

Tax liability Unlimited

Feature Articles

Cite as: November 2011 85(11) LIJ, p.48

As a result of a Queensland appeal decision trustees, including executors of deceased estates, may be held personally liable for tax even where they do not control the trust funds.

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The case of *Barkworth Olives Management Ltd v DCT*¹ (*Barkworth*) potentially undermines existing protections that limit the personal liability of trustees under relevant statutes, the common law and the trust deed. This article examines and explores the significance of the trust deed post-*Bamford*² and the weakening of the statutory protection of trustees, who may now become personally liable for state and federal taxes.

Practitioners beware

This decision will place a greater burden on accountants and legal practitioners in relation to the drafting of trust deeds, the administration of deceased estates and advising trustees of their extended taxation obligations in relation to their trusts and related entities. *Barkworth* demonstrates that an executor or trustee may become personally liable for the tax owing to the Taxation Office where:

- the executor/trustee of the deceased estate/trust may not have controlled any of the funds; or
- the executor/trustee may have distributed the estate/trust assets to the beneficiaries; or
- the deceased estate/trust may not have the funds to pay such tax as is due and payable.

Background

At general law, a trustee of a trust estate (including a deceased estate) is held to account for all the losses and expenses incurred by a trust estate.³ The trustee is, however, entitled to seek indemnity against those losses: *Hardoon v Belilos*.⁴ Further, s35 of the *Trustees Act 1958* (Vic) provides protection in regard to notice when a person is trustee of more than one estate or trust. The trustee of a deceased estate or the legal personal representative must not have acted fraudulently and any payment made must have been made in good faith. Section 36 further provides for a form of implied indemnity of trustees in these terms:

“(1) A trustee shall be chargeable only for money and securities actually received by him.

(2) A trustee may reimburse himself or pay or discharge out of the trust premises all expenses incurred in or about the execution of the trusts or powers.”

Tax obligations of trustees

Historically, the allocation of responsibilities and risks in respect of income tax obligations was different, and often more favourable to trustees.⁵ The tax legislation imposes responsibilities on a trustee to lodge tax returns and to pay the tax on any

income which is retained by the trust and to which no beneficiary has a vested and indefeasible interest in possession – otherwise said to be presently entitled.

The taxation of the income of trust estates is dealt with in Division 6 of Part III of the *Income Tax Assessment Act 1936* (Cth) (*ITAA 1936*). Generally the “net income” (trust income) of a trust estate is equivalent to the amount which would be the taxable income if the trust estate were an Australian resident taxpayer.⁶

Section 96 of the *ITAA 1936* states the general rule that a trustee is not liable as trustee to pay income tax on the trust income except where the law so provides. Accordingly, where tax is payable on the trust income it is the beneficiary who is assessed and is liable to pay the tax unless some legislation provides that the trustee is liable to be assessed and to pay the tax.

Broadly, where a beneficiary is entitled to the trust income and is under no legal disability, then (subject to qualifications) the trustee will not be liable to pay tax on the trust income. The beneficiary or beneficiaries will in that event be assessed and liable to pay tax at their applicable marginal tax rates: s97 *ITAA 1936*.

If the beneficiaries are entitled to all or part of the trust income but one or more of them is under a legal disability, the trustee is to be assessed and is liable to pay tax on all or the corresponding proportion of the trust income at the applicable beneficiary tax rate: s98 *ITAA 1936*.

If no beneficiary is entitled to part of the trust income the trustee is to be assessed and is liable to pay tax in respect of a corresponding part of the trust income: ss99, 99A *ITAA 1936*.⁷ Except for deceased estates, such income is taxed to the trustee at the highest marginal tax rate.

Limitation of trustee liability

Section 254(1) of the *ITAA 1936* deals with the limitation of the trustee’s and agent’s personal liability for any tax debts associated with the trust. Section 254(1)(d) provides that the trustee is authorised and required to retain “from time to time out of any money which comes to him” in his representative capacity so much as is sufficient to pay tax which is or becomes due in respect of the income, profits or gains.

Section 254(1)(e) provides that the trustee is personally liable for the tax payable in respect of the income, profits or gains to “the extent of any amount that he has retained” or should have retained, under paragraph (d); “but he shall not be otherwise personally liable for the tax”.

Given the terms of s254 and on the assumption that the trustee is not relevantly authorised, is it reasonably arguable that the trustee should therefore avoid personal liability? This raises the serious and significant question as to how the courts have viewed this issue.

Earlier courts’ approaches

On a view of earlier decisions, the courts have not provided any clear authoritative pronouncement on the trustee’s obligation in this regard.⁸ In *Howey v FCT*⁹ the High Court postulated that under s89 (the predecessor to s254) a trustee’s personal liability was “not easy to say”. Other courts subsequently made reference to the matter¹⁰ but gave no clear direction.¹¹

The decision in *Barkworth* is of profound significance as it not only clarifies the meaning of s254(1)(d) and (e) but also highlights the limited relevance of the provisions by referring to other sections of the tax legislation to make trustees personally liable. This decision now makes a trustee personally liable for the entirety of the tax debts of a trust estate it administers, with some exceptions applying in certain circumstances.¹²

The facts and contentions in *Barkworth*

The taxpayer was the trustee of four trusts, the beneficiaries of which were investors in olive tree plantations that were meant, presumably, to derive immediate tax deductions and eventual profit. The Taxation Commissioner claimed \$81,425,884 in outstanding income tax, interest and penalties. The Commissioner assessed the taxable income under s99A and obtained summary judgment in the Queensland Supreme Court before Byrne SJA.

The taxpayer contended that pursuant to s254(1)(e) of *ITAA 1936*, the trustee was not personally liable because it had not received any of the funds that had been the subject of the assessments. The taxpayer conceded that under s204 of the *ITAA 1936* it was liable to pay the tax as assessed. The taxpayer argued that the Commissioner was precluded by s254(1)(e) from obtaining judgment unless the trustee had or should have retained sufficient monies coming to it in its capacity as trustee to pay the tax.¹³

The Commissioner's submissions were not directed at the trustee's obligations to retain the funds because the trustee had retained nothing. The Commissioner argued, however, that s254 was overridden by the general assessment provisions of the Act and relied on s204, which creates the legal consequence that the taxpayer is liable for the tax as assessed, and ss175, 175A and 177, which provided the requisite privative protection to such notice of assessment. Those provisions limit the ability of taxpayers to challenge such assessments to Part IVC of the *Taxation Administration Act 1953*.

The court's decision

The court correctly interpreted s254(1)(e) to mean that the section would ordinarily limit the liability of a trustee to any amount of money received by the trustee after the due date for lodging a return and thus after the derivation of income with reference to which the tax is assessed.¹⁴ The court accepted that there may be many constructions of s254. However, it stated that on any construction, there is a substantial conflict between s254 and other provisions in the Act including the general assessment provisions that render trustees liable for tax. The court referred to s99A and similar provisions in Div 6 of Pt III. The court justifiably held that the provisions of Div 6 took precedence over s254. Had the Appeal Court not taken this position, s99A would have been rendered nugatory. Clearly, that could not have been the intention of the legislature. Section 254 should not be construed as qualifying the taxpayer's liability, which was unquestionably "due and payable" under s204. The taxpayer had retained its rights under s175A to object to the assessment under Part IVC of the *Taxation Administration Act 1953*.

McMurdo P focused on the intention of the legislature and concluded that it "seems unlikely" that the legislature "was intending to so significantly limit the liability of agents and trustees . . . contrary to the specific provisions relating to the liability of trust income in Div 6 of Pt III".

Fraser JA said that pursuant to s161(1) "every person" must, if required by the Commissioner by notice, submit a return. Section 166 provides that from the returns and any other information in the Commissioner's possession he may make an assessment. That provision may apply to assessment of trustees under Div 6.

Fraser JA also looked at the intention of the legislature. The conflict between s254 and statutory provisions which make trustees liable for tax must be alleviated by "adjusting the meaning of the competing provisions" to achieve the result which will best give effect to the purpose and language of those provisions. The court took the pragmatic approach to determine which was a "leading provision", a "subordinate provision" and "which must give way to the other".

Fraser JA considered the matter of *DFCT v Brown*,¹⁵ where a trustee was liable even when the funds were not under his control. The taxpayer had escaped full taxation in his lifetime by reason of not having made full and accurate returns. In that event the Commissioner was given the same powers and remedies against the trustees of the deceased estate of the taxpayer as the Commissioner would have had against the taxpayer if he was still living. Section 217 provided that, where at the time of a person's death the tax was assessed, the Commissioner had the same powers and remedies to recover from the trustees of that person's estate.

Fraser JA referred to the matter of *Stapleton v FCT*,¹⁶ where the Commissioner was entitled to claim in priority against the trustees of the bankrupt estate for tax assessed after bankruptcy. The trustees had no control of the funds when the tax liability was initially incurred. The Commissioner was entitled to proceed against the trustees and recover from them nevertheless.

He also referred to *Patterson v FCT*,¹⁷ where the Commissioner had similar powers to proceed against the trustees and administrators of a deceased estate where the deceased had failed to pay the tax. The representative was rendered liable to pay tax in respect of income derived by a taxpayer before the representative was appointed.

Fraser JA concluded that each of the cases of *Brown*, *Stapleton* and *Patterson* concerned taxing provisions that imposed a liability to pay tax upon a person who was appointed *after* the relevant income had been derived. They therefore had no control over the funds and could not therefore have retained any funds for the tax liability. Fraser JA then posed the question: can it be said that because there was no control of the funds the trustee should not become liable? Likewise, s254 cannot be applied generally where Div 6 expressly contemplated that a trustee would be personally liable. He therefore concluded that s254(1)(e) had "no potential application to limit a trustee's personal liability" under Div 6. Section 99A, for example, expressly provides that a trustee is personally liable for tax relating to the income of the trust estate.

The court considered the facts and adopted a technically acceptable approach in concluding that s254 was subservient to s99A of the *ITAA 1936*. The court correctly rejected the taxpayer's argument that it had no control of the funds and should be absolved from a tax liability of some \$81 million. It would be interesting to see if the court might have taken a different view if the tax liability had been a smaller sum or the circumstances slightly different.

There is no leave sought to appeal against the decision in the High Court. Even if the matter were to proceed on appeal to the High Court, I do not believe that the High Court would interpret s99A other than to hold the trustee personally liable because s99A provides precisely for a trustee's liability.

Practical consequences

What does this decision mean for most trustees, particularly where the trustee was not in control of the funds? What should practitioners be concerned with in relation to trustees' personal liability of particular trusts like deceased and bankrupt estates?

Fraser JA said in paragraph 41 of the judgment that Div 6 provides for a trustee's liability "at least where the same person remains trustee during the whole of the period in which the relevant taxable income is derived and up to and including the date upon which the liability for tax accrues under s204". The necessary corollary to such a proposition is that the trustee may not be liable if he was not the trustee for the given period. What if the trust deed is drafted in such a manner as to limit the trustee's liability and for a trustee to hold office no longer than, say, three years – similar to a government holding office for a term before going to the polls? The change of a trustee from time to time may circumvent the liability.

In *Bamford*¹⁸ the High Court confirmed that the trustee is entitled to characterise income or capital as provided in and authorised by the trust deed. Will the Commissioner accept the sanctity of the trust deed if drafted to limit the tenure of a trustee? The Commissioner may well argue that the replacement of the trustee from time to time is a scheme devised with the dominant purpose to obtain a tax benefit or that the trust deed was designed for an ulterior impermissible purpose. The anti-avoidance provisions may, in an appropriate case, lead to criminal sanction.

Ruling IT2544 previously provided for a limitation of a trustee's liability as specified. Regrettably, this Ruling was withdrawn after *Barkworth*. In short, there is no easy solution to the dilemma that trustees and executors of deceased estates may find themselves in. Legal practitioners may also become liable where an executor seeks to place some blame upon the legal advisers on the basis of having placed reliance on their expertise. VCAT ordered damages against a legal practitioner who merely attended to a conveyancing matter but failed to consider the capital gains tax consequences.

It may be a safe option to apply for a deceased estate tax file number, then apply for a Private Ruling and elicit a proper answer from the Taxation Office. The taxpayer can also benefit in that event from the full and frank disclosure provisions under the tax legislation. This would also enable the taxpayer to negotiate with the Commissioner for a better outcome and thereby possibly prevent any personal liability.

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1. (2010) QCA 80. The Commissioner of Taxation recently released a Decision Impact Statement that confirms *Barkworth*.

2. *Commissioner of Taxation v Bamford; Bamford v Commissioner of Taxation* [2010] HCA 10 (30 March 2010).

3. JH Page, *Court of Appeal extends the personal liability of trustees*. Wentworth Chambers, Sydney.

4. [1901] AC 118.

5. Page, note 3 above.

6. *Barkworth*, note 1 above, at [23].

7. Note 6 above.

8. Note 3 above.

9. (1930) 44 CLR 289.

10. See, for example, *Fermanis v Cheshire Holdings Pty Ltd* (1989) 20 ATR 1862.

11. Note 3 above.

12. Note 3 above

13. "Judgement of \$81.4 million stands against trustee", Client Alert, Strategic Wealth Management, June 2010 p4.

14. Note 13 above.

15. (1958) 100 CLR 32 at 42.

16. (1955) 93 CLR 603.

17. (1936) 56 CLR 507.

18. Note 2 above.