

## “CHAMELEON-HUED WORDS’’: A NOTE ON DISCRETIONARY TRUSTS\*

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[371] This note seeks to identify some recurring misunderstandings and sources of imprecision in legal analysis involving trusts and, more particularly, discretionary trusts.

It is convenient to commence with three basal points. First, a discretionary trust, no differently from any other trust, is a relationship, not a legal person. That is not to deny that the misconception that a trust has legal personality, which Barrett JA described as a “heresy”,<sup>1</sup> is widespread.<sup>2</sup> There can be no hope of precision in analysis if it is not clearly understood that it is the trustee which owns the property held on trust and can sue and be sued, and the trust is, subject to the contrary operation of statute,<sup>3</sup> not a legal person.<sup>4</sup>

Secondly, the trustee of a discretionary trust, no differently from any other express trust, may be authorised to enter into contracts, deal with property and otherwise conduct a business. In short, the trustee may trade, and the existence of a trust need not be disclosed to or known by the trustee’s creditors and debtors.

Thirdly, it has long been settled law that persons dealing with the trustee are prima facie entitled to enforce their bargain with the trustee: “to sue him and to get judgment and make him a bankrupt” (*Re Johnson* (1880) 15 Ch D 548 at 552 (Jessel MR)). Sir George Jessel’s judgment was delivered shortly after the liquidation of the City of Glasgow Bank in 1878, which, as Lord Rodger JSC has said, “brought ruin on many people who had merely held shares as trustees” and indicated with “remorseless clarity” that a person entered on a company register in any capacity was a member with all relevant rights and liabilities.<sup>5</sup> It is wrong to think that a trustee’s liability is

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1 *Workplace Safety Australia Pty Ltd v Simple OHS Solutions Pty Ltd* [2014] NSWCA 115 at [10].

2 In addition to decisions referred to in this column last year (“Equity and trusts” (2014) 88 *ALJ* 170) see *Kelly v Mina* [2014] NSWCA 9 at [103]; *Agricultural Land Management Ltd v Jackson [No 2]* (2014) 285 *FLR* 121 at [302]; [2014] *WASC* 102; see also, for an extreme case, “Current issues: A judge’s duty to listen” (2015) 89 *ALJ* 75 at 77.

3 For example the “reserve trusts” created by *Crown Lands Act 1989* (NSW), s 92, or the provision which deems a trust to be an “entity” in *A New Tax System (Goods and Services Tax) Act 1999* (Cth), s 184-1.

4 See the explanations in *Yara Australia Pty Ltd v Oswal [No 2]* [2013] *WASCA* 187 at [55]-[63], [258]-[259].

5 *Farstad Supply AS v Enviroco Ltd* [2011] 1 *WLR* 921 at [69]; [2011] *UKSC* 16.

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confined to the assets held on trust.<sup>6</sup>

The remaining points are directed to discretionary trusts. The term “discretionary trust” bears a meaning “disclosed by a consideration of usage rather than doctrine” and is used in a way that is “descriptive rather than normative”.<sup>7</sup> *Lewin on Trusts* states that the term “discretionary trust” has no precise meaning.<sup>8</sup> There is more than one reason why that is so, and why the expression “discretionary trust” can mislead.

First, “discretionary” is itself ambiguous. It has been said that a discretionary trust is a trust “where the entitlement of beneficiaries to income, or to corpus, is not immediately ascertainable”.<sup>9</sup> That is true, but may confuse in the common case of trusts where a beneficiary’s entitlement is contingent upon an evaluative determination by a trustee. A trustee which is required to determine, say, whether a person was “unlikely ever to engage in gainful Work”, undertakes a contestable [372] exercise of judgment, which does not involve the exercise of a discretion in the presently relevant sense. A unanimous High Court held as much in *Finch v Telstra Super Pty Ltd* (2010) 242 CLR 254 at [29]. The entitlement of a member of a superannuation scheme to a total and permanent invalidity payment turns upon the consideration of his or her case by the trustee, but that does not make the trust a discretionary trust. Ultimately, this is a consequence of the varied use of the term “discretion” in legal reasoning.<sup>10</sup> This makes it no different from other familiar concepts in law which, on analysis, are protean, including “purpose”,<sup>11</sup> “use”,<sup>12</sup> “mistake”,<sup>13</sup> “jurisdiction”,<sup>14</sup> “adversely affected”,<sup>15</sup> and, especially, that “chameleon-hued word”, right.<sup>16</sup>

Secondly, there are two conflicting usages of the term “discretionary trust”. Professor Waters has written that “The expression discretionary trust is not a term of art, and there are two opinions among legal textbooks as to what types of trust the expression includes.”<sup>17</sup> More traditionally, a “discretionary trust” is used to describe a trust power for the distribution of capital or income

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6 Of course, people are free to contract on the basis of limited recourse against the assets held on trust: see *Helvetic Investment Corporation Pty Ltd v Knight* (1984) 9 ACLR 773 at 774 (Glass JA).

7 *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226 at [8], echoing what was said in *Federal Commissioner of Taxation v Vegners* (1989) 90 ALR 547 at 551-552.

8 Tucker L, Le Poidevin N and Brightwell J, *Lewin on Trusts* (19th ed, Sweet & Maxwell, 2015) par 29-024.

9 *Commissioner of Taxation (Cth) v Vegners* (1989) 90 ALR 547 at 551.

10 See *Dwyer v Calco Timbers Pty Ltd* (2008) 234 CLR 124 at [37]-[40]; *SAS Trustee Corp v Cox* (2011) 285 ALR 623; [2011] NSWCA 408 at [90].

11 See *Hayes v Willoughby* [2013] 1 WLR 935 at [9] (Lord Sumption; with whom Lords Neuberger and Wilson agreed, approving what had been said in *Williams v Spautz* (1992) 174 CLR 509 (Brennan J)).

12 See *Minister Administering the Crown Lands Act v NSW Aboriginal Land Council* (2008) 237 CLR 285 at [23], [69]-[75].

13 See *CTM v The Queen* (2008) 236 CLR 440 at [7], by reference to the analysis in *State Rail Authority (NSW) v Hunter Water Board* (1992) 28 NSWLR 721 at 724-725 (Gleeson CJ).

14 *Kirk v Industrial Court (NSW)* (2010) 239 CLR 531 at [63], by reference to *Anisimic Ltd v Foreign Compensation Commission* [1968] 2 QB 862 at 889 (Lord Diplock).

15 *Independent Commission Against Corruption v Cunneen* [2015] HCA 14 at [2] and [57].

16 Hohfeld W, “Some Fundamental Legal Conceptions as Applied in Judicial Reasoning” (1913) 23 *Yale LJ* 16 at 35.

17 Waters D, “Using Discretionary Trusts in Estate Planning” (2012) 19 *JITTCP* 161 at 169.

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amongst a class of beneficiaries. In such a case, the trustee is under an *obligation* to exercise the power, and retains a discretion only as to the manner of its exercise, typically, in favour of one or more persons identified from a widely defined class. The taxation treatment of undistributed trust income causes many trust deeds either to impose an obligation to distribute income each financial year, or for there to be a default distribution if the power is not exercised.<sup>18</sup> However, the term “discretionary trust” is also often used in a wider sense, where there is a mere power, which need not be exercised at all. As *Lewin* puts it:<sup>19</sup>

A typical example of a discretionary trust in the wider sense (particularly in the context of offshore trusts) is one under which the trustees have various mere powers of appointment, and of distribution or application of capital and income, among a class of beneficiaries during the trust period, subject to which income is to be accumulated during the trust period, and at the end of the trust period the trust fund and its income, so far as not disposed of, is held on fixed trusts ... [T]he trust is described as a discretionary trust though none of the discretions are imperative and none of the default trusts themselves involves the exercise of any discretion.

Gummow J referred to this species of trust as a “purely discretionary trust”.<sup>20</sup>

Thirdly, the same trust deed or will may establish quite distinct trusts of different property. It is not uncommon for a trust deed to provide for income to be treated quite differently from capital (for example, the latter may be held on fixed trust, while the trustee may be required to distribute the former).

[373] Ultimately, what matters is not the label used to describe the particular trust or trusts, but the operative provisions established by the settlor or testator. If the question turns on statute, then attention will need to be given to the particular statutory definitions, which display much variation.<sup>21</sup>

There are similar ambiguities with the related terms “beneficiary” and “beneficial interest”. The term “beneficiary” may on occasion be used in contradistinction from “discretionary object”, but very often it used to include discretionary objects. Lord Scarman said that it was “a term which

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<sup>18</sup> See, eg *Raftland Pty Ltd v Commissioner of Taxation (Cth)* (2008) 238 CLR 516 on *Income Tax Assessment Act 1936* (Cth), s 99A.

<sup>19</sup> *Lewin on Trusts*, n 8, para 29-024.

<sup>20</sup> *Federal Commissioner of Taxation v Vegners* (1989) 90 ALR 547 at 552.

<sup>21</sup> See, eg *Duties Act 1997* (NSW), Dictionary; *Stamp Duties Act 1923* (SA), s 2; *Duties Act 2008* (WA), s 3.

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everyone is agreed includes persons who are the objects of the discretionary trusts”.<sup>22</sup> Lindgren J said in *Kafataris v Deputy Commissioner of Taxation* (2008) 172 FCR 242 at [44] that although discretionary objects “do not have a beneficial interest in any property the subject of a ‘discretionary’ trust prior to a distribution or appointment of income or capital, they are freely referred to as beneficiaries”.<sup>23</sup>

It may be helpful to pause to observe the precision in Lindgren J’s analysis. The quotation marks surrounding “discretionary” emphasise the descriptive rather than normative quality of the expression. Moreover, the trustee of a “discretionary trust” may and very often will hold property on a fixed trust – after it has been the subject of the discretionary power of appointment, but before the person so favoured has the property transferred to him, her or it.<sup>24</sup>

If the class of objects is closed, all the discretionary objects of a discretionary trust can invoke the “rule”<sup>25</sup> in *Saunders v Vautier* and bring the trust to an end.<sup>26</sup> However, the class of objects will frequently be so numerous that this cannot occur.<sup>27</sup> That is one of the ways in which modern discretionary trusts have come in some respects to resemble trusts in the United States (where *Saunders v Vautier* does not apply).<sup>28</sup> But it is wrong to reason that because (whether in practice or merely in theory) the objects acting together as a class can end the trust, they enjoy some collective property right. As Ungood-Thomas J said in *Sainsbury v Inland Revenue Commissioners* [1970] Ch 712 at 725, “To treat separate unquantifiable interests as quantifiable seems to me to fuse and confuse the conception of group persona with the separate rights of individuals”. The short point is that there is apt to be no person with a “beneficial interest” in the property. “For too long we have clung to the belief that equitable title to trust assets must always be vested in somebody.”<sup>29</sup> That echoes the passage in Viscount Radcliffe’s advice in *Commissioner of Stamp Duties (Qld) v Livingston* [1965] AC 694 at 712 that it is a fallacy to assume that for all purposes and at every moment of time the law requires the separate existence of a legal and an equitable estate or interest in property.<sup>30</sup>

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<sup>22</sup> *Leedale v Lewis* [1982] 1 WLR 1319 at 1334 (tax was imposed on “any beneficiary under the settlement”).

<sup>23</sup> By reference to *Gartside v Inland Revenue Commission* [1968] AC 553 at 617-618; *R&I Bank of Western Australia Ltd v Anchorage Investments Pty Ltd* (1993) 10 WAR 59 at 79; *ASIC v Carey [No 6]* (2006) 152 FCR 509 at [25]-[28]. Lindgren J’s judgment has been followed in *Colonial First State Investments Ltd v Commissioner of Taxation* (2011) 192 FCR 298 (Stone J) and *Yazbek v Commissioner of Taxation* (2013) 209 FCR 416 at [20]-[24] (Bennett J).

<sup>24</sup> See analysis in *Commissioner of State Revenue v Lam & Kym Pty Ltd* (2004) 10 VR 420 at [36]-[46] (Nettle JA).

<sup>25</sup> See *Beck v Henley* [2014] NSWCA 201 at [32]-[44].

<sup>26</sup> *Sir Moses Montefiore Jewish Home v Howell & Co (No 7) Pty Ltd* (1984) 2 NSWLR 406.

<sup>27</sup> See *Schmidt v Rosewood Trust Ltd* [2003] 2 AC 709 at [34]-[35].

<sup>28</sup> See Matthews P, “The Comparative Importance of the Rule in *Saunders v Vautier*” (2006) 122 LQR 266; *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 224 CLR 98 at [41]-[51]; Panico P, *International Trust Laws* (OUP, 2010) pp 80-97.

<sup>29</sup> Lau M, *The Economic Structure of Trusts* (OUP, 2011) p 167.

<sup>30</sup> See also *Glenn v Federal Commissioner of Land Tax* (1915) 20 CLR 490 at 497; *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 224 CLR 98 at [25]-[31].

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However, and perhaps counter-intuitively, the *trustee* of a discretionary trust may enjoy a beneficial interest in trust assets. The trustee will typically enjoy a right of recoupment or indemnity [374] from trust assets for expenses and liabilities properly incurred,<sup>31</sup> and to that extent enjoys a beneficial interest in those assets.<sup>32</sup> Although the right is commonly called a charge or a lien, that has been said to be anomalous<sup>33</sup> and may mislead. In the ordinary case where a trustee is entitled to be indemnified, the trustee has recourse to trust assets by reason of its legal ownership of the assets, not because of some security interest over the assets of another. However, the language of charge or lien is apt where there is a new trustee, or where a creditor has through subrogation become entitled to exercise the trustee’s right, as White J has observed.<sup>34</sup>

Even the most familiar legal language is often imprecise. For example, it is convenient to distinguish criminal and civil litigation, although there are substantial difficulties drawing the line.<sup>35</sup> In *D’Orta-Ekenaike v Victoria Legal Aid* (2005) 223 CLR 1, Gleeson CJ, Gummow, Hayne and Heydon JJ rejected a submission that a distinction should be drawn between civil and criminal proceedings for the purposes of advocates’ immunity from suit. Their Honours said that the difficulties “are reason enough to reject a principle founded in drawing such a distinction” (at [76]). The same applies to “discretionary trusts”. Like any expression, its meaning is dependent on context (as Lord Neuberger PSC observed earlier this year of the words “reasonable grounds” in *R (on the application of Evans) v Attorney General* [2015] UKSC 21 at [88]). It is often convenient to speak in general terms distinguishing fixed trusts from discretionary trusts, but it may be unsafe to base legal reasoning upon that distinction. There is no rule, for example, that an object of a discretionary trust may never bring a derivative action;<sup>36</sup> this may occur in exceptional circumstances, if the trustee is unwilling or unable to do so.<sup>37</sup> Hohfeld long ago observed that “in any closely reasoned problem, whether legal or non-legal, chameleon-hued words are a peril both to clear thought and to lucid expression”.<sup>38</sup> That is the point of noting that the term “discretionary trust” is merely descriptive and not normative, and is very often used in different senses.

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31 See Allsop J, “The Nature of the Trustee’s Right of Indemnity and its implications for Equitable Principle” (NSW Supreme Court website); Sackville R, “The trustee’s right of indemnity and the creditor’s right of subrogation: The hardening of equity” (2013) 7 *Journal of Equity* 34. Both papers were delivered in 2012 in Sydney to the Society of Trust and Estate Practitioners.

32 *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 367.

33 See *Agusta Pty Ltd v Provident Capital Ltd* [2012] NSWCA 26; (2012) 16 BPR 30,397 at [41].

34 *Newcastle Airport Pty Ltd v Chief Commissioner of State Revenue* [2014] NSWSC 1501 at [73]-[78].

35 See *Chief Executive Officer, Customs v Labrador Liquor Wholesale Pty Ltd* (2003) 216 CLR 161 at [107] (where Hayne J referred to “the dangers in attempting to force proceedings of this kind into a system of classification in which there are only two classes of proceedings: civil and criminal”).

36 See *Alexander v Perpetual Trustees WA Ltd* (2004) 216 CLR 109 at [55]-[56].

37 See *Pearson v Commissioner of Taxation* (2001) 116 FCR 357 at [12]-[14], [48]-[52]; *Highland v Labraga [No 2]* [2005] NSWSC 1212 at [16]-[19]; *Deutsch v Deutsch* [2012] VSC 227 at [41]; *El Sayed v El Hawach* [2015] NSWCA 26 at [47]-[56].

38 Hohfeld, n 16 at 35.