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ANNUAL TRUSTS INTENSIVE

Testamentary Trusts
&
Deceased Estates

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QLD Division
21 May 2014
Tattersall's Club, Brisbane

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1 What is the effect of you dying?

What is the effect of you dying?[1]

You might think this to be a physiological, or even a metaphysical, question.

It isn't. It's a tax question. And Parliament has solved it.

The "effect of you dying" is, apparently, that it alters the first element of the cost base and reduced cost base[2] of CGT assets which pass to another person or entity upon your death.[3] There you go.

With such a deep understanding of death, we can now turn to consider testamentary trusts.

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[1] You could ask Hotblack Desiato who spent "a year dead for tax reasons", except for the fact that he is a fictional character from the *Hitch Hiker's Guide to the Galaxy* trilogy (which was actually 5 books by Douglas Adams, and a sixth published after Adams's death by a different author). See the second book in the series, *The Restaurant at the End of the Universe.*

[2] Section 110-25(2) *ITAA97*.

[3] Section 112-55 *ITAA97*.

2 What is a Testamentary Trust?

A testamentary trust is just a fancy name for a trust created by will (as distinct from a trust created during the lifetime of the testator, which is called an *inter vivos* trust).

Testamentary trusts, typically, are most useful when they are discretionary trusts, as these provide the greatest scope for reducing income taxes via selective distributions to infant beneficiaries. The expression "discretionary trust" is used to identify a species of express trusts in which, unlike a fixed trust, the entitlement of the beneficiaries to income, or to corpus, or both, is not immediately ascertainable "…the beneficiaries are selected from a nominated class by the trustee or some other person and this power may be exercisable once or from time to time."[4]

From an asset protection perspective, caution must be exercised when considering providing for, and operating, a *discretionary* testamentary trust because "a beneficiary who effectively controls the trustee of a discretionary trust may have what approaches a general power and thus a proprietary interest in the income and corpus of the trust."[5]

The creation of a testamentary trust can be provided for simply by stating in the will:

> "I give $10 and, if I own it at my death, Blackacre to my son, JOHN SMITH, to hold as trustee for JOHN SMITH and his lineal descendants to be applied in the trustee's absolute discretion."

Alternatively, the testamentary trust can be as complex as a separate 100 page trust deed annexed to and forming part of the will. In this instance, the will might say, *inter alia*, something like:

> "I give $10 and, if I own it at my death, Blackacre to my son, JOHN SMITH, to hold as trustee for the JOHN SMITH TESTAMENTARY FAMILY TRUST, the terms of which form part of , and are annexed to, this my will."

To be clear, the will does not create the trust when the will is executed.[6] The testamentary trust is created only upon death. The recitals to the testamentary trust might say something like the following:

> "A. The Testator wishes to establish in his will a trust to benefit certain persons and to confer certain powers on the Trustee.
>
> B. This annexure to the will of the Testator forms no immediate trust nor imposes any rights or obligations on any party dehors this will. Rather this annexure forms part of the will of the Testator and can be altered, cancelled or revoked by the Testator at any time prior to his death."

2.1 "Maintenance, education (including past maintenance or education) advancement or benefit"

Regardless of the terms of the trust instrument, in Queensland if the beneficiary is an infant, the **income**, if applied rather than accumulated, must be applied towards the infant's "maintenance,

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[4] *FCT v Vegners* (1989) 20 ATR 1645 at 1648-1650 per Gummow J.
[5] *ASIC v Carey (No 6)* (2006) 153 FCR 509 at [19] per French J.
[6] *Russell v Scott* (1936) 55 CLR 440 at 448 per Starke J.

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education (including past maintenance or education) advancement or benefit”.[7] In Queensland these limitations cannot be opted out of.[8] In contrast, in all other States and Territories the statutory power to apply income for maintenance does not apply if the trust instrument expresses a contrary intention.[9]

“Advancement” means “the establishment in life” of the beneficiary or “at any rate some step that would contribute to the furtherance of his establishment”. The addition of the words “or benefit” are enlarging words. Clearly, the power is to be construed broadly and does “not stand upon niceties of distinction”, provided that the application of the funds can “fairly be regarded as for the benefit of the beneficiary who [is] the object of the power”. Generally, “advancement or benefit” means any use of the money that will improve the material situation of the beneficiary.[10]

A payment of trust monies pursuant to the “advancement” power must be utilised for a definite (and permissible) purpose. It cannot merely be to put money into the beneficiary’s “pocket”.[11]

With respect to **capital** of the trust, in Queensland this, too, must be applied for the “maintenance, education (including past maintenance or education) advancement or benefit” of the infant or adult beneficiary. In Queensland the application of capital cannot exceed the greater of $2,000 or one-half of the capital unless done so with the consent of the court.[12]

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[7] Section 61(1) *Trusts Act 1973* (Qld). Query whether s 61(1) would apply if the interest is vested: see [10.12] of the Queensland Law Reform Commission Discussion Paper, “A Review of the Trusts Act 1973 (Qld)”. The same limitation applies to adult beneficiaries who have a *contingent* interest in the trust property: s 61(3) *Trusts Act 1973* (Qld). Section 60 provides that, generally, section 61 of the *Trusts Act 1973* (Qld) applies whether or not a contrary intention is expressed in the instrument (if any) creating the trust. There is an exception in s 61(7).

[8] Section 60 *Trusts Act 1973* (Qld).

[9] *Trustee Act 1925* (ACT) s 43(11); *Trustee Act 1925* (NSW) s 43(10); *Trustee Act* (NT) s 24(3); *Trustee Act 1936* (SA) s 33(8); *Trustee Act 1958* (Vic) ss 2(3), 37; *Trustees Act 1962* (WA) ss 5(2)–(3), 58.

[10] *Pilkington v Inland Revenue Commissioners* [1964] AC 612 at 634-635.

[11] *Roper-Curzon v Roper-Curzon* (1981) LR 11 Eq 452 at 453.

[12] Section 62(1) *Trusts Act 1973* (Qld).

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3 Why use a Testamentary Trust?

Why not just gift the assets, or settle the assets upon trust, before the testator dies?

a. The primary advantage of providing for a testamentary trust (to come into being upon death) is the well-known taxation concession for infant beneficiaries of testamentary trusts.[13] Basically, infant beneficiaries under testamentary trusts may receive income distributions as if they were adults. They can thus take advantage of the tax-free threshold (currently $18,200), and the other ordinary marginal income tax rates.[14] Compare this with the situation of a normal *inter vivos* discretionary family trust where the tax-free threshold for minors is $416, and any further income to the minor is taxed at the maximum rate.[15] If you have a few children, the tax savings from utilising a testamentary trust can be significant!

b. Disposing of assets by will and testamentary trust also helps defer CGT consequences (as opposed to gifting or settling upon trust *inter vivos*).

c. Utilising a trust, whether *inter vivos* or testamentary, permits the settlor or testator some control over the use and application of the assets—this can help protect accumulated wealth from the depredations of wastrel beneficiaries.[16]

d. Of course, testamentary trusts also provide the same asset protection[17] as *inter vivos* trusts, and this is another important reason for using them.[18]

If the testator is concerned about adult beneficiaries[19] coming together to bring the trust to an end pursuant to the rule in *Saunders v Vautier*,[20] the testator can either leave the class open (for example, to include any children of the primary beneficiaries, born or yet to be born, and their children, born or

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[13] Section 102AG *ITAA36*.

[14] The income is "excepted trust income" for the purposes of Div 6AA, which means that Div 6AA, with its draconian income tax rates, are not applicable.

[15] The special rates of tax applicable to taxable income caught by Div 6AA (ie "eligible taxable income") are set out in ss 13 and 15 and Schedules 11 and 12 of the *Income Tax Rates Act 1986* (Cth).

[16] However, seeking to utilise a discretionary testamentary trust to control assets and protect them from wastrel dependants might backfire on the basis that being a beneficiary of a discretionary trust with no entitlement to income or capital could constitute inadequate family provision: *Stansfield v National Australia Trustees Ltd* [2004] NSWSC 1107. TR 2006/14 deals with the CGT consequences of creating life and remainder interests in property and of later events affecting those interests. It is beyond the scope of this paper to consider these aspects.

[17] Protection against bankruptcy, and against Family Court orders. In the family law arena, the trust assets are more likely to be treated as a financial resource rather than as part of the pool of assets available for division if the trust is not controlled by that party embroiled in the family law litigation: see *Kennon v Spry* (2008) 238 CLR 366 at [55] per French CJ.

[18] Where the trustee is also a beneficiary it is prudent to have more than that one trustee. Otherwise it might be said that that trustee has the power/control to distribute the whole of the income and/or capital to himself—and in this way the supposed asset protection of the trust might be no protection at all. Even where the beneficiary is not the trustee, care must be taken to ensure that the trustee is not just the alter ego of the beneficiary—see, for example, *ASIC v Carey (No 6)* (2006) 153 FCR 509 at [36] per French J: "… where a discretionary trust is controlled by a trustee who is in truth the alter ego of a beneficiary, then at the very least a contingent interest may be identified because, to use the words of Nourse J, 'it is as good as certain' that the beneficiary will receive the benefits of distributions either of income or capital or both." That case concerned the application of powers under s 1323 of the *Corporations Act 2001* (Cth), and the meaning of "property" in that section and in s9. For these reasons, it is a good idea to have an appointor who is not the trustee.

[19] Who are *sui juris*—that is, not under any legal disability.

[20] (1841) Cr & Ph 240; 41 ER 482.

yet to be born), or make the discretionary trust “non-exhaustive”—which is a discretionary trust in which is “purely discretionary” in which income and capital can be withheld altogether.[21]

3.1 Desirability of a Testamentary Trust

In fact, the establishment of a testamentary trust has been seen as so desirable that parties have successfully applied to the Supreme Court for orders that the will of a testator who has not yet died, but who has lost testamentary capacity, be varied by the court to include testamentary trusts when it previously had none.[22]

However, testamentary trusts are not appropriate in all circumstances. For example, it may be better to devise as an absolute gift a dwelling which the donee wishes to use as his main residence. In this way he can take advantage of the tax free capital gains on the property over the years (and avoid any otherwise applicable land tax).[23]

There are also benefits to disposing of assets *inter vivos*. Two of these are discussed below: (a) the threat of family provision applications, and (b) the utilisation of capital losses.

3.2 Family Provision Applications

On the other hand, if the testator has legitimate concerns about family provision applications,[24] then it might be a better idea to consider gifting the assets during his lifetime, or settling them upon trusts during his lifetime. This can be done for the express purpose of “wasting” one’s estate.[25] There will be the crystallization of CGT (and perhaps the impost of duty) via this process at an earlier time than if done by testamentary means, but it will put the assets beyond the reach of a family provision applicant[26]—except in New South Wales which employs a “notional estate” concept that, where applicable, can operate to claw back gifts made within 3 years of the date of death.[27]

It follows that it is better to live (and die) in Queensland than in NSW!

But even in Queensland you must ensure that the *inter vivos* gift is <u>unconditional</u>. The gift must **not** be what is called a *donatio mortis causa* because in Queensland that rule has been reversed by statute.[28] A *donatio mortis causa* comprises these three essential characteristics:

> “(1) The gift must be in contemplation of death;

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[21] *ASIC v Carey (No 6)* (2006) 153 FCR 509 at [20] to [26] per French J.
[22] *Re Matsis; Charalambous v Charalambous* [2012] QSC 349. See ss 21 and 22 *Succession Act 1981* (Qld).
[23] Section 118-110(1) *ITAA97*—note in particular subsection (1)(c).
[24] See, for example, Part 4 (ss 40 to 44) of the *Succession Act 1981* (Qld).
[25] *Palmer v Bank of New South Wales* (1975) 133 CLR 150 at 162 per Barwick CJ.
[26] *Re Brownlee* [1990] NZLR 243 at 246 per Tompkins J; *Re Richardson* [1920] SALR 24 at 40.
[27] The “notional estate” concept in NSW, where applicable, brings gifts back into the estate of the testator for the purposes of a family provision application: s63(5) and s80(2)(a) and generally Part 3.3 *Succession Act 2006* (NSW); formerly s22 *Family Provision Act 1982* (NSW).
[28] Section 41(12) *Succession Act 1981* (Qld).

> (2) there must be a delivery of the subject matter of the gift or a transfer of the means or part of the means of getting at the property or a transfer of the indicia of title; and
>
> (3) the gift must be conditional on the death of the donor."[29]

3.3 Utilisation of Capital Losses

Capital losses that have been carried forward by a taxpayer are **lost** upon his death. They cannot be offset against other income (unless it is other income from a capital gain) in the deceased's final tax return to the date of death. They cannot be carried forward for the benefit of the LPR or the beneficiaries.[30]

Accordingly, here is another planning opportunity. If you have an elderly or ill client who has such carried forward capital losses, you might like to consider utilising those capital losses before death by:

a. selling the asset, and offsetting any capital gain with the carried forward capital losses;[31] or

b. making an *inter vivos* gift of the asset (to someone who would otherwise be the beneficiary of the asset under the will). In this case the market value substitution rule would have the following two consequences: (i) the first element of the cost base or reduced cost base for the recipient of the gift would be the market value of the asset at the date of acquisition;[32] and (ii) the giver of the gift would have a deemed capital proceeds equal to the market value of the asset at the date of disposal, against which the carried forward capital losses could be applied.[33]

A potential *in specie* donee—to ensure he gets the asset (rather than leaving it to the vagaries of will and family provision)—might even "grease the wheels" by offering to pay the donor's CGT on the transaction (if there is any remaining after the utilisation of the capital losses).

Remember to always consider other factors such as a liability to stamp duty, and social security criteria.

[29] *Dufficy v Mollica* [1968] 3 NSWR 751 at 758 per Holmes JA.

[30] TD 95/47.

[31] Section 102-5(1) Step 2 *ITAA97*.

[32] Section 112-20 *ITAA97*.

[33] Section 116-30 *ITAA97*; Section 102-5(1) Step 2 *ITAA97*.

4 Assets of the Estate vs Property held as Joint Tenants

The above discussion highlights the fact that only assets of the deceased's estate[34] at the date of death are available to flow into a testamentary trust. There must be a testamentary succession, not a succession *post mortem*. For example, property held as joint tenants (as opposed to being held as tenants in common) passes by the right of survivorship, which is succession *post mortem*, and not testamentary succession. Accordingly, such jointly held assets would not be available for settlement in a testamentary trust.

Two of the most common types of assets which are held as joint tenants are real property and bank accounts.[35]

In *Russell v Scott*[36] an elderly aunt and a nephew set up a joint bank account. Only the aunt placed funds into the account. The money was only for her use while she lived, but upon her death she had stated to a number of persons that the balance should go to the nephew. When the aunt died the executor claimed the amount in the bank account as part of the estate. The LPR was unsuccessful because the presumption that the nephew held the funds after her death on a resulting trust for the estate was rebutted by the evidence that she intended for him to have the balance in the account at her death. Dixon and Evatt JJ stated:

> "Law and equity supply many means by which the enjoyment of property may be made to pass on death. Succession *post mortem* is not the same as testamentary succession. But what can be accomplished only by a will is the voluntary transmission on death of an interest which up to the moment of death belongs absolutely and indefeasibly to the deceased. This was not true of the chose in action created by opening and maintaining the joint bank account. At law, of course, it was joint property which would accrue to the survivor. In equity, the deceased was entitled in her lifetime so to deal with the contractual rights conferred by the chose in action as to destroy all its value, namely, by withdrawing all the money at credit. But the elastic or flexible conceptions of equitable proprietary rights or interests do not require that, because this is so, the joint owner of the chose in action should in respect of the legal right vested in him be treated as a trustee to the entire extent of every possible kind of beneficial interest or enjoyment. Doubtless a trustee he was during her life time, but the resulting trust upon which he held did not extend further than the donor intended; it did not exhaust the entire legal interest in every contingency. In the contingency of his surviving the donor and of the account then containing money, his legal interest was allowed to take effect unfettered by a trust."[37]

McTiernan J stated:

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[34] Or "notional estate" (NSW) or reversed *donationes mortis causa* (Qld).

[35] Or, more correctly, the chose in action that is the debt owed by the bank to the account holders.

[36] (1936) 55 CLR 440.

[37] (1936) 55 CLR 440 at 454.

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> "The legal interest which accrued to him by survivorship was not saddled with a resulting trust in favour of the representative of the deceased's estate and it is not suggested that there is any other trust upon which he is bound to hold his legal rights as survivor."[38]

Bank accounts, typically being debts for Australian currency, do not have cost base issues arise upon death as occur with real property.

Section 128-50 *ITAA97* prescribes the rules to be applied "if a CGT asset is owned by joint tenants and one of them dies".

- If the jointly held asset is a **post-CGT** asset, upon death the interest that passes by right of survivorship is taken to be acquired[39] on the date of death with the first element of the cost base being calculated as the "cost base of the interest of the individual who died (worked out on the day the individual died) divided by the number of survivors".[40] The effect of this is that the deceased's estate will have no CGT liability in respect of the interest which passed by right of survivorship because the deceased is deemed to have made no capital gain on that disposal (because the disposal cost is the same as the cost base).

- If the jointly held asset is a **pre-CGT[41]** asset, upon death the interest that passes by right of survivorship is taken to be acquired[42] on the date of death with the first element of the cost base being calculated as the market value of that interest at that time.[43] This means that no CGT will be payable upon the survivor's acquisition of the interest if it is a pre-CGT asset, but when it is finally sold by the survivor one-half of the asset will be subject to CGT on the increase in value of that interest from the date of death.

The difference here between a pre-CGT asset and a post-CGT asset is that upon death the transfer of the interest in the post-CGT asset is at (usually) a much lower cost base than the transfer of the interest in a pre-CGT asset (which is calculated on market value). The result, in simple and general terms, in respect of the interest which passed by survivorship, is that upon ultimate sale, the post-CGT asset holder will have more CGT to pay than the pre-CGT holder.

Putting to one side the family-provision-application issue, this raises the question whether it would be preferable to avoid joint tenancy holdings, and instead devolve interests by will?

- From a CGT perspective, it makes no difference whether the interest passes by right of survivorship or by will when it is a pre-CGT asset because in respect of both, upon acquisition

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[38] (1936) 55 CLR 440 at 458.
[39] In fact, s 128-50(2) *ITAA97* **deems** the survivor to have acquired the deceased's interest on the date of death. See TD 1999/72.
[40] Section 128-50(3) *ITAA97*. There is a special indexation rule for deceased estates and surviving joint tenants with respect to the interest having been held for 12 months: s 114-10(6) and (7) *ITAA97*.
[41] Section 104-10(5) *ITAA97*: a capital gain or capital loss you make in respect of an asset acquired by you before 20 September 1985 is **disregarded**.
[42] In fact, s 128-50(2) *ITAA97* **deems** the survivor to have acquired the deceased's interest on the date of death. See TD 1999/72.
[43] Section 128-50(4) *ITAA97*. There is a special indexation rule for deceased estates and surviving joint tenants with respect to the interest having been held for 12 months: s 114-10(6) and (7) *ITAA97*.

the first element of the cost base becomes the market value of the asset as at the date of death.[44]

- Similarly, it makes no difference whether the interest passes by right of survivorship or by will when it is a post-CGT asset because in respect of both, upon acquisition the first element of the cost base becomes the cost base of the asset as at the date of death.[45]

See the discussion below regarding the "CGT Position".

However, property held as a joint tenant will **not** be able to find its way into a testamentary trust. Such property cannot therefore take advantage of the tax concessions available to minor beneficiaries. To fix this, the joint tenancy could be severed, and the half share (or whatever) as a tenant in common of the property could now be disposed of by will into a testamentary trust.

[44] Sections 128-15(4) Item 4 and 128-50(4) and *ITAA97*.
[45] Sections 128-15(4) Item 1 and 128-50(3) and *ITAA97*.

5 What if the testator has a very small estate?

Even if the testator only has a very small estate,[46] with a bit of planning the establishment of a testamentary trust might be very useful.

Trustee for the Estate of the Late AW Furse No 5 Will Trust v FCT[47] is a case in point.

In that case a testamentary trust was established upon settlement of $1. The trustee subsequently borrowed $10, and purchased a unit in a unit trust (which was created some time after the testator's death). Four more of the units were later transferred to the trustee on behalf of the testamentary trust. The unit trust derived income by providing services to a firm of solicitors. The terms of this agreement or arrangement "were not the subject of any evidence".[48] The unit trust and the firm of solicitors were not at arm's length (sharing some individuals as partners or directors or shareholders).

In the 1982 year the trustee of the testamentary trust distributed $12,000 to an infant beneficiary. In the 1983 year the trustee distributed $5,000 to each of two infant beneficiaries. Each of these beneficiaries was, at the time of the relevant distribution to him or her, under 18 years of age on the last day of the year of income, and was not an "excepted person" within the definition of that expression in s 102AC(2) *ITAA36*. Accordingly, each was entitled to be taxed at the rates normally applicable to adults resident in Australia.

The Commissioner did not see the situation in the same way as the trustee of the testamentary trust. The Commissioner assessed the trustee in respect of each of the three distributions on the basis none of those distributions was "excepted trust income" under Div 6AA (Income of certain children). The Commissioner had two complaints:

- First, he contended that the agreement between the unit trust and the firm of solicitors (through which the testamentary trust derived income by being the holder of 5 units in the unit trust) was not entered into by the parties at arm's length.
- Secondly, he contended that the only income available for distribution as "excepted trust income" under s102AG was income "sourced in the will or property of the deceased".[49]

In relation to the first complaint—which related to the proper construction of s 102AG(3) *ITAA36*[50]—Hill J held that the Commissioner (and the AAT) had misunderstood the relevant issue:

> "The first of the two issues is not to be decided solely by asking whether the parties to the relevant agreement were at arm's length to each other. The emphasis in the subsection is rather upon whether those parties, in

[46] Funds or property can subsequently be gifted by living donors to the testamentary trust, but the income generated from that corpus does not attract "excepted trust income" status because the income from that corpus did not "result from" a will: s 102AG(2(a)(i) *ITAA36*. See also Private Ruling 50621. In any event, such an attempt to obtain tax concessions would probably fall foul of s 102AG(4) *ITAA36*.

[47] (1990) 21 ATR 1123.

[48] (1990) 21 ATR 1123 at 1129.

[49] (1990) 21 ATR 1123 at 1136.

[50] It was subsequently amended to its current form.

> relation to the agreement, dealt with each other at arm's length. The fact that the parties are themselves not at arm's length does not mean that they may not, in respect of a particular dealing, deal with each other at arm's length."[51]

The second complaint relates to a proper construction of s 102AG(2)(a)(i), which provides:

> "(2) Subject to this section, an amount included in the assessable income of a trust estate is **excepted trust income** in relation to a beneficiary of the trust estate **to the extent to which the amount**:
>
> (a) is assessable income of a trust estate that resulted from:
>
> (i) a will, codicil or an order of a court that varied or modified the provisions of a will or codicil; or"

Hill J stated:

> "The tribunal held that upon its true construction s 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 s 102AG(2)(a) "that resulted from" refer to the assessable income rather than to the words in subs (i) "a will" etc or in subs (ii) "an intestacy" etc. In my opinion all that is necessary to fall within s 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 s 102AG(2)(a)(i) or (ii) (that is to say not an *inter vivos* trust).
>
> It is not clear what is meant by the notion that the assessable income be "sourced" in the will or the property of the deceased. Presumably the contention is that it is only income from assets already held by the deceased at the time of his death which will be exempted from the provision of Div 6AA. Such a view is too narrow. Clearly the legislature must have contemplated the case where the will assets were sold and the proceeds reinvested. What happened in the present case is that the trustee borrowed funds and used the borrowed funds to invest in such a way as to derive assessable income from the investment. In my view the consequence of such an investment was that assessable income was derived by the trust estate so that that income was "assessable income of the trust estate" and clearly enough the trust estate was one that resulted from the will of the late Mr Furse."[52] (Emphasis added)

This opens up significant planning opportunities. One must always, however, be cognizant of Part IVA; and Div 6AA has its own anti-avoidance provision in s 102AG(4).[53] In *FCT v Bill Wissler*

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[51] (1990) 21 ATR 1123 at 1132. For a recent discussion of the concept of "dealing with each other at arm's length" see *Healey v FCT* (2012) 208 FCR 300 at [94] ff per McKerracher J, who refers to *Trustee for the Estate of the Late AW Furse No 5 Will Trust v FCT* (1990) 21 ATR 1123; *Granby Pty Ltd v FCT* (1995) 30 ATR 400, *FCT v AXA Asia Pacific Holdings Ltd* (2010) 189 FCR 204, *ACI Operations Pty ltd v Berri Ltd* (2005) 15 VR 312, and *Barnsdall v FCT* (1988) 19 ATR 1352. Note that s 995-1 *ITAA97* defines "arm's length" as follows: "in determining whether parties deal at arm's length, consider any connection between them and any other relevant circumstance." This definition applies to *ITAA36*, in which s 102AG is found: see definition of "this Act" in s995-1 *ITAA97*.

[52] (1990) 21 ATR 1123 at 1136. In relation to child maintenance trusts, see paragraph 49 of TR 98/4.

[53] See *FCT v Bill Wissler (Agencies) Pty Ltd* (1985) 16 ATR 952, which construed the meaning of "employment income" in s 102AG(2)(b) *ITAA36*. In this case the taxpayer won, but the "gap" was closed by legislative amendment which included inserting s 102AG(5A).

(Agencies) Pty Ltd Williams J rejected the Commissioner's anti-avoidance argument based on s 102AG(4):

> "I am not certain how s 102AG(4) should be construed, but clearly it cannot strike down an agreement to make a payment for services rendered. Further, if it is necessary for me to so hold, I am of the view that it would not apply merely where the parties were aware at the time they entered into an otherwise legitimate commercial agreement that a consequence would be that moneys received thereunder would be "excepted trust income" for purposes of [Div 6AA]."[54] (Emphasis added)

Note also s 102AG(5) which provides: "In determining whether subsection (4) applies in relation to an agreement, no regard shall be had to a purpose that is a merely incidental purpose."

The comment by Williams J in *Wissler* (in 1985) may have played some part in the Commissioner not even trying to run an anti-avoidance argument in *Furse No 5* (in 1990); or maybe not. Nevertheless, one must always be mindful of the anti-avoidance provisions. See, for example, *Case 44/95* where s 102AG(4) was applied to refuse certain income "excepted trust income" status. It was held that the primary purpose of the arrangement was to seek "to convert income from a discretionary trust to income derived from the investment of property transferred for the benefit of the beneficiary as a result of family breakdown. In my view the purpose was to secure that the assessable income would be excepted trust income and it was no incidental purpose."[55]

[54] (1985) 16 ATR 952 at 957-958.

[55] *Case 44/95* 95 ATC 387; (1995) 31 ATR 1131. This was a "family breakdown" case under s 102AG(2)(c)(viii), to which the amendments in s 102AGA were not applicable.

6 Superannuation

The right to "superannuation death benefits", like survivorship interests in joint tenancies, arises by succession *post mortem*, not by testamentary succession—at least where the funds were never within the deceased's control.[56] For example, policies of life insurance held within superannuation are clearly superannuation death benefits which arise by succession *post mortem*. These are to be dealt with by binding death benefit nomination; not by will.

In contrast, funds contributed into super during the deceased's lifetime would usually be subject to testamentary succession.[57] However, this situation is avoided by regulations 13.11 to 13.15 *SISR* which prohibit the assignment of, or charging of, superannuation interests unless expressly or implicitly permitted by *SISA* or *SISR*. Thus, it cannot be said that these benefits or interests were ever within the control of the member to alienate or charge. Therefore, these, too, are to be dealt with by binding death benefit nomination; not by will.[58]

However, there is still a way of moving "superannuation death benefits" into a testamentary trust!

"Superannuation death benefits" (which include super life insurance policies, and super contributions—if the fund rules prohibit assignment during lifetime) can, by binding death benefit nomination (if the governing rules of the superannuation entity so permit),[59] be directed to be paid to one's LPR[60] which can then (by will) be settled on testamentary trust.[61]

In the absence of such a binding death benefit nomination, the trustee of the super fund has the discretion as to where to pay the superannuation death benefits. She might pay them to the LPR. She might pay them to any "dependant" or "dependants" she chooses (so long as the trust deed and the SIS legislation permits). It most cases this will not be a problem. But there are others—*Katz v Grossman*[62] being one—where the trustee of the super fund pays[63] the whole of the superannuation death benefits to herself instead of to her brother and herself in equal shares (as the deceased father had expressed in a non-binding death benefit nomination[64]).

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[56] *Re Application by Police Association of South Australia* (2008) 102 SASR 215 at 225-227 per Doyle CJ; *Russell v Scott* (1936) 55 CLR 440 at 454 per Dixon and Evatt JJ; *Williams v FCT* (1950) 81 CLR 359 at 379 per Williams J; *McFadden v Public Trustee for Victoria* [1981] 1 NSWLR 15 at 30 per Holland J.

[57] *Re Application by Police Association of South Australia* (2008) 102 SASR 215 at 225-227 per Doyle CJ*; In re MacInnes* [1935] 1 DLR 401; *Baird v Baird* [1990] 2 AC 548 at 561.

[58] In England it has been said that most modern pension schemes incorporate a prohibition upon assignment of benefits, which places those benefits into the category of succession *post mortem*: *Baird v Baird* [1990] 2 AC 548 at 561.

[59] Section 59(1A) *Superannuation Industry (Supervision) Act 1993* (Cth) ("*SISA*") and Regulation 6.17A(2) *Superannuation Industry (Supervision) Regulations* 1994 (Cth) ("*SISR*") apply to "superannuation entit[ies] other than a self managed superannuation fund". In respect of SMSFs, see SMSFD 2008/3 which states that there is no restriction in the Superannuation Industry (Supervision) legislation on a self managed superannuation fund ("SMSF") trustee accepting from a member a binding nomination of the recipients of any benefits payable in the event of the member's death. "SMSF" is defined in s 17A of *SISA*.

[60] LPR is defined in s 10(1) *SISA*: " ***"legal personal representative"*** means: (a) an executor or administrator of an estate of an individual who has died; or (b) a trustee of an estate of an individual who is under a legal disability; or
(c) a person who holds a general power of attorney that was granted by another person."

[61] Section 302-10(1) *ITAA97.*

[62] [2005] NSWSC 934.

[63] Or intends to pay.

[64] [2005] NSWSC 934 at [56].

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The LPR takes on the persona of a "death benefits dependant" if the beneficiaries of the super benefits are "death benefits dependants".[65] In this situation the superannuation death benefits lump sums will **not** be subject to tax on the way into the testamentary trust.[66]

A "death benefit dependant" is defined in s 302-195 *ITAA97*:

> "(1) A ***death benefits dependant*** , of a person who has died, is:
>
> (a) the deceased person's spouse or former spouse; or
>
> (b) the deceased person's child, aged less than 18; or
>
> (c) any other person with whom the deceased person had an interdependency relationship under section 302-200 just before he or she died; or
>
> (d) any other person who was a dependant of the deceased person just before he or she died."

This is similar to the definition of "dependant" under s 10(1) of the *Superannuation Industry (Supervision) Act 1993* (Cth) ("*SISA*"), which provides:

> "***"dependant"*** , in relation to a person, includes the spouse of the person, any child of the person and any person with whom the person has an interdependency relationship."[67]

Conversely, where the beneficiaries of the super benefits are **not** "death benefits dependants", the LPR does **not** take on the persona of a "death benefits dependant",[68] with the consequence that superannuation death benefits lump sums **are** subject to tax on the way into the testamentary trust.[69]

6.1 Why bother directing super to one's LPR?

Why bother directing super to one's LPR?

- It allows one to distribute to persons to whom those funds could not otherwise be distributed under *SISA*, albeit with tax consequences on the "way in".[70]
- Also, there are the concessional tax rates available to infant beneficiaries (because it is "excepted trust income" under Div 6AA) in respect of trust income derived from those settled funds. Note that the income is "excepted trust income" for that beneficiary only if the trust property will vest in that beneficiary when the trust comes to an end.[71]

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[65] Section 302-10(1) and (2) *ITAA97*.

[66] Section 302-60 *ITAA97*—it is not assessable income, and it is not exempt income.

[67] "Interdependency relationship" is defined in s 10A *SISA*.

[68] Section 302-10(1) and (3) *ITAA97*.

[69] Section 302-145 *ITAA97*—at no greater than 15% (plus 1.5% medicare levy) if it has already been taxed in the fund, or no greater than 30% (plus 1.5% medicare levy) if it has not already been taxed in the fund.

[70] See definition of "dependant" in s 10(1) *Superannuation Industry (Supervision) Act 1993* (Cth).

[71] Section 102AG(2A) *ITAA97*.

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The superannuation death benefits can either flow into the testamentary trust by being transferred into it by the LPR pursuant to s102AG(2)(d)(ii) *ITAA36*, or a separate "Superannuation Death Benefits Trust" can be set up pursuant to s102AG(2)(c)(v) *ITAA36*.

Section 102AG(2) provides:

> "(2) Subject to this section, an amount included in the assessable income of a trust estate is **excepted trust income** in relation to a beneficiary of the trust estate to the extent to which the amount:
>
> (c) is derived by the trustee of the trust estate from the investment of any property transferred to the trustee for the benefit of the beneficiary:…
>
> (v) directly as the result of the death of a person and out of a provident, benefit, **superannuation** or retirement fund; …
>
> (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; …"

6.2 Problems with directing super into a testamentary trust

One possible disadvantage of directing super into a testamentary trust is that a family provision applicant might argue that the super is now a part of the "estate" for distribution in family provision proceedings.

Another problem might arise where the superannuation death benefits which flow through to a testamentary trust are made a contingent upon the infant beneficiary attaining a certain age, and child dies before attaining that age. If the superannuation death benefits then pass over to a "non-dependant" the trustee may have to pay tax on the taxable component of the superannuation death benefit.

7 CGT position

There are a number of transfers (disposals/acquisitions) that occur upon death:

1. From the deceased to the Legal Personal Representative ("LPR");
2. From the LPR to a beneficiary under the will;
3. From the LPR to a trustee of a testamentary trust;
4. From the LPR to a third party, or from the beneficiary to a third party.

7.1 Deceased to LPR

When a person dies, and his assets devolve[72] to his LPR, this is a CGT event.

However Div 128 *ITAA97* provides that such a capital gain or capital loss occurring from such CGT events upon death is *disregarded.*[73]

So it is as if the LPR steps into the shoes of the testator, and there are no immediate CGT consequences (see discussion below). This is fair, because the LPR's role is really just to be a conduit.

7.2 LPR to beneficiary

This situation is mirrored when the LPR transfers assets to beneficiaries—this, too, is a CGT event.

However, again, Div 128 *ITAA97* provides that any capital gain or capital loss from such CGT events is *disregarded.*[74]

The purpose is to put the beneficiary into the shoes of the testator—through the LPR—and there are no immediate CGT consequences (see discussion below).

7.3 LPR to Trustee of Testamentary Trust—PS LA 2003/12

Surprisingly, there is no provision in Division 128 which prescribes that a transfer by the LPR to the trustee of a testamentary trust must be disregarded. *Prima facie*, CGT is applicable just as it would be in respect of a transfer to any third party (see below). However, in PS LA 2003/12 the Commissioner states that he "will not depart from the ATO's long-standing administrative practice of treating the

[72] "Devolve" is not defined in *ITAA97*, but generally means the automatic transfer of assets from one party to another by operation of law.
[73] Section 128-10 *ITAA97*.
[74] Section 128-15(3) *ITAA97*.

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trustee of a testamentary trust in the same way that a legal personal representative is treated for the purposes of [Div 128 *ITAA97*], in particular subsection 128-15(3)."

Accordingly, the Commissioner **disregards** any capital gain arising on a transfer of assets from the LPR to the trustee of a testamentary trust.

What level of protection does this afford a taxpayer?

Paragraph 20 of PS LA 1998/1 provides:

> "20. Although LAPS provide direction and assistance to ATO personnel, they are published and approved for taxpayers to rely on them in the same way as other publications that are not rulings. A taxpayer who relies on particular LAPS will remain liable for any tax shortfall if those LAPS are incorrect, or are misleading and the taxpayer makes a mistake as a result. However, they will be protected against any shortfall penalty that would otherwise arise. In addition, they will be protected against interest charges on the shortfall if the particular LAPS were reasonably relied on in good faith."[75]

Paragraph 234 of PS LA 2008/3 provides:

> "234. ATO personnel are required to follow law administration practice statements unless they consider that the application of a particular practice statement would have unintended consequences or is otherwise incorrect. Where this occurs ATO personnel must follow their business line's escalation process."

How long before an ATO employee considers this practice "incorrect"?

The upshot is that the LPR remains in jeopardy of an increased assessment for the estate during the normal period open to the Commissioner to amend notices of assessment.[76]

7.4 LPR to third party, or Beneficiary to third party

However, when the asset is transferred to a third party—either by the LPR to the third party, or by the beneficiary to the third party—the normal CGT rules apply.[77]

This makes sense. It is as if the testator were voluntarily transferring the asset and crystallising any capital gain or capital loss during his lifetime.

Also, because death might otherwise rob a taxpayer of the opportunity of utilising the small business CGT concessions in Div 152, the legislature has magnanimously provided a 2 year window after death (or within a longer period allowed by the Commissioner[78]) during which those concessions can

[75] See also PS LA 2008/3 at [231] to [236].

[76] Section 170 *ITAA36*.

[77] Subject to s 152-80 *ITAA97,* and the special main residence or dwelling rules in s 118-195 *ITAA97*. The beneficiary can also increase the cost base by taking into account any expenditure (such as rates) incurred by the LPR in relation to the asset: s 128-15(5) *ITAA97*.

[78] Section 152-80(3) *ITAA97*.

still be obtained in respect of a CGT event if the deceased would have been entitled to them at the date of death.[79]

7.5 No Immediate CGT Consequences… but there are consequences

Above, I have stated that there are no immediate CGT consequences when the CGT assets pass from the deceased to the LPR, and when they pass from the LPR to a beneficiary. What I mean is that there is no crystallization or realisation of any capital gain or capital loss at that time. But there are consequences:

- A ***pre-CGT asset*** loses its pre-CGT status, with the first element of its cost base and reduced costs base being its market value at the date of death.[80] (However, if the pre-CGT asset is a “dwelling”[81], a capital gain or a capital loss that arises from its sale within 2 years of the date of death (or within a longer period allowed by the Commissioner) is **disregarded**.[82])
- A ***main residence*** loses its main residence status, with the first element of its cost base and reduced costs base being its market value at the date of death.[83] (However, the main residence status may be maintained if the beneficiary moves into the dwelling and it becomes his main residence, or the non-separated spouse of the deceased remains in occupation, or an individual with a right to occupy the dwelling under the will takes up and remains in occupation.[84] Further, a capital gain or a capital loss that arises from the sale of a main residence within 2 years of the date of death (or within a longer period allowed by the Commissioner) is **disregarded**.[85])

Therefore, apart from the above qualifications, any capital gain or capital loss from the date of death falls to be taxed upon a subsequent CGT event.

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[79] Section 152-80 *ITAA97*. This also applies to interests passing by right of survivorship from a joint tenant: s 152-80(1)(a)(ii) *ITAA97*.

[80] Section 128-15(2) and (4) Item 4 *ITAA97*.

[81] Defined in s 118-115 *ITAA97*.

[82] Section 118-195(1) *ITAA97*.

[83] Section 128-15(4) Item 3 *ITAA97*.

[84] Section 118-195(1) *ITAA97*.

[85] Section 118-195(1) *ITAA97*.

8 Conclusion

Even if a client comes to you after a relative (or benefactor) has died, and there is no testamentary trust, all is not lost. You have three years from the date of death to set up what might be called an estate proceeds trust pursuant to s 102AG(2)(d)(ii) *ITAA36*, which will allow some of the benefits of a testamentary trust, but it also has some limitations.[86] It is beyond the scope of this paper to consider these further.

With the assistance of the court, it is also possible to vary the will of a still living testator who has lost testamentary capacity so as to include testamentary trusts when previously there were none.[87]

Given the above discussion about testamentary trusts and the many benefits they provide, it is incumbent on you to canvas the possible use of these with your clients. In fact, failing to do so could amount to negligence.

[86] The value of the property settled on the trust should not exceed the amount to which the children would have been entitled if the deceased had died intestate. To the extent it exceeds this, the income derived from the excess is not "excepted trust income": s 102AG(7) *ITAA36.* Further, an infant obtains the tax benefits only where the infant is the child of the deceased parent. A deceased grandparent cannot benefit a grandchild with the tax concessions if the child's parent is still alive because in those circumstances, on an intestacy, it is the infant child's parent who would benefit: s 36A and Schedule 2 *Succession Act 1981* (Qld); s 102AG(7) *ITAA36.* Further, the trust deed must provide that the trust property will pass to the children when the trust ends: s 102AG(2A) *ITAA36.*

[87] *Re Matsis; Charalambous v Charalambous* [2012] QSC 349. See ss 21 and 22 *Succession Act 1981* (Qld).