



Investment & Financial Services Association Ltd

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Dear Glenn

## **SUBMISSION ON THE MEANING OF 'INDEFEASIBLE'**

### **Introduction**

This submission is provided as a contribution to the discussions that are taking place with the Australian Taxation Office's Trust Consultation Group.

The word 'indefeasible' appears in two important contexts that are covered by these discussions. They are:

- To have a fixed entitlement to a share of the income or capital of a trust for the purposes of the trust loss rules in Schedule 2F to the Income Tax Assessment Act 1936, section 272-5 of that Act provides that a taxpayer must have a vested and indefeasible interest in a share of the income or capital of the trust.
- By virtue of sections 160APHL(10) and (11) of the Income Tax Assessment Act 1936, a taxpayer has a long position in respect of shares where they have a vested and indefeasible interest in so much of the corpus of the trust as is comprised by those shares.

Other provisions that draw on this concept are listed in the appendix.

### **Acknowledgements**

The following two papers have been used in writing this submission:

*Interpreting and applying the tax regime in practice – a legal perspective*, Jennifer Davies SC, Taxation Institute of Australia, 2006 Financial Services Conference, 15-17 February 2006

*How fixed is your trust – can you assume that it will survive a change of ATO's present view?*, Karen Rooke, Taxation Institute of Australia, 21<sup>st</sup> National Convention, 5-8 April 2006

## Executive Summary

This submission makes two points. First, that the provisions under discussion should be interpreted purposively reaching conclusions that unitholders in typical public unit trusts have a fixed entitlement to the income and capital of the trust for the purposes of section 272-5 and that they have a long position in respect of shares in those trusts by virtue of sections 160APHL(10) and (11). These were the positions presented to IFSA in consultation meetings when these two sets of provisions were introduced. Narrower interpretations based on something called ‘the ordinary meaning of’ the word ‘indefeasible’ should not replace these outcomes. The rules of statutory interpretation do not support narrower interpretations.

The second point this submission makes is that even if resort is to be had to something called ‘the ordinary meaning of’ the word ‘indefeasible’, that meaning is broad enough to cover the interest held by unitholders in public unit trusts in most commercial situations.

### The purposive interpretation of the word ‘indefeasible’

Words in statutes do not carry some sort of fixed external meaning. It is the context that creates the meaning of a statutory provision. The High Court in *CIC Insurance v Bankstown Football Club Ltd*<sup>1</sup> said:

the modern approach to statutory interpretation (a) insists that the context be considered in the first instance, not merely at some later stage when ambiguity might be thought to arise, and (b) uses "context" in its widest sense to include such things as the existing state of the law and the mischief which ... one may discern the statute was intended to remedy.

...

Instances of general words in a statute being so constrained by their context are numerous. In particular, ... if the apparently plain words of a provision are read in the light of the mischief which the statute was designed to overcome and of the objects of the legislation, they may wear a very different appearance. Further, inconvenience or improbability of result may assist the Court in preferring to the literal meaning an alternative construction which, by the steps identified above, is reasonably open and more closely conforms to the legislative intent.

Lord Diplock in *The Courts As Legislatures*<sup>2</sup> said:

if ... the Courts can identify the target of Parliamentary legislation their proper function is to see that it is hit; not merely to record that it has been missed.

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<sup>1</sup> (1997) 187 CLR 384 @408

<sup>2</sup> *The Lawyer and Justice*, Sweet and Maxwell, 1978, p274, cited in *Richardson v FCT* (1997) 80 FCR 58 @ 75

The High Court in *K & S Lake City Freighters Pty Ltd v Gordon & Gotch Ltd*<sup>3</sup> said:

to read the section in isolation from the enactment of which it forms a part is to offend against the cardinal rule of statutory interpretation that requires the words of a statute to be read in their context ... Problems of legal interpretation are not solved satisfactorily by ritual incantations which emphasize the clarity of meaning which words have when viewed in isolation, divorced from their context. The modern approach to interpretation insists that the context be considered in the first instance, especially in the case of general words, and not merely at some later stage when ambiguity might be thought to arise.

There is no such thing as an ‘ordinary meaning’ in a statutory provision. There is only the meaning provided by the context.

This is what the Minister for Revenue and Assistant Treasurer Peter Dutton alluded to recently when he criticised the Tax Office for issuing rulings contrary to government policy.<sup>4</sup>

It was understood when these provisions were introduced that the objectives in designing these laws included that unitholders in typical public unit trusts would have a fixed entitlement to the income and capital of the trust within section 272-5 and that they would have a long position in respect of shares in those trusts within sections 160APHL(10) and (11). These were the positions presented to IFSA in the consultation discussions at the time. It is hard to accept that the detail in the trust loss provisions relating to fixed trusts would have been incorporated into the legislation, particularly with reference to trusts with more than 1,000 unitholders and trusts with wholesale investors, if they were not intended to have broad application to these trusts. No-one else would use these provisions.

The interests that unitholders have in public unit trusts give them full value for the money they subscribe. They get an appropriate share of the income of the trust and of the capital of the trust. There is no condition attached to these interests which can cause the unitholder to lose the interest other than through receiving the full current value of their interest. It is quite appropriate to describe such an interest as being ‘indefeasible’ even if it is believed that the word is used differently in other contexts.

As this is the appropriate policy outcome in this situation, the meaning attached to the word ‘indefeasible’ in these two contexts should be broad enough to cover the interests of unitholders in public unit trusts.

### **The ‘ordinary meaning’ of the word ‘indefeasible’**

What follows is a survey of the use of the word ‘indefeasible’ by the High Court and by lower courts in income tax cases. Then follows a discussion of why the rule against perpetuities is not determinative of the meaning of ‘indefeasible’.

Analysing the way the courts have used the word ‘indefeasible’ produces the following summary which can be said to represent the common usage of the word:

<sup>3</sup> (1985) 157 CLR 309 @ 315

<sup>4</sup> *Australian Financial Review*, 17 August 2006, p. 4.

- An interest is ‘indefeasible’ when the instrument that creates the interest does not attach any conditions under which the interest would be lost for no value. In other words, there is no condition subsequent.
- It would be incorrect to say that an interest is ‘indefeasible’ where it can be brought to an end in any way whatsoever. The term ‘indefeasible’ is narrower than that.
- An interest is not prevented from being ‘indefeasible’ just because the instrument that creates it provides for ways in which it will be turned into a benefit for the interest holder. Defeasance of an interest is where the interest holder ceases getting value from the interest, not where the interest is turned into value. Not all divestments of an interest are defeasances. Defeasance is where the interest is defeated, not where it is successful. The etymology of ‘defeasance’ is the Old French word for ‘undo’<sup>5</sup>.
- An interest is not prevented from being ‘indefeasible’ just because its quantum is not fixed.

### High Court Cases

In *Purcell v DFCT*<sup>6</sup> Isaacs J uses “vested ... though defeasible” to describe an interest in pastoral holdings that has been settled but subject to a power retained by the settlor to take the interest back.

In *Commissioner of Succession Duties (South Australia) v Isbister*<sup>7</sup> Rich ACJ uses “defeasible” in respect of trusts to mean the settlor had a power to revoke the trusts and “indefeasible” to mean the situation after the power ceased on the settlor’s death. His Honour provides “defeasance” as a synonym for “revocation” and “condition subsequent” and calls it a “power to destroy”<sup>8</sup>.

In that same case Williams J uses “indefeasibly entitled” in the same way including using the phrase “his already existing state would become indefeasible because it would no longer be liable to be defeated”.<sup>9</sup>

In *Union Trustee Company of Australia Limited v Federal Commissioner of Taxation*<sup>10</sup> Rich ACJ described an interest in a trust as becoming “indefeasible” when a settlor died because the terms of the settlement were that if the interest-holder predeceased the settlor the trustee was to hold the assets on trust for the settlor.

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<sup>5</sup> see ‘defeasance’ in *The Macquarie Dictionary*, Revised Third Edition, The Macquarie Library, Macquarie University, 2001

<sup>6</sup> (1929) 28 CLR 77 @ 87

<sup>7</sup> (1941) 84 CLR 375 @ 379

<sup>8</sup> *ibid*

<sup>9</sup> @ 380

<sup>10</sup> (1941) 65 CLR 29 @ 32

In *Commissioner of Stamp Duties (New South Wales) v Bradhurst*<sup>11</sup> Latham CJ discusses the difference between defeasible and indefeasible interests as being the difference between someone having the power to destroy the interest and that power not being available. McTiernan J uses the word “indefeasible” consistent with this.<sup>12</sup> Williams J uses “indefeasibly”, “defeasance” and “indefeasible” consistent with this.<sup>13</sup>

Further in that case Webb J uses both “defeasible” and “indefeasible”.<sup>14</sup> His Honour also says “in Adamson’s Case (1933) AC 257 there was ‘defeasibility’ apart altogether from the existence of the power of revocation”<sup>15</sup>. In that case the settlor had given the property to trustees to hold for the settlor’s children but only to be distributed to those children subsequently nominated in writing by the settlor inter vivos or in his will. There was a default formula to be used in the absence of a nomination. At the time of the settlor’s death no child had been nominated and no provision was made in the will. The default formula therefore applied. Each child had an interest that was defeasible because the settlor could fail to nominate them for a distribution.

In *Commissioner of Stamp Duties (New South Wales) v Sprague*<sup>16</sup> Dixon CJ uses “defeasible” to describe the situation where a default interest that existed because a power of appointment had not been exercised could cease when the power was exercised.

Barwick CJ in *Nilsen Development Laboratories Pty Limited v Federal Commissioner of Taxation*<sup>17</sup> describes the employees’ entitlement to leave as “indefeasible” even though the amount of wages to be paid to them whilst on leave was not yet fixed. This in particular goes to the point that “indefeasible” has nothing to do with quantum being fixed.

### Income Tax Cases in Lower Courts

The first of the cases specifically about the phrase “vested and indefeasible” used in income tax legislation is the Federal Court decision in *Dwight v Federal Commissioner of Taxation*<sup>18</sup> where Hill J said:

An interest is said to be defeasible where it can be brought to an end and indefeasible where it can not. Thus, a beneficiary with an interest which is not contingent but which interest may be brought to an end by the exercise of a power of appointment would be said to have a vested but defeasible interest.

His Honour went on to say that a third party security interest “does not convert an interest otherwise vested and indefeasible into one that is vested but defeasible”. This is one example of an interest able to come to an end but not being “indefeasible”.

<sup>11</sup> (1950) 81 CLR 199 @ 212 et seq

<sup>12</sup> @219

<sup>13</sup> “indefeasibly” @ 222, “defeasance” and “indefeasible” @ 223

<sup>14</sup> @ 224 and again @ 226

<sup>15</sup> @226

<sup>16</sup> (1959-1960) 101 CLR 184 @ 193

<sup>17</sup> (1981) 144 CLR 616 @ 620

<sup>18</sup> (1992) 92 ATC 4192 @ 4202-4203

In *Walsh Bay Developments Pty Limited v Federal Commissioner of Taxation* Foster J on the Federal Court said:<sup>19</sup>

neither ... had a vested and indefeasible interest in any of the income from the deposited funds. Neither had such a vested interest until such time as the occurrence of the relevant contingency caused such vesting. Even if there were an interest which could be described as vested it was clearly not “indefeasible” as it could be brought to an end by the occurrence of a relevant contingency.

On appeal the Full Federal Court quoted from a text by Fearne<sup>20</sup> as follows:<sup>21</sup>

A defeasible interest is an interest that is subject to be defeated by the operation of a subsequent or mixed condition.

An indefeasible interest ... is one that is not subject to any condition.

There is also a distinction between a contingent interest and a defeasible interest. The latter is a vested interest, which is liable to be divested by a supervening event. This distinction is not always easy to apply.

In the Federal Court Case *Trustees of the Estate Mortgage Fighting Fund Trust v Federal Commissioner of Taxation* Hill J said:<sup>22</sup>

The fact that a trust might come to an end tells nothing about whether until it does the interest of the beneficiaries is vested or indefeasible. Nor do I think that the fact that the deed provided that the beneficiaries might not be entitled to a transfer of the trust assets has any bearing on the issue. No doubt while administration is incomplete no beneficiary would be entitled to call for the assets of the estate, but that would not mean that the beneficiary would not have a vested and indefeasible interest.

Again, the interest in the trust can come to an end but His Honour specifically says that this does not in itself make it indefeasible.

### The Rule Against Perpetuities

The rule against perpetuities is not directly relevant to the meaning of the word ‘indefeasible’ but it does provide some insight into the use of the expression ‘vested and indefeasible’ in income tax legislation.

The rule against perpetuities is a common law principle that balances a person’s right to deal with their property as they choose against the community’s need for property to continue to move freely. The rule voids dispositions of property if the terms of the disposition are such

<sup>19</sup> (1994) 94 ATC 4682 @ 4692

<sup>20</sup> C Fearne, *Contingent Remainders and Executory Devises*, 10<sup>th</sup> Edition, 1844, Volume 2

<sup>21</sup> (1995) 31 ATR @ 27; Fearne @ 30

<sup>22</sup> (2000) 2000 ATC 4525 @ 4541

that the vesting of the property does not reach a finality within a specific period of time, often called ‘the perpetuity period’. For example, a disposition to a person for their life, to transfer on their death to their oldest surviving child and on that child’s death to their oldest surviving child would be void because it would take too long to be certain who that third person was.

In the context of the rule against perpetuities, property vests in a person when their right to enjoy the property is not subject to any contingency. Their right to enjoy the property does not have to be immediate. It only has to be not contingent. It can take effect at a specified point in time in the future. What cannot be the case is that it takes effect only if a specified event happens. For example, a gift to A for one year, to B for the following year and to C thereafter creates a vested interest in the property in A, B and C. On the other hand with a gift to A for their life and on their death, if B is still alive to B but if B has predeceased A to C, A has a vested interest but B does not. B’s interest is contingent on outliving A.

The concept of indefeasibility is not directly relevant to the rule against perpetuities. The creation of an interest that is defeasible needs to be tested against the rule not because the interest is defeasible but because the defeasibility means that it is possible that there is further vesting that could happen. Take as an example a gift to a school subject to a term that if the school’s curriculum ever loses certain features the property shall transfer to a specified charity. This would be void because it would not be certain within the perpetuity period whether the property is going to vest in the charity or not. The school’s curriculum may meet the terms of the gift beyond the end of the perpetuity period but still be at risk of not meeting the term thereafter. The problem is not the indefeasibility of the interest per se. It is that on the terms of the gift there is another vesting that may happen.

*Re Bowen*<sup>23</sup>, *In re Peel’s Release*<sup>24</sup> and *Re Cooper’s Conveyance Trusts*<sup>25</sup> are examples of this type of application of the rule. Nowhere in these cases is the word ‘indefeasible’ used.

The reference source used in this submission for the rule against perpetuities is Ronald H. Maudsley’s *The Modern Law of Perpetuities*.<sup>26</sup> The word ‘indefeasible’ does not appear anywhere in Maudsley’s book.

Maudsley calls the previously described situation ‘vesting subject to divestment’.<sup>27</sup> Not all divestment is due to defeasance. A divestment for value does not destroy or undo an interest. It satisfies that interest.

Another point to take from Maudsley’s discussion is that a vesting that is subject to a condition subsequent is still a vesting. If our tax law just used the word ‘vested’ rather than the expression ‘vested and indefeasible’ then conditions subsequent would not stop an interest from being within the expression.

If ‘vested’ means not subject to a condition precedent and ‘indefeasible’ means not subject to a condition subsequent then ‘vested and indefeasible’ means not subject to any condition. This is a useful way of approaching this last expression.

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<sup>23</sup> (1893) 2 Ch 491

<sup>24</sup> (1921) 2 Ch 218

<sup>25</sup> (1956) 3 All ER 28

<sup>26</sup> Butterworths, London, 1979

<sup>27</sup> p. 13

A public unit trust will typically continue to issue and redeem units. This does not make the existing interests indefeasible. Maudsley discusses this type of interest and calls it ‘vesting subject to open’<sup>28</sup>. This is where more than one interest is created in the property in such a way that it is yet to be finally determined who all of the interest holders are and what the quantum of each holder’s interest is. An example would be a gift to all hospitals operating in a specified geographic area at the time of the grantor’s death to be divided in proportion to the number of beds each hospital has in the area at the time.

Maudsley tells us that each interest in this situation is vested notwithstanding that its quantum will continue to vary. These types of gift have been held to breach the rule against perpetuities where the uncertainty as to quantum goes beyond the perpetuity period; not because the interests are not vested but because there is possibly more vesting to come. The rule against perpetuities is directed against donors and vendors controlling future ownership and this is what happens with a vesting subject to open. This is not to say that the interests are defeasible. The fact that an interest is not yet fully defined does not mean that it has been destroyed or undone. Where an interest will always have some value it is indefeasible even if that value is yet to be finally determined.

An inherent part of Maudsley’s analysis of the rule against perpetuities is that the conditions that are relevant to determining the nature of an interest are those that are incorporated in the terms of the disposition. Events that may happen independent of the terms of the disposition are not relevant. For example, a person’s interest in property can be defeated by their death, by Government action, by the Family Court and through many other externalities. Nothing like this prevents an interest being vested for the purposes of the rule against perpetuities.

If you have any questions, or what like to discuss the matter further, please do not hesitate to contact myself, or Preetha Manoharan, on (02) 9299 3022.

Yours sincerely,

A handwritten signature in cursive script, appearing to read 'Richard Gilbert', is positioned to the left of a vertical red line.

Richard Gilbert  
**Chief Executive Officer**

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<sup>28</sup> p. 12; see also ‘Class Gifts and the Class Closing Rules’ pp. 15 et seq and ‘Class Gifts’ pp. 39 et seq

**APPENDIX – Other Provisions That Draw on the Meaning of ‘Indefeasible’**

In addition to the two provisions mentioned in the Introduction, the word ‘indefeasible’ is used to define the expression ‘fixed trust’ for use in the following provisions.

**Income Tax Assessment Act 1997**

Division 124 - Scrip for scrip rollover relief

Subdivision 165-F - Carry forward of company losses where beneficially owned by trusts

Divisions 703, 713 and 719 - Various consolidation provisions

Division 727 – General value shifting provisions

**Income Tax Assessment Act 1936**

Section 63AA – Bad debts and continuity of ownership tests

Section 50HA - Current year loss continuity of ownership test

Section 73L - Research and Development – grouping of fixed trusts

Section 160ZZPZP - Small business CGT concessions