Taxation of trusts: the scope of sections 226 to 233 of the Income Tax Act 1976

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The general charging provisions of the Income Tax Act 1976 purport to tax all assessable income. Sections 226 to 233 of the Act lay down a code for the taxation of the income of trustees and beneficiaries. Is this code an exhaustive statement of the assessability of trust income over-riding pro tanto the general charging provisions, or can trust income which is not caught by sections 226 to 233 nevertheless be taxed by the general charging provisions of the Act? John Prebble discusses these questions in this article and concludes that sections 226 to 233 do provide an exhaustive code.

I. INTRODUCTION

Liability for tax is imposed by the New Zealand Income Tax Act 1976, section 38(2), which provides that, subject to the Act, "income tax shall be payable by every person on all income derived by him during the year for which the tax is payable". The effect of section 38(2) is extended by section 75(1), which enlarges the meaning of "derived" by providing that —

> every person shall be deemed to have derived income although it has not been actually paid to or received by him, or already become due or receivable, but has been credited in account, or reinvested, or accumulated . . . or otherwise dealt with in his interest or on his behalf.

Apart from section 38(2), most charging or definitional sections of the Act are concerned with "assessable income" or "taxable income", rather than with "income" simpliciter. Thus, section 39 provides that tax shall be levied on "taxable income" at the rate appropriate to the taxpayer concerned. "Assessable income" and "taxable income" are net sums. They are calculated pursuant to the Act by deducting from "income" certain exemptions, such as that permitted by section 59 in respect of some life insurance premiums. However, the difference between "assessable" or "taxable income" and "income" is not relevant for the purposes of this article. What is relevant are definitions in the Act which extend

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the meaning of "assessable income". Since "assessable income" is a part of "income", a definition that extends one also extends the other, and at the same time extends the operation of section 38(2). The most important provision extending the definition of "assessable income" is section 65. Among the items deemed to be included in the assessable income of a taxpayer under section 65 are "all interest, dividends, annuities, and pensions", and "income derived from any other source whatsoever", pursuant to section 65(2)(j) and section 65(2)(l). The last provision is supererogatory, since section 65 expressly extends, rather than exhausts, the meaning of assessable income". Any receipts that are correctly termed "income" are taxable under section 38 (2), no matter what their source. Sections 38 and 39, together with sections of the Act that amplify their area of operation, are often called "the general charging provisions".

Special provision is made in sections 226 to 233 of the Act for the taxation of trusts. Sections 227, 228, and 230 are the most important.[1] Section 227 (1) provides that where income derived by a trustee is also "during the same income year" derived by a beneficiary who is "entitled in possession to the receipt thereof" in that year, the trustee is taxable on that income as the beneficiary's agent. The beneficiary is already taxable on the income in his own right under section 38 (2). Section 227(1) should be read in conjunction with section 268, one of the sections concerning tax assessed to agents. Section 268 preserves the primary liability of a principal in respect of tax assessed to his agent. The effect of sections 38 (2), 227 (1), and 268, when taken together, is to make the beneficiary and trustee jointly and severally liable for the beneficiary's tax. The rate of tax is that applicable to the beneficiary personally, and thus varies according to how much other income he has each year.

Subsections (3) and (4) of section 227 deem a beneficiary to be entitled in possession to certain income which he has derived, but to which he is not in fact entitled in possession for one reason or another, the most important reason being infancy. An example is income expended on the maintenance of an infant beneficiary pursuant to a discretionary power.

Income within section 227(3) and (4) is thus deemed to meet the yardstick laid down in section 227(1). The result is as outlined in the penultimate paragraph; the beneficiary and the trustee are jointly and severally liable for tax on this income. The trustee's liability is as the beneficiary's agent. The rate of tax is calculated by reference to the beneficiary's personal circumstances. For conciseness, it is often said that income within section 227(1), (3), or (4) is taxed to the beneficiary, although the trustee is also liable as the beneficiary's agent. This usage is adopted in this article, to distinguish such income from income which is taxed to the trustee as such, and not as agent for the beneficiary. That income is considered in the next paragraph.

1 Section 226 is definitional; section 229 relates to a statutory official, the Maori Trustee; section 231 is an anti-avoidance provision drafted, somewhat ineffectually, to negate the advantages of spreading income over several trusts; sections 232 and 233 relate to certain adjustments to the accounts of deceased estates held in trust.

Other income derived by a trustee, that is, income which "is not also derived by a beneficiary entitled or deemed to be entitled in possession to the receipt" of the income, is taxed to the trustee pursuant to section 228 or section 230. Two similar sections, rather than one, were used by the draftsman because, for reasons of fiscal policy, some trusts, called "specified trusts", are taxed harder than others. Trustees of specified trusts are taxed under section 228, those of non-specified trusts under section 230. The most important examples of specified trusts are inter vivos trusts created after 19 July 1968,[2] which was budget day in that year. However, the distinction between specified and non-specified trusts may be put to one side for present purposes.

In summary, sections 227, 228 and 230 provide for the taxation of all income derived by a trustee. Where, also, a beneficiary is, or is deemed to be, entitled in possession, section 227 applies to tax the income to the beneficiary. Otherwise the income is taxed to the trustee. Thus, the trustee is taxed on both income which is not derived by any beneficiary, for example income accumulated under a wholly discretionary trust, and also on income which is derived by a beneficiary, but to which the beneficiary is not entitled in possession. An example is income indefeasibly vested under a trust in a beneficiary who lacks the legal capacity to give a valid receipt for it.[3] For ease of reference, income taxed to the trustee is called "trustees' income", and income taxed to the beneficiary is called "beneficiaries' income".

While sections 227, 228, and 230 cover all income derived by a trustee, there is no overlap between them; no item of income could be taxed as beneficiaries' income under section 227 and also or alternatively as trustees' income under section 228 or section 230. Moreover, and importantly, income cannot be taxed in succeeding years to the trustee and then to the beneficiary (or vice versa) under these provisions. This is because, if income is taxed to the trustee in year one, it cannot in year two be taxed to the beneficiary under section 227(1) when paid out to him, because it is not then income to which the beneficiary becomes entitled during the same income year in which it is derived by the trustee. On the other hand, if the income is taxed in year one to the beneficiary, it cannot be taxed in year two to the trustee, because he will have derived it in year one, and not in year two.

II. DO SECTIONS 226 TO 233 FORM A CODE?

Such general provisions as sections 65 and 75, mentioned earlier, clearly apply as well to the income of trusts as to other income.[4] Thus, for example, the word "derived" as used in section 227 must be given the extended meaning attributed to it in section 75. In this sense, sections 226 to 233 cannot be described as a

2 Section 226(1).

3 *Doody* v. *Commissioner of Taxes* [1941] N.Z.L.R. 542. As an exception, s. 227(4) deems infant beneficiaries of non-specified trusts to be entitled in possession to the receipt of income vested in them under the terms of the trust.

4 *Commissioner of Taxes* v. *Luttrell* [1949] N.Z.L.R. 823, 863 per Hutchison J. (C.A.); *Federal Commissioner of Taxation* v. *Angus* (1961) 105 C.L.R. 489, 509-510 per Fullagar J., 515-516 per Menzies J.

complete code of the rules for the taxation of trusts. But in the sense that sections 226 to 233, as modified by such provisions as sections 65 and 75, constitute an exhaustive statement of trustees' and beneficiaries' tax liability, it is the thesis of this article that the sections are a code.

There is a clear distinction between charging sections, like section 38(2) and sections 227, 228, and 230, and provisions like sections 65 and 75, which do not operate independently, but extend or define terms in the charging provisions. This distinction is sometimes blurred in the cases. For example, in *Marshall* v. *C.I.R.*,[5] a case that will be considered in more detail below, Gresson P. was obliged to consider whether a beneficiary was taxable on funds that had been credited to her name in the accounts of a certain trust. His honour held that the beneficiary was taxable under what is now section 227 (1), and that therefore the trustee was assessable as her agent.[6] But he went on to say that she would also be assessable under the predecessor to section 75, as she had been credited in account with the income.[7] This holding obscured the issue of whether a beneficiary is assessable only within the confines of sections 226 to 233 (the contention of this article) or whether he can also be assessed under the general charging provisions in circumstances where sections 226 to 233 do not apply.

Despite the views of Gresson P. in *Marshall* v. *C.I.R.*, it is surely inaccurate to say that a person can be chargeable to tax under section 75, which is merely definitional. Liability is imposed by section 38(2). Section 75 extends the operation of section 38(2) by defining "derived", one of the terms used in section 38(2). The important question is whether a beneficiary can be assessed under section 38(2) even though he has no liability under section 226 to 233. Gresson P. did not address himself to the point.

Similar confusion is apparent from time to time in dicta stating that sections 226 to 233 cannot be a code, because one or other of the definitional or extending provisions clearly applies to them.[8] These dicta do little more than state the obvious, and miss the substantive issues raised by the question of whether sections 226 to 233 are an exhaustive code of the liability of trustees and beneficiaries, a question which is relevant to a number of problems regarding the taxation of trusts:

1. Do sections 226 to 233 embrace all the income of a trust?
2. Where sections 226 to 233 apply to income, can the general charging provisions of the Act be applied to the income cumulatively or alternatively?
3. Can the same income be taxed to both the trustee and the beneficiary?
4. Where the trustee pays a beneficiary out of income accumulated from previous years, can the beneficiary be assessable for tax on that money?
5. Where a trustee raids capital to make up the income of a beneficiary, are the payments taxable in the hands of the beneficiary?
6. What is the effect of sections 226 to 233 on the assessability of off-shore income of trusts?

5 [1960] N.Z.L.R. 972 (C.A.).
6 Ibid. 984.
7 Idem.
8 E.g. citations at n. 4

A. Do Sections 226 to 233 Embrace All the Income of a Trust?

On its face, this question poses a slightly different problem from the issue of whether sections 226 to 233 cover all the income derived by a trustee. They clearly do, as explained above.[9] But it is linguistically possible to postulate income of a trust that is not derived by a trustee. Of course, such income would have to be derived by someone, otherwise it would not be income. This person would, of necessity, be the beneficiary. Can such trust income exist? In *Williams* v. *Singer*,[10] the House of Lords answered a somewhat similar question affirmatively. There, trustees resided in the United Kingdom. The trust funds were invested abroad, and the income beneficiary was resident and domiciled in France. By order of the trustees, all income was paid direct to the beneficiary, without any remittance to the United Kingdom. The claim of the revenue that the trustees were assessable as persons "receiving or entitled to"[11] annual profits was rejected by the House of Lords. Viscount Cave L.C. explained that the trustees had not "received" the income[12] and, although he did not say so expressly, must be taken to have held that by their order for payment direct to the beneficiary, they had "disentitled" themselves to the income. Lord Atkinson and Lord Shaw of Dunfirmline agreed, and Lord Wrenbury and Lord Phillimore delivered speeches to the same effect.

Under New Zealand legislation, however, it seems that all income of a trust must be "derived" by a trustee, because of the extended definition of the word in section 75 of the Act. Thus, Gresson J. explained in *Commissioner of Taxes* v. *Luttrell*[13] that, pursuant to section 102 of the Land and Income Tax Act 1923, a predecessor of sections 227, 228 and 230 of the Income Tax Act 1976, the trustee was assessable to tax on the whole of the income of the trust, as agent for the beneficiary in respect of beneficiaries' income, and as trustee in respect of the remainder.[14] This principle also seems to be the explanation of *Federal Commissioner of Taxation* v. *Angus*,[15] a case decided by the High Court of Australia. The trustees were resident in Singapore, and the trust income took the form of dividends from a Singapore company. The beneficiary was entitled to one third of this income. She lived in Australia. By order of the trustees, the income was paid direct to her, Singapore tax having already been levied. Australian law exempted from tax certain foreign income taxed at source, but this exemption did not apply to dividends. The High Court held, however, that the beneficiary was entitled to the exemption, because what she received was not dividends, but income under a trust.[16] It follows, therefore, that the dividends, which must have been derived by someone, were derived by the trustees. This conclusion is consistent with the Income Tax Assessment Act 1936 (Commonwealth), section 19, which is in similar terms to the New Zealand section 75. Consequently, if the facts of *Williams* v. *Singer* were to come before a New Zealand court, it would seem that the income paid to the beneficiary would be held to have been derived by the trustees.

The question of whether sections 226 to 233 cover all trust income has also been approached judicially from another angle. In *Union Fidelity Trustee Co. of*

9 See text accompanying n. 3.
10 [1921] 1 A.C. 65 (H.L.).
11 Section 100, Income Tax Act 1842.
12 [1921] 1 A.C. 65, 73.
13 [1949] N.Z.L.R. 823 (C.A.).
14 Ibid. 859.
15 (1961) 105 C.L.R. 489.
16 Ibid. 501, per Dixon J

Australia Ltd. v. *F.C.T.*,[17] Barwick C.J. was considering the assessability of trust income that had been paid out to a beneficiary in the same year in which it was derived by the trustee. He held that such income must be taxed under the general charging provisions, and not under section 97, the equivalent in the Australian Act of section 227. His honour's reason was that once income has been paid to a beneficiary he can no longer be described as "entitled to" that income.[18] This view has not been adopted in New Zealand departmental practice, nor in the cases. It has been assumed that such income is assessable under section 227(1). This subsection is slightly different from the Australian provision, in that it requires that the beneficiary be entitled in possession during the income year in which the income is derived by the trustee. Though income may be paid out to a beneficiary later in the year, his liability under section 227(1) matures once he becomes entitled in possession to the income. The word "during" is not used in the Australian section 97.

The conclusion that income paid out to a beneficiary must be assessable under section 227(1) is further supported by an examination of sections 228 and 230. These sections in terms tax to the trustee all income derived by the trustee to which a beneficiary is not entitled, or deemed to be entitled, in possession. If income paid out to a beneficiary is not income to which he is entitled or deemed to be entitled, one is left with the curious result that such income must be taxed to the trustee, whereas, had the trustee simply delayed paying it out, the income would be taxed to the beneficiary. This reasoning is equally, though not so obviously, applicable to the Australian provisions, but it does not appear to have been drawn to the attention of the High Court in *Union Fidelity Trustee Co. of Australia Ltd.* v. *F.C.T.*

Finally, there are two types of receipt which might be described as income in the hands of the beneficiary, but are definitely not income derived in the same income year by the trustee. These are payments out of the accumulated income, and payments out of capital. The former is to be considered below, and the latter in a later article. For the moment, it suffices to observe that such payments cannot be taxed to the trustee as they are, by definition, payments by him, rather than to him. Nor can they be taxed to the beneficiary under section 227(1), because they do not come from income derived in the same income year by the truste. The real issue is whether they can be taxed to the beneficiary under the general charging provisions of the Act. Without at this stage answering this question, it can be concluded from the previous paragraphs that, at least, sections 226 to 233 purport to impose tax liability on all income derived by a trust in the year of its derivation, with no exception.

B. Cumulative Assessment

If it is accepted that sections 226 to 233 do embrace all trust income in its year of derivation, the remaining questions posed earlier in this article become easier to answer. Many of the issues involved arose for consideration by the New

17 (1969) 119 C.L.R. 177.

18 Ibid. 182.

Zealand Court of Appeal in *Commissioner of Taxes* v. *Luttrell.*[19] That case concerned a deceased estate, under which the taxpayer was entitled to a fixed annuity. For ten years, the trustees of the estate did not pay the annuity, being unsure of the solvency of the estate. During those years, the trustees paid tax on the income of the estate pursuant to what is now section 230. In the eleventh year, the annuity was paid, together with the ten years' arrears. The revenue assessed the annuitant to tax not only on the annual sum for the eleventh year, to which no objection was taken, but also on the arrears, claiming that these were taxable as "assessable income" pursuant to what is now section 65(2)(j) of the Act. (The claim would clearly have been unsustainable under the predecessor to section 227(1), for reasons that have been explained.)

The Court of Appeal rejected the claim, primarily because to allow it would be to permit double taxation. Accepting that double taxation entailed taxing the same income twice in the same hands,[20] the court held that trustees were not an independent class of taxpayer, but paid tax as representatives of their beneficiaries.[21] This was true whether the trustee paid tax expressly as agent for the beneficiary under section 227(1), or on trustees' income, under section 228 or 230.[22] Thus tax had already been levied on the funds from which the arrears of the annuity were paid and, in effect, in the hands of the annuitant. Secondly, Gresson J. held that sections 226 to 233 provided for a scheme of payment complete in itself and comprehending all cases.[23] The tenor of the judgments of Kennedy and Finlay JJ. was similar.[24] Thus the Commissioner could not rely cumulatively on section 65(2)(j). In fact, these two lines of reasoning are closely inter-connected, as recognised by Kennedy J.[25] If the trustee is taxed as the representative of the beneficiary, it is because the Act treats the income of a trust as one income, not two. The provisions of section 226 to 233 certainly exhaust one income. It is only if a second income can be postulated that there can be the possibility of a second levy of tax. There being only one income, once tax has been paid by the trustee representing the beneficiary, to tax the beneficiary would be to tax the income a second time.

In summary, *Commissioner of Taxes* v. *Luttrell* holds that once income has been taxed in the hands of a trustee, it cannot be taxed again later when it is paid out to the beneficiary.

If it is accepted that the trustee pays tax in a representative capacity, one is led to a further argument that supports the court's decision. This argument was not expressly canvassed in the judgments, though in a sense it is a recasting of the reasoning in the previous paragraph. Income tax is an annual tax. By section 38(2) it is imposed on "every person on all income derived by him during the year for

19 [1949] N.Z.L.R. 823 (C.A.).
20 Citing *Canadian Eagle Oil Co. Ltd.* v. *The King* [1946] A.C. 119: [1949] N.Z.L.R. 823, 846 per Finlay J., 858 per Gresson J., 841-842 per O'Leary C.J. dissenting.
21 [1949] N.Z.L.R. 823, 845 per Kennedy J., 850 per Finlay J., 860 per Gresson J., 865 per Hutchison J., 841 per O'Leary C.J. dissenting.
22 Ibid. 848 per Finlay J. The modern numbering of the sections has been adopted.
23 Ibid. 859.
24 See, particularly, ibid. 859.
25 Ibid. 845-846.

which the tax is payable". By implication, and indeed obviously, the taxpayer is not obliged to pay tax again on the same income in a later year. Thus, if through his trustee/representative a beneficiary pays tax in year one, he should be immune from asessment when the same income is paid out to him in year two, or later.

Interestingly enough, the English Court of Appeal came to a similar conclusion in the case of *Stanley* v. *I.R.C.*[26] There, trustees accumulated trust income and paid it out to the life tenant on his majority. It seems that the trustees had paid basic rate tax on the income from year to year, but the Crown assessed the beneficiary to surtax on his receipt of the accumulation. The Court of Appeal rejected the assessment, on the grounds that if the beneficiary had not been assessable as the income was derived, he could be no more liable when it was paid over to him on his majority. This reasoning is similar to the "one income" point of view of Kennedy J., discussed above.

The non-discretionary trusts in *Commissioner of Taxes* v. *Luttrell* and *Stanley* v. *I.R.C.* are perhaps not as common nowadays as discretionary trusts, where income is accumulated and then paid out to a beneficiary in later years. The principle in *Commissioner of Taxes* v. *Luttrell* would appear to extend to accumulation cases like this, preventing assessment in the hands of the beneficiary. Moreover, the ratio of *Stanley* v. *I.R.C.* was in fact applied in *Cornwell* v. *Barry,*[27] a case involving a discretionary trust.

III. ALTERNATIVE ASSESSMENT

Commissioner of Taxes v. *Luttrell* was a case where the revenue attempted to tax trust income cumulatively. On the other hand in *Marshall* v. *C.I.R.*[28] the claim was that the general charging provisions could apply to tax income of a beneficiary as an alternative to assessment under what is now section 230. The tax claimed related to certain income which had been credited to the account of a beneficiary by the trustees of a farming estate. The revenue first submitted that, on the facts, the beneficiary had become entitled in possession to the receipt of the income during the year in which it was derived by the trustee. Thus, the income was taxable to her, through the trustees as her agents, under what is now section 227(1). Secondly, if the beneficiary was not entitled in possession, she had certainly derived the income, because the trustees had credited it to her account and she was therefore taxable in her own right under what is now section 75.

Gresson P. and Cleary J. (Hutchison J. dissenting) upheld the first submission for the Commissioner, which was sufficient to dispose of the case. Gresson P. went on briefly to accept the second submission also.[29] Cleary J., on the other hand, recognised that implicit in the second submission was a contention that the revenue could choose to assess the beneficiary on income which, pursuant to the predecessor to section 230, was assessable to the trustees.[30] Did the revenue have that power?

26 [1944] 1 K.B. 255 (C.A.).
27 (1955) 36 T.C. 268, Harman J.
28 [1960] N.Z.L.R. 972 (C.A.)
29 Ibid. 984.
30 Ibid. 990.

The income was derived by the trustees and, for the sake of argument, it was assumed that the beneficiary had also derived the income, but not in circumstances where she was entitled in possession to the receipt thereof. In view of the majority's holding on the first submission, Cleary J. did not find it necessary to come to a conclusion in respect of the second. However, he described it as a contention that "could not be advanced with hope of success except in rather unusual circumstances", which, for his part, he had "difficulty in visualising".[31] Regrettably, the problems implicit in the second submission were not canvassed at all by Gresson P. They are in fact insuperable, a point which can be illustrated by a consideration of *Little* v. *C. of T.*,[32] a case where the taxpayer, rather than the Commissioner, tried to persuade the court that income assessable to the trustee under sections 228 and 230 could instead be assessed to the beneficiary under the general charging provisions.

In that case, the income involved was money applied by trustees for the maintenance of infant beneficiaries. The House of Lords had held in *Drummond* v. *Collins*[33] that such expenditure was correctly described as "income" of the children concerned. However, Northcroft J. held that it had to be taxed to the trustees, as the beneficiaries, being infants, were not entitled in possession, as required by section 227(1),[34] *Little* v. *C. of T.* is clearly correct. Section 228 and 230 are specific and mandatory. Income derived by a trustee to which no beneficiary is deemed to be entitled in possession must be taxed to the trustee. There is no warrant for the beneficiary or the trustee to require the income to be taxed instead to the beneficiary. Equally, there is no provision permitting the Commissioner to make a similar choice. Cleary J.'s doubts in *Marshall* v. *C. of T.* were well founded. The words of the Act do not support the obiter remarks of Gresson P. in the same case.

From an examination of sections 226 to 233 and from the treatment of these sections in the cases, particularly *Commissioner of Taxes* v. *Luttrell* and *Little* v. *C. of T.*, it would appear that the sections do form a code, and that it is not permissible for assessments to be made alternatively or cumulatively under the general charging provisions of the Act. Before attempting a final rationalisation of the relationship between sections 226 to 233 and the general sections, this preliminary conclusion must be examined in the light of a provision that has not yet been mentioned, namely section 227(6). This subsection states that nothing in sections 227, 228, 230 or 231 —

> shall be so construed as to exempt a beneficiary from any income tax which would be payable by him had he derived the income to which he is entitled under the trust directly instead of through a trustee.

31 Idem.
32 [1935] N.Z.L.R. 642.
33 [1915] A.C. 1011.
34 [1935] N.Z.L.R. 642, 647, following *Commissioner of Taxes* v. *Pratt Estate Co. Ltd.* [1934] N.Z.L.R. 347, and *Dalrymple* v. *C. of T.* [1934] N.Z.L.R. 366 (Note), and declining to follow *Buckley* v. *C. of T.* [1923] N.Z.L.R. 1180. Now, pursuant to section 227(3), the beneficiaries would be deemed to be entitled in possession, and therefore assessable in these circumstances.

At first sight, section 227(6) might seem to negate many of the points that have been made so far in this article. It certainly troubled the Court of Appeal in *Commissioner of Taxes* v. *Luttrell,* and it is doubtful whether in fact the subsection can bear any satisfactory construction. Various possibilities may be considered, but on examination none is at all compelling.

(a) The subsection catches trust income that is missed altogether from the net of sections 226 to 233. But, because of the comprehensive drafting of sections 226 to 233, such income cannot exist.

(b) Section 227(6) applies to cases where trustees make payments out of capital to meet day to day or other income needs of the beneficiary. In these circumstances a long line of English authority holds that the beneficiary is taxable on the receipts from capital.[35] Such payments are not caught by section 227(1), because they are not from income derived by the trustee in the same year in which the beneficiary becomes entitled to them. Indeed they are not from income at all. Thus, it is initially attractive to consider that section 227(6) imports the English rule in order to assess these payments in the hands of the beneficiary. But this cannot be so. Section 227(6) purports to tax the beneficiary on the hypothesis that he derives income directly, rather than through a trustee. Therefore, to determine the effect of section 227(6) in any particular case, one must examine the facts as they would be in the absence of any trust. This hypothesis entails treating the beneficiary as the legal owner of the source of the income,[36] that is the trust capital. If a legal owner of capital dips into it to maintain his standard of living, there is, of course, no question of income tax. Thus, section 227(6) can have no effect in this context.

(c) Section 227(6) taxes income derived by a beneficiary whether or not that income is also taxed to a trustee. This interpretation is directly contrary to *Commissioner of Taxes* v. *Luttrell,* and does seem inherently unlikely. If correct it would mean that double taxation was imposed by a provision drafted as a generalised saving clause.

(d) Section 227(6) permits the Commissioner to tax the beneficiary under the general charging provisions as an alternative to assessment of the trustee under sections 228 and 230. This view appears to have been adopted by Hutchison J., dissenting in *Marshall* v. *C.I.R.*[37] It was not supported by the majority and is submitted to be untenable for the reasons given.[38]

(e) Where income would be taxed at a higher rate in the hands of the beneficiary when paid over to him than it was in the hands of the trustee, the difference above the rate imposed on the trustee is assessable to the beneficiary. This interpretation was supported by Finlay J. in *Commissioner of Taxes* v.

35 *Brodie's Trustees* v. *I.R.C.* (1938) 17 T.C. 432, Finlay J.; *Lindus & Horton* v. *I.R.C.* (1933) 17 T.C. 442, Finlay J.; *Williamson* v. *Ough* [1936] A.C. 384 (H.L.); *Cunard's Trustees* v. *I.R.C.* [1946] 1 All E.R. 159 (C.A.).

36 *Commissioner of Inland Revenue* v. *Dasent* [1956] N.Z.L.R. 959, 962, Turner J.

37 [1960] N.Z.L.R. 972 (C.A.).

38 See text accompanying nn. 29 to 34.

Luttrell,[39] but by none of the other members of the Court of Appeal. It does appear to be inconsistent with the court's final decision, in that if section 227(6) does have this effect, the revenue should have been successful to the extent that the beneficiary's tax rate exceeded that of the trustees. This interpretation has other inconsistencies. It involves crediting the beneficiary with tax paid by the trustee. Thus, the trustee is implicitly treated as representing the beneficiary when he pays tax. But if that is so, the beneficiary should be immune from further tax on the same income, because of the annual nature of income tax.[40] In practice, the Commissioner appears to take this view, and does not attempt to impose extra tax on income paid out to the beneficiary.

(f) Section 227(6) preserves the right of the Commissioner to assess the beneficiary directly on income taxable to the trustee as his agent under section 227(1). It might be argued, though faintly, that section 227(1) recognises no direct liability on the part of the beneficiary. If that were so, section 227(6) could be thought of as preserving such a liability. But this interpretation of the relationship between section 227(6) and section 227(1) is seen to be wrong on analysis of section 227(1).

Section 227(1) speaks of income that is derived by a beneficiary. Since the income is derived by a beneficiary, it is prima facie taxable to him under section 38(2). Section 227(1) provides that some of this income, that to which the beneficiary is entitled in possession, is assessable to the trustee as the beneficiary's agent. It does not, either expressly or by implication, relieve the beneficiary of his personal liability for tax on this income. Therefore, section 227(6) is redundant, if its role is to preserve or reimpose the beneficiary's liability.

IV. EFFECT OF SECTIONS 226 TO 233 ON THE OPERATION OF THE GENERAL CHARGING PROVISIONS OF THE ACT

It is submitted that the effect of sections 226 to 233 on the general charging provisions of the Act is to limit the coverage of those sections. Moreover, sections 226 to 233 do not add to liability that already exists under the general charging provisions. Nor do the sections completely supplant the general charging provisions; rather, they prevent their operation in certain circumstances, in the following manner. Prima facie, all income gained by a trustee is taxable in his hands, because he has "derived" it. But section 227 implicitly relieves the trustee of liability for tax on some of this income, except as agent or for the beneficiary. Likewise, all income derived by a beneficiary is prima facie taxable to him. But sections 227, 228, and 230 shift this liability to the trustee in respect of certain income. That is, income to which the beneficiary is not entitled, or deemed to be entitled, in possession, notwithstanding that the beneficiary has derived that income.

The general points made in the preceding paragraph may be illustrated by an examination of how section 230 limits the operation of section 38(2). Section 38(2) taxes income "derived" by any person. But section 230 assesses to the trustee income

39 [1949] N.Z.L.R. 823, 851.

40 See paragraph between nn. 25 and 26

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which is derived by a beneficiary. Section 230 is mandatory and specific. Thus, section 38(2), which is expressed to be "subject to this Act", gives way. This is the ratio of *Little* v. *Commissioner of Taxes*,[41] discussed earlier.[42]

The other apparently "charging" provisions in sections 226 to 233 should be seen in the same light. For example, by taxing to a beneficiary certain income to which he is entitled in possession, section 227(1), combined with sections 228 and 230, prevents this income from being also taxed to the trustee under section 38(2), although the trustee has derived the income. True, sections 228 and 230 do not state specifically that "the following income and no other is assessable to the trustee". Nor is section 227 framed in that fashion in respect of beneficiaries' liability. But the three sections expressly cover all trust income (that is, all income derived by a trustee) and clearly contemplate that this income shall be taxed to either the trustee or the beneficiary, but not to both.

As mentioned above, sections 226 to 233 do not completely displace the general charging provisions in the field of trusts. Rather, sections 226 to 233 overlay and occupy part of the area covered by the general charging provisions. To illustrate, income taxable to a beneficiary under section 227(1) is also taxable to him under section 38(1). Section 227 does not lift the tax imposed on the beneficiary by section 38(2); rather, section 227(1) imposes the same liability for a second time. However, while this analysis is believed to be correct, it is not reconcilable with all the cases; not, in particular, with *Union Fidelity Trustee Co. Ltd.* v. *F.C.T.*[43]

In that case, Barwick C.J. was concerned with the question of income to which a beneficiary is entitled, but which has not yet been paid out to him. The relevant provision is section 97 of the Income Tax Assessment Act (Commonwealth), which corresponds to section 227(1) of the New Zealand Act, but is in somewhat different terms. Section 97 reads:

> Where a beneficiary in a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate, (a) the assessable income of the beneficiary shall include — so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident; . . .

There would appear to be no relevant differences between the meaning of "presently entitled" and the New Zealand "entitled in possession". Barwick C.J. held that income to which a beneficiary was "presently entitled" but which had not been paid out to him was taxable to the beneficiary under section 97.[44] But he held also that it was taxable to the beneficiary only because of section 97.[45] It was not caught by the Australian general charging provisions, because, it seems, the beneficiary had not received the income.[46] Section 97, by taxing at the point of present entitlement, anticipated the liability that would arise under the general charging provisions. This holding, it is submitted, does not vitiate the analysis adopted above, for two reasons.

41 [1935] N.Z.L.R. 642.
42 See text at n. 32.
43 (1969) 119 C.L.R. 177.
44 Ibid. 182, last para.
45 Idem.
46 Idem.

First, section 97 does not in terms require that the income which it taxes to the beneficiary should have been derived by him. Therefore, it is possible to contemplate the existence of income, caught by section 97, to which a beneficiary is presently entitled, but which he has not "derived", as that term is used in the Australian and New Zealand Acts. If such income can exist, it is, admittedly, not taxable to the beneficiary under the general charging provisions, since he has not derived it. On these assumptions, Barwick C.J. is right in saying that section 97 anticipates the beneficiary's liability. But, on this analysis, section 97 is distinguishable from section 227(1), because section 97 is taken to assume the existence of, and to tax, income which a beneficiary has not "derived"; but section 227(1) in terms applies only to income which the beneficiary has both derived, and to which he is entitled in possession.

However, the above is not believed to be the correct interpretation of section 97. Herein lies the second reply to Barwick C.J.'s holding. It is submitted that, contrary to the assumptions in the previous paragraph, if a beneficiary is "presently entitled" to income, he must have "derived" it. The Australian Act contains in section 19 an extended definition of "derived" that is virtually identical to that in section 75 of the New Zealand Act, quoted at the beginning of this article. The argument goes as follows:

(a) The income exists, and must have been derived by the trustee, otherwise the beneficiary could not be presently entitled to it. One cannot be presently entitled to something that does not exist.

(b) Since the trustee has derived the income, he holds it on trust.

(c) Since the beneficiary is presently entitled to the income, the trustee holds it on trust for the beneficiary.

(d) If the trustee holds the income on trust for the beneficiary, he holds it "on behalf of" the beneficiary.

(e) If the trustee holds income "on behalf of" the beneficiary, the beneficiary has "derived" the income, because that is one of the tests of derivation in both section 75 of the New Zealand Act and section 19 of the Australian Act.

(f) If a beneficiary must be taken to have "derived" income to which he is presently entitled, it follows that, in speaking of income to which a beneficiary is presently entitled, section 97 of the Australian Act is also speaking of income which the beneficiary has derived.

(g) If the income caught by section 97 is income that the beneficiary has derived, that income is taxable to the beneficiary anyway, pursuant to the general charging provisions of the Australian Act.[47]

(h) It follows that Barwick C.J. was incorrect in holding that section 97 anticipated a liability for tax that had not already accrued. The liability had accrued; one can, of course, be liable for tax on income which one has derived, but

47 Section 25, Income Tax Assessment Act (C'th).

not yet received. The liability imposed by sections 227(1) and 97 in New Zealand and Australia is a second liability, superimposed on the liability flowing in each case from the general charging provisions.

V. CONCLUSIONS

The role of sections 226 to 233, and their relationship with the rest of the Income Tax Act 1976, may be stated as follows:

1. Apart from sections 226 to 233 —
   (a) all trust income is taxable to the trustee, because, being trust income, it must have been derived by him; and
   (b) trust income that is derived by a beneficiary is also taxable to the beneficiary, again because the beneficiary has derived it.
2. This dual liability is partially confirmed by sections 226 to 233, in that:
   (a) "trustees' income" is taxable to the trustee, and
   (b) "beneficiaries' income" is taxable to the beneficiaries.
3. But the dual liability is partially limited by sections 226 to 233 in that:
   (a) "trustees' income" is not taxable to the beneficiary, even though the beneficiary may have derived the income, as well as the trustee, and
   (b) "beneficiaries' income" is not taxable to the trustee, even though the trustee must have derived the income too.

Of these rules, rule 3 is the most significant. It shows that, in a sense, sections 226 to 233 are more important for what they do not say than for what they do say. In charging income with tax, they merely confirm an existing liability. In omitting to charge other income, they implicitly relieve that income from tax to which it is prima facie liable by virtue of the general charging provisions, in particular by virtue of section 38(2).

Diagrammatically, sections 226 to 233 may be considered as two segments superimposed on a circle. The circle represents the tax liability imposed generally by section 38(2). As far as trust income is concerned, section 38(2) remains operative, but only where its circle is overlaid by the two segments representing the liability imposed by sections 226 to 233 on trustees and on beneficiaries. In other words, section 38(2) operates in respect of the income of trustees and beneficiaries only where it is endorsed by the operation of sections 226 to 233. This is a truer picture than that of two small circles representing the liability of trustees and beneficiaries displacing entirely the larger circle of section 38(2). However, it may have been something akin to this second picture that the draftsman had in mind when composing sections 226 to 233. If so, that might explain his insertion of section 227(6), in order to reactivate section 38(2) in respect of trust income. If the thesis of this article is correct, his action was not necessary.[48] Section 38(2) is not displaced by sections 226 to 233, but merely modified by them.

48 Cf. *Commissioner of Taxes* v. *Luttrell* [1949] N.Z.L.R. 823, 845, per Kennedy J. (C.A.).

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