eJournal of Tax Research

Volume 4, Number 2 December 2006

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In Memory of

JOHN RANERI
1957-2005

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ISSN 1448-2398

eJournal of Tax Research (2006) vol. 1, no. 1, pp.153-196

Testamentary Trusts: Not Just "Another" Trust?

Arlene Macdonald[*]

Abstract
This article examines the use of testamentary trusts and the implications of the taxation of trust rules for such trusts. It looks at the advantages and disadvantages of creating a testamentary trust in the Will as distinct from leaving property to existing inter vivos trusts and deals with the rule against the delegation of testamentary power still existing in some States. It identifies difficulties associated with planning and amending such trusts. It identifies difficulties that may result in a new trust being created and identifies Capital Gains Tax issues arising from cloning or splitting trusts. The article also considers what it terms "after death trusts" and Capital Gains Tax issues arising from those as well as Capital Gains Tax issues arising from the premature ending of life interests. The article concludes that a testamentary trust is not just another trust but is associated with many aspects peculiar to testamentary trusts that do not apply to trusts inter vivos.

INTRODUCTION

There was a young lad named Bill
A donee of Dad's ancient Will
Dad said: 'make it good'
So you did all you could
And got tax benefits and more for Bill

Issues surrounding testamentary trusts are just one of the many good areas for fruitful discussion by tax advisors. In this article I will try to avoid the temptation of wandering too far from the central topic into other fascinating and linked topics to do with death and trusts and tax or some combination of all three.

There is no need to leave property to a trustee to hold that property on trust for one or more beneficiaries, the true recipients of your largesse. Where the choice is made to leave property in trust, that trust can be created in the Will, with the gift being the settled property or it can be left to a trustee of an existing trust which will already have other property (at least the settled sum).

Testamentary trusts have many uses but that doesn't mean they are always a good thing. Where the trust is properly created with trustworthy appointors and trustees - including successors - carefully chosen, a testamentary trust allows flexibility in directing financial resources to those most in need (such as vulnerable adult children)[1] or withholding those resources where they would be at risk to creditors, ex-spouses, and wastage by those children and grandchildren who think money is for spending! It

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[1] This includes intellectually handicapped adults and those with gambling or drink/drug addictions.

can also be used as part of the plan to divide property and control among different family members and their descendants. There is another major advantage that is of particular interest to us: the income tax savings on distributions of unearned trust income to minors.

The much sought after tax advantage is quite simply that minors are taxed as adults with the benefit of the tax free threshold.

To achieve this tax advantage while ensuring all the asset protection and income flexibility is maintained, care is needed by the drafter and the trustee. The aim of this article is to identify where that care is needed and the reasons why.

A caveat is necessary. Tax law and trust law are uncomfortable partners. Tax advisors, the Australian Taxation Office (ATO) and the Courts are still discovering how they interact. In part the development of the law depends on the context in which the problem arises. In our case, it is usually in trying to apply a tax law to a trust. In many cases, trust law, including testamentary trust law develops without any care or concern for the tax implications and is more concerned with conflicting rights of beneficiaries. We tax practitioners are then left to consider the implications for us. The recent High Court decision in *CPT Custodians*[2] is an example of general trust law developments with the tax advisors trying to survive the swell.[3]

This article cannot provide absolute answers in these areas of uncertainty.

PECULIARITIES OF TESTAMENTARY TRUSTS

What is a testamentary trust?

It is first of all, a trust. It has the attributes of other trusts including trust property, trustee and beneficiaries. It can be a fixed trust (eg where a life interest is left) or a discretionary trust or a hybrid.

A *testamentary trust* is a trust created by a Will (or a codicil to a Will) and not inter vivos.[4] A *testament* is a Will.[5] A *testamentary instrument* is a Will or codicil.

Therefore for the testamentary trust to be valid, the Will must be valid! Two areas of common dispute concerning property left in Wills are over the capacity of a testator[6] to make the Will and whether the testator made the Will under undue influence. These are unlikely to be a problem with the creation of inter vivos trusts or the transfer of property into them. There is something about a death of someone with property which

[2] *CPT Custodian Pty Ltd v Cmr of State Revenue* (2005) 221 ALR 196.

[3] See John de Wijn QC, 'CPT Custodians', paper presented at the Taxation Institute of Australia's *14th National Intensive Retreat*, Noosa, 17-19th August, 2006.

[4] Inter vivos means between living persons; during life. A deed or other instrument executed inter vivos is executed between living persons (Butterworths Encyclopaedic Australian Legal Dictionary (online), Lexis Nexis, Australia).

[5] Its strict meaning is a Will dealing only with personal property but it is used to deal with Wills generally (Butterworths Encyclopaedic Australian Legal Dictionary (online), Lexis Nexis, Australia).

[6] *Testator and testatrix* are the male and female forms of the term given to the person who made the Will. Where I use testator, I mean testatrix if I am in fact referring to a female or if you consider I should be doing so.

brings out all the hopes and expectations and greed and resentment of those who knew the deceased.

Delegation of testamentary powers

A person of testamentary capacity may dispose of all of his/her property by Will as they like.

> There is nothing to stop a person making the most capricious will. A person could make a will which said that he gave all his property to X to be held on trust, the terms of which were that X was to arrange for a 0055 telephone number and was to pay the whole of the testator's estate to the hundredth person who rang that number, or for the first child born at a certain hospital in 1998. There is nothing to stop the testator directing that his executor convert the whole of the money into bank notes and proceeding to the corner of George and King Streets at 8 o'clock on a designated night and throwing the money away.[7]

There is a rule that he/she must dispose of that property personally and may not delegate that power of disposition to another. So where a Will directed the executor to distribute the residuary property "to others not otherwise provided for who, in my opinion, have rendered service meriting consideration by the testator", the High Court found this clause breached this rule in *Tatham v Huxtable.*[8] Kitto J said (at 653)

> It is a 'cardinal rule', to which a power of selection among charitable objects is the sole exception, that a 'man may not delegate his testamentary power. To him the law gives the right to dispose of his estate in favour of ascertained or ascertainable persons. He does not exercise that right if in effect he empowers his executors to say what persons or objects are to be his beneficiaries': Chichester Diocesan Fund v Simpson (2). It is therefore necessary in all cases (other than charity cases) that the persons or objects to benefit under the will shall be, by the will itself, ascertained or made ascertainable. They may be made ascertainable by reference to a specified future event, including an act to be done by another person provided that that act does not amount to the making by one man of another man's will: Stubbs v Sargon (3).

The rule has been abolished or modified in some states[9] but in others (NSW, SA, Tas, WA), it continues to exist.

The issue of interest to us of course is whether a testamentary trust which includes the power to the trustee to add beneficiaries would breach this rule. Logically, the answer is yes as the trustee would be able to give the testamentary gift to someone not chosen by the testator or not within the class of potential beneficiaries. However the case of *Gregory v Hudson*[10] indicates this is not the case. In that case, the testator left a gift to an intervivos trust which included the usual power of variation.

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[7] Per Young J in *Gregory v Hudson* (1997) 41 NSWLR 573.
[8] (1950) 81 CLR 639.
[9] Australian Capital Territory (ACT), Northern Territory (NT), Queensland, Victoria –see relevant Wills Acts.
[10] Supra.

Young J considered the rule against the delegation of testamentary power at length in dealing with a gfit to a typical discretionary trust. He summarised the position in New South Wales (NSW)[11] (at 586):

> In summary, reducing the foregoing to their simplest form, the position as to the rule against delegation of will-making powers is as follows:
>
> 1. The rule is part of the law of New South Wales.
>
> 2. A person will not exercise the power personally where a power is given to an executor or some third person to choose the persons who are to benefit from the testator's bounty.
>
> 3. There are exceptions to that rule in the case of powers of appointment including powers of appointment where there is a trust to exercise the power in favour of: (a) charitable purposes; (b) powers where the appointor can appoint to himself or herself so that the interest conferred is equivalent to ownership; and (c) special powers where the class of persons who can be benefited is defined with sufficient precision.
>
> 4. It is not a breach of the rule to give property by will [to] a pre-existing trust or to constitute a trust which is sufficiently constituted according to the rules of certainty in trust law.
>
> 5. There is a further apparent exception where secret or half-secret trusts are used.

The case was argued on the basis that a gift to a typical discretionary trust meant it was possible for the trustee to add as beneficiaries almost the whole world with the exception of the limited specified ineligible beneficiaries. Without agreeing that was the case, Young J said (at 584):

> How then does the rule against delegation apply where the will sets up a trust? Usually, the rule does not apply at all. Thus, if a testator leaves property to the executor to convey it to the trustees for the Barristers' Sailing Club, that will be the end of the matter…. A testator clearly has power to leave his or her property to a trust without infringing the rule against delegation, provided that the trust is for a person or a defined class of persons or is a valid charitable trust.

By giving to the trustee, the testator has fully exercised his testamentary power so a challenge is not expected there. Of possible interest to the reader, he also warns (at 586-7):

> During argument, I remarked that the discretionary trust set up in the instant case was one which makes a judge in equity in 1997 wonder why equity courts are bothering with this sort of trust at all. Trusts, and at an earlier time, uses, were enforced by courts of equity because it was against the conscience of the holder of the legal estate not to carry out the promise that had been made to hold the property concerned on the trust expressed in the instrument. However, where the trustee can virtually designate who is to be the beneficiary, this ground has no validity at all. When one sees that discretionary trusts are used for the anti-social purpose of minimising taxation or defeating the rights of wives (see, eg, Re Davidson and Davidson

[11] The decision of Young J was affirmed on appeal: (1998) 45 NSWLR 300. The conclusions expressed by him represent the law in SA (per Besanko J in *Lines v Lines* [2003] SASC 173 at [36]).

> (No 2) [1994] FLC ¶92-469), there does not seem to be any reason in conscience why a court of equity should take any notice of them at all. Counsel were surprised that any judge should take this view and accordingly I announced during the argument that I would not seek to develop it in this case, but I believe that the message should be put abroad that the time may well have come where equity will have to reconsider its attitude to enforcing this sort of trust.

We have been warned!

Common benefits of testamentary trusts

The main benefit of a testamentary trust compared to the ordinary inter vivos trust is the income tax concession for minors who are taxed as adults with the benefit of the tax free threshold which in the current year results in up to $10,000 being tax free per minor.[12]

Another advantage of the testamentary trust is that as it does not come into effect until death and until then the testator owns the property, the testator can vary it to his or her heart's content until death (by Will or codicil). The testator can change the beneficiaries, trustees, powers, property etc. Also the testator can manipulate what property remains to be dealt with in his or her Will. Property can be transferred absolutely before death or to an inter vivos trust or left for the Will to deal with it.

Confusion in use of term "testamentary trust"

At one level, all deceased estates are for a time at least, "testamentary trusts". On death, the assets of the deceased vest in the executor (if there is one who is willing to act). It is a common myth that the assets don't vest until probate is granted to the executor or administrator by the Court.[13] In SA, at least this isn't correct. Some assets (but not land) can be transferred without probate.

The executor[14] has duties of a trustee to administer the estate (ie to pay all debts including tax bills, funeral expenses and to distribute the bequests). It is only when administration is complete (ie all debts paid or assets have been set aside by the executor to pay them) that the beneficiaries become absolutely entitled to any assets or their share of cash (if there are no further trusts created) and the assets and/or cash are distributed to the beneficiaries.

This is the "estate during administration" and is as much a trust (relationship) as any other. The beneficiaries at this stage have no right to anything except proper administration. It is during this period that unhappy or omitted beneficiaries should make any relevant application for variation of the Will under the Family Provision legislation of the particular State or territory. There is a very limited time allowed for an aggrieved beneficiary to make an application for obvious reasons although the Court may extend the time if it considers it appropriate.

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[12] Sec 102AG(2)(a). See later discussion.

[13] For example see IT 2622 at [2] and see the recent (27.6.06) ATO Guide called "Managing the tax affairs of someone who has died" on ATO website.

[14] *Executor and executrix* are the male and female forms of the term given to the person who is named as executor/executrix of the Will. *Administrator* is the term where the Court appoints a person to administer the deceased estate in the absence of a valid executor. In the CGT provisions, all of these are referred to as the *Legal Personal Representative* (s995-1 ITAA 1997).

Where a testamentary gift is left to an existing inter vivos trust, that may be fairly, although confusingly, be called a testamentary trust at least when dealing with the property given to the trustee through a Will.

However, when most lawyers, tax advisers, will drafters and estate planners refer to testamentary trusts, they usually mean the further trust created by the testator in the Will that continues in existence when administration is complete. Commonly the trustee of these long life trusts is the executor but a new trustee may be provided for in the Will or otherwise appointed.

Is it a different trust to the deceased estate in administration?
It is clear that the ATO treats them as different. The distinction (and some of the income tax implications as the estate passes into administration and out of it) is drawn by the Commissioner in IT 2622.[15]

The ATO also generally treats the trustee of the testamentary trust as the legal personal representative for the purposes of the Division 128 concessions for CGT on the passing of assets from the trustee to the beneficiary and does not treat the end of one trust and the beginning of the other as causing any CGT event (PS LA 2003/12).[16]

Let’s agree on the term “testamentary trust”
So for our purposes a testamentary trust is a trust left in a Will to take effect in the period after the executor has administered the estate, ie the testator leaves identified property or the residue of his/her estate (after specific gifts and debts are paid) to a trustee to hold and deal with for beneficiaries.

Discretionary or Fixed
Such a trust left in a Will may be a discretionary trust - which allows the trustee the discretion to distribute income and/or capital to an identifiable (although not necessarily named) class of beneficiaries.

It may be a fixed trust where the income distribution is fixed for a period - usually for the income beneficiary’s life (life interest)[17] - and the corpus is held for the remainder beneficiaries. It may also be fixed in the sense that a particular person has right to occupy a house for life or until marriage or entry into a nursing home or whatever.

When does a testamentary trust start?
The testamentary trust starts when property is given to the trustee to hold on trust or if already held by the executor, when the executor starts to hold the property under the new trusts. It would be rare for an executor to make a declaration that “I am now holding this property under the testamentary trust”. The evidence would be more likely to show commencement at the earliest of the time when income is first distributed under that trust or a new bank account opened or a TFN sought or some other act which indicates the trustee is now holding under these trusts.

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[15] IT 2622 [4] and [5].
[16] See especially [3] and [8].
[17] The life need not be the life of the beneficiary, it can be the life of another person but this would be odd in a testamentary trust because the usual purpose of the life interest is to provide income for the life of the beneficiary. One example might be to leave a life interest to a child until a grandparent (who is providing for that child in his/her Will) dies.

Assume a life interest is created in the Will. If it is over specified assets such as named shares or real estate, when does the life tenant "enter" into that tenancy? What if it is a life interest over the residuary estate? Does the life tenancy commence when the debts and expenses are paid or at an earlier time, when the executor has set aside sufficient assets or cash to pay them?

The ATO explains its view is that the trust will commence at the completion of the administration of the estate or at earliest when the trustee first pays income:

> …where it is apparent to the executor that part of the net income of the estate will not be required to either pay or provide for debts, etc. The executor in this situation might in exercise of the executor's discretion, in fact, pay some of the income to, or on behalf of, the beneficiaries. The beneficiaries in this situation will be presently entitled to the income to the extent of the amounts actually paid to them or actually paid on their behalf. The fact that the estate has not been fully administered does not prevent the beneficiaries in this situation from being presently entitled to the income actually paid to, or on behalf of, the beneficiaries.[18]

Varying the terms of the a testamentary trust –how far can you go

The subtitle of this article is 'not just "another" trust'? The question for us then isn't about varying trusts in general[19] but whether there is anything peculiar or simply different about varying testamentary trusts.

The general tax issue is whether the variation of the trust which is allowed under the specific trust deed, has the result of ending this trust and creating a new one (or to be more accurate, does it cause the trustee to have new obligations such that it is a new trust relationship?). One way this happens (according to the ATO's Statement of Principles on the Creation of New Trust) is by the addition of beneficiaries.

This brings us back to the issue of the delegation of testamentary powers. In States such as SA, beneficiaries cannot be added to or removed from the testamentary trust to the extent this means the testator has handed to another his/her power of testamentary disposition. This is the case <u>even</u> if the terms of the trust say the trustee can add beneficiaries. Due to the present uncertainty about whether the addition of beneficiaries to testamentary trust is the delegation of testamentary powers (in those States which still forbid this), it is common practice to ensure the problem doesn't arise by expressly excluding this power.

Other than that, the terms of the trust (such as powers of investment) can be varied if the Will contains a suitably wide power of variation of the terms of the trust.

What if the Will does not contain any power of variation? In the absence of a specific power of variation, there may still be some scope using the variation powers in the various *Trustee Acts* to request a Court to vary the Will (eg sec 59C of SA Act).

> 59C—Power of Court to authorise variations of trust

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[18] IT 2662 at [14] and ATOID 2004/458.

[19] For which we must consider the ATO's Statement of Principles (even if we don't agree with all of its conclusions).

> *(1) The Supreme Court may, on the application of a trustee, or of any person who has a vested, future, or contingent interest in property held on trust—*
>
> *(a) vary or revoke all or any of the trusts; or*
>
> *(b) where trusts are revoked—*
>
> *(i) distribute the trust property in such manner as the Court considers just; or*
>
> *(ii) resettle the trust property upon such trusts as the Court thinks fit; or*
>
> *(c) enlarge or otherwise vary the powers of the trustees to manage or administer the trust property.*
>
> *(2) In any proceedings under this section the interests of all actual and potential beneficiaries of the trust must be represented, and the Court may appoint counsel to represent the interests of any class of beneficiaries who are at the date of the proceedings unborn or unascertained.*
>
> *(3) Before the Court exercises its powers under this section, the Court must be satisfied—*
>
> *(a) that the application to the court is not substantially motivated by a desire to avoid, or reduce the incidence of tax; and*
>
> *(b) that the proposed exercise of powers would be in the interests of beneficiaries of the trust and would not result in one class of beneficiaries being unfairly advantaged to the prejudice of some other class; and*
>
> *(c) that the proposed exercise of powers would not disturb the trusts beyond what is necessary to give effect to the reasons justifying the exercise of the powers; and*
>
> *(d) that the proposed exercise of powers accords as far as reasonably practicable with the spirit of the trust.*
>
> *(4) An order made by the Supreme Court in the exercise of powers conferred by this section is binding upon all present and future trustees and beneficiaries of the trust.*
>
> *(5) This section does not apply to—*
>
> *(a) a trust affecting property settled by an Act; or*
>
> *(b) a charitable trust.*
>
> (6) This section does not derogate from any other power of the Supreme Court to vary or revoke a trust, or to enlarge or otherwise vary the powers of trustees

This power isn't particularly useful for tax advisors at least in SA where the Court will not vary the trust if the purpose is to get tax concessions (59C(3)).

It is also interesting to note the usual practice of the SA Supreme Court when it comes to consider whether or not to approve a compromise in such circumstances is to seek an opinion by Counsel as to the desirability of the proposed compromise and <u>not</u> to release that opinion to the beneficiaries! (per Perry J in *Salkeld v Salkeld* [2000] SASC 296 at [34] and [37].

From the ATO perspective expressed in its Statement of Principles, will adding a beneficiary under a specific power given to the trustee to do so result in a new trust? It would seem inevitable and the problem for the testamentary trust is that as well as the

CGT result, it would almost certainly sever the connection with the deceased's Will (the concession applies only to a trust estate that resulted from a will) which gives the tax concession for income distributed to minors and so destroy the benefit which underpins the very reason for having a testamentary trust. (See 2.5 below for further discussion on this tax concession).

When does a testamentary trust end?

The testamentary trust ends like other trusts. If a life interest, it ends when the person whose life is to be counted, dies or when the person with the interest assigns or surrenders it. If a discretionary trust, it ends when the trust deed says so (when the trust vests by one of the actions provided for in the Will, such as distribution of the property to the various beneficiaries or by declaration by the trustee that the trust has vested) or the Court makes an order vesting the trust. It can also end by accident if there is no trust property.

Adding corpus to a testamentary trust

This is a current hot topic. There are some who consider property can be added to a testamentary trust and they read certain comments in articles and papers in support.[20] I am not convinced these comments go as far as some say and there may be more than a hint of wishful thinking on the part of proponents of this view. My view is even where you can add property; you can't obtain the minor's concessionary tax rates from the income produced by the added corpus.

Assume the testamentary trust is in existence, and assume the Will provides that the trustee may accept gifts.[21] Exactly what are we asking and why? If it is simply whether we can add property, the answer is yes. Subject to claw back provisions in bankruptcy law and the reach of the Family Court in property proceedings, that property should be safe from attack by creditors in the trust.

The starting point is what is this testamentary trust there for? If the answer is asset protection of some type, then assuming the trustee can accept new property to hold under the same trusts, assets can be added to that trust and be as protected as the other assets. To the extent that the trust is to split income then again, that also can be done. Here the trust is similar to the typical inter vivos discretionary trust

However, where the trust has income tax advantages of income distribution to minors, I assume our concern is to ensure that those tax advantages are maintained. As this is the major use of testamentary trusts as distinct from inter vivos trusts, the question really is "can you add corpus to a testamentary trust while maintaining the tax advantages of income distribution to minors?"

Can you add property and get the minor's tax concession from its income?

Minors who are beneficiaries of the trust can receive income from assets transferred into the trust and from any substituted or grown assets eg by borrowing, investment, sale and purchase etc. The original assets given to the trust may be viewed as the

[20] For example, see *TIA Trusts Workbook* 2006 at 11.1.2 and Daniel Smedley *Establishing New Trust as part of succession Planning,* paper presented at the Taxation Institute of Australia's *13th National Intensive Retreat*, Noosa, 2005.

[21] If there is no specific power in the Will that allows the trustee to accept a gift of property, it is difficult to see how such property can be accepted by the trustee to be held on the same trust. If there is a power of variation, presumably the power can be added.

"seed assets" and they can vary. The benefit of the testamentary trust is not confined to the assets owned by the deceased or by the deceased estate during administration but that does not mean that other added assets will give rise to income that can be treated concessionally.

Assume the testamentary trust is to predominantly allow Betsy to distribute income among her 2 youngest children and 2 grandchildren (who are all under 18). The trust derives income of $30,000 pa. Betsy has just read in the *Wealth* pages of *The Australian* that minors can get up to $10,000 each tax free this year (taking into account the tax free threshold and the low income offset). She asks if she can transfer property to the trust (or ask her brother to do so) to earn an additional $10,000 and so distribute this as tax free income?

The minor income tax advantages come from secs 102AG(1), 102AG(2)(a)(i) and 102AG(d)(i).

> **102AG(1)** Where a beneficiary of a trust estate is a prescribed person[22] in relation to a year of income, this Division applies to so much of the share of the beneficiary of the net income of the trust estate of the year of income as, in the opinion of the Commissioner, is attributable to assessable income of the trust estate that is not, in relation to that beneficiary, excepted trust income.
>
> **102AG(2)** Subject to this section, an amount included in the assessable income of a trust estate is excepted trust income in relation to a beneficiary of the trust estate to the extent to which the amount:
>
> (a) is assessable income of a trust estate that resulted from:
>
> (i) a will, codicil or an order of a court that varied or modified the provisions of a will or codicil; or.
>
> (d) is derived by the trustee of the trust estate from the investment of any property:
>
> (i) that devolved for the benefit of the beneficiary from the estate of a deceased person;…

The tax concession of treating trust income distributed to minors as if distributed to resident adults applies where the trust income comes from the deceased estate and assets acquired by the estate.[23] This was established in the decision of the late Justice Hill in *Trustee for the Estate of the late A W Furse No 5 Will Trust v FCT*.[24]

In summary in that case, the trust was established with property of $1 left in Mr Furse's Will. The trustee borrowed $10 and used that to acquire units in a unit trust which was a solicitor's service trust.

The issue was whether the income from the unit trust which was distributed by the No 5 Will Trust to minor beneficiaries was excepted trust income. It was because Hill J held that all that is required was that the assessable income be assessable income of the trust estate where that trust estate be one resulting from a will, codicil, order of the

[22] A minor is a prescribed person (unless also an *excepted person* eg employed).
[23] Because the income is *excepted trust income* and all the other conditions are satisfied.
[24] *Trustee for the Estate of the late A W Furse No 5 Will Trust v FCT* (1990) 21 ATR 1123; 91 ATC 4007.

court or arising on intestacy. Hill J also held that s102AG(2)(a) applies where the trustee borrows funds and invests them and derives assessable income from those investments. He did not go on to say (as it was not relevant here) that the same conclusion applies to income from assets gifted to the trust.

Hill J rejected the Commissioner’s argument that the concession only applied to income derived from property left in the Will.

> The Tribunal held that upon its true construction sec. 102AG(2)(a)(i) merely required that the trust estate should arise under or by virtue of a will. It was submitted for the Commissioner, however, that for the subsection to operate, it was necessary that the assessable income of the trust estate itself be sourced in the will or property of the deceased. With respect, I do not accept the Commissioner's submission. It requires that the words in sec. 102AG(2)(a) ``that resulted from'' refer to the assessable income rather than to the words in subpara. (i) ``a will'' etc. or in subpara. (ii) ``an intestacy'' etc. In my opinion all that is necessary to fall within sec. 102AG(2)(a) is that the assessable income be assessable income of the trust estate, that trust estate being one of the forms of trust estate referred to in sec. 102AG(2)(a)(i) or (ii) (that is to say not an inter vivos trust).
>
> It is not clear what is meant by the notion that the assessable income be ``sourced'' in the will or the property of the deceased. Presumably the contention is that it is only income from assets already held by the deceased at the time of his death which will be exempted from the provision of Div. 6AA. Such a view is too narrow. Clearly the legislature must have contemplated the case where the will assets were sold and the proceeds reinvested. What happened in the present case is that the trustee borrowed funds and used the borrowed funds to invest in such a way as to derive assessable income from the investment. In my view the consequence of such an investment was that assessable income was derived by the trust estate so that that income was ``assessable income of the trust estate'' and clearly enough the trust estate was one that resulted from the will of the late Mr Furse.[25]

Hill J also needed to consider whether the income subject to the concessional tax was limited because of s 102AG(3) as it then stood.

The former sec 102AG(3) provided:

> 102AG(3) Subject to sub-section (4), where assessable income is derived by a trustee, directly or indirectly, under or as a result of an agreement (whether entered into before or after the commencement of this sub-section) any 2 or more of the parties to which were not dealing with each other at arm's length in relation to the agreement and the amount of the assessable income so derived is greater than the amount (in this sub-section referred to as the `arm's length amount') of the assessable income that, in the opinion of the Commissioner, would have been derived by the trustee, directly or indirectly, under or as a result of that agreement if the parties to the agreement had dealt with each other at arm's length in relation to the agreement, sub-section (2) does not apply in relation to that assessable income to the extent to which the amount of the assessable income exceeds the arm's length amount.

[25] At 91 ATC 4018.

The issue for sec 102AG(3) was whether the income derived by the Will Trust from the units in the service trust was as a result of an agreement between any 2 or more parties not dealing with each other at arm's length. The Tribunal (from which this case was the Appeal to the Federal Court) failed to identify the relevant agreement. The matter was remitted to the Tribunal to make the necessary findings of fact.

Since that decision, s 102AG(3) has been amended

It now provides:

> 102AG(3) [Non-arm's length transactions]
>
> Subject to subsection (4), if any 2 or more parties to:
>
> (a) the derivation of the excepted trust income mentioned in subsection (2); or
>
> (b) any act or transaction directly or indirectly connected with the derivation of that excepted trust income;
>
> were not dealing with each other at arm's length in relation to the derivation, or in relation to the act or transaction, the excepted trust income is only so much (if any) of that income as would have been derived if they had been dealing with each other at arm's length in relation to the derivation, or in relation to the act or transaction.

Applying this to Betsy's example, a gift to the trustee (assuming it derives an arm's length amount) is nevertheless the first step in deriving assessable income of the trust and so is, in my view, an "*act or transaction directly or indirectly connected with the derivation of that excepted trust income"* and as it is a gift, the donor is not dealing with the trustee at arm's length. Therefore any income derived from gifted property would be excluded from the concessions applying to excepted trust income.

This interpretation is supported by the view expressed by the Commissioner in *Private Ruling 50621* where minor children had each received gifts of money from 2 sources which have been invested on their behalf by a relative. The sources were:

1. money left to them in a will,
2. other gifts made to them by persons who were alive at the time.

The questions and answers are:

1 Are investment earnings from monies from a deceased estate held in trust for minor beneficiaries excepted income? Yes

2 Are investment earnings from monies gifted to children by their living relatives excepted income? No

The explanation for the ruling included this

> In contrast to such income, which arises from property inherited through a will or intestacy, any income derived from amounts given to a child by a living person or given to a trustee to hold on the child's behalf will not be 'excepted assessable income' or 'excepted trust income'.

Sec 102AG(4) may also prevent the income from the gifted property being excepted income.

> **102AG(4) [Agreement to secure income excepted trust income]**
>
> Subsection (2) does not apply in relation to assessable income derived by a trustee directly or indirectly under or as a result of an agreement that was entered into or carried out by any person (whether before or after the commencement of this subsection) for the purpose, or for purposes that included the purpose, of securing that that assessable income would be excepted trust income.
>
> 102AG(5) [Incidental purpose disregarded]
>
> In determining whether subsection (4) applies in relation to an agreement, no regard shall be had to a purpose that is a merely incidental purpose.

CAN YOU CREATE A "TESTAMENTARY TRUST" AFTER DEATH?

I wanted a testamentary trust
Without one I knew I would bust
So I asked my good friend
If towards that good end
He'd create one without any fuss!

You can't create a testamentary trust once the testator has died (except by forging the Will!).[26] However you may be able to obtain some income tax benefits by transferring property left in a Will to another trust.

This isn't a testamentary trust but a post death trust using property left in a Will. There is no standard title given to this type of trust. It has been called a *Post Death Trust*, *Post-Mortem Trust*, *Post-Will Trust*, *Estate Proceeds Trust*, *Post Testamentary Trust* or even a *"Second Chance Testamentary Trust"*. The latter term is confusing because it isn't a trust created in a Will even though the tax saving is restricted to income from property that was in a deceased estate.

Charles has a home made Will in which he leaves everything he has, including shares and real estate investments to his wife, Dianna. They have one child, Wilma. Charles dies tragically in a work accident when Wilma is only 8 years old. Dianna is in full time employment and is already on the top marginal tax rate and she has heard that despite Charles' failure to create a testamentary trust in his Will, she can set up such a trust for Wilma which will save income tax. Is this a tax law urban myth?

No, it isn't a myth but it is very limited in application and even where it could be used, it may not be worth the trouble in making it work.

Where minor children receive income distributions from trusts, the income is usually taxed without the benefit of the tax free threshold and at roughly the same rate as the top adult rate.

One of the exceptions is where the income is *excepted trust income* (sec 102AG(2) *Income Tax Assessment Act 1936*) . It is one of these exceptions which provide the income tax advantage to testamentary trusts. Other examples of *excepted trust income* are bona fide employment income, child maintenance trusts following family

[26] Not recommended.

breakdown, income from certain trust income from personal injury damages and post-death trusts.

Saving tax with a "second chance/post death/post-mortem trust"[27]

Dianna can transfer shares or investment property or money[28] left to her by Charles to a trust in which Wilma is a beneficiary. Income derived by the trustee from that property can be distributed to Wilma in a tax effective manner by using the provisions in sec 102AG(2)(d)(ii).

> 102AG(2) [Excepted trust income]
>
> Subject to this section, an amount included in the assessable income of a trust estate is excepted trust income in relation to a beneficiary of the trust estate to the extent to which the amount:
>
> (d) is derived by the trustee of the trust estate from the investment of any property: ;
>
> (ii) that was transferred to the trustee for the benefit of the beneficiary by another person out of property that devolved upon that other person from the estate of a deceased person and was so transferred within 3 years after the date of the death of the deceased person; or…

Limitations

There are strict limits on when and whether and to what extent income derived from the transferred property is taxed at normal adult rates to the trustee (for the minors) instead of at the non concessional rates. Due to these limits it is often not practical to use this provision.

1. This type of trust can only obtain the tax benefit where the deceased is the parent of the minor child. It is of no value where the deceased is a grandparent and the child's parent is still living because the tax concessions only apply to income derived from property that would have gone to the beneficiary if the deceased person died intestate (sec 102AG(7)). Here Wilma would have been directly entitled to almost half of her father's estate if he had died intestate in SA.
2. The property transferred must have been inherited through the estate and not directly eg life insurance left directly to spouse.
3. The property transferred to the trustee must earn the income. This is a practical problem requiring careful recordkeeping at least if the trust consists of other property (or property for more than one minor child).
4. The concessional tax rates only apply to the arm's length amount of income derived. Eg if Dianna transfers to herself as trustee a house which is rented to a friend, any rent in excess of the arm's length amount will not attract the concession.
5. The minor must acquire the property that was transferred and from which the income was derived when the trust ends (sec 102AG(2A)) (this need not be when Wilma turns 18 and the end depends on the terms of the trust). Her entitlement

[27] I wish we could agree on what to call this type of trust –what about the *Clayton's testamentary trust*?

[28] Property means any property whether real or personal and includes money –see 102AA(1) ITAA 1936.

must be an absolute right according to the terms of the trust and not depend on the discretion of the trustee. Strictly read, the provision requires the preservation of the actual property transferred! The requirement surely means that she must have the absolute right and the actual act of acquiring it isn't required. If it were, what do you do when 16 years after the trust has commenced and all the income has been taxed concessionally, Wilma disclaims her interest in the property?

6. And don't forget that if the property transferred is a CGT asset and there is a capital gain, then CGT will be payable due to the transfer and the funds will need to be found from other sources. Transferring money, if money was inherited, avoids this problem.[29]

Practical matters

1. The gift of property from a testamentary beneficiary to the trustee must be within 3 years of the death of testator.
2. It is done by transfer after inheritance and does not require and should not involve any variation to the Will or renunciation of interests.
3. The usual CGT and stamp duty implications result from this transfer of property to a trust.
4. The trust for Wilma need not be a stand alone trust but for practical reasons including the need for special terms such as Wilma's entitlement to the property in the end, it usually is.
5. Dianna may transfer as much property as she wishes or allow the property to derive as much income as she (or an associate) can direct through the property but the excess is not concessionally taxed. It is far simpler (and therefore less prone to expensive errors and administration) to work out the property to which Wilma would have been entitled on intestacy and transfer only that amount. Similarly it is practical to ensure the income derived does not exceed arm's length amounts.
6. To ensure there are no tax problems with the settlor being entitled to the property (causing the trustee to be taxed at the maximum rate) the trustee should not be the settlor. If Dianna wishes to be the trustee (as she normally would) she should transfer the property to a trust already settled by an independent person).
7. If transferring to an existing trust with property, any variation (eg to ensure Wilma acquires the property on vesting) is likely to cause a resettlement and CGT and stamp duty issues for the property already held on trust.
8. In order to avoid any later challenge by Wilma (who eventually comes to hate Dianna), consider whether to use the trust income for expenses such as her private school fees and orthodontic treatment.
9. Finally, this method may not be the best way for Dianna to achieve her aims.

INCOME TAX ISSUES FOR TESTAMENTARY TRUSTS

The "big one"- the children's tax break

The main reason for the testamentary trust (as distinct from using an inter vivos trust) is that where there are minor children and/or grandchildren and/or great grandchildren (or they are still possible) income can be distributed to them tax free or at least at

[29] Assuming it is a problem-the CGT liability may be moderate or would have been crystalised soon in any event.

usual adult rates. If distributing only to adults the testator doesn't need a testamentary trust and an inter vivos trust can be used.

Income splitting

As with inter vivos discretionary trusts, any testamentary trust with the discretionary power to appoint the income to different beneficiaries can split the income among beneficiaries with mixed tax rates to reduce the overall tax liability. This combined with the children's tax break gives testamentary trusts a unique benefit where there are children.

Franking credits problems

For the beneficiaries of a testamentary trust to be entitled to franking credits, the trustee will generally need to make a Family Trust Election (FTE). This won't have the effect of reducing the scope of beneficiaries where we are dealing with simple life interests because only one person (the life tenant) is entitled to distributions of income.

If it is life interest with discretion to pay income to others then a FTE may restrict the tax effective distribution of the income where the life tenant is not a parent, spouse or child of the deceased. It sometimes happens that the life interest is left to a friend.

Example

Mrs Danvers was Arthur's nurse and close friend in the final years of his life and she is the life tenant of Arthur's estate. Arthur left an adult child, Rebecca and 5 grandchildren. Rebecca takes in remainder. Under Arthur's Will, the trustee can distribute income to the children and grandchildren with the consent of Mrs Danvers (who likes Rebecca).

Arthur is dead and so cannot be named as the test individual. If Mrs Danvers is named as test individual, the distributions of income to Rebecca or the grandchildren will attract family trust distribution tax (FTDT) (at maximum rates). If Rebecca is named as test individual, the distributions of income to Mrs Danvers will attract FTDT (at maximum rates). Furthermore Rebecca or Mrs Danvers (as appropriate) will not be entitled to franking credits.

> 'The "family" of an individual (the "test individual") consists of all of the following (if applicable):
>
> (a) any parent, grandparent, brother, sister, nephew, niece, child, or child of a child, of:
>
> (i) the test individual; or
>
> (ii) the test individual's spouse;
>
> (b) the spouse of the test individual or of anyone who is a member of the test individual's family because of paragraph (a).[30]

Without a FTE, there was no entitlement to franking credits for the life tenant (or anyone else) from shares acquired post 31 December 1997[31] until the retrospective amendments were announced in March this year.[32] So, although franking credits will be allowed to a life tenant who has a vested right to the income but not the capital (the

[30] 272-95 Schedule 2F ITAA 1936.
[31] ATOID 2002/122.
[32] Minister for Revenue Press Statement No 010 20.3.06.

usual case), where there is any element of discretion (where the right to income is not vested), a FTE (with the possible problems of naming a test individual) will still be necessary.

Note that the income tax concessions given to the executor as trustee of estate during the administration of the estate are not tax issues concerning testamentary trusts (because of our earlier agreed meaning of the term *testamentary trust*).

Commencement of the trust

Each testamentary trust is a separate trust and needs to be treated as such for tax purposes, including lodging of tax returns. For more detail on the ATO's requirements, see IT 2622.

CGT ISSUES FOR TESTAMENTARY TRUSTS

Commencement of the trust

There is no CGT liability on the transfer of any asset from the executor to the trustee or when the executor starts holding the property as the trustee of the particular testamentary trust. This is due to sec 128-15.[33]

Cloning or Splitting

Assume a single testamentary trust exists and the deceased's children are all adults with at least one having a burning desire to control his/her "own share". Assuming the trust contains the right of the trustee to vary the terms; can you clone or split the trust as you may do for an inter vivos trust in some cases?

Cloning

The first step in cloning is to establish a new trust with "identical terms" to the testamentary trust. Can this be done where the trust to be cloned was set up in a Will? TR 2006/4, deals with the ATO's view of the circumstances in which the beneficiaries and terms of two trusts are considered to be the same for the purpose of applying an exception to CGT event E2.

The following do not have to be the same:[34]

- the trustees;
- name;
- commencement or establishment date;
- settlor; or
- trust property (except that the transferred asset must be an asset of both trusts, though obviously not at the same time).

However, the appointor, if any, has to be the same. The ATO is also of the view that if a FTE was made in one, it must be made with the same test individual in the other. Therefore, it may be difficult to achieve the desired separation of control by cloning.

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[33] Confirmed in PS LA 2003/12.

[34] [25].

Splitting

Assuming splitting is effective in actually separating the assets and the different trustee's indemnities,[35] there is nothing in particular which makes it more or less difficult to split a testamentary trust.

A Warning: Something that *may* impact the effectiveness of these is that ignoring the interposition of the testamentary trust between the executor and the beneficiary of the Will may really rest on the ATO's practical indulgence which can be withdrawn. When the trustee of the testamentary trust distributes assets owned by the deceased to a beneficiary, the ATO has had a long-standing administrative practice of treating the trustee of a testamentary trust in the same way that a legal personal representative is treated for the purposes of Division 128 of the ITAA 1997, in particular subsection 128-15(3).[36]

Paying the CGT

The Government has announced it will amend the CGT provisions[37] to enable the CGT liability arising from a CGT event happening to a trust asset to be paid by the trustee of a testamentary trust where a presently entitled income beneficiary will not obtain the benefit of the capital gain.[38] The trustee can make the choice on a beneficiary-by-beneficiary basis and this is intended to ensure the trustee is not assessed on part of the capital gain in circumstances where no tax would have been paid on the gain by the income beneficiary, for instance where the income beneficiary is an exempt entity or a foreign resident. The amendments are intended to apply to the 2005–06 and later income years.

PLANNING ISSUES

Do you need one or more separate testamentary trusts at all?

It depends on what you are trying to achieve for your client. One size does not fit all. Not all clients require one and where one is suitable, it needs to be drafted to deal with the client's actual needs and expectations. A client should be encouraged to review the Will and the trust as circumstances change and at least every 4 years[39] instead of trying to draft the trust to deal with any contingency.

I also doubt many people really think through the risks in giving responsibility for the assets to a trustee. People in control of other people's money may be dishonest, whether they are the much trusted brother, friend or advisor. The assets will only be protected (from creditors, ex spouses etc) if the beneficiary does not have control so someone else must (trustee or appointor). Much careful thought must be given to protecting the beneficiaries from dishonesty or even incompetence. In some cases, a testator may prefer to give the property absolutely and let the beneficiary deal with it, whatever that means.

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[35] And I don't assume this, at least for the assets at the time of the split…but that is another topic!

[36] PS LA 2003/12.

[37] Following consultation with industry on the design and the implementation of the amendments – see Minister for Revenue and the Assistant Treasurer's Press Release N0. 074, 17 October 2006.

[38] Media release no 074 from Minister for Revenue dated 17 October 2006

[39] A good trigger is the Federal election (4 years) or the Census (5 years).

Asset protection for one person may mean the creditor or ex-spouse who may have a moral claim is left with nothing. I am not sure advisers should assume our clients all want such asset protection!

What are you trying to achieve? What does your client want?

- Tax benefits on distributing income to minor children, grandchildren
- Tax benefits on distributing income to lower taxed beneficiaries
- Protection of assets from ex-spouses,
- Protection of assets from creditors,
- Protection of assets from being wasted by spendthrift beneficiaries
- Protection of assets from being wasted by addicted beneficiaries
- All of the above (what an unfortunate family!)

Ted the testatrix has one 45 year old daughter, Deborah who has no children and is not intending to or expected to have a child. Ted wants the bulk of his property to go to Deborah.

Do you advise a testamentary trust in case Deborah has a child or adopts a child or do you advise Ted to change his Will if the unexpected happens?

The advantages of the testamentary trust as distinct from an inter vivos discretionary trust are the opportunity to have where thought useful:

- different beneficiaries;
- different property;
- different trustees;
- different appointors; and
- different powers.

It can also be simpler for a less sophisticated trustee to deal with the property in different trusts instead of trying to have one trust cover all.

An existing discretionary trust may be quite suitable and if the beneficiaries, appointor, trustee and powers are suitable and if there are and will not be any minor children or grandchildren or great grandchildren (of the testator.)

Asset protection

From frivolous spending, gambling, addiction, divorce and bankruptcy; good Lord deliver us![40]

A secondary reason for the testamentary trust is to provide asset protection.

The first question for a client with substantial assets and a moderate to high risk profile is why are there any substantial assets in the Will? Surely the assets are already in discretionary trusts? So the first question is really what is owned by the testator

[40] This is not part of the prayers of the Church but should be.

(and spouse) in their own names? If it is merely the family home and some small investments, is there any need for the expense and comparative complexity of a testamentary discretionary trust?

The answer may be the testamentary trust is primarily to deal with superannuation or life insurance benefits and/or are intended for different beneficiaries to those in the discretionary trust. That's a good answer. I assume you will plan the required division accordingly and the tricks and traps that can occur are beyond the scope of this article.[41]

The second question is to what extent does the trust actually give protection from creditors and ex spouses? Again this is beyond the scope of this article.[42]

No guidance from settlor (deceased)
Unlike an inter vivos trust, the trustee (and appointor) can obtain no assistance or guidance from the deceased. If the testator has firm views about what he/she is trying to achieve as distinct from ensuring maximum flexibility for the trustee at the relevant time, then they need to be expressed in the Will or at least in a Statement of Wishes.[43]

Preserving pension entitlements[44]
Another purpose of the testamentary trust is to allow a vulnerable beneficiary (eg someone in receipt of a disability pension) to remain eligible for the pension and associated benefits while allowing an independent trustee (such as trusted sibling) to provide for additional needs of the vulnerable person.[45] This is done by ensuring the appointor and trustee is entirely independent from the beneficiary.

It should be remembered that severing control in this and other testamentary trusts brings with it the risk of fraud by the trustee.

The Will and inter vivos trusts
It is well known that the assets owned in a discretionary trust controlled by a testator are not owned by that individual and so cannot be left in their Will. It is sometimes assumed the Will is entirely irrelevant to the assets but is it? Where the testator is the appointor at death, what happens? In many cases, the testator had the power to name then new appointor in the Will. In some cases, the trust deed provides that the executor is the appointor. Whatever the terms of the trust deed, it is essential the Will drafter properly deals with the issue to avoid expensive disputes or the appointment of an inappropriate person. There is danger in simply appointing the executor as appointor or even simply allowing the terms of the trust deed to take effect in default

[41] See for example Whitney *Will drafting tips and traps*, TIA 3 June 2002.
[42] See Michael Lhuede, 'Asset protection/Bankruptcy', paper presented at the Taxation Institute of Australia's *14th National Intensive Retreat*, Noosa, 17-19th August, 2006.
[43] A Statement of Wishes is rather wishy washy and in no way binding but can serve the purpose of giving some guidance if the trustee wants any. Firm views should be expressed in the terms of the trust unless they are against public policy and so would be struck down.
[44] Under current pension/benefit rules.
[45] I do not comment here on the ethics of an act that ensures the taxpayer continues to support someone who is well able to be supported by the family.

of appointment. Where the executor is appointed by the testator does the executor have any duty to bring all property he can into the deceased estate?[46]

It is also common knowledge that the testator cannot control the assets in the inter vivos family trust except through control of appointor and/or trustee but is this true?

First of all, where the trust deed expressly provides that where the appointor dies, they may appoint a successor in their Will or in the absence of this, the executor of their Will is the appointor.

It is common knowledge that this is the only way the testator can have some control – by controlling the appointor and so indirectly having control over the distribution of the trust assets and income (if the appointor and trustee know what the testator wants eg by a non binding statement of wishes). However, this may not be correct.

I was recently introduced to the concept of "fail-over trusts". The concept as I understand it is to allow a direction from the testator to the trustee of the inter vivos family discretionary trust (ie direct control) over the trust's assets and income.

Assume the typical family discretionary trust (which typically includes as objects, trusts in which any of the individual objects are also objects) is varied to acknowledge the existence of a sub trust called the Fail-over Trust (which needs to be separately created at about the same time) and the introduction of a requirement that the Trustee obey any Direction left in the Will of the Appointor.[47]

Assume the Will provides a Direction to distribute specified income and/or capital to named or identifiable beneficiaries (of the family trust). The concept of the 'fail-over trust' is introduced into the inter vivos deed (by variation of its terms but assuming such a trust is already an object to the trust) to take the income subject to the testator's direction in the Will if obeying the demand from the Will is inappropriate for tax reasons eg due to a Family Trust Election, the distribution would attract the Family Trust Distribution Tax.

The idea of a fail-over trust could be considered in cases where the testator wants to direct distribution of income and/or capital, eg to ensure the assets over which he had control in life but didn't own are shared among the beneficiaries as he likes.

Obviously, if this control can be exercised, this could make it more attractive to put most assets into the family trust and in effect divide all controlled assets at death. The aim is to direct the trustee of the family trust to distribute certain income and/or capital from the grave.

So although assets of the family trust don't pass through the Will, real control of them may!

Checklist for planning where assets go on death

This is simply one blank checklist which gives a range of matters that should be considered. It only deals with the questions we have been considering. You may have your own or wish to use this as a basis for yours.

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[46] This is a raised in *Aileen Pty Ltd v One Hawker Holdings Pty Ltd* [2006] VSC 135 at [52].

[47] This should not be a resettlement as the beneficiaries are not varied and these powers do not change the nature of the trust obligations etc.

1. ASSETS THAT DON'T PASS THROUGH WILL

Asset	MV $	Anticipated CGT or income tax	Beneficiary

2. ASSETS THAT PASS THROUGH WILL

Asset	MV $	Anticipated CGT or income tax	Preferred beneficiary

3. BENEFICIARY

Name	Under 18/For how long	Assets at risk to creditors, ex spouse	Assets need protection from beneficiary

4. PLANNING

Questions	Answers
What does testator want to achieve?	
What are alternatives to achieve this? What is best?	
What changes should be made to assets passing through Will so more effective protection or tax advantages?	
What will testamentary trust achieve for Beneficiary 1?[48]	
What will testamentary trust achieve for Beneficiary 2?	
etc	

An example of how this could work

The aim is to direct the mind to planning issues and having decided the preferred approach, then to take the necessary steps to achieve the plans.

Julian has 4 children by his first marriage aged between 12 and 24. He is currently in a defacto relationship with Melanie and they have one child aged 2 (Michael). He wants to ensure Melanie has sufficient income to live off after his death but that all his assets end up with his children.

1. ASSETS THAT DON'T PASS THROUGH WILL

[48] Having ensured only the appropriate assets pass through the Will.

Asset	MV $	Anticipated CGT or income tax	Beneficiary
Home	400	None	Joint tenant-Melanie
Assets in first family trust	200	n/r	Expect all children to share overall, 1st wife will be trustee when Julian dies
Superannuation[49]	300		Minor child or other dependant for tax benefits

2. ASSETS THAT PASS THROUGH WILL

Asset	MV $	Anticipated CGT or income tax	Preferred beneficiary
Superannuation[50]	300	It depends on who gets it	Minor child or other dependant for tax benefits
Shares	110	10 CGT	-
Investment property	500	100 CGT	-

3. BENEFICIARY

Name	Under 18/For how long	Assets at risk to creditors, ex spouse	Assets need protection from beneficiary
1. Michael	Yes/16 years	No	No
2. Joseph	Yes/6 years	No	No (or at least, don't know yet)
3. Liz	No but has 2 children by 2 dads	Yes, bad at choosing partners	No
4. Joan	No	Yes, accountant	No
5. Oscar	No has 1 child	No	Spendthrift/Gambler
6. Melanie	No	Don't want her to get more assets	Don't want her to get more assets. Should Michael or all the siblings be remainder beneficiary?

4. PLANNING

1. What does Justin want? Equal share of assets or tax minimisation or asset protection? Any particular needs for particular beneficiaries? What is the priority?
2. What changes should be made to assets passing through Will so there is more effective protection or tax advantages?

   Why is investment property in Justin's name and not in a trust? What about putting it in a new family trust effectively for Michael and his line?
3. What about superannuation –through Will or not?

   Does Justin have the choice?
4. Having arranged the appropriate assets through the Will, ask should there be 6 separate testamentary trusts? If not, why not?

[49] Doesn't have to pass through Will but he can choose to make a binding death nomination if you advise.
[50] Supra.

What will the testamentary trust achieve for Beneficiary 1?

Children's tax break while under 18. This may also mean that Melanie needs less from the life interest (ie fewer assets may be needed to give her sufficient income)

What will the testamentary trust achieve for Beneficiary 2?

Children's tax break while under 18

What will the testamentary trust achieve for Beneficiary 3?

Maximum protection from property distribution in case of divorce(s)

Children's tax break for grandchildren/great grandchildren under 18

What will the testamentary trust achieve for Beneficiary 4?

Maximum protection from losing assets in professional negligence claim

What will the testamentary trust achieve for Beneficiary 5?

Maximum protection from losing assets in professional negligence claim

Children's tax break for grandchildren/great grandchildren under 18

What will the testamentary trust achieve for Beneficiary 6?

In this case, life interest in either investment property or some or all shares not discretionary trust

5. Assuming separate trusts in each case, who should be trustee/appointor and why? These are not fixed or "right" answers but indicate what should be considered

Name	**Appointor**	**Trustees**	**Comment**
1. Michael	2 or 3 of Liz, Joan and Oscar	Melanie	Assuming Mum will be good. If not her and all siblings or just them alone or just Joan.
2. Joseph	Liz, Joan and Oscar[51]	Liz, Joan and Oscar	What will happen when he is 18 or 25?
3. Liz	Joan and Oscar	Joseph, Joan and Oscar	Not in control herself to protect from loss on divorce or to manipulative lover.
4. Joan	Joan	Joan	Do you assume Joan will remove herself as appointor and trustee if any risk arises (eg she becomes aware of a big problem by employee or partner).
5. Oscar	Joan and Liz	Joan and Liz	Spendthrift/Gambler so Oscar shouldn't be trustee of his own trust unless two other

[51] Assuming Oscar will be responsible when dealing with assets for the benefit of his little brother and his risk lies with his own assets.

			sensible siblings are joint trustees with him.
6. Melanie	No	Don't want her to get more assets.	Don't want her to get more assets.

Consider if these choices -which might look good on paper- will nevertheless cause family problems especially if Oscar or Melanie think they are being patronized.

Ask whether all the trusts except the life interest will have the same beneficiaries in effect (ie siblings, their children).So for example the Liz trust would have Liz as primary beneficiary, her spouse, children, grandchildren (all appropriately defined), associated companies, trusts and charities as objects.

Finally, do all you can to get this reviewed at least in 5-6 years? Joseph is nearly 18 - should he be given some responsibility at 18 or 21 eg as a joint trustee of his own trust? Has Oscar stopped drinking and gambling? You don't want to think about the possibility that Joan has gone off the rails partly due to the major responsibility she has taken on to keep the family happy.

DRAFTING ISSUES

Drafting the trust

Assume a testamentary trust is thought to be a good thing in a particular case.

It goes without saying that the testamentary trust(s) and the rest of the Will should be clearly set out, preferably in reasonably plain language and be able to be understood by the testator, executor, appointors, trustees and potential beneficiaries (some of whom may be young or not particularly well educated or not sophisticated in dealing with trusts or finances).

Should the Will be drafted to give the executor the power to decide whether to provide any property for it (ie to start it) or should some conditions be included in the Will.

One option is to add a pro forma modified discretionary trust to the Will creating one or more testamentary trusts. A *pro forma trust* is eminently suitable for a *pro forma client* eg happily married once with children, any married children are happily married, no disputes between any family members and their spouses, everyone's financial needs are more or less equal, all are responsible spenders and savers, no one is addicted or weak willed and no one is particularly vulnerable and where none of this changes between the date of making the Will and the date of death.

Otherwise you need to carefully draft the trust/s to provide exactly what best suits the client.

I know that in practice it is hard enough to get a client to make a Will at all and so there is a great temptation to draft the Will (and any testamentary trust) to take into account any contingencies between now and the date of death. Tax laws change and family circumstances change and drafters continually find better ways to express themselves. It is a pity the Will can't be drafted looking at say the next 5-10 years and not with an expectation that it is the best expression of the testator's wishes in 20 or 30 years. Is one solution to this a "free review" service each 5 years as part of the original cost?

Once you have decided what priorities can be best satisfied by a testamentary trust, then it should be drafted to provide for that priority (or with a range of aims).

Again, I know it is tempting to use a pro forma testamentary trust deed maybe modified a little but this may be the very worst of all options. The trust, by trying to be "all things to all people" may actually allow the very thing the testator doesn't want.[52]

If the priority is to protect the assets from the gambling oldest child, then control of the trust (via appointor and trustee) needs to be elsewhere. If it is to maximise the income splitting benefits including those for minor children, then the appointor and trustee can be the relevant child.

If it is to ensure maximum flexibility for the financial needs and desires of the income beneficiaries, it can be drafted accordingly.

What is to happen with trustee –is aim to hand it over at some time to child or grandchildren? Is this consistent with asset protection?

CLAUSES:

Don't include:

- Any agreement with trustee.
- Any settlor clause as the Will itself is the settlement of the gift.

Do include as appropriate for the particular needs of the testator:

- The 28 or 30 day survivor issue (for the sake of ensuring clarity where the same event cause death of testator and spouse or child),
- Property to be held in the trust.
- Initial trustee of each trust with careful consideration of current and successor trustees. This depends on relationship between spouse and children (especially where the spouse is a second or third).
- Change of trustee.
- Removal of trustee and appointor on events such as bankruptcy.
- Trustee's right to distribute income or capital to self (if intended to be a possible beneficiary) or, if professional or non beneficiary, trustee's right to charge fees.
- Appointor clause with careful consideration of current and successor appointors including final control back to children etc. Who is to control the trust ultimately? There is an inherent conflict between the desire to give the children control and to protect these assets from creditors and ex spouses. Control can be given to other siblings but this may not work if there is a falling out between them. The power to distribute to maximise tax benefits and needs can be used a easily to do the opposite!

[52] If you are serious about good trust drafting, you will find James Kessler QC's UK book, *Drafting Trusts and Will Trusts* somewhere between invaluable and merely useful. Published by Thomson –Sweet and Maxwell. Current cost is $310. It also includes a CD containing precedents. I only came across it by accident so I am not sure how many tax advisers are aware of its existence.

- Is the trust to be set up whatever age the children (and so is a trust for the grandchildren as well) or is the gift absolute if child is over 18 or 21 or 30 or whatever?
- When trust is to end and rights of trustee to end earlier (including by distribution of all income and capital so there is no trust property left) - this may require consent of spouse or some beneficiaries.
- Definitions especially for meaning of spouse and child (to give maximum flexibility if desired for children not yet conceived, foster children, 'test tube' children,[53] pre-adopted children, same sex partners etc) and income (including power to treat income as capital as vice versa).
- Who is to get a child's share if child dies before testator?
- Discretionary appointment of and distribution of income and capital.
- Streaming income from particular types or specified assets. This is essential if new assets are added to the trust and income from those assets is distributed to minors.
- Usual powers of trustee to sell, invest, borrow, lend generally and lend specifically to beneficiary at interest or otherwise, permit use of property by beneficiary free of charge etc.
- Usual protections to trustee for liability and indemnities.
- Power to accept gifts?? In the absence of such a clause can the trustee do so?
- Right to accumulate income (and whether it remains as income or is treated as capital).
- Investment powers including the preferred balance (if any) between investing for income or capital growth or total flexibility.
- What happens with any after acquired property eg through issue of bonus shares.
- Variation of terms including beneficiaries? Do you direct the trustee to get tax advice before exercising this?
- Perpetuity clause (if needed in your state/territory).
- Any specific requirements such as specific powers where vulnerable beneficiaries (especially if a professional trustee instead of a family one is used. For example, to specify the capital can be used for things for comfort and enjoyment eg holidays, travel).
- Add clause specifically negating any act that would be the delegation of testamentary power (and severing any act).

A couple of more points about the Will:

Does the Will create separate testamentary trusts for each child (and their descendants if any), with the spouse as first appointor and the relevant child as successor in each case. This allows the surviving spouse to control all the income and property during his or her life and then each child gains control on mum or dad's death.

At least in the States which prohibit delegation of testamentary power, the Will should specify the property for each testamentary trust (it need not be named, by percentage

[53] Assuming medical science will shortly allow children to be conceived and fully develop ex utero.

of certain assets is fine). Leaving the full decision to the executor may otherwise result in the trusts being ineffective.

Superannuation and tax benefits

This article is not dealing with death benefits from superannuation policies except to make these simple points:

1. Whether or not to pay the superannuation benefits into a testamentary trust is one of the last decisions in planning what to do with them.
2. If a superannuation payment is made to a trustee its 'death benefit' tax concession is generally lost. However, the ATO considers that a payment made to the trustee of a trust set up to benefit a single dependant of a deceased person will maintain this concession. Provided the benefit is paid to or for the benefit of dependant of the deceased person, it will be exempt from tax.[54] It needs to be noted this interpretation is based on the dependant having an absolute entitlement to the income (ie is the sole beneficiary and any income on death would form part of the dependant's estate).
3. To be sure the benefit of the ATO view is obtained, there needs to be separate testamentary trust for each dependant and the superannuation payment paid to the separate trusts. These trusts cannot be discretionary as to appointment of the income although accumulation could be allowed as long as the dependant is entitled to any accumulation in due course.

CURRENT ISSUES WITH LIFE INTERESTS AND CGT

Update on ruling on life interests

In late November 2006, the ATO issued its final ruling on the topic TR 2006/14. The most significant result relevant to this article is that the ATO has changed its view from the draft ruling on the cost base of the life tenant. The result is that the life tenant has a market value cost base (instead of a nil cost base). This solution to the complexities of the law gives some relief to the life tenant and in many cases will give complete relief where the value of the life interest has decreased. Where the value of the life interest has increased (because the value of the property has increased), the best result continues to be that no CGT is payable if the surrender is made before administration of the deceased estate is completed or where the life tenant does what comes naturally to us all one day.

The relevant extracts follow (my emphasis):

> 25. The first element of the cost base and reduced cost base of an equitable life or remainder interest is the sum of any money and the market value of any property given to acquire it: subsection 110-25(2).
>
> 26. If, as is generally the case, no money or property is given to acquire an equitable life or remainder interest, section 112-20 provides that the first element of the cost base and reduced cost base of the interest **is its market value at the time it was acquired**.
>
> 27. However a market value cost base cannot be obtained for an equitable life interest that arose other than as a result of someone's death) if:
>
> nothing is actually paid or given to acquire it; and

[54] ATOIDs 2001/751 and 2002/155.

it is not acquired by way of assignment from another entity.

(See item 1 in the table in subsection 112-20(3).)

28. Note that for the purpose of paragraph 112-20(1)(a), **equitable life and remainder interests are considered to have been acquired as the result of CGT event E1 happening. That is, a market value acquisition cost is not denied** on the basis that the interests resulted from CGT event D1 happening or no CGT event at all happening.

The problem:

The problem is the massive CGT on the surrender of a life interest in CGT assets such as investments when the life interest ends other than through the death of the life tenant. This is particularly unfair where the life tenant does not receive anything for the surrender or receives well under full market value of his/her interest. Let me show you what I mean:

Assume shares with market value of $120 are left in Robert's Will. Cost base of deceased is $20.

Shares sold by deceased

If Robert had sold them at market value the day before his death, he would have CGT of $25.[55]

Capital proceeds	120
Less cost base	20
Capital gain	100
CGT, say 25%	**$25**

Direct gifting, no life interest

If in his Will, Robert gifted 80% to Rosie and 20% to their son, Ryan then no immediate CGT liability arises when the shares are transferred to them and Rosie inherits shares with a cost base of $16 (80% of $20). Five years later Rosie sells all the shares at market value (to a third party or to Ryan, it doesn't matter for the calculation below) and the value is much the same due to the big dip we had in 2008:

Rosie

Capital proceeds	96
Less cost base	16
Capital gain	80
CGT, say 25%[56]	**$20**

Ryan

Is holding onto shares inherited with market value of $24 and cost base about $4.

If he sells them now, his CGT is about **$5.**

[55] For these examples I will assume everyone is on top marginal rates and will be entitled to 50% discount and that this is roughly 25% of total. It will be less but 25% is easier to work with and makes the same point.

[56] Supra.

The effect of the deferral of CGT given by Division 128 is simply that, the CGT liability is deferred and taken into account when the shares are finally sold. In either case the total CGT of $25 gets paid some time (assuming the shares do not decrease in value).

Life interest ended 5 years later for nil consideration
When the executor is able to do so once the estate's debts are paid etc, he commences holding the shares on the trust with the income for life to Rosie. Ryan is the remainder beneficiary.

When Rosie starts to hold the life interest, CGT event E1 occurs and she has a new CGT asset which was not owned by the deceased. The deceased has no CGT due to sec 128-10.

Rosie's interest is property and has a market value.[57]

It has no cost base (because she paid nothing for it and there is no deemed cost base). This is explained in TR 2005/D14:

> 14. An equitable life or remainder interest is a created interest acquired when it starts to be owned. Its first element of cost base and reduced cost base is limited to the sum of any money and market value of property given to acquire it, except where it is not acquired under an arm's length dealing. If no expenditure is incurred to acquire it, paragraph 112-20(1)(a) of the ITAA 1997 has the effect that the interest is not treated as having been acquired for its market value.

Sec 112-20 provides:

> SECTION 112-20 Market value substitution rule
>
> 112-20(1)
>
> The first element of your *cost base and *reduced cost base of a *CGT asset you *acquire from another entity is its *market value (at the time of acquisition) if
>
> (a) you did not incur expenditure to acquire it, except where your acquisition of the asset resulted from:
> (i) *CGT event D1 happening; or
> (ii) another entity doing something that did not constitute a CGT event happening; or
> (b) some or all of the expenditure you incurred to acquire it cannot be valued; or
> (c) you did not deal at arm's length with the other entity in connection with the acquisition.
>
> The expenditure can include giving property: see section 103-5.
>
> 112-20(2)
>
> Despite paragraph (1)(c), if:

[57] Based on actuarial calculations of expected life.

> (a) you did not deal at arm's length with the other entity; and
>
> (b) your *acquisition of the *CGT asset resulted from another entity doing something that did not constitute a CGT event happening;
>
> the *market value is substituted only if what you paid to acquire the CGT asset was more than its market value (at the time of acquisition).
>
> The payment can include giving property: see section 103-5.

Rosie

Capital proceeds	96
Less cost base	0
Capital gain	96
CGT, say 25%[58]	**24**

Ryan

Acquires the shares free of the life interest with market value of $120 and cost base about $20.

If he sells them now, his CGT is about **$25**

Life interest ends in death of life tenant

Rosie

Capital proceeds	0 (market value at her death is also nil)
Less cost base	0 (incidental costs only)
Capital gain	0
CGT	**0**

You can see the problem!

The capital loss is ignored for the reason given in TR 2005/D14

> 69. If the life interest was measured by the life of its owner, any capital loss from CGT event C2 happening is disregarded under section 128-10 of the ITAA 1997. That section disregards gains and losses from CGT events that happen to assets owned by an individual as a result of their death.

If Rosie gives her interest away she becomes liable to CGT based on deemed market value even though she receives nothing.

I can think of no principle why this should be the case. It occurs because of the CGT provisions and especially the deeming provisions of the capital proceeds and cost base.

Life interest ended 5 years after death for market value consideration which is paid by remainderman in cash

Rosie

[58] Supra.

Capital proceeds	96 (in this case this is real)
Less cost base	nil
Capital gain	96
CGT, say 25%[59]	**$24**

In this case, Ryan is in the same position except he has paid Rosie to end the trust early. Ryan gets $120 worth of shares for $80. Does he have his father's entire cost base of $20 as well as the $80 he paid? Why not?

Life interest ended 5 years after death by in specie transfer of shares owned by deceased

This becomes very interesting. Where Rosie ends her right to income by receiving an in specie distribution CGT event E6 would have occurred with the result that, as the shares being transferred are shares that were owned by Robert at death (and so are covered by Div 128), E6 does not apply. Rosie receives the shares as if gifted in the Will and any CGT liability is rolled over. CGT event E6 provides:

> SECTION 104-80 Disposal to beneficiary to end income right: CGT event E6
>
> 104-80(1)
>
> CGT event E6 happens if the trustee of a trust (except a unit trust or a trust to which Division 128 applies) *disposes of a *CGT asset of the trust to a beneficiary in satisfaction of the beneficiary's right, or part of it, to receive *ordinary income or *statutory income from the trust.
>
> 104-80(2)
>
> The time of the event is when the disposal occurs.
>
> Trustee makes a capital gain or loss
>
> 104-80(3)
>
> The trustee makes a capital gain if the *market value of the asset (at the time of the disposal) is more than its *cost base. It makes a capital loss if that market value is less than the asset's *reduced cost base.
>
> Exception for trustee
>
> 104-80(4)
>
> A *capital gain or *capital loss the trustee makes is disregarded if it *acquired the asset before 20 September 1985.
>
> Beneficiary makes a capital gain or loss
>
> 104-80(5)
>
> The beneficiary makes a capital gain if the *market value of the asset (at the time of the disposal) is more than the *cost base of the right, or the part of it. The beneficiary makes a capital loss if that market value is less than the *reduced cost base of the right or part.
>
> Note:
>
> If the beneficiary did not pay anything for the right, the market value substitution rule does not apply: see section 112-20.]

[59] Supra.

> Exception for beneficiary
>
> 104-80(6)
>
> A *capital gain or *capital loss the beneficiary makes is disregarded if it *acquired the *CGT asset that is the right before 20 September 1985.

If Div 128 applies so CGT event E6 doesn't:

Rosie

Capital proceeds	nil (for life interest)
Less cost base	nil
Capital gain	nil
CGT	nil (she inherits the shares with the cost base of deceased)

This was the view expressed in several ATOIDs[60] withdrawn on the release of TR 2005/D14 but the view still seems to be accepted:

> 18. In the context of CGT events E5, E6 and E7, the exception will therefore apply if, as part of the administration of the deceased's estate, an asset the deceased owned when they died passes to the beneficiary in accordance with section 128-20 of the ITAA 1997. (Note that in certain circumstances where an asset passes to a beneficiary the Commissioner treats the trustee of a testamentary trust in the same way as he treats a legal personal representative: Law Administration Practice Statement PS LA 2003/12).
>
> 114. In the context of CGT events E5, E6 and E7 this means that the exception applies if subsection 128-15(3) applies to relieve any capital gain or capital loss that arises (or would apply in that way if there were a capital gain or capital loss) when an asset passes from the deceased's legal personal representative to a beneficiary in their estate.

It is not clear whether the former views are being re-expressed or are resiled from. The relevant example is: (with my emphasis)

> Example 4: equitable life interest created by will – later agreement between the parties
>
> 162. Hector's will provided that his 50 hectare farming property be held on trust for his wife for life, and for his three daughters in remainder in equal shares. Hector acquired the property in 1993 and died in 2000.
>
> 163. In 2005, Hector's wife and daughters get together and decide to wind-up the trust and have the property distributed to them as tenants in common in equal shares (that is, four interests).
>
> 164. Hector's wife and daughters acquired their interests in the testamentary trust for no consideration. Their first elements of cost base and reduced cost base are nil.
>
> 165. The ending of the trust results in CGT event E6 happening in relation to the part of the land transferred to Hector's wife and CGT event E7

[60] ATOIDS 2003/1115, 2003/1117, 2004/151.

happening in relation to the parts of the land transferred to Hector's daughters.

166. The exceptions for trusts to which Division 128 applies have no relevance in this case because the land is not passing to the beneficiaries in terms of section 128-20. That is, the interests in the land are not passing under the will nor are they passing under a deed of family of family arrangement entered into to settle a claim to participate in the estate.

167. The trustee of the testamentary trust and Hector's wife may make a capital gain or capital loss from CGT event E6 happening. Depending on the application of Division 6 of Part III of the ITAA 1936, and on section 118-20 and subsection 118-20(1A) of the ITAA 1997, any capital gain made by Hector's wife may be reduced to the extent of amounts referable to the trustee's capital gain included in her assessable income under Division 6 (see also PS LA 2005/1 (GA)).

168. The trustee of the testamentary trust may make a capital gain or capital loss from CGT event E7 happening in relation to the parts of the land used to satisfy the interests of the daughters in the trust. CGT event E7 also happens on the ending of the capital beneficiaries trust interests. Because the daughters did not pay anything for their interests, or acquire them by assignment, any capital gain or capital loss they may make on the ending of their interests in the trust is disregarded by subsection 104-85(6).

169. The beneficiaries acquire their interests in the land for their market values at the time it was disposed of to them.

The land being distributed (a tenancy in common of 25% of the whole land) is different to interest left in the Will (which would have been for the girls a tenancy in common of 33.33% of the whole land. However, shares can be identified as the identical interest owned by the deceased and left in the Will. Does Div 128 still apply in such a case? It seems to me it does.

Life interest ended 5 years later by combination of cash and in specie transfer of shares owned by deceased
Assume the deed ending Rosie's interest is set out as follows:

(a) Consideration for the right to x years income from estate $30[61]

(b) Consideration for balance of life interest $50

Leaving aside the CGT effect on (a), will the CGT on (b) follow the same analysis as 8.1.7 above?

Life tenant disclaims life interest
A few months after Robert's death, Rosie disclaims the gift in writing. The CGT effect is based on the view that she never acquired the life interest (all she had was a right to proper administration of the Estate and this is not a CGT asset). As she didn't acquire it, she couldn't end it or dispose of it. Therefore there are no CGT implications but

[61] Assume based on actuarial calculation.

beware of stamp duty![62] Ryan simply receives the shares when the executor is able to transfer them to him as if gifted absolutely in the Will.

Deed of Family Arrangement
Ryan was on active duty in Iraq when his father died. He returns to Australia and goes bush for 12 months to get over the experience. By this stage Rosie has started to receive the dividends. He then considers his bequest. He is most unhappy with his father's Will and is given bona fide written advice that he has a valid claim under the relevant family provisions statute in his State or Territory and even though he is out of time to lodge a claim, he also has grounds to obtain an extension of time.[63] He informs the executor and his mother and they enter into a Deed of Family Arrangement to settle his claim.

The deed ends the life interest and divides the shares 80:20. The CGT consequences are as set out above in 8.1.2 and are as if the agreed split was left in the Will.

Results summarised

Action	She receives	Her CGT	She keeps	Out of pocket
Gift to Rosie	96	20	76	
Ends 5 yrs for no consideration	-	24	-	24
Ends on Rosie's death	-	-	-	-
Ends 5 yrs for mv consideration	96	24	72	
Ends for shares owned at death UNCLEAR	96	20 (deferred until she sells)	76	-
Ends for combination of cash and death shares UNCLEAR	96	??	??	-
Disclaims shortly after Robert's death	-	-	-	-
Deed of Family Arrangement to settle dispute	96	20 (deferred until she sells)	76	

Some possible solutions: What can the adviser do?

[62] Eg 71AA Stamp duty act 1923 (SA); 42 Duties Act 2000(Vic).
[63] 128-20(1)(d) ITAA 1997 and see ATOID 2003/107.

Assuming it is too late to disclaim without CGT implications (eg some income has been paid to Rosie or the trustee has commenced to hold the shares on the terms of the life and remainder interests)[64] the cheapest solution is to try to convince your client not to end her life interest early.

You need to find out why your client wants to end her life interest and whether there is a better way to achieve the aim. Some clients do not want to wait and often have personal reasons such as wanting to help the remainder beneficiaries for wanting to end the life interest!

There is nothing to stop her gifting the income she receives (after paying tax) or lending her son money or even possibly using the value of the interest to secure his debt. If Ryan needs money, does the Will allow the trustee to lend it directly or advance any?

What about using the relevant Trustee Act (if the relevant one allows it) to allow advancement of capital to the remainder beneficiary without the life tenant having to do anything? Would the equivalent of sec 33A *Trustee Act (SA) 1936* to pay up to half of capital from shares or similar investments to remainder beneficiaries (with the consent of the life tenant) be of any assistance? If allowed, it is difficult to see how the mere consent of the life tenant has any CGT effect.

> 33A—Power to apply capital towards advancement and benefit
>
> (1) Where under a trust a person is entitled to the capital of the trust property or any share thereof, the trustee may from time to time pay or apply any capital money subject to the trust, not exceeding altogether in amount one half of the value of the property or share for the advancement, maintenance, education, or benefit of such person in such manner as the trustee shall in his absolute discretion think fit.
>
> (2) The power conferred by this section may be exercised whether the person is entitled absolutely or contingently on his attaining any specified age or on the happening of any event, or whether his interest is subject to a gift over on his death under any specified age or on the happening of any other event, and notwithstanding that the interest of the person so entitled is liable to be defeated by the exercise of a power of appointment or revocation, or to be diminished by the increase of the class to which he belongs or whether the person is entitled in possession or in remainder or reversion.
>
> (3) If the person is or becomes absolutely and indefeasibly entitled to a share in the trust property, the money so paid or applied for his advancement, maintenance, education or benefit shall be brought into account as part of such share.
>
> (4) No such payment or application shall be made so as to prejudice any person entitled to any prior life or other interest, whether vested or contingent, in the money paid or applied, unless such person is in existence and under no disability and consents in writing to the payment or application.
>
> (5) This section applies only where the trust property consists of money or securities or property held upon trust for sale calling in and conversion,

[64] Are you absolutely sure? Where and what is the evidence?

> and the money or securities or the proceeds of the sale calling in and conversion are not by statute or in equity considered as land.
>
> (6) This section applies only and if and as far as a contrary intention is not expressed in the instrument, if any, creating the trust, and shall have effect subject to the terms of that instrument and to the provisions therein contained.

Also consider if any of the potential beneficiaries have a valid bona fide claim under the family provisions statute. Although it is not necessary to commence court proceedings,[65] the claim must surely be bona fide (and provable as such).[66]

If that fails, would Rosie be satisfied with an in specie transfer of shares owned by Robert? Obviously the longer the life interest has been active, the more post death assets will usually exist. As a partial balance, the older the life tenant, the less the market value of their interest! At this stage, if the answer is yes, seek a private ruling (until TR 2005/D14 is finalised).

Another possible approach is set out below.

Other possible solutions: Over to the ATO!

The different results for the ending of the life interest over investment assets appear to have no logical reason. The overall policy of Div 128 is to allow gifting of assets with deferred CGT liability. Where there will be no CGT liability (eg on the ending of the life interest by death) then why not interpret the CGT trust provisions in such a way (even generously) to achieve the aim. The draft ruling is a noble effort to try to deal with the issue in a relatively abstract manner by trying to make sense of the trust law implications of starting and ending life interests (including those left in Wills). It tries to do too much by dealing with legal and equitable life interests and does not face the practical inconsistencies that I refer to above.

The life tenant has no CGT

Why not accept that a life tenant can surrender the life interest whether for full market value consideration or not, "tax free". There is no loss to the Revenue as the remainder beneficiary doesn't acquire the life interest and so the payment isn't part of his cost base of any CGT asset and so is not taken into account in any CGT liability.

The ATO may fear this approach may be used as a planning tool to get a tax free amount to the "life tenant". However, it is difficult to see what the mischief is. There will still be all the normal CGT on the disposal of any assets which finally pass to the remainder beneficiary. Where the life and remainder beneficiaries are related (as is often the case) the arrangements are domestic not commercial. Where they are not related, the remainder beneficiary is paying for an advancement of the trust but not acquiring an asset.

I accept with sadness that as a practical matter it is too much to expect Parliament to change the CGT law to allow this (even if it is fair or even intended in the current legislation) but the ATO can deal with the inconsistency by introducing an administrative practice based on the policy behind Div 128. This has been done before

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[65] 128-20(1)(d) ITAA 1997 and see ATOID 2003/107.

[66] A written legal advice should suffice especially if from counsel or solicitor who practices in the area.

eg in PS LA 2003/12 (also concerning Div 128) and eg TR 95/35 which was necessarily to make CGT on compensation receipts work at all!

In PS LA 2003/12, the ATO states:

> Although this is a difficult issue, particularly given the wording in section 128-15 of the ITAA 1997, it is open to the Commissioner to follow a long-standing practice that promotes the policy intent of the provisions and that might be adopted by a court.[67]

The following explains why there is no loss to the revenue.

1) Shares sold by remainder on death of life tenant-

Assuming Rosie dies while still entitled to the life interest, she will have no CGT liability on the acquiring or ending of her life interest.

Ryan then inherits the capital assets with a cost base of $20 (as Robert had). Assume he sells them all. Assuming the value hasn't decreased, then the capital proceeds that Robert would have obtained and paid tax on will now be "included" in Ryan's gain and the "above CGT" will then be paid.

That is the usual case. All that has happened is the CGT on the shares owned by Robert is deferred until his capital beneficiary disposes of them. This is the point of the CGT death concessions in Div 128.

2) Life tenancy surrendered for no consideration-

Assume instead, Rosie ends the life interest when it has a market value of $50. She asks for and receives nothing.

The effect of the ending is that Ryan's interest is accelerated so he inherits the capital assets with a cost base of $20 (as Robert had). Assume he sells them all. Again all that has happened is the CGT on the shares owned by Robert is deferred until his capital beneficiary disposes of them. Robert does not gain except by either being able to sell the shares sooner than Robert and God intended which is a benefit to the Revenue as it gets the deferred CGT earlier. There is no loss to the Revenue in ordinary income tax–whoever holds the rights to the income from the shares will be paying income tax on the income derived.

3) Life tenancy surrendered for mv consideration-

Ryan pays $50,000. Rosie receives it and surrenders her interest. Ryan doesn't acquire the life interest by paying the amount nor does he acquire the remainder interest or the absolute interest in the assets by the payment (as these were acquired because of the Will). By paying his mother, she ends her life interest. That means the payment simply accelerates his interest left by the Will. As the sum does not form any element of the cost base of any CGT asset, it is not available to be offset against any later capital gain. The payment of the $50,000 has no CGT effect on Ryan. Therefore there is no revenue need to impose a CGT liability on Rosie to offset or balance any benefit to Ryan.

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[67] From [7] of PS 2003/12. The practice need not be long standing to attract this approach.

The relevant parts of sec 110-25(2) are set out below so you can check my claim. In summary, the cost base rules deal with amounts incurred etc. in acquiring the asset. If Ryan spent the money for a reason other than acquiring the asset (ie the shares), the cost base rules don't apply.

5 elements of the cost base -

> 110-25(2)
>
> The first element is the total of:
>
> (a) the money you paid, or are required to pay, in respect of *acquiring it; and
>
> (b) the *market value of any other property you gave, or are required to give, in respect of acquiring it (worked out as at the time of the acquisition).
>
> [Note 1: There are special rules for working out when you are required to pay money or give other property: see section 103-15.]
>
> [Note 2: This element is replaced with another amount in many situations: see Division 112.]
>
> 110-25(3)
>
> The second element is the *incidental costs you incurred. These costs can include giving property: see section 103-5.
>
> [Note: There is one situation to do with options in which the incidental costs relating to the CGT event are modified: see section 112-85.]
>
> 110-25(4)
>
> The third element is the costs of owning the *CGT asset you incurred (but only if you *acquired the asset after 20 August 1991). These costs include:
>
> (a) interest on money you borrowed to acquire the asset; and
>
> (b) costs of maintaining, repairing or insuring it; and
>
> (c) rates or land tax, if the asset is land; and
>
> (d) interest on money you borrowed to refinance the money you borrowed to acquire the asset; and
>
> (e) interest on money you borrowed to finance the capital expenditure you incurred to increase the asset's value.
>
> These costs can include giving property: see section 103-5.
>
> [Note: This element does not apply to personal use assets or collectables: see sections 108-17 and 108-30.]
>
> 110-25(5)
>
> The fourth element is capital expenditure you incurred:
>
> (a) the purpose or the expected effect of which is to increase or preserve the asset's value; or
>
> (b) that relates to installing or moving the asset.
>
> The expenditure can include giving property: see section 103-5.
>
> [Note: There are 3 situations involving leases in which this element is modified: see section 112-80.]
>
> 110-25(6)
>
> The fifth element is capital expenditure that you incurred to establish, preserve or defend your title to the asset, or a right over the asset. (The expenditure can include giving property: see section 103-5.)

4) Life tenancy surrendered for less than mv consideration-

The only difference here is the deemed market value for the first element of the cost base due to sec 112-20. This doesn’t matter in this case as there is still no nexus between the acquisition of any asset by Ryan and the payment. Therefore the argument for less than market value is the same as for market value payment.

The life tenant has a cost base

An alternative to no CGT is a reduced CGT by accepting there is a deemed market value cost base as Rosie didn’t pay anything for her life interest. It is possible to interpret sec 112-20(1) in this case so that the cost base (where no consideration was received) is deemed market value. If it is deemed market value, then there is a reduction in the capital gain. For ease of reference I set sec 112-20 out again:

> SECTION 112-20 Market value substitution rule
>
> 112-20(1)
>
> The first element of your *cost base and *reduced cost base of a *CGT asset you *acquire from another entity is its *market value (at the time of acquisition) if:
>
> (a) you did not incur expenditure to acquire it, except where your acquisition of the asset resulted from:
>
> (i) *CGT event D1 happening; or
>
> (ii) another entity doing something that did not constitute a CGT event happening; or
>
> (b) some or all of the expenditure you incurred to acquire it cannot be valued; or
>
> (c) you did not deal at arm's length with the other entity in connection with the acquisition.
>
> The expenditure can include giving property: see section 103-5.
>
> 112-20(2)
>
> Despite paragraph (1)(c), if:
>
> (a) you did not deal at arm's length with the other entity; and
>
> (b) *your acquisition of the *CGT asset resulted from another entity doing something that did not constitute a CGT event happening;
>
> the *market value is substituted only if what you paid to acquire the CGT asset was more than its market value (at the time of acquisition).
>
> The payment can include giving property: see section 103-5.

In summary, for our purposes, the market value cost base substitution rule will not apply to determine the cost base of the taxpayer's life interest where the acquisition of the asset resulted from any one of these three:

A. CGT event D1 happening on acquisition of life interest;
B. another entity doing something that did not constitute a CGT event happening; or
C. the life tenant did not deal at arm’s length with the other entity from which the life tenant acquired the life interest.

Personalising this to Robert, Rosie and Ryan the market value cost base substitution rule will **not** apply to determine the cost base of the taxpayer's life interest where the acquisition of the asset resulted from any one of these three:

A. CGT event D1 happening on acquisition of life interest;;
B. Robert or someone else doing something that did not constitute a CGT event happening; or
C. Rosie did not deal at arm's length with Robert or whoever she acquired the life interest from.[68]

The arguments are as follows:

A. The Will creates a life interest in Rosie and remainder interest in Ryan over assets. Is this a CGT event D1? Was the life interest created as a result of CGT event D1 happening (section 104-35 of the ITAA 1997).

CGT event D1 happens if the deceased or someone else creates a contractual right or other legal or equitable right in another entity. Has the deceased created an equitable right in Rosie or can you argue that the Will has no effect until the person dies and at that moment, when the Will comes into effect the deceased is no longer is (at a minimum) able to create a legal or equitable right in any entity?[69] Also she does not acquire her life interest until the estate has been administered and by then the deceased is well out of the picture. The deceased set up the process (the Will) that results in the life interest but doesn't actually create it.[70]

B. The market value substitution also does <u>not</u> occur where the acquisition of the life interest resulted from another entity doing something that did not constitute a CGT event.

Was the acquisition of the life interest the result of the deceased or executor or another person doing something that did not constitute a CGT event? The steps required for the life tenant to acquire the interest are:

1. The deceased leaves the life interest in the Will –no acquisition yet.
2. The deceased dies-no acquisition yet.
3. The executor administers the estate-no acquisition yet.
4. The executor or a new trustee commences to hold the assets under the terms of the life interest – acquisition now.

Which of these actions, if any, result in the acquisition of the life interest? Arguably only the last can be said to result in the acquisition. At any earlier stage the life interest may not happen eg. if there are insufficient assets in the estate to pay the deceased's debts. Also arguably, the last step is not "something done" by the executor or trustee (in the sense of what the section means). It is simply the consequence of duly administering the estate.

C. The market value substitution also does <u>not</u> occur if Rosie did not deal at arm's length with Robert (or whomever she acquired the life interest from). For the reasons given above, Rosie did not acquire the life interest from anyone so it is irrelevant

[68] Apologies for the preposition ending the sentence!
[69] I am leaving aside any ongoing spiritual existence because as you are deemed to have disposed of all your assets at the moment of death, you have no ability to do anything with them after that time. I am quite simply applying the tax law to the deceased.
[70] The ATO considers the life tenant acquires the interest from the deceased - see TR 2005/D14 at [45] to [48].

whether she was dealing with them at arm's length or not. Furthermore, and as a further illustration of how impossible it is to use the general CGT provisions with assets held on death, it is also likely that **in fact** Rosie did not deal with Robert at all – she may have no knowledge of the life interest until after his death. Even if she was aware, this is surely not the type of "dealing" that the CGT provisions are meant to tax.

Another (almost) solved CGT problem for life tenants

A life tenant of an active testamentary trust is the sole income beneficiary and is presently entitled to the income pursuant to the Will. The result is that any CGT liability arising from the sale of trust assets (such as shares) also flows to the life tenant even though the life tenant has no right to the capital benefit of the event that gave rise to the liability. The Commissioner has a current concessional administrative practice allowing the trustee of a testamentary trust to assume liability for the CGT in certain circumstances.[71]

The Government has very recently announced it will amend the CGT provisions to fix this problem.[72]

The aim of the amendments is to enable the CGT liability arising from CGT event happening to a trust asset to be paid by the trustee of a testamentary trust where a presently entitled income beneficiary will not obtain the benefit of the capital gain.[73] The trustee can make the choice on a beneficiary-by-beneficiary basis and this is intended to ensure the trustee is not assessed on part of the capital gain in circumstances where no tax would have been paid on the gain by the income beneficiary, for instance where the income beneficiary is an exempt entity or a foreign resident. The amendments are intended to apply to the 2005–06 and later income years.

Is it in fact a life interest over each CGT asset? Does this matter?

The discussion always concerns the life interest left in the Will or terms similar to that. Is it more accurate to say that the deceased leaves a life interest over each CGT asset subject to the life interest? This would make it easier to end the life interest over the assets owned by the deceased and so use the exception to CGT E6 resulting in no CGT on those surrenders.

What if the life interest were an asset owned by the deceased

This approach has been promoted in arguments for the part disposal view.[74] The ATO holds the creation view which results in no cost base for the life interest.[75]

> 53. Being trust interests, the life and remainder interests are created interests that are acquired when they commence to be owned: subsection 109-5(1) of the ITAA 1997. The interests are not acquired pursuant to Event number E1 in the table in subsection 109-5(2) because this is only relevant to the

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[71] Practice Statement PS LA 2005/1(GA). Note this PS applies beyond testamentary trusts.

[72] Following consultation with industry on the design and the implementation of the amendments.

[73] Media release no 074 from Minister for Revenue dated 17 October 2006

[74] For example see Barkoczy, S and Cussen, P, (1993) 'Capital gains tax and the grant of life and remainder interests under wills: the debate between the creation and part disposal views', *Australian Tax Review*, Volume 22.

[75] TR 2005/D14.

> trustee's acquisition of the original asset. Further item 3 in the table in section 109-10 does not apply because the trust is not a unit trust.
>
> 54. The first element of the cost base and reduced cost base of a life or remainder interest is limited to the sum of any money and the market value of any property given to acquire it, except where it is not acquired under an arm's length dealing. The market value substitution rule does not apply in calculating the first element of the cost base and reduced cost base of life and remainder interests acquired for no expenditure: paragraph 112-20(1)(a) of the ITAA 1997.

The problem for the life tenant arises in part because there is no cost base and no deemed cost base. This results in almost the entire capital proceeds or deemed capital proceeds (that is the other problem) being subject to CGT.

Could Robert was treated as owning not only the shares but also each interest that he can leave in the shares. So when the life interest commences, the life interest and remainder interest each have a percentage of the cost base of the shares etc over which the interests exist.

So if Rosie's life interest is worth 80%, she has 80% of the cost base. If she surrenders the interest for market value, she has 80% of cost base. In the above example, this was worth $16.

If she surrenders the interest when its value is $80 the result would be as if she was left shares with that value and sold them. In practical terms as far as she is concerned that is what should have happened.

If Robert leaves an interest in shares to Rosie then while she has that interest, the shares themselves will either:

- Be disposed of by trustee and he/she will use Robert's cost base and replace investment with new market value cost base. These shares formerly owned by Robert will never pass to Ryan and so the Div 128 cost base rules are irrelevant for those shares.
- Be held by trustee until interest ends (and so no one makes use of their cost base during this time) and when the interest ends, then if the shares pass to Ryan as would occur on Rosie's death, he acquires them with his father's cost base. This is the same whether he received the shares in the Will, on the death of Rosie or earlier if she surrenders or disclaims her interest.
- If transferred to Rosie in return for some or all of life interest, then she also acquires them with Robert's cost base. Ryan never gets them.

What about the CGT impact on the remainder beneficiary?

If Rosie dies when she still has the life interest, then as above, Ryan acquires the shares with his father's cost base.

If Rosie surrenders her life interest before her death, and has the use of the cost base of the life interest when she acquired it what is Ryan's position? The alternatives are:

She receives no consideration: she has deemed market value and offsets her percentage of the cost base. Ryan pays nothing to her and he acquires all Ryan acquires the shares with his father's cost base. There is a duplication of part of the cost

base but there is CGT on the balance of the deemed consideration which is a bonus to the Revenue (caused by the early ending of the life interest).

She "sells" her life interest. If she accepts shares, then Ryan only acquires the shares left over. If Ryan funds this out of his funds, then he acquires all the shares.

Comment on "solutions"

These ideas are offered as just that - ideas! I release these balloons of hot air in the hope one of them will be found to hold a better answer than the current position for the life tenant especially one who wishes to be generous and let the remainder beneficiaries receive their inheritance early.

CONCLUSION

There once was a man named Flowers
Whose wealth was from building showers
He made his own Will
The silly old dill
So "gave" all of his assets to lawyers

Well, after reading all of this, do you think testamentary trusts are just another trust? There are undoubtedly some interesting and difficult tax questions unique to trusts arising from Wills and as much as I hope more answers will come soon until they do, the interest will have to do!