AT THE INTERERFACE: A TRUST-BASED SOLUTION TO A TAXING DILEMMA

KELLEE CLARK*

Introduction

The final judgment in the long-running saga concerning the tax status of the Crown Forestry Rental Trust has recently been delivered, with the Privy Council over-turning the Court of Appeal's decision and deciding in the trustees' favour.[1] Of considerable interest is the fact that this decision was largely based not on the statutory exemption from income tax, which had been the focus of argument in all three courts, but on the Board's understanding of the Trust deed as constituting a *Quistclose*[2] trust. Here I will summarise the case and the decisions reached at each level of judgment. Then I will consider the ramifications of the case and some possible criticisms of it.

A: Facts

The case has its genesis in the privatisation regime of the 1980s and the government's desire to sell off Crown-owned assets under the State Owned Enterprises Act 1986. These assets included the Crown's commercial forestry interests, and concerns were expressed that the legislation would prejudice Māori claims to the assets in accordance with Waitangi Tribunal recommendations. Thus negotiations between the Crown and the Māori Council and Federation of Māori Authorities Inc. were entered into and an agreement was reached on 20 July 1989. This provided that the Crown would grant fixed period licenses to third party commercial licensees over the land at issue. In return, the licensees would pay an annual rental. The Crown was to pay this money into the Crown Forestry Rental Trust, which it settled for this purpose. The Trust then had two functions. First, it was to hold the license fees as the capital of the Trust, until the Waitangi Tribunal determined whether the Māori claimants were entitled to the land. If the Tribunal

* Candidate for LLB (Hons) BCom, University of Otago.

[1] *Latimer v Commissioner of Inland Revenue* [2004] 2 NZLR 157 (*Latimer*).

[2] *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567.

decided that they were, the claimant would receive all license fees relating to that land, and could resume possession on the expiration of the license. If the Tribunal decided against the claimant, the Crown was to receive the license fees and ultimately possession of the land. This was the 'stakeholder' function of the Trust. Its second function was to invest the money received from the license fees and make the interest earned available to assist Māori claimants in the "preparation, presentation and negotiation of claims before the Waitangi Tribunal which involve, or could involve, Licensed Land" (Clause. 9.2.2 of the Trust deed). This was known as the 'assistance' purpose. In doing so, the trustees were empowered to accumulate income and its application was at their sole discretion. Any income left over when the trust was wound up was to be paid to the Crown.

B: The Lower Courts

The case went to the High Court on the issue of whether the Trust came within section 61(25) of the Income Tax Act 1976. Section 61(25) provides an exemption from income tax for:

> Income derived by trustees in trust for charitable purposes or derived by any society or institution established exclusively for charitable purposes […]

O'Regan J held that this required that a *trust* be *established* exclusively for charitable purposes, and because the stakeholder function is not a charitable purpose, the Section did not apply. He did, however, acknowledge that the assistance purpose was charitable.

This decision was appealed by the trustees, and the Commissioner of the Inland Revenue cross-appealed on the finding that the assistance function was a charitable purpose. The Court of Appeal, with Blanchard J delivering the judgment of the Court, dismissed both appeals. First, the Court of Appeal rejected O'Regan J's view that the trust had to be established for exclusively charitable purposes to come within section 61(25). In their opinion, the plain language of the section incorporates two separate limbs.

The first limb, 'income derived in trust for charitable purposes' does not require that the trust be established exclusively for those purposes,

as distinct from societies and institutions which are dealt with in the second limb. Therefore, as the stakeholder function dealt only with the capital of the Trust, this would not exclude the Trust from coming within the exemption. The second question the Court of Appeal dealt with was whether the Trust's *income* was derived for exclusively charitable purposes. In doing so, they had to traverse the inarguably confused and uncertain test as to what constitutes a charitable purpose. In the end, however, they agreed with O'Regan J's conclusion that the assistance purpose was charitable.

However, they went on to conclude that the assistance function was not the *only* purpose for which income was derived. Clause 9.4 of the Trust deed stated that any surplus income would, at the end of the Trust's life, be paid to the Crown. The Court held that there was a real possibility that a surplus would exist, and that the payment of the surplus to the Crown was not merely incidental to the assistance function, being a separate purpose in itself.

The Court of Appeal was clearly swayed by the evident potential for private settlers to abuse section 61(25) if the Court were to uphold a tax exemption for income of a trust that could be accumulated from year to year and ultimately paid over for a non-charitable purpose. The Court also rejected an argument that the gift to the Crown contained an implicit limitation to the effect that it could only be used for charitable purposes[3] or that all the Crown's purposes are charitable.

C: The Privy Council Decision: Lord Millett

The finding in the Court of Appeal (and the High Court) that the assistance function was a charitable purpose was not challenged by the Commissioner on appeal. This left two main issues for the Board: whether section 61(25) requires trusts to be *established* for exclusively charitable purposes; and whether, on the facts, the income was so derived, despite the residual payment to the Crown.

[3] See *Re Smith* [1932] 1 Ch 153.

1. The statutory interpretation question

The Commissioner maintained his argument that, to qualify for the section 61(25) exemption, a trust must be *established* for exclusively charitable purposes. However, the Privy Council approved the Court of Appeal's approach in emphasising the difference between charities in the form of trusts and charities in the form of societies or other institutions. The difference was considered to be justified in that, whereas trusts are often established for multiple purposes, societies or institutions usually have just one. Therefore, the Board held that section 61(25) will apply if the trust's income is *applicable* for charitable purposes, irrespective of whether the trust is *established* exclusively for charitable purposes. They concluded that the stakeholder function of holding the capital of the trust for non-charitable purposes did not exclude the Trust from the exemption.

2. Income derived exclusively for charitable purposes

The trustees appealed against the Court of Appeal's decision that the income of the Trust was not derived exclusively for charitable purposes, as a result of the surplus being paid to the Crown. The Board pointed out that this requirement does not exclude a charitable trust from co-existing either "vertically or horizontally" with a private trust.[4] They cited *Re Sir Robert Peel's School at Tamworth*[5] as an example of the former. There, the income was to be applied on mandatory trust for the maintenance of a school, subject to a power of revocation. It was held that, until the power was exercised, the trust was charitable. In the same vein, their Lordships stated that had the Trust required the trustees to apply all of the income (minus expenses) for the assistance purpose, the Trust would have come within section 61(25).

However, the Trust deed allowed the trustees to accumulate the income and apply it in later years, and any surplus income was ultimately to be paid to the Crown. Therefore, 'it cannot be said of any sum of income in the hands of the trustees that it will be applied for charitable

[4] *Latimer*, supra n. 1, para. [31].
[5] (1868) 2 Ch App 543 (*Peel's Case*).

purposes; it may be retained and ultimately become payable to the Crown.'[6]

Thus, the income could not be seen to be derived exclusively for charitable purposes unless either the trust in the Crown's favour was simply incidental to the assistance function, or the Crown is itself a charity or holds the surplus income on a charitable trust.

The Board cited as an example of an incidental, ancillary function the ability of trustees to charge a trust for their fees and expenses. Such a function cannot, according to the Privy Council, be regarded as a purpose of the trust. Instead it only facilitates its purpose. Importantly, Lord Millett went on to state the following principle:

> "The distinction is between ends, means and consequences. The ends must be exclusively charitable. But if the non-charitable benefits are merely the means or the incidental consequences of carrying out the charitable purposes and are not ends in themselves, charitable status is not lost."[7]

However, the fact that the surplus income was to be held on trust for the Crown was considered by the Board to be 'neither a means of furthering the Trust's charitable purpose nor an incidental consequence of carrying out that purpose.'[8] It was a purpose in its own right.

Nor did the Privy Council accept the alternative argument that the Crown is a charity or holds its money for exclusively charitable purposes. They did acknowledge that a gift to a non-charitable entity can be 'impressed' with an implied trust, restricting the recipient so that they can only use the property for charitable purposes.[9] But, like the Court of Appeal, they did not consider this to be the situation here. The Board thought that this was because there was no gift to the Crown – the Crown is simply 'resuming its own property' and it would

---

[6] *Latimer*, supra n. 1, para. [33].
[7] Ibid., para. [36].
[8] Ibid.
[9] As per *Re Smith* [1932] 1 Ch 153.

be 'unrealistic' to see them as limiting their use of the money after it is no longer required for the charitable purpose.[10]

However, unlike the Court of Appeal, the Privy Council did not consider this to be the end of the matter. Instead, following on from this last point, they concluded that the Trust deed was really 'an elaborate mechanism which serves much the same purpose as a *Quistclose* trust.'[11] This was because, through it, the Crown was able to provide financial support for one specific purpose and so far as the money was not used for that purpose, to retain ownership of that property throughout. Whether income tax is payable or not depends on 'the status for tax purposes of the person beneficially entitled to the income in question'.[12] Here, this was the Crown, and the Crown is exempt from income tax. Therefore, the Board concluded that, so far as the income was used for the assistance function, it was applied for charitable purposes and exempt under section 61(25), and so far as it was not, it remained the tax-exempt income of the Crown. Thus the Board allowed the appeal.

D: Commentary

1. The importance of the decision

According to Matthew Conaglen,[13] the case is important in two ways. First, he suggests that it is quite possible that similar arrangements will be entered into in the future to deal with other Māori claims to land. Therefore it is necessary that parties to such agreements have a full understanding of the consequences of this particular structure.[14] Note though that this view can be contrasted with the equally true point that 'the decision will have limited application to other charitable trusts given that it turns on the specific terms of the trust deed in question.'[15]

---

[10] *Latimer*, supra n. 1, para. [39].
[11] Ibid., para. [41].
[12] Ibid., para. [43].
[13] Matthew Conaglen, 'A Legislative Definition of "Charitable Purpose"' [2004] NZ Law Review 449.
[14] Ibid., p. 449.
[15] Adrian Sawyer and Charmaine Edward '$40 Million and the Meaning of "Charitable" – The Final Statement' (2004) 10 New Zealand Journal of Taxation Law and Policy 5, p. 10.

However, Conaglen also argues that the case is important in that it applies and/or establishes some important legal principles with regard to charities, trust and tax law.[16] Thus, even though the ultimate decision may be quite context-specific, the judgment has wider significance. One such principle is that the Privy Council definitively answers the statutory interpretation question, upholding the Court of Appeal's view that a trust need not be established exclusively for charitable purposes to qualify for the section 61(25) tax exemption. Moreover, they acknowledged the agreement by all that this section is "materially identical" to the equivalent provision in s CB4(1)(c) of the Income Tax Act 1994. This conclusion has in effect been codified by s CW(1) of the Income Tax Act 2004, which applies from the 2005–2006 tax year.

Secondly, the Board also applied the principle that, to be charitable, a trust's *income* must be derived for *exclusively* charitable purposes — a requirement that has been read into the statutory language, and derives from the general principle of charities law that a charitable trust must be for exclusively charitable purposes.[17] The Board then elaborated on what this means. As stated above, they accepted that a charitable trust could co-exist with a private trust and cited *Peel's Case*[18] as an example of vertical co-existence.

However, it is arguable that they did not sufficiently stress just what the difference is between vertical co-existence and a trust with two simultaneously existing purposes. For example, in the subsequent case *Hester v Commissioner of Inland Revenue*, the trust at issue allowed income to be applied for non-charitable entities.[19] The trustees argued that as income was not applied to these entities in the income year in question, this did not affect the charitable status of the trust.

The Court of Appeal (in obiter) preferred the Commissioner's argument that it was irrelevant that no income was applied to non-charitable purposes in the year in question. This was because they thought it "unsatisfactory" to allow a trust to claim charitable status

[16] Conaglen, supra n. 13, p. 449.
[17] See *Morice v Bishop of Durnham* (1805) 10 Ves 522, pp. 541–543; *Attorney-General for New Zealand v Brown* [1917] AC 393.
[18] (1868) 2 Ch App 543.
[19] (2005) 22 NZTC 19,007.

where non-charitable purposes could be introduced 'at the will of a person associated with the trust'.[20]

In my view, the important factor is that the income was applicable to the non-charitable entities 'at the will' of an associated person. Likewise, the Trust in *Latimer* was not an example of vertical co-existence because, at the trustees' sole discretion, they could accumulate the income and carry it forward, so that it ultimately formed part of the surplus income paid to the Crown.

This can be contrasted with the situation in *Peel's Case* where the income was held on a *mandatory* trust for the charitable purpose until the power of revocation was exercised, and thus the income derived until the revocation, was fully and definitely applicable only to that purpose. This point is clearly implicated in Lord Millett's judgment, but, in my view, this crucial difference should have been emphasised more strongly, so that the issue is clear in future cases, such as *Hester v Commissioner of Inland Revenue*.

The Privy Council did, however, give clear guidance with regard to the issue of when a purpose can be considered to be ancillary and thus not relevant to the charitable status of the trust. Here they distinguished between ends, means and consequences (see above), positing a test that Conaglen describes as 'illuminating'.[21] The case is also clear authority for the general proposition in tax law that liability to income tax is dependent on the tax status of the person beneficially entitled to the income, and is a New Zealand example of a *Quistclose* trust, as defined by the House of Lords in *Twinsectra Ltd v Yardley*.[22]

2. The reasoning

One commentator has described the approach that the Privy Council adopted in this case as 'logical and difficult to disagree with',[23] and certainly the result of the case seems to be welcome. However, there have been criticisms levelled against the reasoning employed.

---

[20] Ibid., para. [115]
[21] Conaglen, supra n. 13, p. 452
[22] [2002] 2 AC 164 (*'Twinsectra'*)
[23] Sawyer and Edward, supra n. 15, p. 10

Despite ultimately finding for the trustees, the Board nonetheless largely upheld the Court of Appeal's reasoning in finding that the income of the Trust was being derived for more than one purpose, one of which was non-charitable. Thus, the criticisms that David Brown levels at the Court of Appeal's judgment are arguably relevant with regard to the decision of the Board as well.[24]

Brown considered that the reasoning portrayed 'an unnecessarily narrow point of construction in relation to a relatively insignificant part of the Trust deed', and that the result of the reasoning was avoidable.[25] Firstly, he cites the 'benign construction' principle whereby the charitable status of a trust is to be sustained if at all possible. However, Matthew Conaglen also discusses this principle[26] and reveals that it only applies where the trust has only one purpose which is either ambiguous or may be implemented in a charitable or non-charitable way[27] — not when there are in fact two purposes,[28] as was the case here. At this point Brown also criticises the factual finding that the payment of the surplus to the Crown was a purpose in its own right.[29] He contends that it was merely incidental and just a reflection of the reality that the surplus had to go somewhere when the Trust wound up. This latter point is, of course, true, but it arguably fails to place enough importance on the trustees' ability to accumulate the income and thus that the surplus may be sizeable and not just what was left over in the year during which the assistance purpose was entirely fulfilled.

Therefore, as the Privy Council emphasised, any amount of income in the hands of the trustees could just as easily be applicable to the surplus function as it could the assistance purpose, and so the former was held to be a substantial purpose in itself. In my view, this finding was definitely open on the facts, and appropriately reflects the terms of the Trust deed.

---

[24] David Brown, 'Charity, the Crown and the Treaty' [2003] NZLJ 65, p. 70.
[25] Ibid., p. 68.
[26] Conaglen, supra n. 13, p. 452.
[27] See *Charles v Barzey* [2003] 1 WLR 457, para. [12].
[28] See *Funnell v Stewart* [1996] 1 WLR 288, pp. 296–297.
[29] Brown, supra n. 24, p. 68.

Brown also argues the Court was "unduly" influenced by the possibility of abuse of section 61(25) by private settlers.[30] This is because the precedental effect could be confined to the context in which the Crown is the settler. However, section 61(25) and the meaning of 'charitable purpose' are widely applicable and the principle via which the Crown is distinguishable from other taxpayers is unclear. Here Brown contends that the Court of Appeal (and so the Privy Council) was too dismissive of arguments to the effect that all of the Crown's functions are charitable and/or that the gift of the surplus to the Crown was impressed with a limitation such that it could only be used for charitable purposes.[31]

Regarding the former, Brown argues that, as 'the less the Crown does…the more charity has left to do', the Crown's purposes must be automatically charitable.[32] Moreover, he states that it is difficult to pinpoint any function of the Crown which would not come within the common law definition of 'charitable', and that, in any practical sense, it really does not matter as a gift to the Crown performs the same function (of funding Crown activities) as taxes do.[33]

The Privy Council rejected this contention for the simple reason that it is *not* true that all public purposes are charitable purposes. They pointed to the special Crown exemption from income tax as indicative of this — if all Crown purposes were charitable, this exemption would be otiose.[34] Moreover, with respect, the practical consequence that the money is going to the same over-all body (the Crown) does not answer the legal question.

With regard to the argument based on *Re Smith*,[35] Brown pointed to cases where gifts had been held to be implicitly charitable simply because their recipient was a public authority.[36] In addition, he contends that it was relevant that the gift was made in the context of a

[30] Ibid.
[31] Ibid., citing *Re Smith* [1932] 1 Ch 153.
[32] Ibid., p. 70.
[33] Ibid.
[34] *Latimer*, supra n. 1, para. [37].
[35] [1932] 1 Ch 153.
[36] Brown, supra n. 24, p. 70.

trust which was otherwise clearly for charitable purposes.[37] Here, however, the Privy Council emphasised that there was no gift to the Crown — and indeed it seems awkward to look at it as the Crown gifting itself. Even if it was accepted that it was a gift to the Crown, that the Crown was implicitly limiting itself in the use of the returned property is, in my view and as stated by Lord Millett, 'unrealistic'.[38]

Therefore, I posit that the criticisms levelled by Brown against the reasoning employed by the Court of Appeal and affirmed by the Privy Council, are not, in the final analysis, able to stand their ground. This is especially so if Brown's comments are seen in the light of his clear dissatisfaction with the Court of Appeal's conclusion. The Board ultimately reached the arguably desirable conclusion on other grounds, in that it recognised the 'beneficial role played by the [Trust] in the claims process and the wider benefit of the Waitangi Tribunal for resolving historical grievances'.[39] Therefore, it may be seen to be less necessary to attempt to squeeze the Trust into the mould of deriving its income for exclusively charitable purposes, either by downplaying the surplus income function or by manipulating the status of the Crown or the gift.

However, the Privy Council's finding of a *Quistclose* trust has also been criticised. Jan James points out that section 61(25) is still open for abuse by private settlers in that they can settle a trust for charitable purposes that they do not intend to discharge and incorporate a residual reversionary right actionable at the end of a fixed term.[40]

Thus they can contend that they still retain beneficial ownership of the property not used for the charitable purposes and the charitable status of the trust will not be lost. They will still have to pay tax on the income when the trust's term expires, but they gain the significant advantage of deferring this for the life of the trust. To avoid this, James states that the implication of the case must be that the income used for the charitable purposes and the income 'retained' by the settler must be annually determined.[41]

---

[37] Ibid.
[38] *Latimer*, supra n. 1, para. [39].
[39] Brown, supra n. 24, p. 70.
[40] Jan James, 'Charity and Reversion' [2004] NZLJ 68, p. 72.
[41] Ibid.

In my view, an annual determination would be consistent with the principle that liability for income tax is dependent on the tax status of the person beneficially entitled to the money. If the settler retains beneficial ownership, their tax status is the pertinent factor. This, of course, was not an issue in *Latimer* as neither the settler nor the Trust was liable to pay income tax. It might be arguable that this would weaken the position of *true* charitable trusts classifiable as *Quistclose* trusts, in that all income not applied in the current year would be liable for income tax. However, the Privy Council specifically stated that, had the ultimate trust been in favour of a private individual, in terms of the section 61(25) exemption, the Trust would have been indisputably taxable.[42] Therefore, such trusts will be no worse off.

The general principle is that, to be charitable, all of a trust's income must be applied for charitable purposes. James also argues that, to maintain the 'integrity' of this rule, in the case of a *Quistclose* trust the income cannot be settled on the trust until it is applied for the charitable purpose.[43] This, she avers, is not what the facts of this situation suggest. Thus, in effect, she is arguing against the Board's understanding of the terms of the Trust as constituting a *Quistclose* trust. Of interest here, therefore, is the fact that neither the lower courts nor counsel for either side considered this as a possible analysis. It has been suggested that this was due to the confusion which abounded concerning the nature of *Quistclose* trusts up until the decision of the House of Lords in *Twinsectra*,[44] which occurred shortly before oral argument in the Court of Appeal for the present case.[45]

Alternatively, it could simply have been because of the general difficulty that exists in distinguishing *Quistclose* trusts from other types of arrangements.[46] The Privy Council decided that the Trust here constituted a *Quistclose* trust, but, in light of the difficulty averred to, it is unsurprising that others might have different views. However, this does not undermine the legitimacy of the factual finding that the Board reached.

---

[42] *Latimer*, supra n. 1 [36].
[43] James, supra n. 40, p. 72.
[44] [2002] 2 AC 164.
[45] Conaglen, supra n. 13, p. 453.
[46] Ibid., citing Lord Millett, 'Foreword' in William Swadling (ed), *The Quistclose Trust* (2004) i, vii for this general proposition.

Lastly, although not a criticism of the actual judgment, it is perhaps unfortunate that the decision regarding the charitable nature of the assistance purpose was not challenged before the Board. This is not because of any dissatisfaction with the finding, but simply that it might have been a good opportunity for our (then) highest court to clarify the test as to what constitutes a 'charitable purpose'. Of particular uncertainty is whether *CIR v Medical Council of New Zealand*[47] can be used as authority for the proposition that 'a purpose which is beneficial to the public is prima facie charitable unless good reason is put forward for holding otherwise'.[48] It was considered unnecessary to decide this in the Court of Appeal (as the case could be decided by analogy) and thus the proper approach to the issue 'remains unsettled'.[49] Any statement on the point would probably have been obiter (in that analogies applied), but it would have been a welcome insight.

Another major site of uncertainty was whether the majority House of Lords decision in *Oppenheim v Tobacco Securities Trust Co Ltd*,[50] that blood link is fatal to charitable status, was still good law. This latter issue, however, has since been definitively settled in the negative by section OB3B(1) of the Income Tax Act 1994, effective from March 2003.[51]

Conclusion

The actual result of the case is almost indubitably the favourable one – as Brown stated, it would have been 'deeply ironic [if] the Trust became liable for millions of dollars of tax because of a residual possibility that surplus moneys might go to the Crown, to whom the tax is payable'.[52] Moreover, I would argue that the Board's reasoning in reaching this conclusion stands up against the criticisms levelled at it. It will be interesting to see whether this analysis will be picked up by privately settled trusts looking to evade income tax liability and thus whether annual determination will be considered a necessary requirement. Moreover, the state of the law concerning the definition of 'charitable

[47] [1997] 2 NZLR 297.
[48] Brown, supra n. 24, p. 66.
[49] Conaglen, supra n. 13, p. 451.
[50] [1951] AC 297.
[51] James, supra n. 40, p. 68.
[52] Brown, supra n. 24, p. 68.

purpose' clearly needs to be considered further. However, on the whole, and in the author's opinion, the case has been satisfactorily resolved.