Disclaimer of an interest in a trust – can this be tax-effective?

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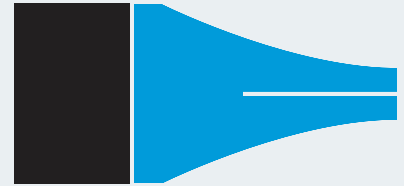

Disclaimer by a beneficiary of their interest in a discretionary trust may be tax-effective depending on the nature, and their knowledge, of the interest and the timing of any disclaimer.

Introduction

Depending on the timing and level of knowledge of the particular beneficiary of their interest, a valid disclaimer by a beneficiary of their interest in a discretionary trust may result in them averting tax liability that may otherwise flow from that interest.

Promises to never make a claim

A beneficiary or beneficiaries of a trust may seek to disclaim their interest in a trust by way of releasing the trustee from all claims, actions, proceedings, accounts, costs, damages, entitlements, demands and other amounts whatsoever that they may be entitled to as against the trustee and in respect of the administration of the trust. This could include a disclaimer from trust distributions.[1]

Why would a disclaimer be implemented?

A beneficiary of a trust may wish to disclaim their interest in the trust for:

- personal or family reasons (acceptance of a distribution might trigger a family dispute);
- possible bankruptcy concerns; and
- relationship breakdown concerns.

There may also be financial reasons for wishing to disclaim an interest in a trust, including ensuring that an unwanted capital gain is not derived.[2] If there are unwanted capital gains tax outcomes from receiving a gift from an inter vivos discretionary trust, for example, a beneficiary may wish to disclaim their interest.

The Full Federal Court decision of *Ramsden*,[3] a landmark decision in relation to disclaimers, looked at whether a group of beneficiaries to a trust had successfully disclaimed their interests and any entitlement to income that might otherwise have accrued to them under the trust for the earlier income year.

Ramsden's case and the making of an effective disclaimer

On being informed of an entitlement to any part of the income of a trust, a beneficiary may wish to disclaim that entitlement.

Notwithstanding that it is helpful to formalise a disclaimer in a written document, it is not obligatory to do so. Any disclaimer of an interest in a trust by a trust beneficiary must be made to the trustee of that trust. For a disclaimer to be valid, it must be supported by some evidence that the beneficiary is disclaiming their interest. Silence or otherwise passive behaviour will not suffice.[4]

In the High Court decision of *Cornell*, Latham CJ noted the following:[5]

> "A devise, however, being prima facie for the devisee's benefit, he is supposed to assent to it, until he does some act to show his dissent. The law presumes that he will assent until the contrary be proved; when the contrary, however, is proved, it shows that he never did assent to the devise, and, consequently, that the estate never was in him."

A crucial aspect of *Ramsden* was the determination that any gift disclaimed by a trust beneficiary must be of the gift in its entirety. The four applicants in *Ramsden* were the default beneficiaries of the Steve Hart Family Trust (SHFT), a discretionary trust. From the minutes of a meeting of directors of the trustee company, the trustee purportedly distributed an amount of $429,000 to a trust known as the Adcock Practice Trust during the financial year ending 30 June 1996. It was held, however, that the Adcock Practice Trust did not fall into the category of a beneficiary of the SHFT for that financial year, and nor could it be appointed as a beneficiary. With the distribution failing, it was the view of the Commissioner that the amount of $429,000 had been distributed to the default beneficiaries (split four ways, $107,250 each).

The issue for the court was whether disclaimers entered into by the default beneficiaries a number of years after receiving the assessments from the ATO were effective in validly disclaiming the distributions. Ultimately, it was held that they were not.

The issue was not that the disclaimers were retrospective. In *Ramsden*, Lee, Merkel and Hely JJ stated the following:[6]

> "Until disclaimer, a beneficiary's entitlement to income under a trust is operative for the purposes of s 97 of ITAA from the moment it arises notwithstanding that the beneficiary has no knowledge of it (*Federal Commissioner of Taxation v Vegners* (1989) 89 ATC 5274; (1991) 91 ATC 4213 at 4215). A beneficiary may disclaim an entitlement on its coming to his or her knowledge. At law an effective disclaimer operates retrospectively, and not merely from the time of disclaimer."

The Commissioner has accepted the retrospective operation of a valid disclaimer:[7]

> "If a discretionary beneficiary repudiates a benefit of the trust when he or she becomes aware of his or her entitlement, such a disclaimer would have a retroactive effect and the transfer of property would be void ab initio. The trust probably revests in the trustee and, in effect, it never passes from the trustee".

The failure of the disclaimers in *Ramsden* was due essentially to two factors: (1) that the disclaimers had purported to only

disclaim part of the distribution; and (2) because the disclaimers had not, within a reasonable time of becoming aware of the distribution, disclaimed it.

A disclaimer must be an actual disclaimer of all interest

The default beneficiaries in *Ramsden* attempted to disclaim only the entitlement resulting from the failed distribution to the Adcock Practice Trust in the income year ending 30 June 1996, in lieu of the whole distribution. In general terms, the nature of a gift given to a trust beneficiary will depend on the way the trust deed is termed. In *Ramsden*, the court was able to distinguish between the entitlements received by default and by discretionary beneficiaries pursuant to provisions of the trust deed. The interest of a default beneficiary in the trust was to be characterised as a single entitlement, whereas each distribution of trust income to a discretionary beneficiary in any given accounting year was to be deemed a separate and discrete entitlement. This meant that any disclaimer by a default beneficiary of the trust had to be of the interest in the trust in its entirety, meaning that the claimants in *Ramsden* could not effectively disclaim only their interest in the income of the trust for the income year ended 30 June 1996. This is confirmed by an earlier decision of the Administrative Appeals Tribunal (AAT) in which it was held that a disclaimer must be “an actual disclaimer of all interest”.[8]

From *Ramsden*, the CGT benefit to a beneficiary disclaiming their (whole) interest in a discretionary trust is that at law, the beneficiary is treated as if they had never held the interest disclaimed at all, for any successful disclaimer acts retrospectively. Therefore, where there is a disclaimer of a beneficiary’s interest, any value otherwise attributable to that interest would be nil as it would be treated as never having existed.

Effectiveness of removing beneficiaries as a discretionary object

While a disclaimer of an interest in a trust may be effective to avoid tax liability, the same may not be said for the attempted removal of a beneficiary as a discretionary object.

In TD 2001/26, the Commissioner’s view is that a renunciation of interest (being a CGT asset) by a beneficiary in a discretionary trust gives rise to CGT event C2 for the beneficiary as it involves the abandonment, surrender or forfeiture of the interest. For practical purposes, where the cost base and market value of this interest is nil, then there may not be a capital gain. This position may be different, however, if the beneficiary has an interest in either the assets or the income of the trust before or after the exercise of any discretion by the trustee as to the allocation of those assets or income (such as in the case of a default beneficiary). In these circumstances, a capital gain is more likely to be made by the beneficiary (assuming their interest was acquired on or after 20 September 1985) on the basis that the interest at the time of renunciation, even if it has nil cost base, may have significant value.[9] While any such CGT consequences would usually sit with the beneficiary, the consequence of amendments to a trust deed to exclude a beneficiary from a discretionary trust deed need to be considered as this may, unless any such change is either made pursuant to a valid exercise of a power under the trust deed or varied with court approval, result in the creation of a new trust and the occurrence of CGT event E1.[10]

When considering the effectiveness of a removal of a beneficiary of a discretionary trust compared to a disclaimer of an interest in a trust, the outcome in the AAT case of *Nguyen and FCT*[11] should also be considered. In *Nguyen*, the applicant, a beneficiary of a discretionary trust, attempted to renounce her interest as a discretionary object of a trust. She did so by signing a deed renouncing her interest in the income and capital of the trust. However, this occurred more than five years after her present entitlement to the income arose and more than four years after lodging her tax return for the relevant income year where she acknowledged her present entitlement to the income of the trust. In these circumstances, the AAT held that this is was not a disclaimer on becoming aware of an interest in the trust, but an attempt to “undo the past” and renounce an interest in income already received in earlier years.[12]

Therefore, while removal of a beneficiary as an object of a discretionary trust may be possible, the authors suggest that a better approach would be for the beneficiary, if their circumstances allow, to disclaim their interest. In *Nguyen*, the trustee had already effectively exercised its power and made a distribution of income to the beneficiary who had confirmed the benefit of that distribution. That the beneficiary subsequently wished to reverse this distribution in order to bring about a better tax outcome was not a reason in itself for the trustee to resile from the distribution (resolution) that had been made.

Timing of an effective disclaimer – Alderton

Any disclaimer of interest in a trust must be prompt to ensure validity. In *Ramsden*, the disclaimers were not made for a number of years, and the court described the period between the receipt of the ATO’s notices and the disclaimers as being “well in excess of a reasonable period”.[13] Any beneficiaries wishing to disclaim an entitlement resulting from a distribution from a trust should therefore do so as soon as practicable after they have become aware of the entitlement being created.

The recent AAT decision of *Alderton*, supporting the analysis reached in *Nguyen* on the timing of a valid disclaimer, provides further clarification as to the timing of a valid disclaimer.[14] In *Alderton*, the applicant, Ms Alderton, had been in a de facto relationship for 10 years with her partner, Mr Trapperton. Ms Alderton relied entirely on her partner for financial support. Initially, funds were transferred from Mr Trapperton’s bank account to Ms Alderton’s bank account. Some years into the relationship, this arrangement changed and Mr Trapperton elected to establish a discretionary trust of which he was the trustee and the two of them were beneficiaries. By using a debit card and online banking, Ms Alderton was able to access funds from the discretionary trust.

The relationship ended and a tax return was lodged for the trust disclosing net income of $79,880 for the 2009 income year, which was said to have been distributed to Ms Alderton. In 2014, the Commissioner made a default assessment of Ms Alderton’s taxable income for the 2009 income year. The trust distribution was the major component of the assessment. Further, in respect of the tax liability, a 75% penalty was imposed.

Ms Alderton sought to disclaim her interest in the trust by a letter from her solicitors to Mr Trapperton. However, the tribunal failed to recognise the letter as a valid disclaimer as it was not an absolute rejection of the gift. In his decision, Deputy President PE Hack SC noted:[15]

> "Here, Ms Alderton did not reject the gift because, having accepted the benefit of it, it was no longer able to be disclaimed. She had the use and benefit of the distribution. It follows that the objection decision was correct."

Although Ms Alderton had no knowledge of the operation of the trust, and it could be arguable that she was not aware she had an entitlement to a trust distribution, the decision supports the view that a beneficiary's use and benefit arising from the distribution from the trust, even where they were not aware of the trust itself, will bar the beneficiary from disclaiming their interest.

Conclusion

As has been illustrated above, the nature, timing and need for any disclaimer to be effected within a reasonable period of the beneficiary becoming aware of their interest in a discretionary trust are all crucial when assessing whether a disclaimer will be valid. Where a beneficiary has taken the benefit of an interest, it will prove difficult for them to subsequently argue that they intended to disclaim their interest. Beneficiaries should seek tax advice before attempting to disclaim their interest in a trust.

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References

1 A valid disclaimer made by a beneficiary in relation to their interest in a discretionary trust should be compared and contrasted with an attempt to resile from a distribution of income by a trustee under a valid distribution because the beneficiary wishes to "fix a perceived problem or undo unwanted or inconvenient tax consequences of a transaction" (see ATO, Transformation presentation, 18 February 2015, slide 29). Any attempt by a taxpayer to abuse the process of resiling from a resolution by a trustee will not be looked at kindly by the ATO, particularly as the ATO may seek to deter and discourage any such activity through the tools at their disposal, including: assessing multiple alternative beneficiaries and/or trustees in relation to any disputed income, considering the imposition of possible criminal fraud and evasion charges, considering possible penalties for the lodgment of incorrect tax returns and statements, and/or considering whether any tax agent involved in a suspect arrangement should have their conduct referred to the Tax Practitioners Board (see also D Smedley, R Somers and P Martins, "Trusts – current risk areas", paper delivered to The Tax Institute's 30th National Convention, 4 March 2015, p 21).

2 For example, a beneficiary may wish to disclaim an interest where the economic benefit of receiving the interest is not commensurate with the tax consequences due to misalignments of tax and trust income.

3 *FCT v Ramsden* [2005] FCAFC 39.

4 *Townson v Tickell* (1819) 106 ER 575.

5 *FCT v Cornell* (1946) 73 CLR 394 at 401.

6 *Ramsden* at [30].

7 See IT 2651 (now withdrawn), particularly para 12.

8 *Re Taxation Appeals* [1990] AATA 52 at [30].

9 Para 4 of TD 2001/26.

10 Para 13 of TD 2001/26; see also paras 1 to 5 of TD 2012/21.

11 [1999] AATA 228.

12 Ibid at [25].

13 *Ramsden* at [60].

14 *Alderton and FCT (Taxation)* [2015] AATA 807.

15 Ibid at [9].