
Life and Remainder Interests in Property and the CGT Taxing Points

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1 Overview

- 1.1 While complex in its application and tax implications, life interests continue to offer a niche solution for certain estate plans.
- 1.2 Whether used to balance the risks associated with estate plans for blended families, or to protect any built-up wealth from a surviving spouse's new relationship; life interests should only be used with proper consideration of potential disadvantages as well as the taxation implications for all parties.
- 1.3 The focus of this paper is to decipher the complex taxation treatment of life interests and will seek to cover the following topics:
 - (a) Life interests and their use in modern estate planning.
 - (b) Capital gains tax and death – a broad summary.
 - (c) The difference between equitable and legal life and remainder interests.
 - (d) The capital gains tax consequences of granting a life interest and a right to reside in property.
 - (e) The effects of a deed of arrangement to vary the terms of the Will.
 - (f) The capital gains tax consequences when a life interest owner dies.
 - (g) The capital gains tax consequences in ending the life interest early.
 - (h) The effect of life interests on the capital gains tax main residence exemption.
- 1.4 Case studies will be offered throughout the paper.
- 1.5 It is acknowledged that life and remainder interests may be used in arrangements outside of an estate plan. This paper will not specifically address the taxation implications of such arrangements (which may yield different taxation outcomes). Thought should also be had as to the stamp duty implications of life interests.
- 1.6 More specifically, this paper seeks to address equitable life interests, being the kind that arises as part of such interests drafted as part of an estate plan.
- 1.7 This paper should be considered supplementary to the presentation which it relates to.
- 1.8 This paper will make reference to the following key legislation and Australian Taxation Office (ATO) guidance:
 - (a) *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**).
 - (b) *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**).
 - (c) Taxation Ruling 2006/14 (**TR 2006/14**).
 - (d) ATO Practice Statement Law Administration PS LA 2003/12 (**PSLA 2003/12**)
- 1.9 References to the following defined term will have the following meanings:
 - (a) LRI – life and remainder interests.
 - (b) CGT – capital gains tax.
 - (c) PBR – private binding ruling.
 - (d) LPR – legal personal representative.



2 Life interests and their use in modern estate planning

- 2.1 At its simplest, a 'life interest' in an asset is a person's entitlement to the income of such asset (and its use) during the life of such person (**life interest owner**).
- 2.2 As a life interest must end on the death of a life interest owner (and potentially earlier), 'remainder interests' must exist entitling the underlying capital of the asset and residuary income for the benefit of other individual/s (**remainder owner**).
- 2.3 LRIs can exist in a variety of circumstances with each LRI arrangement differing from another through slight variations. All LRI arrangements, however, require the asset subject to the LRI to have been owned by someone originally (**original owner**).

Life interests in modern estate planning

- 2.4 While long-term provisions in Wills may generally be avoided due to their lack of flexibility and increased burden where the passing of time has resulted in the provisions being outdated, life interests over certain estate assets may offer solutions in specific circumstances.
- 2.5 Circumstances where life interests may be of use include:
- (a) 'Blended families' – life interests offer a level of certainty in balancing the interests of a current spouse (often the second spouse of the deceased) and children of a prior marriage by ensuring the assets revert to the children as remainder owners following the death of the current spouse (life interest owner).
 - (b) Providing for an incapacitated beneficiary – beneficiaries who require a level of security in relation to income or a place to live post death of a Willmaker (such as a spouse who has lost capacity or elderly parents who are dependent on the Willmaker) may benefit from receiving a life interest in income generating assets, whilst the long term beneficiaries (such as children of the Willmaker) may receive their interest as remainder owners.
 - (c) Protecting the estate from a Willmaker's spouse remarrying – where a Willmaker is concerned that a surviving spouse may remarry and 'forget' to provide for their children, life interests offer a level of security that the estate of the Willmaker reverts for the children's benefit as remainder owners post death of the life interest owner (the surviving spouse).
- 2.6 Despite potentially achieving the stated objective, thought should be had as to the disadvantages which may include:
- (a) Family provisions applications – the use of LRIs in blended families may increase the risk of at least one of the life interest owner or remainder owner being dissatisfied with the arrangement. Children from an earlier marriage may feel they are entitled to receive part of the estate before the death of the life interest owner (the current spouse). The current spouse may feel that they should be entitled to benefit from the underlying capital of the asset.¹
 - (b) Lack of flexibility to income – where the asset in which a LRI is being created over either does not generate income (as in the case of an asset intended to be the home for the life interest owner) or is not expected to yield large income returns, LRIs may not offer the life interest owner with sufficient income to cater for future rises in the cost of goods and services required to enable them to live comfortably.

¹ Consider *Hurley v Hurley* (1947) 75 CLR 289; *Golosky v Golosky* [1993] NSWCA 111.



- (c) Creating a lack of trust – the use of LRIs in shielding a Willmaker’s assets from a surviving spouse’s remarriage may inadvertently create a lack of trust between the couple.
- 2.7 In addition, difficulty may exist in determining whether to allow the life interest owner to hold the asset in their direct name, or whether a person/entity should act as legal owner of the asset (**trustee**) for the benefit of the life interest owner and remainder owner. Whilst possible for a spouse or partner (as a life interest owner) to hold the asset directly, due to the difficulty in balancing the interests of the life interest owner and remainder owner and potential conflict of interest, independent trustees are preferred to offer the level of expertise and impartiality to the management of the asset.
- 2.8 That is, equitable LRIs (explained further below) are preferred for the use in a modern estate plan.
- 2.9 The rule in *Howe v Dartmouth* as summarised below provides the difficulty in managing the competing interests:²
- “The rule in Howe v Dartmouth requires a trustee to be impartial, not favouring a beneficiary who is interested for life at the expense of any one interested in the remainder or visa versa. The rule says that, where residuary personality is settled by will for the benefit of persons who are to enjoy it in succession, it is the duty of the trustees to convert into property of a permanent and income bearing character those parts of it which are of a future or reversionary nature (in the interests of the tenant for life) and those parts of it which are consist of wasting assets (in the interests of the persons interests in the remainder). Adjustments should prima facie be made between successive beneficiaries upon this basis, so that a tenant for life would be entitled only to receive, not the possibility of very large but temporary income from a disappearing security, leaving perhaps nothing for a remainderman, but the income which he would have received if there had been a due conversion into authorised securities”*
- 2.10 If the estate plan calls for the use of LRIs, thought should be had in tailoring the LRI provisions to consider the following:
- (a) The extent to which the life interest owner may use and occupy the asset, including but not limited to:
- (i) who is responsible for the outgoing (the executors or the life interest owner);
 - (ii) how much monies should be set aside for the benefit of the life interest owner;
 - (iii) whether the life interest owner is entitled to benefit from any gain in the capital value accruing in the asset (e.g. to assist the life interest owner in downsizing into a retirement unit or finding alternative accommodation).
- (b) The circumstances where a life interest can be terminated.
- (c) To ensure the LRI contains sufficient trustee powers to administer the assets, including but not limited to:
- (i) any appropriate right to occupy;³

² *Michael v Calil* (1945) 72 CLR 509 at 522 per Latham CJ.

³ Where the interest is only partially over an asset, provisions must be tailored accordingly.



- (ii) the power to insure fund property;
 - (iii) the power to vary certain clauses;
 - (iv) the express power to purchase a dwelling for a beneficiary.⁴
- (d) Appropriately worded provisions determining when such assets revert to the remainder owners. Care should be considered where:
- (i) contingent interests exists;
 - (ii) general wording such as 'to those children who survive me' which introduces ambiguity whether children born after the death of a Willmaker were to be included as beneficiaries;⁵
- 2.11 Where LRIs are not considered appropriate, having considered the various factors, testamentary discretionary trusts may offer a flexible solution by not fixing the life and remainder interests.
- Right to occupy and life interests***
- 2.12 Life interests differ from a general right to occupy a property for life largely in part due to life interests carrying with it a right to any income from the asset.⁶
- 2.13 A right to occupy also does not give a beneficiary the right to create interests over the asset⁷ and is liable to terminate upon the beneficiary abandoning the asset.⁸
- 2.14 As a result of such reduced rights over the asset, mere rights to occupy (or reside) are considered as a 'weaker' estate planning tool compared to LRIs, notwithstanding the simpler taxation implications (considered further below).
- 2.15 Care must be taken in the drafting of such provisions as the inclusion of a right to 'use and occupy' a property may suggest the creation of a life estate as opposed to a mere right to occupy the property.⁹

⁴ A general power to invest in land may not enable executors to buy a house for occupation by a beneficiary. See *Re Power; Public Trustee v Hastings* [1947] 1 Ch 572.

⁵ *Re Andrews* [1985] 2 Qd R 161.

⁶ TR 2006/14 at paragraph 195.

⁷ *Leese v Davis* (1951) 71 WN (NSW) 39.

⁸ *Hurley v Hurley; Pagano v Ruello* [2001] NSWSC 63.

⁹ TR 2006/14 at Paragraph 195.



3 CGT and death – a broad summary

3.1 Before considering the tax implications of utilising LRIs in an estate plan, it is of benefit to refresh on some general taxation rules in relation to death and the estate administration process.

CGT on death – Division 128 ITAA 1997

3.2 Division 128 ITAA 1997 outlines the effect of death on capital gains or losses.

3.3 Capital gains and losses arising from CGT events regarding CGT assets owned by a Willmaker just prior to death are disregarded.¹⁰

3.4 Further, capital gains and losses that a LPR makes as a result of an asset passing to a beneficiary of a Willmaker's Will are disregarded.¹¹ PSLA 2003/12 extends this taxation treatment to the trustee of a testamentary trust distributing to a beneficiary of the testamentary trust.¹²

3.5 Upon the asset passing under the Will, the LPR and beneficiary is treated as having obtained the following cost base for the asset:¹³

- (a) If the asset was acquired by the deceased before 20 September 1985 – cost base is equal to the market value of the asset at the date of death of the deceased.
- (b) If the asset was acquired by the deceased on or after 20 September 1985 – cost base is equal to the cost base of the asset that the deceased had.
- (c) If the asset was the main residence of the deceased just prior to death and:
 - (i) the asset was not being used for income producing purposes; and
 - (ii) the deceased was not a 'foreign resident',cost base is equal to the market value of the main residence on the date of death of the deceased.

3.6 An asset is taken to pass to a beneficiary if the beneficiary becomes the owner of the asset under the will (or Court varied will), by way of intestacy or a deed of arrangement (if entered into to settle a claim).¹⁴

CGT as part of estate administration

3.7 Where a LPR receives assets as part of administering an estate, a trust relationship exists between the LPR and the beneficiaries under the Will.

3.8 The LPR of the estate is therefore assessed on amounts received after the death of the deceased that would have been received by the deceased during their lifetime.¹⁵

3.9 During the estate administration process, no beneficiary is generally considered as being presently entitled to the income of the estate and therefore, such income would be assessed under section 99A ITAA 1936, or 99 ITAA 1936 if the Commissioner considers it unreasonable for section 99A to apply.

¹⁰ Section 128-10 ITAA 1997.

¹¹ Section 128-15(3) ITAA 1997.

¹² PSLA 2003/12 at paragraph 2.

¹³ Section 128-15(4) ITAA 1997.

¹⁴ Section 128-20 ITAA 1997.

¹⁵ Section 101A ITAA 1936



- 3.10 Section 99A(2)(a) ITAA 1936 provides that the section does not apply to a trust estate that results from a Will, and therefore the LPR would be taxed under section 99 ITAA 1936.¹⁶
- 3.11 The result being that the LPR is taxed at a margin rate under section 99 ITAA 1936 as opposed to a flat 45% under section 99A ITAA 1936.
- 3.12 Where the present entitlements of beneficiaries of an estate can be ascertained (perhaps by way of the estate effectively being finalised), the accepted 'proportionate' adoption of section 97 ITAA 1936 would apply to the estate's trust law income being taxed to the beneficiaries subject to the following:
- (a) Where any capital gains or franked dividends are able to be streamed to beneficiaries (by way of making such beneficiary specifically entitled to such gain) in a way that is consistent with the clauses of the deceased's Will.
 - (b) Where the point of administration of a deceased estate has been reached where it is apparent to the LPR that the income of the estate will not be required to either pay or provide for debts. The LPR subsequently pays such income to, or on behalf of, the beneficiaries. The beneficiaries who receive such presently entitled income would be taxed on such amount.¹⁷

CGT and market value substitution rule

- 3.13 While not always applicable for deceased estates as capital gains (and losses) are disregarded and the cost base of assets are calculated under specific provisions; it should be appreciated that 'market value substitution rules' apply where CGT events are treated as having occurred and that market value consideration was received for such asset in circumstances where either parties did not deal with each other at arm's length or no payment was received for the transaction.¹⁸
- 3.14 This will be of relevance when considering the tax treatment of life interests and remainder interests, particularly when interests are made or affected (often for no consideration).

¹⁶ PBRs 1051376714267, 1051961592913 and 1051942015539 provide examples in which the Commissioner will exercise such discretion that section 99 ITAA 1936 applies where tax avoidance is not involved.

¹⁷ Income Tax Ruling IT 2622 at paragraph 14.

¹⁸ Section 116-30 ITAA 1997 for the market value substitution of capital proceeds and section 116-20 ITAA 1997 for the market value substitution of an asset's cost base.



4 The difference between equitable and legal life and remainder interests

- 4.1 Having considered what LRIs are as well as the general tax implications for a deceased estate, it is important to appreciate the distinction between legal LRIs and equitable LRIs.
- 4.2 Depending on the type of LRI, different tax implications may occur.
- 4.3 LRIs can be distinguished as either 'equitable' or 'legal'.
- 4.4 As mentioned above, equitable LRIs are the common arrangements implemented as part of an estate plan.
- 4.5 An equitable LRI is an arrangement whereby a trustee holds assets for the benefit of life interest owners and remainder owners. The trustee is treated as being the owner of the trust assets and each of the life interest owners and remainder owners are treated as having separate CGT assets, being their interest in the trust.
- 4.6 Examples of equitable LRIs can include:
- (a) A deceased's Will providing for shares to be held on trust with the income to be paid to a sister and the remainder to the deceased's children.¹⁹
 - (b) A deceased's Will providing for a property to be held on trust for the deceased's wife for life, and for his three daughters in remainder in equal shares.²⁰
 - (c) In a non-estate planning context – Craig declaring that he holds a share portfolio on trust for his great aunt (for life) and the remainder for himself and his wife.²¹
- 4.7 In contrast, the ATO considers legal LRIs where legal title of the asset is disposed of by the original owner of the asset to be held by the life interest owner (during their lifetime)²² before reverting to the remainder owner.²³
- 4.8 Examples of legal LRIs can include:
- (a) A deceased's Will requiring his executor to transfer legal title of a property to a life interest owner, and then the remainder owner.²⁴
 - (b) An original owner of land transferring a life interest in a property to his eldest sister whilst retaining the reversion.²⁵
- 4.9 Whilst it is accepted that a legal LRI can be created during one's lifetime over real property; it is contentious whether legal LRIs are able to be created over personal property *inter vivos* and TR 2006/14 does not consider such implications.
- 4.10 The key difference between equitable and legal LRIs is that a trust relationship exists because of an equitable LRI, and consequently, the CGT events applicable to trusts may apply.
- CGT implications for legal LRIs**
- 4.11 Given the rare use of legal LRIs (particularly as part of an estate plan), the tax implications for use of legal LRIs are summarised below.

¹⁹ TR 2006/14 at Example 1.

²⁰ TR 2006/14 at Example 4.

²¹ TR 2006/14 at Example 3.

²² TR 2006/14 at Paragraphs 85 and 193.

²³ TR 2006/14 at Paragraph 91.

²⁴ TR 2006/14 at Example 2.

²⁵ TR 2006/14 at Example 6.



- 4.12 Upon the granting of a legal LRI *inter vivos*:²⁶
- (a) CGT event A1 is taken to happen to the original owner (due to the change in legal ownership from the original owner to the life interest owner).
 - (b) Capital gains and capital losses are calculated in the ordinary manner subject to the market value substitution rules that may apply.
 - (c) Where LRI are only granted over part of an asset, the cost base will be apportioned under sections 112-30(2) and (3) ITAA 1997.
 - (d) A disposal of the remainder interest triggers CGT event A1 and the cost base of such remainder interest is calculated under the above calculation.

Example: Legal LRI *inter vivos*

Jamie wishes to grant a legal life interest over land he owns to Melissa for no consideration.

Jamie wishes to retain the reversion.

CGT event A1 occurs and Jamie calculates his capital gains by reducing his capital proceeds against a portion of the cost base of the land.

As Jamie did not receive any money or property from Melissa, the market value substitution rules apply as to the capital proceeds received, and the cost base of Melissa's interest is equal to such market value at the time of the transfer.²⁷

- 4.13 Upon the granting of a legal LRI under a Will:²⁸
- (a) The LPR is taken to receive the deceased's asset under the general deceased cost base rules (see paragraph 3.5).
 - (b) The following CGT events are taken not to happen:
 - (i) CGT event E6 – which relates to the disposal of an asset from a trust to a beneficiary in satisfaction of the beneficiary's right to income – does not occur due to Division 128 applying.
 - (ii) CGT event E7 – which relates to the disposal of an asset from a trust to a beneficiary in satisfaction of the beneficiary's right to capital – does not occur due to Division 128 applying.
 - (iii) CGT event A1 – which relates to the disposal of a CGT asset – does not occur as a more specific CGT event applies.
 - (c) The life interest owner and remainder owners acquire their interests in the property at the date of death based on a reasonable apportionment of the LPR's cost base.
- 4.14 Where a legal LRI ends (whether due to the death of a life interest owner or prematurely):
- (a) If a valid disclaimer of a life interest owner or remainder owner occurs:
 - (i) no CGT event happens as it is taken to never have occurred;²⁹ and

²⁶ TR 2006/14 at Paragraphs 86 to 94.

²⁷ TR 2006/14 at Example 6.

²⁸ TR 2006/14 at Paragraphs 95 to 99.

²⁹ TR 2006/14 at Paragraph 100.



- (ii) if both life interest owner and remainder owner disclaims their interest, then the original owner or their residuary beneficiaries receive the benefit of the asset.³⁰
- (b) Any CGT arising due to the death of the life interest owner due to CGT event C1 (being the loss of a CGT asset) is disregarded under Division 128. No tax implications occur for the remainder owner other than their interest being enlarged without any additional cost base included.³¹

Example: Legal LRI via Will

Jarrod's Will provides for his LPR to transfer legal life and remainder interests in land to Lauren (life interest owner) and Jessica and Harry (remainder owner).

The LPR acquires the land on 1 February 2000 with a cost base of \$200,000.

No CGT is payable on the transfer of the land to the LPR.

Lauren (life interest owner), Jessica and Harry (both the remainder owners), acquire their interests under a reasonable apportionment of the cost base of the land.

Following Lauren's death, there are no CGT consequences for Jessica and Harry. Any capital gain made by Lauren on her death would be disregarded under Division 128 (as no CGT event would be taken to have happened).³²

³⁰ TR 2006/14 at Paragraph 101.

³¹ TR 2006/14 at Paragraphs 102 and 103.

³² TR 2006/14 at Example 2.



5 The CGT consequences of granting a life interest and a right to reside in property

5.1 We have summarised the CGT consequences on the grating of a legal LRI in the prior section.

5.2 This section will consider the CGT implications where a Will grants an equitable LRI or right to reside in a property.

CGT consequences of granting an equitable LRI

5.3 As equitable LRIs effectively involves the creation of a trust over original assets for life interest owner and remainder owners, CGT consequences are relevant for the original owner of the asset (the Willmaker), the LPR of the deceased and each of the life interest owner and remainder owners.³³

5.4 On creation of a trust over the original assets of the original owner, the following consequences occur:³⁴

- (a) CGT event E1 happens when a trust is created over CGT assets.³⁵
- (b) The original owner makes a capital gain or capital loss depending on whether the capital proceeds from creating the trust exceeds the cost base of the asset.
- (c) Market value substitution rules where no capital proceeds are received or the parties did not deal at arm's length.
- (d) Where CGT event E1 happens as a part of the administration of a Will of a deceased, any capital gain or loss is disregarded under Division 128.
- (e) In the event the original assets are transferred to an existing trust rather than a trust being created over the original assets, CGT event E2 happens and the above CGT consequences apply.

5.5 For the equitable LRI created in a Will, any CGT consequences are disregarded for the Willmaker.

5.6 Upon acquiring the original assets subject to the equitable LRI, the following consequences occur in relation to the LPR:³⁶

- (a) The LPR obtains a cost base for the asset as follows:
 - (i) for equitable LRIs created as a result of the death of an individual – pursuant to the rules in paragraph 3.5; and
 - (ii) for equitable LRIs created *inter vivos* – equal to the market value of the original asset at the time.
- (b) The LPR can make capital gains or losses from CGT events in relation to the original asset subject to the LRI.
- (c) Specific CGT exemptions such as the main residence exemption may be available for the LPR, if applicable and discussed further below.

5.7 As the creation of an equitable LRI creates owners in life interests and remainder, the following consequences occur for the life interest and remainder owners:³⁷

³³ Similar CGT triggers apply to an equitable LRI created during the life of an original asset owner.

³⁴ TR 2006/14 at Paragraphs 12 to 16.

³⁵ Section 140-55 ITAA 1997.

³⁶ TR 2006/14 at Paragraphs 17 to 23.

³⁷ TR 2006/14 at Paragraphs 24 to 28.



- (a) Separate CGT assets of the equitable life and remainder interests are acquired upon the creation of the equitable LRI.
- (b) Where the equitable life interest and remainder interest arose:
 - (i) as a result of someone's death, the cost base for such interest will be equal to the market value of the interest at the time it was acquired; otherwise
 - (ii) *inter vivos* and nothing was paid or given to acquire it, no market value cost base can be obtained³⁸ for a right to receive ordinary income from a trust.

CGT consequences of granting a right to reside

- 5.8 In contrast to equitable LRIs, a right to reside does not create a trust over the original asset.
- 5.9 Rather, a right is created granting a person (**grantee**) the right to reside in a property (whether for a term of years or for life) that another person holds (**grantor**). Upon the creation of the right, CGT event D1 (creation of a right) is taken to have happened.
- 5.10 The tax consequences of the grantor are summarised as follows:
- (a) A grantor will make a capital gain if the capital proceeds from creating the right to reside are more than the costs incurred in relation to the creation of such rights.
 - (b) If the grantor does not receive any capital proceeds, then the market value substitution rules will not apply.³⁹
 - (c) If any capital proceeds are received and the grantor is considered not to have dealt on arm's length terms, then the market value substitution rules will apply.⁴⁰
 - (d) The CGT main residence exemption is not available for capital gains made by the grantor in granting a right to occupy the dwelling.⁴¹
- 5.11 In the context of a right to reside granted under a Will, capital proceeds are not generally received and therefore, no capital gain would be made to the grantor.
- 5.12 Upon the grantee receiving the right to reside, the grantee is taken to receive a cost base equal to the amount paid.
- 5.13 Similar provisions regarding the capital proceeds for the grantor applies to the calculation of the cost base for the grantee (i.e. the market value substitution rules do not apply if no amount was paid by the grantee). In contrast, a right to reside in a dwelling constitutes an ownership interest in a dwelling for the purposes of the main residence exemption and capital gains arisen by the grantee of a right to occupancy may be disregarded.⁴²

³⁸ Section 112-20(3) at Item 1 ITAA 1997.

³⁹ Section 116-30(3)(b) ITAA 1997.

⁴⁰ Section 116-30(2) ITAA 1997.

⁴¹ Section 118-110(2) ITAA 1997.

⁴² TR 2006/14 at Paragraphs 119 to 120.



6 The effect a deed of arrangement to vary the terms of the Will

- 6.1 As outlined above, the use of life interests may result in dissatisfied beneficiaries of an estate.
- 6.2 Where assets pass to beneficiaries of an estate pursuant to a deed of arrangement, no consequences result as the interests are treated as if they had not been bequeathed to the life interest and remainder owners.⁴³
- 6.3 A valid deed of arrangement applies if the beneficiary entered into the deed to settle a claim to participate in the distribution of the estate and any consideration given by the beneficiary for the asset consisted only of the variation or waiver of a claim to one or more other CGT assets that formed part of the estate.⁴⁴
- 6.4 It is not required for the legal proceedings to commence, the communicating to the LPR of a beneficiary's dissatisfaction of the Will is sufficient.⁴⁵
- 6.5 The deed of arrangement must be entered into prior to the administration of the estate being finalised unless the beneficiary can demonstrate that an extension of time would have been entertained by the Courts.⁴⁶

Example:⁴⁷ Deed of arrangement to vary terms of the Will

Hector's Will provided that his farming property in Queensland be held on trust for his wife for life, and then for his three daughters in remainder in equal shares.

Due to dispute, Hector's wife and daughters entered into a deed of family agreement to vary the terms of the Will prior to the estate being fully administered.

The land would be considered to pass to the beneficiaries pursuant to section 128-20(1)(d) ITAA 1997 and therefore the exemptions to CGT events E6 and E7 in relation to the trusts to which Division 128 applies would apply (i.e. no CGT event E6 or E7 would be taken to happen).

No taxing points would arise.

The beneficiaries would acquire their interests in the land for a reasonable apportionment of the cost base.

⁴³ TR 2006/14 at Paragraph 34.

⁴⁴ Section 128-20 ITAA 1997.

⁴⁵ TR 2006/14 at Paragraphs 37 and 210.

⁴⁶ TR 2006/14 at Paragraph 36 and 223.

⁴⁷ TR 2006/14 at Example 5.



7 The CGT consequences when a life interest owner dies

- 7.1 Once the equitable LRIs have been created and any outstanding claims settled, thought should be turned as to the CGT consequences upon the death of the life interest owner.
- 7.2 Upon a life interest owner's death the following CGT consequences are taken to happen to the life interest owner:
- (a) CGT event C2 is taken to happen to the life interest owner as a result of an ownership in an intangible asset ending (including by way of expiry).
 - (b) A capital gain is made if any capital proceeds from the ending of the asset are more than its cost base (which was acquired per paragraph 5.7 above).
 - (c) Where no capital proceeds are received, the market value substitution rules will not apply because CGT event C2 has happened as a result of the expiry of the asset.⁴⁸
 - (d) Further, if the life interest was measured by the life of its owner, any capital gain or loss is disregarded due to Division 128.
- 7.3 In contrast, upon the death of a life interest owner, CGT event E5 (where there is a sole remainder owner who is absolutely entitled to the original asset) or CGT event E7 may occur to the LPR and remainder owner/s.
- 7.4 Capital gains and losses are then calculated on the happening of such events and where capital gains may be made by both the LPR and remainder owner, anti-overlap rules⁴⁹ may apply to reduce a capital gain made by the remainder owner by the amount of the trust capital gain included (by way of a CGT event happening to the LPR).⁵⁰
- 7.5 Where CGT event E5 or E7 applies to the trust relation to which Division 128 applies, those CGT events are taken to not have occurred.⁵¹
- 7.6 TR 2006/14 outlines the scope in which the CGT events E5 to E8 happens to a trust to which Division 128 applies.⁵²
- 7.7 Division 128 applies to the passing of an asset from a deceased individual's LPR to a beneficiary in their estate (provided the asset was owned by the deceased individual at the time of their death).⁵³
- 7.8 This requires the CGT E5 to E7 event to happen in relation to an asset that was originally owned by the deceased at the date of death **and** for the passing of the asset to be from the deceased's LPR to the remainder owner provided for under a deceased's Will.
- 7.9 This is because the Commissioner adopts the position in PS LA 2003/12 where a distribution from a trustee of a testamentary trust (which is the relationship the LPR holds the estate asset for the benefit of the life interest owner and remainder owner) to a beneficiary is treated the same as the passing of an asset from a LPR (in the course of administering a Will) to a beneficiary of the Will.⁵⁴

⁴⁸ Section 116-30(3)(a)(i) ITAA 1997.

⁴⁹ Section 118-20 ITAA 1997.

⁵⁰ TR 2006/14 at Paragraph 84 provided Subdivision 115-C ITAA 1997 does not apply.

⁵¹ TR 2006/14 at Paragraph 204.

⁵² TR 2006/14 at paragraphs 77 to 81 and 197 to 208.

⁵³ TR 2006/14 at Paragraph 202.

⁵⁴ TR 2006/14 at Paragraph 205.



- 7.10 It is outside the scope of this paper to consider the circumstances in which a beneficiary is considered absolutely entitled for CGT event E5 to happen. The following are noted, however:
- (a) There is no settled position regarding the law surrounding the concept of absolute entitlement.
 - (b) Absolute entitlement is intended to '*describe a situation in which the beneficiary of a trust has a vested, indefeasible and absolute entitlement in trust property and is entitled to require the trustee to deal with the trust property as the beneficiary directs*'.⁵⁵
 - (c) It has been accepted that a trustee's power of sale would make a beneficiary's interest a defeasible interest.⁵⁶ A trustee's right to indemnity out of the assets of a trust are also considered as making a beneficiary's interest a defeasible interest in the trust assets.
 - (d) Further, CGT event E5 cannot happen where there are two or more remainder owners.⁵⁷
- 7.11 It is therefore contended that CGT event E7 is the more likely CGT event to happen upon the death of a life interest owner.
- 7.12 Where the transferring of the original asset from the LPR to the remainder owners pursuant to the Will happens, Division 128 may be treated as applying and the CGT event is taken not to have occurred.
- 7.13 Where the original asset is no longer held by the LPR at the time of transferring to the remainder owner (for example, due to the sale of the original asset and purchase of a replacement asset), the exemption under Division 128 may not be available.

Example: Equitable life and remainder interests created under Will and life tenant dies⁵⁸

Jarrold died on 1 February 2000.

At the time he owned shares in Australian public companies (acquired post 19 September 1985).

Jarrold's Will provides that his shares are to be held on trust with the income to be paid to his sister Lauren for life and the remainder to his children, Jessica and Harry.

Lauren subsequently died in February 2005. During the period from 1 July 2004 to the time of Lauren's death, dividends that had been derived by the trust were paid to Lauren. Lauren's estate was also entitled to a portion of the dividends paid to the trustee after her death by virtue of certain apportionment provisions. Jessica and Harry were entitled to the remainder of the dividends paid to the trustee during 2005 income year.

The trustee transferred the shares to Jessica and Harry in June 2005.

CGT consequences – Jarrold death

⁵⁵ *Kafataris & Anor v DFC of T* [2008] FCA 1454 per Lindgren J at paragraph 61.

⁵⁶ *Kafataris & Anor v DFC of T* [2008] FCA 1454 at paragraph 65 and *Oswal v Commissioner of Taxation* [2013] FCA 745 per Edmonds J at paragraph 72.

⁵⁷ TR 2006/14 at footnote 3 referencing Draft Taxation Ruling TR 2004/D25.

⁵⁸ TR 2006/14 at Example 1



When Jarrod's estate was administered CGT event E1 happened but was disregarded under section 128-10 ITAA 1997. The trustee acquired Jarrod's cost base in the shares.

Lauren, Jessica and Harry acquired cost base for the life interest and remainder interest in the shares.

CGT consequences – Lauren death

When Lauren died, CGT event C2 happened to her life interest and any capital gain resulting was disregarded under Division 128.

As there are two or more remainder owners, CGT event E5 does not occur.

CGT event E7 is also disregarded as the distribution of the shares from the trustee to Jessica and Harry (as remainder owners) was in relation to a trust which Division 128 applies.

Jessica and Harry acquires the shares for the trustee's cost base and they are taken to have acquired the shares on the day that Jarrod died.

Example: CGT consequences to remainder owner on death of life interest owner over pre-CGT asset⁵⁹

Person A purchased and constructed a house on a Property prior to 20 September 1985.

Upon the death of Person A, Person A's Will provided Person B with a life interest in the Property in addition to Person X and Person Y being granted remainder interests.

A Trustee was appointed to administer Person A's estate.

The Property is the only asset remaining of Person A's estate.

Person B resided at the Property until they passed away.

CGT implication for the remainder owners

The passing of Person B had no CGT consequences for the remainder owner but resulted in the interests in the Property held by the remainder owner being enlarged. Consequently, no additional amount can be included in the first element of the cost base of the remainder owner's interests in the Property.

As Person A had acquired the Property before 20 September 1985, for CGT purposes each remainder owner each acquired their ownership interest in the Property for its market value on the day that Person A passed away.

Example: Right to reside created under Will with equitable remainder interests and right to reside relinquished⁶⁰

Person A passed away and Person A's Will provided for Child Two to reside in a dwelling (which was Person A's main residence) as long as they met certain conditions in the Will.

⁵⁹ PBR 1051617740961

⁶⁰ PBR 1051774412944



Should Child Two cease to reside in the dwelling, Person Two, Child One and Child Two (the remainder owners) will each be entitled to a one-third ownership interest in the dwelling.

A Trust was established to administer the right to occupy.

A few years later, Child Two sought to relinquish their right to occupy (as Child Two found a new property they were in the process of relocating to).

Child Two did not receive consideration for their relinquishment of their right to occupy.

The dwelling was transferred to the remainder owners.

Does a CGT event happen to the asset owned by the Trust when Child Two relinquished their right to reside in the property?

The asset being disposed of is the right to occupy the dwelling. The owner of the right to occupy is Child Two.

As the Trust did not own the right to occupy, a CGT event does not happen to the asset owned by the Trust when Child Two relinquishes their right to occupy.⁶¹

Can the Trust disregard any capital gain made when the asset is transferred to the remainder owners?

Division 128 applies to the passing of an asset from a deceased individual's LPR to a beneficiary in their estate.

A trust to which Division 128 applies requires more than the identification of the trust as a deceased estate and includes a trust over an asset originally owned by a deceased individual and which may pass to the beneficiary in accordance with section 128-20 ITAA 1997.

The ATO's practice is to not recognize any taxing point in relation to assets owned by a deceased person until they cease to be owned by the beneficiaries named in the Will (in this case, the remainder owners).

The Trustee will transfer the dwelling to the remainder men to satisfy their interest or share in the estate.

Therefore, Division 128 ITAA 1997 will apply to the Trust and the CGT event is taken not to have occurred.

⁶¹ It is noted that where the main residence CGT exemption applies, Child Two would disregard any capital gain arising from the CGT event.



8 The CGT consequences in ending the life interest arrangement early

8.1 As considered in earlier examples, a person with a first right to the asset (in right to reside owner in the prior example; but can also include a life interest owner) may wish to end an arrangement early.

Disclaimers of life interests and remainder interests

- 8.2 It is well established that a person cannot be required to accept a gift of property unwillingly.⁶²
- 8.3 In circumstances where a beneficiary does not wish to receive such life interest or remainder interest, the beneficiary may be able to disclaim their interest.
- 8.4 Where a life interest or remainder owner effectively disclaims their interest, no CGT event is taken to happen.⁶³
- 8.5 In order to validly disclaim an interest, the nominated life interest or remainder owner must reject their interest as soon as possible⁶⁴ noting that the right to disclaim may be lost if a beneficiary consents to the receipt of the distribution.⁶⁵
- 8.6 TR 2006/14 summarises the broad position that mere silence does not suffice and actions must be taken to intentionally show the unequivocal rejection of such interest.⁶⁶
- 8.7 Although no CGT event happens as a result of an effective disclaimer, thought should be had as any flow-on consequences:
- (a) Where a life interest owner disclaims their interest, is a trust still created if the LPR and remainder owner are the same?
 - (b) Where a remainder owner disclaims their interest, to who does the remainder interest vest? In such a circumstance the interest will either vest to the original owner (for an *inter vivos* trust) or the residuary beneficiaries (for a deceased estate).⁶⁷

Life interest and remainder owners request for the trust to wind up and have the assets distributed

- 8.8 Alternatively, all beneficiaries of the trust (the life interest owners and remainder owners) may request for the trustee to bring the trust to the end and have the assets of the trust to be distributed.
- 8.9 Where a trustee transfers assets of a trust to a life interest owner, the following tax implications occur:
- (a) CGT event E6 is taken to happen if the trustee of a trust disposes of a CGT asset of the trust to a beneficiary in satisfaction of the beneficiary's right to receive income from the trust (except if it happens to a unit trust or to a trust in which Division 128 applies).

⁶² See as far back as *Townson v Tickell* (1819) 3 B. & Ald. 31; 106 E.R.575 per Best J at 578: "It seems to be contrary to common sense to say, that an estate should vest in a man not assenting to it: there must be the assent of the party, before any interest in the property can pass to him".

⁶³ TR 2006/14 at Paragraph 29.

⁶⁴ TR 2006/14 at Paragraph 30.

⁶⁵ *Re Stratton's Disclaimer* [1958] Ch 42 at 54.

⁶⁶ TR 2006/14 at Paragraph 30.

⁶⁷ TR 2006/14 at Paragraph 32.



- (b) Under normal circumstances, capital gains and losses are calculated in the usual manner noting that capital gains or losses made by a life interest owner is not disregarded merely because the interest was acquired for no actual expenditure.⁶⁸
- (c) Further, the main residence exemption is not available to disregard a capital gain or loss for a life interest owner ending their interest as the exemption cannot be utilise for a capital gain of a main residence arising from CGT event E6.⁶⁹
- (d) From an estate planning perspective, provided the equitable LRI arose due to a deceased's Will, any CGT implications are disregarded by way of the event happening to a trust which Division 128 applies.

8.10 Where a trustee transfers assets of a trust to remainder owners, the following tax implications occur:

- (a) CGT event E7 is taken to happen if the trustee of a trust disposes of a CGT asset of the trust to a remainder owner in satisfaction of their interest in the trust capital (except if it happens to a unit trust or to a trust in which Division 128 applies).
- (b) Like a life interest owner under normal circumstances, capital gains and losses are calculated in a similar manner.⁷⁰
- (c) Unlike a life interest owner, however, a capital gain or loss that the remainder owner makes is disregarded if they acquired their trust interest for no expenditure.⁷¹
- (d) Again from an estate planning perspective, provided the equitable LRI arose due to a deceased's Will, any CGT implications are disregarded by way of the event happening to a trust which Division 128 applies.

Example: Equitable LRI created by Will wound up by agreement between parties⁷²

Hector's Will provided his farming property in Queensland be held on trust for his wife for life, and for this three daughters in remainder in equal shares.

Hector acquired the property in 1993.

At the time of his death in 2000, the cost base of the property was \$400,000.

Hector's wife and daughters acquired their interests in the testamentary trust for no consideration. Their interests are taken to have been acquired for their market value. The market value of the life interest at the time was \$175,000.

At the end of the 2005-06 income year, Hector's wife and daughters agree to wind-up the trust and have the property distributed to them as tenants in common in equal shares (i.e. ¼ share held by each of them).

The market value of the property at this time was \$1,200,000. Hector's wife was presently entitled to the trust income for the 2005-06 income year.

CGT implications for the life interest owner (Hector's wife) and remainder owners (Hector's daughters)

⁶⁸ TR 2006/14 at Paragraphs 53 to 57.

⁶⁹ Section 118-110(2)(a) ITAA 1997.

⁷⁰ TR 2006/14 at Paragraphs 61 to 64.

⁷¹ TR 2006/14 at Paragraph 65.

⁷² TR 2006/14 at Example 4.



CGT event E6 happens in relation to the land transferred to Hector's wife and CGT event E7 happens in relation to the land transferred to Hector's daughters.

In these particular facts, the land is not passing in a manner consistent with Hector's Will (as Hector's wife is receiving a share of the capital) and therefore Division 128 does not apply. It is noted that the land is also not passing under a deed of arrangement (and either way, the timeframe for such deed has since passed).

In relation to Hector's wife (the life interest owner):

- (a) *the trustee of the testamentary trust will make a capital gain of \$200,000 from CGT event E6 happening upon distribution of the land to Hector's wife;⁷³*
- (b) *Hector's wife will make a capital gain of \$125,000 as a result of CGT event E6 happening to her interest in the trust.⁷⁴*

Section 118-20 ITAA 1997 can apply to reduce Hector's wife capital gain from \$125,000 to nil.

In relation to Hector's daughters (the remainder owners):

- (a) *the trustee of the testamentary trust will make a capital gain of \$600,000 from CGT event E7 happening upon distribution of the land to Hector's daughters;⁷⁵*
- (b) *CGT event E7 is exempted for Hector's daughters as each daughter acquired their remainder interest for no expenditure.⁷⁶*

Surrender or release of life interest or remainder interest

- 8.11 Where a life interest owner or remainder owner surrenders or releases their interest, the Commissioner considers CGT event A1 as having happened.⁷⁷
- 8.12 Where the surrender occurred for no capital proceeds or for less than market value on non-arm's length terms, then the market value substitution rule will apply in relation to the event for capital proceeds purposes for the disposing party, whilst the party acquiring the interest is treated as having received market value consideration for the cost base.

Example: Surrender of equitable life interest⁷⁸

Jack died on 1 January 2001. At the time of his death he owned a property which, under his Will, he left on trust for his daughter Georgia for life and his grandchildren Dylan and Thomas in remainder.

The administration of the estate was completed in 2002.

The first element of the cost base of Georgia's life interest was \$90,000. The first element of the cost base of Dylan and Thomas' remainder interests is \$200,000.

⁷³ Capital proceeds are equal to $\frac{1}{4}$ * current market value (\$1,200,000), reduced by apportioned cost base which is equal to $\frac{1}{4}$ * cost base of the property received by the trustee (\$400,000).

⁷⁴ Capital proceeds are equal to $\frac{1}{4}$ * current market value (\$1,200,000), reduced by Hector's wife cost base of the life interest calculated at the time the testamentary trust was established.

⁷⁵ Capital proceeds are equal to $\frac{3}{4}$ * current market value (\$1,200,000), reduced by apportioned cost base which is equal to $\frac{3}{4}$ * cost base of the property received by the trustee (\$400,000).

⁷⁶ An exemption pursuant to section 104-85(6) ITAA 1997.

⁷⁷ TR 2006/14 at Paragraph 66.

⁷⁸ TR 2006/14 at Example 7.



Georgia surrendered her life interest to Dylan and Thomas in 2003. Georgia incurred \$5,000 in legal expenses associated with the surrender. The market value of the life interest at the time was surrendered was \$100,000.

What was the CGT consequence for Georgia's surrender of her life interest

CGT event A1 will happen when Georgia surrenders her life interest. The cost base of Georgia's life interest is \$95,000 (being the \$90,000 original cost base and \$5,000 expenditure incurred as part of the surrender).

As Georgia did not receive any capital proceeds as a result of the surrender, she is taken to have received the market value of the life interest equal to \$100,000.

Georgia has made a capital gain of \$5,000.

Dylan and Thomas have each acquired a life interest with an acquisition cost of \$50,000 each.

- 8.13 Where a life interest owner surrenders their interest, thought should be had as to the CGT implications of the distribution of the original asset to the remainder owner.
- 8.14 Although TR 2006/14 does not address the tax implications to the LPR or remainder owner explicitly, the principles relating to the distribution of trust assets to an absolutely entitled beneficiary (CGT event E5) or a disposal to a beneficiary to end a capital interest (CGT event E7) are applicable.
- 8.15 Where upon such CGT events E5 or E7 happens as a result from the death of a life interest owner, Division 128 applies and capital gains and losses are disregarded. If the surrender of the life interest, however, happens to a trust in which Division 128 applies, then capital gains and losses are required to be calculated in the ordinary course.
- 8.16 Whether a surrender of a life interest during the lifetime of an owner occurs to a trust in which Division 128 applies may ultimately be dependent on the drafting of such life interest provisions in the Will with such scenarios provided for.



9 The effect of life interests on the CGT main residence exemption

9.1 The CGT implications of ending a life interest early can be broadly summarised as follows:

- (a) In the case of an effective disclaimer – no CGT consequences.
- (b) Where the life interest owner and remainder owners agree to end the trust early – CGT events E6 and E7 are taken to happen to the life interest owner and remainder owner respectively, as well as the LPR. Capital gains and losses will be calculated in based on the market value unless the ending of the trust occurred to a trust in which Division 128 applies.
- (c) Where the life interest owner or remainder owner surrenders their interest – CGT event A1 is taken to happen and the life interest owner/remainder owner is treated as making a capital gain or loss (calculated in the ordinary manner).

9.2 The above is based on the broad operation of the tax legislation.

9.3 Given that a common asset subject to LRI is a main residence (to ensure the life interest owner has a place to call home during their lifetime), thought should be had as to the interaction of the main residence CGT exemption rules⁷⁹ with the CGT consequences of equitable LRIs.

Main residence CGT exemption

9.4 A capital gain or loss arising from a CGT event in relation to a 'dwelling'⁸⁰ or a person's 'ownership interest'⁸¹ in the dwelling is disregarded if:

- “(a) you are an individual and the interest passed to you as a beneficiary in a deceased estate, or you owned it as the trustee of a deceased estate; and*
- (b) at least one of the items in Column 2 and at least one of the items in column 3 of the table are satisfied; and*
- (c) the deceased was not an excluded foreign resident just before the deceased's death.”⁸²*

9.5 The requirements of 'Column 2' and 'Column 3' are met provided at least either of the following:

- (a) “the deceased acquired the ownership interest on or after 20 September 1985 and the dwelling was the deceased's main residence just before the deceased's death and was not then being used for the purpose of producing assessable income; or*
- (b) the deceased acquired the ownership interest before 20 September 1985”⁸³*

and either of the following:

- (c) “your ownership interest ends within 2 years of the deceased's death, or within a longer period allowed by the Commissioner; or*

⁷⁹ Subdivision 118-B ITAA 1997.

⁸⁰ Which is defined in section 118-110 ITAA 1997 to include a building used wholly or mainly for residential accommodation.

⁸¹ Which is defined in section 118-130 ITAA 1997 to mean a legal or equitable interest in land on which the dwelling is erected, or in the relevant stratum unit, or a right to occupy the dwelling.

⁸² Section 118-195(1) ITAA 1997.

⁸³ Column 2 of section 118-195(1) ITAA 1997.



- (d) *the dwelling was, from the deceased's death until your ownership interest ends, the main residence of one or more of:*
- (i) *the spouse of the deceased immediately before the death (except a spouse who was living permanently separately and apart from the deceased); or*
 - (ii) *an individual who had a right to occupy the dwelling under the deceased's will; or*
 - (iii) *if the CGT event was brought about by the individual to whom the ownership interest passed as a beneficiary--that individual",⁸⁴*

applies.

- 9.6 Importantly, the main residence CGT exemption is only available to apply to CGT events A1, B1, C1, C2, E1, E2, F2, K3, K4 and K6.⁸⁵
- 9.7 This limited application of the main residence CGT exemption poses potential issues where CGT events not listed above happen, such as on the happening of CGT events E5, E6 and E7.
- 9.8 As such, where a life interest owner or remainder owner receives the main residence as part of any of the CGT events E5, E6 or E7 happening without Division 128 applying, CGT may be payable.
- 9.9 Consider the below example of the application of the main residence CGT exemption for a life interest owner who surrenders their life interest in the main residence (which results in CGT event A1 happening – see paragraph 8.11):

Example: CGT consequences of surrender of life interest by owner of main residence⁸⁶

Spouse was married to the Testator who died many years ago.

Spouse and Testator owned two common properties as tenants in common, with Property 2 as the main residence of the Spouse and Testator.

Spouse continues to live in Property 2, which is over 2 hectares.

Both properties were acquired before 20 September 1985, and the Testator left a life interest in both properties to the Spouse.

The life interest has continued and the Spouse now wishes to surrender the life interest to 'speed up the terms of the Will' at which point the Testator's interest in both properties will pass to the remainder owners.

CGT consequences for the life interest owner

The surrender of the life interest by the Spouse will not result in any ordinary assessable income as the surrender of the life interest is capital in nature.

CGT event A1 will occur when the Spouse surrenders the interest in the properties.

Under section 118-195 ITAA 1997, a capital gain made in relation to the Spouse ownership interest in a dwelling:

- (a) *acquired prior to 20 September 1985; and*

⁸⁴ Column 3 of section 118-195(1) ITAA 1997.

⁸⁵ Section 118-195(2) ITAA 1997.

⁸⁶ PBR1051493300043



(b) *used as the main residence of the Spouse from the Testator's death until the disposal of the Spouse's ownership interest by the Spouse of the Testator immediately before the Testator's death,*

can be disregarded.

The Spouse's life interest is regarded as an ownership interest and any capital gain or loss made on the surrender of the Spouse's life interest in the dwelling that is the Spouse's main residence is disregarded.

It is noted that the main residence exemption can apply to a dwelling's adjacent land to the extent that the land was used primarily for private or domestic purposes in association with the dwelling. The maximum area of adjacent land covered by this exemption is two hectares, less the area of the land immediately under the dwelling.

A note on cost base and capital proceeds (for example regarding the other property)

Where a taxpayer acquires a CGT asset from another entity but does not incur any expenditure to acquire it, the market value substitution rules may apply.

If the Spouse did not receive anything in exchange for the surrender, then the Spouse is treated as having received the market value of the asset.

The Commissioner does not generally rule on the market value for a future CGT event. The market value should be fair and reasonable. Relevant information should be kept to support the calculation of the market value at the time the life interest is surrendered.

- 9.10 Where a life interest owner surrenders their life interest in a main residence and the LPR subsequently distributes the main residence to the remainder owners, CGT events E5 or E7 will be taken to occur.
- 9.11 Where Division 128 does not apply, a capital gain will be made and subsequently, no main residence CGT exemption will be available as the CGT events are not ones in which the exemption may be applied to.
- 9.12 An alternative arrangement may be to have the LPR sell the main residence prior to distributing the proceeds to the remainder owners.
- 9.13 In such a circumstance, CGT event A1 would be taken to occur, and provided the requirement regarding the use of the dwelling as a main residence is satisfied, the exemption may be available.

Example: CGT consequences of the disposal a main residence to the remainder owners

Situation A - Background

Andrew's Will provided for the main residence to be held on trust for Beth for life, with his children (Carmen and Derek) to benefit as remainder owners in equal shares.

At the time of Andrew's death on 1 January 2012, the cost base of the property was \$200,000.

At all times following Andrew's death until 1 January 2021, Beth resided in the property.

Beth wished to surrender her life interest for no consideration as her children found a retirement village for her.

On 1 January 2021, the market value of the property was \$1,000,000.



The LPR transferred the main residence to the remainder owners on 1 January 2022. The market value of the property was \$1,200,000.

Situation A – Tax outcomes

CGT event A1 happens to Beth's surrender of her life interest and she would be eligible for the main residence CGT exemption as at 1 January 2021.

CGT event E7 happens on the transfer of the property to the remainder owners.

The market value on 1 January 2022 is treated as the capital proceeds (\$1,300,000).

The cost base of the property was \$200,000.

The main residence CGT exemption is not available for CGT event E7.

A capital gain equal to \$1,000,000 is made and assessable to the remainder owners.

Situation B – Background

Same facts as Situation A other than the LPR selling the property on 1 January 2022 before distributing the proceeds.

Situation B – Tax outcomes

Same outcome for Beth.

CGT event A1 occurs to the LPR on 1 January 2021.

A capital gain of \$1,000,000 is made by the LPR.

A partial main residence CGT exemption is available for the 9/10 years in which Beth (as life interest owner) resided in the property.

The capital gain is reduced to \$100,000.

Example: Court ordered variation on a life interest and will the LPR be entitled to apply the main residence exemption upon the disposal of the property⁸⁷

The deceased acquired the main residence before 20 September 1985 and was the main residence of the deceased until the time of death.

Probate was granted, appointing F as Executor.

The Will established a life interest over the property for C.

C lived in the house as their main residence from before the deceased's death until the settlement of the property.

Prior to the administration of the estate, C initiated proceeds seeking a provision from the deceased's estate which resulted in Court Orders made.

The Court Ordered the sale of the property and the balance of the proceeds to be paid to C pursuant to the relevant Family Provision Act in lieu of the provisions of the Will.

In addition to residing in the property until settlement, C rented a portion of the property, producing assessable income.

Was the main residence CGT exemption available?

⁸⁷ PBR 1051337361226



A partial main residence exemption is available as a portion of the property was used to produce income.

TR 2006/14 provides guidance on life and remainder interests. Where the assets pass to a taxpayer as beneficiary under a deed of arrangement, there will be no consequences for the life and remainder interests as the intended owners of those interests are treated as if they had not been bequeathed them. The same principle applies for a variation by Court order.

The deceased acquired the dwelling prior to 20 September 1985 and C was provided with a right to occupy the dwelling under the Court Order which varied the deceased's will, however the estate will not be entitled to apply the full main residence exemption as a portion of the property was used by C to produce assessable income.

Granny flat exemption

- 9.14 Provisions were introduced in 2021 to govern the circumstances when a CGT event will not be treated as happening to a granny flat arrangement.
- 9.15 Specifically, a CGT event does not happen when certain granny flat arrangements are entered into, varied or terminated.⁸⁸
- 9.16 The provisions apply to an individual holding a granny flat interest in a dwelling which is defined to be an arrangement where an individual has a right to occupy the dwelling for life.⁸⁹
- 9.17 An individual is eligible for a granny flat interest if:
- “(a) the individual has reached pension age at or before that time; or*
 - (b) the individual needs, because of a disability, assistance to carry out most day-to-day activities **and** is likely to continue to need that assistance, because of that disability for at least 12 months after that time.”⁹⁰*
- 9.18 The following should also be noted:
- (a) There is no defined term for disability and a reference to pension age is the same age threshold that is used in determining eligibility for the age pension.
 - (b) Provisions of the main residence CGT exemption in Subdivision 118-B ITAA 1997 applies to the dwelling subject to a granny flat interest (namely, the adjacent land of a dwelling and an adjacent structure).⁹¹
- 9.19 A CGT event will not happen to the extent it relates to creating of a granny flat interest in a dwelling under an arrangement if:
- “(a) the individual who holds, or who is to hold, the granny flat interest under the arrangement is eligible for a granny flat interest at the start time; and*
 - (b) another individual either holds an ownership interest in the dwelling at the start time or agrees, under the arrangement to acquire an ownership interest in a dwelling that is to be the dwelling in which the first-mentioned individual is to hold the granny flat interest; and*

⁸⁸ Section 137-1 ITAA 1997.

⁸⁹ Section 137-10(1) ITAA 1997.

⁹⁰ Section 137-10(2) ITAA 1997.

⁹¹ Section 137-10(3) ITAA 1997.



- (c) *at the start time, both individuals are parties to the arrangement; and*
- (d) *the arrangement is in writing and indicates an intention for the parties to the arrangement to be legally bound by it; and*
- (e) *the arrangement is not of a commercial nature.*⁹²

9.20 Similar provisions apply to a variation of a granny flat interest at the variation time.⁹³

9.21 While the inclusion of such provisions to exempt a CGT event on the creation of a granny flat interest as part of an estate plan provides welcome certainty as to the CGT implications, there may be difficulties in satisfying the '*agreement is in writing*' requirement whilst embedding the provisions in the drafting of a Will.

9.22 The provisions also extend to disregard a CGT event in relation to a termination of a granny flat interest in a dwelling that the above provisions apply. This may assist with the various surrender or ending scenarios considered in prior sections of this paper, particularly as there is no limitation as to the application of such exemption (unlike the main residence CGT exemption). The issue of concern, however, is ensuring the requirements are met.

9.23 Given the recent introduction of such rules regarding granny flat interests, it is hoped guidance will be provided and private binding rulings made over time to provide clarity as to the interaction of such provisions as part of a modern estate plan.

⁹² Section 137-15 ITAA 1997.

⁹³ Section 137-20 ITAA 1997.



10 Disclaimer

- 10.1 This paper covers legal and technical issues in a general way. It is not designed to express opinions on specific cases. It is intended for information purposes only and should not be regarded as legal advice. Further advice should be obtained before taking action on any issue dealt with in this paper.

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