TAXATION OF TRUSTS*

INTRODUCTION.

The annual yield from income taxes has increased dramatically in the last 20 years, from just under £64 million in the year ended 31 March 1947 to £332 million in the year ended 31 March 1967. Due partly to the increase in productivity, but more significantly to the bite of inflation, those in the middle income group in the community have found themselves paying more and more taxes. Over the same period and partly for similar reasons and partly because of the increase in the rates of estate duty in the late nineteen fifties, the burden of meeting estate duties came to be of far greater practical significance than ever before.

As the impact of taxes and duties has been increasingly felt by taxpayers they and their advisers have devised and utilised various methods of tax and duty saving. For a number of reasons it has been increasingly recognised that the trust is a particularly effective planning technique and it has been widely used especially in farming communities. Recently the Director-General of Agriculture expressed the opinion that 1700 farms in New Zealand were farmed by trusts! All told the number of trustees' returns filed annually under section 155 is approaching 7000. Again, a check made in one large and wealthy province where the farming trust is king, revealed that only ten per cent of farmers were paying tax at maximum rates.[2]

The selection by the legislature of the individual, rather than the family, as the basic taxable unit and the existence of a graduated income tax provide an incentive for income splitting—diverting the income from one taxpaying entity to a number of entities. Take the simple example of a taxpayer with a wife and four young children, none of whom derives any income, who receives $4,000 income annually from investments, which income is taxed at maximum rates. The tax on that income will be $2,700. If he sells the assets to a trust under which his wife and children share equally in the income, the tax on that income will be only $220. He will lose the exemption for his wife and may eventually lose the child exemption. Even so, the total tax saving through the income splitting device will be at least $1,800 per year and, of course, the whole of the income, including this $1,800 bonus, will

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1. The Dominion, 7 June 1967.

2. Another factor is the deductibility of certain capital expenses in farm development.

remain within the family.

This example assumes the existence of a trust. The figures given would be the same if, without the introduction of a trust, the assets and thus the income were divided amongst the family in this way. But there are major disadvantages in allowing infants to hold land, shares or other assets in their own names. Moreover, taxpayers show an understandable reluctance to part with control over assets and income and the trust is a useful vehicle for preserving substantial control and at the same time achieving significant tax and duty savings. Furthermore, the trustees are a separate tax entity which gives rise to the possibility of further tax benefits.

PRINCIPLES OF TAXING TRUSTS.

The concepts of trusts and partnerships were evolved centuries ago —long before the rise of income tax which is basically a twentieth century development. It was accordingly necessary for the framers of our tax system to make special provision for their treatment. They were faced with two conflicting principles. The first is the principle that a trust is a separate legal entity. The second is the notion of a trust as a vehicle for passing capital and income on to beneficiaries. The compromise we have reached is to tax the income which passes to a beneficiary as his income and the unallocated remainder of the income as income of the trustees. In other words the first principle of the trust as a separate entity is recognised except that a deduction is made of all income which passes to beneficiaries. By way of contrast a company is also recognised as a separate entity for tax purposes, but deduction of dividends is not allowed. The second principle—of a trust as a conduit pipe for passing income and capital on to beneficiaries—is also recognised, but only up to a point. If it were fully adopted it would result in the tax on income being deferred for so long as the trustees did not allocate that income to particular beneficiaries and in the complete avoidance of tax on income capitalised by trustees.

Framers of tax systems have been faced with a further conflict in principle—the need to reconcile recognition of the independent legal existence of trusts with the inequitable results to taxpayers generally of accepting the tax avoidance objects and effects. To what extent in the interests of equity should the tax system decline to recognise trusts as shifting income for tax purposes where the dominant taxpayer retains control over the situation, for example, by means of powers of revocation of the trust or of encroachment on income or through the benefits he gains through retention in the family unit of income allocated to its members and taxed at the lower rates applicable to their total incomes? To understand the manner in which New Zealand has faced and resolved these problems requires consideration of the three basic provisions, sections 155, 105 and 84A, supplemented by a review of the general anti-avoidance provision, section 108.

SCHEME OF SECTION 155.[3]

The approach of the section is to require a trustee to make a return of all income derived by him as trustee[4] and all such income is assessable to the trustee. But where section 155(a) applies and thus the income is "derived by a beneficiary entitled in possession to the receipt thereof under the trust during the same income year" the trustee is taxed only as agent for the beneficiary and so at the rate applicable to that beneficiary. Under section 155(b) the remainder of the income of the trustee, that is to say income to which beneficiaries are not entitled in possession under para.(a), is assessed to the trustee "as if he were beneficially entitled' but ignoring any income derived by him in any other capacity. Unlike an individual taxpayer a trustee is not entitled to an exemption for social security income tax and his exemption for ordinary income tax is limited to $400, but the same rate structure apples to both.[5]

In *C. of T.* v. *Luttrell*[6] the Court of Appeal held that under para.(b) a trustee is taxed in his representative character representing the beneficiary and in respect of what is ultimately the beneficiary's income and, therefore, that once income has been assessed under para.(b) it cannot be assessed again under para.(a). This amounted to a rejection of the view that trustees and beneficiary are separate and independent taxpayers. Although the correctness of the decision is

3. Paras. (a) and (b), which are the substantive provisions, provide:
   (a) If and so far as the income of the trustee is also income derived by a beneficiary entitled in possession to the receipt thereof under the trust during the same income year, the trustee shall in respect thereof be deemed to be the agent of that beneficiary, and shall be assessable and liable for income tax thereon accordingly, and all the provisions of this Act as to agents shall, so far as applicable, apply accordingly. . . .
   (b) If and so far as the income of the trustee is not also income derived by any beneficiary as aforesaid, the trustee shall be assessable and liable for income tax on that income in the same manner as if he were beneficially entitled thereto, save that the rate of tax shall be calculated by reference to that income alone, and that the trustee shall be entitled to a deduction by way of special exemption of two hundred pounds for the purpose of assessing ordinary income tax, and shall not be entitled to any further deduction by way of special exemption for the purpose of assessing either ordinary income tax or social security income tax:
   Provided that in any case where a trustee is required or is empowered at his discretion to pay or apply income derived by him to or for the benefit of specified beneficiaries or to or for the benefit of some one or more of a number of specified beneficiaries or of a specified class of beneficiaries, a beneficiary in whose favour the trustee so pays or applies income shall be deemed to be entitled in possession to the receipt of the amount paid to him or applied for his benefit during the income year by the trustee under the trust:
   Provided also that where the income of the trustee is also income derived by any beneficiary who is an infant but whose interest in that income is vested, the beneficiary shall for the purposes of this section be deemed to be entitled in possession to the receipt of that income under the trust during the same income year:
4. Section 155(c).
5. Section 155(b).
6. [1949] N.Z.L.R. 823.

arguable, it would be an arid exercise to analyse the reasons for judgment because it has never been challenged by the Commissioner and the re-enactment of the Land and Income Tax Act in 1954 adopted the same scheme and the same language. But one consequence of the decision calls for some comment. Its effect is that retentions of income taxed to the trustee under para.(b) in one year and distributed to a beneficiary at the beginning of the following year bear no more tax. Unless section 108 applies, it follows that a taxpayer can in effect provide himself with an additional tax entity by siphoning off through a trust what would otherwise be taxed in his hands and then, as an income beneficiary under the trust, receive retentions of income which have already borne tax at a much reduced rate in the hands of the trustees under para.(b).

The advantages of trusts as income splitting devices are increased where multiple trusts are constituted. The reason for this is the separate trustee's exemption for each trust and the application of the progressive rate structure to trustee's income under each trust. Para.(f) is designed to cancel the tax advantages of spreading income among several separate trusts all of which are for the benefit of the same beneficiaries. If there were no such provision a taxpayer who wanted to have $4,000 per year from investments accumulated during the minority of his son could set up ten trusts each of which would have an income of $400 per year and, because of the trustee's exemption of that amount for each trust, there would be no ordinary income tax payable. Para.(f) accordingly provides for aggregation of income from separate trusts in the circumstances specified. It is, however, of limited application. Before it strikes, the whole of the income of the trusts must pass immediately or ultimately to the same beneficiaries or group or class of beneficiaries. Thus, a father who decides to settle property for the benefit of his four children has at least three choices open to him, only one of which will result in the aggregation of income under para.(f). If he settles four trusts each for the benefit of all four children clearly para.(f) applies. But it does not do so where he sets up a separate trust for the benefit of each child (and he can do this with one trust deed) or omits a different child from the class of beneficiaries under each separate trust. The fact that beneficiaries under the separate trusts are all children of the one settlor does not constitute them a group or class for the purposes of the paragraph. The beneficiaries either individually or as a class must be common to the separate trusts before the paragraph applies.[7]

Para.(a) and the two provisos to para.(b) together determine whether income is beneficiary's income. To come within para.(a) a beneficiary must be entitled in possession to the receipt of income under the trust during the same income year in which the income is derived by the trustee. It is not sufficient that the beneficiary is contingently entitled, for example if he is aged 22 and entitlement depends on his reaching the age of 30, or that the income is defeasibly vested in him.

7. See Cohen, *Income Taxation of InterVivos Trusts* (1964) 55-57.

To satisfy para.(a) the income must be absolutely vested in the beneficiary and he must be entitled to have the income paid to him during the year in question. Consequently, in *Doody* v. *C. of T.*[8] income absolutely vested in an infant beneficiary was outside para.(a) and assessable as trustee's income under para.(b) because, owing to his infancy, the beneficiary could not have successfully demanded receipt of the income or sued for it. As a result of this decision the second proviso to para.(b) was added. It deems income derived by an infant beneficiary whose interest in that income is vested to come within the operative words of para.(a). Shortly afterwards the Court of Appeal held in *C. of T.* v. *Johnston and Maeder*[9] that "vested" in the proviso meant indefeasibly vested so that income vested in A but liable to divesting should he die under the age of 21 was outside the proviso and assessable as trustee's income under para.(b).

If it were not for the first proviso to para.(b) trusts would lose most of their attraction as a planning technique. It is this provision that makes discretionary trusts so beneficial from a taxation point of view. It deems the income to which it refers to come within the magic language of para.(a) and so be assessable as beneficiary's income. Three requirements must be met before the proviso is satisfied. First, the trustee must be required or empowered to pay or apply the income to the beneficiary. Secondly, he must in fact pay or apply the income. Problems have sometimes arisen where moneys have been retained by the trustees but allocated in the books to a particular infant beneficiary. In *Montgomerie* v. *C.I.R.*[10] the former Chief Justice held, as had the Board of Review,[11] that on the facts of the case income so allocated was not applied to or for the benefit of the beneficiaries and was accordingly assessable as trustees' income, not beneficiaries' income. But in *Re Vestey's Settlement, Lloyds Bank* v. *O'Meara*[12] the Court of Appeal held that a resolution by trustees appropriating income to a beneficiary was an application for his benefit. There is no difficulty in reconciling the decisions. It is important to recognise that the facts in *Montgomerie* were most unusual. The trust deed provided for the income, or such part as might be necessary, to be applied for the maintenance, education, advancement in life, or benefit of the infant beneficiaries and for the balance to be accumulated for the beneficiaries either as a lump sum or in equal or unequal shares. But it then went on to empower the trustee to vary or alter any share of income or share of accumulations as between the beneficiaries and to allot to any person who might subsequently be born and qualify as a beneficiary the whole or part of the accumulations previously allotted to any other beneficiary. Any income or accumulation allotted to a beneficiary who died before 30 June 1983 automatically divested on his death. No attempt had been made to segregate the income in question in the

8. [1941] N.Z.L.R. 452.
9. [1946] N.Z.L.R. 446.
10. [1965] N.Z.L.R. 951.
11. 2 N.Z.T.B.R. Case 19.
12. [1951] Ch. 209.

interests of the infant beneficiaries. It had been retained in the trust and used for trust purposes. In short, the income in question remained subject to the original trusts and thus subject to the revocation and re-allottment provisions. On the special facts there can be no question as to the correctness of the decision of the Board of Review and the Court.

Vestey raised a different issue—whether a resolution of trustees to allocate income to a beneficiary, there being no power of revocation or re-allotment in the trust instrument, constituted an application of the income for the benefit of the beneficiary. On the facts the decision was clearly correct. But some of the dicta in *Vestey* must be read in the light of the judgments in *In re Pilkington's Will Trusts, Pilkington* v. *I.R.C.*[13] In the former case Jenkins L. J. said:[14] "When the trustees decide to apply some part of the income in hand for the benefit of an infant . . . then it seems to me that the infant becomes absolutely entitled to the amount in question by a new title consisting of the exercise of the trustees' discretion in the infant's favour . . . ". But in *Pilkington* the House of Lords held that a re-settlement could come within the power conferred by section 32 of the Trustee Act, 1925 to "pay or apply any capital money subject to a trust, for the advancement or benefit . . . of any person entitled to the capital of the trust property or of any share thereof whether absolutely or contingently . . . ". The emphasis throughout Viscount Radcliffe's judgment, with which Lords Hodson, Jenkins and Devlin agreed, was on action by the trustees "to free the money from one trust and to subject it to another"[15] or for it to "pass out of the old settlement into the new trusts".[16] Money is freed from trusts under which it is held by the trustees when (and only when) the trustees acting within their powers irrevocably dispose of it. *Pilkington* involved a settlement of capital but there is no logical distinction in this respect between settlements of capital and settlements of income. It is accordingly submitted that the test of whether there has been an application of income under the proviso is, have the trustees irrevocably allocated the income in question to or for the benefit of the beneficiary.

It would not be difficult to avoid the problems that arose in *Montgomerie* by providing for the allocations of income to beneficiaries to be irrevocable or by not providing that they should be revocable. It is a desirable practice, too, expressly to provide in trust deeds for appropriation of income to be sufficiently evidenced by crediting in the account of beneficiaries or by signed record in the minute book of the trustees. In the case of existing trusts which contain no such provisions,

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13. [1964] A.C. 612.
14. Supra note 12 at p.224. Cf. Evershed M.R. at 220 and 221.
15. Supra note 13 at p.638.
16. Ibid p.639. Again, at 633, he treated the payment or application of trust moneys as constituting the "release" of those moneys from the trusts of the settlement; cf. 3 N.Z.T.B.R. Case 31, now under appeal. It is submitted that the emphasis by the Board on the manner in which the sums allocated were subsequently dealt with confuses application with investment.

proper minutes recording the decisions of the trustees should be kept as well as having the position reflected in the accounts of the trust.

The third and final requirement of the first proviso to para.(b) is that the payment or application of income must take place "during the income year" in question. It is not sufficient that an allocation made after the year has ended is expressed to relate to the income of that year. The income must be allocated before the end of the income year. The practical difficulty is that in the ordinary course the exact income of the trust is not known until after the end of the year and in some cases, for example some farming trusts, there may still be considerable uncertainty at balance date as to the results of the year's trading. If there is too much doubt to permit of appropriation of specified sums during the year, an allocation to the beneficiaries of fractional shares in the income should satisfy the proviso. What is vital is the creation during the income year of an obligation on the trustees constituting a binding disposition for the benefit of the beneficiary in respect of an amount of that year's income. The amount need not be expressed in dollars and cents. Indeed, in *Vestey* the allocation made by resolution of the trustees was of a fractional share of the ascertained income. It is submitted that there is no distinction in this respect between an amount which is both quantifiable and physically identifiable when the resolution is passed and one which will become quantifiable when the income year ends. In each case the passing of the resolution is the act which both binds the trustees and benefits the beneficiary. In short, the ascertainment of the exact amount involved is a matter of arithmetical calculation only and this is so whether the quantification can be made when the resolution is passed or whether it has to be deferred until the end of the income year.[17]

As a safeguard against the risk of having all income under a discretionary trust treated as trustee's income due to the inadvertent failure of the trustee to make an allocation to the beneficiaries during the income year it is desirable to provide in the trust deed that any income not expressly allocated to beneficiaries or accumulated or retained by the trustees shall vest at the end of the year in some or all the beneficiaries in specified shares. In this respect it is submitted that the device employed by some conveyancers of providing in the trust deed that an allocation of income by trustees within a specified period after balance date shall be deemed to be an allocation made during the income year under the trust does not satisfy the proviso and that any income allocated in reliance on it is properly assessable as trustees' income.

Both provisos to section 155(b) provide for the treatment of

17. If this view were wrong, it would be impossible in the case of most trusts ever to satisfy the proviso. This is because the income of most trusts does not accrue from day to day and there is no certainty during the year that income will be derived by the trustee in and for that income year (cf. *Williams* v. *C.I.R.* [1965] N.Z.L.R. 395). It is only after the year has ended that it can be ascertained whether there has been any income for the year and, if so, the amount.

income that would otherwise be trustee's income as beneficiary's income. The requirements are alternative and never cumulative. The first proviso applies to trusts where the trustees have discretionary powers as to disposal of income and the test of whether income has been applied is whether it has been irrevocably allocated to or for the benefit of the beneficiary. The second proviso applies to non-discretionary trusts and the test is whether the income in question has been indefeasibly vested in the infant beneficiary.

It frequently happens that income allocated to an infant beneficiary but not expended on his maintenance and support is employed in the business carried on by the trustee or for other trust purposes. A trustee who invests the allocations in this way lays himself open to a subsequent claim by the beneficiary that he acted in breach of his duties as trustee. Any income simply allocated to an infant beneficiary under a discretionary trust must in my view be dealt with as provided by the Trustee Act 1956 and thus, subject to the powers of maintenance and advancement in sections 40 and 41, must be invested only in authorised trustee investments. Some trust deeds endeavour to overcome this problem by providing that income which is allocated to infant beneficiaries may be invested in any investments authorised by the trust deed itself. It is submitted that such a provision achieves nothing. The point is that once the income is allocated outright to the beneficiary it is no longer subject to the provisions of the original trust, so that any attempt in the trust deed to confer investment powers in respect of that income is in vain. There is, however, a workable solution to this problem. If, instead of making an outright disposition of income to the infant beneficiary, the trustees, exercising their powers under the trust deed or under section 40 of the Trustee Act 1956, settle that income upon trust for the beneficiary, they can provide in the new trust deed sufficiently wide powers of investment to enable them as trustees of the new trust to invest the amount allocated in the trust business. On the re-settlement the property settled automatically becomes subject to the powers of investment under the new settlement and it is of no relevance that the same individuals are trustees of both the old and the new trusts.[18]

In the case of non-discretionary trusts para.(a) itself requires that the beneficiary be entitled in possession to the receipt of the income during the same year in which it is the income of the trustee. Problems have arisen in two types of case. The first is on cesser of an interest on death or remarriage of the income beneficiary. The time when income under the trust is derived by the beneficiary will depend on the provisions of the trust instrument and the nature of the income in

18. *Pilkington*, supra note 13, per Viscount Radcliffe at 639. Questions may arise as to whether a resettlement is "for the benefit of" the beneficiary. The trustees' determination will ordinarily be conclusive as a bona fide and conscious exercise of a discretion reposed in them to apply income for the improvement of the material situation of the beneficiary (cf. *Re Paulings Settlement Trusts* [1964] Ch. 303 and *Re Clore's Settlement Trusts* [1966] 1 W.L.R. 195) but they cannot validly exercise such a power unless they know the effect in law of the resettlement, e.g. where it offends against the perpetuity rules (*Re Abraham's Will Trusts* [1967] 2 All E.R. 1175).

question, for example, whether it is investment or business income.[19] The second case is where the trustees have an accounting year different from the statutory income year ending 31 March. Para.(bb), which in effect provides that it is the accounting year of the trust which is material for the purpose of determining the beneficiary's title to income, was enacted to confirm the previous practice which was rejected by the Supreme Court in *Marshall* v. *C.I.R.*,[20] although as it happened the Court of Appeal[21] subsequently reversed the Supreme Court decision on that point.

Where a trustee derives income other than income which is assessable in the ordinary way and part of the income of the trust is also beneficiary's income, the question arises on what basis is that income to be assessed in the hands of the beneficiary. For example, the maximum rate of tax on dividends derived by individual taxpayers is 35 cents in the $ as against 67.5 cents in the $ in the case of other assessable income. Again, income of a trust may include non-assessable or exempt income. In principle, income of a trust retains its character in the hands of a beneficiary, the trust being regarded in this respect as the vehicle for passing income on to beneficiaries.[22] Para.(a) makes it clear that it is *the* income of the trustee which is derived by a beneficiary and that it does not lose its identity or character in the process of passage through the trust even though the beneficiary does not physically receive the dividend warrants, cheques for interest and so on. There is thus no difficulty where the whole of the income of the trust is of the one character. Problems of apportionment arise where the income of the trust consists of different types of income. There are no New Zealand decisions in point and, in practice the beneficiary is usually regarded as deriving from the trust the same proportion of say income from dividends as the dividend income of the trust bears to the total trust income. But where under the trust instrument moneys such as annuity payments may properly be paid to a particular beneficiary from say either dividends or other assessable income, it is submitted that the trustee may appropriate shares to meet the annuity and then pay the beneficiary out of the dividend income alone with the consequential tax benefit to the beneficiary.[23]

A final question arising under section 155 is whether the section constitutes an exhaustive code for determining the assessability of income from trusts. To put the practical issue, if income of a trust is trustee's income under para.(b) because it is not income to which the beneficiary was entitled in possession to the receipt in that year, could it be assessed direct to the beneficiary if it was income derived by him

19. *Public Trustee* v. *C.I.R.* [1957] N.Z.L.R. 535; *Marshall* v. *C.I.R.* [1960] N.Z.L.R. 972.
20. [1959] NZ.L.R. 609.
21. Supra note 19.
22. *Syme* v. *C. of T.* [1914] A.C. 1013 at 1020-1021; *Baker* v. *Archer-Shee* [1927] A.C. 844; *Gunn's Income Tax Law and Practice* (8th ed. 1966) Vol. 3 paras. 97/20 and 97/21.
23. *I.R.C.* v. *Crawshay* (1935) 19 T.C. 715. Questions may arise as to the propriety of such an appropriation *vis a vis* other beneficiaries.

in the year under other provisions of the Act. On the face of it para.(d) preserves the possibility of an assessment of a beneficiary in respect of income assessable to him under other provisions of the Act which is simultaneously derived by his trustees. In *Marshall's* case Turner J.[24] took this view and on appeal so did Gresson P.[25] and Hutchison J.[26] but Cleary J.[27] preferred to leave the matter open. It is difficult, however, to visualize many circumstances in which a beneficiary could be said to derive income where the income was trustee's income for that year under section 155(b),[28] although before the enactment of the second proviso to section 155(b) a case in point was the infant beneficiary whose interest in income was indefeasibly vested.

SECTION 84A.

With the child exemption giving an annual tax saving of £47 to the taxpayer on maximum rates, trusts under which income was accumulated for the ultimate benefit of his children had the additional advantage over arrangements under which the children had income in their own right, of not affecting the right to the exemption. Section 84A, which was enacted to close this gap, provides a complex set of rules to determine whether a child who is a beneficiary under a trust created by a taxpayer or his spouse is dependent on the taxpayer. *Cameron* v. *C.I.R.*[29] established that retentions or accumulations of the income of previous years are deemed to have been available for the support of the child in the income year even though taken into account under the same section in earlier years. It is important then to watch the accumulated income as well as the amounts paid or applied for the benefit of infant beneficiaries.

After section 84A was enacted it became fashionable to have a relative of the taxpayer lend his name to a trust deed as settlor and put up say $20 before disappearing from the picture, in the hope of retaining the child exemption for the taxpayer notwithstanding his contributions to the trust. This invited challenge from the Commissioner as it was clearly a device to circumvent section 84A and in the two cases[30] taken on this issue to the Supreme Court the device failed, the holding being that on the facts it was the taxpayer and not the nominal settlor under the trust deed who created a trust of the property producing the income in question. However, the section is of limited application. For it to operate there must be "income of the trust" created by the taxpayer and/or the spouse of the taxpayer. So long as the taxpayer does not dispose of income-producing assets the section does not apply as, for instance, where he transfers life insurance policies or where he simply guarantees a bank overdraft which finances the trustees into the

24. Supra note 20, at p. 615.
25. Supra note 19, at p. 984.
26. Ibid. 992-3.
27. Ibid. 990.
28. One possibility is where the beneficiary is insane and there is no-one able to give the trustee a receipt for income which is indefeasibly vested in him.
29. [1965] N.Z.L.R. 1017.
30. *Baldwin* v. *C.I.R.* [1965] N.Z.L.R. 1; *Tucker* v. *C.I.R.* [1965] N.Z.L.R. 1027.

purchase of income-producing assets. Again, it is difficult to see how the section could be applied where the trustees have received trust assets from various sources, only one of which was the taxpayer and the funds have been mixed, because of the impossibility in those circumstances of identifying a specified amount as being the income of the trust created by the taxpayer.

SECTION 105.

Short term trusts where the settlor retains control over the disposition of the corpus and revocable trusts have such beneficial tax consequences, and at the same time involve only limited loss of control over the property settled, that many countries have set limits to recognition of these trusts for tax purposes. Section 105 is in point. It deals with transfers and settlements of income for less than the specified period and was completely recast in 1967[31] in its application to transfers and settlements made after 8 November 1967.

The section now applies to a transfer or settlement of income to or for the benefit of any other person or for any specified purpose. Unlike its predecessor, it is not limited to cases where the transferee or beneficiary is a relative or a company controlled by the transferor or settlor or a relative. The second feature of the recast provision is that it applies whether or not the property producing the income is transferred but, where the property is transferred, it applies only if there is a provision for the property to revert to the transferor or settlor or a relative or to a family company, or if there is reserved to the transferor or settlor or a relative or family company a right to dispose or control or direct the disposition of the property. Finally, the section applies only to transfers and settlements for less than the prescribed period which is a period which cannot be less than seven years or until the beneficiary atains majority whichever is the greater.[32]

Section 105 is inelegantly expressed and assumes,[33] wrongly it is submitted, that a transferor may have a disposable right to income which is not derived from a property right owned by him. As recast it is much wider and more complex than its predecessor but there are still several gaps in its application to short-term trusts. It does not apply where the transferor transfers the right to income and at the same time transfers the corpus to a relative. This is because the section applies where the transfer or settlement provides for the property to "revert" and not, as in the example given, where there is an immediate disposition of the corpus. Again, it does not cover a transfer for less than the prescribed period of an interest or share in a life interest or a right to annual payments. Subsection (1) applies only where there is a transfer of the right to income as such and not, as in the example given, where the disposition is of part of the corpus. Subsection (2) does not apply in such a case because the disposal of the income is a consequence of the transfer which is not effected "by the terms of any settlement".

31. Finance Act (No. 2) 1967 s.3A.
32. Section 105(4).
33. Section 105(1)(b).

A final comment on section 105. It is submitted that the subsection applies to the typical trust under which the trustees have a discretion as to which members of the designated class are to take the corpus and also have a power of advancement from capital, if the settlor or a relative is sole trustee or if the settlor and/or relatives of the settlor are the trustees. Clearly the power to accelerate vesting of the corpus may prevent the provisions for disposition of income from operating for the prescribed period and so come within paragraph (a). It is submitted too that the language of paragraph (b) is prima facie wide enough to cover the right to dispose of the corpus to members of the nominated class where the disponer is exercising a special power of appointment and not acting in a fiduciary capacity, and that this construction is consistent with the broad purpose of the subsection to tax the settlor on the income from short term trusts where he retains the corpus or, either directly or through his family, will recover it or be able to control its disposition.[34]

ALIENATION OF INCOME.

It is implicit in section 105 that the right to income may be effectively disposed of so that the liability for tax on that income is shifted off the shoulders of the person who retains the right to the corpus or source. There is then a vital distinction for tax purposes between an application of income under an obligation to dispose of income in a particular way after it has been derived as income, and an alienation of income where the taxpayer effectively disposes of his right to the income in such a way that the income is not derived by him and so not taxed to him. With the more sophisticated approach to family property planning that has been evident in recent years there has been much activity in this area. The two methods which have been adopted by advisers to dispose of this right to income are assignments and declarations of trust. The law of assignments is outside the scope of this paper and the alienation of income through the use of trusts is a subject which is too vast to be dealt with comprehensively here. Clearly there are certain points which must be watched when considering settlements of income.

(1) Existing income cannot be effectively disposed of so as to shift the incidence of tax. Once the income is derived liability arises and no one can displace an existing tax liability. So if a deed is executed declaring trusts in respect of profits of a business say from 1 April 1967, it cannot apply for tax purposes to any profits derived between 1 April 1967 and the date of the deed.

(2) In view of the distinction already noticed between an alienation and an application of income it is important to consider the exact terms of the settlement in order to determine whether the income is

34. The contrary view that subs.(2) does not extend to rights of disposal limited as to objects and exercisable only so long as the disponer is trustee of the settlement, derives some support from the interpretation given to the somewhat similar words in the English duties legislation, "competent to dispose" which are considered not to cover a special power of appointment. *Green's Death Duties* (6th ed. 1967) 68; *Dymond's Death Duties* (14th ed. 1965) 94.

derived and then passed on to B or whether it is derived by B without passing through A's hands.

(3) A settlement of future property made without consideration is ineffective in equity to shift the income for tax purposes. In *Williams* v. *C.I.R.*[35] the Court of Appeal held that a deed made without consideration affecting the first $500 out of the net income from a certain trust to accrue to the appellant in each year for a limited period failed, both as an equitable assignment and as a declaration of trust, because the subject matter was an expectancy. There is a further point arising from *Williams* which may be mentioned. It was assumed in that case that had the deed disposed of the whole or a fractional share of the income it would have been effective as dealing with an existing chose in action, namely the life interest itself. There is an argument, which is supported by the decision in *Norman* v. *F.C.T.*,[36] that the right to a life interest for a future period is an expectancy and not an existing chose in action. This is for the reason that the death of the life tenant terminates the interest and accordingly there is no certainty at the time the settlement is made that what is disposed of will in fact exist during that period.

(4) Difficulty arises where the settlor retains some measure of control of the situation. If the decision in *Arcus* v. *C.I.R.*[37] rests on a secure basis or if the general assumption that salary and wages to be derived in the future can never be alienated so that they are not taxable as income of the salary or wage-earner, even where consideration is given for disposition of rights to future income under a long-term contract of service, is justified, it means that there are circumstances where a valid and binding trust of income will not be recognised as shifting that income for tax purposes. In the present state of the authorities it is difficult to reach conclusions on this issue with any assurance and it would unduly lengthen this paper to discuss the cases and principles involved. But one point is clear. Declarations of trust will be less susceptible of attack where either the corpus itself is settled under irrevocable trusts or the taxpayer enters into covenants which preclude him from preventing the earning of income during the term of the settlement.

Finally, there are techniques in the use of trusts which may achieve the same results as an alienation of income without raising some of the difficulties involved in alienations of income. Two such possibilities which have been employed in other countries but not yet to any extent in New Zealand are the provision of a power to require payment of income to a beneficiary on timely demand being made[39], and the waiver for a limited period, e.g. a year, of the right to income under a trust.[40]

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35. Supra note 17.
36. (1963) 109 C.L.R. 9.
37. [1963] N.Z.L.R. 324.
38. *Spratt* v. *C.I.R.* [1964] N.Z.L.R. 272 at p. 277; *Johnstone* v. *C.I.R.* [1966] N.Z.L.R. 833 at 838.
39. Cf. *Re Marshall (deceased), Public Trustee* v. *C.I.R.* [1964] N.Z.L.R. 905.
40. *Herman* v. *M.N.R.* 61 D.T.C. 700, cited in Cohen, supra note 7, at p. 21.

SECTION 108.

The difficulty with all general anti-avoidance provisions such as section 108 is how and where to draw the line between permitted and void transactions. There must be few lawyers in this country who have not pondered over the recent landmark Court of Appeal decision in *Elmiger Bros.* v. *C.I.R.*[41] and its possible extension to other types of business and family arrangements. Without attempting an analysis of the section and case law it is appropriate to end this paper with some comments as to the use of trusts in the light of section 108.

(1) The section is not designed to prevent ordinary commercial, family or charitable dispositions. But transactions should have a solid base of business, family or charitable reality and, if explicable on that test, without necessarily also being branded as a tax avoidance measure, they should survive attack. For example, farming trusts are often established as part of an estate duty saving plan or to better secure the loyalty of family members to the farming enterprise. In short, so long as tax saving is an incidental consequence of such a transaction rather than being an immediate purpose or effect section 108 does not apply.

(2) All trusts and other intra-family transactions should be subjected to scrutiny from this viewpoint. Section 108 is part of the law to be applied in all cases. For example, if a transaction satisfies section 105 and in other respects is a valid settlement, it may still fail for tax purposes. In the recent Australian case of *Bolton* v. *F.C.T.*[42] Windeyer J. held that an attempted disposition of partnership interests failed as an assignment and declaration of trust but then went on to say that if he had found otherwise, he would have held that section 260 (the counterpart of our section 108) applied to void the transaction as against the Commissioner.

(3) Clearly the emphasis in intra-family transactions should be on the genuineness and reality of the family purposes involved. It is much sounder, or at least safer, to introduce members of the family or a family trust into the business where a new venture is involved, or at least a new asset is needed, rather than to vary an existing business arrangement by the introduction of a family trust.

(4) The section applies only where the transaction bears on its face the stamp of tax avoidance. Where that is lacking the section cannot operate even though the taxpayer did intend to avoid tax. This places a premium on the skill of the tax avoider to mask the transaction to obscure its tax avoidance objects.

(5) Finally, and quite unrelated to what has been said earlier, section 108 stands in the way of obtaining authorisation from the Supreme Court under section 64A of the Trustee Act 1956 of a variation of trusts sought for income tax avoidance purposes.

I. L. M. RICHARDSON.

41. [1967] N.Z.L.R. 161.
42. (1964) 9 A.I.T.R. 385.