IT 2651 - Income tax: omission of trust income by beneficiaries - the effect of disclaimer.

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TAXATION RULING IT 2651

NO Ref.: 88/619-0 Date of effect: Immediate

BO Ref.: Date original memo issued:

EDR Ref.: 35

FOI INDEX DETAIL

Reference no.:	Subject refs.:	Legislative refs.:
I 1012827	**ADDITIONAL TAX FOR INCORRECT RETURN TRUST DISTRIBUTION - LACK OF KNOWLEDGE - DISCLAIMER**	**97, 101, 223, 226(2)**

OTHER RULINGS ON THIS TOPIC: IT 329, IT 347, IT 2141, IT 2344, IT 2517

TITLE: INCOME TAX: OMISSION OF TRUST INCOME BY BENEFICIARIES - THE EFFECT OF DISCLAIMER.

NOTE:
- . Income Tax Rulings do not have the force of law.
- . Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

PREAMBLE

In a decision reported as Case V22, 88 ATC 224; AAT Case 4078 (1988) 19 ATR 3173 the Administrative Appeals Tribunal (Mr P. M. Roach, Senior Member) held that two beneficiaries of a discretionary trust who were unaware of their entitlements to trust income were not liable for additional tax for incorrect returns under the former subsection 226(2) (now governed by subsection 223(1)) of the Income Tax Assessment Act 1936 ("the Act"). The Tribunal considered that the trust income did not become "income" of the beneficiaries until they assented to their status as beneficiaries and accepted the trust distributions and until then, the beneficiaries had not "omitted" any income from their returns. The Commissioner has not appealed against the Tribunal's decision.

FACTS

2. This case involved a discretionary trust, the beneficiaries of which included a married couple and their four children. The taxpayers were two of the children. They were adults who derived non-trust income and were liable to lodge personal income tax returns. During the years ended 30 June 1978 to 1984 inclusive

the trustee of the trust derived income which it distributed among members of the family. It made the distribution by crediting the amount distributed to loan accounts. When they lodged their personal returns for the years ended 30 June 1980 to 1984, the taxpayers failed to disclose amounts which the trustee had credited to their loan accounts. The Commissioner included the amounts of the taxpayers' entitlements to the income of the trust in their assessable incomes and assessed additional tax in respect of the trust income not included in the returns.

3. The Tribunal accepted the evidence of one of the two taxpayers in question, an employee of the accountant who prepared the returns of the trust, that he did not know of the existence of the trust, did not know that he was a contingent beneficiary and that the trust had derived income. It was also accepted that he did not know that the trustee had resolved to make a distribution in his favour or that the trustee held to his credit amounts "distributed" pursuant to any such resolution. The other taxpayer did not give evidence but it was agreed that the same principles were to apply to his case as those applied to the taxpayer who gave evidence.

4. The Tribunal held that the two beneficiaries had not "omitted" assessable income from their returns. On the trustee's determination to distribute income to each beneficiary, that beneficiary became entitled to the benefits of the distribution, but only, in the Tribunal's view, if he chose to accept them. No such choice could be made until he learned of the existence of the trust and the passing of the resolution. That knowledge did not come to him until his assessment was received and his enquiries led to discovery of his entitlement. In the Tribunal's view, the trust income did not become the beneficiary's "income" until he assented to the status of being a beneficiary and accepted the trust distribution. Prior to that time, the Tribunal considered that it could not be said that either beneficiary had "omitted" any income from his return.

RULING

5. The Commissioner does not accept that the Tribunal was correct in deciding that the beneficiaries had not omitted assessable income from their returns. However, the Commissioner accepts that in all the circumstances of this case additional tax under former subsection 226(2) of the Act should have been remitted to nil. As the taxpayers did not know that they had derived assessable income and could not have been reasonably expected to know that they had derived assessable income, their behaviour was entirely without fault.

6. The Commissioner does not accept the Tribunal's view that a person cannot be said to have "omitted" assessable income from his or her return when he or she did not know, and could not have known as a result of any act of his or hers that he or she had derived any assessable income. The words "omits from his return

any assessable income" in former paragraph 226(2)(a) of the Act impose a simple objective test: was an amount of assessable income not included in the taxpayer's return? There is no requirement of knowledge or carelessness.

7. Paragraph 226(2)(a) has been repealed and has been replaced with section 223 of the Act. Section 223 provides for additional tax for false or misleading statements. Where a taxpayer makes a statement in a return that is false or misleading in a material particular, and the tax properly payable by the taxpayer exceeds the tax that would have been payable if it had been assessed on the basis that the statement was not false or misleading, the taxpayer is liable under subsection 223(1) to pay, by way of penalty, additional tax. Subsection 223(7) of the Act provides in effect that where a person omits from a return any assessable income derived by the person, that person is deemed to have made a statement in the return to the effect that the taxpayer did not derive the assessable income. As with former paragraph 226(2)(a), subsection 223(7) imposes an objective test. There is no requirement that the omission be made knowingly or carelessly. This view is consistent with the Commissioner's policy as set out in Taxation Ruling IT 2141.

8. The Commissioner also does not accept the correctness of the Tribunal's view that the distributions to the beneficiaries only became their assessable income when accepted by the beneficiaries. The trust income in question became the income of the beneficiaries when they became presently entitled to it. Under section 101 of the Act, where a trustee is given a discretion to pay or apply trust income to or for the benefit of specified beneficiaries, a beneficiary in whose favour the trustee exercises his or her discretion is deemed to be presently entitled to the amount paid to him or her or applied for his or her benefit. In such a case, the beneficiary will be assessable under section 97 on the income so applied (unless he or she is under a legal disability, in which case the trustee will be assessable under section 98).

9. Section 101 is, in the Commissioner's view, applicable in the present case. The trustee effectively exercised its discretion in favour of the two beneficiaries. They are therefore deemed to be presently entitled to the trust distributions, i.e., they each had an absolutely vested beneficial interest in possession in the trust income. When they became presently entitled to the trust income, it became assessable income capable of being "omitted" from their returns, even though they were unaware of the existence of the income.

10. In the High Court case F.C. of T. v. Cornell (1946) 73 CLR 395 at 402, Latham C J cited with approval Standing v. Bowring (1885) 31 Ch.D. 282 at 288, where it was held that, when there is a transfer of property to a person, it vest in the person even before knowledge of the transfer, "subject to his right when informed of it to say, if he pleases, 'I will not take it'.

When informed of it, he may repudiate it, but it vests in him until he so repudiates it". In a recent AAT decision, Case X30 90 ATC 287; AAT Case 5756 (1990) 21 ATR 3281, it was held that, in order for a disclaimer to be effective, it must be an actual disclaimer of the whole interest, not part of an interest, created under a discretionary trust. In other words, the taxpayer had a right to disclaim the property the subject of the discretionary family trust - he or she could disclaim the benefit of the trust - but not simply disclaim the income for a particular year.

11. It was established in Townson v. Tickell, (1819) 106 E.R. 575 that the repudiation need not be evidenced by disclaimer in a court of record or by deed; any evidence of actual dissent is sufficient.

12. If a discretionary beneficiary repudiates the 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 property revests in the trustee and, in effect, it never passes from the trustee.

13. In whose hands the repudiated trust income will be taxed will need to be determined, (in the absence of any applicable trustee's resolution) by the terms of any default clause in the trust deed. A disclaimer of the interest in the trust (including the entitlement to trust income), would generally occur during a year of income subsequent to the income year in which the relevant trust income was derived. For a trustee's resolution to apply to the repudiated income, therefore, it would need to pass during the latter year of income or before the following 1 September (see Taxation Ruling IT 329, paragraph 11) and it would need to be framed in terms which can confer present entitlement to the income. The resolution would need, for example, to confer on certain nominated beneficiaries an entitlement to income of the trust in specified ascertainable shares and not simply refer to specific amounts of income.

14. The Commissioner did not appeal the decision in Case V22 (supra) for the reasons set out in paragraph 5 of this Ruling. The question whether a taxpayer is properly assessable on income distributed by a determination of a trustee of a discretionary trust even where the taxpayer is unaware of the existence of the trust or the distribution has been clarified in F.C. of T. v. Vegners 89 ATC 5274; (1989) 20 ATR 1645. The Federal Court of Australia (Gummow J) did not accept the view that amounts received by a beneficiary from a trust are not the income of the beneficiary until that person assents to being a beneficiary and accepts the distributions. His Honour held that the amounts paid by the trustee to the taxpayer were assessable income under sections 97 and 101 and it was irrelevant that the taxpayer had no understanding of the existence of the discretionary power to pay or apply income to or for her benefit. The taxpayer did not at any time take any action to refuse receipt of or otherwise reject the moneys paid to her by the trustee. In Vegners v. F.C. of T.

91 ATC 4213; (1991) 21 ATR 1347, the taxpayer's appeal to the Full Federal Court was dismissed. The Court (Davies, Sheppard and Hill JJ) held that "... an entitlement under a trust is valid notwithstanding that the beneficiary has had no knowledge of it". (ATC at p. 4215; ATR at p. 1349).

15. The decision in Vegners (supra) is not regarded as affecting the Commissioner's policy on trust schemes with non-resident beneficiaries as previously stated in Taxation Ruling IT 2344. The decisions of the Full Federal Court in Faucilles Pty Ltd v. F.C. of T. 90 ATC 4003; (1989) 20 ATR 1712 and of the AAT in Case X40 90 ATC 342; AAT Case 5813 (1990) 21 ATR 3352 support the policy. In these decisions, purported distributions to overseas beneficiaries were held to be invalid. In essence, there may be situations where, although a trust is validly created and distributions to beneficiaries are within the trustee's discretion, it is evident that there was never any intention for such beneficiaries to actually receive funds. The purpose of the arrangement is to reduce tax payable in Australia.

COMMISSIONER OF TAXATION
22 August 1991

ISSN 0813 - 3662 Price $0.50