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Testamentary trusts and taxes

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Overview

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- Why testamentary trust?
- Division 6AA
- Impact of May 2018 Federal Budget
- CGT and testamentary trusts
- Structuring testamentary trusts
- Main residences in testamentary trusts
- Non-resident beneficiaries
- Disability
- Capacity

Why testamentary trusts?

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- Not tax driven
- Vulnerable beneficiary needing protection
- Blended family circumstances with competing claims
- Restricting to bloodline descendants
- Future remarriage concerns
- Asset protection concerns
- Non-resident concerns

Why not testamentary trusts?

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- Complex!
- Lack of ability to properly appreciate and understand
- Ongoing compliance costs (after death)

Division 6AA

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- Applies to a 'person…less than 18 years of age on the last day of the year of income' **and** 'the person is not an excepted person in relation to they year of income'
- Excepted person includes:
  - Minor engaged in full time work
  - Minor on certain social security pensions
  - Minor a principal beneficiary of a special disability trust
  - A double orphan
- Such persons are limited to how much income can be received tax free

Division 6AA

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- Applies to a 'person…less than 18 years of age on the last day of the year of income' **and** 'the person is not an excepted person in relation to they year of income'
- Such persons are limited to how much income can be received tax free
- Two exclusions to this rule in that recipient is an 'excepted person' or the income is 'excepted assessable income' or 'excepted trust income'
- Excepted person includes:
    - Minor engaged in full time work
    - Minor on certain social security pensions
    - Minor a principal beneficiary of a special disability trust
    - A double orphan

Division 6AA

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- Excepted assessable income or 'excepted trust income' includes:
  - Income derived through business or employment activities
  - Income derived as a result of the investment of compensation sums as a result of personal injury or death
  - Income derived as a result of sums received from superannuation death benefits, life insurance policies and family law settlements
- Trust types called as testamentary trust, superannuation proceeds trust, insurance proceeds trust and child maintenance trusts are based on ensuring access to specific definitions of 'excepted trust income'

Division 6AA

- http://classic.austlii.edu.au/au/legis/cth/consol_act/itaa1936240/s102ag.html

Traditional testamentary trusts

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- Excepted trust income includes assessable income of a trust estate that resulted from **a will, codicil or an order of a court that varied or modified the provisions of a will or codicil**.
- Simple terms – income derived from investment of assets in a Will is excepted trust income
- *Trustee for the Estate of the late A W Furse No. 5 Will Trust v FCT* (1990) 21 ATR 1123
  - Units in a unit trust bought from estate assets
  - Income derived from unit trust 'excepted trust income'? Court says yes
  - Contrast 'resulted from assessable income from Will ' v 'resulted from a Will'

Other testamentary trusts

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- Superannuation proceeds trust
  - Trust created for superannuation death benefit dependent under Will (no tax on superannuation, otherwise, non-death benefit dependent taxed at 17%)
  - Transfer superannuation benefits to a trust that satisfies certain capital and other requirements (i.e. capital of trust must go to certain people only)
- Life insurance proceeds trust
  - Life insurance paid either to someone to hold on trust for minor child, or paid to a trust set up to be the life insurance proceeds trust
  - Again, certain capital requirements must be met

Other testamentary trusts

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- Employment death benefits trust
  - Relates to employment termination payment
  - Similar requirements to life insurance proceeds trust
- Existing 'inter vivos' trust
  - Distribute to an existing trust under Will
  - Slight difference from traditional testamentary trust exemption as the income here 'is derived by the trustee of the trust estate from the investment of any property that devolved for the benefit of the beneficiary from the estate of a deceased person'
  - Simplier than having a testamentary trust in the Will, however, more complex requirements to satisfy excepted trust income status (i.e. capital issue)

Keep it simple

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- Easier to access excepted income rules (i.e. able to invest estate assets and such income derived from invested assets can be considered excepted income)
- No intestacy limit – s102AG(7)
- No capital requirement
- Longer life than an intervivos trust
- Potential CGT issues to certain testamentary trusts created after death
- Ability to benefit unborn minors
- Income allocation issues if excepted trust income mingled with normal trust income

May 2018 Federal Budget

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- Excepted trust income '*limited to income derived from assets that are transferred from the deceased estate or the proceeds of the disposal or investment of those assets*'
- Intended to prevent inappropriate benefits for minors by injecting outside assets into a testamentary trust
- No movement on this front yet
- Query how this will impact ability for testamentary trusts to make investments in other entities?
- Note Division 6AA includes anti-avoidance provisions

Division 6AA Anti-avoidance

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- Non-arm's length dealing – s102AG(3)
- Agreement to secure excepted trust income – s102AG(4)

CGT Death Rollovers

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- Rollover for transfer of deceased assets from testator to 'LPR' – s128-10 ITAA 1997
- Rollover for transfer of deceased assets from LPR to testamentary trust – s128-15 ITAA 1997
- Rollover for transfer of deceased assets from testamentary trust to a beneficiary – PS LA 2003/12 (note not binding and Commissioner may choose to not follow); talks of codifying in 2012/2013 but fell through
- Note no rollover if intended beneficiary dies before administration completed
- Application of foreign resident capital gains withholding

Testamentary trust structuring

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- Testamentary trust on death of initial spouse or both
- Single testamentary trust
- Multiple testamentary trusts
- Single testamentary trust (on death of initial spouse) 'cascading' (and transferring) into multiple testamentary trust (on passing of surviving spouse)
- Single testamentary trust (on death of initial spouse) with multiple testamentary trusts (on passing of surviving spouse) with single testamentary trust continuing to hold all assets and making loans to other testamentary trusts

No go?

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- Single testamentary trust (on death of initial spouse) 'cascading' (and transferring) into multiple testamentary trust (on passing of surviving spouse)
- No go
- Potential stamp duty issues

Main residences in testamentary trusts

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- CGT main residence applies on sale of main residence from a deceased estate – s118-195 ITAA 1997
- Exemption can also apply for recipient beneficiary if sold within 2 years of the date of death provided the main residence was not being used for income producing purposes and was the main residence of the deceased at date of death
- Note precise wording does not cover testamentary trust sale
- Administrative concession of ATO in PS LA 2003/12 does not apply to s118-195 ITAA 1997
- But treating the phrase 'trustee of a deceased estate' in s118-195 ITAA 1997 has been seen to relate to testamentary trusts – ATOID 2006/34 and 2004/882

Main residences in testamentary trusts

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- Various minor quirks, so the review of the provisions is critical
- Ability of a right to occupy to potentially extend the main residence exemption period to access
- Again, subject to ATO IDs referred above
- If certainty is wished then the property should be disposed at the 'LPR' level within 2 years of the deceased's date of death or have the main residence gifted to a person to use it as their main residence
- **Also consider land tax**

Non-resident beneficiaries

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- CGT event K3
- 'Taxable Australian Real Property'
- Direct and indirect
- *Generally*, applies to non real estate assets passing to a 'foreigner'
- Structuring includes delaying completion of estate to having relevant assets passed to an appropriately structured testamentary trust
- Consider all the usual 'foreigner' taxes that could apply

Disability

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- Special disability trust in Will or created 'today'?
- Requirements include:
  - Principal purpose for meeting the reasonable care and accommodation needs of the disabled beneficiary during their lifetime
  - Only one principal beneficiary for whom it was created and meets the severe disability requirement in s1209M Social Security Act 1991
  - Trust deed mandated by the Department of Social Services
  - Trustee is an independent professional trustee or other requirements
  - Complies with various investment restrictions (per model trust deed)
  - Providing annual reports to Centrelink and being audited potentially

Disability

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- Anyone can gift to a special disability trust except the principal beneficiary or their partner
- Principal or their partner can only gift a superannuation death benefit received within 3 years of the gift to the special disability trust
- Prescriptive restrictions include way capital and income can be used including a limit on a small amount that can be used for discretionary lifestyle purposes (around $12,000 and indexed annually)

Benefits of special disability trust

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- No CGT for anyone gifting property for no consideration
- Stamp duty concessions usually available
- Ability to access main residence exemption in trust
- No penalty tax rates of Division 6AA
- Income accumulated assessed at disabled beneficiary's tax rate
- Assets in trust exempt from social security means test (up to a certain limit)
- Income derived by trust no included in social security income test
- Ability for people receiving a social security pension to gift up to $500,000 in assets without being subject to the social security deprivation rules (some form of clawback provision for social security purposes)

When to use special disability trust

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- Although there are benefits, there is significant compliance
- Use special disability trust to receive a main residence (i.e. access to main residence exemption via trust without relying on Commissioner's discretion)
- Ability to allow family members to contribute without impacting on their social security tests
- Ability to gift more to disabled beneficiary than would be able to without impacting the social security assets test limit ($258,500 for homeowner and $465,500 for a non-homeowner)
- Otherwise, why not just use a testamentary trust (or protective trust)

The question of capacity

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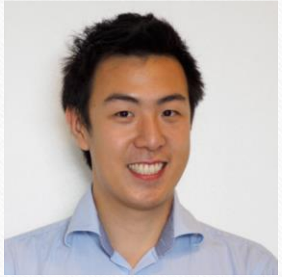
- Assess client's understanding of concepts
- If potentially lacking in ability to understand what are complicated trust law and taxation concepts, then the Will is open to challenge from a disgruntled beneficiary

Contact details



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