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Comparative analysis of trust taxation: a deep dive into Australian and Canadian regimes

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ABSTRACT

This article examines trust taxation in Australia and Canada, focusing on the Australian Income *Tax Assessment Act 1936*'s Section 97(1) and the Canadian *Income Tax Act*'s Section 94.1. It explores the Australian Carter and the Canadian Fundy Settlement cases, highlighting their implications for tax avoidance strategies. The article employs a comparative methodology to provide insights into the policy and legislative nuances shaping trust distribution taxation in these jurisdictions. The goal is to bridge traditional legal frameworks with modern fiscal challenges and inform future reforms in common-law countries.

INTRODUCTION

In the realm of common law jurisdictions, the taxation of trusts remains a complex and evolving area of legal discourse. Trusts, an ancient instrument of equity, have been adapted and reinterpreted in various legal systems to meet contemporary fiscal challenges. This article aims to provide a comprehensive analysis of trust taxation within two such jurisdictions: Australia and Canada. These nations, though sharing a common legal heritage, have developed distinct approaches to trust taxation, making them ideal subjects for comparative analysis.

Our investigation begins by acknowledging the roots of trust taxation in common law. Trusts, historically conceived within the law of equity, have journeyed through the annals of legal history, evolving from simple protective mechanisms into sophisticated tools for asset management and tax planning. This evolution, while preserving the fundamental principles of equity, has been significantly influenced by the changing dynamics of fiscal governance and policy objectives in different jurisdictions.

In this article, we aim to unravel the intricacies of how Australia and Canada have each navigated the challenges presented by trust taxation. Our focus is primarily on the legislative and judicial developments in these countries, examining how historical precedents and modern fiscal demands have shaped their respective tax regimes. This article delves into specific legislative provisions—section 97 (1) of the *Australian Income Tax Assessment Act 1936* and section 94.1 of the *Canadian Income Tax Act*—to explore their interpretation, application, and the policy motivations underlying them.

Through a comparative methodology, this article aims to provide a detailed analysis of trust taxation, juxtaposing the Australian and Canadian approaches. This comparison not only highlights the unique attributes of each system but also sheds light on the broader implications and potential lessons for other common law jurisdictions. By examining seminal court decisions and legislative amendments, we seek to understand the rationales driving the evolution of trust taxation in these two countries.

In essence, the purpose of this article is to contribute to the ongoing discourse among legal practitioners, scholars, and policymakers. It aims to bridge the gap between traditional legal frameworks and the challenges posed by contemporary fiscal realities, particularly in the realms of trust law and taxation. Our aspiration is to offer a nuanced understanding of trust taxation in Australia and Canada, providing insights that may inform future reforms in similar legal systems.

HISTORICAL CONTEXT AND EVOLUTION OF TRUST TAXATION

Trusts, sometimes falsely labelled as an old device of common law, actually originate within the law of equity. Although both law and equity were merged by the 19th century *Judicature Act*, the differences in application between the two are relevant in any discussion of trusts. While the common law tended to place stress upon the rights of the plaintiff, allowing them to recover their property, damages or debt, the law of equity was historically concerned with the duties of the defendant to refrain from doing something because of either an act or forbearance.[1] As such, trusts developed as a direct descendant of the equitable concept of 'use'. Put simply, a use allows for property to be conveyed for either a specific purpose or a specific time.[2] These devices, recognised by the Courts of Chancery (equity) but not the Courts of Common law, would be utilised to both avoid the law of primogeniture and to avoid estate taxes throughout the 15th and 16th centuries.[3] Such early trusts, or 'uses' as they were called, were such commonplace that Henry VIII passed the *Statute of Uses*, in 1536, which made the 'use' a legally enforceable device.[4] Interestingly, however, this early concept of medieval law seems to have taken on differing conceptions within the Canadian and Australian contexts which has led to differing tax treatment.

While in Canada, like Britain, the trust was historically recognised as a conduit,[5] with the trustee having no legal ownership, in Australia, introduced with the *Income Tax Assessment Act 1936* (*Australian Tax Act*), the trustee is recognised as a legal owner of a trust and tax is assessed upon legal entitlement to the assets by the beneficiaries.[6] In other words, while Canada has historically accepted the English orthodoxy of the trust, namely that a trust is merely a flow-through or conduit, the Australian example marks a legal shift. This shift, although it does not explicitly make trusts a separate legal entity, allows trusts to essentially be treated as such.[7] Although, as will be discussed later, Canada has begun to move away from the 'conduit' approach in recent years, Australian legal innovation seems to have done so long ago.

The Australian rule is not without its faults, though, and the difficulties in interpreting what constitutes 'distributable income' and 'share of distributable income', both requirements within section 97 (1) of the *Australian Tax Act*, have been marred with muddled interpretation. This was illustrated within a 2011 Consultation Paper on the subject[8] following the lack of clarity in *Minister of Taxation v. Bamford*.[9] The Consultation Paper noted that section 97(1), and the interpretation from *Bamford*, created confusion, most notably concerning which type of trusts are covered by the section and how section 97(1) interacts with other provisions of the *Australian Tax Act*.[10] Since no legislative reform came about, the continued confusion set the stage for the 2022 Australian High Court decision in the *Carter*[11] case.

THE AUSTRALIAN PERSPECTIVE: SECTION 97(1) OF THE INCOME TAX ASSESSMENT ACT, 1936

Section 97(1) of the *Income Tax Assessment Act 1936*, forms a fundamental part of Australian trust taxation law. Historically, this section was conceptualised to address the taxation of income from trusts, clarifying the responsibilities and liabilities of trustees in the process of distributing trust income. The key objective of Section 97(1) is to ensure equitable and accurate taxation of trust income, wherein trustees are liable for tax on trust income in certain scenarios, especially when beneficiaries are not presently entitled to the income or when the income is accumulated.

Over the years, the interpretation and application of Section 97(1) have evolved through legislative amendments and judicial interpretations, responding to the changing dynamics of trust structures and financial practices. This evolution reflects a balancing act between preventing tax avoidance through trusts and ensuring that trust beneficiaries are not unduly burdened by taxation rules.

The case of the *Federal Commissioner of Taxation v Carter* is instrumental in interpreting Section 97(1) within the broader context of trust distribution taxation.[12] In this landmark decision, the High Court of Australia addressed the intricacies of 'present entitlement' and its implications for the taxation of trust distributions under the *Australian Tax Act*.[13] This case revolved around the interpretation of a beneficiary's 'present entitlement' to trust income and its taxation implications.[14] The critical question was whether beneficiaries who disclaim their entitlements after the end of an income year could be considered 'presently entitled' for the purposes of taxation under the Act. The High Court's decision, affirming the beneficiaries' tax liability despite the post-year-end disclaimers, highlighted a stringent interpretation of 'present entitlement' as envisaged in Section 97 (1).

The implications of the High Court's decision in *Federal Commissioner of Taxation v Carter* are far-reaching for the taxation of trust distributions in Australia.[15] Firstly, the decision reinforces the importance of timing in the management of trust distributions and disclaimers.[16] Beneficiaries and trustees must be acutely aware of the critical dates and the legal implications of actions taken in relation to the end of the income year. The ruling emphasises that disclaimers to avoid tax

1 James Barr Ames, 'The Origin of Uses and Trusts,' *Harvard Law Review* (1908) 21:261, 261.
2 David Pinto and Stewart Karlinsky, 'Darwinian Evolution of the Taxation of Trusts: A Comparative Analysis,' *Journal of Australian Taxation* (2007) 10:251, 262.
3 ibid, 263.
4 ibid, 263, Ames, 267, 'The History of Trusts of Land,' *Law Coach* (1921) 2: 58, 59.
5 Wolfe D. Goodman, 'The Future of Taxation of Trusts,' *Canadian Tax Journal* (1970) 18 380, 380.
6 Pinto and Karlinsky, 268.
7 ibid.
8 Government of the Commonwealth of Australia, 'Modernising the taxation of trust income—options for reform,' (2011) Consultation Paper.
9 *Commissioner of Taxation v. Bamford*, [2010] HCA 10.
10 2011 Consultation Paper, 9.
11 *Federal Commissioner of Taxation v. Carter* [2022] HCA 10.
12 ibid.
13 ibid, [4].
14 ibid.
15 ibid; for a detail case analysis, see Charles Ho Wang Mak, *Federal Commissioner of Taxation v Carter [2022] HCA 10- A Game Changer for Taxation of Trust Distributions in Australia?*, Trusts & Trustees (2022) 28 (9), 886.
16 ibid.

liability must occur before the end of the relevant income year. This finding has significant implications for trust deed drafting and administration. Trustees and beneficiaries need to ensure proactive management of trust affairs to comply with the legal requirements set out in the judgment.[17]

Moreover, the decision affirms the principle that trust law and tax law are interlinked yet distinct. While trust law may allow for the retrospective effect of a disclaimer, tax law, as interpreted in this case, does not necessarily follow suit. This distinction necessitates a more integrated approach to trust management, considering both trust law principles and tax law requirements.

Furthermore, this judgement may lead to a more cautious approach in trust administration. Trustees may need to engage in more detailed consultations with beneficiaries regarding their intentions and potential disclaimers to avoid unintended tax consequences. The decision in *Federal Commissioner of Taxation v Carter* underscores the necessity for ongoing legislative clarity and reform in the area of trust taxation.[18] It highlights the complexities inherent in the intersection of trust and tax laws and the need for clear, comprehensive guidance to navigate these complexities effectively.

THE CANADIAN APPROACH: NON-RESIDENT TRUSTS AND SECTION 94.1 OF THE INCOME TAX ACT

Provisions governing non-resident trusts in Canada have existed within the *Income Tax Act* since 1972.[19] Such provisions are contained within section 94 of the act. Although, in the Canadian context, the residence of trusts have historically been determined according to common law principles,[20] such has been supplemented by provisions contained within the *Income Tax Act.* Traditionally, the residency of the trust, pursuant to these common law principles, was determined as being where the trustee resides.[21] However, the standard for determining residence of a trust has shifted as illustrated in the *Fundy Settlement*[22] case.

Therein, St Michael Trust Corp. was the trustee of two separate trusts, the Fundy Settlement, and the Summersby Settlement. These trusts disposed of shares they owned in two Ontario corporations. The purchaser of the shares remitted $152 Million to the Minister of National Revenue as Capital Gains taxes realized by the trusts on the sale of the shares.[23] In response, St Michael sought the amounts returned pursuant to the trusts being resident in Bermuda.[24] The Minister of National Revenue was of the opinion that the trusts resided in Canada and refused to return the withheld taxes on account of them being obtained lawfully.[25] The main issue in this case was how residence of a trust should be determined under Canadian law. This case was eventually appealed all the way to the Supreme Court of Canada (SCC).

The SCC determined that trusts have great similarities to corporations, and, thanks to this, the residence of a trust should be determined utilising a similar control test as does corporate law. They noted six determining factors in coming to this conclusion:

1) Both trusts and corporations hold assets that require management;
2) They both involve the acquisition and disposition of assets;
3) Both may require the management of a business;
4) They both require banking and financial arrangements;
5) Both may require the instruction of professionals, such as, lawyers accountants, etc; and
6) They both distribute income, corporations by way of dividends, trusts by way of distributions.[26]

As a result, the SCC determined that: ‘As with corporations, residence of a trust should be determined by the principle that a trust resides for the purposes of the Act where “its real business is carried on” which is where the central management and control of the trust actually takes place.’[27] By importing the corporate management and control test to trusts, St Michael was unable to have the withheld taxes returned as the trust was effectively set up to ensure that a Canadian-resident corporation would avoid paying taxes in Canada. Since the majority of both the Fundy and Summersby Settlement trusts’ activities were in Canada, they must be taxed in Canada.

Following this decision, Canadian Parliament amended section 94 of the *Income Tax Act* in 2013, by including the new section 94.1 provision. While the previous rules required that, in order for Canadian tax law to apply, there needed to be both a Canadian-resident beneficiary and a Canadian-resident contributor, the new rules require only a Canadian-resident contributor.[28] This means that the new rules would even apply when a Canadian-resident contributes property to a trust even if such is for the benefit of non-residents. This broadens the application of *Fundy Settlement*, and the previous section 94, and applies to any trust where there is either a resident beneficiary or contributor. So long as there is a connection to a Canadian resident on either side, Canadian tax law applies.

COMPARATIVE ANALYSIS: TRUSTS AS INSTRUMENTS OF TAX AVOIDANCE

Although a discussion of present entitlements and foreign trusts seems to have no commonality on its surface, in both

17 ibid.
18 *Federal Commissioner of Taxation v. Carter* [2022] HCA 10.
19 Elie Roth, ‘Canadian Taxation of Non-Resident Trusts: A Critical Review of Section 94 of the Income Tax Act,’ *Canadian Tax Journal* (2004) 52: 329, 332.
20 *Thibodeau Family Trust v. The Queen*, 78 DTC 6376 (F.C.T.D.)
21 ibid.
22 *Fundy Settlement v. Canada*, 2012 SCC 14.
23 ibid, paras. 1–2.
24 ibid, para. 3.
25 ibid, para. 4.
26 ibid, para. 14.
27 ibid, para. 15.
28 Brandon Wiener, ‘Non-resident trusts and offshore investment properties,’ *Tax Law For Lawyers* (2023: Canadian Bar Association), p. 5.

the Australian and Canadian cases, the courts utilised some degree of policy in rendering their decisions. While the Australian High Court attempted to clarify 'present entitlement' in a practical way, the Supreme Court of Canada sought to understand the practical purpose of the foreign trust scheme.

The main objective, in both cases, appears to be the minimisation of trusts as a device of tax avoidance. While Australia sought to move away from the conduit approach to taxation, likely recognising the potential for abuse in trusts, Canada sought to prevent the use of foreign-domiciled trusts in tax avoidance. Both cases also discuss the competing taxation policy goals alongside the equitable nature of trusts.

This is readily apparent in *Carter* when the Court discusses what constitutes 'presently entitled' pursuant to section 97(1). The Court's analysis decided to treat the present entitlement literally as being in the present tense.[29] This means that, in Australia, what is important is not the actual receipt of the distribution but the right to receive such a distribution.[30] This means that taxable income is to be assessed based upon what each beneficiary is presently entitled ' … just prior to midnight at the end of the year of income'.[31] The respondents argument that 'presently entitled' must be construed to be read in a manner which ' … later events could subsequently disentitle a beneficiary who was presently entitled before the end of the income year … ' was rejected on the basis that it would create uncertainty.[32] Interestingly here, while the court concluded that the question of present entitlements must be tested at the close of a taxation year, and not some reasonable time thereafter, the court also mentions that there is potential unfairness in such a result.[33] This speaks to the inherent conflict between taxation policy, which requires certainty, and trust law doctrine, which imputes equity.

The potential unfairness of the *Carter* approach was discussed in relation to the previous case law of *Bamford*[34] whereby ' … the construction that has been adopted means that a beneficiary might be presently entitled at the end of an income year but unaware of it'.[35] Nonetheless, the court in *Carter* recognised that certainty in application outweighed the desirability to achieve greater fairness in such applicable cases. As such, the court evaluated competing interests, namely certainty and fairness, and ultimately settled on certainty being the dominant interest. This was likely informed by a desire to close the ability of the flexible trust to be used as a device of tax avoidance. Similarly, the SCC, in *Fundy Settlement*, needed to reconcile the competing goals of taxation policy and trust law's inherent equity.

Fundy Settlement attempts to ascertain what is actually occurring not what is 'technically' occurring in the instance of foreign trusts. The main question in this case is what constitutes a 'person' according to section 2(1) of the *Income Tax Act*. While a trust is not technically a 'legal person' like a corporation, it can be construed as such because the ' … reference to a "person" must be read as reference to the taxpayer whose taxable income is being subject to income tax'.[36] In the case of a trust, the trust is subject to income tax and not the trustee. As such, the court determined that the ' … residence of a trust should be determined by the principle that a trust resides for the purposes of the Act where "its real business is carried on"'.[37]

Similar to the Australian *Carter* decision, the Canadian *Fundy Settlement* case is concerned that a trust should not be used as a device of tax avoidance. While equitable principles should give a great deal of flexibility to a trust as a legal device, the courts have intervened to ensure that such flexibility is curtailed in order that tax avoidance may not occur. In both cases, the courts refused to allow the trusts to be used as indefinitely flexible devices as such would allow the trusts to create uncertainty in taxation ultimately allowing such trusts to avoid taxes. While the court in *Carter* details the unfairness with its approach, the policy objective of preventing the use of trusts as devices of tax avoidance is readily apparent in both cases.

POLICY OBJECTIVES AND LEGISLATIVE NUANCES

One notable area of potential difference in the two cases is in the applicable policy standards. While the Australian *Carter* decision states that the main purposes of the requirement for a clarified standard for section 97(1) was that an alternative standard would ensure 'uncertainties' to arise which would ' … not be fair, convenient or efficient'.[38] The *Fundy Settlement* decision, on the other hand, argued that the applicability of a corporate control test for trusts would ensure ' … the important principles of consistency, predictability and fairness in the application of tax law'.[39]

While both courts are interested in fairness as an applicable policy objective in the taxation of trusts, the different competing goals in Canada and Australia perhaps warrant a more in-depth discussion. While the interpretation of the Court in *Carter* deems the Australian *Income Tax Assessment Act 1936* more concerned with convenience and efficiency, the Canadian judiciary's interpretation of the *Income Tax Act* prefers to look at whether a tax provision is consistent and predictable. While the terminology is subtly different, the question turns to whether they are realistically different. Indeed, convenience and efficiency do likely share much overlap with consistency and predictability.

A predictable result is most likely an efficient one. If the taxation provisions are predictable, they can likely be dealt with in an efficient manner. On the flip side, if the taxation provisions are meant to be predictable, they will, overtime, create a

29 *Federal Commissioner of Taxation v. Carter* [2022] HCA 10, [19].
30 ibid, 20.
31 ibid, 22.
32 ibid, 24.
33 ibid, 25–26.
34 ibid.
35 ibid.
36 *Fundy Settlement v. Canada*, 2012 SCC 14, 13.
37 ibid, 15.
38 *Federal Commissioner of Taxation v. Carter* [2022] HCA 10, 24.
39 *Fundy Settlement v. Canada*, 2012 SCC 14, 16.

certain degree of efficiency. Furthermore, a convenient result is likely to also be both efficient and predictable. However, none of these objectives relates particularly to the question of consistency.

This is interesting as the Australian case, although it did not expressly state that consistency was a goal in taxation, seem to be informed by the policy objective in the *Carter* decision. The case is ultimately concerned with preventing 'uncertainties' in the law. Since an uncertain result is inherently inconsistent from one decision to the next, it can be presumed that the search for a consistent application ultimately informed the High Court of Australia in reaching its decision. As such, it would appear that the policy goals in both cases, although stated differently, appear to be in relative alignment. This is perhaps unsurprising given the shared histories of the two jurisdictions as both are Commonwealth nations with received English common law.

IMPLICATIONS AND FUTURE DIRECTIONS

The taxation of trusts in Australia and Canada has undergone significant changes that have impacted legal professionals, policymakers, and academics. This has resulted in a complex relationship between trust and tax laws that lawyers must understand. Cases like *Federal Commissioner of Taxation v. Carter* and *Fundy Settlement v. Canada* mentioned above, illustrated the complexity of trust taxation.[40] Lawyers require proficiency in both trust law's technicalities and tax law's strategic aspects to advise on trust creation, management, and dissolution.

Policymakers must balance fairness, efficiency, and simplicity in tax law. Both jurisdictions' cases highlight the difficulties in achieving this balance. They must refine trust tax laws to minimise ambiguities and loopholes that enable tax avoidance while not overburdening legitimate trusts. The Australian and Canadian experiences offer valuable lessons in policy outcomes. One such lesson is the importance of clear, specific tax laws. Ambiguities can lead to complex disputes and unintended outcomes. Reforms should aim for precise terms and conditions, ensuring clarity for taxpayers and authorities. Balancing tax avoidance prevention and trust utility is also crucial. Reforms should avoid excessive regulation that could limit trusts' beneficial aspects, such as asset protection and estate planning. Considering trusts' unique features and varied roles, a nuanced approach is necessary.

Looking ahead, trust taxation in Australia and Canada is likely to continue evolving. In Australia, interpretation issues around present entitlement under the *Income Tax Assessment Act 1936* suggest more clarity. This might involve revisiting distributable income concepts or introducing detailed trust administration guidelines. In Canada, the trend towards treating trusts similarly to corporations, as seen in the *Fundy Settlement* case, may lead to more legislative changes. This includes addressing complexities in cross-border trusts and the impact of global mobility on trust taxation.

CONCLUSION

In conclusion, this comparative study of Australian and Canadian trust taxation regimes offers a detailed understanding of the complexities and evolution in this area. Both jurisdictions, influenced by their common law heritage, exhibit unique approaches to trust taxation, reflecting their distinct legal histories and policy objectives. Australia's focus on the concept of 'present entitlement' under section 97(1) of the *Income Tax Assessment Act 1936*, as exemplified in the *Carter* case, underscores the importance of timing and the legal status of trust distributions. The Australian approach illustrates a shift from traditional views, aiming to balance tax avoidance prevention with equitable treatment of trust beneficiaries. Conversely, Canada's interpretation of non-resident trust taxation, particularly after the *Fundy Settlement* decision and subsequent legislative amendments, as contained within section 94.1 of the *Income Tax Act*, signifies a move away from the conduit approach towards treating trusts akin to corporations. This shift, primarily aimed at preventing tax avoidance through foreign-domiciled trusts, highlights the evolving nature of trust law in response to global fiscal challenges.

AUTHOR BIOGRAPHY

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[40] *Fundy Settlement v. Canada*, 2012 SCC 14; *Federal Commissioner of Taxation v. Carter*, [2022] HCA 10.

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