

HIGH COURT OF AUSTRALIA

GLEESON CJ,
McHUGH, GUMMOW, KIRBY AND CALLINAN JJ

COMMISSIONER OF TAXATION

APPELLANT

AND

AUSTRALIA AND NEW ZEALAND
SAVINGS BANK LIMITED

RESPONDENT

*Commissioner of Taxation v Australia and New Zealand Savings Bank
Limited (M108-1997 and M109-1997) [1998] HCA 53
2 September 1998*

ORDER

In each of matters M108/1997 and M109/1997 –

- 1. Appeal allowed with costs.*
- 2. Set aside the orders of the Full Court of the Federal Court of Australia entered on 21 July 1997 and in lieu thereof order that:*
 - (a) the matter be remitted to the Commissioner of Taxation for reassessment:*
 - (i) in accordance with the reasons for judgment of this Court and;*
 - (ii) so far as the deductibility of interest is concerned, in accordance with the judgment of Jenkinson J entered on 18 March 1996.*
 - (b) respondent to pay the costs of the appellant of the proceedings in the Federal Court of Australia, including reserved costs.*

On appeal from the Federal Court of Australia

2.

Representation:

B J Shaw QC and G T Pagone QC with G P Harris for the appellant
(instructed by Australian Government Solicitor)

D H Bloom QC with B J Sullivan for the respondent (instructed by Freehill
Hollingdale & Page)

Notice: This copy of the Court's Reasons for Judgment is
subject to formal revision prior to publication in the
Commonwealth Law Reports.

CATCHWORDS

Commissioner of Taxation v Australia and New Zealand Savings Bank Limited

Income Tax – Deductions and rebates in calculating taxable income – Annuities – Purchase by trust – Whether whole of annuity payments capital or exempt income of the trust – Interest on money borrowed to acquire units in trust – Whether interest expense to be apportioned on ground that it was partly incurred in relation to the gaining or production of exempt income.

Words and Phrases – "exempt income".

Income Tax Assessment Act 1936 (Cth), ss 27H, 51(1), 97.

1 GLEESON CJ. For a number of years the appellant Commissioner and the respondent taxpayer have been engaged in litigation concerning the income tax consequences of a transaction entered into by the respondent in 1986. In brief, the respondent, as a member of a partnership, incurred interest expenses in respect of moneys borrowed to acquire units in a trust estate which derived income from annuities. Disputes as to the appropriate tax treatment of the arrangements entered into have already been to this Court on a previous occasion.¹

2 The essential facts of relevance to this appeal are as follows. The respondent and a related company were the members of a partnership which was formed to acquire units in a trust known as the Narvaez Trust. The trust was established by deed dated 29 April 1986 ("the trust deed") for the purpose of purchasing annuities to be issued by the New South Wales Treasury Corporation. In order to put themselves in funds to subscribe for units in the trust, the partners borrowed the bulk of the subscription money and incurred a liability for interest. Pursuant to agreements with the Treasury Corporation the trustee acquired three annuities and received payments thereunder. In each of the years of income ended 30 September 1986 and 30 September 1987 the respondent claimed a deduction for a share in a partnership loss calculated on the basis that the partnership was entitled under s 51(1) of the *Income Tax Assessment Act* 1936 (Cth) (the Act) to a deduction for the interest upon the whole of the borrowed money.

3 A more detailed account of the transaction is set out in the judgments of Davies J and Hill J, at an earlier stage of the litigation, in *Australia & New Zealand Savings Bank Ltd v Federal Commissioner of Taxation*.² That decision resolved an issue as to the character of the arrangements, and of the income received pursuant to those arrangements, and in the light of that resolution it is unnecessary for present purposes to examine the facts at greater length.

1 *Federal Commissioner of Taxation v Australia & New Zealand Savings Bank Ltd* (1994) 181 CLR 466.

2 (1993) 42 FCR 535.

- 4 Initially, the Commissioner declined to assess the income of the trust as income from annuities. This position was upheld by Jenkinson J in the Federal Court,³ but there was a successful appeal to the Full Court (Davies, Hill and Heerey JJ) who held that the agreements were agreements for annuities, and that s 27H⁴

3 (1992) 92 ATC 4630.

4 27H(1) The assessable income of a taxpayer of a year of income shall include –

- (a) the amount of any annuity derived by the taxpayer during the year of income excluding, in the case of an annuity that has been purchased, any amount that, in accordance with the succeeding provisions of this section, is the deductible amount in relation to the annuity in relation to the year of income; and
 - (b) the amount of any payment made to the taxpayer during the year of income as a supplement to an annuity, whether the payment is made voluntarily, by agreement or by compulsion of law and whether or not the payment is one of a series of recurrent payments.
- (2) Subject to sub-sections (3) and (3A), the deductible amount in relation to an annuity derived by a taxpayer during a year of income is the amount (if any) ascertained in accordance with the formula $A(B-C)/D$, where
- A is the relevant share in relation to the annuity in relation to the taxpayer in relation to the year of income;
- B is the amount of the undeducted purchase price of the annuity;
- C is
- (a) if there is a residual capital value in relation to the annuity and that residual capital value is specified in the agreement by virtue of which the annuity is payable or is capable of being ascertained from the terms of that agreement at the time when the annuity is first derived – that residual capital value; or
 - (b) in any other case – nil; and
- D is the relevant number in relation to the annuity.

...

(4) In this section –

"annuity" includes a superannuation pension;

(Footnote continues on next page)

3.

applied to the payments made under them.⁵ On the basis that the income of the trust fell to be assessed under s 27H, an issue then arose as to whether the deductions in respect of interest claimed by the respondent under s 51(1) should have been allowed in full, or should have been apportioned on the ground that the interest expense incurred by the partnership was in part incurred in relation to the gaining or production of exempt income. The Full Court of the Federal Court held that it had no jurisdiction to determine that question. An appeal to this Court on the jurisdictional issue was allowed, and the matter was remitted to the Federal Court for consideration of the deductions allowable to the partnership under s 51(1). The matter again came before Jenkinson J, who held that part of the interest

"approved actuary" means a person referred to in sub-section 4A(2) of the *Life Insurance Act 1945*;

"life expectation factor", in relation to a person in relation to an annuity, means the number of years in the complete expectation of life of the person as ascertained by reference to the prescribed Life Tables at the time when the annuity first commenced to be payable;

"relevant number", in relation to an annuity in relation to a year of income, means –

- (a) where the annuity is payable for a term of years certain – the number of years in the term;
- (b) where the annuity is payable during the lifetime of a person and not thereafter – the life expectation factor of the person; and
- (c) in any other case – the number that the Commissioner considers appropriate having regard to the number of years in the total period during which the annuity will be, or may reasonably be expected to be, payable;

"relevant share", in relation to an annuity derived by a taxpayer during a year of income, means –

- (a) in a case where the annuity derived by the taxpayer is a share of an annuity (which annuity is in this paragraph referred to as the "total annuity") payable to the taxpayer and another person or other persons – the fraction ascertained by dividing the number of whole dollars in the amount of the annuity derived by the taxpayer during the year of income by the number of whole dollars in the amount of the total annuity derived during the year of income by the taxpayer and the other person or persons; or
- (b) in any other case – the number 1.

4.

paid by the partnership in each year was incurred in relation to the gaining or production of exempt income, and that there should be an apportionment of the interest. The parties agreed upon a formula to effect the apportionment. The respondent taxpayer successfully appealed against that decision to the Full Court of the Federal Court (Lockhart, Carr and Sundberg JJ).⁶ The Commissioner was given special leave to appeal to this Court against the decision of the Full Court.

5 At common law the instalments of an annuity have the character of income.⁷ However, purchased annuities include an element representing a return to the purchaser of the purchase price paid for the annuity. In recognition of this, s 27H(1)(a) provides that a taxpayer's assessable income includes:

"the amount of any annuity derived by the taxpayer during the year of income excluding, in the case of an annuity that has been purchased, any amount that, in accordance with the succeeding provisions of this section, is the deductible amount in relation to the annuity in relation to the year of income".

6 The "deductible amount" is to be calculated in such a way as to identify so much of the capital component of an annuity payment as has not been, or will not be, an allowable deduction or the subject of a rebate.

7 Sundberg J, with whose reasons Lockhart and Carr JJ agreed, held, contrary to an argument advanced on behalf of the respondent, that the deductible amount referred to in s 27H(1)(a) is "exempt income" within the meaning of the definition in s 6 of the Act. Exempt income is defined to mean income which is exempt from income tax and includes income which is not assessable income.

8 It was argued on behalf of the respondent that the deductible amount is capital, and not income. In support of this argument reference was made to the history of the legislative treatment of annuities. There is, however, a difference between recognising that an instalment of a purchased annuity contains a component reflecting the need to return to the purchaser the price paid for the annuity, and a conclusion that an instalment of an annuity bears, at least in part, the character of capital.

6 (1997) 75 FCR 25.

7 *Egerton-Warburton v Deputy Federal Commissioner of Taxation* (1934) 51 CLR 568 at 572-573; *Australia & New Zealand Savings Bank Ltd v Federal Commissioner of Taxation* (1993) 42 FCR 535 at 555-559, 563.

9 The position was accurately stated by Hill J in the earlier appeal as follows⁸:

"At common law the whole of the instalments of the annuity have the character of income and thus fall within s 25(1). Section 27H is intended to take annuities out of the general provisions of s 25 and include in assessable income only the income portion of the annuity instalment, treating as exempt income a part of the annuity representing the return of the purchase price of the annuity (if any) included in the definition of 'deductible amount'".

10 The judgment of Hill J⁹ contains an illuminating examination of the commercial history of annuities, and their tax treatment. His Honour pointed out that, although their use in Australia had been relatively confined, annuities had an important part to play in both public and private financing in the United Kingdom. They were originally used as a device to circumvent the prohibition against usury. In *Scoble v Secretary of State in Council for India*¹⁰ Mathew LJ said:

"An annuity means generally the purchase of an income, and usually involves a change of capital into income, payable annually over a number of years."

11 For the word "annually" it would be not inaccurate to substitute "periodically".¹¹ In the present case the annuity instalments were paid every six months.

12 In a given case it may be difficult to distinguish between a loan, with repayments including components of principal and interest, and the purchase of an annuity where, in the language of the authorities, the capital has ceased to exist, and what is paid to the purchaser is wholly income, although income which includes an amount to reflect the fact that a purchase price has been paid. Hill J held that the present case fell into the second category. Sundberg J, correctly, followed that process of reasoning to its logical conclusion, concluding that the instalments of annuity paid to the trust included no element of capital but were, in accordance with s 27H, made up of assessable income and exempt income (the deductible amount).

13 The trust deed defined income to mean the net income of the fund as determined in accordance with s 95 of the Act. Thus the deductible amount was treated under the deed as capital, and dealt with by cl 10 of the trust deed. Income as defined was dealt with by cl 9, and was held on trust for the investors. By cl

8 (1993) 42 FCR 535 at 563.

9 (1993) 42 FCR 535 at 554-561.

10 [1903] 1 KB 494 at 504.

11 See *Beswick v Beswick* [1968] AC 58 at 98.

10.2 the capital of the fund was held on trust for the investors in proportion to the number of investment units held by them. Clause 10.3 provided that investment units were to be redeemed "as and when and to the extent that the Trustee receives cash representing capital" of the fund to which an investor was entitled. Redemption was effected by payment by the trustee to the investor of the redemption price of the relevant units. The redemption price was one dollar, which was the purchase price of a unit. Thus, subject to payments to be made to the manager, the unit holders were entitled to the whole of the income and capital as defined.

14 It was argued that the unit holders in the trust, (relevantly, the partnership), had no such individual interest in the amounts in question as would satisfy s 97. However, the relevant provisions of the trust instrument, including those relating to interest in capital, and the procedures concerning redemption, were such that Sundberg J correctly held that the requirements of s 97 were satisfied. He observed that the partnership's interest in the whole of the annuity income of the trust, which, by reason of the definitions in the deed was treated by the deed partly as income and partly as capital, was vested in interest and possession. The partnership was then presently entitled within the meaning of s 97(1).

15 For the reasons earlier given, the whole of the annuity amounts received by the trustee constituted income of the trust. The circumstance that the trust instrument, for the purpose of dealing with the entitlements of unit holders, treated the deductible amount as capital, did not alter what was described in *Charles v Federal Commissioner of Taxation*¹² as "the character of those moneys in the hands of the trustees."

16 Section 51(1) of the Act provides that losses and outgoings, to the extent to which they are incurred in gaining or producing the assessable income of a taxpayer, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent that they are incurred in relation to the gaining or production of exempt income. Those words require apportionment in appropriate cases, and direct attention to whether, in the present case, any part of the interest expense was incurred in relation to the gaining or production of exempt income. Whether the concluding words of s 51(1) are a true exception, or whether they are wholly or partly implicit in what had gone before, is not a question which requires examination in this case.¹³

12 (1954) 90 CLR 598 at 608.

13 cf *Ronpibon Tin NL v Federal Commissioner of Taxation* (1949) 78 CLR 47 at 55-56; *Magna Alloys and Research Pty Ltd v Federal Commissioner of Taxation* (1980) 33 ALR 213 at 216.

7.

17 The interest was incurred as a result of the borrowing by the partnership of funds to enable it to acquire units in the Narvaez Trust.

18 Section 97(1) of the Act, so far as presently relevant provides:

"Where a beneficiary of 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 –

(i) ... that share of the net income of the trust estate ...

(b) the exempt income of the beneficiary shall include –

(i) ... the individual interest of the beneficiary in the exempt income of the trust estate ...

...

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate."

19 The question is whether, the partnership being presently entitled to a share of the income of the Narvaez Trust estate, the deductible amount ascertained in accordance with s 27H(1)(a), which constituted exempt income of the trust estate, fell within the exception made by the concluding words of the provision quoted above. The respondent argued, and the Full Court of the Federal Court agreed, that the deductible amount had been "taken into account in calculating the net income of the trust estate". The Commissioner challenges that conclusion.

20 Division 6 of Pt III of the Act (ss 95-102) deals with trust income. It contains a definition of exempt income which, for present purposes, takes up the earlier definition in s 6, and covers the deductible amount of the annuity instalments. It also provides that net income, in relation to a trust estate, means the total assessable income of the trust estate calculated as if the trustee were a resident taxpayer, less all allowable deductions save for some presently irrelevant exceptions.

21 The argument of the respondent, accepted in the Full Court, was as follows. The net income of the Narvaez Trust estate was calculated by reference to two integers: total assessable income and allowable deductions. Pursuant to s 27H, assessable income was calculated by looking to the amount of the annuity instalments, and excluding therefrom the deductible amount, which has been held to be exempt income. Of necessity, the exempt income (the deductible amount) was taken into account in calculating the assessable income of the trust estate, and therefore it was taken into account in calculating the net income of the trust estate.

Hence, if the deductible amount would otherwise have been exempt income of the partnership under s 97(1)(b), it was wholly taken out of that category by reason of the terms of the exception.

22 Before 1979, s 97 was in the following form:

"97 (1) Where any beneficiary is presently entitled to a share of the income of a trust estate and is not under any legal disability, his assessable income shall include that share of the net income of the trust estate.

(2) The exempt income of any such beneficiary shall include his individual interest in the exempt income of the trust estate, except to the extent to which that exempt income is taken into account in calculating the net income of the trust estate."

23 The words of the exception were not materially different from the words presently under consideration.

24 The purpose of s 97(2) was explained by Dixon CJ in *Federal Commissioner of Taxation v Belford*¹⁴. He said that it "is directed to dealing with a case where losses of a previous year are taken into account in calculating the income of the trust estate."

25 The appellant argues that the key to the correct understanding of the words of exception contained in s 97(2) is to be found in the scheme of the Act in relation to carrying forward losses, and the relationship between that scheme and the provisions of the Act concerning trusts.

26 In 1938, the authors of Ratcliffe and McGrath, *The Law of Income Tax*, observed¹⁵:

"The net income of a trust estate is ascertained by deducting from the total assessable income of the trust estate all deductions allowable to an individual taxpayer, except concessional deductions ... and the statutory exemption (s 95). Losses are carried forward in the returns of the trust estate and deducted in arriving at the net income of subsequent years. In this respect the assessment of trust estates is on a different basis to that of partnerships. In the case of a partnership the loss is divided in proportion to the interests of the individual partners and carried into the returns and assessments of the individual partners."

14 (1952) 88 CLR 589 at 599.

15 at 654.

27 Section 80(2)(b) provides that, where a taxpayer seeks to carry forward losses of previous years to a given year of income, if the taxpayer has in that year derived exempt income, the deduction shall be made successively from the net exempt income and from the assessable income. Section 97(2) complements this scheme in relation to income of a beneficiary in a trust estate. However, the scheme had to cover a case where exempt income of a trust estate had already been set against losses in calculating the net income of the trust estate.

28 The same authors said¹⁶:

"Where a trust estate derives exempt income the beneficiary's share in such exempt income is transferred to his individual return, and is taken into consideration in the making of his assessment in any case where a loss incurred by him in a previous year is being carried forward, or where a loss incurred by him in the year of income is to be carried forward to a later year. This does not apply in those cases in which the exempt income is taken into account in calculating the net income of the trust estate (s 97(2)). This latter position would arise in the case in which exempt income had been derived by a trust estate in a year in which losses of previous years were allowable as a deduction (see s 80(2)(b))."

29 There is, in the provisions dealing with partnerships, nothing corresponding to the exception in s 97(2). The reason is clear. It arises out of the different manner in which carried forward losses are treated.

30 The purpose of the exception in s 97(2), (now s 97(1)(b)), is not open to dispute. It is as explained by Dixon CJ in *Belford*, and by the authors quoted above. The disagreement is as to its effect, which, according to the respondent, is wider than the purpose of its enactment. This preceded the enactment of s 27H by s 15 of the *Income Tax Assessment Amendment Act (No 3) 1984* (Cth).

31 The respondent's argument correctly assumes that an amending Act is to be construed as part of the principal Act (*Acts Interpretation Act 1901* (Cth), s 15). The respondent submits that the literal meaning of the words of the exception embraces s 27H and the deductible amount there identified, even if it also covers the matter which may be taken to have been primarily in contemplation, that is to say the subject of allowable deductions and losses carried forward.

32 In this respect, however, the position is not quite as simple as the respondent contends. The words to be construed are "taken into account in calculating the net income of the trust estate". Where does the relevant calculation begin? The expression "net income of (the) trust estate" is defined in s 95. It means, in brief, assessable income less allowable deductions. That particular calculation is made

16 at 657.

after the assessable income has been determined. In the present case, the determination of assessable income was made pursuant to s 27H and involved exclusion from the annuity instalments of the deductible amounts. That process of exclusion was, from one point of view, antecedent to the calculation of the net income of the trust estate. The words of the exception are not unambiguous, as the respondent contends, and it is necessary to determine their meaning in the context in which they appear, having regard to the purpose they were intended to serve.

33 The language of the Act does not require that the process of excluding the deductible amount of an annuity payment for the purpose of arriving at the assessable income of the trust under s 27H be equated with the application of s 80(2)(b), and that both be regarded as taking exempt income into account in calculating the net income of the trust estate. It is acknowledged that it is the latter which is the purpose of the exception, and it is appropriate so to confine its effect. Separating annuity income, pursuant to s 27H, into exempt income and assessable income, does not involve taking exempt income into account in calculating net income for the purposes of s 97(1)(b).

34 The appeals should be allowed with costs. The judgment and orders made by the Full Court of the Federal Court should be set aside. The matters should be remitted to the appellant for reassessment in accordance with the reasons for judgment of this Court and, so far as the deductibility of interest is concerned, in accordance with the judgment of Jenkinson J entered on 18 March 1996. The respondent should pay the costs of the appellant in relation to the proceedings in the Federal Court including reserved costs.

11.

35 McHUGH J. I agree with the judgment of Gleeson CJ.

- 36 GUMMOW J. Each appeal should be allowed. I agree with the reasons for judgment of the Chief Justice and with the orders proposed therein.

13.

37 KIRBY J. I agree with the orders proposed by Gleeson CJ and with his reasons.

38 CALLINAN J. I agree with the reasons and orders proposed by Gleeson CJ.