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How the ATO is trying to change the law to force innocent people who owe no tax to pay tax

Briefing

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The ATO is again demonstrating how it seeks to operate as a law maker rather than a law administrator. In this current case explained below the ATO is attempting to change the law affecting the rights of beneficiaries of trusts thus overturning decades of settled tax law. If successful the ATO's law change would force people who owed no tax to pay tax. Bizzare but true!

This ATO attempt to change the law is occurring without government policy proposals or government or parliamentary oversight. It's an ATO legal slight of hand!

This is bad tax administration. It further demonstrates the need to reform the law under which the ATO administers tax with a view to securing taxpayer rights and justice.

1. Overview

- The ATO is appealing to the High Court a Federal Court ruling of late 2020.
- The Federal Court ruling (see below) says that it is accepted law that a beneficiary of a trust has the right <u>not</u> to accept profit distribution from a trust.
- People reject trust profits when the 'profit' is theoretical and no money has been transferred to them. That is logical.
- If the ATO's appeal succeeds and beneficiaries cannot reject the theoretical profit, the ATO will force them to pay tax on money/income they have not received. That is unfair.
- The changes would open the opportunity for fraud as explained below.

What the ATO is doing—

- The ATO is trying to change the law to force people to pay tax on income/profit they have not actually received.
- The ATO seems to be running a wider campaign on this (see section 6, below, the Gold case).
- This is being done without referral to the government or parliament.

This is a prime example of where the ATO:

- is operating as a law-maker rather than a law administrator; and

- acts unfairly and vindictively against innocent Australians

This is yet another example of why urgent reform of the ATO is needed.

2. Background Facts – Trusts distributions and disclaimers

Small and medium business, particularly family businesses, are frequent users of trusts to structure their business affairs.

A *discretionary* trust is one where the trust has the 'discretion' to distribute money/profits to beneficiaries (most often family members). Legally:

- the trust doesn't have to distribute profits, but can keep the money in the trust; and
- the beneficiaries do not have to accept the trust money.

Either way, tax is paid on the trusts' profits—either directly by the trustee or by the beneficiaries after profit distribution.

This has been ATO practice and accepted as law by the courts since 1991. The ATO is now seeking to overturn this. The ATO is seeking to impose tax [assessments?] on trust beneficiaries who have been allocated an 'ATO assessed' profit distribution, even where the beneficiaries have not actually received any money from the trust.

3. The specific case – *Carter v Commissioner of Taxation* [2020] FCAFC 150

a) Natalie Carter is a mother with two school-aged children. The extended family runs a medium-sized land development business started by her grandfather. The business is structured as a discretionary trust. Natalie is a beneficiary. She does not participate in the operations of the business.

b) In 2014, the ATO decided that, for tax purposes, Natalie was entitled to profits from the business/trust. But the trust did not transfer any money/profit to Natalie. In other words, the ATO demanded that she pay tax on a theoretical income when she had not actually received any of the income.

c) The ATO had assessed theoretical profits in the trust. The assessment was based on its profit estimate which was calculated as gross sales less construction costs. The ATO ignored significant expenses such as interest, land tax, council rates and contributions, etc, which ultimately led the development to break even. No actual realised, cash profit had been made. That is, the trust did not have any money to distribute to Natalie.

d) Natalie did as the law allows and immediately declared that she did not want the theoretical trust income/profit and 'disclaimed' the trust distribution. The ATO turned around and said that she cannot refuse the theoretical income/profit.

e) Natalie appealed to the Federal Court and won her case. The Federal Court ruled that, under law, she could disclaim the trust distribution/profit, and that she did so correctly.

f) However, during the process of appealing to the Federal Court the ATO forced (garnished) Natalie and her family into paying the theoretical tax bills, which resulted in the forced sale of the family home to pay the ATO's theoretical tax bill.

g) Following the Federal Court ruling, the ATO now owes Ms Carter the tax they forced her to pay.

h) Now the ATO is taking the case to the High Court. It is asking the High Court to declare that a beneficiary can only renounce a trust profit distribution in the year that the profit is made (i.e., before 30 June). In other words, the ATO is seeking to totally change the law.

Such a change to the law would mean that if a trust profit distribution is made (or assessed by the ATO) in one year, a beneficiary must renounce the distribution before the end of the financial year. This would be the case even if a distribution had not actually occurred and/or the beneficiary did not know that a profit distribution was to occur.

This attempt to change the law by the ATO is illogical and opens the door for fraud (see section 5, below).

4. Comment: the ATO's attempted change to the law – implications

As stated above, the ATO is attempting to change the law so that a trust beneficiary cannot disclaim a trust distribution unless that disclaimer is made before 30 June of the relevant year..

This would mean that if a person did not disclaim a trust distribution (whether or not they knew about or consented to the distribution) by 30 June, they would be forced to pay tax on that trust distribution even where they had not received any actual payment from the trust.

The ATO is attempting to create and enforce a tax debt where no income has been received by a person and that person does not want the income. This is illogical and unfair. Moreover, this is being done by the ATO without any community, parliamentary or government review or discussion.

5. The potential for fraud – Examples

<u>Scenario 1: Vindictive ex-husband</u>

A vindictive ex-husband could make significant profits in his business trust 'on paper', then 'distribute' those profits to his ex-wife (without her knowledge or consent) and take the physical cash outside of the Australian jurisdiction. The ex-wife would be stuck with a tax bill, with no right to disclaim the purported distribution and no ability to pay the tax bill from the trust's assets. In conducting this tax fraud, the ex-husband would no longer be defrauding the ATO but instead defrauding his ex-wife. In forcing the ex-wife to pay the tax, the ATO would effectively become an accomplice with the ex-husband in committing fraud against the wife. The ATO would make the wife the victim.

<u>Scenario 2: Vindictive father-in-law</u>

Trust A makes profits in FY2020, and the director causes Trust A to make an "on paper" distribution to his son-in-law. The distribution is made on 30 June 2020 at 1:00pm. The director of Trust A spends all of the cash profits from FY2020, and in January 2021, the son-in-law finds out that a distribution was made to him. Ordinarily, the son-in-law would get legal advice to disclaim his rights, and that would be sufficient to absolve him from any income tax liability. The Trustee for Trust A would be liable for tax instead.

However, the ATO's new interpretation would mean that the son-in-law cannot disclaim the trust distribution for FY2020 and would be stuck with a tax bill for the amount of the purported trust distribution, with no assets in Trust A that he could use to pay the tax bill.

<u>Scenario 3: Conning the Tax Commissioner</u>

This scenario might seem far-fetched, but it demonstrates how 'far-fetched' is the law change being attempted by the ATO.

Trust B is established, and names the Commissioner of Taxation, personally as a beneficiary. Trust B makes trading profits, and "on paper" distributes those profits to the Commissioner on 30 June every financial year, let us say for FY2017 – 2020. The director spends the cash profits made by Trust B, and eventually liquidates the corporate trustee for Trust B. The Tax Commissioner personally would be liable to pay income tax, on the trust distributions for FY2017 – 2020 and could not escape those income tax liabilities by disclaiming the trust distribution.
(NB: It is standard under historial common law for many trust types to be able to make someone a beneficiary without that someone knowing. This also happens under wills for example.)

6. Similarities between the Carter case and the Gold case

There is evidence that the ATO is on a campaign to seek broad powers to force tax debts upon people who have no real tax debt.

In late 2020, the ATO lost a legal case (the Gold case) where it had attempted to impose the cost of a massive tax fraud upon innocent third parties. Tax fraudsters had traded in gold bullion but not paid the GST they should have paid to the ATO. Instead, they disappeared overseas with hundreds of millions of dollars. The ATO sought to recover the money from gold refiners who the ATO admit did nothing wrong. The courts have ruled against the ATO. As in Natalie Carter's case, the ATO is appealing to the High Court.

There are obvious similarities between Ms Carter's case and the Gold case. In both cases the ATO has assessed and imposed a 'theoretical' tax debt on innocent third parties. In both cases the ATO is seeking to change the law through High Court challenges to enable the ATO to impose and collect tax debts on people who have no tax debt.

It is reasonable to form the view that the ATO is appealing the Carter case to the High Court in another attempt to change the law to enable the ATO to impose and collect tax debts on innocent people. It is also reasonable to speculate that the ATO is acting against Ms Carter in this way as part of the ATO's efforts to ensure that it, the ATO, avoids its responsibilities for its massive mismanagement by employing overzealous recovery action against innocent taxpayers, as happened in the Gold Case.

7. Observations on the ATO's behaviour

In relation to Ms Carter's case, at minimum, the ATO is:

- in clear breach of its model litigant obligations;
- acting as a 'law maker', thereby usurping the role of Parliament;
- being devious and underhand, displaying the worst features of corporate misbehaviour and abuse of power; and
- seeking to set precedent and practices to impose tax liabilities on Australians in situations where no tax liability exists.

The ATO is doing this where no government policy has changed, no public debate has occurred and where it would appear that parliament is not even aware of the ATO's attempt to change the law.

8. Legal details

The current law holds that if somebody has not received profits and has rejected their right to those profits, it would be illogical that they would have an obligation to pay tax on those amounts. The Full Federal Court accepted this in the case of *Commissioner of Taxation v Ramsden* [2005] FCAFC 39, and the Commissioner has accepted this as his practice in administering taxation law, as early as 1991 (in its published Taxation Ruling IT 2651).

In the Carter case, the Commissioner sought to argue that a beneficiary's 'present entitlement', which is essentially their share of the trust profits for each financial year, is established at 30 June of every year, and that the *Income Tax Assessment Act 1936* (Cth) should be interpreted so that a beneficiary cannot retrospectively disclaim their rights to absolve them from income tax liabilities.

This argument was raised before the Full Court. Justice Thawley put it to Senior Counsel for the Commissioner that the argument was contrary to the way in which it had administered taxation law and the position accepted by the Commissioner in previous cases.

> "The Commissioner must have a position one way or the other as to what the correct law is. And as far as I'm aware, the Commissioner accepted in Ramsden that these disclaimers have retrospective effect. I've seen it argued in one other case. But otherwise my recollection is that the Commissioner has always adopted the view that such a disclaimer does have retrospective effect and that's the exact basis that the Commissioner taxes the trust under section 99A."
> (Hearing transcript Justice Thawley)

The Full Court eventually rejected the ATO's argument, finding that a beneficiary can disclaim their rights retrospectively).

> "Until disclaimer, a beneficiary's entitlement to income under a trust is operative for the purposes of s 97 of the ITAA 1963 from the moment it arises (*Ramsden* at [30]) but upon disclaimer, the general law extinguishes the entitlement to trust income ab initio.
> The disclaimer is determinative as against the Commissioner in the application of s 97 to the beneficiary as the effect of a disclaimer is that the beneficiary must be treated as never entitled to the income for the purposes of s 97 in respect of the relevant income year."
> (paragraphs 109 – 110 from the judgment)

The Commissioner now seeks to run the same issue by Special Leave Application to the High Court—namely, that a beneficiary cannot disclaim rights retrospectively, and that a beneficiary must disclaim before 30 June to be effective.

If the High Court accepts the Commissioner's case, the newly adopted interpretation would significantly alter the rights of Australians, especially small/medium-sized family businesses, which commonly use discretionary trust structures.