Failed trust distributions: their tax consequences

by Matthew Burgess, CTA, Partner, and Darius Hii, Lawyer, McCullough Robertson

Abstract: There is a range of issues that can potentially undermine the intentions of a trustee when attempting to make distributions from the trust to beneficiaries. Failure to address methodically each potential issue in a timely way will lead to unintended outcomes that may be impossible to remedy once discovered. Further, there is increasing evidence that the Australian Taxation Office is acutely aware of many of the issues, and actively conducts compliance activity in the area. This article focuses on a number of the more common scenarios where purported distributions fail, in the context of a typical family discretionary trust with a range of beneficiaries, including family members and related trusts and companies. It also addresses the potential resulting tax consequences. The article considers trust distributions to a "beneficiary", distributions to particular beneficiaries, ATO requirements for tracing distributions, areas of ATO focus, and the ramifications of failed distributions.

Introduction

A methodical approach is needed when approaching trust distributions to ensure that the intended outcomes are achieved. This article focuses on a number of the more common scenarios where purported distributions fail. It also addresses the potential resulting tax consequences.

Unless otherwise flagged, all references to trusts in this article should be read as a reference to a "typical" family discretionary trust with a range of beneficiaries, including a wide range of family members and related trusts and companies.

The specific scenarios considered in this article broadly follow the topics and order set out under the following specific headings:

(1) trust distributions to a "beneficiary";

(2) distributions to particular beneficiaries;

(3) Australian Taxation Office (ATO) requirements for tracing distributions;

(4) areas of ATO focus; and

(5) ramifications of failed distributions.

Trust distributions to a "beneficiary"

Is the intended recipient a beneficiary?

A beneficiary is a person or an entity who has an equitable interest in the trust fund. A potential beneficiary has enforceable rights against a trustee who fails to comply with their duties.

The range of eligible beneficiaries will generally be defined in the trust deed, and the first step in any proposed distribution should be to ensure that the intended recipient falls within the range of potential beneficiaries of the trust.

The Federal Court, from a tax perspective, confirmed in *Yazbek v FCT*[1] that a beneficiary is not simply a person who, as a matter of fact, has obtained some tangible benefit from the trust, but rather they are someone "who is entitled to enforce the trustee's obligation to administer the trust according to its terms". In other words, a person is a beneficiary if they fall within the range of eligible beneficiaries under the trust deed, regardless of whether they have ever received distributions of income or capital from the trust.

When considering whether an intended recipient is an eligible beneficiary, care should be taken to identify classes of specifically excluded beneficiaries, which will typically override the provisions in a trust deed which create the class of potential beneficiaries. Some common examples of these excluded classes include:

(1) persons who have either renounced their beneficial interest or have been removed as a beneficiary of the trust fund;

(2) the settlor;

(3) any "notional settlor" (discussed below); and

(4) the trustee.

A comprehensive review of a trust deed must include an analysis of every variation or resolution of a trustee or other person that may impact on the interpretation of the document.

The range of documents that could impact on the potential beneficiaries of a trust at any particular point in time is almost limitless. Some examples include:

(1) resolutions of the trustee to add or remove beneficiaries pursuant to a power in the trust deed;

(2) nominations or decisions of persons nominated in roles such as a principal, an appointor or a nominator; and

(3) consequential changes triggered by the way in which the trust deed is drafted (for example, beneficiaries who are only potential beneficiaries while other named persons are living).

It is important to remember that the unilateral actions of a potential beneficiary may also impact on whether they can validly receive a distribution. For example, a named beneficiary may disclaim their entitlement to a distribution in any particular year, or may in fact renounce all interests under the trust.

There are a myriad of issues that potentially arise in relation to disclaimers and renunciation that are outside the scope of this article. This said, the fact that beneficiaries can unilaterally take such steps highlights the care that trustees must take when determining whether an intended recipient of a distribution is in fact a valid beneficiary of the trust.

In most instances within a close family group, the trustee is likely to have personal knowledge of any changes to the range of eligible beneficiaries (such as a unilateral renunciation by a beneficiary). However, these changes will not always be apparent to a professional adviser whose knowledge is limited to the trust documentation provided to them.

Inappropriately appointed beneficiaries

To the extent that steps have been taken to nominate additional beneficiaries, an analysis is needed as to whether the nomination was effective pursuant to the trust deed.

An example of a clause in a trust deed defining the range of beneficiaries and permitting additional beneficiaries to be appointed is as follows:

> "**Additional Members of the Class of General Beneficiaries:**
>
> (a) The children of the Primary Beneficiaries;
>
> (b) The more remote issue of the Primary Beneficiaries including any grandchildren or any Trust which may be formed for any of them or for any of the Primary beneficiaries;
>
> (c) Any company in which any one or more of them may hold a controlling interest; and
>
> (d) Any person, trustee or company who shall be entitled by nomination of the appointor to become a general beneficiary."

Given the way in which this clause is crafted, if there is an intention to distribute to a beneficiary not otherwise clearly within the parameters of subparas (a) to (c), then the strict requirements of subparagraph (d) must be followed and the intended beneficiary must be formally nominated by the appointor.

Obviously, there are a number of potential issues that arise in this regard, including:

(1) whether the appointment needs to be made in writing;

(2) whether the appointor is validly nominated in their role;

(3) at what point the nomination needs to take place in the context of the time frame within which a distribution must be made; and

(4) whether there are any consequential ramifications of the nomination, for example, stamp duty, resettlement for tax purposes or asset protection issues.

None of these issues should be considered in isolation and must be addressed methodically by the trustee and their advisers.

Exclusion of settlor: the notional settlor clause

Almost all trust deeds contain a clause excluding the settlor of a trust from being a beneficiary in order to ensure that the trust is not a "revocable trust" under s 102 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). Some deeds, however, take the restriction further by prohibiting distributions to any "notional settlor", in addition to the actual settlor. For example, a trust deed may include a provision along the following lines:

> "A person who has transferred property for other than full consideration in money or money's worth to the Trustee to be held as an addition to the Trust Fund (herein called 'the excluded persons'), or any corporation in which and the trustee of any settlement or trust in or under which any excluded person has an actual or contingent beneficial interest, so long as such interest continues, is excluded from the class of General Beneficiaries."

Where such a clause exists, a beneficiary will likely be excluded from receiving distributions if they have:

(1) made interest-free loans to the trust;

(2) sold an asset to the trust at less than market value; or

(3) gifted cash or other assets to the trust.

As the main beneficiaries of a trust will have often contributed amounts to a trust in one or more of the ways mentioned above, the risk of invalid distributions being made where such a clause exists in a deed are significant and anecdotally we understand that this issue is one the ATO reviews regularly.

Furthermore, any income or capital distributions to a trust (containing a clause along the lines outlined above) from another discretionary trust in the group could be considered a "transfer of property for other than full consideration". This would then prevent the trust with the "notional settlor" clause distributing to those other entities which have previously distributed income or capital to it.

Exclusion of trustee

Another commonly overlooked clause relates to the exclusion of the trustee, be that the current, former or future trustee, as a beneficiary of the trust. These clauses are often found in deeds prepared by New South Wales advisers, as s 54(3) of the *Duties Act 1997* (NSW) limits the nominal duty exemption for a change of trustee to trust deeds that contain provisions ensuring:

(1) none of the continuing trustees remaining after the appointment of a new trustee are or can become a beneficiary under the trust;

(2) none of the trustees of the trust after the appointment of a new trustee are or can become a beneficiary under the trust; and

(3) the transfer is not part of a scheme for conferring an interest, in relation to the trust property, on a new trustee or any other person, whether as a beneficiary or otherwise, to the detriment of the beneficial interest or potential beneficial interest of any person.

An example of such a clause complying with the above is as follows:

> "None of the continuing Trustees remaining after the retirement of a Trustee is or can become a beneficiary under the Trust, and none of the Trustees of the Trust after the appointment of a new Trustee is or can become a beneficiary under the Trust."

As with all of the previous clauses, the impact of this type of restriction will ultimately depend on how the clause is drafted in the relevant trust deed.

Distributing to a non-beneficiary

The case of *Harris v Harris*[2] considered the purported distributions from a trust to a recipient who was found not to be a beneficiary. On reading the trust deed for the family trust, the trial judge noted that the recipient in question was not in fact an eligible beneficiary of the trust. This meant, in the context of the case and for the purposes of a property settlement, the recipient should be ignored as a beneficiary as all of the potential value derived was from invalid distributions.

While the "wrongful distributions" (in the words of the court) were not explored further, the decision highlights the importance of reading the source documentation before any steps are taken to rely on what might otherwise be assumed to be permitted.

Where a distribution has been made to an excluded beneficiary, a range of tax and commercial issues arise. Again, a detailed analysis of the various ramifications in this regard is outside the scope of this article; however, briefly:

(1) whether there are valid default distribution provisions under a trust deed will be highly relevant;

(2) the effectiveness of any default distribution clause needs to be carefully considered, as highlighted in the *BRK* case (summarised in more detail below);

(3) a significant number of trust deeds will either have no default provisions or the default provisions will be ineffective; and

(4) where there are no default provisions, at least in relation to capital, there is a risk that the trust itself will be considered void.

Assuming that there is a valid default distribution provision which operates as intended, the main consequences are commercial in nature. In particular, the practicalities that surround recovery of invalid trust distributions, reallocation of the distributions, together with the flow-on taxation and stamp duty implications and potential personal liability for the trustee.

These issues are all also relevant if there is no valid default distribution provision. However, where that situation arises, the trustee is assessed under s 99A ITAA36 on the basis that no beneficiary will be presently entitled. This means that the trustee is assessed at the top marginal tax rate of 45% plus the Medicare levy of 1.5%, unless the Commissioner exercises his discretion in the limited circumstances specified in s 99A(2) ITAA36.

Importantly, where the trustee is taxed under s 99A ITAA36, the ability to access the general 50% capital gains tax discount is denied.

Family trust elections and interposed entity elections

In addition to the traditional trust law-related restrictions on the potential beneficiaries of a trust, it is important to keep in mind the consequences of a trustee making a family trust election or interposed entity election. In particular, where such an election has been made, despite what might otherwise be provided for in the trust instrument, the election will effectively limit the range of potential beneficiaries who can receive a distribution without triggering a penal tax consequence (being the family trust distribution tax).

A family trust election will generally be made by a trustee for one or more of the following reasons:

(1) access to franking credits;

(2) ability to utilise prior year losses and bad debt deductions;

(3) simplifying the continuity of ownership test; and

(4) eliminating the need to comply with the trustee beneficiary reporting rules (as mentioned in more detail below).

A family trust election is made in accordance with s 272-80 of Sch 2F ITAA36 which requires that a "test individual" be specified, of which their family will benefit from all future distributions.

A test individual's family will broadly include, under s 272-95 of Sch 2F ITAA36, the immediate family of the test individual and their spouse, as well as the lineal descendants of the immediate family.

Once a family trust election has been made, the trust will be restricted to making distributions to trust beneficiaries within the family group. Failure to do so will incur family trust distribution tax being imposed at a flat rate of 47%, which is payable by the distributing trust within 21 days after distribution is made.

Likewise, an interposed entity election for a company, trust or partnership in a test individual's family group may be made where income is intended to be distributed to that entity from a trust that has a family trust election in place. In order to be eligible to make an interposed entity election, a "family control test" must be satisfied, as set out under s 272-87 of Sch 2F ITAA36.

Again, while a full analysis of the impact of family trust elections and interposed entity elections is outside the scope of this article, it is critical to consider the potential implications of any such election on what might otherwise appear to be a permissible distribution in accordance with the trust deed.

Practical application

Set out below are some clauses extracted from a "standard" trust deed established in the 1990s. The provisions highlight how some of the issues outlined above can arise when determining whether intended trust distributions are likely to be effective.

Deed provisions

The beneficiaries were defined in the trust deed as follows:

> "The **Primary Beneficiaries** means that person or persons specified as such in the Schedule hereto.
>
> The **Secondary Beneficiaries** means the person or persons specified as such in the Schedule hereto.
>
> The **Tertiary Beneficiaries** means the person or persons specified as such in the Schedule hereto.
>
> The Primary Beneficiaries, the Secondary Beneficiaries and the Tertiary Beneficiaries include persons who from time to time until the Perpetuity Date come under each category respectively notwithstanding that such persons may not be in existence, or have not come into such category at the date of this Deed."

The beneficiaries were listed in the schedule of the trust deed as follows:

> "**Primary Beneficiaries:**
>
> (a) Joseph Jones;
>
> (b) Janet Jones;
>
> (c) The children of the said Joseph Jones and the said Janet Jones; and
>
> (d) The grandchildren of the said Joseph Jones and the said Janet Jones.
>
> **Secondary Beneficiaries:**
>
> (a) The parents of the said Joseph Jones;
>
> (b) The brothers and sisters of the said Joseph Jones; and
>
> (c) The children of the brothers and sisters of the said Joseph Jones.
>
> **Tertiary Beneficiaries:**
>
> (a) The parents of the said Janet Jones;
>
> (b) The brothers and sisters of the said Janet Jones; and
>
> (c) The children of the brothers and sisters of the said Janet Jones."

The following clause in the trust deed provided the power to appoint additional beneficiaries:

> "Notwithstanding anything to the contrary herein contained the Trustee shall have the power at any time or times and from time to time in its absolute discretion with or without consideration to pay, transfer, apply, set aside or accumulate the whole or any part of the Trust Fund and/or income to any such persons, incorporated companies, trusts, charities, bodies or associations whether incorporated or unincorporated having a separate legal identity in the country or place according to the laws of which they have been created as the Principal during his, her or their lifetime shall by notice in writing to the Trustee before the Perpetuity Date appoint to be a beneficiary for the purpose of this Deed PROVIDED HOWEVER and notwithstanding the provisions of anything herein contained or implied none of the following shall be appointed to be a beneficiary nor they shall be permitted to acquire a beneficial interest in the Income or capital of the Trust or any part thereof —
>
> (a) the Settlor; or
>
> (b) a Trustee or former Trustee hereof; or
>
> (c) any corporation or Trust in which the settlor or any Trustee or former Trustee has any actual or contingent beneficial interest; or
>
> (d) any Trust which would, if appointed, result in the infringement of the law against perpetuities.
>
> PROVIDED FURTHER that where the primary beneficiaries or any one or more of them (not being a body corporate) shall be the original Trustee hereof the provisions of this clause shall not apply in respect of any payment, transfer, application, setting aside or accumulation hereunder by the Trustee to such primary beneficiary nor to the acquisition of a beneficial interest in the income or capital of the trust or any part thereof by such primary beneficiary from the Trustee.

> The expressions 'beneficiary', 'beneficiaries', 'Beneficiary' or 'Beneficiaries' where used in this Deed or in the Schedule hereto shall include beneficiaries appointed pursuant to the terms of [this clause]."

Relevantly, the variation clause allowed the trustee to vary the trust deed, subject to the following restrictions:

> "… PROVIDED THAT the Trustee shall not have any power to revoke add to or vary any of the trusts or powers hereof so that the Settlor or the Trustee may acquire a beneficial interest in the Trust Fund or any part thereof nor to affect the beneficial entitlement of any Beneficiary to any amount applied for him prior to the date or revocation or alteration ..."

More importantly:

(1) the initial trustee was Joseph Jones; and

(2) the initial principal was Janet Jones.

Factual scenario

Over a period of some years, the following additional events took place (among other things):

(1) the original trustee was replaced with a corporate trustee;

(2) the corporate trustee was used as a corporate beneficiary of the trust; and

(3) distributions were made to Joseph Jones.

Practical implications

The first time the trust deed was comprehensively reviewed in relation to the history of distributions was as part of proceedings brought by the former daughter-in-law of Joseph and Janet Jones, who was (among other things) arguing that her husband (one of the sons of Joseph and Janet) was entitled, pursuant to the default distribution provisions under the trust, to distributions (plus interest) that had historically been purported to be made to both Joseph Jones and the corporate beneficiary.

Other relevant issues identified as part of the initial review (in the context of the focus of this article) included the following:

(1) in addition to the apparently invalid distributions to Joseph Jones and the corporate beneficiary, there were obviously also consequential limitations on distributions to related entities;

(2) while the breadth of excluded beneficiaries may have been wider than initially intended, the specific prohibition on variations to the trust deed would seem to prevent any steps that may be taken to remove the initial restrictions; and

(3) the records of the trust were also incomplete in relation to the written notification by the principal nominating certain additional beneficiaries.

Distributions to particular beneficiaries

Regardless of whether a distribution is otherwise permissible, there are a number of particular types of distributions that should be carefully considered before they are made. The three most relevant categories in this regard are as follows:

(1) trust-to-trust distributions;

(2) distributions to non-resident beneficiaries; and

(3) distributions to companies.

Each of these distributions is considered below.

Distributions from trust to trust

All Australian jurisdictions except for South Australia have a statutory perpetuity period of 80 years. In Victoria, Tasmania, Western Australia and the Northern Territory, the common law perpetuity period may also be adopted, that is, "a life in being plus 21 years".

Despite South Australia essentially abolishing the rule against perpetuities, s 62 of the *Law of Property Act 1936* (SA) allows the court to dispose of any remaining unvested interests after 80 years on the application of a beneficiary.

Generally, when trust-to-trust distributions are made, the vesting date of both trusts should be considered. Where the recipient has a vesting date which is later than the distributing trust, the risk that the rule against perpetuities is breached is a relevant issue.

Historically, many advisers believed that, if the vesting date of the recipient trust was later than the distributing trust, then this automatically caused a breach of the rule against perpetuities, making the purported distribution void. However, the case of *Nemesis Australia Pty Ltd (formerly Steve Hart Family Holdings Pty Ltd) v FCT*[3] confirmed that the "wait and see rule" in s 210 of the *Property Law Act 1974* (Qld) can be relied on in a situation where a trust distributes to another trust with a later perpetuity date.

The "wait and see" rule means that the initial distribution will not be void when made, and will not become void until such time as there is a failure to distribute out of the recipient trust before the vesting date of the original distributing trust.

Distributions from trust to non-resident beneficiary

When making trust distributions to non-resident beneficiaries, it is important to consider the interaction between s 128A ITAA36 in relation to withholding tax for non-residents and the general provisions of Div 6 ITAA36 in relation to the taxation of trust distributions.

Withholding tax will be payable on all dividends, interest or royalties included in the income paid by a resident trust to a non-resident beneficiary to the extent that the non-resident beneficiary is presently entitled to the relevant amount.

To the extent that income is caught by the withholding tax provisions, s 128D ITAA36 excludes it from being treated as assessable income, which will potentially impact the Div 6 treatment of the relevant trust distributions. For example, if a resident trust distributes income to beneficiaries in the United States (who are non-resident beneficiaries), then:

(1) under the withholding tax system, a flat rate is deducted from the source of the income before the income is sent overseas;

(2) each part of the income (depending on whether it is interest, dividends or royalty distribution) will be taxed on the relevant withholding tax rate, ranging between 10% and 15%; and

(3) if the beneficiary is not presently entitled to the distribution, the withholding tax rules will not take effect.

For trust income distributions to non-residents where withholding tax does not apply, the amount will be taxed to the trustee under s 99 or 99A ITAA36, as outlined earlier in this article.

Distributions from trust to corporate beneficiary

Caution is required when distributing to a corporate beneficiary, in particular if it may result in the creation of an unpaid present entitlement (UPE) owing from a trust to the company.

TR 2010/3 and PS LA 2010/4 outline the ATO's view that it is possible for a Div 7A loan to, in effect, arise from UPEs created after 16 December 2009. Specifically, the Commissioner takes the view in TR 2010/3 that a UPE falls within the "financial accommodation" definition of a Div 7A loan unless the terms of the arrangement fall within certain safe harbours.

While detailed comments about Div 7A are outside the scope of this article, some of the practical considerations relating to corporate beneficiaries are as follows:

(1) all pre-16 December 2009 UPEs should be "quarantined" to ensure that they are not treated as Div 7A loans;

(2) trust deeds should be reviewed to ensure that no clauses operate to deem or automatically convert UPEs into loans; and

(3) for post-16 December 2009 trust distributions to corporate beneficiaries, documentation that complies with the Commissioner's stance under TR 2010/3 and PS LA 2010/4 should be implemented (for example, appropriate loan or sub-trust arrangements).

A great deal of literature has been published regarding the accuracy (or otherwise) of the Commissioner's views in TR 2010/3 and PS LA 2010/4, an analysis of which is outside the scope of this article.

ATO requirements for tracing distributions

In addition to the various issues outlined above about the impact that the approach of the ATO has in relation to trust distributions, it is important to remember that trustees will also often have particular reporting requirements imposed on them by the ATO. This is most starkly demonstrated by the requirements of the ATO concerning identification of beneficiaries of certain distributions and, in particular, where trust-to-trust distributions are involved. In this regard, the ITAA36 contains requirements for a trustee to assist the ATO with tracing distributions which have been made to beneficiaries.

Under Div 6D ITAA36, a trustee is required to complete an ultimate beneficiary statement (UBS) where a distribution is made to another trust.

The Commissioner states in PS LA 2001/12 that trustees of a closely held trust group are assumed to know how income is intended to be distributed from the original trust to any recipient trust and finally to the ultimate individual or corporate beneficiary.

By requiring the UBS to be provided, the Commissioner is seeking the ability to easily trace the flow of a distribution through interposed trusts to the ultimate recipients.

Failure to provide the Commissioner with a correct UBS will result in ultimate beneficiary non-disclosure tax being imposed on the trustee of the original trust equal to the highest marginal tax rate plus the Medicare levy (46.5%).

Limited trustee relief from the UBS requirements is available in some situations. PS LA 2001/12 outlines the specific circumstances where relief may be granted, for example, the trustee "is not in a position to readily identify all ultimate beneficiaries" or is unable to obtain a tax file number from a beneficiary despite otherwise identifying the ultimate beneficiary.

> "A comprehensive review of a trust deed must include an analysis of every variation or resolution … "

Areas of ATO focus

Following the 2013 federal Budget, the ATO announced the focus of the "Trusts Taskforce" (Taskforce). In addition to the stated goal of identifying "egregious tax avoidance and evasion using trust structures", the ATO has said that the Taskforce will examine a number of arrangements, including:

(1) trusts or their beneficiaries who have received substantial income that are not registered, or have not lodged tax returns or activity statements;

(2) offshore dealings involving secrecy jurisdictions;

(3) arrangements which result in income being assessable to low-tax beneficiaries where the benefits of the income are enjoyed by others;

(4) arrangements which involve artificial recharacterisation of amounts to change the tax outcome; and

(5) "sham" transactions and round-robin circulation of income between related trusts.

The ATO has stated that the intended targets of the Taskforce are high-risk taxpayers and not ordinary arrangements and tax planning associated with genuine business or family dealings.

Ramifications of failed distributions

Where a purported trust distribution is subsequently found to be invalid, there are a series of issues and potential ramifications that may need to be considered. The main issues in this regard include:

(1) the "knowing recipient" principle;

(2) the impact of disallowed deductions;

(3) disclaimers;

(4) equity and rectification; and

(5) default distribution provisions.

Each of these concepts is dealt with in turn below.

Distributions from trustee-knowing recipient

"Knowing recipient" is a principle that evolved out of situations where a trustee (who holds property on trust on behalf of the beneficiaries of a trust) appropriates trust funds for the benefit of a third party who has knowledge of the trust relationship.

The concept gives the "wronged" beneficiaries the right to make a personal claim against the third party on the basis that the third party received the trust property, while having knowledge of the relationship between the property in question, the trustee and the beneficiary. In other words, the third party knowingly assisted in the wrongful distribution (or breach of trust) by the trustee.

Although the claim is property based, the remedy is personal and it is only available where the third party can be shown to have had knowledge (or ought to have had knowledge) of the breach of trust.

The defences against claims arising from the knowing recipient principle were settled in the case of *Koorootang Nominees Pty v ANZ Banking Group Ltd*.[4] In that case, it was held that liability should be strict and subject only to the defences of bona fide purchase and change of position.

Effect of disallowed deductions on the trust distribution resolution

The exact manner in which disallowed deductions will be treated turns largely on the way in which the relevant distribution resolution is crafted and, in turn, whether the resolution effectively deals with disallowed deductions. Broadly, there are three possible outcomes, namely:

(1) the amounts representing the disallowed deduction will be validly distributed to a particular beneficiary via the provisions of a distribution resolution;

(2) the default provisions under the trust deed will regulate the distribution; or

(3) the amount will be treated as an accumulation and the trustee will be taxed.

Obviously, where the trustee is taxed, the flat highest marginal tax rate (as explained above) under s 99A ITAA36 will apply.

The case of *Norman and FCT*[5] provides an example of the ramifications of the Commissioner disallowing deductions and the additional amounts being included in the assessable income of a beneficiary due to the way in which the distribution resolution was crafted. In this case, the taxpayer was the director of the corporate trustee for the Norman Family Investment Trust (Norman Trust). The trustee resolved to establish an employee welfare plan which provided for all of the profits of the Norman Trust to be paid to the employees of a related business in the trustee's discretion.

The trustee claimed deductions over a number of years, which the Commissioner subsequently disallowed and imposed tax shortfall penalties of 50% for recklessness on the basis that the employee welfare program was established as a scheme to which the general anti-avoidance provisions of Pt IVA ITAA36 applied.

The Commissioner treated the amounts disallowed as deductions as additional distributions to one of the beneficiaries. The Commissioner's reasoning for this approach was based on the fact that the original resolution of the trustee provided that, after all deductions were properly claimed, any balance of the trust's income should be distributed to that beneficiary. The beneficiary taxpayer objected to this on the basis that the amounts that were now being included in the income of the trust had never in fact been received by them.

The Administrative Appeals Tribunal held that, based on the trustee's resolution regarding the distribution of income, the taxpayer was in fact the person presently entitled and therefore liable for the additional tax, notwithstanding that the amounts in question had never been received by the beneficiary.

Disclaimer and effects on distributions

Arguably, the leading case in relation to disclaimers is *FCT v Ramsden & Ors.*[6] In this case, Steve Hart Family Holdings Pty Ltd (SHF Holdings) was the trustee at all material times of The Steve Hart Family Trust (SHF Trust).

The trust deed of SHF Trust contained a default income clause which provided that the trustee was to hold any undistributed income for the benefit of four named beneficiaries as tenants in common. The named beneficiaries were Troy Hart, Philip Hart, Tamara Ramsden and Steve Hart.

In the year ending 30 June 1996, SHF Holdings as trustee for the SHF Trust prepared a resolution distributing $429,000 to the Adcock Practice Trust (AP Trust), which was neither a general beneficiary, nor an eligible beneficiary.

Among the other trust distributions made by SHF Holdings as trustee for the SHF Trust, no distribution was made to the default beneficiaries named in the trust deed. As a consequence, the named default beneficiaries lodged an income tax return for the year ending 30 June 1996 on the basis that no distribution was received.

In July 2000, the Commissioner issued a notice of amended assessment to each of the named default beneficiaries, increasing their taxable income by $107,250 (ie one quarter each of $429,000).

The Commissioner had found that the 1996 distribution of $429,000 to AP Trust was invalid and therefore the default income clause under the trust deed applied.

The four beneficiaries lodged objections to the assessments in September 2000 that were dismissed by the Commissioner. The beneficiaries then appealed against the dismissal to the Federal Court in June 2001.

The default beneficiaries claimed to have disclaimed their interest in the income of the SHF Trust through the following actions:

(1) on 17 April 2002, the beneficiaries claimed to have entered into deeds of disclaimer, disclaiming any amounts (except such amounts paid for their benefit) that may have accrued under the SHF Trust deed for the year ending 30 June 1996;

(2) on 2 October 2003, the beneficiaries confirmed the above disclaimer by signing another set of deeds; and

(3) on 8 October 2003, the beneficiaries entered into additional deeds disclaiming all of their interests to the income of the SHF Trust.

At first instance, Spender J found that the disclaimers made by the beneficiaries were "effective to disclaim any interest which [they] had in any part of the distribution" of the $429,000. However, on appeal, the Full Federal Court disagreed with the approach of Spender J and held that the disclaimers were ineffective. Specifically, the court found:

(1) that the distribution in favour of AP Trust was a nullity;

(2) that it is possible for a beneficiary to be entitled to more than one gift from a discretionary trust;

(3) when the trustee exercised its discretionary appointment power in accordance with the trust deed, that the gifts made were of a discretionary nature. Moreover, each of these gifts was an independent gift each year and therefore each distribution could be separately disclaimed;

(4) that any interest acquired in the net income of the trust under the default provisions of the deed could be disclaimed by a specified beneficiary separately from any other entitlements which might accrue to that beneficiary under other provisions of the deed;

(5) that, to be effective, a disclaimer under the default provisions of a trust deed must extend to the whole of that subject matter; hence, a purported disclaimer confined to only one accounting period was necessarily ineffective;

(6) that it was accepted that the respondents had knowledge of the interest by April 2001 at the latest; and

(7) that the beneficiaries had to determine, within a reasonable time from the default distribution of April 2001, whether they would renounce the vested interest they had in the annual income of the trust for the duration of the trust. Once they became aware of their vested interests in the trust income, they had to determine in a timely manner whether they wished to disclaim those interests.

It is clear from this decision that a disclaimer can be made with retrospective effect and not simply from the date of the disclaimer, provided it is made within a reasonable period of time from the beneficiary first becoming aware of the relevant interest they wish to disclaim.

Will equity assist a failed distribution?

While equity can assist in relation to a failed trust distribution through rectification, this remedy is only available in limited circumstances.

Broadly, a court may use the equitable remedy of rectification where there is an error requiring correction in a trust document which does not reflect the intentions of the parties and results in a failed or invalid trust distribution.

If rectification is held to be an appropriate remedy, the practical effect is that the document may be changed retrospectively and be able to be read as if it was originally executed in the intended format.

In order for rectification to be granted, the party applying for the court to exercise its discretion must establish three elements:

(1) the intention that the parties had in relation to the document up until the time the distribution resolution was executed;

(2) a mistake was made in the document that does not reflect the parties' true intentions; and

(3) if the rectification order was granted, it would correct the mistake and match the parties' intentions.

A case that highlights the doctrine of rectification being effective for trust distributions is *Kirkham as trustee of the Kirkham Family Trust*.[7] In this case, Mr Kirkham established a trust under which he was the settlor, the trustee and also a named specific beneficiary.

Due to the way in which the deed was crafted, even though he was a named beneficiary, Mr Kirkham was (under other provisions) excluded from receiving distributions.

Income distributions were made from the trust to Mr Kirkham as if he was an eligible beneficiary as the exclusion was overlooked.

When Mr Kirkham discovered he was not an eligible beneficiary, he applied to the court for rectification so that he would be included as a member of the general beneficiary class. To support his claim for rectification, Mr Kirkham provided the court with evidence that it was his intention as settlor and trustee that he be a beneficiary from the date of the trust deed's execution and that it was a mistake on his solicitor's behalf that he was not included in the general beneficiary class.

Chief Justice Martin held that an order for rectification be granted for Mr Kirkham so that the trust deed was rectified to include Mr Kirkham as a general beneficiary of the trust fund from the date of establishment of the trust. In particular, it was held:

> "When an application is made for the rectification of a trust instrument the essential question is whether there is clear and convincing evidence that it was the common intention of the settlor and the trustee, at the time the trust was created, that some result other than that which was ultimately effected by the instrument should be achieved."

The evidence provided by the affidavits of Mr Kirkham, the solicitors who drafted the trust deed and the accountants for the trust established the intention that Mr Kirkham always intended to be included as an eligible beneficiary. That intention was manifested in the fact that Mr Kirkham was nominated expressly as a specified beneficiary in the trust deed and it was also consistent with his actions as trustee in making distributions to companies in which he had an interest.

Ultimately, the court held:

> "I am satisfied, therefore, that all the appropriate requirements for the making of an order for rectification have been made out. There is clear evidence of the relevant intention of the settlor and the trustee at the time, that intention was frustrated by an accidental omission by those responsible for the preparation of the trust instrument and so the trust instrument did not reflect that intention."

Although equity may grant rectification in particular circumstances, rectification will not be granted where there is simply an inadvertent financial result. For example, if a party restructures their business for tax advantages based on the advice of an accountant and, after the accountant's advice is followed, large tax liabilities are triggered, rectification is unlikely to be granted.[8]

The key distinction in relation to when a rectification is available is whether the requested correction is concerning a mistake as to the implementation of the parties' intentions as opposed to the ramifications of implementing the arrangements.

Operation of default beneficiary provisions when resolutions fail

As mentioned earlier in this article, one approach designed to prevent the adverse tax consequences that can arise from an invalid distribution could be that discretionary trust deeds will contain default income and capital beneficiary provisions. The purpose of this type of clause is to ensure that, if the trustee fails to effectively exercise their power to distribute trust income or capital, the relevant amount will be automatically distributed to specific beneficiaries who have already been defined in the clause.

An example of this style of provision was illustrated in the case of *Ramsden* (discussed above). That is, although there was an invalid distribution (due to the purported distribution to the AP Trust, which was not in fact a beneficiary), it was ultimately determined that the named specified beneficiaries were entitled.

The main objective from a tax perspective of a default distribution clause is to ensure that the default beneficiaries will be assessed on the failed distribution, rather than the trustee being assessed under s 99A ITAA36 at the top marginal rate.

Care must, however, be taken with the drafting of default clauses that are in fact effective.

The case of *BRK (Bris) v FCT*[9] is particularly relevant in this regard. In that case, the default distribution clause required that the trustee on default "divide the Fund equally among the beneficiaries named in the Schedule hereto" on a date after the end of a tax year.

The court held, therefore, that, as the trustee would not in fact make the distribution to the default beneficiaries until after the end of a tax year, the income was accumulated for tax purposes in the previous tax year and, in accordance with s 99A ITAA36, the trustee was taxed on the entire default amount at the top marginal rate.

Care must also be taken to ensure that default clauses are drafted so that the recipient beneficiaries are ascertainable.

The tribunal's findings in *Hopkins & Anor and FCT*[10] are particularly relevant. Specifically, the tribunal considered the certainty as to the objects of the Hopkins Family Trust. The following clauses in relation to the definition of primary beneficiaries, as well as the default income provision, were considered:

> "The 'Primary Beneficiaries' means and includes RONALD JAMES HOPKINS, KATHLEEN CLARE ADAM, SAMUAL ALAN JOHN HOPKINS, DONNA MAREE HOPKINS, TONY TROY HOPKINS and any other the children and grandchildren, spouses of children and spouses of grandchildren of either of the said RONALD JAMES HOPKINS or the said KATHLEEN CLARE ADAM the parents, brothers and sisters of the said RONALD JAMES HOPKINS and KATHLEEN CLARE ADAM and the children and grandchildren of such brothers and sisters and any company in existence at the Vesting Day incorporated in any country throughout the world the shares in which are owned by any one or more of them or by a Trustee upon trust of any trust or trusts in existence at the Vesting Day under which any one or more of them is a beneficiary present or contingent.
>
> ... the Trustee shall pay or apply the whole or any part of the income in any year of income of the Trust Fund for the benefit of all or such one or more of the Primary Beneficiaries ... PROVIDED

> that such Deed or oral declaration be made on or before the last day in any year of income and in the event of such Deed or oral declaration not being so made any income not so paid or applied shall be deemed to have been paid or applied for the benefit of the Primary Beneficiaries in equal shares and in such an event the Trustee shall credit such proportions of such income to the account of the respective Primary Beneficiaries in the books of account of the Trustee and shall hold the same absolutely on behalf of each such Primary Beneficiary."

The tribunal rejected the Commissioner's claim that the there was "uncertainty in the objects" of the trust and held that, as all of the primary beneficiaries could be ascertained, there being 46 in total, it was possible to say with certainty that "any given individual was, or was not, a" primary beneficiary of the trust.

Although not explored in the above case, the failure to have a default income clause appropriately drafted would result in the trustee accumulating the default income and taxed under s 99A ITAA36, as explained above.

Conclusion

As highlighted by a number of aspects of this article, there are a range of issues that can potentially undermine the intentions of a trustee when attempting to make distributions.

While the starting point in any situation is always the provisions of the trust deed, trustees must also be acutely aware of a myriad of other potentially relevant issues before making any distribution.

A failure to methodically address each and every potential issue in a timely way will invariably lead to unintended outcomes that, in most instances, will be impossible to remedy once they are discovered. In this regard, there is increasing evidence to suggest that the ATO is acutely aware of most, if not all, of the issues set out in this article, and actively conducts compliance activity in the area.

Matthew Burgess, CTA
Partner
McCullough Robertson

Darius Hii
Lawyer
McCullough Robertson

Acknowledgment

This article has been based on material prepared by a number of the partners and staff at McCullough Robertson Lawyers. In this regard, the work of Patrick Ellwood, senior associate, is gratefully acknowledged.

References

1 [2013] FCA 39.
2 [2011] FAMCAF 245.
3 (2005) 225 ALR 576.
4 [1998] 3 VR 16.
5 [2004] AATA 1164.
6 [2005] FCAFC 39.
7 Unreported, Supreme Court of Western Australia, Martin CJ, 19 May 2010.
8 *Baird v BCE Holdings Pty Ltd* (1996) 40 NSWLR 374.
9 [2001] FCA 164.
10 [2012] AATA 324.