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Trust Disclaimers following *Carter*: clarity or (more) confusion

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The High Court has this week delivered the much anticipated decision in relation to trust disclaimers in the case of *FCT v Carter* [2022] HCA 10.

In a sentence, the High Court has unanimously allowed the ATO's appeal and confirmed that a beneficiary's present entitlement under s 97(1) of the ITAA 1936 must be determined immediately prior to the end of an income year. That is, anything that occurs after the end of the income year (such as a disclaimer) is irrelevant – regardless of whether the beneficiary was aware of their entitlement as at 30 June

The tax position: before this week

The case of *The Beneficiary and FCT* [2020] AATA 3136 arguably provides the best context of the key principles for effective trust disclaimers prior to the High Court's decision in *Carter*: see 2020 WTB 34 [915].

In *The Beneficiary* there was a distribution from a discretionary trust to the wife of the husband who ultimately controlled the trust in the year their relationship ended. In deciding that the wife had not effectively disclaimed the distribution the Court confirmed the following.

- The principles explained in *FCT v Ramsden* [2005] FCAFC 39 were the starting point for determining the effectiveness of any purported disclaimer.
- While it is sometimes argued that a disclaimer of a gift must be made within a "reasonable" time of becoming aware of it, the position is more nuanced.
- In particular, as set out in Ramsden, "the question is not answered by measurement of the period of time that has elapsed simpliciter, but by whether in all the circumstances acceptance of the gift should be inferred from absence of dissent from the donee, and the passage time".
- Whether a beneficiary actually receives a distribution is irrelevant to whether it is effectively disclaimed, although here, the setting off of the distribution against an indebtedness the wife had to the trust did constitute use of part of the distribution. A fact reinforced by the family court consent orders which provided evidence that the wife's beneficiary account balances were considered as part of the basis on which the property settlement was negotiated.
- Here, an otherwise effective deed of disclaimer was made in April 2018.
- This disclaimer was however more than 3 years after the wife became aware of the distribution and her failure over this extended period to take any action to explicitly disclaim the distribution created a strong inference that she had accepted it.

- Furthermore, the wife claimed and retained the benefit of substantial instalment payments relating to income from the trust. This fact combined with the lengthy delay in signing the disclaimer supported the conclusion that the wife should have been inferred to have accepted the distribution.
- Some actions (such as removing the distribution from the draft tax return provided to her) were unhelpful to the wife, as there was no evidence to suggest that when taking this step the wife had any concept of disclaimer in mind at the time

Carter – the factual matrix

At the heart of the *Carter* case there was a quintessential example of a mantra often cited in this *Bulletin* – namely "read the deed".

In particular, a failure to follow the requirements in a trust deed and trustee company constitution saw a number of purported resolutions held to be invalid; which in turn saw the failed trust distributions left to be regulated by the default distribution provisions under the trust deed.

This included the following.

- Different versions of the "minutes of meeting" in relation to a purported trust distribution on 30 June were produced to the Court – one version recorded that the meeting was held at 12pm and lasted 10 minutes and the other version recorded that the meeting was held at 2pm and lasted 15 minutes.
- Neither of the minutes indicated whether they were minutes of a meeting of a directors' or general meeting.
- The minutes did not record who was present at the meeting (and the company constitution required at least 2 attendees at meetings of both directors and members).
- The director signing the minutes gave evidence that the meeting did not in fact take place on 30 June, but would have taken place before that day.
- The provisions under s 1305 of the Corporations Act (that provide that a book kept by a company is *prima facie* evidence of any matter recorded) do not automatically mean that the matters contained in the books can be assumed to be true, ie the Court must still have regard to the wider factual context.
- Even if the minutes were in fact effective from a Corporations Act perspective, they were invalid under the trust deed because the terms of the trust deed were not observed in that the consent of the guardian to the distribution was not obtained.
- That is, where a trust deed requires the consent of a named individual for the trustee to exercise a power (such as a power of distribution), a purported exercise of the power without consent is void (see *Re Forster's Settlement* [1942] Ch 199).
- A potential consent by the guardian here could also not be inferred from the signature on the minutes of a meeting, given the different capacity which that document was signed under (ie director of the trustee company, as opposed to guardian of the trust).
- Furthermore, where 2 guardians were appointed under the deed, but one guardian claimed they were unaware of their appointment did not, based on the terms of the trust deed, mean the other guardian could act unilaterally.

Carter – the Full Court decision

The Full Court decision in *Carter* confirmed many of the principles outlined above in the summary of the decision in *The Beneficiary*, while also concluding that:

- where a distribution has been made to a beneficiary who is also a default beneficiary, in order for the disclaimer to be effective the disclaimer by the beneficiary must also disclaim their rights as a taker in default;
- if the ATO rejects the effectiveness of a disclaimer, it may be possible for a beneficiary to subsequently sign a disclaimer that is effective; and
- effective disclaimers have retrospective operation for the purposes of the Tax Act, to effectively circumvent the provisions of s 97(1).

Carter – the High Court decision

As flagged above, the High Court unanimously allowed an appeal of the Full Court decision, specifically confirming the following.

- At general law, the effect of a disclaimer can operate retrospectively. In other words, at general law the principle of liberty that rights or liabilities are not generally to be conferred or imposed upon a person independently of that person's actions is respected.
- However, for the purposes of s 97(1), it is clear that this is directed to the position existing immediately before the end of the income year for the purpose of identifying the beneficiaries who are to be assessed with the income of the trust.
- This means that the relevant focus for tax purposes (despite the clear unfairness created by the approach) is the right to receive an amount of distributable income; not the actual receipt of income.
- Therefore events (such as a purported disclaimer) occurring after the end of the income year cannot for tax purposes disentitle a beneficiary who was in fact "presently entitled" under s 97(1) immediately before the end of the relevant income year.
- In turn, purported disclaimers are ineffective to the extent they seek to retrospectively extract a beneficiary from an assessment that has arisen as at the end of the relevant financial year.
- Furthermore, once the beneficiaries with the rights to income as at 30 June are identified, those beneficiaries are then assessed on their share of the net income of the trust estate, based on their present entitlement to a share of the income of the trust estate.
- Finally, it was also confirmed that arguments raised by the taxpayer in relation to the presumption of assent (to the default distribution) being able to be rebutted due to the disclaimers were also of no assistance.

Conclusion

As the High Court succinctly confirms in *Carter*, the contention that the phrase "is presently entitled" in s 97(1) should in fact be construed to mean "really is" presently entitled for that income year, such that, for "a reasonable period" after the end of the income year, later events could subsequently disentitle a beneficiary who was presently entitled immediately before the end of the income year, has been categorically rejected.

This is despite the fact that, due to the interpretation adopted by the High Court, a beneficiary might be presently entitled at the end of an income year, yet be completely unaware of it.

With the overlay of the recent ATO statements in relation to s 100A there are likely to be ongoing and significant complications due to the approach of the High Court in the *Carter* decision, particularly in relation to adult children or other beneficiaries not actively involved in the management of the trust who unknowingly "receive" (for tax purposes) trust distributions.

These detrimental tax consequences for beneficiaries who may have no knowledge of their entitlements (and related tax exposure) until well after the end of financial year likely mean that the (alleged) practice of some trust deed providers historically of listing the "Commissioner of Taxation" as a default beneficiary may become widespread.

Alternatively, particularly in an election year, conceivably deed drafters will look to nominate their least favourite member of Parliament.

A further trust deed drafting iteration of having no default beneficiaries will also likely remain a relevant consideration; despite the material trust law (and in some States) stamp duty risks of such an approach.

Perhaps then the main certainty achieved by the High Court's decision is the continuing confusion faced by trust advisers and their clients in appropriately determining how to craft discretionary trust deeds.

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