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[1426] **Some ramifications of failed trust distributions**
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As regularly addressed in the *Weekly Tax Bulletin*, a methodical approach is needed when preparing trust distribution resolutions to ensure the intended outcomes are achieved. As explored at 2014 WTB 27 [942], there are a range of issues often overlooked in relation to distribution resolutions.

Where a purported trust distribution is subsequently found to be invalid, several potential ramifications arise, including:

1. The "knowing recipient" principle.
2. Disallowed deductions.
3. Disclaimers.
4. Equity and rectification.
5. Impact of any default provisions.

Further comments on each of these issues are set out in turn below.

"Knowing recipient" principle

"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, whilst having knowledge of the relationship between the property in question, the trustee and the beneficiaries.

Impact of disallowed deductions

The treatment of disallowed deductions turns largely on the way in which the relevant distribution resolution is crafted.

Broadly, there are 3 possible outcomes, namely:

1. the amounts representing the disallowed deductions 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 (further comments in this regard are set out below); or
3. the amount will be treated as an accumulation to the trust and the trustee will be taxed at the highest marginal tax rate is applied.

Disclaimers

In *FCT v Ramsden* [2005] FCAFC 39, the court held that the purported disclaimers by particular beneficiaries were ineffective. However, it was confirmed that any interest acquired in the net income of a trust under the default provisions of a deed could be disclaimed by a beneficiary separately from any other entitlements which might accrue to that beneficiary under other provisions of the deed.

It was also confirmed that a disclaimer can be made retrospectively, provided it is made within a reasonable period of time from the beneficiary first becoming aware of the relevant interest that they wish to disclaim.

Equity and rectification

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

In order for rectification to be granted, the party applying for the court to exercise its discretion must establish 3 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; an
3. if the rectification order was granted, it would correct the mistake and match the parties' intentions.

Importantly, rectification will not be granted where there is simply an inadvertent financial result that occurred due to a misunderstanding of the consequences of a deliberate act.

Default provisions

From a trust law perspective, default capital provisions, and in some cases, default income provisions, under discretionary trusts are generally seen as important to ensure that the trust is valid at law.

From a tax perspective, the main objective of a default distribution clause, particularly for income, is to ensure that the default beneficiaries are assessed on the failed distribution, rather than the trustee being assessed at the top marginal rate.

The case of *BRK (BRIS) PTY LTD v FCT* (2001) 46 ATR 347 is arguably the leading example in this regard. In this case, the default distribution clause of the relevant trust required, where there was a failure to distribute, that the trustee "divide the Fund equally among the beneficiaries named in the Schedule hereto".

However, the clause was crafted such that the distribution did not take place until a date after the end of a tax year.

Based on the drafting of the relevant clause, the court confirmed that while the provisions were valid from a trust law perspective, the trustee was unable to make the required distribution to the default beneficiaries until after the end of each tax year. This, in turn meant that all undistributed income was in fact effectively accumulated for tax purposes each tax year. Therefore, all undistributed income was taxed to the trustee at the top marginal rate.

Conclusion – start by reading the deed

Given the range of significantly adverse consequences that can result where a purported trust distribution is subsequently found to be invalid, advisers should proactively invest in processes and systems to minimise the risk of such an outcome.

Invariably, best practice dictates that in every situation before preparing a resolution there should be:

1. a comprehensive review of the relevant trust deed including an analysis of every variation or resolution of a trustee or other person (such as a principal, appointor or guardian) that may impact on the interpretation of the trust document;
2. specific review of the relevant tax legislation applicable to the amounts to be addressed by the resolution; and
3. thought applied to the exact factual scenario that the trustee is addressing, in the context of the trust deed and tax laws.