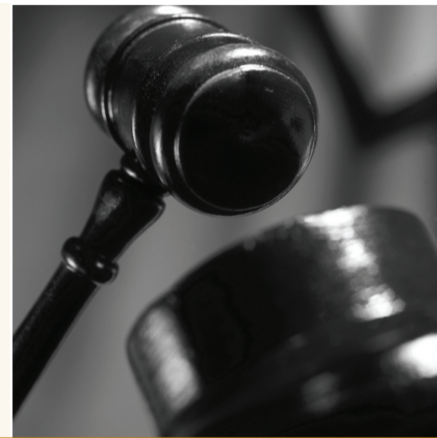
Can loans to beneficiaries be taxable trust distributions?



WEYERS V COMMISSIONER OF TAXATION [2006] FCA 818

INTRODUCTION

It is not uncommon for a discretionary trust to make interest free loans to beneficiaries of the trust that are repayable on demand. These loans or payments are usually treated as loans to the beneficiaries in the accounts of the trust. Although this is common practice careful consideration should be given to the nature of the transaction recorded as a loan to determine whether it is in fact a loan. In *Weyers v Commissioner of Taxation* [2006] FCA 818 the Court found that approximately $1.8 million dollars of loans to the beneficiaries of the trust were in fact assessable distributions of income. The circumstances surrounding the payment of $1.8 million dollars to the beneficiaries indicated that there was never an intention to repay the money.

FACTUAL BACKGROUND

Until December 1994 Mr. Weyers ("Weyers") traded in the construction and property development industry through Cherrybrook Pty Ltd ("Cherrybrook") as trustee for the Weyers Family Trust ("Family Trust"). As Cherrybrook was expected to derive substantial amounts of income, Weyers, on the basis of advice from his accountant and two solicitors acquired control of the Elizabeth Street Sydney Trust ("Sydney Trust") in December 1994. This trust had accumulated tax losses of $2.6 million and the income generated over the 1995 – 2000 and the 2002 year was offset against these losses resulting in nil taxable income for the Sydney Trust over those years. This income, which would have been taxable if the losses were not claimed, was largely paid out to Mr. & Mrs. Weyers ("the taxpayers") as loans to them.

The Sydney Trust

The Sydney trust was established on 11 October 1985 by parties unrelated to the taxpayers. The $2.6 million tax losses arose from a failed property investment and were made up of the deposit forfeited, interest on the loan to fund the deposit and consultancy fees. On 24 December 1994, in view of the "sale" of the trust to the taxpayers, income tax returns for the 1990 to 1994 financial years were lodged by the Sydney Trust, showing accumulated losses of $2,655,292 these accumulated losses were apparently reflective of the debts owed by the Sydney Trust.

The Acquisition of the Sydney Trust

The transfer of control of the Sydney Trust[1] to the taxpayers was effected by two facilitation agreements. These agreements effectively transferred control of the Sydney Trust to one of the solicitors advising the taxpayers and then from that solicitor to the taxpayers. The consideration paid for the control of the Sydney Trust by the solicitor was $35,000 whilst the consideration paid by the taxpayers to the solicitor was $155,000. The taxpayers were also advised that upon acquisition of the Sydney Trust that the trustee of the trust would not be liable for the debts incurred prior to the acquisition.

Trading through the Sydney Trust

Nommack Nominees Pty Ltd ("Nommack") was appointed as trustee of the Sydney Trust and Weyers ceased working for Cherrybrook on 20 December 1994. After this appointment as trustee, Nommack contracted with clients for the supply of consultancy services previously provided by Cherrybrook.

Nommack paid the taxpayers salaries but these salaries were not sufficient to meet their living expenses so the taxpayers regularly paid for living expenses out of the funds of the Sydney Trust. These payments over and above salaries were treated as loans to the taxpayers.

Over the period 1994-95 to 2001-02 the Sydney Trust derived substantial amounts of business income and also received distributions from the Family Trust. The Sydney Trust did not make resolutions for the distribution of income because that income was offset against the carry forward losses of $2,665.292.[2] By 2002 the losses had been soaked up and the taxpayers' indebtedness to the Sydney Trust was $1,828,085.

The only distribution made to the taxpayers, as disclosed on their income tax returns, was for PPS credits for the 1995 year. Some eight years later attempts were made by the taxpayers to seek amendments to their tax returns on the basis that this distribution was made in error.

The Commissioner issued amended assessments to the taxpayers reflecting the income generated by the trust after forming the view that the accumulated losses were not deductible against that trust income generated over the 1995 to 2002 years.

Additional penalty tax was imposed at the rate of 75 percent of the primary tax on the basis that the taxpayers showed an intentional disregard for the law.

ISSUES

Taxpayer's submissions

The taxpayers appealed against the Commissioner's amended assessments on the following grounds:

1. The losses in the Sydney Trust were available to be offset against income derived by the Trust.
2. The payments to the taxpayers were not distributions of income, as they were not beneficiaries of the Sydney Trust, rather they were loans to them.
3. As the taxpayers were not beneficiaries the distribution of the PPS credit to them was made in error.
4. The Commissioner did not have the power to make the amended assessments as there was no fraud or evasion.
5. The additional tax imposed was excessive as there had been no intentional disregard of the law.

The Commissioner's argument

In holding that the assessments were correct the Commissioner argued that:

1. The purported losses were not available and even if they were incurred by December 1994 they ceased to be available because it was obvious the loans would not be called in.
2. The trust had ceased to exist at some time prior to December 1994 as there was no property subject to the trust.
3. The taxpayers were beneficiaries of the Sydney Trust and the payments to them were distributions of income.
4. The Commissioner had the power to make amended assessments.
5. The additional tax imposed was not excessive.

THE COURT'S FINDINGS

Was the Loss deductible?

Although the Court accepted that the Sydney Trust lost its deposit it did not conclude that there was a loss for the purposes of s 8-1 of the *Income Tax Assessment Act 1997* (" ITAA 1997") (formerly s 51 of the ITAA 1936). The deposit to purchase the Elizabeth Street property was advanced by a financier but the Court could not conclude that the amount borrowed was repayable by the trustee of the Sydney Trust if the project failed. The non recourse loan arrangement meant that the financier bore some of the risk of the transaction.

For a loss to be deductible under the general deduction provisions[3] the expense or debt must be "incurred". Reference was made to Dixon J in *New Zealand Flax Investments Limited v Federal Commissioner of Taxation*[4] where it was held that although the word "incurred" is not suitable for exhaustive definition, a loss must actually be incurred. It does not include a loss or expenditure which is no more than impending threatened or expected, there must be an actual liability to make payment.

At the time the loan was made to the trustee of the Sydney Trust nobody expected the trustee of the Sydney Trust to repay the loan and interest if the project failed. The fact that there was no subsequent attempt to recover the amount confirms this view. On this basis it was held that the loss was not incurred and the deduction was not allowable.

Although the Court found that the debts were not incurred it went on and concluded that if the debts had been incurred, by December 1994 these trust debts did not exist as liabilities of the trust. Referring to the judgment of Hill J in *Warner Music Australia Pty Ltd v Commissioner of Taxation*[5] where a number of approaches were suggested for the treatment of debts that no longer existed, the Court found that trust debts were over valued, were worth nothing and should have been taken out of the accounts.

The Loans to the Weyers – were they really loans?

The Court found that the so called loans made to the taxpayers to meet their living expenses were not loans at all, rather they were distributions of income.[6]

Oral evidence[7] given by the taxpayers indicated that the income derived by the Sydney Trust was deposited into the trustee's bank account and then it was withdrawn by them to pay for their personal expenses. They treated the money in the bank account as their own money using it as they saw fit. As it was "their money", something their accountant had told them, they saw no obligation to repay that money. The Court correctly highlighted that it would be absurd to call these payments loans; one cannot borrow their own money.[8]

Although the payments to the taxpayers were described as a loan, there was no documentation to that effect, no interest charged and no consideration given to if, when and how this loan was to be repaid. It is submitted that the fact the loan was interest free is not a crucial factor in deciding whether a loan exists. Trust deeds may, and very often do give the trustee power to advance loans to beneficiaries on any terms they deem fit. The critical issue for a payment to be characterised as a loan is that it must bear the hallmarks of a loan, there must be an intention to repay it.

The Court found that the parties to this matter had two objectives:

1. to utilise the perceived accumulated losses in the trust; and
2. to make funds available to the Weyers for their exclusive use.

Nommack was not treated as a trustee with duties. Its only purpose was to provide access to the perceived tax benefits and to act as banker to the taxpayers. The use of the Sydney Trust was necessary to obtain the tax advantage because the losses resided in the Sydney Trust.

The taxpayers argued that they were not beneficiaries of the Sydney Trust, consequently payments to them could not be characterised as distributions. The difficulty with this argument is, if they were not beneficiaries it is unlikely that the payment of funds to them could be consistent with the trust terms.

The Court found that the taxpayers were beneficiaries of the trust and the payments to them were distributions of income because:

- the trust deed of the Sydney Trust provided that the trustee, with the consent of the guardian is able to appoint as a general beneficiary

anyone who makes a donation to the one of three identified charities;

- the taxpayers made the appropriate donations in June 1995 in order to qualify as potential beneficiaries;
- although the trustee did not make a determination in writing to add the taxpayers as additional beneficiaries, such a determination was not required to be in writing;
- the failure by the trustee to make a written determination to appoint income to the taxpayers as required by the trust deed, could not defeat the Court's finding;
- the payment of funds to the taxpayers without a genuine obligation for repayment constituted distributions of income rather than loans and provided further evidence that the trustee had determined that the taxpayers were beneficiaries;
- the taxpayers acted on the advice of their accountant, as he understood that they were beneficiaries of the Sydney Trust the inference drawn was that it was intended that they be beneficiaries of the Sydney Trust ; and
- A distribution of PPS credits in 1995 to the taxpayers in 1995 was consistent with them being beneficiaries.

Subsequent attempts to explain the distribution of the PPS credit as an error and request amended assessments were found unacceptable by the Court. Such an explanation eight or nine years after the event may be accepted if it stood on its own. The accountant's understanding that the taxpayers had become beneficiaries of the trust, the donations made to enable them to become beneficiaries on 23 June 1995 and the coincidence of the claim of the PPS credit for that year could not be explained as an error or accidental.

The Court held that the money received by the taxpayers from the Sydney Trust were taxable in their hands. To the extent that the Sydney Trust had received income distributions from the Family Trust, that income was held to be a distribution to the taxpayers directly from the Family Trust. Nommack merely held it on their behalf. The amounts purportedly lent to the taxpayers should have been included in their taxable income.

To the extent that income of the trust was not paid across to the taxpayers, a dilemma was created, either:

(a) all the profits were distributed, but the amounts not paid remained undrawn; or

(b) only the amounts paid were distributed.

The Court preferred the second view which meant that the undistributed amounts were assessed to Nommack, the trustee of the Sydney Trust. The reason given by the Court for this conclusion is not clear, it appears that prior to any drawings by the taxpayers from the Sydney Trust, Nommack had taken no positive action inconsistent with its duty as trustee. The inference being that it only intended to distribute the amounts actually paid.

Additional Tax

The Commissioner assessed the taxpayers to penalty tax pursuant to s 226J of the ITAA 1936 at the rate of 75 percent and the Court found this justified. Sections 226G, 226H and 226J provided a graduated scheme of penalties from failing to take reasonable care to recklessness and intentional disregard of the law. The taxpayers failed to take reasonable care and were reckless in treating the distributions of income as loans.

It is important to note that the taxpayers liability for additional tax was partly caused because of the conduct of their accountant/tax agent. It was found that in relation to verifying the losses in the trust he was reckless, but in relation to the failure to disclose the "loans" as distributions of income showed intentional disregard for the requirements of the tax legislation. This resulted in an increase in the penalty from 50 percent to 75 percent.

The Court commented that although taxation legislation of this country is arcane, if not incomprehensible to most people,[9] the concept of carry forward losses is not too difficult to understand. What was difficult to understand was how a debt incurred in 1988, and never paid could give rise to substantial tax advantages in 1995 to 2002. The taxpayers should have pressed for a rational explanation rather than accepting "bland assurances".

Mrs. Weyers could not be exonerated because of lack of business experience or reliance on her husband. It was held that it is anachronistic to accept that a female's duty in relation to taxation matters is less that that of a male.

Other Matters

The Court concluded that the Commissioner did have the power to make the amended assessments outside the four year time limit because there had been an avoidance of tax and the taxpayers could not identify grounds on which this decision could be impugned. Therefore there was no ground to interfere with the exercise of the Commissioner's discretion.

The Court did not accept the Commissioner's argument that the trust cease to exist because of the lack of assets subject to trust. Even if the settled sum had been lost the trust had books of account and these constitute property.

Lessons and Conclusions

Payments to beneficiaries cannot be characterised as loans when there is no intention to repay the loan. Although it is common practice to treat such payments as loans this case highlights that they may be treated as distributions of income.

This is usually not a problem if the income of the trust has been taxed in the hands of the beneficiary and/or trustee but the problem arises in the case of a loss trust where the losses are subsequently disallowed. This may also apply to a trust that has elected to be a family trust.[10]

Loans should be documented in a loan agreement setting out the terms of the loan including whether interest is payable on the loan. The loan agreement should clearly state that there is an obligation to repay. This is, after all fundamental to the existence of a loan.

Trustees should consider from time to time whether repayment of the loan should be demanded and this should be recorded in a minute.

Where losses or deductions are disallowed, the increase in taxable income will be assessed to either:

- the beneficiary who is made presently entitled to that income by the distribution minutes; or
- the taker in default where a distribution determination has not been made; or
- the trustee of the trust.

A greater appreciation of trust law and the features of the trust relationship is required by taxpayers and advisers, particularly accountants. The fiduciary obligations imposed on trustees, the powers given in the trust deed and the legislative provisions dealing with trustees must be carefully considered.

Penalties and interest can have a severe impact. Tax agents should be aware that where they are the cause of the shortfall in tax and the associated penalty they may be liable to their client for part or all of the penalty pursuant to s 251M of the ITAA 1936.

GEORGE KOLLIOU
Lawyer
AMBRY LEGAL

Reference notes

1. *The Sydney Trust was acquired prior to the application of the trust loss provisions contained in Schedule 2F (ss 265-5 - 272-140) of the Income Tax Assessment Act 1936 ("ITAA 1936").*
2. *PPS stands for Prescribed Payments System. This was a withholding system applying to the building industry, cleaners, transport operators and motor vehicle repairers.The system was replaced with the PAYG system on 1 July 2000.*
3. *Section 51(1) of the ITAA 1936 replaced. by section 8-1 of the ITAA 1997.*
4. *(1938) CLR 179 at 207.*
5. *(1996) 70 FCR 197.*
6. *[2006] FCA 818 at paragraph 131.*
7. *See [2006] FCA 818 at paragraphs 117 to 120.*
8. *[2006] FCA 818 at paragraph 163.*
9. *[2006] FCA 818 at paragraph 157.*
10. *Schedule 2F (ss 265-5 - 272-140) of the ITAA 1936.*
11. *Each state has legislation dealing with trustee's and their responsibilities, for example in Victoria see – Trustee Act 1958 (Vic).*

AD SPACE