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Written by:
Dung Lam, CTA
Team Leader - Tax,
Argyle Lawyers Pty Ltd

Presented by:
Dung Lam, CTA
Team Leader - Tax,
Argyle Lawyers Pty Ltd

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1 Introduction

The title of this paper is 'Testamentary Trusts and Taxes' and one may presume that the speaker is motivated to spruik testamentary trusts because of their tax benefits. Having drafted and advised on testamentary trusts for close to two decades in my experience the key driver for the establishment of a testamentary trust is not tax at all. Rather will makers who establish testamentary trusts are primarily concerned with control and family wealth preservation – ruling from the grave is not a myth, it is a carefully devised estate plan. Situations where a testamentary trust may be useful include:

1. where there is a vulnerable beneficiary that needs to be protected e.g. a beneficiary with issues such as disability, spend thrift or drug addiction;

2. blended family situations where there are competing claims (e.g. a second spouse and children from the first marriage);

3. where the will maker only wishes their bloodline to benefit from their assets and is concerned that the surviving spouse may take on a new partner after their death; or

4. where the intended beneficiary should not practically receive the gift in their own name because they have asset protection concerns (e.g. a person in business or a professional who is at risk of being sued) or are a non-resident to whom a bequest would trigger CGT event K3.

Another common reason for using a testamentary trust relates to basic asset protection and tax planning where immense wealth should generally not be given to an individual personally. With the transfer balance rules forcing more benefits out of superannuation on the death of one spouse the testamentary trust may be viewed as the 'natural home' for excess benefits.

Testamentary trusts, however, are not for everyone. There needs to an adequate level assets to bear the annual compliance costs of running a trust (e.g. costs related to accounting and tax returns, and from time to time legal advice on the operation of the trust). Additionally the benefits of income splitting and the exclusion from Division 6AA's penalty tax rates may be of no benefit to a hermit with no children or relations. Australia's aging population also raises an important issue concerning testamentary capacity. Testamentary trust wills are typically long and complex documents. A key concern when implementing a testamentary trust solution is to ensure the will maker has mental capacity to enter into such complicated document. All the careful tax planning and will drafting may fly out the window, if the will is challenged on the basis that the will maker did not understand what they signed.

However, having decided that a testamentary trust is appropriate in a will maker's circumstances there are a number of issues and traps to navigate to ensure that family wealth is not unnecessarily eroded by tax. Apart from the availability of the CGT discount and income splitting, the two main tax advantages provided by a testamentary trust are the testamentary trust exceptions from the penalty tax rates of Division 6AA of Part III of the *Income Tax Assessment Act 1936* (**ITAA 36**) and the way the capital gains tax (**CGT**) death rollover operates in the testamentary trust context. This paper examines both these aspects as well as:

1. the impact of the May 2018 Federal Budget proposal on the testamentary trust exceptions from Division 6AA;

2. whether the death rollover allows for trust splitting in the testamentary trust context despite the ATO's position in Taxation Determination TD 2018/D3;

3. tax issues with holding a main residence in a testamentary trust;

4. the Australian tax issues arising where there are foreign beneficiaries;

5. the tax concessions available for severely disabled persons which extend beyond the testamentary trust, and which could be used either in conjunction with a testamentary trust or to rescue a situation where a testamentary trust has not been established in the will; and

6. the situation were a will maker has lost capacity, but there is still a desire to create a testamentary trust for family wealth preservation purposes.

The Labor Party proposes to amend the law to further rein in the income splitting advantages of discretionary trusts – their impact on testamentary trusts is also touched on.

2 Division 6AA and the testamentary trust exceptions

Division 6AA of Part III of the ITAA 36 is anti-avoidance measure aimed at preventing trustees from using dependent minor children to income split. Broadly Division 6AA assesses a 'prescribed person' on their unearned income (i.e. income which the prescribed person has not earned from by their own efforts e.g. passive income or trust distributions) at the following penalty tax rates:[1]

Income	Tax rate
$0 - $416	Nil
$417 - $1,307	66% of excess over $416
Over $1,307	45% of total amount of income

A person will be a 'prescribed person' if they are less than 18 years of age on the last day of the relevant year of income and they are not an 'excepted person' in relation to that income year.[2] A minor who receives trust income will generally be a prescribed person caught by Division 6AA's clutches. This is the reason why distributions to minor children from inter vivos trusts are generally limited to $416 – distributions above this amount being taxed at penal rates.

There are two ways that a minor child may be exempted from Division 6AA's penalty rates, namely:

1. the child may be an 'excepted person' and thus not a prescribed person in the first place – broadly this covers a minor engaged in a full time occupation at year end or a minor who is severely disabled, permanently blind child or a double orphan;[3] or

2. the income derived by the child is 'excepted assessable income' or 'excepted trust income' which the Government considered appropriate to exempt from Division 6AA's reach – this includes income which a minor genuinely earned through business or employment activities, income derived as a result of the investment of compensation sums received as a result of personal injury or death, sums received from superannuation death benefits and life insurance policies and family law settlement sums.[4]

The testamentary trust exceptions were included in Division 6AA presumably to ensure that the measure was not seen as a de facto death duty. The main benefit of being exempted from Division 6AA lies in the ability to access the scaled adult marginal tax rates and in particular the $18,200 tax-

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[1] These rates are for Australian resident prescribed persons – non-resident prescribed persons are not eligible for any tax free threshold. The 2% Medicare levy may also be imposed on top of these tax rates depending on the assessable income of the minor.
[2] Section 102AC(1) of the ITAA 36.
[3] See section 102AC of the ITAA 36 for these excepted person exceptions – noting that there are carve outs from these exceptions where the child is dependent on relatives.
[4] Besides testamentary trusts the other main trust structure spawned by Division 6AA are child maintenance trusts arising from family breakdown – see section 102AGA of the ITAA 36 and Taxation Ruling TR 98/4 which is focused on child maintenance trusts but is currently the main ATO guidance on Division 6AA.

free threshold. This benefit is one reason why testators who have minor children or minor grandchildren may wish to establish a testamentary trust. This tax advantage can be seen in the following case study:

> Mike is a successful retired business man with three adult children, Jenny, Sue and John who are on the top marginal tax rate. Currently Mike has three minor grandchildren, Marcia, Jane and Tim but he is sure that more will come in later years.
>
> Assume Mike dies and a discretionary testamentary trust is established under his will. In its first financial year the testamentary trust it makes $100,000 net income and assume trust income is also $100,000. The trust deed allows for tax effective income splitting.

	Testamentary Trust		**Inter Vivos Trust**	
	Trust income distribution	Tax	Trust income distribution	Tax
Marcia	$18,200	$0	$416	$0
Jane	$18,200	$0	$416	$0
Tim	$18,200	$0	$416	$0
Jenny	$15,000	$7,050	$32,900	$15,463
Sue	$15,000	$7,050	$32,900	$15,463
John	$15,400	$7,238	$32,952	$15,487
TOTAL	$100,000	**$21,338**	$100,000	**$46,413**

> The use of the testamentary trust has reduced tax on the $100,000 by more than half.

The $18,200 tax free threshold can be used to tax effectively pay school fees, sport registrations and various other costs with raising a minor child.

The Labor Party proposes to expand Division 6AA's reach by imposing a minimum 30% tax rate on trust income distributions to beneficiaries over the age of 18 years from 1 July 2019. This proposal targets income splitting in favour of stay at home spouses and adult university children. This proposal will only apply to discretionary trusts and there will be exceptions for non-discretionary trusts such as special disability trust, testamentary trusts, fixed trusts, cash management unit trusts. Farm trusts and charitable or philanthropic trusts will also be excepted, presumably whether or not they are discretionary in nature.[5] It is unclear what Labor considers is a 'farm trust' and why farmers are singled out for special favourable treatment as opposed to other small businesses. Clearly the policy proposal will require detailed work to implement.

[5] See 'A Fairer Tax System, Discretionary Trust Reform' paper issued by Labor on 29 July 2019 which can be accessed conveniently at: https://www.charteredaccountantsanz.com/member-services/technical/tax/tax-in-focus/Australian-Labor-Party-Policies-for-2019-Federal-Election

It is not clear how the Labor policy will apply to the tax rates applying to minor child beneficiaries as it is only targets beneficiaries 18 years or over. Certainly it crimps the income splitting advantages of a discretionary testamentary trust, but it does not entirely eliminate it. Income splitting to an adult at a 30% tax rate may still be beneficial when compared to the top marginal tax rate (notably Labor proposes to increase the top marginal tax rate to 47% for incomes above $180,000) and it avoids the compliance costs of having a bucket company to defer tax.

2.1 'True' Testamentary Trusts

The testamentary exceptions in Division 6AA can be broadly divided into the 'true' testamentary trust exception and other options which are available where no testamentary trust is created.

Section 102AG(2)(a) of the ITAA 36 provides that an amount assessable income of a trust is 'excepted trust income' (and thus not subject to Division 6AA's penal tax rates) to the extent that 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 …*" [Emphasis added.]

This is the 'true' testamentary trust exception from Division 6AA and only requires that the testamentary trust to arise from a testamentary instrument such as a will or codicil (which by definition is met for a testamentary trust).

The Federal Court case of *Trustee for the Estate of the late A W Furse No. 5 Will Trust v FCT* (1990) 21 ATR 1123 (*Furse*) indicates that it is not necessary that the excepted trust income covered by section 102AG(2)(a) of the ITAA 36 be confined to the assets of the deceased estate over which the testamentary trust was established. Income derived by the testamentary trust from earnings on the original deceased estate assets and substituted assets funded by both the deceased estate assets, earnings and borrowings, will also be excepted income under this subsection.

In *Furse* the Commissioner argued in that the exception in section 102AG(2)(a) of the ITAA 36 required not only that the trust arise by virtue of the will but also that the income of the trust itself be sourced from the property of the deceased. Namely, the Commissioner argued that it was not open to enhance the assets of the testamentary trust with assets that did not form part of the assets of the deceased at the time of his death. The testamentary trust in *Furse* had borrowed funds to subscribe for units in a solicitors' service trust. The Commissioner disputed whether the income derived by minor beneficiaries of the Furse Trust which was sourced from the unit holding in the solicitors' service trust was excepted trust income under section 102AG(2)(a) ITAA 36.

Justice Hill rejected the Commissioner's argument stating:

> '*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 subparagraph (i) "a will" etc. or in subparagraph (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 Division 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.*'[6] [Emphasis added.]

Section 102AG(2)(a) of the ITAA 36 relates to the 'true testamentary trust' exemption. However, income derived by other forms of trusts may also gain the benefit of an exclusion from the provisions of Division 6AA. These are discussed below.

2.2 Superannuation proceeds trust

A superannuation proceeds trust is essentially a trust which receives the deceased's lump sum death benefits from superannuation. There are two ways that a superannuation proceeds trust may be structured so as to fall within an excepted trust income exception.

The more conventional way is to establish a superannuation proceeds trust is via the true testamentary trust exception in section 102AG(2)(a) of the ITAA 36. Under superannuation law the trustee of a superannuation fund can only pay death benefits to certain people comprising the deceased's legal personal representative[7] (**LPR**) and their dependants as defined under superannuation law (i.e. their spouse, children, a person who was financially dependent on the deceased at the date of their death or a person who was in an interdependent relationship with the deceased at the date of their death).[8] To comply with this superannuation law usually a testator completes a binding death benefit nomination requesting that the trustee of their superannuation fund pay their death benefit to their LPR who then uses it to establish the superannuation proceeds trust under the terms of their will.

To minimise tax on the receipt of the death benefit the discretionary beneficiaries of a superannuation proceeds trust are limited to persons who are classed as death benefit dependants for tax purposes (i.e. the deceased's spouse, children under the age of 18 years, a person who was financially

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[6] At 1136.

[7] This may be the executor or administrator.

[8] Regulation 6.22(2) of the *Superannuation Industry (Supervision) Regulations 1994*.

dependent on the deceased at the date of their death or a person who was in an interdependent relationship with the deceased at the date of their death). Death benefit dependants are not taxed on the receipt of the deceased's superannuation death benefits, whilst non-death benefit dependants may be taxed on the receipt of such death benefits where they contain a taxable component. The tax rate is usually 17%.[9] In the context of a death benefit being paid to a trustee of the superannuation proceeds trust, the Commissioner looks through the trust to see who will ultimately benefit from the death benefit.[10] This is why beneficiaries of the trust are limited to death benefit dependants.

Confining the beneficiaries of a superannuation proceeds trust to death benefit dependants can be unduly restrictive but it is generally the only way to be sure that the death benefits with taxable components are not assessed. With more superannuation death benefits being pushed out of superannuation, many will makers are choosing to pay the 17% additional tax on taxable components to obtain the flexibility of having more beneficiaries in their testamentary trust. This is particularly where the number of death benefit dependants they have is extremely small.

The less conventional way to establish a superannuation proceeds trust is to rely on the excepted trust income exception in section 102AG(2)(c)(v) of the ITAA 36. That section provides that an amount assessable income of a trust is excepted trust income to the extent which the amount:

> *'(c) is derived by the trustee … from the investment of any property transferred to the trustee for the benefit of the beneficiary:*
>
> *….*
>
> > *(v) directly as a result of the death of a person and out of a provident, benefit, superannuation or retirement fund;'*

For a trust to benefit from the exception in section 102AG(2)(c)(v) ITAA 36 its terms must also meet the capital requirement in section 102AG(2A) of ITAA 36. This capital requirement is intended to ensure that the exception does not apply in the situation where there is a transfer of property to a trustee on terms that the income from the investment of property is to be distributed to a child during his or her minority, while the property is either to be returned to the settlor of the trust (that is, the person creating the trust), or distributed to beneficiaries other than the child, once the child attains the age of 18. The Commissioner notes that this requirement means that the trust property must go to the child's deceased estate in the event that the child dies before the trust ends[11] and where there is more than one minor child, then each child must have a fixed share to the trust property.[12]

Practically due to the tax and superannuation requirements discussed above in relation to the 'dependants' definition, a superannuation proceeds trust under this exception usually involves a trustee holding the superannuation death benefits for the benefit of a child of the deceased's who is under 18 years.

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[9] This is 15% plus the 2% Medicare levy and assumes the death benefit has no untaxed element.
[10] Section 302-10 of ITAA 97.
[11] TR 98/4 at 33.
[12] TR 98/4 at 37.

Setting up a superannuation proceeds trust under exception in section 102AG(2)(c)(v) of the ITAA 36 involves liaising with the superannuation fund trustee and drafting the relevant trust deed with terms that include the capital requirement in section 102AG(2A) of the ITAA 36.

The benefit of setting up the superannuation proceeds trust as a true testamentary trust as opposed to the second less conventional way, is that the true testamentary trust is not subject to the capital requirement in section 102AG(2A) of the ITAA 36.

2.3 Life insurance proceeds trust

Section 102AG(2)(c)(iv) of the ITAA 36 provides that an amount assessable income of a trust is excepted trust income to the extent which the amount:

> '*(c)* *is derived by the trustee … from the investment of any property transferred to the trustee for the benefit of the beneficiary:*
>
> *….*
>
> *(iv)* *directly as a result of the death of a person and under the terms of a policy of life insurance;*'

Commonly this type of trust is referred to as a life insurance proceeds trust. There are a number of possible ways a life insurance proceeds trust may be established:

1. a minor child beneficiary may be named as a beneficiary of the deceased's life insurance policy, and the proceeds of the policy are transferred to the trustee (e.g. their legal guardian) to hold for the benefit of the minor child beneficiary during their minority; or

2. the trustee of a trust especially set up to be the life insurance proceeds trust receives the proceeds from the life insurance policy directly from the insurer either because they are the policy owner or are a person who the policy owner has nominated to receive the proceeds on the deceased's death. The life insurance trust may be established either before or after the deceased's death.

A key requirement that must be met before the exception in section 102AG(2)(c)(iv) ITAA 36 is that child beneficiaries must under the terms of the trust acquire the trust property (e.g. the trust capital representing death benefit or life insurance proceeds) other than as trustee, when the trust ends.[13]

Apart from this capital requirement there does not appear to be any other mandatory requirement that a life insurance proceeds trust must meet. One issue which arises when considering the structure of the life insurance proceeds trust is whether it can be a discretionary with regards to income amongst a range of beneficiaries whilst still adhering to the terms of the capital requirement. This may be important to ensure that a surviving spouse is a discretionary income beneficiary of the trust to prevent the children from invoking Saunders v Vautier to collapse the trust prematurely once they turn 18 years. This issue goes to what the phrase 'transferred to the trustee for the benefit of the beneficiary' means. Arguably, it is possible for the life insurance proceeds trust to be discretionary as

[13] Section 102AG(2A) of the ITAA 36.

to income as a consequence of section 102AG(8) ITAA 36. Broadly, that section provides that where property is transferred to a trust and the trustee of the trust has a discretion to apply the income derived from the investment of that property amongst a class of beneficiaries, the property is deemed to have been transferred to the trustee for benefit of each of the beneficiaries in the specified class.

The receipt of the life insurance proceeds by the trustee of the life insurance proceeds should generally not be subject to CGT as the life insurance exemption should apply.[14] The subsequent pay out of the life insurance proceeds to a child beneficiary also is exempt from CGT.[15]

In practice I have not seen many life insurance proceeds trusts established. This is because if it is planned that a person's life insurance will be paid to a trust for child beneficiaries, the more appropriate approach would be to set up a true testamentary trust under the deceased's will which is not subject to the capital requirement.

2.4 Employment death benefits trust

Section 102AG(2)(c)(vi) of the ITAA 36 provides that an amount assessable income of a trust is excepted trust income to the extent which the amount:

'*(c) is derived by the trustee … from the investment of any property transferred to the trustee for the benefit of the beneficiary:*

….

(vi) directly as a result of the death of a person by an employer of the decease person;'

For a trust to benefit from this exception its terms must also meet the capital requirement in section 102AG(2A) ITAA 36 discussed above.

The exception in section 102AG(2)(c)(vi) of the ITAA 36 is rarely used in practice since it generally covers employer compensation situations where an employment termination payment is paid to a trust for the deceased employee's children. Although it is worthy to note if you are acting for the surviving partner who is looking at tax effective ways of maintaining the children.

2.5 Property which devolves from a deceased estate – gift to a pre-existing trust

Section 102AG(2)(d)(i) of the ITAA 36 provides that an amount of assessable income of a trust will be excepted income to the extent to which the amount:

'*(d) is derived by the trustee of the trust estate from the investment of any property:*

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[14] Items 3 or 4 of section 118-300(1) of the ITAA 97.
[15] Section 118-300(1A) of ITAA 97.

> *(i) that* ***devolved for the benefit of the beneficiary*** *from the estate of a deceased person;*' [Emphasis added.]

Section 102AG(2)(d)(i) covers a situation where property devolves to a trust for the benefit of a minor child beneficiary. The recipient trust would be either be an already existing inter vivos trust or a trust arising after death as a consequence of the child being a minor and perhaps not being able to legally the hold the property and their parent or guardian instead holds the property for the benefit of the child. The trust would not be a trust created under the will, because otherwise the true testamentary trust exception in section 102AG(2)(a) of the ITAA 36 would apply.

The advantage of gifting deceased estate assets to an existing trust under this exception is simplicity in the drafting of the will and reduced compliance costs as no additional entity is created subsequent to the death.

Whilst the capital requirement in section 102AG(2A) of ITAA 36 does **not** apply to this exception, there is an unsettled issue as to whether the phrase 'devolved for the benefit of' of a child beneficiary incorporates some requirement that the child beneficiary be entitled to the capital of the gift. In the context of inter vivos child maintenance trusts the Commissioner has suggested that the concept of transferring property for the 'benefit' of a minor child requires that the child benefit from both the income and capital of the gift.[16] The Commissioner does not accept that property is transferred for the benefit of a child if the child is only entitled to income but not capital of a gift. Notably the capital requirement in section 102AG(2A) of ITAA 36 also does not apply to the child maintenance trust exception from Division 6AA in section 102AG(2)(c)(viii) of the ITAA 36.

The Commissioner's position conflicts with the AAT case of Case 44/95 95 ATC 387 which held that an amount was transferred for the benefit of a child where the child beneficiary was entitled to all the income derived from the investment of an amount during her minority and yet was one of a group of potential discretionary beneficiaries of capital once she turned 18 years of age. Since this issue of whether 'devolved for the benefit' implicitly incorporates a capital is not resolved, I tend to err on conservatism have only the existing minor children (and subsequent minor children who may be born over the years) to be the only beneficiaries entitled to capital of the gift. If there is a desire for others to take the benefit of the capital of the gift, it may be safer to establish a true testamentary trust than rely on the reasoning in Case 44/95 which is not a binding precedent since it is only an AAT decision.

To support the position that a testamentary gift has 'devolved for the benefit' of minor child beneficiaries the terms of the existing trust which will receive the gift should expressly contain provisions that:

1. allow the trustee to receive the testamentary gift; and
2. require the trustee to hold the gift separate from other assets of the trust and to use its trustee powers so that distributions of income derived on the gift to minor child beneficiaries will be classed as excepted trust income.

[16] Paragraph 40 of TR 98/4.

Since the exception from Division 6AA only relates to income derived on the property which has devolved for the benefit of the child beneficiaries, the trustee of the recipient inter vivos trust will need to adopt an appropriate accounting system that clearly identifies the income derived on that property as only that income is excepted trust income. The accounting for this can be intricate (see section 3.2 below on income allocation issues between excepted trust income and other trust income). The accounting difficulties which can arise are another reason why a separate testamentary trust may be used as opposed to gifting to an existing trust.

Before adopting this excepted trust exception it will be necessary to review the terms and structure of the chosen recipient trust to see whether it is an appropriate vessel to receive the gift. This includes whether:

1. the existing trust marries up with the testator's estate plans – a new testamentary trust may allow for bespoke control and release of trust clauses. Whilst the existing trust may be amended to include bespoke clauses, a variation may not be possible because of resettlement concerns or because the variation power is limited;

2. the existing trust has defects e.g. a short vesting date, limited trustee powers or limited variation clause;

3. control of the existing trust is appropriate and whether it can be devolved appropriately in line with the testator's plans.

The effect of referring to the existing trust in the will (as part of the gift of the asset to the existing trust) is that the law treats the terms of the existing trust as being incorporated into the will.[17] If there is a change in the terms of the existing trust after the will is signed, then those changes do not affect the testamentary gift unless the changes were executed in accordance with the requirements to make a valid will or the testator re-signs their will after the trust deed amendment. Where these latter actions are not done, then on the death of testator two trusts may arise:

1. the first trust being the existing trust with its amended terms and covering the assets of the existing trust; and

2. the second trust being a trust with the same terms as the existing trust prior to its amendment and covering the testamentary gift.[18]

To avoid this result of multiple trusts arising (when the intention was to not set up another trust!) it would be necessary to monitor subsequent changes to the pre-existing trust after the will is signed.

A common will drafting technique to prevent multiple testamentary trusts from arising is for a husband and wife to have mirror wills which provide that on the death of one spouse a testamentary trust will be established and on the death of the survivor their assets will be gifted to that testamentary trust if it still exists, rather than establishing a second testamentary trust at that point in time. There is a question whether income from the surviving spouse's deceased assets which are gifted to the existing testamentary trust is excepted trust income. This is particularly so if the existing testamentary trust

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[17] *Re Edwards Will Trusts* [1948] Ch 440.

[18] This point was raised by Katerina Peiros, 'Existing trusts as beneficiaries of wills' Taxation in Australia Vol 51(6) December/January 2017 at 329.

has corpus beneficiaries other than minor child beneficiaries. In private ruling PBR 32258 (which now appears unattainable from the ATO website) the Commissioner ruled that income from the settlement of the surviving spouse's deceased estate assets onto an existing testamentary trust was excepted trust income under section 102AG(2)(d)(i) of the ITAA 36. It was not entirely clear whether the testamentary trust in PBR 32258 was a discretionary trust and whether other persons besides the minor child beneficiaries could benefit from corpus of the testamentary gift.

A more recent private ruling PBR 1013038270642 addressed this husband and wife mirror will situation. In that PBR the ATO accepted that the income derived from the settlement of the surviving spouse's deceased estate assets was excepted trust income. The ATO's reasoning in this PBR was that such income was excepted trust income under section 102AG(2)(a)(i) of the ITAA 36 because it was income derived by a testamentary trust. *Furse* indicated that the only requirement for that section to apply was that the income was derived by a testamentary trust. The ATO accepted that the anti-avoidance provisions in sections 102AG(3) and (4) of the ITAA 36[19] did not apply to such income on the basis that the testamentary trust would derive income from arm's length dealings and the aim of having mirror wills was to reduce compliance costs rather than trying to secure the excepted trust income. The ATO acknowledged that the surviving spouse could have otherwise set up a second testamentary trust under their will and thus secured the excepted trust income exception in section 102AG(2)(a)(i) of the ITAA 36 without any anti-avoidance issues. Interestingly, in this private ruling the testamentary trust had an express condition that it could not accept any further corpus additions except upon the survivor's death.

Private rulings are of course not binding but they do shine a spotlight on the ATO's thinking on issues.

2.6 Post mortem trust

Section 102AG(2)(d)(ii) of the ITAA 36 allows one to save a situation where no testamentary trust has been established in the will, and after death it is desired that a trust be established for minor beneficiaries from the assets of a deceased estate. That section provides that an amount of assessable income of a trust will be excepted income 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;*'

Trusts established under this 3 year rule are known as 'post mortem trusts' or 'estate proceeds trusts'. An example of how the 3 year rule can be used is where a husband benefits under the estate of his wife, that husband could transfer part of that amount to a new inter vivos trust to be held for the benefit of minor children.

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[19] These provisions are discussed in more details at section 3.1 below.

Critical conditions which need to be met before the exception in section 102AG(2)(d)(ii) ITAA 36 applies include the fact:

1. the transfer must be within 3 years of death;

2. the transfer must be out of property which devolved from the estate. For instance, it is not possible to set up a post mortem trust with the proceeds of a life policy directly received by the husband; and

3. the child beneficiaries must under the terms of the trust acquire the trust property when the trust ends (i.e. the capital requirement in section 102AG(2A) applies). This is a problematic requirement because of concerns that the child beneficiaries may try to invoke the rule in Saunders v Vautier to end the trust once they turn 18 years so as to take the capital and “go to Rio”. The typical way to prevent the premature taking of capital is to include other discretionary income beneficiaries in the trust.[20]

The amount of income sheltered by this exception to Division 6AA is limited by section 102AG(7) ITAA 36. Very broadly that subsection limits the amount of income sheltered to that amount which would have been derived on property that would have been received by the minor child beneficiary if the deceased had died intestate. To determine whether practically a post mortem trust can be of benefit to child beneficiaries it is necessary to consider the intestacy rules of the particular state or territory which applies to the deceased.

In Queensland, South Australia, the Australian Capital Territory, the Northern Territory and Western Australia[21] there may be practical benefit in establishing a post mortem trust since the spouse and children may share the deceased spouse’s estate on intestacy depending on the estate’s size.

In NSW, Victoria and Tasmania there is no benefit in establishing a post mortem where the children are children of the relationship between the surviving spouse and the deceased. This is because in that situation the surviving spouse inherits 100% of the deceased’s estate on intestacy.[22] It is only where the minor beneficiaries are step children of the deceased that there may be a benefit in establishing a post mortem trust in NSW, Victoria and Tasmania since in that situation the surviving spouse and step children may share in the deceased estate depending on its size.[23]

Private international law determines the succession laws that apply on intestacy – generally moveable property of a deceased is governed by the law of the deceased’s domicile at the date of their death, whilst immoveable property such as land is governed by the succession law in which the immoveable property is situated. An intestate person may have assets and property in multiple Australian jurisdictions. The fact that different states and territories have different intestacy laws and that minors

[20] Suggested by the Commissioner in TR 98/4 at 45.
[21] Part 3 of the *Succession Act 1981* (Qld), section 72G of the *Administration and Probate Act 1919* (SA), section 49 of the *Administration and Probate Act 1929* (ACT), section 66 of the *Administration and Probate Act* (NT) and section 14 of the *Administration Act* 1903 (WA).
[22] Section 70K of the *Administration and Probate Act 1958* (Vic), section 112 of the *Succession Act 2006* (NSW) and section 13 of the *Intestacy Act 2010* (Tas).
[23] Section 14 of the *Intestacy Act 2010* (Tas), section 70L of the *Administration and Probate Act 1958* (Vic) and section 113 of the *Succession Act 2006* (NSW).

of persons domiciled or have property in NSW, Victoria or Tasmania may be disadvantaged as a result of section 102AG(7)'s operation suggests that there is a case for law reform in this area.

Given that the succession law in many jurisdictions gift residuary assets to the surviving spouse, a more appropriate limitation in section 102AG(7) may be to limit the amount of excepted trust income to what a child would be entitled to an overall indexed cap amount. This would prevent state succession laws from inadvertently affecting Commonwealth law which is the current situation.

The restriction in section 102AG(7) of the ITAA 36 means that a post mortem trust cannot be established from a grandparent or other person's will or intestacy because in those situations the minor child would not have an interest in intestacy.[24] A post mortem trust therefore covers the narrow circumstance of a child benefiting from assets of their deceased parent.

Besides the restriction in section 102AG(7) of ITAA 36, another reason why a post mortem trust may not be set up is because there are generally no CGT and stamp duty exemptions for the asset transfer to the trust.

2.7 Benefits of choosing a true testamentary trust

There are at least six reasons why setting up a true testamentary trust to benefit minor children is the preferred course of action rather than relying on the other Division 6AA options, namely:

1. Potential for excepted income sourced from assets other than deceased estate assets

Furse indicates that excepted income from a true testamentary trust may be sourced from assets outside deceased estate assets such as assets acquired via investment earnings or borrowings. This contrasts with the other exceptions from Division 6AA discussed above which all are limited to income derived from the investment of property transferred to the trustee of the existing trust for the benefit of the minor beneficiary. Whilst it is not entirely clear the wording of these other exceptions could on one reading mean that it is only income derived from transferred property and does not cover substituted assets (i.e. assets bought using the proceeds received from the disposal of the original transferred property). This is an extremely narrow reading and one hopes common sense will prevail to allow substituted assets.

It is noted in this respect that section 102AA(4) of the ITAA 36 operates as an anti-avoidance rule in relation to income derived from property. It provides that 'income that is derived from particular property shall be read as including a reference to income that is derived from property that, in the opinion of the Commissioner, represents that property".

2. Intestacy limit

The intestacy limit in section 102AG(7) of the ITAA 36 does not apply to a testamentary trust, but it does apply to transfers of property to inter vivos trusts.

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[24] Katerina Peiros, 'Estate proceeds trusts: benefits for families' Taxation in Australia Vol 51(4) October 2016 at 223.

3. Capital requirement

The capital requirement which applies to post mortem trusts established under the 3 year rule and to trusts arising as a result of the payment of superannuation death benefits, life insurance proceeds and employer death payments, does not apply to true testamentary trusts.

4. Period of Trust

The maximum potential 'life' of the testamentary trust may be longer than the maximum potential 'life' of the existing inter vivos trust which has already started.

5. CGT and stamp duty on transfer to existing trust

CGT and stamp duty arises on a transfer to a post mortem trust. There are no such issues for a testamentary trust.

6. Benefit to unborn grandchildren

A true testamentary trust can benefit future unborn grandchildren of testator. There is an issue as to whether the other Division 6AA exceptions can cover such unborn grandchildren. This is because those exceptions refer to a transfer of property for the benefit of the minor beneficiary. This is hard to do when the grandchild does not exist at the time of the transfer.

3 The impact of the May 2018 Federal Budget

In the May 2018 Federal Budget the current Liberal Government proposed to amend the provisions of Division 6AA with effect from 1 July 2019 to clarify that the concessional tax rates for minors from testamentary trusts is 'limited to income derived from assets that are transferred from the deceased estate or the proceeds of the disposal or investment of those assets'.[25] This measure is intended to prevent taxpayers from inappropriately obtaining the benefit of the concessionary tax rates for minors by injecting outside assets into a testamentary trust. At the date of this paper the Government has yet to introduce a legislative bill to enact this proposal and it is unclear when, if ever the proposal will be enacted. Given the tenor of Labor's tax policies one would not be surprised if this Budget measure was still proceeded on.

It is difficult to understand why this proposed amendment is needed at all. The author understands that there were some tax opinions floating around the market place suggesting that it was possible to introduce new assets into a testamentary trust and yet minor child beneficiaries would still be exempted from Division 6AA's penalty tax rates. However, these opinions were always plainly wrong and not in the spirit of the law. The testamentary trust exceptions to Division 6AA are exceptions to an anti-avoidance measure and need to be read and interpreted in that light. The legislation already contains anti-avoidance provisions to prevent this and the Explanatory Memorandum to the *Income Tax Assessment Amendment Bill (No. 6) 1979* (being the legislative bill that enacted Division 6AA into law) indicates that various anti-avoidance provisions were embedded into Division 6AA to prevent the inappropriate 'padding out' of property to take advantage of the exemptions from Division 6AA.[26] Presumably since Division 6AA was enacted such a long time ago in early 1980 when John Howard was Treasurer these points have been forgotten in the mists of time.

3.1 Anti-avoidance provisions in Division 6AA

3.1.1 Section 102AG(3) – non-arm's length dealing

To understand the way the provisions of section 102AG(3) operate it is instructive to consider the terms of the old section 102AG(3) it replaced and the facts of *Furse*. The old wording of section 102AG(3) was as follows:

> '*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***

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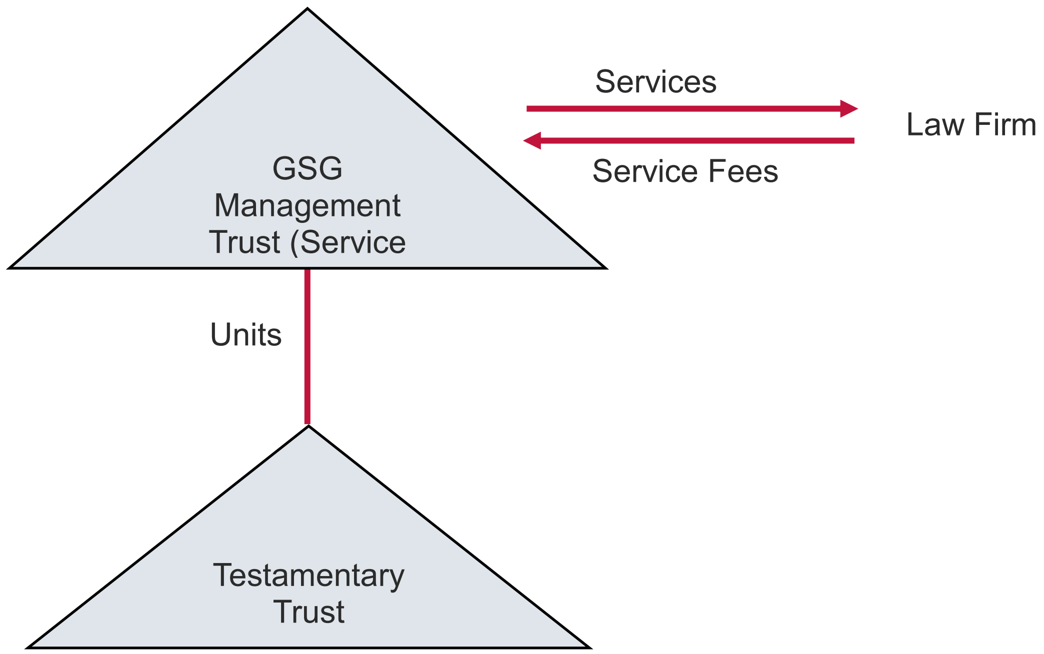
[25] Page 44 of Budget Measures, Budget Paper No. 2, 2018-2019.

[26] It can also be seen in John Howard's Ministerial Speech to the House of Representatives on 14 November 1979 – See the Hansard at page 2977.

> ***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.*' [Emphasis added.]

Furse involved a testamentary trust which was established with $1 corpus. Originally the trustee of the testamentary trust was Furdel Pty Ltd. The trustee of the testamentary trust was changed to Delfur Pty Ltd. The directors and shareholders of Delfur Pty Ltd were Mr and Mrs Delaney. The testamentary trust then borrowed $10 from Furdel Pty Ltd and acquired five units in a solicitors' service trust called the GSG Management Trust. The trustee of the GSG Management Trust was GSG Management Pty Ltd of which Mrs Delaney and Mrs Gillis were the shareholders and directors.

The partners of the law firm which used the service trust were Mr and Mrs Delaney and Mr Gillis. Mrs Gillis was not a partner of the law firm. The service trust was initially funded with interest free loans amounting to $100,000 from Mr Gillis, Furdel Pty Ltd and certain superannuation funds.



At first instance the Administrative Appeals Tribunal (**AAT**) applied the former section 102AG(3) to the arrangement such that income distributed by the testamentary trust to minor child beneficiaries was subject to Division 6AA penalty tax rates. On appeal to the Federal Court, Justice Hill ruled that the AAT had made errors of law in coming to its decision because the AAT considered that the GSG Management Trust was effectively controlled by the partners of the law firm, when the shareholders and directors of its corporate trustee were Mrs Delaney and Mrs Gillis (not a partner of the law firm).

Significantly Justice Hill ruled that the former section 102AG(3) required a determination as to whether the parties were dealing at arm's length. What is required in determining whether parties deal with each other at arm's length is 'an assessment whether, in respect of that dealing, they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing was a matter of real bargaining'.[27] The AAT erred because it merely looked at the relationship between the parties, rather than whether they were dealing at arm's length. Additionally the AAT failed to identify the agreement out of which the non-arm's length income arose. The matter was remitted back to the AAT for review.

The provisions of section 102AG(3) were completely replaced with effect from 7 March 1994 with the following current wording of section 102AG(3):

> '[I]*f 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.*' [Emphasis added.]

The Explanatory Memorandum to the *Taxation Laws Amendment Bill (No. 4) 1994* (**1994 EM**) indicates that the amendment to section 102AG(3) was intended to overcome the difficulties in applying the anti-avoidance rule raised by *Furse*. Paragraph 2.44 of the 1994 EM provides that the section would apply to a situation where a family member arranges for high returns to be paid to a trustee investing nominal property held on a child's behalf, 'perhaps by exercising a discretion to distribute income to a trust with no property in which the trustee is persuaded to take units.'

Later on paragraph 2.47 of the 1994 EM provides:

> '*2.47 In relation to a unit in a unit trust, for example, the relevant question in determining the arm's length return is how much return would a person be entitled to if all parties were dealing at arm's length in relation to the return on that unit. The fact that property is transferred at arm's length does not establish that the income from investment of that property is an arm's length return. If the investment is by subscription of nominal property for a unit in a discretionary unit trust, then the arm's length return is nominal or zero. Any greater return is no arm's length return because a person who did not benefit from a non-arm's-length arrangement would get no significant return on his/her holding of such a unit.*'

Further at paragraph 2.52 of the 1994 EM provides:

> '*2.52 The* ***proposed amendments extend beyond the dealings between the party deriving the excepted income and the party from whom that income is derived****.* New paragraphs 102AE(6)(b) and 102AG(3)(b) ***extend to parties to any act directly or indirectly connected to the derivation of such excepted income****. Take for example the situation of a minor investing (in partnership with another person) in a company. The proposed new provision ensures not only that the return from the partnership to the minor is*

[27] At 1132.

> *at arm's length, but that the return from the company to the partnership is at arm's length. The provision allows inquiry into any transaction related to the derivation of excepted income, even if removed from that derivation. This confirms the former provisions.*' [Emphasis added.]

The above EM comments indicate that in determining whether the current section 102AG(3) applies, it is not enough to consider whether the testamentary trust invested on an arm's length basis, the entity in which the testamentary trust invests in must also derive its income on an arm's length basis. The amended section 102AG(3) should apply to the testamentary trust income distributed to minors in *Furse* because interest free loans to the service trust enabled the service trust to derive the relevant income. Similarly an injection of assets into the testamentary trust for no consideration should be caught by section 102AG(3).

This non-arm's length enquiry has parallels with the non-arm's length income (**NALI**) rule for superannuation fund income in section 295-550 of the *Income Tax Assessment Act 1997* (**ITAA 97**). Under the NALI rule a superannuation fund may derive non-arm's length income if the entity in which it invests derives income from non-arm's length dealings.[28]

The practical effect of section 102AG(3) is that to ensure that minor child beneficiaries benefit from excepted trust income from the testamentary trust, the testamentary should always act on an arm's length basis. If it does not then any income derived from such a non-arm's length dealing is not excepted trust income and should be distributed to adult beneficiaries or other entities besides the children to prevent Division 6AA penalty rates from applying.

3.1.2 Section 102AG(4) – agreement to secure excepted trust income

Section 102AG(4) ITAA 36 applies where a trustee derives assessable income directly or indirectly under or as a result of an agreement that was entered into or carried out by any person for the purpose, or for purposes that included the purpose, of securing that that assessable income would be excepted trust income. In these circumstances, such income does not qualify as excepted trust income. A merely incidental purpose is not relevant.[29]

In *FCT v Bill Wissler (Agencies) Pty Ltd* 85 ATC 4626, GN Williams J of the Supreme Court of Queensland suggested that section 102AG(4) ITAA 36 would not apply where the parties to an otherwise legitimate commercial agreement were merely aware at the time they entered into the agreement that a consequence would be that moneys received under the agreement would be excepted trust income.

An injection of assets into a testamentary trust for less than market value is likely to be caught by section 102AG(4) where the intention is to boost excepted trust income.

[28] See *Allen & Anor (As Trustees for the Allen's Asphalt Staff Superannuation Fund) v FCT* 2011 ATC 20-277.
[29] Section 102AG(5) ITAA 36.

3.2 Income allocation issues

Another practical reason why injecting assets into a testamentary trust with the aim of boosting excepted trust income does not work relates to the difficult income allocation issues that arise as a result. Where a trust contains a mixture of property – i.e. property on which excepted trust income is derived and also property on which the income derived is subject to tax at the penalty rates under Division 6AA, then it is necessary to apportion a trust distribution made to a minor child beneficiary between the excepted income and the other income (which is subject to penalty tax under Division 6AA)?

The Explanatory Memorandum the *Income Tax Assessment Amendment Bill (No.6) 1979* indicates that section 102AG(8) ITAA 36 lays down a rule for income apportionment in relation to discretionary trusts. Under this rule the net income received by each beneficiary of the trust is “regarded as receiving the same proportion of each type of income as the ratio of the amount of property yielding that type of income bears to the total amount of property.”

The Explanatory Memorandum provides the following example of income apportionment:

> Assume $10,000 of property was transferred to a discretionary trust, comprising $6,000 being a cash legacy from a deceased estate transferred within 3 years of the death of the deceased person (to which section 102AG(2)(d)(ii) ITAA 36 applies unaffected by the limit in section 102AG(7) ITAA 36) and a gift from a parent, for the benefit of two children A and B. The net income of the trust is $1,200 and the trustee exercises its discretion to distribute $1,100 to A and $100 to B.
>
> The apportionment rule would consider that A derived the following:
>
> $6000/$10,000 x $1,100 = $660 (excepted income)
>
> $4,000/$10,000 x $1,100 = $440 (subject to Division 6AA penalty tax)
>
> B would be regarded as having derived:
>
> $6,000/$10,000 x $100 = $60 (excepted income)
>
> $4,000/$10,000 x $100 = $40 (subject to Division 6AA penalty tax)

The example provided by the Explanatory Memorandum is too simplistic in that it assumes that the transfers of property for the benefit of the children occur at the same time, at the start of the trust. Difficulties arise in trying to apply the apportionment rule where further settlements are made a trust after its establishment. For instance, say a discretionary testamentary trust is established, and then a later settlement of property is made on the trust which does not fall within the excepted income exceptions. Presumably one would need to obtain a market valuation of trust property which is covered by excepted income exceptions, and trust property which is not, at the time of the additional settlement so as to apply the apportionment rule. A similar market valuation/apportionment exercise may need to be done where property is devolved to a pre-existing inter vivos trust under the exception in section 102AG(d)(i) of the ITAA 36.

To undertake this apportionment exercise there would need to be careful book keeping so as to isolate that property which is covered by the excepted income exceptions. This is particularly so where such property is sold by the trust, and reinvested into other assets. There is no statutory apportionment rule for fixed trusts.

The take home message from this income allocation issue is that to reduce compliance costs, it is wise to keep a true testamentary trust 'pure' by not making further settlements on the trust which are not covered by an excepted income exception.

3.3 Concerns arising from May 2018 Federal Budget announcement

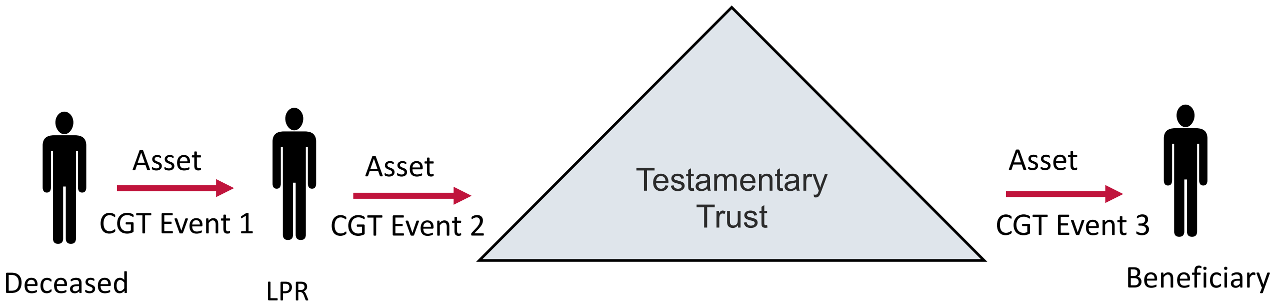
The main concern arising from May 2018 Federal Budget announcement relates to what mechanism will be used to limit excepted trust income 'to income derived from assets that are transferred from the deceased estate or the proceeds of the disposal or investment of those assets'. Justice Hill's decision in *Furse* was a practical decision which rejected the ATO's narrow view that excepted trust income of a testamentary only comprised income derived on property 'sourced' from the deceased estate. To Justice Hill's mind excepted trust income could arise from assets held by a testamentary which were not actually assets of the deceased estate, but rather were acquired subsequently using borrowings or sale proceeds on the sale of deceased estate assets (i.e. reinvestments of such sale proceeds).

If the Budget measure is drafted too strictly then it may lead to prohibitive compliance costs in tracing through reinvested assets. Given the anti-avoidance rules in sections 102AG(3) and (4) it is difficult to know what further provisions could be enacted to achieve the Government's aim. Hopefully the new amendments will not prevent husband and wife mirror wills from being able to access the testamentary trust exception from Division 6AA.

4 The CGT death rollovers and testamentary trusts

There are three CGT death rollovers relevant to testamentary trusts, being:

1. the rollover for the transfer of deceased estate assets from the testator to the LPR;
2. the rollover for the transfer of those deceased estate assets from the LPR to the testamentary trust; and
3. the rollover for the transfer of those deceased estate assets from the testamentary trust to a beneficiary.



4.1 Distributions from testator to LPR

Generally when a taxpayer dies, any capital gain or loss from any event relating to a CGT asset owned by the deceased is disregarded under section 128-10 of the ITAA 97. This section provides the CGT death rollover for the transfer of deceased estate assets from the deceased to their LPR so the assets may be distributed under their will or the rules of intestacy.

The LPR is deemed to have acquired the deceased estate CGT assets on the date the deceased died.[30] The LPR's cost base in those assets (other than for a property which was a main residence for the deceased immediately before they died) is as follows:[31]

1. for **pre-CGT assets** in the hands of the deceased – the first element of the LPR's cost base is the market value of the asset on the day the deceased died – the asset also converts to a post-CGT assets in the hands of the LPR; and
2. for **post-CGT assets** in the hands of the deceased – the first element of the LPR's cost base is the deceased's cost base at the date of their death.

[30] Section 128-15(2) of the ITAA 97.
[31] See section 128-15(4) of the ITAA 97.

4.2 Distributions from LPR to the testamentary trust

Section 128-15(3) ITAA 97 outlines a CGT rollover where assets of a deceased estate ‘pass’ to a beneficiary of the estate. Any capital gain or loss made on the asset passing to a beneficiary are disregarded. The concept of a ‘beneficiary’ for these purposes includes the trustee of a testamentary trust.

A CGT asset is taken to have ‘passed’ to a beneficiary of a deceased’s estate if the beneficiary becomes the owner of the asset whether under the terms of the deceased’s will, the intestacy laws or a deed of arrangement.[32]

The CGT rollover in section 128-15(3) of the ITAA 97 covers the distribution of deceased estate assets from the LPR to a testamentary trust.

A trustee of a testamentary trust is taken to have acquired the CGT assets of the deceased at the date of the deceased’s death (rather than on the date they were distributed by the LPR) and the first element of the cost base for the trustee is deemed to be:

1. for **pre-CGT assets** in the hands of the deceased – the market value of the asset on the day the deceased died; and

2. for **post-CGT assets** in the hands of the deceased – the deceased’s cost base at the date of their death.[33]

The trustee of the testamentary trust is also able to include in its cost base any expenditure the LPR has incurred, up to the time of the disposal by the LPR, that the LPR would have been entitled to include in its cost base had it retained the asset.[34]

4.3 Distributions from the trustee of the testamentary trust to the remainder beneficiary

There is no legislative provision that provides a rollover for a transfer of a deceased estate assets from the trustee of testamentary trust to a beneficiary. However, the Commissioner has a long standing administrative practice of treating the trustee of a testamentary trust in the same way as a LPR is treated for the purposes of Division 128 of ITAA 97 (and in particular section 128-15(3) of the ITAA 97). This practice is outlined in Practice Statement Law Administration PS LA 2003/12.

This administrative practice provides the CGT rollover for a transfer of deceased estate assets from the trustee of the testamentary trust to a beneficiary. Under the rollover:

1. any capital gain or loss that the trustee of the testamentary trust makes is disregarded under section 128-15 (3) of the ITAA 97; and

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[32] Section 128-20 of the ITAA 97
[33] Section 128-15(4) of the ITAA 97
[34] Section 128-15(5) of the ITAA 97.

2. the beneficiary is deemed to have acquired the CGT assets of the deceased at the date of the deceased's death (rather than on the date they were distributed by the LPR) and the first element of the cost base or the beneficiary will be:

   a. for **pre-CGT assets** in the hands of the deceased – the market value of the asset on the day the deceased died; and

   b. for **post-CGT assets** in the hands of the deceased – the deceased's cost base at the date of their death.[35]

The effect of PS LA 2003/12 is that CGT death rollover applies twice (in particular sections 128-15(2), (3) and (4) of ITAA 97):

1. initially, when the LPR is the 'LPR' for the purposes of Division 128 and the testamentary trust trustee is the 'beneficiary'; and

2. subsequently, when the testamentary trust trustee is treated as an 'LPR' for the purposes of Division 128 and the beneficiary of the testamentary trust is treated as the 'beneficiary'.

This administrative rollover applies regardless of whether the testamentary trust is a fixed trust or a discretionary trust. This can be seen in Example 2 of PS LA 2003/12:

> '*Mr Smith died in 2001. At that time, he owned a variety of assets acquired after 19 September 1985. His will provides that the assets are to be held by the trustee of a trust created under his will. The trustee can distribute those assets at his absolute discretion among a wide range of objects including trustees of various trusts.*
>
> *In 2012, the trustee of the testamentary trust validly transferred some of the assets to Mr Smith's children and some to the trustee of another trust. The Commissioner accepts that the transfers did not result in a CGT event happening to the trustee of the testamentary trust if the beneficiaries agree that their acquisition cost for the assets is equal to the trustee's cost base.*
>
> *In 2014, the trustee of the beneficiary trust (itself a discretionary trust) transfers one of the assets to one of its beneficiaries. CGT event A1 happens at the time of the transfer.*'

PS LA 2003/12 is not a binding public ruling and the Commissioner may choose not to follow it. If the Commissioner chooses not to follow his practice then the testamentary trust trustee would be liable to pay CGT on any gain made on the transfer of a deceased asset to a beneficiary. The Full Federal Court case of *Macquarie Bank Limited v FCT* [2013] FCAFC 119 is a stark reminder of the Commissioner's ability to change his administrative practice retrospectively with no redress for a taxpayer who has followed such administrative practice. That said, the Commissioner's administrative practice as enunciated in PS LA 2003/12 is a long standing practice and for the Commissioner to deviate from it would overturn many more arrangements in the community than the OBU practice statement which was at issue in the *Macquarie Bank* case.

In the 2011 and 2012 Federal Budgets, it was proposed that the current ATO practice set out in PS LA 2003/12 of allowing a testamentary trust to distribute an asset of a deceased person without a

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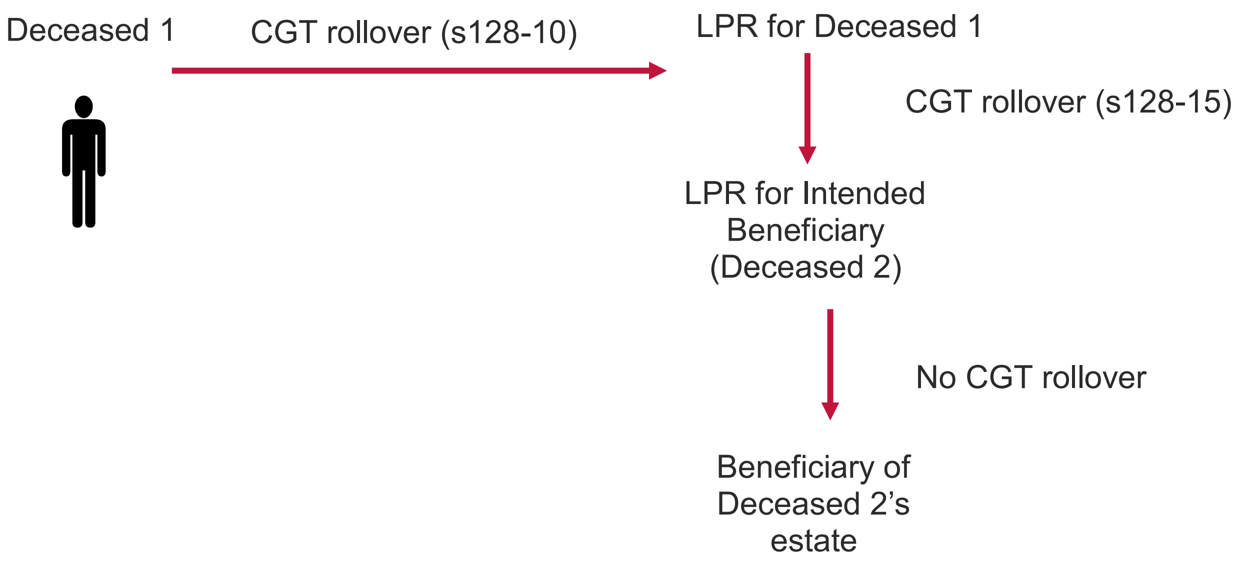
[35] Section 128-15(4) of the ITAA 1997.

CGT taxing point occurring would be codified. Unfortunately this proposal was abandoned by the Government on 14 December 2013 as not being an important enough tax reform, with the result that taxpayers must now continue to rely on the ATO's administrative practice in PS LA 2003/12.

4.4 Where an intended beneficiary dies before administration is completed

Currently there is a CGT issue where the intended beneficiary of a deceased estate dies before the administration of the deceased estate is completed. This is because whilst section 128-15 of the ITAA 97 provides a CGT rollover for an asset passing from a deceased's LPR to the beneficiary's LPR. There is no CGT rollover which applies where the asset passes (ultimately) from the first deceased's LPR via the second deceased's LPR to the trustee of a testamentary trust or a beneficiary of the second deceased. This is because the asset was **not** actually owned by the intended beneficiary (second deceased) when they died. It is a key requirement of the CGT rollover in section 128-15 of the ITAA 97 that the deceased own the asset before it applies.



In June 2012 the Federal Government proposed to introduce measures to allow the intended beneficiary's LPR to access the rollover where the intended beneficiary dies before an asset that the first deceased owned passes to them.[36] It was proposed that this change would be backdated to apply to CGT events that happen in the 2006-07 income year.

Unfortunately once again on 14 December 2013, the Government indicated that it would not proceed with this proposed measure and as such there still remains an issue that there is no CGT rollover where an intended beneficiary dies before the administration of the first's deceased's estate is completed.

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[36] This proposal was contained in Treasury's 'Minor amendments to the capital gains tax law' paper in June 2012.

4.5 Foreign resident capital gains withholding (FRCGW)

The FRCGW provisions apply from 1 July 2016. Broadly, these provisions require the transferee of a transaction that involves either:

1. Australian land; or

2. 10% or more interests in companies or trusts whose majority of assets, by market value, comprise Australian land,

to withhold and remit 12.5% of the market value asset transferred unless the transferee has relevant evidence that the transferor is an Australian resident for tax purposes, or the interests in the trust or company do not constitute taxable Australian property.

In the case of Australian land, a transferor will only be considered an Australian resident for these purposes if the transferor obtains and provides an ATO clearance certificate to the transferee by settlement of the transaction. Where the relevant asset is an interest in a company or trust whose majority of assets comprise Australian land, then the transferor may avoid withholding by providing the transferee with a written declaration that the transferor is an Australian tax resident or the interests are not taxable Australian property. Such a declaration would need to be provided by settlement of the transaction.

It is often forgotten in testamentary asset transfers that this withholding could technically apply. The Commissioner has issued a legislative instrument 'PAYG Withholding variation for foreign resident capital gains withholding payments – deceased estates and legal personal representatives' (F2016l01396) which prevents this withholding applying most testamentary asset transfer cases.

Under that legislative instrument **no** withholding is required where as the result of the death an individual:

1. the LPR is taken to have acquired the relevant asset following the death of the individual;

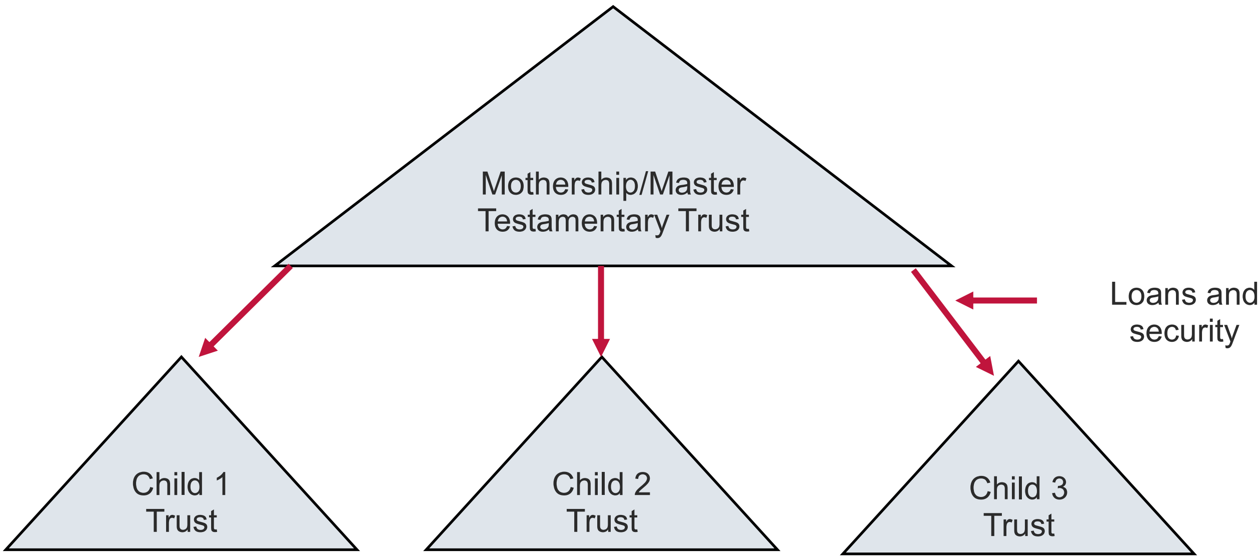
2. a beneficiary obtains ownership of the relevant asset by way of direct transfer from the deceased or by transfer from the LPR of the deceased; or

3. a surviving joint tenant acquires the deceased joint tenant's interest in the relevant asset.

Significantly, it is not clear whether this legislative instrument covers the situation where a testamentary trust trustee distributes an asset to a beneficiary. Conceivably if the Commissioner applies the position in PS LA 2003/12 of treating the testamentary trust trustee in the same position as a LPR then the legislative instrument should apply to this transaction. However, since there is uncertainty as to whether the Commissioner will adopt this position it is recommended that the testamentary trust trustee ensure that the relevant procedures are undertaken to prevent withholding applying (as outlined above) or alternatively withholding applies.

5 One testamentary trust to rule them all or multiple trusts

A common issue that arises when considering the use of a testamentary trust is whether there should be one testamentary trust, or multiple testamentary trusts where there a multiple ultimate beneficiaries (e.g. children). Where family law concerns are paramount there may be a desire for there to be one testamentary trust with beneficiaries being confined to the will maker's bloodline. The argument being that the Family Court is more likely to treat such a trust as a 'financial resource' in property proceedings rather than matrimonial property on the basis that the divorcing spouse is only a discretionary beneficiary of the trust and perhaps only co-controls the trust with their siblings. In situations where there is a desire for independence between beneficiaries, a variation on this single testamentary trust model is what may be called the 'mother ship' or 'master trust' model which is best illustrated diagrammatically:



Under the 'mother ship'/'master trust' model, assets of the trust are loaned out or leased/licenced to the children's trusts and security is taken in relation to these loans and leases/licences. The aim being that should a child's relationship breakdown the mothership testamentary trust can preserve family wealth by calling in the security. Each child's trust could also be testamentary trusts established under the will, or inter vivos trusts.[37] The ability for this mothership model to work depends on there being generally liquid assets in the deceased estate and it can break down if income and capital distributions from the mothership testamentary trust are not managed in such a way that the trust continues to be shared across the family.

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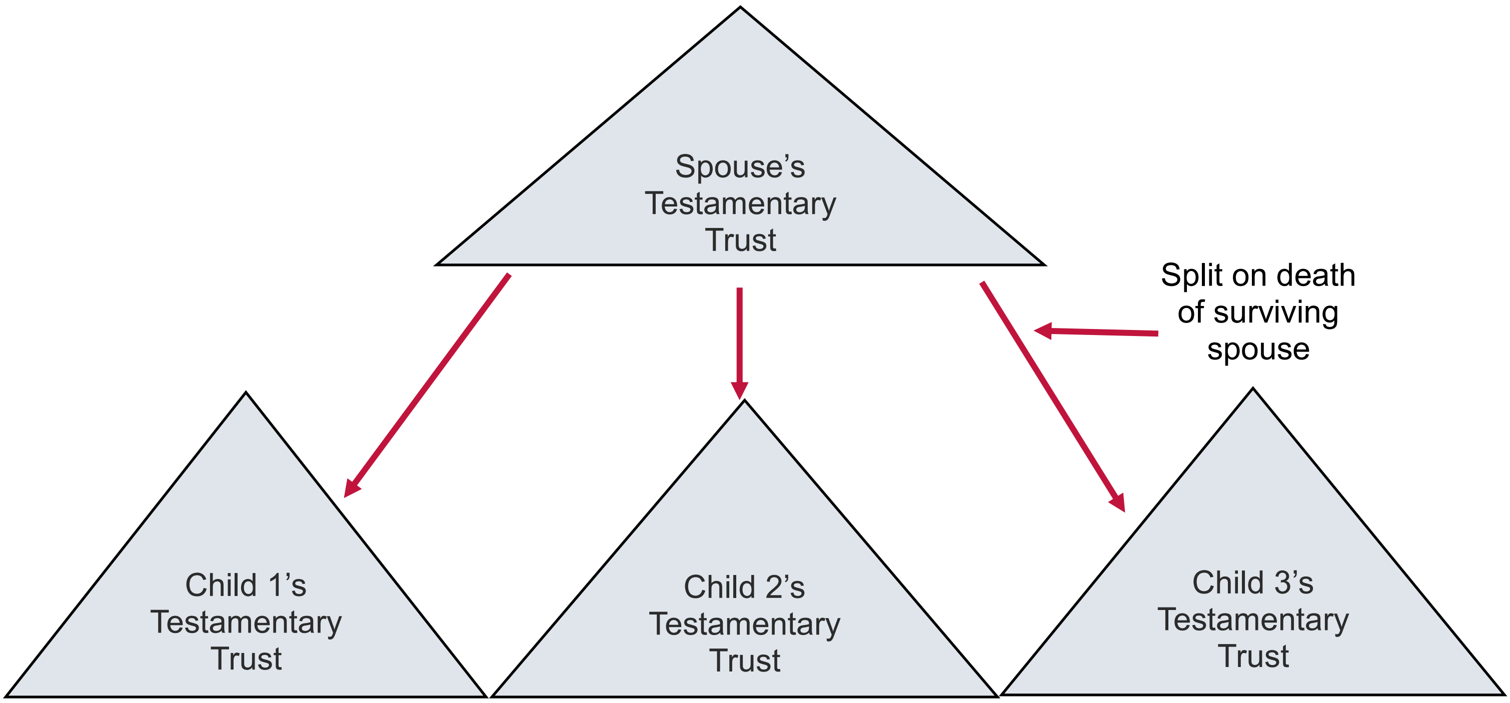
[37] If the mothership testamentary trust has made a family trust election to carry forward losses or wishes to pass on the benefit of franking credits attached to franked dividends, then it would be necessary to ensure the children's trusts fall within the mother testamentary trust's family group if they were to receive income or capital distributions from the mothership testamentary trust.

The estate claims of the surviving spouse and children may also be relevant in determining whether one or more testamentary trust is established. A testator may be want to provide for the surviving spouse during their lifetime but there is a concern to protect family wealth for the testator's children (who may not be issue of the testator's spouse). In such a case there is a strategy of a flowering testamentary trust,[38] where terms of the will create one discretionary testamentary trust during the lifetime of the surviving spouse which contains all members of the family as discretionary beneficiaries. On the death of the surviving spouse, the testamentary trust splits into a number of testamentary trusts – one for each surviving child. The benefit of the flowering testamentary trust is reduced compliance costs since there is only one testamentary trust during the surviving spouse's lifetime. Additionally because the trust splits into multiple testamentary trusts for the children there is a benefit of independence for each child to control their own destiny. Since the children's testamentary trusts were created under the will, arguably the excepted trust income exception in section 102AG(2)(a)(i) of the ITAA 36 should apply to the children's testamentary trusts. This is provided the dealings of the single testamentary trust (which benefited the surviving spouse during their lifetime) have always been on arm's length such that the anti-avoidance rule in section 102AG(3) of the ITAA 36 does not apply.



I personally do not favour adopting the flowering testamentary trust strategy because real CGT and duty issues arise on the transfer of CGT assets to effect the split of the surviving spouse's testamentary trust into the children's testamentary trusts.

On the CGT front the transfer to the children's testamentary trust prima facie triggers CGT. The main argument against CGT applying is that the administrative rollover provided by the ATO in PS LA 2003/12 should apply to this transfer because the children's testamentary trusts in effect represent

[38] See 'Testamentary trust will structuring', Will Monotti, Edward Skilton and Rob Jeremiah, Taxation in Australia Vol 53(1) at 33.

beneficiaries of the testamentary trust. The ATO adopted this reasoning in private ruling PBR 1012846046513. That private ruling did not involve a flowering testamentary trust, but rather a single testamentary trust intended to benefit the will maker's children. The children had different investment objectives and life circumstances and so there was a desire to split the testamentary trust between the children. In that private ruling the ATO accepted that the transfer of capital assets to inter vivo trusts (for particular children and which had been subsequently added as beneficiaries to the trust) did not trigger CGT because the administrative rollover in PS LA 2003/12 applied.[39]

Should it be accepted that the administrative rollover applies to the transfer of assets to the children's testamentary trusts, relevant points to note are:

1. the rollover only applies to CGT assets which formed part of the deceased's estate – if other trust assets were acquired during the surviving spouse's life time then the rollover does not apply, and CGT is triggered by the transfer;
2. the cost base which the children's testamentary trusts have in CGT assets which formed part of the deceased estate and which are transferred to them under the terms of the will may be very low due to the passage of time. This is because where the deceased held such assets as a post-CGT asset, the children's testamentary trust will inherit the deceased's cost base in that asset. If the deceased held such assets as pre-CGT assets, then the children's testamentary trusts will have a cost base in such assets equal to their market value at the date the deceased died.

Whether the split to the children's testamentary trusts triggers duty depends on whether the assets transferred constitute dutiable property. Where the deceased estate assets are not dutiable property (e.g. shares or units in entities which are not landholders, cash or non-land business assets located in every Australian state or territory jurisdiction apart from Queensland, Western Australia or the Northern Territory[40]) then the split should not trigger duty.

Where the assets transferred are dutiable property (e.g. land) then a duty liability is likely to be triggered. This is because the deceased estates concession from duty may not apply. The issue in most jurisdictions is whether such a transfer is in conformity with the will or whether it represents a distribution of the deceased estate, and it is not likely that either of these conditions are met. For instance, in *Shipard v Chief Commr of State Revenue* [2006] NSWADT 254 the Administrative Decisions Tribunal held that a testamentary trust was not a 'trust contained in the will' such that the deceased estates concession in section 63 of the *Duties Act 1997* (NSW) could apply. Revenue NSW applies *Shipard* in NSW to deny the deceased estates concessions to transfers to beneficiaries out of a testamentary trust.

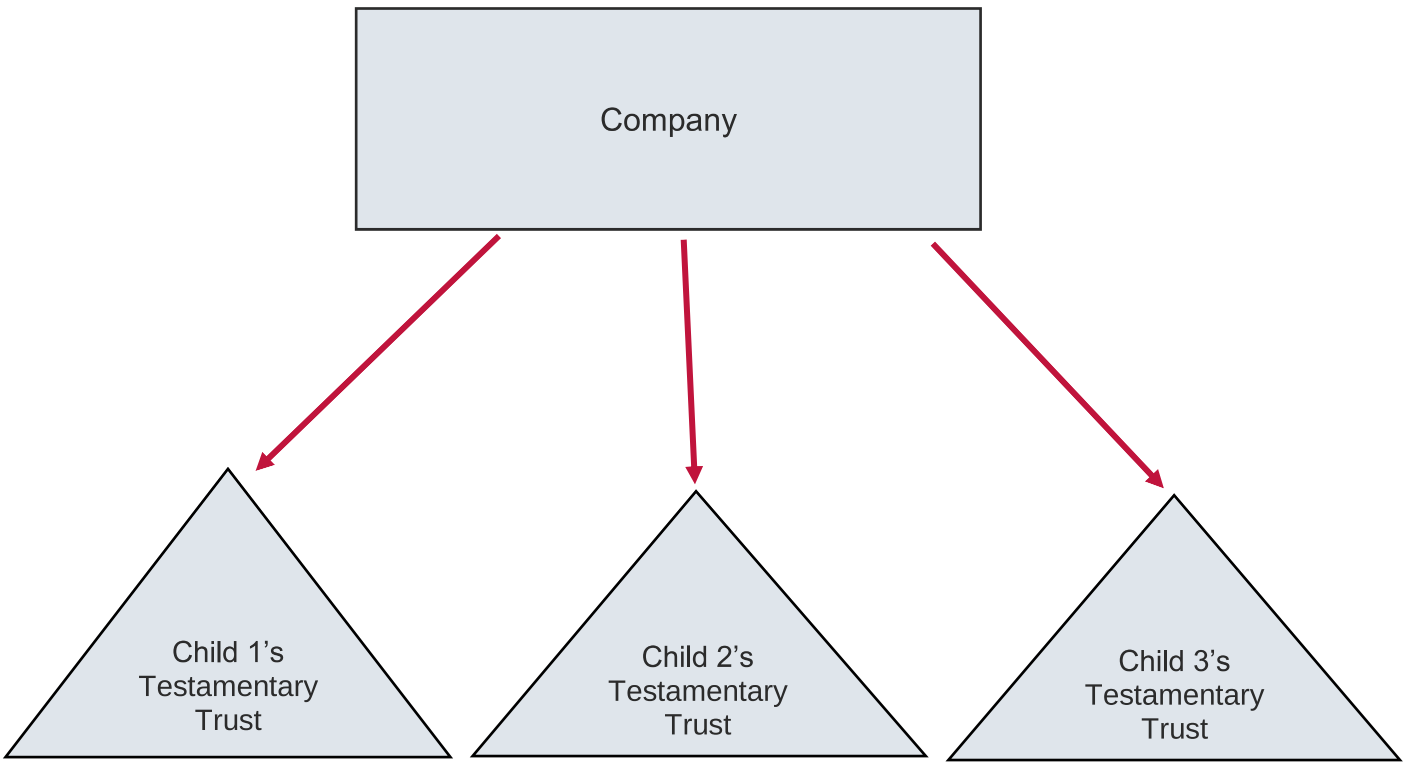
Where the deceased estate comprises mainly shares or units in non-land holder entities one may see the attraction of the flowering testamentary trust strategy if one is willing to take the position that the administrative rollover in PS LA 2003/12 applies to split, since there is no CGT or duty. On one view the strategy represents a 'neat' way of using the CGT death rollover to split a trust. The rollover occurring both in relation to the creation of the children’s testamentary trusts later on and the transfer of the assets from the surviving spouse’s testamentary trust to the children’s testamentary trusts. The strategy avoids the resettlement issue raised by the ATO with regards to trust splitting in draft

[39] For other private rulings with the same result see PBRs 1051376054839 and 1013015219230.
[40] Queensland, Western Australia and the Northern Territory still levy duty on non-land business assets.

Taxation Determination TD 2018/D3, since the split is embedded in the terms of the trust from the outset. The ATO's views in TD 2018/D3 are difficult to understand, particularly, the suggestion that the resettlement cases of *FCT v Commercial Nominees of Australia Ltd* [2001] HCA 33 and *FCT v Clark* [2011] FCAFC 5 are not relevant to the issue of trust splitting. This paper does not propose to outline the arguments against the ATO's views in TD 2018/D3 but merely notes the possibility of using the CGT death rollover to split a trust to overcome the CGT issue suggested by the ATO in TD 2018/D3.

In my view if the asset base is large enough, or if it is possible to use life insurance to increase deceased estate assets, multiple testamentary trusts for each child is recommended so each can control their own destiny later on. This prevents family conflict later on as the children are not forced to be together in one entity. If there is a surviving spouse to take care of during their lifetime then control of each of the children's testamentary trusts can be given to the relevant persons (whether it be the surviving spouse themselves or an independent trustee) during this period of time with the view that the trusts are controlled on a unified basis to benefit of the surviving spouse primarily. On the death of the surviving spouse control of each child's testamentary trust would then be divested to the relevant child. Whilst multiple trusts mean increased compliance costs, they are a cost of providing beneficiaries with independence and are likely to be small compared to CGT and duty issues that may arise where a large testamentary trust is broken up.

Apart from having separate trusts for each child to avoid future conflict, thought should be had to assets that distributed to each child's testamentary trust. Whilst you may get separation at the bottom with separate testamentary trusts, you may not achieve independence if the deceased estate asset is lumpy. Consider the following situation:



In the above scenario the Company represents virtually all of the testator's assets. Whilst the testator has provided for separate testamentary trusts, the children are still tied to each other in relation to the direction of the Company's investments and dividend policy. It may be possible for each child's testamentary trust to interpose a wholly owned company between themselves and the Company using the Subdivision 122-A rollover. This would assist in managing differences as to the size of a dividend and when the company pays a dividend. However, the differences in investment policy cannot be managed without breaking the company apart.

Whilst it is not always feasible, where a testator has multiple beneficiaries good estate planning may be to build up wealth in a number of entities which can then be gifted separately to different beneficiaries. For instance, rather than having one bucket company, thought may be had to having a few to avoid the situation where all the wealth is trapped in one structure.

Where significant estate assets are business assets, the small business CGT concessions may provide a way of restructuring assets to provide separation. (Noting that the small business restructure rollover may not generally be used for estate planning because of the requirement that there be a genuine restructure of an ongoing business.) Given that the small business CGT concessions have a hard cliff, where they are no longer available once a taxpayer exceeds the $6 million net asset value and the $2 million turnover test, thought may be had to restructuring a will maker's business structures during their lifetime prior to these tests being exceeded. Splitting apart the business structure may seem to be a drastic action but gifting a single indivisible structure to heirs who cannot co-operate may be just creating family conflict later on. Where land is involved duty can often be a stumbling block for inter vivos restructures. However, Australian jurisdictions apart from Queensland, Western Australia and the Northern Territory do not levy duty on non-land business assets allowing for restructures of such assets.

Where a will maker has not chosen to split their assets during their lifetime and gifts a single bulky asset to heirs who wish to now go their own way, all may not be completely lost where the asset is a business asset. Section 152-80 of the ITAA 97 may provide a way to minimise the tax on break up of the estate. That section provides access to the small business CGT concessions based on the deceased person meeting the threshold conditions to claim the small business CGT concessions just before their death – this is as opposed to the disposing taxpayer (i.e. either the LPR, testamentary trust trustee or a beneficiary who receives the asset under the will) having to meet those conditions. This can be useful where you have some beneficiaries who do not want to be involved in the business and may not otherwise meeting the threshold conditions to claim the small business CGT concessions.

Section 152-80 ITAA 97 provides access to the small business CGT concessions where all the following are met:

1. the relevant CGT asset on which the capital gain is made must either be a deceased estate asset or the asset owned by the deceased as a joint tenant;

2. any of the following applies:

    a. the asset devolves to the LPR;

    b. the asset passes to the beneficiary;

c. the asset owned by the deceased joint tenant reverts to the surviving joint tenants; or

d. the asset devolves to a trustee of a testamentary trust;

3. the deceased would have been able to claim the small business CGT concessions if the asset was disposed of immediately before their death (i.e. just before death the deceased must have satisfied the $6 million net asset value test or have been a small business entity and the CGT asset must have met the active asset test); and

4. the relevant CGT asset is disposed of by the LPR, a beneficiary, a surviving joint tenant, or a trustee or beneficiary of a testamentary trust **within two years of the deceased's death**.

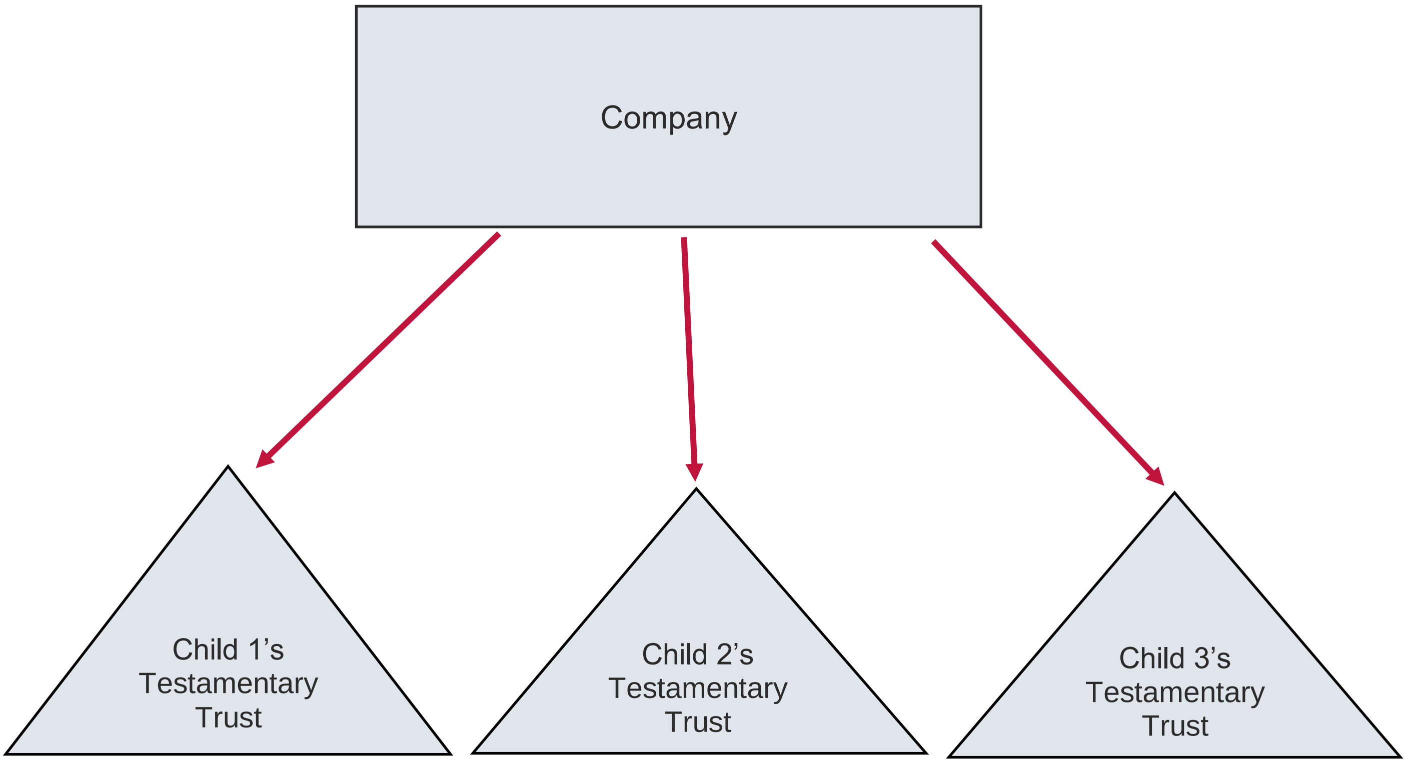
Where the conditions of section 152-80 are met the LPR, a beneficiary, a surviving joint tenant, or a trustee or beneficiary of a testamentary trust may claim the benefit of various small business CGT concessions to reduce the taxable capital gain they make on the disposal of the deceased estate asset.

Some of the small business CGT concessions contain additional conditions which must be met before they can be claimed, once again section 152-80 operates such that these conditions are assessed against the deceased just before the date of their death. Section 152-80 does make two modifications with respect to these additional conditions:

1. in relation to the 15 year exemption, there is no need for the asset disposal to be related to the deceased's retirement – as they have already died; and

2. in relation the retirement exemption, there is no requirement that monies be contributed to superannuation even if the deceased was under 55 years when they died.

Going back to the example where a single company is gifted to a number of testamentary trusts. Assume that company carries on an active business.



Child 1 and Child 2 are actively involved in the business whilst Child 3 ran away to the city and became a high flying barrister with no interest in the family business. The family company was gifted to the three children equally on the basis of fairness and an unrealistic desire on the part of the will maker to encourage Child 3 back to a more productive business than the law. Having Child 3's presence in the company is disruptive because they are not involved in the business but being a lawyer still has opinions on how it should be run and how profits should be drawn from the company.

Provided the children act quickly within 2 years of the will maker's death, section 152-80 of the ITAA 97 may provide a tax effective way of resolving family conflict. In this case, Child 1 and 2's testamentary trusts may seek to buy out the shares held by Child 3's testamentary trust in the company for market value. Provided the will maker could have met the threshold conditions of the small business CGT concessions just before their death, those concessions may be applied to any capital gain made by Child 3's testamentary trust. This is so even if Child 3's testamentary trust cannot itself meet the threshold conditions of the small business CGT concessions. For instance, this result applies even if Child 3 controls the trustee of their testamentary trust such that they are connected with their testamentary trust, and Child 3's net assets causes their testamentary trust to fail the $6 million maximum net asset value test.

Section 152-80 of the ITAA 97 may be used alternatively in situations where the will maker gifts a significant business asset to an individual personally and for asset protection and income splitting reasons it is desired to move that asset to a discretionary trust. There may also be a benefit of a step up in cost base where the asset was post-CGT in the deceased's hands – although there should be other commercial reasons for such a transfer. Section 152-80 may also be used to prevent CGT arising on the creation of a post-mortem trust.

Whether a single testamentary trust can work for multiple heirs depends on family dynamics. In my experience having a single testamentary trust can sometimes bring disparate branches of the family together – albeit that this may only be annually for meetings in relation to income and capital distributions from the trust. For some families such enforced meetings are actually enjoyable and allow them to catch up with family members who they may not otherwise see the rest of the year. For other families having one testamentary trust can lay the seeds of family conflict later on and thought should be had in the estate planning discussions as to whether it is better to restructure asset holdings now so that separate testamentary trusts can be set up.

6 Main residences in testamentary trusts

6.1 CGT

Section 118-195 of the ITAA 97 outlines the rules that determine whether the CGT main residence exemption applies on the sale of a main residence from a deceased estate. It contains the rule that the main residence exemption can still be accessed where a beneficiary sells a dwelling they inherit within 2 years of the date of death, provided that if the deceased owned the dwelling as a post-CGT asset then at the date of death the dwelling was the deceased's main residence and was not being used for income producing purposes.

In considering whether to put a main residence in a testamentary trust (e.g. to provide a home for the surviving spouse but with the intention that the capital eventually go to the children) it is necessary to consider the provisions of section 118-195 of ITAA 97. Relevantly the section applies to capital gains made in relation to dwellings owned by individuals whose interest in the dwelling was passed to them as 'a beneficiary in a deceased estate, or … as trustee of a deceased estate'. A 'trustee of a deceased estate' covers the LPR but **not** the trustee of a testamentary trust.

The administrative concession the ATO has in PS LA 2003/12 which treats the trustee of a testamentary trust the same as a LPR for the CGT death rollover in section 128-15, does not extend to section 118-195 of the ITAA 97. However, it appears the ATO has an administrative practice of treating the phrase 'trustee of a deceased estate' in section 118-195 of the ITAA 97 as broad enough to include the trustee of a testamentary trust (as exemplified in ATO IDs 2006/34 and 2004/882) such that the testamentary trustee can claim the benefit of the main residence exemption provided the conditions of section 118-195 of the ITAA 97 are met.

Based on the administrative practice outlined in these ATO IDs, if a deceased's main residence passed to a trustee who then held that property on trust solely for the benefit of:

1. the deceased's spouse (this does not include a spouse who was living permanently separately and apart from the deceased at the time of their death); or
2. a person who is granted a right to occupy the house under the deceased's will,

and those persons actually use the dwelling as their main residence from the date of death, then the main residence exemption should remain available to the testamentary trust trustee on a subsequent disposal of the dwelling. On the death of the spouse or person with the right to occupy, the capital of the trust would go to other named capital/remainder beneficiaries.

Where the dwelling was a post-CGT asset in the hands of the deceased, then the main residence exemption only applies if the dwelling was the deceased's main residence at the date of their death and was not used for income producing purposes at that time. Where the dwelling was rented out at the date of death (e.g. rented out whilst the deceased is in a nursing home), it may be possible to apply the absence concession in section 118-145 of the ITAA 97 to preserve availability of the exemption. Significantly, provided the post-CGT dwelling meets these two requirements the fact that the dwelling may be been used for income producing purposes during the deceased's lifetime is ignored in applying the main residence exemption.

Where the dwelling was a pre-CGT asset there are no requirements in relation to use at the date of death.

If one wanted to maximise the main residence exemption on the sale of a dwelling from a deceased estate, all persons who are living with the deceased in the dwelling should be granted a right to occupy the dwelling under the will. This allows for the possibility that one of the persons granted the right of occupancy may move out in the interim time before the sale of the dwelling. The right of occupancy should have an unlimited time frame. In ATO ID 2004/882 a right of occupancy which only lasted for 18 months from death was not considered by the ATO to provide access to the full main residence exemption because the dwelling was sold after that time had expired and at that point the person occupying the dwelling was occupying it not under a right of occupancy but rather a licence. In such a case the trustee was only able to claim a partial main residence exemption. Whether this strategy works obviously depends on family dynamics since a beneficiary's right of occupancy may impede the remainder beneficiaries' desire to accelerate the sale of the dwelling.

A surviving spouse does not need a right of occupancy under the will for the main residence exemption to continue to apply under section 118-195 of the ITAA 97.

Importantly the spouse or the person with the right of occupancy needs to use the deceased's dwelling from the date of death until the time when the dwelling is sold for the full main residence to apply. Section 118-35 of the ITAA 97 may be relied on by a beneficiary with a right of occupancy who moves into a dwelling as soon as practicable once the estate's administration is complete. That section provides that where a taxpayer moves into a dwelling as soon as it is practicable to do so, that they are treated as using the dwelling as their main residence from the time they acquired an ownership interest in it. Where the dwelling is not used as the main residence of the spouse or beneficiary with a right of occupancy from the time of death to sale, then a partial main residence exemption may apply.

If the intended beneficiary has asset protection concerns then it may be preferable to provide a right to occupy under the will only, rather than a life estate. This is on the basis that it is difficult for a trustee in bankruptcy to extract value from a right to occupy which yields no entitlement to income. However, complications can arise later on if the intended beneficiary (e.g. the surviving spouse) wishes to move into a nursing home and needs funds to meet the refundable accommodation deposit (**RAD**), and they only have a right of occupancy. This is because the right of occupancy would have little value since it carries with it no right to income derived from the dwelling. On this basis some will makers prefer the grant of a life interest to the surviving spouse than a right of occupancy, so that the life tenant has something valuable to trade to meet these needs. Personally I am not sure that a life interest provides the necessary security for the surviving spouse since the market for such an interest is narrow and co-operation with the remainder beneficiaries would be required either for them to buy out the life interest, or agree to sell the whole property to a third party.

For flexibility it is recommended that the terms of the will include a provision which permits the trustee to dispose of the main residence during the spouse or person with the right of occupancy's lifetime and substitute another dwelling for use. This allows for changes in life style of the beneficiary with the right to occupancy or life interest. Notably section 118-210 of the ITAA 97 provides for a main residence exemption for the testamentary trustee on the sale of the substitute dwelling later on.

In practice, generally multiple testamentary trusts are established where a main residence is involved. That is, there may be a discretionary testamentary trust for all other residuary assets, and then a special testamentary trust to hold only the main residence. On the death of the person with the right of occupancy or life interest the capital of the main residence trust may then flow to the discretionary trust.

The above testamentary trust structuring relies on the above two ATO IDs which are not binding public rulings. If there is a desire to be certain that the main residence exemption can be claimed on the sale of a dwelling on death under section 118-195 ITAA 1997 then:

1. the property should be disposed of by the LPR or an individual beneficiary (i.e. without passing to a testamentary trust) within 2 years of the deceased's date of the death; or

2. the deceased's main residence is gifted to a person who uses it as their main residence.

Finally it is noted that the controversial *Treasury Laws Amendment (Reducing Housing Pressure on Housing Affordability Measures No. 2) Bill 2018* proposes to amend the main residence exemption to deny foreign residents access to it. It is unclear whether this bill will be enacted at all. If the bill is enacted, then relevantly section 118-195 will be amended so that the main residence exemption is removed if the deceased died at a time when they are foreign resident. No allowance is provided for the fact that the deceased may have owned the dwelling for a significant period of time when they were an Australian resident. Where a non-resident beneficiary inherits a main residence, then this bill will also deny that beneficiary the ability to claim the main residence exemption for the period they own the dwelling – although if the deceased was an Australian resident, the non-resident beneficiary may claim a partial exemption based on the period of the deceased owned the dwelling and used it as their main residence.

6.2 Land tax

Where a main residence is left in a testamentary trust it is also necessary to consider the land tax implications of doing this. The land tax consequences vary in each state or territory.

For instance, in NSW discretionary testamentary trusts are not entitled to the tax-free land tax threshold and are liable to pay land tax on the first dollar of taxable value of the main residence. It is possible to structure a main residence testamentary trust so that the principal place of residence exemption for NSW land tax applies in two ways:

1. the beneficiary who will use the dwelling as their main residence is granted a life estate under the will (and not by an exercise of discretion under the will) and the life tenancy is based on the life of the life tenant;[41] or

2. the beneficiary who will use the dwelling as their main residence is granted a right of occupancy under the will,[42]

[41] Section 20 of the *Land Tax Management Act 1956* (NSW).
[42] Clause 10 of Schedule 1A of the *Land Tax Management Act 1956* (NSW).

then the exemption will apply while the beneficiary actually uses the dwelling as their main residence.

In Queensland there is an exemption from land tax for a life tenant who uses the dwelling as their principal place of residence.[43]

In Victoria the principal place of residence exemption from Victorian land tax can apply to a testamentary trust it is structured as follows:

1. all of the following apply:

    a. the beneficiary is granted a right to reside in the dwelling for no consideration;

    b. the dwelling was the principal place of residence of the deceased; and

    c. the beneficiary does not have another principal place of residence anywhere else;[44] or

2. the beneficiary is granted a life estate under the will,[45]

and the beneficiary uses the dwelling as their principal place of residence.

In Tasmania there does not seem to be a principal place of residence exemption for land tax for a discretionary testamentary trust. There appears to be an exemption where an executor holds a residence for a beneficiary who uses it as their principal place of residence.[46]

[43] Sections 14 and 41 *Land Tax Act 2010* (Qld).
[44] Section 54(1)(ab) of the *Land Tax Act 2005* (Vic).
[45] Sections 11 and 54(1)(a) of the *Land Tax Act 2005* (Vic).
[46] Section 6(3) of the *Land Tax Act 2000* (TAS).

7 Non-resident beneficiaries

7.1 CGT event K3

As the Australian community becomes more and more global in nature, the possibility of a beneficiary being an Australian non-resident increases. Where an Australian tax resident will maker gifts a post-CGT asset which is not taxable Australian property to a foreign resident, CGT event K3 is triggered.[47] Broadly, taxable Australian property covers Australian land interests and a 10% or more interest in a company or trusts whose majority of assets, by market value, comprises Australian land interests. An example of a CGT asset which is not taxable Australian property is a less than 10% shareholding in a widely held listed company. The deceased makes a capital gain under CGT event K3 equal to the market value of the CGT asset at the date of decease less cost base. This capital gain is then included in the deceased's final tax return. The policy rationale behind CGT event K3 being to ensure that the capital gain embedded in asset is taxed before the asset goes out of the Australian taxation net.

One way to avoid CGT event K3's clutches is delay completion of administration of the deceased estate until the deceased's standard period (two years if the deceased is a simple taxpayer or four years if they are not) has expired. An executor is required to complete the administration of an estate as expeditiously as possible and residuary beneficiaries are entitled to simple interest on their residuary gift if twelve months has passed since the date of death and they have not received their entitlement. In NSW the relevant interest rate is 2% above the cash rate published by the Reserve Bank of Australia before 1 January in the calendar year in which the interest accrues.[48] Although a non-resident beneficiary may not quibble about the lateness of receiving their gift if such a delay prevents CGT event K3 reducing its value. Notably generally the Commissioner's discretion not to apply section 99A of the ITAA 36 to a deceased estate runs out after the third year and the exclusion of a deceased from the family trust loss rules runs out after the fifth anniversary of death.[49]

In the May 2012 Budget the then Labor Government proposed to amend CGT event K3 so that it could still occur outside the deceased's standard tax return amendment period – this would have been done by excluding CGT event K3 from the standard amendment period. Later in June 2012[50] the proposed change was amended due to concerns that the original proposal could lead to amendments to a deceased's tax returns decades after their death. Under the amended proposal CGT event K3 would be triggered for the entity passing the CGT asset (e.g. the LPR) to non-resident beneficiary, rather than the deceased. No amendments would be done to the deceased's tax return and CGT event K3 would in substance operate in the same way as if the LPR had sold the asset. On 14 December 2013 the Government announced that it would not be proceeding with the proposal to amend CGT event K3.

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[47] Section 104-215 of the ITAA 97.

[48] Section 84A of the *Probate and Administration Act 1898* (NSW).

[49] Section 272-100 of Schedule 2F to the ITAA 36.

[50] The modified proposal can be found in the Treasury Paper 'Minor amendments to the capital gains tax law' dated June 2012.

Allocating cash assets of the deceased estate or assets which are taxable Australian property to a non-resident beneficiary and other non-taxable Australian property assets to Australian resident beneficiaries under a power of appropriation is another to avoid triggering CGT event K3.

Yet another way of preventing CGT event K3 arising is to gift the non-taxable Australian property asset to an Australian resident testamentary trust under which the intended non-resident is a beneficiary. Where a testamentary trust is used to deal with CGT event K3 it is relevant to note that the non-resident may benefit from concessionary Australian withholding tax rates whilst the asset is held in the testamentary trust and income is derived on it – e.g. there is no withholding tax on fully franked dividends distributed to a non-resident and typically the interest withholding tax rate is only 10%. However, the non-resident beneficiary may not be exempted from Australian tax on any gain made later on when the asset is sold.

In ATO ID 2010/55 the ATO notes that the fact that a CGT asset is not taxable Australian property is irrelevant to the issue of whether a non-resident beneficiary is assessable on any gain made on the sale of an asset by an Australian resident trust which is then distributed to the non-resident beneficiary. This is because such a gain is assessed to the trustee under section 98 of the ITAA 36 if it is considered to have an Australian source. The classification of whether or not an asset is taxable Australian property, is irrelevant to this question of Australian source. The relevant CGT asset in ATO ID 2010/55 was shares in an Australian company. It was considered that the capital gain made on the sale of the shares was Australian sourced because of this fact and also because the contract for the sale of the shares was concluded in Australia. As a result the trustee of the trust was liable to be assessed under section 98 of the ITAA 36 when the gain was distributed to a non-resident beneficiary. Notably any gain distributed to a non-resident is not eligible for the CGT discount.

Failure to recognise that a capital gain made on non-taxable Australian property may still be assessable to a beneficiary is a common mistake.

In many cases using an Australian resident testamentary trust merely acts as a way of deferring Australian tax, rather than having it occur all at once under CGT event K3. This is because the gain made on a deceased estate asset of an Australian resident will maker is likely to be Australian sourced. The use of a testamentary trust provides a non-resident beneficiary with time to manage the Australian tax payable on the deceased estate asset. For instance, the non-resident beneficiary could gradually realise a gain on CGT assets held by the testamentary trust over time to manage the tax. Where the non-resident beneficiary only intends to remain outside Australia for a period of time and eventually wishes to come back to Australia then the testamentary trust is a useful store of assets until that later time when the non-resident returns. In such a case the testamentary trust preserves the ability to claim the 50% CGT discount once the beneficiary becomes an Australian resident.

If the non-resident beneficiary has no desire to migrate to Australia then consideration needs to be had as to whether it is more practical to have the executor sell the asset as part of their administration of the estate under, for instance a trust for sale, claim 50% CGT discount[51] and then distribute a cash legacy to the non-resident beneficiary. If the deceased has significant carry forward capital losses or

[51] On the basis that the Commissioner accepts that section 99 of the ITAA 36 applies to assess the executor during the time when the estate is being administered.

they hold the asset as a pre-CGT asset then CGT event K3 may not be an obstacle and a direct gift to the non-resident beneficiary is feasible.

Where a will maker is not an Australian tax resident and they wish to create a testamentary trust care should be taken in choosing their executors and the trustees of the testamentary trust. Choosing an Australian resident as executor or trustee can create adverse tax consequences as the deceased estate and testamentary trust automatically become Australian resident trusts and non-taxable Australian property gets drawn into the Australian tax net. Whilst this tax result is straight forward to a tax lawyer, it is a surprisingly common mistake to find where the will maker's children are scattered around the world and the will maker, trying to be fair wishes to have all the children involved in the administration of their estate. The child who is currently studying at university in Australia and an Australian tax resident may be included as an executor or trustee. Cross border estate planning is a vast growing topic – the above points reflect some common costly pitfalls I have seen over the years in the structuring of testamentary trusts.

7.2 Surcharge land tax and residential land

Where a proposed testamentary trust will include Australian land it is necessary to consider whether surcharge land tax may apply to the land, and whether it is possible to draft the terms of the trust to ensure that the surcharge land tax does not apply. In recent years foreign surcharge duty and land tax has crept across the nation with the following table summarising the state of play:

State or Territory	Surcharge Duty	Surcharge Land Tax	Relief for developers?
Victoria	7% foreign purchaser additional duty on residential property	1.5% absentee owner surcharge on all types of land on land owners who do not ordinarily reside in Australia	Yes
NSW	8% surcharge purchaser duty on residential property	2% surcharge land tax on residential land	Yes
Queensland	7% additional foreign acquirer duty on residential property	1.5% absentee surcharge (individuals only) on all types of land	Yes – ex gratia duty relief
Western Australia	7% foreign transfer duty from 1 January 2019 on residential property	No	Yes
South Australia	7% foreign ownership surcharge on residential property	No	No

State or Territory	Surcharge Duty	Surcharge Land Tax	Relief for developers?
Tasmania	3% foreign investor duty surcharge on residential property 0.5% foreign investor duty surcharge on primary production property	No	No
Australian Capital Territory (**ACT**)	No	0.75% of Average Unimproved Value on residential land	No
Northern Territory (**NT**)	No	N/A does not have land tax[52]	N/A

Unfortunately the surcharge provisions differ in each state and territory jurisdiction – so the definition of who is a foreign resident for surcharge purposes, the type of land affected and what falls within the concept of 'residential property' that is affected by surcharge. For instance, Victoria levies surcharge land tax on all types of property whilst NSW only imposes surcharge land tax on residential land. NSW adopts a 'foreign person' definition based the definition in the *Foreign Acquisitions and Takeovers Act 1975* with some modifications.[53] Other states such as Queensland and Victoria have their own specific definition of a 'foreign person'.

Generally the deceased estates concessions in duties law prevent surcharge duty arising on the initial distribution of assets from a deceased estate to beneficiaries, whether under the will or the rules of intestacy. Surcharge duty may apply to a distribution from the trustee of a testamentary trust to a remainder beneficiary later on, where that beneficiary is a foreign resident. This is because many of the deceased estates duty concessions in different states and territories would not see that later distribution as being in conformity with the will[54] or a distribution from a deceased estate.[55]

There is no general testamentary trust exemption from surcharge land tax in the jurisdictions that levy it, and it is necessary to delve into the detail to work out whether a particular land tax exemption applies. Where a testamentary trust has been created over a dwelling which is used by the primary beneficiary as their main residence, the principal place of residence exemption may apply. For instance, NSW allows for the principal place of residence exemption to apply to a deceased estate for after the date of death where the deceased used the dwelling as their principal place of residence,[56]

[52] It is noted that the Northern Territory Government proposes to imposed a vacant and derelict property levy from 1 July 2019, but this is not focused on foreign residents.

[53] The modifications relate to excluding Australian citizens from being a 'foreign person' and treating New Zealand citizens who enter Australia on a 444 visa as not being subject to a time limit with respect to their visa.

[54] Section 42 of the *Duties Act 2000* (Vic), section 71(5)(h) of the *Stamp Duties Act 1923* (SA), section 63 of the *Duties Act 1997* (NSW), section 47 of the *Duties Act 2001* (TAS), item 6(d), Schedule 2 of the *Stamp Duty Act 1978* (NT) and section 69 of the *Duties Act 1999* (ACT).

[55] Section 124 of the *Duties Act 2001* (Qld) and section 139 of the *Stamp Act 1921* (WA).

[56] Clause 9 of Schedule 1A to the *Land Tax Management Act 1956* (NSW).

and to a situation where a person uses a dwelling as their principal place of residence under a right of occupancy granted under a will.[57]

Significantly, in NSW, Victoria and the ACT the way a testamentary trust is drafted can affect whether surcharge land tax applies to the land held by the trust. The effect of the 'foreign person' definition for NSW land tax purposes[58] is that if a trust has just one discretionary beneficiary who is a foreign person, the trustee of the trust would be considered a 'foreign person'.[59] A 'foreign person' for these purposes includes a natural person who is neither an Australian citizen nor a person with a permanent resident visa who is ordinarily resident in Australia (i.e. has spent 200 days of the calendar year in Australia), and a company or a trust in which a foreign person holds a 20% or more interest. Where a discretionary testamentary trust will own NSW residential property and the only beneficiaries who are intended to benefit from the trust are Australian citizens or permanent residents permanently residing in Australia, the typical way to draft the testamentary trust is to exclude beneficiaries who are 'foreign persons' so as to prevent the testamentary trust from being regarded as foreign and thus subject to surcharge land tax. Whilst it is not outlined in the legislation, in line with Revenue NSW's administrative practice the provisions which prevent a foreign person from being a beneficiary of the trust, must be irrevocable in that they cannot be altered later on.[60]

Surcharge land tax applies in Victoria to discretionary trusts (including discretionary testamentary trusts) if there is at least one specified beneficiary (i.e. someone named in the trust deed) who is an 'absentee beneficiary'.[61] Broadly a 'natural person absentee' is someone who is not an Australian citizen or a resident who ordinarily resides in Australia. To prevent a testamentary trust which will hold Victorian land from being subject to Victorian surcharge land tax, it would be necessary to ensure that specified beneficiaries of the trust are not an 'absentee beneficiary' (as defined). This is a much easier test to meet than the NSW surcharge land tax.

The ACT levies foreign ownership surcharge land tax on the first day of each quarter on 'foreign persons' as defined for the purposes of the *Land Tax Act 2004* (ACT). A discretionary testamentary trust would be a foreign trust and liable to pay this surcharge if a foreign person is named in the trust deed and under the terms of the trust may take trust capital either as a result of the exercise of a discretionary power, or otherwise in default.[62] A 'foreign person' for these purposes includes an individual who is not an Australian citizen, an Australian permanent resident or ordinarily resident in Australia, and a foreign company or trust (i.e. a company or trust in which foreign persons hold 50% or more of the interests).[63] Additionally if the trustee of the testamentary trust is a foreign person in its own right, then the trustee will be regarded as a foreign person liable for this surcharge.[64] The consequence of this is that to prevent ACT foreign ownership surcharge land tax, it would be

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[57] Clause 10 of Schedule 1A to the *Land Tax Management Act 1956* (NSW).

[58] NSW land tax uses the same 'foreign person' definition as for surcharge duty. The definition can be found in section 104J of the *Duties Act 1997* (NSW).

[59] This comes about as a result of the 'foreign person' definition in section 4 and section 18(3) of the *Foreign Acquisitions and Takeovers Act 1975* (Cth).

[60] See Practice Note CPN 004.

[61] See definitions of 'absentee beneficiary', 'absentee trust' and 'natural person absentee' in section 3 of the *Land Tax Act 2005* (Vic) and section 46IA of the *Land Tax Act 2005* (Vic).

[62] Section 17C(1)(b) of the *Land Tax Act 2004* (ACT).

[63] Sections 17A to 17C of the *Land Tax Act 2004* (ACT).

[64] Page 4 of Revenue Circular LTA002.

necessary to ensure a foreign person is not named in the trust deed as a capital beneficiary and the trustee is not a foreign person.

Given the complexities of surcharge legislation thought may be had to recommending to a will maker to consider gifting Australian land to Australian beneficiaries and gifting other non-land assets to non-resident beneficiaries. This may involve establishing two testamentary trusts – i.e. one for Australian beneficiaries which excludes foreign persons and one for non-resident beneficiaries. Additionally, since surcharge legislation varies across Australian jurisdictions thought may be had to having different trusts for land in different jurisdictions.

8 Disability

Where the intended beneficiary has a severe disability there are a number ways to create a tax effective trust for their benefit. The attraction of creating a testamentary trust on death generally lies in the CGT and duty concessions which allow assets held in the will maker's own name to be move to a trust structure without triggering material tax and duty liabilities. In the case of a beneficiary with a severe disability it is not necessary to wait to death to create a tax effective trust.

8.1 Exceptions from Division 6AA

Significantly the following disabled minor child beneficiaries are excepted from Division 6AA's penalty tax rates as they are 'excepted persons':

1. a minor with a severe disability or medical condition in respect of whom a carer allowance under the *Social Security Act 1991* (Cth) was payable in respect of a period which included the last day of the relevant income year when one tests whether Division 6AA's penalty rates should apply – note there is an income test for a carer to meet before they can access the carer allowance;[65]

2. a minor with a permanent medical condition which stops them from working and to whom a disability support pension under the *Social Security Act 1991* (Cth) was payable in respect of a period which included the last day of the relevant income year – note the minor needs to meet an income and assets test before they can access the disability support pension ;[66]

3. a minor in respect of whom the Commissioner has received a certificate issued by a legally qualified medical practitioner certifying that they are either:

   a. a disabled child within the meaning of Part 2.19 of the *Social Security Act 1991* (Cth) (i.e. a child who suffers from a physical, intellectual or psychiatric disability for a permanent or extended period of time); or

   b. the minor has a continuing inability to work within the meaning of Part 2.3 of the *Social Security Act 1991* (Cth), or is permanently blind,

   and the Commissioner is satisfied the minor met these conditions on the last day of the relevant income year;[67] or

4. a minor in respect of whom the Commissioner has received a certificate issued by a legally qualified medical practitioner certifying that the minor is unable to work full time because of a permanent disability and the Commissioner is satisfied this is the case on the last day of the

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[65] Section 102AC(2)(c)(i) of the ITAA 36. For a brief description of eligibility for the Carer's Allowance see the fact sheet: https://www.dss.gov.au/disability-and-carers/benefits-payments/carer-allowance
[66] Section 102AC(2)(c)(ii) of the ITAA 36. For a brief description of eligibility for the Disability Support Pension see: https://www.humanservices.gov.au/individuals/services/centrelink/disability-support-pension
[67] Section 102AC(2)(d) of the ITAA 36.

relevant income year.[68] However this exception will not apply if during this time the minor was wholly or substantially dependent on the support of relatives.[69]

These exceptions enable inter vivos trust distributions to a minor child beneficiary who falls within these exceptions without being subject to Division 6AA's penalty tax rates.

8.2 Special disability trust (**SDT**)

Where the disabled beneficiary has a severe disability as defined under section 1209M of the *Social Security Act 1991* (Cth) then it is possible to establish a special disability trust (**SDT**) for their benefit regardless of whether or not they are a minor child. Broadly to be eligible the beneficiary needs to be receiving a form of disability support pension or would be a person in respect of which a carers allowance is provided. A SDT can be established as a testamentary trust or an inter vivos trust. For a trust to be a SDT it must meet particular requirements including:

1. the principal purpose of the trust must be for meeting the reasonable care and accommodation needs of the disabled beneficiary during their lifetime;[70]
2. the trust must only have one principal beneficiary for whom it was created and who meets the severe disability requirement in section 1209M of the *Social Security Act 1991* (Cth);
3. it must contain compulsory trust deed clauses as mandated by the Department of Social Services – these clauses can be found in the Model Trust Deed published by the Department;[71]
4. the trustee must be an independent professional trustee, or alternatively more than one trustee if friends and family act as trustee;[72]
5. complying with various investment restrictions –these restrictions are outlined in the compulsory model trust deed clauses. Additionally section 1209R of the *Social Security Act 1991* (Cth) which prohibits the SDT from paying immediate family for care services or maintenance of accommodation for the disabled beneficiary, or from buying or leasing property from immediate family for accommodation purposes;
6. providing annual reports to Centrelink and conducting independent audits when required.[73]

It is normal to liaise with Centrelink on the set up of a SDT as they have a Special Disability Trust Assessment Team that assesses whether the beneficiary meets the severe disability condition and whether the terms of the SDT meet the requirements to be a SDT.

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[68] Section 102AC(2)(g) of the ITAA 36.
[69] Section 102AC(4) of the ITAA 36.
[70] Section 1209N of the *Social Security Act 1991* (Cth).
[71] See https://www.dss.gov.au/our-responsibilities/disability-and-carers/publications-articles/model-trust-deed-for-special-disability-trusts
[72] Section 1209Q of the *Social Security Act 1991* (Cth).
[73] Section 1209S and 129T of the *Social Security Act 1991* (Cth).

Anyone can gift to a SDT except the principal beneficiary or their partner. The principal or their partner can only gift a superannuation death benefit that they receive within 3 years of the gift to the SDT.[74]

The tax benefits of a SDT are:

1. an exemption from CGT for anyone who gifts property to the SDT for no consideration;[75]

2. usually there is a stamp duty concession for transfers of dutiable property to a SDT, although the conditions of the concession vary across jurisdictions and not all dutiable property may be afforded concessionary duty treatment;[76]

3. the principal place of residence exemption for land tax may apply where the beneficiary uses a dwelling held in the SDT as their main residence;[77]

4. the main residence exemption can apply to a dwelling held in the SDT and used by the beneficiary as their main residence. This applies if the trustee disposes of the dwelling during the disabled beneficiary's lifetime[78] (e.g. trustee substitutes one dwelling for a more comfortable one later on), or later on after the disabled beneficiary has died and either the trustee or the capital beneficiary disposes of the dwelling within 2 years of death;[79]

5. the penalty tax rates of Division 6AA do not apply to a minor who is the principal beneficiary of a SDT;[80] and

6. income accumulated within the SDT is assessed at the disabled beneficiary's marginal tax rate rather than the top marginal tax rate.[81]

The social security benefits of a SDT are:

1. assets held by the SDT up to the concessional asset value limit (this is indexed annually and is currently $669,750 for the 2018 year) are exempt from the social security means test when assessing the disabled beneficiary's eligibility for social security benefits;[82]

2. income derived by the SDT is not included in the disabled beneficiary's social security income test;[83] and

3. there is a gifting concession that allows immediate family members of the disabled beneficiary (i.e. parent, guardian, grand parent or sibling) who are currently receiving a social security

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[74] Section 109R(1) of the *Social Security Act 1991* (Cth).
[75] Section 118-85 of the ITAA 97.
[76] See section 111 of the *Duties Act 2008* (WA), section 65(22) of the *Duties Act 1997* (NSW); section 38A of the *Duties Act 2000* (Vic); section 126A of the *Duties Act 2001* (Qld); section 54 of the *Duties Act 2001* (TAS); section 71CAA of the *Stamp Duties Act 1923* (SA); section 73B of the *Duties Act 1999* (ACT) and clause 6(e) of Schedule 2 to the *Stamp Duty Act* (NT).
[77] For example see sections 26 of the *Land Tax Assessment Act 2002* (WA); the definition of a 'concessional trust' in section 3B and clause 11(2) of Schedule 1A to the *Land Tax Management Act 1953* (NSW).
[78] Section 118-218 of the ITAA 97.
[79] Sections 118-220 and 118-222 of the ITAA 97.
[80] Section 102AC(2)(da) of the ITAA 36.
[81] Section 95AB of the ITAA 36.
[82] Section 1209Y of the *Social Security Act 1991* (Cth).
[83] Section 1209X of the *Social Security Act 1991* (Cth).

pension because they have reached pension age to gift up to $500,000 in assets to the SDT without being subject to the typical social security deprivation rules.[84] These deprivation rules provide that a single person or a couple combined cannot gift more than $10,000 in one financial year or $30,000 in 5 financial years, or otherwise those assets are deemed to still belong to the donor for the purposes of the social security assets and income test for 5 years after the date of the gift.

A SDT has many prescriptive restrictions imposed on the way that capital and income of a SDT must be used – such income and capital must primarily be used to provide reasonable care and accommodation – the Department of Social Services' Social Security Guide provides detailed commentary on what reasonable care and accommodation means. Only a small amount can be used for discretionary lifestyle purposes for the disabled person (this is indexed annually and for the 2018 year is $12,000).

Many parents who are considering establishing a protective trust for their disabled child baulk at the meanness of a SDT where only $12,000 can be used to culturally enrich the child's life e.g. for recreation and leisure activities, toiletries, clothes and communication devices. Many wealthy will makers choose not to establish a SDT but rather instead establish a protective testamentary trust for the maintenance of the disabled beneficiary during their lifetime, with the ability to provide for these other comforts of life.

Practically there are three situations where one may consider establishing a SDT:

1. where there is sufficient wealth to acquire a main residence for the disabled person, then a SDT can be used as the vehicle to hold the main residence so as to secure the main residence exemption later on when the dwelling is sold – there is no need to rely on the ATO's administrative practice in ATO IDs 2006/34 and 2004/882. In such a situation the dwelling may be the only material asset held in the SDT with a separate protective testamentary trust set up for the disabled beneficiary without the income and capital restrictions imposed on a SDT;

2. to enable an immediate family member to make an inter vivos gift to the SDT to meet the social security assets and/or income test so as to gain access to social security benefits. For instance, say the parent of a disabled child is hovering at the threshold of the assets or income test, they may choose to gift to a SDT to come under that threshold and secure greater social security benefits;

3. where the disabled person relies on the disability support pension to live, and say their parents will gift more than the social security assets test limit (which for the 2018 income year is $258,500 for a homeowner and $465,500 for a non-homeowner) then there may be benefit in establishing a SDT to preserve the value of the disability support pension.

In any other situation, the utility of establishing a SDT must be questioned because you may be able to establish a protective trust for a disabled beneficiary with many of the tax advantages without having such onerous investment and use restrictions.

[84] Section 1209Z of the *Social Security Act 1991* (Cth).

9 Capacity – can your will maker even sign that testamentary trust will?

The bulk of this article has been focused on the tax benefits that a properly drafted testamentary trust can provide. An important issue which should always be addressed when advising on the establishment of a testamentary trust is whether the will maker has the necessary mental capacity to actually understand the trust that is proposed to be established. Failure to address this point could lead to the will being challenged and overturned on the basis the testator did not actually have the capacity to make the testamentary trust will.

The test on mental capacity to make a will is a long standing test outlined in *Banks v Goodfellow* (1870) LR 5 QB 549. Under this test for a person to have mental capacity to make a will they must:

1. understand the nature of the act of will making and its effects;
2. understand the extent of the property they are disposing;
3. understand and appreciate the claims on their estate which they ought to provide for; and
4. not be affected by any mental disorder which would poison their affections, pervert their sense of right or prevent the exercise of their natural faculties such that they would dispose of their assets in a way that they would not have if they were of sound mind.

A testamentary trust will may be a complex sophisticated document – particularly where it mimics an inter vivos family trust. Arguably for such a document a higher level of mental capacity is required than the *Banks v Goodfellow* test since the testator should understand broadly how the trust works. It may be that a will maker has the mental capacity to make a will under the *Banks v Goodfellow* test but only a simple will. To create a testamentary trust for such a simple will maker may expose the will to a challenge.

It is significant to note that where a will maker does not have the required mental capacity all is not completely lost with respect to creating a testamentary trust. It is possible in all Australian states and territories to go to the Supreme Court to ask for a statutory will to be made, and this can possibly include a testamentary trust.[85] Each state and territory jurisdiction has its own particular requirements for a statutory will be approved by a Court but generally it is three step process involving proving:

1. the will maker has lost capacity;
2. the proposed will (or alteration or revocation) reflects the will maker's intentions if they had capacity; and

[85] See Part 3A of the *Wills Act 1968* (ACT), Division 2 of Part 3 of the *Wills Act 2000* (NT), Division 2 of Part 2.2 of Chapter 2 of the *Succession Act 2006* (NSW), Subdivision 3 of Division 3 of Part 2 of the *Succession Act 1981* (QLD), Division 2 of Part 2 of the *Wills Act 1936* (SA), Division 2 of Part 3 of the *Wills Act 2008* (TAS), Division 1 of Part XI of the *Wills Act 1970* (WA) and Division 2 of Part 3 of the *Wills Act 1997* (Vic). Note the Victorian law allows a Court to make or revoke a will but not alter it.

3. it is appropriate in all of the circumstances for Court to authorise the will and make the relevant order.

A testamentary trust established under a statutory will should be able to access the true testamentary trust exception in section 102AG(2)(a) ITAA 36 since the testamentary trust would have resulted from a 'will'.

Case law examples where testamentary trusts have been included in a court made statutory will include *A Limited v J (No 2)* [2017] NSWSC 896 and *Gau v Gav* [2014] QCA 308.

The incapacitated person in *A Limited v J (No 2)* [2017] NSWSC 896 was a 13 year old child who was severely brain damaged due a birth injury and never had capacity. The child had received a $8.5 million compensation settlement as a result of his birth injuries. The child was due to undergo life-threatening surgery and as a result the professional trustee appointed to oversee the child's estate sought orders from the NSW Supreme Court to approve a statutory will for the child should they die from the procedure. The child's mother and father had separated when the child was young and his mother had been entirely responsible for his care. The proposed statutory will sought to exclude the father from the child's estate, leaving the estate to his mother and siblings. It was necessary to seek the statutory will because the rules of intestacy would have otherwise given half of the child's estate to his father.

Chief Justice Ward of the NSW Supreme Court authorised a statutory will that split the child's estate based on a provision of 42.5% to the mother and the balance to be split equally between the father and his six siblings (i.e. around 8.21% each). Significantly the Court accepted evidence from the mother's solicitor of the tax and asset protection advantages of a discretionary testamentary trust and included provision for the establishment of testamentary trusts for the siblings' share of the estate in the statutory will.[86]

In *Gau v Gav* [2014] QCA 308 the will maker had made a will but had then since lost capacity. Under this original will a mother had gifted substantial assets (around $5.5 million) to her son and if he did not survive her for 30 days then it would go to his wife. Subsequent to this, the son divorced his wife and property proceedings were pending in the Family Court. At this time the mother had suffered a severe stroke and was in a vegetative state, there was a concern she might die at any time.

The will maker's husband then filed an application to amend her will by a codicil which replaced the gift to the son and gift over to the daughter, with a clause which gifted the assets to a discretionary testamentary trust under which the primary beneficiaries were her son, grandchildren and great grandchildren. The Queensland Court of Appeal approved the alteration of the will in the manner sought by the husband. It ruled that there was nothing contrary to the policy of the law in making the alteration which indirectly affected the family law property proceedings. Additionally it accepted that the will amendment was something that the will maker would likely have implemented if she had mental capacity and received relevant legal advice on how a testamentary trust may be used where an intended beneficiary is in the midst of a divorce.

[86] See paragraphs 75 to 77 of the judgment.

The testamentary trust in *Gau v Gav* should also be able to benefit from the true testamentary trust exception in section 102AG(2)(a) ITAA 36 since that exception also includes wills amended by court order.

A final case where a Court altered a will to include testamentary trusts is the case of *Re Matsis; Charalambous v Charalambous* [2012] QSC 349. In that case the estate totalled around $13 million and under the original will was to be distributed to three grandsons outright. The grandfather has since lost capacity and the grandsons (who were all involved in risky business ventures) sought court orders to alter the will to convert the gifts to testamentary trusts for each of them. This was to provide asset protection and protection from family law claims. The Queensland Supreme Court approved the amendment to the will on the basis that the amendment was something that the testator would likely have done due to his extensive business experience, entrepreneurial nature and desire to keep his wealth within the family.

The above case law examples show that depending on the size of the estate seeking such statutory will orders may be worthwhile.

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