WILLS AND TAXATION – ODD BEDFELLOWS?

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Why Odd Bedfellows?

"Wills and taxation: odd bedfellows?" is a curious question and intrigued me when indicated to me as the topic to give a presentation.

The obvious question raised by someone who advises in tax and estate planning matters is why would it be suggested that these two are odd bedfellows? I guess it should be asked why a lawyer preparing a will for a client (and therefore involved with a client's estate plan) would shy away from tax implications of such advice. For example, I have heard it said recently by a solicitor to a client that the solicitor would prepare the will provided it is understood he is not giving any advice in respect of tax.

How is it that we as a profession have come to this position?

I say that deliberately as less than 40 years ago solicitors involved in wills and estate planning were very much concerned with tax matters. This was due to the fact that Australia until the late 1970's imposed death and estate taxes (supported by gift duties) and estate planning necessitated the legal adviser understanding the complex provisions of estate taxes at both federal and state levels. I think it is worthwhile reflecting initially on this history.

Wills and Taxation Pre-1980

Estate taxes were first introduced in the early part of the nineteenth century in New South Wales in the form of probate duties (a tax on property passing by will) charged by courts. By 1901 estate taxes had been adopted by all of the colonies. Following the outbreak of World War One, the Fisher Labor Government introduced the *Estate Duty Assessment Act.* As a consequence there were then two layers of taxes on deceased estates, one at federal level and a second at state level.

Up to about the time of World War Two the taxing of estates was increased by both levels of government and then shifted from the extension of estate taxes to the extension of exemptions.

At the same time there was an increased interest in planning to avoid the adverse consequences of taxes on deceased estates. This interest in tax planning for estates intensified in the 1960's and 1970's. There were several leading cases concerning schemes or transactions which were adopted to secure the transfer of assets without incurring liability for gift duty (so that estate duty was avoided on death). In particular, these cases included *Fadden v Federal Commissioner of Taxation, (1945) 70 C.L.R. 555; Crimwade v Federal Commissioner of Taxation, (1949) 78 C.L.R. 119; Birks v Federal Commissioner of Taxation, (1953) 10 A.T.D. 266; Gorton v Federal Commissioner of Taxation, (1965) 113 C.L.R. 604; McGain v Federal Commissioner of Taxation, (1965) 13 A.T.D. 556, (1966) 14 A.T.D. 190; Robertson v Federal Commissioner of Taxation (1952) 86 CLR 463.*

The most famous (or infamous) being the Gorton case which lent its name to what became known as the "Gorton schemes". The decision in ***Gorton's*** case had apparently created an enormous loophole whereby wealth could be transferred from one person to another without involving the payment of gift duty. The Commonwealth Government and the Commissioner of Taxation chose not to address this loophole and as a result any lawyer acting in this area of the law would see wills and taxation as "hand in glove" and definitely not odd bedfellows.

This growth in the area of tax and wills led obviously to some concerns being expressed and an example is a paper by his Honour R. Else-Mitchell of the NSW Supreme Court entitled "Taxation of Gifts of Capital and Gifts of Income" (a paper read at a 1967 Law Summer School and published in the *Western Australia Law Review*). After reviewing the cases in this area to that date (and the judgements in particular of Barwick CJ) his Honour concluded

For practical purposes it must be conceded that, with the guidance of the many decisions of the courts which have declared the law authoritatively, the paths which a successful tax scheme must follow in order to be successful are fairly well defined, and whilst I am no political prophet it seems reasonable to assume that, short of another comprehensive enquiry such as was conducted by the Ligertwood Committee, it is unlikely that there will be any fundamental revision of the basis of income taxation for many years to come. The operation of section 260 of the Income Tax Assessment Act and the possibility that American decisions may be invoked to lift the veil of corporate personality may therefore prove to be the only clouds on the wide horizon of the tax planner.

These sentiments eventually drew results in the mid 1970's with a change in interpretation by the High Court and the introduction of amendments to legislation. The decision in 1974 of the Full High Court in *Ord Forrest Pty. Ltd. v. Federal Commissioner of Taxation 74 A.T.C. 4034* effectively put an end to the Gorton schemes by assessing the company used in such schemes as the party liable to gift duty rather than the principal individual attempting to tax plan. The decision in the *Ord Forrest case* probably could be said to bring into focus the different attitudes of judges in deciding taxation cases (namely, the end of the Barwick CJ era).

In 1976 there were also moves by legislators to combat the avoidance of estate taxes. For example, the NSW state government introduced legislation and in moving the amendments the Hon. D. P. Landa stated

The second major change proposed in the bill is to stem the loss of revenue from duty avoidance schemes. For too long this State has tolerated a situation in which some taxpayers are able to gain unfair advantages over others through the adoption of such schemes. Tax avoidance is by no means new but the past twenty years have seen a tremendous growth in duty avoidance measures. The provisions I shall shortly outline will negate devices to avoid duty which are based on the principle that companies do not die but can be made to continue almost for ever. The use of tax avoidance measures is now so widespread and has assumed such significance that our death duty laws can no longer be regarded as meeting the test of equity. Each year, death duty is being paid by a relatively smaller number of estates.

However, by this time the political tide had already commenced to address the problems with estate taxation in a different manner. Namely, the abolition of the estate taxes altogether. After Queensland dispensed with its tax in 1977, there was concern in other states about emigration of residents and capital and the potential impact of the tax on electoral outcomes. The federal government abolished its estate and gift duties in 1979. By 1984 all estate duties had been removed, both state and federal.

Australia had become the first rich country in the world to abolish death duties – that is, taxes upon the estates of decedents, or the inheritance of beneficiaries. Since that time there have been a number of other countries that have followed our lead including Israel in 1981, New Zealand in 1992, Sweden in 2005, and Austria and Singapore in 2008. Also, from 2003 the US progressively cut its top rate for estate taxes.

Wills and Taxation Post-1980

The abolition of estate taxes in Australia removed the need for lawyers to be overly concerned with tax issues in estate planning. Until 1985 (with the introduction of capital gains tax) Australia essentially had no tax on capital. In any event, the importance of capital gains tax on deceased estates and estate planning generally took a number of years to gain prominence.

In May 1986 the then Federal Treasurer stated in the Second reading Speech of the Bill introducing capital gains tax ('CGT') in Australia (note, with interest, that it took more than 6 six months after CGT in fact commenced to operate in September 1985 before we even had the benefit of the legislation)

> *An important general design feature of the tax is that the death of an asset holder will not be taken to give rise to a realisation of his or her assets for capital gains tax purposes.*

This principle is reflected now in Section 128-10 of the *Income Tax Assessment Act 1997* ('ITAA 1997 Act') which states

> *When you die, a capital gain or capital loss from a CGT event that results for a CGT asset you owned just before dying is disregarded.*

Accordingly, one would assume that the death of an individual should not cause questions to be raised by the deceased's representatives relating to CGT. It has only been in recent years that the impact of CGT, together with the importance general tax planning, on deceased estates has been recognised. During the period from about 1980 it could be said that wills and taxation are odd bedfellows.

More importantly, the post 1980 period has been a period that estate planning lawyers lost their expertise in revenue matters (as they regarded it unnecessary in their practice). Unfortunately, it has been other professionals (including accountants and financial planners) that have recognised the importance of taxation in connection with wills and estate planning leaving our profession behind. Hopefully wills and taxation are in the future not odd bedfellows as far as our profession is concerned.

The Estate Planning Process

A central component of any estate plan is the person's will. That is, the will can act as the instrument to effect most of the estate plan. In any event, it provides the opportunity to consider all aspects of planning in respect of assets within and outside the future estate.

However, a properly constructed estate plan is not simply the drafting of a will. The will that is drafted without any thought to general considerations of an estate plan and the related financial considerations may, on the administration of the estate, give rise to unfavourable structuring with adverse tax consequences. At the very least, a will that is drafted without any thought to tax and superannuation issues will have lost the opportunity to gain the tax benefits that are available.

The estate planning and financial considerations that need to be considered include:

(a) Asset protection planning.
(b) Family law issues (and of particular concern the potential exposure of claims that may be made by spouses of the children of the family).
(c) Ownership and control of assets.
(d) Revenue issues such as stamp duty, capital gains and income tax.
(e) Claims made by family members in contradiction to the plan.
(f) Providing for members of the family that may be unable to look after their own affairs.
(g) Superannuation.

The estate planning advice should consider the transfer of ownership and/or control of assets held by the family group and what structuring can be undertaken to provide the most efficient result for the family group. As such, the issues above need to be considered at different levels of generations in the family group. The movement of assets from one generation to the next is obviously a time when substantial restructuring in the family asset holding occurs.

Overall Strategies for Estate Planning

The general approach that can be taken in estate planning can be summarised as follows:

(a) Decide on the entities in the current group to be used to move assets into the next generation (for example, taking the opportunity to reorganize the group ownership either before death or as a consequence of death).
(b) Consider what entities need to be established in the will (for example, testamentary trusts).

(c) Decide whether to create the transfer of assets to selected entities at the time of death of one of the spouses or on death of the surviving spouse.

(d) Decide whether to create one structure for all family members or individual structures for each member of the family. The advantages of a single trust include simplicity and protection in respect of family law disputes occurring at the children level. Namely, a testamentary trust in which all children participate would be sufficient to exclude that trust from the assets of one of the children where that child is embroiled in a family law dispute. The disadvantage of a single trust entity is that the assets are intermingled with all family members.

(e) Review as to where assets are held and, more importantly, what assets will in fact flow to the structure proposed. Namely, what will be dealt with through the estate and what will not be dealt through the estate.

(f) Consider whether to convert joint tenancy ownership to tenant-in-common (or *vice versa*); what arrangements should be put in place in regard to superannuation (establishment of self - managed fund or entry into binding death benefit nominations); alter recipients of life insurance policies; examine the ownership of existing companies and the control of existing trusts.

(g) Make decisions on how the current superannuation arrangements may best move to the next generation.

Property in the Will

It is fundamental in an estate plan to know precisely what assets will form part of the estate and what assets will not (and therefore need to be dealt with separately).

(a) Joint Tenancy

As a planning tool, consideration should be given to whether or not the jointly owned assets are allowed to "divert" the estate or, alternatively, required to pass through the estate. Such measures include converting joint ownership to tenancy in common or *vice versa*.

For capital gains tax purposes, an asset held jointly is deemed to be owned by the person as a tenant in common (section 108-7 of the Income Tax Assessment Act, 1997 ("ITAA 1997 Act")). Accordingly, on the death of one of the joint tenants, a disposal for capital gains tax purposes nevertheless occurs. The conversion of a property held as joint tenants to a property held as tenants in common (or *vice versa*) will not be a disposal for capital gains tax purposes nor give rise to any stamp duty exposure.

It is my preferred view to change investment assets to tenancy in common so that on the death of the first owner the share held can go into the estate and be dealt in accordance with the provisions of the will. In particular, this allows such assets to be transferred to entities such as trusts established under the will.

(b) Superannuation Entitlements

Superannuation arrangements may not entitle testators to dispose of their death benefits by their will. The rules differ from scheme to scheme and the provisions of the deed of the superannuation fund should be considered. The Superannuation Industry (Supervision) Act, 1993, ("SIS Act") confines, in effect, the trustee of a superannuation fund to pay benefits on the death of a member only to a spouse, a child of the deceased or the legal personal representative of the deceased.

In practice, this means that the proceeds may be paid to the estate and be governed by the will; or they may be paid directly to the particular deceased member's family without passing through the estate and so fall outside the scope of the will. The trustee of the superannuation fund at the time of death has a discretion as to who receives the benefit and how it is paid (that is, as a lump sum or pension).

Accordingly, it is important to consider superannuation within a managed fund environment as compared to superannuation in a self-managed fund environment. Obviously, greater control can be exercised, or considered to be exercised, as part of the estate planning process where a self-managed fund is involved.

A binding death benefit nomination is necessary to override the usual discretion that the trustee of a superannuation fund has in relation to the distribution of a member's death benefits. If no binding death benefit nomination is in force at the time when a member dies, the trustee of the superannuation fund will have an absolute discretion to decide who to pay the death benefit to.

For managed funds, the key provisions underpinning binding death benefit nominations can be found in subsection 59(1A) of the SIS Act and regulation 6.17A of the Superannuation Industry (Supervision) Regulations 1994 ("SIS Regulations"). For self-managed superannuation funds, however, these strict guidelines do not need to be met and the Rules of the fund concerned may specify their own requirements. For example, my firm's standard Rules for a self-managed superannuation fund only requires the binding death benefit to be in writing and remains in force until revoked (does not need to be refreshed on a regular basis).

The importance of superannuation for wealth accumulation has increased dramatically in the past 10 years. It is now an important component to be considered by solicitors, financial planners and accountants advising on estate planning issues. The great advantage of having a self-managed superannuation fund is that it allows the beneficiaries of the estate to decide whether to pay out the benefits as so-called lump sum death benefits or to retain the self-managed superannuation fund structure and pay pensions to certain beneficiaries. It is increasingly more common for the latter to occur.

All death benefits paid as a lump sum to a tax dependant (spouse, child under 18 years, or child financially dependent over 18 years) will be tax free. A lump sum payment out of a taxable component of a death benefit to a non-tax dependant (for example, a financially independent adult child) is taxed at a flat rate of 15% (plus Medicare).

The tax treatment of a pension paid to a tax dependent on the death of a member is tax free if the member was 60 years or over (whatever the age of the recipient of the pension). If the deceased member was under 60 the pension is tax free if the recipient of the pension is 60 or over. However, if the recipient is under 60 then the pension is taxed at marginal personal tax rates less a 15% tax offset. Note that any tax free amount (for example, non-concessional contributions) is always received by the recipient tax free.

(c) Nominations in Life Insurance Policy

The owner of a life insurance policy has a nominated beneficiary of the policy. The nomination takes precedence over the terms of the will. It follows that where a nomination is made the proceeds of the policy do not form part of the estate.

(d) Property Held in a Discretionary Trust

Property held in the typical family/discretionary trust cannot be directly dealt with in a will. From an estate planning perspective, it is critical to ensure that the control over the trust and the trust property is addressed in the will. In particular, where a family trust has accumulated substantial assets then it is important how the beneficiaries will take control of the trust.

The “control” can be passed on in a number of ways. The person entitled to exercise the power to appoint and remove the trustee of the discretionary trust (the “appointor”) obviously holds the ultimate control of the trust. Accordingly, in the event that the trust deed itself does not make provision for the appointment of a successor appointor on the death of the appointor, provision should be made in the will of the appointor. This requires some care and attention as, in essence, continuation of the trust in a manner desired by the outgoing appointor will only be achieved by selecting an appropriate person to carry on such a role.

At the same time, you might leave some "Statement of Wishes" which outlines how you want the trustee's discretions to be exercised. Although a Statement of Wishes is not legally binding, where a clear statement of wishes is left with the will and the trustee deviates from this, the beneficiaries might have a basis to challenge such decisions.

Discretionary trusts cannot continue indefinitely and the life of a trust is determined by its vesting date. At that time, any remaining capital will be distributed to the beneficiaries and there will be capital gains tax consequences. There is little that can be done to change this without incurring tax, however, it is something to be aware of in planning the testator's disposal of wealth on death.

The Capital Gains Tax Aspects of Death

These consequences can be summarised as follows:

(a) an asset owned by a person as a so-called "pre-capital gains tax" asset (an asset acquired prior to 20 September 1985) will, on the death of that person, be acquired by the beneficiaries under the estate as a "post-capital gains tax" asset. The death of a person causes the conversion of what was otherwise a tax exempt asset into a taxable asset for the purposes of the capital gains tax regime.

(b) a post-capital gains tax assets owned by a person will, on the death of the person, be deemed to be acquired by the beneficiaries under the estate as if the beneficiaries were the original purchasers of the assets. Namely, the beneficiaries inherit, from a capital gains tax perspective, the indexed cost base of the asset that the deceased person previously held. Any unrealized capital gains (or unrealized capital losses, as the case may be) accrue to the beneficiaries as an unrealized capital gain (capital loss) in their hands.

(c) particular rules apply in respect of the capital gains tax treatment for deceased estates relating to a residence previously owned by the deceased person.

Every opportunity should be taken to delay the conversion of a pre-CGT asset to a post-CGT asset. This, for example, can be achieved in certain circumstances. One situation that often arises is the family company that is owned by, say, Mr & Mrs A and their shares are so-called pre-CGT shares (acquired prior to 20 September 1985). On the death of Mr A, the shares are normally transferred to his spouse through the estate. This means that Mrs A now owns half the company as pre-CGT shares and the other half as post-CGT shares. If Mrs A is fortunate to live, say, another 10 or 20 years then more than likely the value of the company's assets will have increased (hopefully, substantially). If Mrs A then dies and leaves the shares to her son, he will now hold all the shares as post-CGT shares. However, half of the shares will have a relatively low cost base for tax purposes (Mr A's old shares). Accordingly, a disposal of the shares by the son could give rise to significant capital gains tax issues.

An alternative would be for the rights on the shares to have been altered whilst Mr A was alive so that on his death his shares lose all their value (provided Mrs A is still living). This would mean that no shares of any value in the company transfer to Mrs A on Mr A's death. Rather, Mrs A continues to hold all the shares in the company as pre-CGT shares. On her death, son inherits the company with a cost base in the shares equal to the market value of the company at the time of the death of Mrs A. This approach follows some of the pre-1980 estate planning principles and in particular the decision in *Robertson v Federal Commissioner of Taxation (1952) 86 CLR 463.*

It should be noted that such value shifting as indicated in the previous paragraph should not be applied where the shares losing value are so-called post-CGT shares. The reason for this is the provisions of the value shifting rules in Division 725 of the ITAA 1997 Act.

Another consideration is where pre-CGT assets are held personally. For example, say Mr & Mrs A own the rural property in their own names and that property was acquired by them before the introduction of CGT. In this case it may be possible to transfer the ownership of the property into a company wholly owned by Mr & Mrs A. Such a transfer could gain the CGT roll-over benefits of Division 122 of the ITAA 1997 Act. In this case the property would retain its pre-CGT status in the company and the shares now held by Mr & Mrs A in that company would also be treated as pre-CGT shares. On the death of both Mr & Mrs A the property would retain its status as a pre-CGT asset (that is, Division 149 of the ITAA 1997 Act is not triggered even though there is a complete change of ownership of the company).

CGT Treatment of Main Residence on Death

There is a set of provisions directed specifically to main places of residence flowing through deceased estates. The general effect of these provisions is that a disposal by an executor or beneficiary will give rise to no capital gain or loss in the situation where the dwelling (as distinct from a main residence) was acquired by the deceased prior to 20 September 1985 or, in the case of 1, 2, and 3 below, the dwelling was acquired by the deceased after 19 September 1985 and was used as a main residence, in any of the following circumstances (see s 118-195 of the ITAA 1997 Act):

1. the disposal occurs within two years of the deceased's death (for example, the deceased acquired a dwelling in 1995 for $300,000 and continuously used it as his main residence till death in 2008 and the executor sold the dwelling in 2010 for $700,000 – no CGT applies); or

2. the dwelling passes to a beneficiary who uses it as his or her main residence, or is disposed by the trustee following use by a spouse or beneficiary entitled to occupy under the will (for example, the deceased in point 1 instead left the main residence to his executor with the condition that the deceased's surviving spouse could occupy the residence, the spouse died in 2007 and the executor sold the residence in 2008 for $750,000 – again no CGT);

3. the dwelling was used by the beneficiary as his or her main residence from the date of the deceased's death and the dwelling is disposed of by the beneficiary; or

4. the dwelling was acquired by the trustee pursuant to the terms of the deceased's will for occupation by a beneficiary who uses it as his or her main residence.

Note that so-called pre-CGT dwellings owned by the deceased need not be the deceased's former main residence to gain the exemptions from capital gains tax outlined above. For example, a pre-CGT property owned by the deceased and rented as an investment residence will be capital gains tax exempt if sold within the two-year period following the death of the deceased. This would remain the case if, say, the property was continued to be rented by the executors following the death of the deceased.

If a disposal does not come within the above rules, because the dwelling was not used by a relevant person throughout the whole of the period which is required for total exemption, a partial exemption may be available (s 118-200 of the ITAA 1997 Act).

The exemptions described above apply where a dwelling is acquired "by a taxpayer as a beneficiary in the estate of a deceased person". These exemptions can now include acquisitions under certain "deeds of arrangement". Namely, a deed entered into in settlement of a claim to participate in the estate, and the consideration if any given by the beneficiary involved a waiver of the claim. For example, a right to occupy a dwelling granted pursuant to a court order is also treated as a right that passes under the will – see ATO ID 2004/734.

Life Interests

It should be mentioned that it is not as common at present to create life estates for a spouse as in the days when death duty savings might have resulted from their use. However, a life interest might be appropriate, for example, where the testator seeks to control the disposition of capital through the estate. For example, if the testator wished to leave their spouse the income on certain assets but ensure the capital was passed on to the testator's children.

The Commissioner of Taxation has expressed his view in respect of the tax treatment of life and reversionary interests (see Taxation Ruling TR 2006/14 ("Ruling")). The view adopted is that the grant of a life estate and remainder interest involves a part disposal of existing rights in respect of what once constituted a larger asset out of which the life and remainder interests have been carved. This is the so-called "part disposal view".

Testamentary Trust – Equitable Life Interest and Main Residence

It is more often the case that under a will an equitable, as distinct from a legal, life estate is created in respect of a main residence. The common form of an equitable life interest is as follows:

> *If my spouse survives me, my trustees to hold my principal residence on trust for my spouse for life and in remainder to my children.*

In this circumstance, the Commissioner of Taxation is of the view that the main residence is acquired by the executors of the estate for the market value of the property as at that date (s 128-15(4) Item 3 of the ITAA 1997 Act and para 18 of the Ruling).

On the death of the spouse, the Commissioner regards CGT event C2 to be triggered (para 40 of the Ruling and Example 1 at para 125) on the basis that the life interest "expires". This appears to be an extraordinary conclusion as I would have thought that the interest in possession does not expire but rather has shifted back to the trustee for the absolute benefit of the children. Since CGT event C2 is not subject to the market substitution rules and, in any event, s 128-10 operates to ignore a gain or loss as a result of death, there is no tax consequence arising in respect of the death of the spouse.

As for the children, they become absolutely entitled to the main residence. The Commissioner accepts that the trust in this case is a trust to which Division 128 applies (this is the Division that applies to deceased estates), as the property was a main residence when it went into the testamentary trust and ultimately it is owned by the children as a direct result of their father's will. There are no CGT consequences for the trustee nor the children (see para 126 of the Ruling).

The children are taken as having acquired the main residence for the cost base (and reduced cost base) that the trustee had in the main residence (the market value as at the date of death of the father). However, the children should not be exposed to any CGT relating to any increase in value of the property between the date of death of the father and the death of the mother. The reason for this is that section 118-195(1) Item 2(a) or (b) applies. That section allows tax exemption, in the example, whilst ever the property is used as a main residence.

In summary, the grant of a life interest in respect of a main residence operating through a testamentary trust is tax effective and will allow the owner of the residual estate to gain the same tax advantages as if the main residence had been left directly to that person without the interposition of the life tenant. For example, the children in the above case would be able to sell the residence post their mother's death (assuming the mother was the last family member to use the property as a main residence) with only a portion of the proceeds possibly exposed to CGT. That portion would be the period since the mother's death to date of sale divided by the period since the father acquired the property multiplied by the difference between the sale proceeds and the assumed cost base (that cost base being the market value at the time of death of the father).

Transferring Assets to Tax Effective Structures

There are a number of disadvantages of holding post-capital gains tax assets in companies. This essentially relates to the problem that companies are not entitled to the 50% general discount for capital gains tax purposes pursuant to Division 115 of the ITAA 1997 Act). Further, holding assets in an individual's name does not provide any opportunity to "split" taxable capital gains and income with other persons.

Accordingly, the use of trusts and, especially, discretionary trusts to hold capital appreciating assets is important. The use of trusts allows for flexibility in tax planning and, in many cases, such flexibility can be the cornerstone of any good tax plan. Trusts also provide the ideal vehicle to hold assets in respect of asset protection planning.

The opportunity to obtain capital gains tax roll-over relief by transferring assets from an individual or a company to a trust on a tax effective basis is generally unavailable. However, the one exception is where an asset is transferred to a trust pursuant to a will.

This provides an opportunity for the current asset owning generation to transfer assets to the next generation on a capital gains tax effective basis. This will allow the next generation to own such assets in tax and asset protection efficient structures.

The transfer of assets in a deceased estate to trust entities can be undertaken in two broad ways:

(a) the nominating under a person's will of an existing *inter vivos* trust (for example, instead of nominating an individual or a beneficiary an individual's existing family trust - assuming one exists - is nominated as the beneficiary);

(b) the creation of a trust in the will - the so-called "testamentary trust" (or what I prefer to call a "will trust").

Testamentary or Will Trusts

(a) Taxation Advantages: Income Tax

A testamentary trust is simply an express trust created by the testator's conveyance of property (in a like manner to a settlor in respect of the creation of an *inter vivos* trust - that is, during the life time of a person) by will with the intention that the property be held in trust for others under the terms of the will.

Much of the discussion relating to the merits for drafting wills with a testamentary trust has concentrated on the possible income tax advantages of directing investment income to minors. Namely, the opportunity to avoid the adverse consequences of Division 6AA of Part III of the Income Tax Assessment Act,1936 ("ITAA 1936 Act").

The use of testamentary trust in a succession plan can be far more significant than simply to enable "income splitting" to minors. However, because of the benefits that can be achieved from "income splitting" it would appear sensible to draft the testamentary trust for succession planning purposes to also achieve the benefits in relation to minors.

Division 6AA of the ITAA 1936 Act operates to discourage income splitting by means of the diversion of income to children under 18. A minor within this class of taxpayer (i.e. a prescribed person) is generally liable to pay tax at special rates (generally the top marginal personal rate) on unearned income (e.g. interest, dividends, rent and royalties), whether derived directly or through a trust.

Assessable income derived by a trust which resulted from, amongst others, a will is excepted trust income in relation to a beneficiary of the trust and therefore not subject to the special provisions of Division 6AA (Section 102AG(2)(a)). Under this provision, all that is necessary is that the income be assessable income of a trust which is one of the forms of trust referred to in subparagraphs (i) or (ii) of Section 102AG(2)(a). This is the true testamentary trust.

As far as drafting such a trust within the will it is a question for the drafter to determine the extent to which the terms should encompass. Namely, whether to draft a trust in terms which effectively mirror a trust deed which would normally be established in the case of the ordinary family discretionary trust or to draft the trust in a much shorter and simple form. Obviously, if the testator wishes to restructure the family estate in a flexible form then there would be significant advantages in effectively having the testamentary trust provisions reflecting what would normally be constituted in an ordinary discretionary family trust. In this way, the testamentary trust could continue to exist for up to 80 years.

In this manner, the testator would be establishing a trust (to commence after the administration of his estate) with wide discretionary powers vested in the trustee. The terms could, for example, include the discretion to apply income and capital to various beneficiaries within the defined class of beneficiaries; the advancement of capital for education and maintenance; the "streaming" of income; the power to borrow, lend, guarantee, grant securities and the like.

In most wills, the testator normally appoints the same person as the executor and trustee. However, it is open to appoint different persons to such roles and, for this purpose, a private company could be appointed as the trustee (although a private company cannot be appointed as an executor). In any event, it would be desirable to have a power allowing for the trustee to be changed and the question then becomes who should be given this power of appointment. This is the same type of question faced when establishing an *inter vivos* discretionary trust.

The case of *The Trustee for the Estate of the Late A W Furse No. 5 Will Trust v FCT* is one of the few reported decisions dealing with Div 6AA. In this case, a will made in July 1974 established multiple testamentary trusts, each for a capital of $1 after the testator passed away shortly after making the will. A trustee was then appointed over one of the testamentary trusts and proceeded to borrow small amounts of money and acquire a unit in a unit trust. The ATO did not consider the income from the unit trust as excepted income and argued that the income derived by the trustee was not assessable income of a trust estate that "resulted from a will".

Justice Hill rejected the ATO's argument and held that it was only necessary that the parties be dealing on an arm's length basis and that it was not necessary that they be arm's length parties. The court noted that provided the trust estate was created by a will and the arm's length test applied, then any income of a testamentary trust would be considered as excepted trust income.

(b) Taxation Advantages: Capital Gains Tax Tax

In PS LA 2003/12 The Commissioner of Tax stated that:

> *"The Commissioner will not depart from the long-standing administrative of treating the trustee of a Testamentary Trust in the same way as a 'legal personal representative' is treated for the purposes of Division 128 of the ITAA 1997".*

In particular, the Commissioner stated:

> *"there is widespread understanding in the tax community of the Tax Office's practice not to recognise any taxing point in respect of assets owned by a deceased person until they cease to be owned by the beneficiaries named in the Will (unless there is an earlier disposal by the legal personal representative or testamentary trustee to a third party or CGT event K3 applies). To adopt a different approach now would result in a general unsettling of the community and an increase in compliance costs".*

This interpretation was to be incorporated into the legislation however on 14 December 2013, the Assistant Treasurer announced that the 'Capital gains tax minor amendments ensuring the proper functioning of the capital gains tax provisions –deceased estates' and the 'Capital gains tax - refinements to the income tax law in relation to deceased estates' measures will not be proceeding.

The 'minor amendments ensuring the proper functioning of the capital gains tax provisions – deceased estates' measure was announced in the 2011-12 Federal Budget. This measure proposed to legislate the current ATO practice of allowing a testamentary trust to distribute an asset of a deceased person without a capital gains tax (CGT) taxing point occurring.

Despite this failure to proceed with the amending legislation the Assistant Treasurer stated

> *Law Administration Practice Statement PS LA 2003 confirms that the Commissioner "will not depart from the ATO's long-standing practice of treating the trustee of a testamentary trust in the same way that a legal personal representative is treated for the purposes of Division 128 of the Income Tax Assessment Act 1997."*
>
> *This means that where the assets of a deceased person pass to the ultimate beneficiary of a trust created under the deceased person's will, any capital gain or loss that might have arisen during this passage will be disregarded.*

(c) Tax Issues in Drafting Testamentary Trusts

One of the critical outcomes of the High Court's decision in Commissioner of Taxation v Bamford & Ors is the determination of the meaning of the term "income" under section 97 of the ITAA 1936 Act. The High Court concluded that in determining the "income of the trust estate" for the purposes of section 97, consideration needs to be given to the deed, rather than the ordinary concept of income. Practically, therefore, all testamentary trust wills must incorporate powers for a trustee to determine what is and what is not included as income for the trust. Among other things, this should include the ability for the trustee to determine whether or not to include net or gross capital gains as trust income.

The other main component of the decision in *Bamford* related to the appointment of trust distributions to beneficiaries. The High Court considered the meaning of the term "share" for the purposes of section 97. A "percentage" approach simply assigns a set proportion or percentage of the income to individual beneficiaries. In contrast, a "fixed amount" approach involves the trustee resolving to appoint a fixed amount of income to an individual beneficiary. Fixing the amount of the distribution of income for say, two of three beneficiaries of the trust with the remaining being distributed to the third beneficiary means that any increase or decrease in assessable income would only affect the distribution to the third beneficiary.

The High Court in *Bamford* held that "share" in the context of section 97 referred to the proportionate entitlement of each beneficiary to the income of the trust estate. Namely, it is the proportion that determines the amount of assessable income that is attributed to the beneficiary, even if fixed amounts have been appointed to the beneficiaries under the trust.

Assuming that trustee resolutions (or minutes) are appropriately drafted in the context of the High Court's decision in *Bamford*, there should not be any particular concern for distributions out of testamentary trusts as a result of this aspect of the *Bamford* decision. Having said this, in relation to a testamentary trust where the income and capital beneficiaries are different there is potential for significant adverse consequences to arise.

In Wilson & Anr v. Champion & Anr [2012] QSC 395 the trust under the will provided in part

> *To hold the remaining part or portion either in its present form or in any form of investment that they in their absolute discretion may think fit (including in the investment of shares in any mining company) upon trust for daughter MARGARET HARRIS and to pay transfer and hand over the income and profits derived therefrom to her until she shall become bankrupt or shall do or suffer any act or thing whereby the said income and profits or her interest therein or any part thereof would or might but for this provision become charged encumbered or become vested in any other person or persons or a corporation and I direct that my Trustees shall during the residue of the life of the said MARGARET HARRIS pay transfer and hand over the income and profits therefrom to my son WILLIAM FRASER but so that my trustees shall not be responsible for paying the said income and profits derived therefrom to the said MARGARET HARRIS after the happening of any such act or thing as aforesaid unless and until they have received express notice thereof and as from her death transfer and hand over such equal part or portion unto and to my son the said WILLIAM FRASER for his sole use and benefit absolutely provided however that should he have predeceased my said daughter then to pay transfer and hand over the same unto and to one or more of his children as shall survive him and if more than one in equal shares as tenants in common for their sole use and benefit absolutely.*

A declaration was sought as to the meaning of the words "income and profits" in the above clause of the will

The Court found that in the use of both the words income and profits, the use of the word profits was deliberate. Namely, the testatrix intended the respondent to receive something more than income – she intended that the first respondent receive realised capital gains made by the trust which should be the net of the costs associated with accounting for the income and realisation of the gains respectively. Further, it was held that this phrase does not extend to unrealised capital gains – agreed with judgment in *Graham v Trust Company Australia* that the meaning of profits should not be exceeded and should not include unrealised capital gains. Any unrealised capital gain, provided it remains in this form, should be preserved for the residuary beneficiaries. Determined

The lesson from the above is to ensure that the drafting is consistent with tax and accounting principles.

(d) Asset Protection and Testamentary Trusts

In addition to the taxation advantages of a testamentary trust, many clients look to trusts as a possible answer in protecting family assets in respect of the possibility of a matrimonial disputes involving their children. Namely, the concept of the so-called "blood-line trust". Clients in this situation request that the estate plan is structured so that the plan has the effect of prohibiting the spouse of one of the children from gaining access to assets accumulated through the efforts of the parents of the child.

Accordingly, the estate planner needs to at least understand the issues that can arise in respect of trusts in a family law dispute. There are of course significant powers available to the Family Court to treat trust property as the property of the parties (or one of them) and so make orders that take account of such property. See, in particular, the High Court decision in Kennon v Spry [2008] HCA 56. From a family law perspective, where a spouse is the real controller/appointor of a trust then the assets of the trust are usually treated as property of the parties to the marriage and added to their pool of property to be divided in the event of a financial settlement relating to a matrimonial dispute. This is more so where the assets of the trust accrued during the marriage from the efforts of one or both spouses.

On the other hand, where a party to the marriage was not a settlor, trustee, appointor nor beneficiary then the assets of the trust concerned may not normally be included in the pool of property. (In the Marriage of Kelly (No. 2) (1981) 7 Fam LR 762). The High Court in Kennon referred to the decision in Kelly and stated:

> *The Court was concerned, inter alia, with the assets of a family company and family trust which were under the "de facto control" of the husband. The assets could be taken into consideration as a "financial resource" of the husband within the meaning of s 75(2)(b) of the Family Law Act. The trust assets, however, did not fall within the description of the "property" of the husband for the purposes of s 79 because "the husband could not assert any legal or equitable right in respect of them"[19]. That was a case in which the husband had neither a legal nor a beneficial interest.*

(e) Separate Trusts for Each Child or a Single Joint Trust

One issue faced is whether to have in an estate plan the establishment of one testamentary trust for the benefit of all adult children or to establish separate testamentary trusts such that each child will have the control and benefit of their own trust. In the case of separate testamentary trusts for each child, the question then raised is whether the fact that the source of the assets of the testamentary trust is from the parent (and not from the efforts of the adult child during that adult child's marriage) sufficient to protect the assets from a disputing spouse of the child concerned?

The question then is whether a single testamentary trust owned and controlled equally by several adult children will protect the property of the trust from a matrimonial dispute involving one of the adult children. It is ultimately a question of fact or degree, and the courts will look at factors including:

- whether the spouse is the appointor of the trust,
- the degree of control the spouse can exercise over the trustee (eg if the spouse a director or majority shareholder in a corporate trustee?)
- whether the spouse is a sole beneficiary,
- whether it is evident from the circumstances that the assets of the trust are ultimately intended solely for the spouse,
- whether the one or both spouses has contributed assets to the trust, and
- whether there is a pattern of distributions of income to the spouse.

By way of example, note the recent case of Romano & June [2013] FamCA 344, in which the assets of a discretionary trust were included in the pool of matrimonial assets where the husband was a director of the corporate trustee (but not a shareholder) and a named beneficiary of the trust but not an appointor. On the facts in that case (including the fact that the assets of the trust were largely the result of his efforts) the court found that the husband consistently treated the trust assets as his, to be used for his benefit or at his direction.

In Lovine & Connor and Anor [2011] FamCA 432 the husband was a beneficiary under a testamentary trust established by his father. The father had in his estate provided for the establishment of two testamentary trusts. Moshin J at [122] + [124] held

> *I find the following facts. The will appointed the husband and his two sisters as executors and trustees. It divided the Estate, to the extent that it was not left to the deceased's widow, into the proportions of two thirds and one third. The one third portion was designated for the husband's sister, Ms H and has been applied accordingly. The two thirds portion was designated for the husband but intended for both the husband and his other sister, Ms S. The reason for the difference between the designation and the intention was the breakdown of Ms S's relationship. However, Ms S and/or her children have effectively received approximately half of the two thirds of the estate being one third of the entirety of the trust funds. As a result, there is a remainder of one half of the two thirds being one third of the entirety of a trust fund. They have not been distributed. It is entirely consistent and probable that they are intended by the husband to be distributed to himself and/or the parties' children.*

The Court then went on to discuss the 'control' element in relation to trusts and family law matters.

> *Circumstances in which a party to proceedings for alteration of property interests before the Court might have control of a trust in relevant terms have been the subject of judicial consideration on many occasions. In Ashton and Ashton, 1986 FLC 91-777, the husband had created a trust of which he was appointor and in exercise of that power of appointment, had appointed several different trustees over a period of time. However, the Court found that he had always had control arising out of that power of appointment and determined that the assets of the trust were there for assets of the husband to be included in the pool of assets in the proceedings. (See also Davidson and Davidson (1991) FLC 92-197, Stephens and Stephens and Ors (2007) FLC 93-336).*
>
> *The circumstances of this matter are distinguishable from those in Ashton's case (supra) but not in any ultimately material sense. While that trust was not a testamentary trust, there were beneficiaries other than the husband. The husband had the sole power of appointment and treated the assets of the trust as effectively his assets.*
>
> *In this matter there are other beneficiaries. However in every sense the husband is the only real decision maker and while the will appointed his sisters as trustees with him, they play no active role. The actual distributions in this matter have already benefited the husband's two sisters and/or their children and it is entirely consistent with the facts that the residual benefit should be applied to the husband and/or his children. Accordingly, I find that the residual assets must be included as an asset in these proceedings. I will refer to their quantum in due course.*

The husband in Lovine appealed the decision of Moshin J including that part of the decision discussed above. However, in the Full Court the husband did not ultimately challenge this part of the judgement of Moshin J.

<u>Lovine</u> may be compared with the trust in <u>MacDowell & Williams and ors</u> [2014] FamCA 479. The wife in <u>MacDowell</u> was a primary and default beneficiary of the F G MacDowell Discretionary Trust (her parents being the secondary beneficiaries) and B Pty Ltd was the corporate trustee for the Trust, the directors of which were the wife's parents. The wife's parents had absolute control of the F G MacDowell Discretionary Trust, and, although the wife was the primary and default beneficiary of that Trust, the wife's parents had in the past caused the Trust to make distributions to themselves and to other entities they controlled where the wife might have otherwise received those distributions as the default beneficiary.

Kent J in <u>MacDowell</u> referred to the decision in <u>Spry</u> and, in particular, paragraph 73 of French CJ's reasons as quoted above in this paper under paragraph (a). His Honour then held

> *It is clear, on the evidence before me, that the Wife does not in fact control any of the entities from which documents are sought by the Husband. The Husband concedes that the Wife is neither a director nor a shareholder in any of those companies, and that her interest is restricted to being the primary and default beneficiary of the F G MacDowell Discretionary Trust. … I also find unpersuasive the Husband's submission that the creation of C Pty Ltd in March 2010, near to the date of separation of the parties, of itself implies that this company was to be used as a vehicle for the protection of the Wife's funds from any property dispute between the parties, without further evidence.*

(f) The Master Trust Concept

If the single testamentary trust is to be used then how do you address the question of individual choices for investment by the respective siblings. The answer to this issue probably rests with the adult children once the single testamentary trust is established. However, one suggestion is to preserve the single testamentary trust and have that trust lend money to family trusts established by each of the adult children. This 'master trust' structure then allows the respective adult children to make their own choices for investment but at the same time preserve the asset value of the testamentary trust (the master trust) through the inter-trust loans. Obviously, any increase in asset values in the individual family trusts will become property in the event of a matrimonial dispute but hopefully the liability to the testamentary trust (the master trust) will preserve the position as if the parents were still living.

Drafting the provisions of a jointly owned and controlled testamentary trust then requires some care. In particular, the protection of minors under the single testamentary trust in the event of the death of one of the adult children needs to be considered. For example, if there are three adult children and one dies, how do you protect that deceased's minor children in the testamentary trust? In any event, how does the control (through the appointment of family members whether as minors or otherwise as appointors) under the trust take place on the death of one of the adult children?

It may be necessary therefore to consider having an independent party appointed as a representative of the deceased adult child's minor children as a joint appointor with the surviving two adult children. This may also apply to the appointment as a director of a trustee company or direct appointment where individuals are trustees. The issue then becomes how the children, once they reach an appropriate age, take the place of the independent party. Is that role left to the eldest child or some other mechanism are issues that need to be considered.

Accordingly, where a master trust concept is adopted a full understanding of the control and ownership of such a structure is essential. These control mechanisms can include:

(i) the position of the appointor;

(ii) the terms of the trust deed; and

(iii) the directors and shareholders of the trustee company.

In essence, the estate planner needs to consider the above factors in providing in the estate plan the mechanism for shifting the control of the family trust to the next generation.

(g) Appointors of Trusts

The appointor of a trust is generally the key to control of the trust. The appointor normally has the power to appoint and dismiss the trustee. It should not be overlooked, therefore, when drafting the will to review the mechanism of the appointment of a new appointor on the death of the first appointor. In particular, it is normally desirable to make provision in the will for the specific nomination of a new appointor. The question then is whether the appointment should be made to an individual (or individuals) or a corporate entity. The appointment of adult children jointly as appointors has advantages for family law reasons as discussed above however there are the difficulties of the requirement for unanimous decision making and the problem on the death of one of the adult children.

Accordingly, consideration should be given in the case of a master testamentary trust structure to the appointment of a special purpose company as the appointor. Namely, the control of the trust concerned is then exercised through the corporate entity and that entity is structured in a manner allowing for the adult children to more effectively exercise the joint power of that position in the trust. For example, the constitution of the special purpose company to take the role of appointor could include specifically defined terms in respect of voting, appointment of directors and entitlements, restrictions on transfers and transmissions of the shares concerned, amongst other matters.

(h) Terms of the Trust Deed

The terms of the trust deed can therefore extend or limit the powers of a guardian. If the deed provides for the trustee to obtain the consent of the guardian before exercising any major power then of course the guardian's role is significant. The issue for the estate planner is therefore to anticipate the likely requirements and to balance the needs for controls without severely restricting the successful operation of the trust in the future.

(i) Shareholders and Directors of Corporate Trustee

It is not uncommon in an estate plan to overlook the structure of the corporate entities in the family group. These entities could be companies acting in their own right as investment vehicles or trading vehicles. Alternatively, the entities could be acting as corporate trustees of family trusts and the testamentary trust. The constitution of all such companies should be reviewed and considered as part of the estate plan. In particular, consideration should be given to the following matters:

(i) *The Number of Shares Available to be Transferred*

It is common in a will to see the following:

"I give my shares in A Pty Ltd to my children equally as tenants in common".

This can have the undesirable result that the ownership of the shares concerned in the share register of the company will only be recognised for corporate law purposes as a joint tenancy ownership (see section 169 of the Corporations Act). Further, and possibly an even greater problem is that the first shareholder mentioned on the share register will be the shareholder recognised at a meeting of shareholders entitled to vote (see section 250F of the Corporations Act) and entitled to receive notices of meetings of shareholders (section 249J of the Corporations Act).

Accordingly, if there are say 3 adult children then the shares in the company should be split in to a number of shares which can be divided evenly by 3. Then in the will it would be preferable to gift a specific number of shares to each of the adult children. This ensures that each child has their own share allocation and have an entitlement to vote in the proportions intended.

(ii) *Right of Appointment as Director*

Consideration should be given to the rights of shareholders to appoint directors. For example, if there are 3 equal shareholders then each one individually is unable to appoint a director. It may be intended that each child has that right and therefore such a provision should be included in the constitution of the company.

(iii) *Voting by Directors*

Where unequal shareholdings are present then it may be desirable to tie the number of shares a director represents to the number of votes that director may cast at a directors' meeting. In addition, the constitution of the company could provide for the requirement of a unanimous decision of the directors in respect of certain matters. For example, such matters could include the issue of shares, the approval for the transfer of shares, the granting of loans to related parties, the expenditure in excess of certain limits, financial transactions such as grant of mortgages and guarantees. In the case of corporate trustees the matters could also include issues relating to the trust such as the vesting date, capital distributions, loans and the like. Finally, the issue of a quorum for a directors' meeting should be addressed.

(iv) *Provisions where Child Dies*

The constitution of corporate entities should consider the decision making process of the corporate entity in the event that say one of the adult children subsequently dies leaving minor children. Namely, there needs to be considered special provisions so that the surviving children of one of the adult children are protected.

Trusts other than Testamentary

A further opportunity is provided under the tax legislation to use an existing trust or to establish a trust after the death of the deceased such that it operates like a testamentary trust. Namely, an amount included in the assessable income of a trust is excepted trust income in relation to a beneficiary of the trust, to the extent to which the amount is derived by the trustee from the investment of any property:

- which devolved for the benefit of the beneficiary from a deceased estate (Section 102AG(2)(d)(i)of the ITAA 1936 Act); or
- which was transferred to the trustee for the benefit of the beneficiary by another person out of property that devolved upon the last-mentioned person from a deceased estate and was so transferred within three years of the deceased's death (Section 102AG(2)(d)(ii) of the ITAA 1936 Act).

The first category above would include the position where the deceased leaves an asset in their estate to the trustee of a pre-existing family trust. Namely, instead of creating a trust in the will an alternative is for the testator to leave the asset to an existing family trust. The advantage of this is simplicity in the drafting of the will and one less tax entity subsequent to the death of the client. That part of the income of the family trust that relates to the property devolved from the estate can then be directed to minor children and they would obtain, for example, the normal tax free threshold of $18,000.

The important issue if this option is chosen is to ensure that the provisions of the pre-existing family trust are appropriate for the implementation of the proposed estate plan. I would suggest as a bare minimum amendment that the provisions of the deed recognise that property may devolve from an estate and in such a circumstance the trustee has the power to direct any such income to minor children as specified in the estate from which the property devolves.

The second area where a testamentary trust may still operate even if it is not planned is the so-called "3 year rule". Namely, where, say, 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. The income derived by that trust can then be directed to the children and the latter would gain the benefits of the adult tax free threshold plus adult marginal tax rates. The critical factor being that the transfer of property occurs within 3 years of the death of the wife/mother in my example. The other critical factor is that the property transferred must result from the estate. It is not possible, for example, to transfer, say, the proceeds of a life policy received by the husband to a trust and receive the tax concessions for the minor children.

There are, as you might expect, problems with relying on the "testamentary trusts" which are not established under the will. The significance of the distinction between the "true" testamentary trust and the other trusts for the purposes of Section 102AG of the ITAA 1936 Act is that trust income will not be excepted trust income of the non-testamentary trusts if the property of such trusts will not vest in the beneficiary when the trust ends, i.e. the transfer must be a beneficial transfer (Section 102AG(2A)). That section is intended to exclude, for example, 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.