, 99B, CGT event E4, CGT event E5, CGT event E6, CGT event E7, CGT event E8, CGT event H2 and ultimate beneficiary statements.

This article will focus upon whether an asset revaluation reserve distribution could be ordinary income under section 6-5 ITAA97 for the receiving beneficiary. Before analysing section 6-5, Division 6 and section 26(b)’s potential operation will be initially reviewed.

**Division 6’s core provisions**

Division 6 of the ITAA36 is the primary source of legislative law governing the taxation of trusts, though not necessarily the only one. There have been some dicta that Division 6 and Section 26(b) is an exclusive code for the assessability of trust distributions. Though this has been judicially discredited by the majority view of the High Court in *Federal Commissioner of Taxation v Belford*. Additionally, the Commissioner has affirmed that he does not regard Division 6 as an exclusive taxing provision.

The acknowledgment that over the last number of decades there have been further provisions influencing the taxation of trusts and beneficiaries

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180 ITAA36.
181 ITAA97.
182 ITAA36.
183 Section 104-70 ITAA97.
184 Section 104-75 ITAA97.
185 Section 104-80 ITAA97.
186 Section 104-85 ITAA97.
187 Section 104-90 ITAA97.
188 Section 104-155 ITAA97.
189 Section 102UI ITAA36.
190 The applications of the CGT provisions are consider in another article by the author.
191 ITAA36.
192 *Triknew Holdings Pty Ltd v Federal Commissioner of Taxation* 91 ATC 4272, per Hill J at 4283.
193 (1952) 88 CLR 589. That Division 6 was not an exclusive code was affirmed in *Union Fidelity Trustee Co v FCT* (1969) 119 CLR 177. It is submitted that the insertion of section 99B and 99C ITAA36 does not alter these decisions.
195 Such as the CGT events in Sub-Division 104-E of the ITAA97, the trust loss measures in schedule 2F of the ITAA36 and the foreign investment fund provisions in Part XI ITAA36.
inserted elsewhere in the Assessment Acts re-enforces the rebuttal of such a proposition.\textsuperscript{196}

Under the general framework of Part III of Division 6 the trustee of a trust will not be subject to tax on the income of the trust estate except as provided by the Act.\textsuperscript{197} While Division 6 looks at present entitlement of trust income, the determination of taxation liability centres on ‘net income’ of the trust estate. The unrealised gain represented by an asset revaluation reserve distribution will not be regarded as part of net income of the trust estate, as it is neither ordinary income derived nor statutory income.\textsuperscript{198}

It is submitted that this means, even if a beneficiary is presently entitled to income of the trust,\textsuperscript{199} the beneficiary only has to include in its assessable income its share of ‘net income’,\textsuperscript{200} which will not include the asset revaluation. What this also means is that the trustee is not liable for tax on the asset revaluation gain, as it does not fall part of net income to which no beneficiary of the trust estate is presently entitled to.\textsuperscript{201} Note while there is some conjecture whether a mere object is indeed a beneficiary, as such an entity may receive nothing, once a Trustee exercises its discretion the object clearly becomes a beneficiary.\textsuperscript{202}

**Section 26(b) ITAA36**

Another potential source of taxation liability for the receiving beneficiary is section 26(b),\textsuperscript{203} as the assessable income of a taxpayer includes any beneficial interest in income derived under an instrument of trust.\textsuperscript{204} However this section can be refuted for asset revaluation reserve distributions, as the unrealised gain is not ‘income’ according to ordinary concepts derived by

\textsuperscript{196} Section 96 ITAA36:
\textsuperscript{197} Refer to the prior discussion of this.
\textsuperscript{198} Calculated pursuant to trust law and accounting principles.
\textsuperscript{199} Section 95 ITAA36 defines this term.
\textsuperscript{200} Section 99 and 99A of ITAA36.
\textsuperscript{202} ITAA36.
\textsuperscript{203} The operation of this section has been considered in Union Fidelity Trustee Co of Australia Ltd v Federal Commissioner of Taxation (1969) 119 CLR 177 and Federal Commissioner of Taxation v Belford (1952) 88 CLR 581.
\textsuperscript{204} For a discussion of this section’s operation refer to: Magney, TW, and Holz, RG. (1981). Taxation of Differences Between Trust Law Income of a Trust Estate and the ‘Net Income’ of the Trust Estate – A Burden for Beneficiaries, Taxation in Australia, Vol 16, 2.
the trust. Therefore, it is submitted that this section has no application in relation to an asset revaluation reserve distribution as it is not income derived by the trust estate.\textsuperscript{205}

**Section 6-5 ITAA97**
A potential source of tax liability for the receiving beneficiary is section 6-5(1),\textsuperscript{206} as a taxpayer’s assessable income includes income according to ordinary concepts.

It is submitted that the bringing to account of the unrealised gain is not income according to ordinary concepts for the trust estate itself. However, how is an asset revaluation reserve distribution to be regarded in the hands of the beneficiary?\textsuperscript{207} If the conduit theory did apply to the trustee’s determination to pay an amount from retained profits, after a transfer from an asset revaluation reserve, it would be difficult to regard the cash receipt by the beneficiary as income according to ordinary concepts. This is because it was concluded that bringing to account the unrealised gain for an appreciating asset was not income of the trust estate.

However, it was submitted that it is a questionable whether the conduit theory has any application to asset revaluation reserve distributions or even to discretionary trusts generally. Accordingly, the categorisation of this cash receipt by the beneficiary is problematic.

Adopting an economist’s definition of income, an asset revaluation reserve distribution to the beneficiary is a gain to the beneficiary and therefore income. The potential of assessability for the beneficiary as ordinary income increases if there is regularity of payments of a similar nature,\textsuperscript{208} as regularity of payment points to a receipt having an income character.

However, against the conclusion that the receipt of an asset revaluation reserve distribution is income for the receiving beneficiary, are the following comments from Charles’ case:

“At first sight it may seem that a person who invests in units under a trust deed...does so with a view to obtaining the half-yearly distributions for which

\textsuperscript{205} ITAA97.
\textsuperscript{206} Federal Coke Co Pty Ltd v Federal Commissioner of Taxation 77 ATC 4255.
\textsuperscript{208} Charles, supra note 135, per Dixon CJ, Kitto and Taylor JJ at 608.
the deed provides; just as he might have bought shares in an investment company with a view to deriving half-yearly dividends from them; and that the potential distributions received should be regarded as income in the one case just as they would be in the other.”

While the recurrent nature of transactions suggests that the profit derived from them will be income,\(^{210}\) *Myer Emporium*\(^{211}\) makes it clear that the fact that a transaction is a one-off will not preclude the profit being characterised as income according to ordinary concepts. Also, the fact that a payment is received as a lump sum or as a once for all payment, will not necessarily result in the payment being received on capital account.\(^ {212}\) Accordingly, while not determinative, what needs to be considered is whether there have been regular asset revaluation reserve distributions to the beneficiary.

Another consideration is whether the distribution is in lieu of salary, because if the distribution can be linked to services performed by the beneficiary and the lack of other remuneration, inferences of an income character will arise for the payment.\(^ {213}\)

In the decision of *Case V152*\(^ {214}\) the taxpayer was a private company that was a beneficiary of a discretionary trust. The discretionary trust was in turn a unit holder in a family unit trust, which had been assigned a proportion of a solicitor’s interest in the income of his practice. The corporate taxpayer became presently entitled to $87,271 as a beneficiary of the discretionary trust. During that year the corporate taxpayer did not carry on business, and derived its income solely as a beneficiary of the discretionary trust.

The Commissioner assessed the corporate taxpayer to undistributed profits tax on the basis that the beneficial entitlement of the corporate taxpayer to the $87,271 under the discretionary trust was ‘income from property’. This meant that the corporate taxpayer had not made sufficient distributions for the year. The corporate taxpayer objected, contending that its entitlement under the discretionary trust was neither income nor income derived from property. If the corporate taxpayer was correct it

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209 Federal Commissioner of Taxation v Dixon (1952) 86 CLR 540.

210 Myer Emporium, supra note 95, at 210.

211 Federal Commissioner of Taxation v Cooling (1990) 90 ATC 4472, per Hill J at 4480.

212 Pacall, T. supra note 208, at 6.

213 88 ATC 962.

214 Case V152 88 ATC 962, at 968: quoting as authority Gartside v IRC [1968] 1 All ER 121, at 127.
would have made sufficient distributions during the year, and therefore it would not be liable for the undistributed profits tax.

In reaching his decision, Purvis J held that there was no basis at law for the corporate taxpayer’s submission that the amount received by a discretionary beneficiary pursuant to the exercise of a trustee’s discretion was not income, or the beneficiary’s income.\textsuperscript{215} It is submitted, that this statement by Purvis J implies that the entitlement of a discretionary beneficiary can be ordinary income.

**Taxation Ruling IT 2512**

It is submitted that an asset revaluation reserve distribution to a beneficiary could be assessable pursuant to section 6-5 as ordinary income. In this regard, it is worth highlighting the Commissioner’s comments in *Taxation Ruling No IT 2512: Income Tax: Financing Unit Trusts*.\textsuperscript{216} In this ruling the Commissioner concludes that potentially tax free distributions\textsuperscript{217} to finance unit holders were assessable to the unit holders as ordinary income.\textsuperscript{218}

**FINANCING ARRANGEMENTS**

This ruling regarded financing arrangements where banks and insurance companies would subscribe for units in property unit trusts. Pursuant to the trust instrument the unit holders would be guaranteed an agreed rate of return, with the rate being calculated in much the same fashion as interest on a loan. Additionally the financiers, being banks and insurance companies, undertook few of the risks of ownership. This was because the developer would be liable to top up any shortfall if the agreed rate of return was not met. Also the financier was indemnified against any liability to third parties arising out of the trust’s activities.

Furthermore, the funds invested via the units would normally only be committed for a fixed term, and at the end of this fixed term the units would be redeemed for a predetermined amount. Distributions to be received by the unit holders would contain tax-preferred amounts, due to special building concessions. The participants in the financing arrangement

\textsuperscript{215} Released 20 December 1988.
\textsuperscript{216} The distributions referred to were distributions of tax-preferred amounts due to special tax concessions available on income-producing buildings.
\textsuperscript{217} Commissioner of Taxation. supra note 195, at paragraph 19.
\textsuperscript{218} *Myer Emporium*, supra note 95.
thought the receipt of these tax-preferred amounts were tax-free for the unit holders.

**INTENTION OF BENEFICIARIES**

The Commissioner considered that the participation by banks in the financing unit trust formed part of the bank’s commercial activities, and consequently any profits from these commercial arrangements should be taxed.

The decision of *Federal Commissioner of Taxation v The Myer Emporium Ltd* was relied upon by the Commissioner in concluding the receipt of the tax-preferred amounts would be assessable. In that case, the court held that a gain made by the taxpayer from a transaction entered into with the intention or purpose of making a profit or gain could well constitute income under subsection 25(1) or section 25A. This was even though it was not a transaction in the ordinary course of carrying on the business of the taxpayer.

The Commissioner distinguished *Charles’ case* in relation to the proposition that the distributions to the unit holders were capital in nature, because that was the character in the hands of the trustee. The Commissioner based his differentiation of *Charles’ case* on three premises.

Firstly, the amounts received by the unit holders covered by the ruling were contractual and predetermined. Secondly, the units in *Charles’ case* conferred a proprietary interest in all of the trust property, whereas the financier’s interest in the trust was more limited. In that, distributions under the financing unit trust instrument were effectively just a repayment of agreed amounts, representing the repayment of subscription money plus a predetermined rate of return on investment. Thirdly, the Commissioner observed that the transaction in *Charles’ case* was of a very different kind, and in that decision there was no evidence of a profit-making arrangement.

Consequently, the intention of the beneficiary may be relevant in determining the nature of the receipt of the asset revaluation reserve distribution in the hands of the beneficiary. Also relevant could be the extent of the proprietary interest of the beneficiary.

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219 Section 25(1) ITAA36 being the predecessor to section 6-5 ITAA97.
220 Commissioner of Taxation. supra note 195, at 22.
221 *Charles*, supra note 135.
222 Commissioner of Taxation. supra note 195.
223 Such as private companies, partnerships or other trusts.
Family circumstances

It is submitted that the profit-making intention could exist even in the circumstances of a discretionary trust with family members or associated entities being potential beneficiaries. This is especially given the modern popularity to utilise discretionary trust to conduct businesses.

The Commissioner came to the opposite conclusion in the Ruling stating the following in relation to normal family trusts:

“It should also be emphasised that this ruling does not extend to situations where, in the case of an ordinary trust, a distribution is made in excess of the taxable income for tax purposes. The excess, which may be referable to allowable tax deductions, should not be assessed on the basis of this ruling. An ordinary trust would in this context include a family trust whether the trustee made investments or carried on a business, or a trust created by a will or unit trust where the beneficiaries or unit holders are entitled to both corpus and income of the trust, i.e. they are effectively exposed to all the risks of ownership and participate in the profits of the trust. The interests in such a trust are not ones where it could normally be concluded that the beneficiary or unit holder is obtaining a return on commercial activities carried on by the beneficiary or unit holder.”

(Emphasis added)

This conclusion by the Commissioner in the ruling is somewhat at odds with case law and later statements of the Commissioner. In particular, in relation to discretionary beneficiaries it has been held that they do not have any proprietary interest in the trust property. Indeed, all discretionary beneficiaries have is a right to due administration of the trust, which a court of equity would protect.

Accordingly, discretionary beneficiaries are not effectively ‘exposed to all the risks of ownership’, as they do not have an interest in the trust property. The Commissioner in determining that companies cannot meet

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224 Commissioner of Taxation. supra note 195, at paragraph 31.
225 Gartside, supra note 19 and Buckle, supra note 139.
226 Gartside, supra note 19.
227 Section 155-12 ITAA97.
the continuity of ownership test\(^{228}\) if a trustee of a discretionary trust holds 50 per cent or more of its shares has relied upon this principle.\(^{229}\)

Consequently, it is submitted that a beneficiary of discretionary trust could be assessed on the receipt of an asset revaluation reserve distribution as ordinary income. This is because the beneficiary does not have the risk of ownership in respect of an appreciating asset held by the trustee of discretionary trust, and the beneficiary could have a profit making intention.

**Conclusion**

The Commissioner has confessed that ascertaining income according to ordinary concepts can be difficult.\(^{230}\) This is particularly the case when considering whether the receipt of an asset revaluation reserve distribution by a beneficiary of a discretionary trust is ordinary income for the receiving beneficiary. This determination involves the initial analysis of whether the relevant amount is income, either ordinary or statutory, for the trust estate. Then it is necessary to consider the treatment of the receipt of the asset revaluation reserve distribution in the hands of the receiving beneficiary.

As discussed it is unlikely that an asset revaluation would be included in the net income of a discretionary trust. This is because the revaluation of the appreciating asset would not be ordinary income of the trust, as the ‘income has not yet come in’.\(^{231}\) This conclusion does not appear to be affected by the recent judicial acceptance for the inclusion of unrealised gains into profit when it was locked-in. This is because that decision appears to be limited to the statutory provision under consideration.\(^{232}\)

Furthermore, no CGT provisions would apply to include an amount in the net income of the trust estate. In particular, if CGT events E5 or D1 do apply to asset revaluation reserve distributions, they were both likely to result in a nil capital gain for the trustee, as the capital proceeds would equal the relevant cost base.

\(^{228}\) Commissioner of Taxation. (2000). *Taxation Determination TD 2000/27: Income tax: can a company satisfy the requirements of section 80A or section 80E of the Income Tax Assessment Act 1936 if 50% or more of its shares are held by the trustee(s) of a discretionary trust(s)?:* Australian Taxation Office, Canberra.

\(^{229}\) Aust. supra note 60, at paragraph 5.5.

\(^{230}\) Waincymer, J. supra note 64, at 96.

\(^{231}\) *Sun Alliance* supra note 72.

\(^{232}\) *Baker* supra note 132, and *Charles* supra note 135.
Consequently, it appears there are no adverse taxation consequences in relation to the revaluation of an appreciating asset by a trustee of a discretionary trust. However, once the trustee determines to make an asset revaluation reserve distribution to a beneficiary; it becomes necessary to determine the nature of this receipt in the hands of the beneficiary. To do this, it is first necessary to consider the application of the conduit theory to asset revaluation reserve distributions by discretionary trusts. In particular, whether the cash amount received by a beneficiary because of an asset revaluation reserve distribution could be continually be referred to the source that created it.

The application of the conduit theory to asset revaluation reserve distributions by discretionary trusts is problematic on two grounds. Firstly, the trust estate has not actually received an amount to distribute. Indeed, the trustee may have to borrow funds to enable such a distribution to occur. Second, there is doubt as to the general application of the conduit theory to discretionary trusts. This is due to the fact that the focus of judicial proceedings on the area has been on ascertaining whether the conduit theory applies when beneficiaries have a vested interest in trust property. This interest is not possessed by a discretionary or default beneficiary of a discretionary trust. It is submitted that this lack of interest and the requirement for the intervention of the exercise of the trustee’s discretion is detrimental to the application of the conduit theory to a discretionary trust.

Because of the non-application of the conduit theory to asset revaluation reserve distributions by discretionary trusts and the general character of them, it is submitted that they could be assessed as ordinary income for the receiving beneficiary. In reaching this conclusion, the status and the intention of the beneficiary involved, as well as the regularity of similar payments would need to be considered. It is more likely that the distribution will be considered to be ordinary income when asset revaluation reserve distributions are made regularly, and the beneficiary involved has a profit making intention. Also, it should be considered whether the distribution is in lieu of salary for the beneficiary. As stated by Purvis J there is no

233 Gartside supra note 19.
234 Memec supra note 158.
235 In that it is a business entity or not.
236 Case V152, supra note 215, at 968.
basis in law for the submission that the amount received by a discretionary beneficiary pursuant to the exercise of a trustee’s discretion is not income or the beneficiary’s income.\textsuperscript{237}

Accordingly, it is submitted that there is indeed potential for section 6-5 to apply to assess a beneficiary of a discretionary trust on an asset revaluation reserve distribution as ordinary income. This is regardless of the application of the CGT provisions, or even Division 7A as amended.\textsuperscript{238} This conclusion has already been reached by the Commissioner in relation to financing unit trusts.\textsuperscript{239}

It is further submitted that the Commissioner should pursue such possibilities by instigating test cases to resolve this issue. It may be the situation that the Tax Office’s solution to asset revaluation reserve distributions is already within the pages of the existing legislation, and has been there all along.

\begin{footnotes}
\footnote{237 Schedule 8 of the \textit{Tax Laws Amendment (2004 Measures No 1) Act 2004} (Cth).}
\footnote{238 Commissioner of Taxation. supra note 195.}
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