

Disclaiming an interest in a trust – can you do it?

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I have recently been asked to give some advice to a brother and sister who are potential beneficiaries of a discretionary trust which was established by their father. The advice they sought related to them disclaiming their respective interests in the trust.

The matter arose in the context of an acrimonious divorce between their mother and father. The children became estranged from their father as a result of the divorce. As part of the arrangements between the mother and father the father agreed to pay various university and other expenses of our clients. Both of our clients are adults. They were aware that the father had agreed to pay these expenses and knew that they had been paid on their behalf.

The father treated the payment of the expenses as distributions to the children from the discretionary trust which he controlled.

Whilst the children acknowledged that they had received the benefit of the father paying the relevant expenses they had no knowledge that the father had treated the payments as distributions of income from the trust until they were asked by their father to sign tax returns that the father had prepared for them. The father gave each child an estimate of their personal tax liability which resulted from the income that they had received through the trust distribution.

Neither of the children had the financial resources to pay the income tax and their father refused to pay it on their behalf. The children sought our advice as to what they could do in relation to the distributions to them.

In particular they sought our advice as to whether or not they could disclaim their entitlement to the income that had been distributed to them by the trustee of the trust and if so would that relieve them of their tax liability.

Ultimately an agreement was reached with the father and the tax was paid.

COULD THE CHILDREN DISCLAIM THE GIFT OF THE INCOME?

Whilst the matter was settled it raised the question as to whether you can disclaim an interest in a trust and if so what are the conditions on which you can do it.

Beneficiaries of a trust do in certain circumstances have the right to disclaim their gift or the distribution that has been made to them by the trustee of a trust.

WHY WOULD YOU WANT TO DISCLAIM?

A beneficiary of a trust may wish to disclaim for a number of reasons including personal and family reasons, the avoidance of tax liabilities including a potential Capital Gains Tax (CGT) liability, possible bankruptcy concerns or possible relationship breakdown concerns.

THE ATO'S POSITION

The Australian Taxation Office (ATO) in ATO ID 2010/85 state that a beneficiary may disclaim an entitlement to trust income on the distribution or gift coming to their knowledge. The ID goes on to state that whilst a disclaimer does not need to be effected by a formal deed, the beneficiary must however do some act to show that they do not accept the distribution. Mere silence or inactivity is not sufficient to establish that the interest has been disclaimed.

The disclaimer must be made to the trustee of the trust and to be valid must be supported by some evidence that the beneficiary is disclaiming their interest.

The disclaimer can be made even if the beneficiary has previously agreed and accepted gifts of income from the trustee in respect to earlier tax years.

For the disclaimer to be valid it must be made within a reasonable time of the disclaimer becoming aware of it. There is no indication in the ID as to what is a reasonable time and it will depend on the particular facts. A disclaimer made a

number of years after becoming aware of the gift is unlikely to be effective. It should be done as soon as practicable after the recipient becomes aware of it.

When a beneficiary does disclaim a gift the disclaimer is effective from the date of distribution or gift rather than the time the disclaimer was made. In other words the disclaimer operates retrospectively.

The gift must be disclaimed in its entirety. This raises the issue as to whether or not where several gifts are made whether the beneficiary must disclaim all of the gifts or can disclaim some of them only.

If a beneficiary receives multiple gifts the disclaimer can be in respect of one or more of those gifts and does not have to be in respect of all of the gifts. The beneficiary will need to identify the gift that needs to be disclaimed and disclaim that gift in its entirety.

COMPARE DISCLAIMER WITH A RENUNCIATION

As an alternative to disclaiming your interest in a gift a beneficiary may consider renouncing their interest, as a beneficiary of a discretionary trust. Does this have the same effect as a renunciation? In my view it does not have the same effect.

As a separate issue renunciation may also result in a CGT liability.

In TD 2001/26 the ATO's view is that a renunciation of an interest (being a CGT asset) by a beneficiary in a discretionary trust gives rise to CGT Event C2 for the beneficiary. CGT Event C2 relates to the abandonment surrender or forfeiture of an interest.

Generally the renunciation of an interest by a beneficiary should not cause any CGT issue for the beneficiary as the cost base and the market value of the interest in each case would be nil. If however the beneficiary does have some interest in the assets or the income of the trust (as a default beneficiary may do) the CGT

consequences of a renunciation of interest will need to be considered if the interest was acquired on or after 20 September 1985. Even though the cost base for the interest may be zero at the time of the renunciation it may have a significant value taking into account the value of the assets in the trust.

The other issue with a renunciation is that it cannot be used to renounce an interest in income already received. It does not have a retrospective effect like a disclaimer. It operates from the time of the renunciation. Accordingly it is not as effective as a disclaimer if you wish to disclaim an interest in a past gift or distribution.

You could also consider removing the beneficiary as a potential beneficiary of the trust. This article does not address the consequences of such an action and extreme care must be taken if your client wishes to do this.

TAKING THE BENEFIT OF THE GIFT

As I mentioned earlier any disclaimer of interest in a trust must be prompt to ensure its validity. An example of how things can go wrong is in the case of *Alderton and FCT (Taxation) [2015 AATA 807]*.

In that case Ms Alderton had been in a defacto relationship for ten years with her partner Mr Trapperton.

During that time Mr Trapperton financially supported Ms Alderton.

During the course of the relationship Mr Trapperton established a discretionary trust of which he was the trustee and Ms Alderton and Mr Trapperton were beneficiaries.

Ms Alderton was able to access funds from the discretionary trust by using a debit card and online banking.

A tax return was lodged for the trust in the 2009 income year which disclosed net income of \$79,880. By this stage the relationship between Mr Trapperton and Ms Alderton had ended.

All the 2009 income had been distributed to Ms Alderton.

In 2014 the Commissioner issued a default assessment of Ms Alderton's taxable income for the 2009 income year the trust distribution was a significant component of the assessment. A 75% penalty was also imposed.

On receiving the default assessment Ms

Alderton sought to disclaim her interest in the trust. Her solicitors wrote to Mr Trapperton seeking to disclaim her interest.

The matter went before the Administrative Appeals Tribunal (AAT). The AAT however did not recognise the letter as a valid disclaimer as it was not an absolute rejection of the gift. The Tribunal found that Ms Alderton did not reject the gift because Ms Alderton had accepted the benefit of it. Once you accept the benefit of the gift you are no longer able to disclaim it. The Tribunal held that the assessment was correct.

Although Ms Alderton had no knowledge of the trust and Ms Alderton was unaware of any entitlement to a trust distribution the decision supports the view that if a beneficiary accepts the benefit arising from the distribution of the trust even where they were not aware of the trust is itself likely to be a bar to the beneficiary from disclaiming their interest.

CONCLUSION

There is an opportunity for beneficiaries to disclaim a distribution that has been made to them by a trustee of a trust. However the disclaimer must be effected within a reasonable period of the beneficiary becoming aware of the distribution.

If the beneficiary has taken the benefit of the distribution it will be very difficult for the beneficiary to disclaim the interest. This is likely to mean that to disclaim they may have to repay the amount of the distribution back to the trustee.

Be careful if you remove a beneficiary from a trust. This is likely to have its own tax and stamp duty consequences. Consider a renunciation by the beneficiary rather than a removal.

Note that if there is a valid disclaimer the relevant income that has been disclaimed would be assessed to the trustee. Depending on the circumstances this may be less attractive than accepting the distribution.

As always seek advice from a tax practitioner before you advise on any of these types of issues.

Tax Files is contributed on behalf of the South Australian based members of the Taxation Committee of the Business Law Section of the Law Council of Australia.

CPD Events

For further details and to register:
www.lawsocietysa.asn.au
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All sessions that are being held at LSSA, will be held at Level 10 Terrace Towers, 178 North Terrace Adelaide.

Relocation of the Full Court of the Family Court

28 June 2017
5.30pm – 7.00pm 1.5 Units *

Victims As Genuine Participants in the Criminal Justice System

5 July 2017
5.30pm – 7.00pm 1.5 Units *

Collaborative Practice Training

13 and 14 July 2017
9.00am– 5.00pm 14 Units *

General Protection Orders

26 July 2017
5.30pm – 7.00pm 1.5 Units *

Electronic Court Filing

27 July 2017
4.30pm – 6.00pm 1.5 Units *

*Total CPD Units are accurate at time of printing and should be taken as a guide only.
HAVE AN IDEA FOR A FUTURE SEMINAR?

We invite practitioners to tell us what seminar they would like to see conducted next. Email us at
cpd@lawsocietysa.asn.au with your ideas.