HIGH COURT OF AUSTRALIA

FRENCH CJ,
GUMMOW, HAYNE, HEYDON AND CRENNAN JJ

THE COMMISSIONER OF TAXATION OF THE COMMONWEALTH OF AUSTRALIA APPELLANT

AND

GRAHAM BARGWANNA & MELINDA BARGWANNA AS TRUSTEES OF THE KALOS METRON CHARITABLE TRUST RESPONDENTS

Commissioner of Taxation v Bargwanna [2012] HCA 11
29 March 2012
S284/2011

ORDER

1. *Appeal allowed and the respondents' application for special leave to cross-appeal dismissed.*

2. *Set aside orders 2 and 3 of the orders of the Full Court of the Federal Court of Australia made 17 February 2011 and in place thereof order that the appeal to that Court be dismissed.*

3. *The appellant pay the respondents' costs in this Court.*

On appeal from the Federal Court of Australia

Representation

D M J Bennett QC with K J Deards for the appellant (instructed by Maddocks Lawyers)

D B McGovern SC with J Horowitz for the respondents (instructed by Charles Hockey Solicitor)

CATCHWORDS

Commissioner of Taxation v Bargwanna

Taxation – Income tax – Exemption from income tax under Div 50 of *Income Tax Assessment Act* 1997 (Cth) – Charitable purpose – Whether fund was applied for the purposes for which it was established – Whether application of fund viewed as a whole sufficient to qualify for exemption.

Trusts – Trustees – Charitable trust – Breaches of trust – Mingling of trust monies with other monies – Use of trust monies by trustees in their personal capacity – Relevance of success on possible application under s 85 of *Trustee Act* 1925 (NSW).

Words and phrases – "charitable trust", "income tax exemption", "misapplication of trust monies", "purposes for which it was established".

Income Tax Assessment Act 1997 (Cth), Div 50.
Trustee Act 1925 (NSW), s 85.

1 FRENCH CJ, GUMMOW, HAYNE AND CRENNAN JJ. The respondents, Mr and Mrs Bargwanna, are husband and wife who reside in New South Wales and were, at all material times, the trustees of a deed executed on 14 October 1997 ("the Deed"). The Deed was an instrument of thirteen clauses. Clause 3 stated that the trustees hold "the Trust Fund", being the trust assets and the income thereof, "in trust for such public charitable purposes as [they] shall from time to time determine". The trusts of the Deed were styled the "Kalos Metron Charitable Trust" ("the Trust").

2 Clause 12 of the Deed was expressed in terms having the effect of selecting the law in force in New South Wales as the proper law. Further, the evidence shows that the seat of the administration of the Trust was in that State.

3 Between 2003 and 2007 the trustees distributed a total of $293,914.55 to numerous charitable causes.

4 This litigation concerns the construction and operation of Div 50 of Pt 2-15, headed "Exempt income", of the *Income Tax Assessment Act* 1997 (Cth) ("the Act"). The dispute begins with the application made on 22 November 2004 for endorsement by the appellant ("the Commissioner") of the Trust with effect from 1 July 2000, as "a fund established in Australia for public charitable purposes by ... instrument of trust". The endorsement would qualify the Trust as an entity exempt from income tax, within the operation of Div 50 of Pt 2-15, but the exemption from income tax would only apply if "the fund is applied for the purposes for which it was established" (s 50-60). It is important to note that income tax is payable in respect of each income year (ss 3-5, 4-10), so that the existence of an exemption will fall annually for consideration and application.

5 The endorsement application made in November 2004 was refused and on 13 January 2005 the Commissioner wrote advising of that decision. An objection was disallowed by the Commissioner on 9 September 2005. On an application to the Administrative Appeals Tribunal (Mr PW Taylor SC) ("the AAT") for review of that decision, the Commissioner contended that between 2002 and 2007 there had been a number of applications of the assets of the Trust (called "the Fund") which were not for the purposes for which it was established. However, that application was successful. On 7 April 2008, the AAT gave detailed reasons for setting aside the disallowance decision of the Commissioner of 9 September 2005 and substituting a determination that, as at 9 September 2005, the Fund was entitled to endorsement as exempt from income tax with effect from 1 July 2000.

The administration of the Trust

6 An appreciation of the issues arising under the Act is assisted by consideration of the matters of general law, concerning in particular the administration of charitable trusts, which are engaged by those issues of revenue law.

7 First, it may be observed that in many respects the administration of a charitable trust does not differ from that of a private trust. A critical distinction is that a trust for charitable purposes lacks the individual beneficiaries who commonly hold the beneficial interest in the trust assets.

8 When delivering the reasons of the Privy Council in *Latimer v Commissioner of Inland Revenue*[1] Lord Millett stated the following "general principles" respecting charitable trusts:

> "It is of the essence of a charitable trust that it is a trust for the promotion or advancement of social purposes rather than a trust for individual beneficiaries. Of course, individuals may benefit from the application of trust moneys, but they are not, as individuals, the beneficiaries of the trust and may not enforce its terms. If the purposes of the trust are charitable, they may be enforced by the Attorney-General; if they are not charitable then, with certain anomalous exceptions, they are not enforceable and the trust is not valid. Whether the purposes of the trust are charitable does not depend on the subjective intentions or motives of the settlor, but on the legal effect of the language he has used. The question is not, [w]hat was the settlor's purpose in establishing the trust? [B]ut, [w]hat are the purposes for which trust money may be applied?"

9 The reference to enforcement by the Attorney-General requires some qualification with reference to the statute law of New South Wales. Proceedings with respect to an alleged breach of charitable trust or its administration may be brought by the Attorney-General, with or without a relator, or by another authorised person, as provided by s 6 of the *Charitable Trusts Act* 1993 (NSW) ("the Charitable Trusts Act").

10 In considering the issues of revenue law on this appeal, it is particularly important to note that general principles of trust law obliged the respondents as

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1 [2004] 3 NZLR 157 at 168 [24]; [2004] 1 WLR 1466 at 1475; [2004] 4 All ER 558 at 567.

trustees strictly to conform to and carry out the terms of the Deed[2]. In the exercise of their powers of administration, the trustees were obliged to act with the care which an ordinary prudent man of business would take[3]. The respondents also were under a duty to keep the property comprising the Trust Fund distinct from their own property and from property which was held on other trusts; by mingling trust funds with other property they become more difficult to trace and identify and are subjected to risks of loss to which they otherwise would not be subjected[4]. Power to mix trust property with other property may be given by statute (exemplified by legislation permitting solicitors in specified circumstances to mix trust money with other money[5]) or by the terms of the trust. No such power applied here. In particular, the terms of the Deed, although widely drawn, did not authorise the admixture of trust funds.

11 In *Scott v National Trust for Places of Historic Interest or Natural Beauty*[6], Robert Walker J said of the duties of trustees:

> "They must inform themselves, before making a decision, of matters which are relevant to the decision. These matters may not be limited to simple matters of fact but will, on occasion (indeed, quite often) include taking advice from appropriate experts, whether the experts are lawyers, accountants, actuaries, surveyors, scientists or whomsoever. It is however for advisers to advise and for trustees to decide: trustees may not (except in so far as they are authorised to do so) delegate the exercise of their discretions, even to experts."

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2 Thomas and Hudson, *The Law of Trusts*, 2nd ed (2010), at §10.08.

3 *Fouche v The Superannuation Fund Board* (1952) 88 CLR 609 at 641; [1952] HCA 1; *Youyang Pty Ltd v Minter Ellison Morris Fletcher* (2003) 212 CLR 484 at 500 [38]-[39]; [2003] HCA 15.

4 *Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd (In liq)* (2000) 202 CLR 588 at 605 [34]; [2000] HCA 25; *Scott and Ascher on Trusts*, 5th ed (2007) at §17.11.1.

5 See, *Legal Profession Act* 2004 (NSW), s 260; *Legal Profession Act* 2004 (Vic), s 3.3.19; *Legal Profession Act* 2007 (Q), s 257; *Legal Practitioners Act* 1981 (SA), s 31(6)(a); *Legal Profession Act* 2008 (WA), s 224; *Legal Profession Act* 2007 (Tas), s 251; *Legal Profession Act* 2006 (ACT), s 228; *Legal Profession Act* (NT), s 253.

6 [1998] 2 All ER 705 at 717.

12 Part 2, Div 2 (ss 14-63) of the *Trustee Act* 1925 (NSW) ("the Trustee Act") contains various provisions respecting investments which applied subject to the terms of the Deed. Section 63 enabled the respondents as trustees to apply to the Supreme Court for an opinion, advice or direction on any question respecting the management or administration of the trust property, or respecting the interpretation of the Deed.

13 Clauses 4 and 5 of the Deed conferred widely expressed powers of investment. Clause 6 stated that every discretion and power conferred on the trustees "shall be an absolute and uncontrolled discretion or power". Clause 6 further provided that no trustee is to be held liable for any loss or damage accruing as a result of concurring in any exercise of any such discretion or power. But "trustee exemption" clauses of this nature are to be construed no more widely than their language on a fair reading requires[7]. The statement of intent in cl 4 that the trustees were to have the same powers in all respects "as if they were absolute owners beneficially entitled", must be read as subject to the requirement in cl 3 that the trustees hold the Trust Fund for those "public charitable purposes" which the trustees determine from time to time. Likewise the reference in cl 6 to the absolute and uncontrolled discretions and powers of the trustees should be read in the light of authorities which treat such apparently unconfined discretions and powers as not extending to alteration of the substratum of this trust for charitable purposes[8].

14 The personal liability as trustees to which the respondents were exposed was mitigated by the power conferred by s 85 of the Trustee Act upon the Supreme Court wholly or partly to relieve trustees of personal liability for breach of trust where it appeared to the Court that they had "acted honestly and reasonably" and that they "ought fairly to be excused"[9]. However, it is desirable

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7 *Walker v Stones* [2001] QB 902 at 941; Underhill and Hayton, *Law of Trusts and Trustees*, 18th ed (2010) §48.64-48.67; Thomas and Hudson, *The Law of Trusts*, 2nd ed (2010) at §21.41-21.49.

8 See the analysis of the authorities by Hely J in *Cachia v Westpac Financial Services Ltd* (2000) 170 ALR 65 at 82-83.

9 See *Maguire v Makaronis* (1997) 188 CLR 449 at 473-474; [1997] HCA 23; *Youyang Pty Ltd v Minter Ellison Morris Fletcher* (2003) 212 CLR 484 at 498 [33]; *Macedonian Orthodox Community Church of St Petka Inc v His Eminence Petar the Diocesan Bishop of The Macedonian Orthodox Diocese of Australia and New Zealand* (2008) 237 CLR 66 at 81-83 [33]-[36]; [2008] HCA 42.

that trustees in doubt as to a course of action should seek judicial advice under s 63 rather than proceed and then seek relief under s 85[10].

The facts

15 The moneys comprising the Trust Fund were held in two bank accounts which may be identified as "the MLC cash management account" and "the David Craik and Co Trust Account" ("Mr Craik's Trust Account").

16 Mr David Craik is the father of Mrs Bargwanna. He conducted at Chatswood a practice as a chartered accountant under the style "David Craik & Co". Mr Craik advised the trustees concerning the affairs of the Trust, performed administrative functions in that regard, and was the principal benefactor of the Trust. In 2002 he settled $160,000 upon the Trust. Subsequently, the Trust received $547,198. This included $509,000 generated by the provision of accounting services by Mr Craik pursuant to an arrangement whereby his fees for services were paid by the client not to Mr Craik personally but into Mr Craik's Trust Account. The balance of $38,198 was investment income.

17 The exemption was sought with effect from 1 July 2000, but the Commissioner relies upon various acts of maladministration of the Trust between 2002 and 2007. In particular, over this period Trust moneys were paid into Mr Craik's Trust Account where, in breach of trust, they were mixed with moneys held by him on behalf of others. Moreover, the interest generated by this mixed account was credited not to clients but to a separate bank account. This separate account was described by Mr Craik as his "practice account", which provided him with a means of defraying the costs of maintaining his trust account and its related requirements. The AAT accepted that there was a "standard arrangement" with clients that this interest was foregone by them. The evidence did not specify the amount of interest generated by the funds in Mr Craik's Trust Account to which the Trust was entitled but which was foregone in this way. However, as the Commissioner submits, it cannot have been insubstantial.

18 Further, in March 2004, the respondents in their personal capacities obtained a housing loan from a bank. As partial consideration for that advance, the sum of $210,000, which at the time represented almost half of the net assets of the Trust, was transferred by the respondents into a non-interest bearing

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10 *Macedonian Orthodox Community Church of St Petka Inc v His Eminence Petar the Diocesan Bishop of The Macedonian Orthodox Diocese of Australia and New Zealand* (2008) 237 CLR 66 at 83 [36].

account with the bank which was maintained by the respondents in their personal capacity; by this means the interest on the housing loan was reduced. The respondents made payments into this account from other sources, but, overall, the sums withdrawn from the account exceeded the total of those other payments, the excess representing assets of the Trust. Late in the piece, in June 2007, Mr Craik credited to the Trust ledger account some $40,954, which he regarded as representing a "shortfall" in the assets of the Trust. In September 2007 he paid a further $6,706.22 into the Trust bank account as "compensation".

19 The AAT held that these activities of Mr Craik manifested "the basic and dominant" purpose of pursuing those of the Trust and that the administration of the Trust "in a real sense" was conducted for those purposes. The AAT found that there was no evidence that the respondents, as trustees of the Trust, authorised, condoned, suspected or even contemplated "the kinds of accounting irregularities the evidence revealed", albeit "they typically acted on the accountant's advice and recommendations". Further, the AAT held that within the meaning of s 50-60, there would be an application for the purposes for which the Trust was established if the Trust was administered "substantially in accordance with its constituent terms". This, as the Commissioner correctly submits in this Court, was an error of law which coloured the fact finding by the AAT.

The litigation

20 An "appeal" by the Commissioner under s 44 of the *Administrative Appeals Tribunal Act* 1975 (Cth) to the Federal Court (Edmonds J)[11] succeeded and the decision of the Commissioner rejecting the endorsement application was reinstated. The only live issue before Edmonds J had been whether the AAT had erred in concluding that the Fund was applied for the purposes for which it was established, within the meaning of s 50-60 of the Act. His Honour held that the AAT had erred in the test it applied in determining the issue under s 50-60. However, the Full Court (Dowsett, Kenny, Middleton JJ) allowed an appeal by the respondents[12]. It is against that decision of the Full Court that, by special leave, and upon an undertaking not to seek to disturb the costs order made by the Full Court and to pay the costs of the respondents in this Court, the Commissioner appeals to this Court. The Commissioner seeks the restoration of the orders of Edmonds J and thus of the refusal of the exemption endorsement.

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11 (2009) 72 ATR 963.

12 (2010) 191 FCR 184.

21 The Full Court remitted the proceedings to the AAT for determination of such further facts as it deemed necessary. In this Court the respondents seek special leave to cross-appeal against that remitter order and to achieve a result that the litigation is at an end by dismissal of the appeal from the AAT. However, if the Commissioner succeeds in this Court, no occasion to entertain the proposed cross-appeal will be presented and the application should be dismissed.

The legislation

22 In Div 50 of Pt 2-15 of the Act, a distinction is drawn between the establishment by will or instrument of trust of a fund for charitable purposes, and the actual application thereafter of the fund for those purposes. It is with this latter requirement that the appeal is concerned.

23 The relevant effect of s 50-1 and Item 1.5B of s 50-5 (which are found in Sub-div 50-A headed "Various exempt entities") is that the total ordinary income and statutory income of an "exempt entity", being a "fund established in Australia for public charitable purposes by will or instrument of trust", is exempt from income tax. The exemption conferred by these provisions is subject to two special conditions. First, the entity is not exempt from income tax unless it is endorsed by the Commissioner as so exempt under Sub-div 50-B. Section 50-52 so provides. Secondly, there is no exemption "unless the fund is applied for the purposes for which it was established". Section 50-60 so states.

24 When dealing with an application, the Commissioner may request the applicant to give specified information and documents (s 50-120(1)). The Commissioner must endorse an entity as exempt from income tax if it is so entitled and has applied for endorsement (s 50-105). To be entitled it was necessary that the Trust be "covered" by Item 1.5B as described above, and that the two special conditions described above be satisfied (s 50-110).

25 An endorsement has effect from a date specified by the Commissioner. This may be a date preceding that of the application (s 50-130), a matter reflected in the present case in the terms of the decision of the AAT set out above[13].

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13 At [5].

26 An unsuccessful applicant may object against the refusal in the manner set out in Pt IVC of the *Taxation Administration Act* 1953 (Cth). This was the path to the AAT in the present case.

27 The Commissioner may revoke, from a day specified by the Commissioner, an endorsement if (a) the entity "is not entitled to be endorsed as exempt from income tax", or (b) the entity has failed to provide information or a document which is relevant to its entitlement to endorsement and which has been requested by the Commissioner (s 50-155).

Earlier legislation

28 Provisions in revenue law such as s 50-60 of the Act have a lengthy provenance. The effect of Sched C to s 88 of the *Income Tax Act* 1842 (UK)[14] was to confer upon charitable institutions and charitable trusts exemptions from income tax. In particular, the third paragraph of Sched C spoke of stock or dividends:

> "which according to the Rules or Regulations established by ... Deed of Trust, or Will, shall be applicable ... by any Trustee, to charitable Purposes only, and in so far as the same shall be applied to charitable Purposes only".

It will be seen that the distinction was drawn here between the terms of the deed of trust or will and the application thereafter of the fund to charitable purposes. Both conditions had to be satisfied to enliven the exemption from income tax. It has long been established that a provision in a will or settlement for the "application" of moneys to a designated end requires that the moneys be devoted to or employed for that special purpose[15].

29 In Australia, s 11(1)(f) of the *Income Tax Assessment Act* 1915 (Cth), as amended by s 4 of the *Income Tax Assessment Act (No 2)* 1916 (Cth), conferred an exemption upon:

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14 5 & 6 Vict c 35.

15 *Williams v Papworth* [1900] AC 563 at 567; *Davies v Perpetual Trustees Executors and Agency Co of Tasmania Ltd* (1935) 52 CLR 604 at 608; [1935] HCA 26. See also *Flynn v Commissioner of Stamp Duties (NSW)* [1975] 1 NSWLR 208 at 211.

> "... the income of a fund established by any will or instrument of trust for public charitable purposes if the Commissioner is satisfied that the fund is being applied by the trustees to public charitable purposes".

This formulation of the exemption presented questions of construction of the phrase "is being applied". In *Trustees, Executors and Agency Co Ltd v Acting Federal Commissioner of Taxation*[16] the Commissioner submitted the fund was not so applied if the income was being accumulated rather than *expended* for charitable purposes.

30 A submission along these lines was unsuccessfully put to the AAT by the Commissioner, but was not renewed in this Court. As Dixon and Evatt JJ pointed out in *Attorney-General (NSW) v Perpetual Trustee Co (Ltd)*[17], the purpose of a charitable trust most usually does not involve the expenditure or consumption of *corpus*. The Commissioner now accepts that a fund may be "applied" for charitable purposes without immediate expenditure of income as it is derived. Rather, on the present appeal the Commissioner directs attention to what is required for due administration of the trust.

31 To the submission in *Trustees, Executors* Isaacs J responded that[18]:

> "a distinction is made between the 'income' and the 'fund', and 'applied' is attached to 'fund' and not to 'income'. Further, the words are 'the fund is being applied' – not simply 'applied'. I agree that some elasticity must be given to the phrase."

His Honour continued:

> "[I]f a fund were established to purchase radium for free curative purposes, and if it were found that (say) £20,000 were required as a minimum, but the fund could accumulate only at the rate of £5000 a year, and the Commissioner were satisfied that each year's income was deposited in a bank for the special purpose of getting together £20,000, and buying the radium, he could well say he was satisfied the fund was 'being applied' to the charitable purpose."

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16 (1917) 23 CLR 576 at 580; [1917] HCA 56.

17 (1940) 63 CLR 209 at 223; [1940] HCA 12.

18 (1917) 23 CLR 576 at 586-587; [1917] HCA 56.

This, Isaacs J indicated, was an example of the "elasticity" which was to be given to the expression in s 11(1)(f), "the fund is being applied". But it may be assumed that in the example given the accumulation of income to provide the fund to purchase the radium was not in breach of the terms of the trust.

32 However, the reasons given by the AAT relied upon the notion of "elasticity" used by Isaacs J in the above case, and in this Court counsel for the respondents referred to its adoption by Owen J at first instance in *Mahoney v Commissioner of Taxation*[19].

33 It was a requirement for the exemption provided by s 23(j) of the *Income Tax Assessment Act* 1936 (Cth) ("the 1936 Act") that a provident, benefit or superannuation fund established for the benefit of employees "is being applied for the purpose for which it was established". Section 23(j) was considered by Owen J in *Mahony* and on appeal by Kitto J, Taylor J and Windeyer J[20]. What is of significance for present purposes is the statement by Windeyer J[21]:

> "The statutory requirement that the fund 'is being applied' for the purposes for which it was established was the subject of some discussion during the course of the argument. It does not cause me any great difficulty in this case. If a fund answering the statutory description was not being administered according to the trusts thereof, the statutory requirement of due application would not be met."

34 In *Compton v Federal Commissioner of Taxation*[22], another case concerning s 23(j) of the 1936 Act, Kitto J questioned whether "the purpose which governed the application of the fund throughout the relevant years [of income] was not rather the purpose of benefiting the Comptons as individuals than the purpose of providing them with superannuation as employees". The Comptons were directors of a family company and trustees of a superannuation fund to which (on other grounds) it was held s 23(j) did not apply.

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19 (1965) 39 ALJR 62 at 63-64; [1966] ALR 888.

20 (1967) 41 ALJR 232.

21 (1967) 41 ALJR 232 at 238. See also the remarks of Taylor J at 237.

22 (1966) 116 CLR 233 at 246-247; [1966] HCA 1.

The decision of the Full Court

35 The conclusions reached by the Full Court respecting the contravention of s 50-60 resemble those of the AAT. The Full Court approached the case on the footing that "[i]t seems unlikely that the purpose of s 50-60 is to deny a fund its exempt status merely because a trustee is inept or makes a mistake", although deliberate misapplication, in the sense of intending to breach the trust, "may justify adverse inferences as to the transaction in question and other transactions". Their Honours considered that the primary judge had erred in finding non-compliance with s 50-60 without treating the explanations of the trustees as relevant and "without regard to the administration of the Fund as a whole"[23].

36 The Full Court[24] also referred to a passage in the joint reasons in *Federal Commissioner of Taxation v Word Investments Ltd*[25] in which there was consideration of the distinction drawn in the exemption provisions between a "charitable institution" on the one hand (the provisions in issue in *Word Investments*) and on the other those dealing with a "fund" or "trust" (the provisions in issue on this appeal). The distinction explained why in the latter, but not the former, class of case the requirement "applied for the purposes for which [the fund or trust] was established" was necessary; if a body answered the requirements for a "charitable institution" its assets would be being applied for charitable purposes.

37 The Commissioner correctly submitted on the present appeal, what was said in *Word Investments* respecting charitable institutions provided no support for the proposition derived by the Full Court respecting the administration of trust funds. This proposition was[26] that "a discrete breach of trust" which involves only part of the trust assets does not fail the requirement in s 50-60 that the fund be "applied for the [charitable] purposes for which it was established" and that misapplication of the fund "as a whole" is needed for there to be failure to meet that requirement.

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23 (2010) 191 FCR 184 at 210 [72].

24 (2010) 191 FCR 184 at 207-208 [59]-[63].

25 (2008) 236 CLR 204 at 236-237 [70]; [2008] HCA 55.

26 (2010) 191 FCR 184 at 208 [63].

The contentions in this Court

38 The respondents submitted that the exemption provisions of Div 50 of Pt 2-15 of the Act with which this appeal is concerned should be interpreted "generously", that is to say to favour the interests of those claiming exemption. This was said to be so because "[c]harity [is] involved". The phrase is that of Barwick CJ in *Ryland v Federal Commissioner of Taxation*[27]. The general law favours the advancement of charitable purposes in various respects so as, for example, to permit perpetual duration[28] and to provide for *cy-près* schemes[29]. But this state of the general law provides no ground for some special rule of construction of the revenue law.

39 The Commissioner points to the use elsewhere in Subdiv 50-A[30] of adverbs such as "principally" or "substantially" and to their absence from the opening words of s 50-60 which are critical for this case. Further, the Commissioner correctly submits that the evident purpose of s 50-60 in conferring an exemption from income tax in respect of "a fund" established in Australia for public charitable purposes is not promoted by a construction of s 50-60 which accepts that the exemption applies even if a significant part of the assets of that fund has been put towards extraneous purposes.

40 Further, the use of the term "a fund" in s 50-60 emphasises the legislative requirement of a discrete entity in respect of which the exemption is to apply; this intersects with the requirement of trust law referred to earlier in these reasons[31] that trust funds be kept distinct from other property.

41 The Commissioner, again correctly, accepts that not all acts or omissions giving rise to maladministration of a trust for charitable purposes will have the

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27 (1973) 128 CLR 404 at 411; [1973] HCA 33. See also the remarks of Webb J in *Lloyd v Federal Commissioner of Taxation* (1955) 93 CLR 645 at 665; [1955] HCA 71.

28 *In re Tyler; Tyler v Tyler* [1891] 3 Ch 252 at 257, 259; Dal Pont, *Law of Charity*, (2010) at §6.9-6.11.

29 *Attorney-General (NSW) v Perpetual Trustee Co (Ltd)* (1940) 63 CLR 209 at 216, 219, 224.

30 Sections 50-55(a), 50-65(a), 50-70(a) and 50-60(a).

31 At [10].

result of denying entitlement to exemption under Div 50 of Pt 2.15 of the Act. For example, the trustees may make an unauthorised investment and so be in breach of trust, but still will hold that investment for trust purposes. Further, the Commissioner accepts that allowance may be made for *de minimis* misapplications of the Trust Fund. In other cases, if there be maladministration of the fund whereby it loses its distinct identity by admixture with other funds, or whereby benefits are derived personally by the trustees or a third party, there is an intersection between the concept of breach of trust and the statutory criterion of application for charitable trust purposes. Where there is misapplication of this nature, it is no answer that upon a proceeding under the Charitable Trusts Act against the trustees for breach of trust, the trustees may have been able to obtain absolution under s 85 of the Trustee Act as having acted honestly and reasonably, and as trustees who ought fairly to be excused.

42 These submissions should be accepted.

Conclusions

43 The relevant provisions of the Act direct attention to the terms of the instrument of trust by which a fund is established in Australia for public charitable purposes. It would appear that too little attention to the terms of the Deed was paid in submissions to the AAT, and to Edmonds J and then to the Full Court. It is by reference to those terms and to the general provisions of the law of trusts that it will be determined whether in a period under consideration by the Commissioner the fund the subject to the charitable trusts of the deed has been duly administered.

44 The terms of s 50-60 of the Act require that this fund be "applied" for those purposes. That term is used in the sense of so administered as to give effect to the trusts established by the relevant instrument. Not all breaches of trust will deny the conclusion that the fund nevertheless has been applied for the relevant "public charitable purposes". But, on the other hand, and contrary to the reasoning of the Full Court, upon which the respondents relied, the term "applied" is not to be understood as if s 50-60 used such an expression as "substantially applied" or "on the whole, applied". The taxpayer seeks to gain a valuable benefit through establishment of exempt status.

45 In the present case, as Edmonds J held, there was misapplication of the funds of the Trust by admixture with other funds in Mr Craik's Trust Account, coupled with the failure of the respondents to obtain interest upon those moneys, together with, by means of the interest off-set account, the reduction in the interest payable by the respondents in their personal capacity upon their home

loan. None of these acts of maladministration were referable to the carrying out of the charitable purposes for which the Deed provided.

46 The acts of maladministration of the Trust occurred over the period between 2002 and 2007. The respondents sought exemption in respect of the period beginning 1 July 2000. It was an error for the AAT to substitute a determination that as at 9 September 2005 there was an entitlement to endorsement. The application was correctly refused by the Commissioner. In doing so, it was appropriate to have regard to the whole of the evidence in refusing to grant under s 50-130 any endorsement from a date, 1 July 2000, which preceded the application date of 22 November 2004.

Orders

47 The appeal should be allowed and the respondents' application for special leave to cross-appeal should be dismissed. Orders 2, and 3 of the orders of the Full Court made 17 February 2011 should be set aside, and in place thereof the appeal to the Full Court should be dismissed. The costs of the respondents of the appeal to this Court should be paid by the appellant, in accordance with the terms of the grant of special leave.

48 HEYDON J. Clause 3 of the Deed creating the Kalos Metron Charitable Trust provided: "The Trustees shall stand possessed of the Trust Fund and the income thereof IN TRUST for such public charitable purposes as the Trustees shall from time to time determine." Section 50-60 of the *Income Tax Assessment Act* 1997 (Cth) provides, inter alia, as follows: "A fund covered by item … 1.5B is not exempt from income tax unless the fund is applied for the purposes for which it was established". The reference is to item 1.5B in the table in s 50-5. Relevantly, item 1.5B is: "fund established in Australia for public charitable purposes by … instrument of trust".

Procedural background

49 The trustees of the Kalos Metron Charitable Trust are the respondents in this Court. They applied for the endorsement of the Kalos Metron Charitable Trust as a tax-exempt entity. The Commissioner of Taxation decided to refuse that application, and disallowed an objection to that decision. The reason was non-compliance with s 50-60. The Administrative Appeals Tribunal reversed that decision on the ground that there had been compliance. The Federal Court of Australia (Edmonds J) set aside the Tribunal's decision. The Full Court of the Federal Court of Australia allowed the trustees' appeal. The Commissioner now appeals to this Court.

The key events

50 The Commissioner in this Court pressed two points.

51 The trustees of the Kalos Metron Charitable Trust, acting in their personal capacities, borrowed $210,000 from a bank. This was referred to as the "loan account". At the same time $210,000 was paid into an "interest offset account" with the same bank. That sum came from the Trust Fund. It formed a substantial fraction of it. Mr Craik, adviser to the trustees, gave evidence that any money in the interest offset account reduced the amount of interest payable on the balance of the loan account.

52 Edmonds J made the following findings[32]:

> "It is not in dispute that the substantive economic effect of [the interest offset account], by reason that it was non-interest bearing, was to reduce the interest payable by the respondents to the [bank] on their home loan by an amount referrable to the balance of the interest offset account for the time being and from time to time. The … trustees … did not pay interest

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32 *Commissioner of Taxation v Bargwanna as Trustee of the Kalos Metron Charitable Trust* (2009) 72 ATR 963 at 973 [33].

> to the [Trust Fund], either concurrently with the effective reduction of their interest liability to the bank or, it seems, at any time afterwards. Compensation to the [Trust Fund] for the interest foregone was effected by and through the instrumentality of Mr Craik. But this does not, in my view, cure the misapplication of the [Trust Fund's] funds to purposes other than purposes for which the [Trust Fund] was established."

53 In this Court, the trustees admitted that the first sentence in that passage was correct. They endeavoured, at length, to explain away the second sentence. But they did not succeed. The third sentence is correct. So is the fourth.

54 The Commissioner also relied on a second point. It centred on a breach of trust. The breach of trust was the placing of the Trust Fund in the trust account of Mr Craik's practice. This intermingled it with monies held on behalf of other clients, himself, his wife and companies controlled by him. The Trust Fund earned no interest while in the trust account. In response, the trustees argued that a breach of trust does not necessarily result in non-compliance with s 50-60. The trustees also claimed that only a small amount of interest had been lost.

55 It is not necessary to consider the merits of the second point. The quoted findings of Edmonds J were sufficient to justify his conclusion that s 50-60 had not been complied with. Part of the Trust Fund had been applied for purposes other than those for which it had been established. It followed that it could not be said that "the fund [had been] applied" for those purposes. Part had been. But part had not.

The construction of s 50-60

56 The Tribunal found that the Kalos Metron Charitable Trust had been administered "substantially" in accordance with its terms. The Full Court essentially adopted the same approach, for it said that s 50-60 did not address "individual misapplications of parts of the fund" and that it was necessary to have regard to the administration of the Trust Fund "as a whole"[33]. The trustees supported that latter test. However, s 50-60 contains no qualifications of these kinds. In that regard it stands in sharp and significant contrast with other provisions which use the word "principally" (cf ss 50-50(a), 50-55(a), 50-60(a) and (c), 50-65(a) and 50-70(a)). Section 50-60 contains no qualifications relating to quantum. It says nothing about the frequency of non-compliance. It does not speak of whether the trustees or their agents were conscious of a breach of trust. It does not refer to whether the intention of the trustees or their agents was to apply the fund for trust purposes. It does not turn on whether attempts, even

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33 *Bargwanna v Federal Commissioner of Taxation* (2010) 191 FCR 184 at 209-210 [69]-[72].

successful attempts, to repay any funds wrongly applied were later made. The statutory language is unqualified. It unequivocally supports Edmonds J's approach.

57 There is a further reason for accepting the conclusions of Edmonds J. The claim that the Kalos Metron Charitable Trust was exempt from income tax depended on its being a fund "covered by item … 1.5B". For the trust to fall within item 1.5B it was necessary for it to have been established for public charitable purposes, and for no other purpose[34]. It would be extraordinarily anomalous if the Trust Fund could obtain exemption from income taxation if, although the *purposes* of the Trust Fund had to be solely charitable, its *application* was not solely for those charitable purposes. Item 1.5B funds are not exempted from income tax because they were *established* for certain favoured purposes. They are exempted because they are *applied* for those purposes and only for those purposes – not partly for those purposes and partly for the purpose of benefiting trustees or their associates. The function of s 50-60 is not to encourage aspirational purposes merely, but to secure, as a practical matter, the benefits at which the favoured purposes are directed. This extraordinary anomaly demonstrates the incorrectness of the trustees' construction. Indeed, it positively supports the construction advanced by the Commissioner of Taxation.

58 It is necessary to deal with two particular arguments of the trustees.

59 The trustees relied on *Federal Commissioner of Taxation v Word Investments Ltd*[35]. Nothing in that authority supports the trustees' proposition that a failure to apply a part of the Trust Fund to public charitable purposes is compatible with tax-exempt status under s 50-60. It is equally true that nothing in it supports the Commissioner's submissions about s 50-60. The question in the present case was not before the Court in the *Word Investments* case.

60 The trustees also submitted that s 50-60 should be given a "liberal construction". They relied on what Barwick CJ said about legislation conferring an exemption from estate duty: "Charity being involved, generosity rather than pedantry is called for in the construction of the section"[36]. Whatever status that

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34 *Compton v Federal Commissioner of Taxation* (1966) 116 CLR 233 at 248; [1966] HCA 1; *Mahony v Commissioner of Taxation (Cth)* (1967) 41 ALJR 232 at 235; and *Driclad Pty Ltd v Federal Commissioner of Taxation* (1968) 121 CLR 45 at 67; [1968] HCA 91.

35 (2008) 236 CLR 204 at 236-237 [70]; [2008] HCA 55.

36 *Ryland v Federal Commissioner of Taxation* (1973) 128 CLR 404 at 411; [1973] HCA 33.

observation has as a canon of construction outside its particular context, it must yield to the clear words of s 50-60.

61 The trustees referred to the width of the investment clause in the Trust Deed (cl 4), but did not rely on it as a conclusive answer to the Commissioner's case. Nor did they rely on the supposedly absolute and uncontrolled discretions conferred on the trustees (cl 6). They were correct not to do so. Wide powers of investment and wide discretionary powers will not cause application of part of the Trust Fund to purposes other than public charitable purposes to meet the terms of s 50-60. They relate to the techniques by which purposes may be achieved. They do not widen the purposes themselves.

Problems which do not now arise

62 There may be difficult problems to be solved in relation to s 50-60. A problem would arise where funds are inadvertently misapplied (as where a bank makes a slip in carrying out a direction and pays trust monies into the wrong account). Another problem might arise where the funds not applied to the correct purposes are trivial in amount, either relatively to the total funds or in absolute terms. Another problem might arise where any error in application of trust funds was speedily corrected. No doubt there are other possible problems. But the circumstances under consideration in this appeal do not raise these problems. They may be put aside until a particular controversy requires their solution.

The mental state of the trustees and Mr Craik

63 It should be noted that the Commissioner accepted at all stages in this protracted litigation that the misapplication of the Trust Fund was not deliberate in the sense that the trustees or Mr Craik were conscious that the intermingling was in breach of trust or that the interest offset account conferred a benefit on the trustees in breach of trust. It should also be noted that most of the Trust Fund derived from Mr Craik's generosity. These circumstances are, however, irrelevant to the construction of s 50-60.

Orders

64 The appeal should be allowed. The application for special leave to cross-appeal should be dismissed. Orders 2 and 3 of the orders of the Full Court of the Federal Court of Australia made on 17 February 2011 should be set aside. The appeal to that Court should be dismissed. The costs of the respondents of the appeal to this Court should be paid by the appellant. Those orders will leave undisturbed the costs orders made by the Full Court of the Federal Court of Australia, which were partly favourable to the Commissioner and partly favourable to the respondents.