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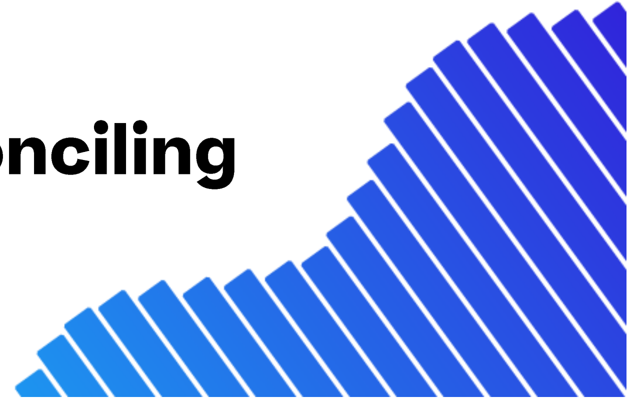

Trust disclaimers: Reconciling Carter and Ramsden

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Introduction

The recent High Court decision in *Federal Commissioner of Taxation v Carter & Ors* [2022] HCA 10 (***Carter***) has affirmed the complexity underlying the interaction of trust law and Division 6 of Part III of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**). The *Carter* decision emphasises, when renouncing an entitlement to section 97(1) income of the trust estate for an income year, the necessity for a disclaimer to be executed in that same income year to be effective for tax purposes. The High Court also affirmed that the presumption of assent for the creation of trust entitlements can be unilateral.

Historically, the *Federal Commissioner of Taxation v Ramsden* [2005] FCAFC 39 (***Ramsden***) is the leading case in establishing the requirements to effectively disclaim an interest in a distribution made by a discretionary trust. *Carter* has not invalidated *Ramsden*; rather, *Carter* provides greater clarity for beneficiaries seeking to effectively disclaim their trust entitlements for tax purposes.

Summary of facts and decision in *Ramsden*

On 30 June 1996, the trustee of the Hart Family Trust (**the Trust**) resolved to distribute the net income of the trust in specific amounts to its beneficiaries and the Adcock Practice Trust (**the Adcock Trust**). The remaining balance was resolved to be distributed to Mr Steven Hart.[1]

In July 2000, the Commissioner issued amended assessments to the beneficiaries, including one-quarter of the Adcock Trust's distribution in the assessable income of each of the four beneficiaries.[2] The case was heard in the Federal Court with the beneficiaries arguing the validity of the distribution to the Adcock Trust. In the event that the distribution was invalid, the residual balance was to be distributed to Mr Steven Hart in accordance with the trustee minute dated 30 June 1996.

[1] See *Ramsden & Ors v Federal Commissioner of Taxation* [2004] FCA 632 (***Ramsden & Ors***) at [4].

[2] Ibid, at [14].

The beneficiaries signed a deed of disclaimer, executed on 2 October 2003,[3] disclaiming their entitlement to the trust income for the year ended 30 June 1996 pursuant to the default distribution clause in the Trust Deed. On 8 October 2003, a deed of disclaimer was executed disclaiming all interests under the Trust Deed.[4] The Federal Court denied the validity of the distribution but accepted the disclaimers were valid.

The Commissioner appealed this decision to the Full Federal Court, contending that the disclaimers were ineffective. The Commissioner's reasoning was that the beneficiaries disclaimed only part of their interests and the disclaimers were not made within a reasonable timeframe.

The Full Federal Court agreed with the Commissioner's arguments, stating:[5]

> The failure of the respondents to disclaim their entitlements under cl 3(e) until the day before the trial justifies an inference that they were reluctant to disclaim these entitlements. The limited and ineffectual disclaimers … are consistent with an intention not to disclaim their entire interests in the Trust income and, therefore, are also consistent with tacit acceptance of those interests.

The Full Federal Court subsequently allowed the Commissioner's appeal, agreeing with the primary judge's conclusion accepting the distributions as valid. However, the disclaimers were deemed to be ineffective because they did not satisfy the required conditions to effectively disclaim an entitlement to trust income.

Three key principles from *Ramsden*

As a result of the *Ramsden* decision, three key principles were identified for beneficiaries to effectively disclaim an interest.[6]

	Prerequisites to effectively disclaim an interest according to *Ramsden*
1	A beneficiary cannot disclaim the trust distribution for a specific period; rather the disclaimer has a retrospective operation, applying to all of a beneficiary's interest.
2	The beneficiary must disclaim the interest within a reasonable period from when they become aware of the benefit.
3	Where the beneficiary becomes aware of the interest and does not disclaim it, they will be taken to have accepted the interest.

3 Ibid, at [11].

4 Ibid, at [55].

5 See *Federal Commissioner of Taxation v Ramsden* [2005] FCAFC 39 (***Ramsden***) at [62].

6 Ibid, at [30], [31] and [53].

Summary of facts and decision in *Carter*

The *Carter* decision related to assessments arising from default distributions from the Whitby Trust for the 2011 to 2014 income years. On conclusion of the ATO audit, the Commissioner identified additional assessable income for the Whitby Trust. The additional assessable income was distributed in accordance with clause 3.7 of the Whitby Trust Deed, distributing the trust income equally between five beneficiaries; namely, four adult beneficiaries and one minor beneficiary.[7]

On 4 and 5 June 2014, the adult beneficiaries executed a deed of disclaimer (**the first disclaimer**) renouncing their interest arising from the income distributed in the 2011 to 2013 income years and any income that may be derived of default distributions. The first disclaimer was initially accepted by both the Commissioner and the Administrative Appeals Tribunal (**AAT**).[8]

On 27 October 2015, the Commissioner issued the 2014 amended assessments. The beneficiaries executed a deed of disclaimer on 3 and 4 November 2015, similar to the first disclaimer; however made in respect of the 2014 income year (**the second disclaimer**). The Commissioner disallowed this disclaimer. The beneficiaries subsequently executed another deed of disclaimer (**the third disclaimer**) on 30 September 2016 with broader terms and encompassing all years.[9]

The taxpayers in *Carter* case appealed the AAT's decision to the Federal Court, then to the Full Federal Court, then sought and were granted special leave to appeal to the High Court. On 6 April 2022, the High Court handed down its decision that the disclaimers were ineffective for the purposes of section 97(1). Interestingly, the principles relied upon by the High Court in arriving at this decision were not the same as *Ramsden*.

Three key principles from *Carter*

The *Carter* decision focused on the three criteria to effectively disclaim an interest for the purposes of section 97(1).

	Prerequisites to effectively disclaim an interest according to *Carter*
1	The disclaimer must reject the entirety of the beneficiary's interest.
2	The disclaimer must be executed prior to the end of the accounting period to be effective for that accounting period.[10]
3	A valid distribution does not require the assent of the beneficiary. The creation of beneficiary entitlements can occur without a beneficiary's knowledge.[11]

7 See *Carter v Commissioner of Taxation* [2020] FCAFC 150 (***Carter***) at [3].

8 Ibid, at [3].

9 See *Federal Commissioner of Taxation v Carter & Ors* [2022] HCA 10 (***Carter & Ors***) at [11] and [12].

10 Ibid, at [25].

11 Ibid, at [30].

Reconciling Carter and Ramsden

Revisiting ‘income of the trust estate’

As determined in *Bamford*, section 97(1) ‘income of the trust estate’ is determined by the law of trusts.[12] This includes the trust deed and any powers exercised by the trustee under the deed to recharacterise an amount as being included in or excluded from the trust income. Accordingly, trust income could include amounts inconsistent with ordinary concepts.[13]

Section 97(1) of the ITAA 1936 relevantly provides as follows:

> … where a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate: (a) the assessable income of the beneficiary shall include: (i) so much of that share of the net income of the trust estate …

Section 95(1) relevantly provides as follows:

> **net income**, in relation to a trust estate, means the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income and were a resident, less allowable deductions … or in respect of any life tenant, the deductions allowable under Division 36 of the *Income Tax Assessment Act 1997* in respect of such of the tax losses of previous years as are required to be met out of corpus.

Subsequent to *Bamford*, the ATO released draft Taxation Ruling TR 2012/D1 *Income tax: meaning of 'income of the trust estate' in Division 6 of Part III of the Income Tax Assessment Act 1936 and related provisions* (**TR 2012/D1**). TR 2012/D1 provides guidance for the 2011 and later income years and explains the meaning of the expression ‘income of the trust estate’ as used in Division 6 and related provisions. The draft Ruling also considers the changes effected by the *Tax Laws Amendment (2011 Measures No. 5) Act 2011*[14] to Subdivision 115-C and Subdivision 207-B of the ITAA 1997 when streaming trust capital gains and franked distributions respectively.

How do we reconcile Carter with Ramsden?

Importantly, the principles in *Ramsden* have not been superseded by the decision in *Carter*. Both decisions continue to have application to trust arrangements. The key findings by the High Court (in *Carter*) and the Full Federal Court (in *Ramsden*) arose from the difference between the income of the trust estate in section 97 (defined as being income according to the law of trusts)[15] and the net income of the trust calculated in accordance with section 95(1).

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[12] See *Bamford v Commissioner of Taxation* [2009] FCAFC 66 (***Bamford***) at [37].

[13] Ibid, at [40].

[14] Enacted on 29 June 2011 as Act No. 62 of 2011.

[15] Ibid, at [37].

The key difference between the two cases is that *Carter* was focused on timing; specifically whether a beneficiary's present entitlement under section 97(1) – the present legal right to demand and receive payment of a share of the income of a trust estate – is determined immediately prior to the end of the income year by reference to the legal relationships then in existence, or whether events after the end of the income year can affect or alter those legal relationships. The issue in *Ramsden* focused on what is required for a beneficiary to validly disclaim an interest from a trust law perspective.

The focus of the High Court was on the phrasing in section 97(1) that refers to the entitlement in its present tense[16] and subsequently when the legal right arose. It was determined that the entitlement to the trust income and subsequent taxation liability would arise at a point immediately preceding midnight at the end of the income year.[17] The liability to taxation under section 97(1), based on the beneficiaries' entitlements to a share of the trust income that arose at the end of the income year, could not be altered by changing circumstances subsequent to the end of that income year.[18]

The *Carter* decision means that, while a beneficiary may be able to effectively disclaim their interest from a trust law perspective (based on the principles in *Ramsden*), such a disclaimer will not be effective for tax purposes unless it is done by the end of the income year in which the present entitlement arose.

Presumption of assent

The application of the presumption of assent in respect of beneficiary's distribution was examined by Edelman J as part of the High Court's decision. The presumption of assent is a presumption of law that a donee accepts a gift without requiring positive conduct;[19] it is a unilateral vesting of rights.[20] The gift can be rebutted via a disclaimer.

Edelman J emphasised that real life examples demonstrate this concept. The financial system being an example of how amounts could be deposited into bank accounts without formal assent required by the beneficiary to receive the deposits.[21]

This premise is particularly prevalent in family law disputes. In *Alderton v Commissioner of Taxation* [2015] AATA 807, the applicant was demonstrated as having inadvertently assented to the distribution through the access of trust funds for personal use. The beneficiary was unaware of the trust distribution until a default assessment was issued by the Commissioner.

The more recent decision in *The Beneficiary v Commissioner of Taxation* ***(Beneficiary)*** [2020] AATA 3136 indicated acceptance of receiving the trust's benefits through the inclusion of PAYG instalments paid by the trustee in the beneficiary's tax return. The beneficiary was made aware of the distributions only after the end of the income year.

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16 *Carter & Ors*, at [19].

17 Ibid, at [22].

18 Ibid, at [23].

19 Ibid, at [30].

20 Ibid, at [35].

21 Ibid, at [45].

These two cases are representative of numerous family law cases whereby entitlements have been distributed to beneficiaries without their knowledge but are still required to be included as part of the beneficiary's section 97(1) income.

In the *Beneficiary* decision, the AAT further clarified that a beneficiary's entitlement under section 97 arises at the point of distribution irrespective of the beneficiary's awareness of that entitlement.[22] In *Carter*, and for many trusts, the assent would occur immediately preceding the end of the income year resulting in a valid distribution.[23]

Section 100A

Interestingly, the High Court's approach may have some inadvertent consequences for arrangements that may fall within the scope of the recently released ATO draft guidance on section 100A.[24]

Where an adult child beneficiary has unknowingly become presently entitled to a distribution in an income year, they may be unable to effectively disclaim their entitlement from a tax law perspective. This could raise the prospect whether their present entitlement arose in connection with a reimbursement agreement, whether there was a purpose of reducing tax and whether the arrangement was an ordinary family or commercial dealing. If all the conditions of section 100A are satisfied, the beneficiary — who otherwise would be saddled with a taxation liability — could contend that the trustee should instead be assessed under section 100A instead of the beneficiary under section 97(1).

Further details of the ATO's recent draft guidance on section 100A can be found in our blog Section 100A and draft ATO guidance.

Next steps

Ramsden remains the principal case in determining the conditions required for a beneficiary to effectively disclaim a trust entitlement for trust law purposes. The *Carter* decision, however, provides clarity on disclaimer requirements for the purposes of section 97(1). Beneficiaries seeking to disclaim entitlements from discretionary trusts will need to consider the timing of the execution of the disclaimer for it to be effective for section 97(1) purposes.

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22 See *The Beneficiary v Commissioner of Taxation* [2020] AATA 3136 at [62].

23 *Carter & Ors*, at [30].

24 See draft Taxation Ruling TR 2022/D1 *Income tax: section 100A reimbursement agreements*; Draft Practical Compliance Guideline PCG 2022/D1 *Section 100A reimbursement agreements – ATO compliance approach*; and Taxpayer Alert TA 2022/1 *Parents benefitting from the trust entitlements of their children over 18 years of age.*

Update on 15 June 2022

On 10 June 2022, the ATO released a decision impact statement (**DIS**) in response to the *Carter* decision. As a consequence of the *Carter* decision, ATO ID 2010/85 *Trust income: disclaimer of an entitlement to trust income* – which expressed the view derived from the decision in *Ramsden* that a beneficiary who has validly disclaimed an entitlement to trust income is not presently entitled to a share of the income of the trust estate for the purposes of section 97 – has been withdrawn. The DIS has affirmed that legally effective disclaimers executed after the end of the income year do not alter the existing tax result.

Further guidance and information

Further guidance and information is available from the ATO website.

If you have any specific concerns that have not been outlined above, please email taxpolicy@taxinstitute.com.au.

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