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In Memory of

JOHN RANERI
1957-2005

Atax

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can also be used as part of the plan to divide property and control among different family members and their descendants. There is another major advantage that is of particular interest to us: the income tax savings on distributions of unearned trust income to minors.

The much sought after tax advantage is quite simply that minors are taxed as adults with the benefit of the tax free threshold.

To achieve this tax advantage while ensuring all the asset protection and income flexibility is maintained, care is needed by the drafter and the trustee. The aim of this article is to identify where that care is needed and the reasons why.

A caveat is necessary. Tax law and trust law are uncomfortable partners. Tax advisors, the Australian Taxation Office (ATO) and the Courts are still discovering how they interact. In part the development of the law depends on the context in which the problem arises. In our case, it is usually in trying to apply a tax law to a trust. In many cases, trust law, including testamentary trust law develops without any care or concern for the tax implications and is more concerned with conflicting rights of beneficiaries. We tax practitioners are then left to consider the implications for us. The recent High Court decision in *CPT Custodians*[2] is an example of general trust law developments with the tax advisors trying to survive the swell.[3]

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> (No 2) [1994] FLC ¶92-469), there does not seem to be any reason in conscience why a court of equity should take any notice of them at all. Counsel were surprised that any judge should take this view and accordingly I announced during the argument that I would not seek to develop it in this case, but I believe that the message should be put abroad that the time may well have come where equity will have to reconsider its attitude to enforcing this sort of trust.

We have been warned!

Common benefits of testamentary trusts

The main benefit of a testamentary trust compared to the ordinary inter vivos trust is the income tax concession for minors who are taxed as adults with the benefit of the tax free threshold which in the current year results in up to $10,000 being tax free per minor.[12]

Another advantage of the testamentary trust is that as it does not come into effect until death and until then the testator owns the property, the testator can vary it to his or her heart's content until death (by Will or codicil). The testator can change the beneficiaries, trustees, powers, property etc. Also the testator can manipulate what property remains to be dealt with in his or her Will. Property can be transferred absolutely before death or to an inter vivos trust or left for the Will to deal with it.

Confusion in use of term "testamentary trust"

At one level, all deceased estates are for a time at least, "testamentary trusts". On death, the assets of the deceased vest in the executor (if there is one who is willing to act). It is a common myth that the assets don't vest until probate is granted to the executor or administrator by the Court.[13] In SA, at least this isn't correct. Some assets (but not land) can be transferred without probate.

The executor[14] has duties of a trustee to administer the estate (ie to pay all debts including tax bills, funeral expenses and to distribute the bequests). It is only when administration is complete (ie all debts paid or assets have been set aside by the executor to pay them) that the beneficiaries become absolutely entitled to any assets or their share of cash (if there are no further trusts created) and the assets and/or cash are distributed to the beneficiaries.

Where a testamentary gift is left to an existing inter vivos trust, that may be fairly, although confusingly, be called a testamentary trust at least when dealing with the property given to the trustee through a Will.

However, when most lawyers, tax advisers, will drafters and estate planners refer to testamentary trusts, they usually mean the further trust created by the testator in the

Assume a life interest is created in the Will. If it is over specified assets such as named shares or real estate, when does the life tenant "enter" into that tenancy? What if it is a life interest over the residuary estate? Does the life tenancy commence when the debts and expenses are paid or at an earlier time, when the executor has set aside sufficient assets or cash to pay them?

The ATO explains its view is that the trust will commence at the completion of the administration of the estate or at earliest when the trustee first pays income:

> …where it is apparent to the executor that part of the net income of the estate will not be required to either pay or provide for debts, etc. The executor in this situation might in exercise of the executor's discretion, in fact, pay some of the income to, or on behalf of, the beneficiaries. The beneficiaries in this situation will be presently entitled to the income to the extent of the amounts actually paid to them or actually paid on their behalf. The fact that the estate has not been fully administered does not prevent the beneficiaries in this situation from being presently entitled to the income actually paid to, or on behalf of, the beneficiaries.[18]

Varying the terms of the a testamentary trust –how far can you go

The subtitle of this article is 'not just "another" trust'? The question for us then isn't

(1) The Supreme Court may, on the application of a trustee, or of any person who has a vested, future, or contingent interest in property held on trust—

(a) vary or revoke all or any of the trusts; or

(b) where trusts are revoked—

(i) distribute the trust property in such manner as the Court considers just; or

(ii) resettle the trust property upon such trusts as the Court thinks fit; or

CGT result, it would almost certainly sever the connection with the deceased's Will (the concession applies only to a trust estate that resulted from a will) which gives the tax concession for income distributed to minors and so destroy the benefit which underpins the very reason for having a testamentary trust. (See 2.5 below for further discussion on this tax concession).

When does a testamentary trust end?

The testamentary trust ends like other trusts. If a life interest, it ends when the person

"seed assets" and they can vary. The benefit of the testamentary trust is not confined to the assets owned by the deceased or by the deceased estate during administration but that does not mean that other added assets will give rise to income that can be treated concessionally.

Assume the testamentary trust is to predominantly allow Betsy to distribute income among her 2 youngest children and 2 grandchildren (who are all under 18). The trust derives income of $30,000 pa. Betsy has just read in the *Wealth* pages of *The Australian* that minors can get up to $10,000 each tax free this year (taking into account the tax free threshold and the low income offset). She asks if she can transfer property to the trust (or ask her brother to do so) to earn an additional $10,000 and so distribute this as tax free income?

The minor income tax advantages come from secs 102AG(1), 102AG(2)(a)(i) and 102AG(d)(i).

> **102AG(1)** Where a beneficiary of a trust estate is a prescribed person[22] in relation to a year of income, this Division applies to so much of the share of the beneficiary of the net income of the trust estate of the year of income as, in the opinion of the Commissioner, is attributable to assessable income of the trust estate that is not, in relation to that beneficiary, excepted trust income.
>
> **102AG(2)** Subject to this section, an amount included in the assessable income of a trust estate is excepted trust income in relation to a beneficiary of the trust estate to the extent to which the amount:
>
> (a) is assessable income of a trust estate that resulted from:
>
> (i) a will, codicil or an order of a court that varied or modified the provisions of a will or codicil; or.
>
> (d) is derived by the trustee of the trust estate from the investment of any property:
>
> (i) that devolved for the benef(t)5.6(s)-(d)-1.1.5(nef(e)12(t)6.16.6(e)4)]TJ083(6.6(e)ef(t)5.6a.1(y)5.5( )](

court or arising on intestacy. Hill J also held that s102AG(2)(a) applies where the trustee borrows funds and invests them and derives assessable income from those investments. He did not go on to say (as it was not relevant here) that the same conclusion applies to income from assets gifted to the trust.

Hill J rejected the Commissioner's argument that the concession only applied to

The issue for sec 102AG(3) was whether the income derived by the Will Trust from the units in the service trust was as a result of an agreement between any 2 or more parties not dealing with each other at arm's length. The Tribunal (from which this case was the Appeal to the Federal Court) failed to identify the relevant agreement. The matter was remitted to the Tribunal to make the necessary findings of fact.

Since that decision, s 102AG(3) has been amended

It now provides:

> 102AG(3) [Non-arm's length transactions]
>
> Subject to subsection (4), if any 2 or more parties to:
>
> (a) the derivation of the excepted trust income mentioned in subsection (2); or
>
> (b) any act or transaction directly or indirectly connected with the derivation

102AG(4) [Agreement to secure income excepted trust income]

Subsection (2) does not apply in relation to assessable income derived by a trustee directly or indirectly under or as a result of an agreement that was entered into or carried out by any pe

breakdown, income from certain trust income from personal injury damages and post-death trusts.

Saving tax with a "second chance/post death/post-mortem trust"[27]

Dianna can transfer shares or investment property or money[28] left to her by Charles to a trust in which Wilma is a beneficiary. Income derived by the trustee from that property can be distributed to Wilma in a tax effective manner by using the provisions in sec 102AG(2)(d)(ii).

> 102AG(2) [Excepted trust income]
>
> Subject to this section, an amount included in the assessable income of a trust estate is excepted trust income in relation to a beneficiary of the trust estate to the extent to which the amount:
>
> (d) is derived by the trustee of the trust estate from the investment of any property: ;
>
> (ii) that was transferred to the trustee for the benefit of the beneficiary by another person out of property that devolved upon that other person from the estate of a deceased person and was so transferred within 3 years after the date of the death of the deceased person; or…

Limitations

There are strict limits on when and whether and to what extent income derived from the transferred property is taxed at normal adult rates to the trustee (for the minors) instead of at the non concessional rates. Due to these limits it is often not practical to use this provision.

1. This type of trust can only obtain the tax benefit where the deceased is the parent of the minor child. It is of no value where the deceased is a grandparent and the child's parent is still living because the tax concessions only apply to income derived from property that would have gone to the beneficiary if the deceased Thishs/ 82o2(s/il.0.0516 n)s/il.02o2(s/i5 t)-6.46.8(l)-0d the t(l)-0d t(ldr(8)6.)s/ 5(r)4(e)w70eldr1elyas

usual adult rates. If distributing only to adults the testator doesn’t need a testamentary trust and an inter vivos trust can be used.

Income splitting
As with inter vivos discretionary trusts, any testamentary trust with the discretionary power to appoint the income to different beneficiaries can split the income among beneficiaries with mixed tax rates to reduce the overall tax liability. This combined with the children’s tax break gives testamentary trusts a unique benefit where there are children.

Franking credits problems
For the beneficiaries of a testamentary trust to be entitled to franking credits, the trustee will generally need to make a Family Trust Election (FTE). This won’t have the effect of reducing the scope of beneficiaries where we are dealing with simple life interests because only one person (the life tenant) is entitled to distributions of income.

If it is life interest with discretion to pay income to others then a FTE may restrict the tax effective distribution of the income where the life tenant is not a parent, spouse or child of the deceased. It sometimes happens that the life interest is left to a friend.

Example
Mrs Danvers was Arthur’s nurse and close friend in the final years of his life and she is the life tenant of Arthur’s estate. Arthur left an adult child, Rebecca and 5 grandchildren. Rebecca takes in remainder. Under Arthur’s Will, the trustee can distribute income to the children and grandchildren with the consent of Mrs Danvers (who likes Rebecca).

Arthur is dead and so cannot be named as the test individual. If Mrs Danvers is named as test individual, the distributions of income to Rebecca or the grandchildren will attract family trust distribution tax (FTDT) (at maximum rates). If Rebecca is named as test individual, the distributions of income to Mrs Danvers will attract FTDT (at maximum rates). Furthermore Rebecca or Mrs Danvers (as appropriate) will not be entitled to franking credits.

> 'The "family" of an individual (the "test individual") consists of all of the following (if applicable):
>
> (a) any parent, grandparent, brother, sister, neTa7(n)7.s2.9(a)12.4(n)-7.8(o6)6.4(7.8(o6 10 4(d)6(e)]Tp)11p'T

usual case), where there is any element of discretion (where the right to income is not

Splitting

Assuming splitting is effective in actually separating the assets and the different trustee's indemnities,[35] there is nothing in particular which makes it more or less

Asset protection for one person may mean the creditor or ex-spouse who may have a moral claim is left with nothing. I am not sure advisers should assume our clients all want such asset protection!

What are you trying to achieve? What does your client want?

- Tax benefits on distributing income to minor children, grandchildren
- Tax benefits on distributing income to lower taxed beneficiaries
- Protection of assets from ex-spouses,
- Protection of assets from creditors,
- Protection of assets from being wasted by spendthrift beneficiaries
- Protection of assets from being wasted by addicted beneficiaries
- All of the above (what an unfortunate family!)

Ted the testatrix has one 45 year old daughter, Deborah who has no children and is not intending to or expected to have a child. Ted wants the bulk of his property to go to Deborah.

Do you advise a testamentary trust in case Deborah has a child or adopts a child or do you advise Ted to change his Will if the unexpected happens?

The advantages of the testamentary trust as distinct from an inter vivos discretionary trust are the opportunity to have where thought useful:

- different beneficiaries;
- different property;
- different trustees;
- different appointors; and
- different powers.

It can also be simpler for a less sophisticated trustee to deal with the property in different trusts instead of trying to have one trust cover all.

An existing discretionary trust may be quite suitable and if the beneficiaries, appointor, trustee and powers are suitable and if there are and will not be any minor children or grandchildren or great grandchildren (of the testator.)

Asset protection

From frivolous spending, gambling, addiction, divorce and bankruptcy; good Lord deliver us![40]

A secondary reason for the testamentary trust is to provide asset protection.

The first question for a client with substantial assets and a moderate to high risk profile is why are there any substantial assets in the Will? Surely the assets are already in discretionary trusts? So the first question is really what is owned by the testator

[40] This is not part of the prayers of the Church but should be.

(and spouse) in their own names? If it is merely the family home and some small investments, is there any need for the expense and comparative complexity of a testamentary discretionary trust?

of appointment. Where the executor is appointed by the testator does the executor have any duty to bring all property he can into the deceased estate?[46]

It is also common knowledge that the testator cannot control the assets in the inter vivos family trust except through control of appointor and/or trustee but is this true?

First of all, where the trust deed expressly provides that where the appointor dies, they may appoint a successor in their Will or in the absence of this, the executor of their Will is the appointor.

1. Assets that don't pass through Will

Asset	MV $	Anticipated CGT or income tax	Beneficiary

2. Assets that pass through Will

Asset	MV $	Anticipated CGT or income tax	Preferred beneficiary

3. Beneficiary

Name	Under 18/For how long	Assets at risk to creditors, ex spouse	Assets need protection from beneficiary

Asset	**MV $**	**Anticipated CGT or income tax**	**Beneficiary**
Home	400	None	Joint tenant-Melanie
Assets in first family trust	200	n/r	Expect all children to share overall, 1st wife will be trustee when Julian dies
Superannuation[49]			

What will the testamentary trust achieve for Beneficiary 1?

Children's tax break while under 18. This may also mean that Melanie needs less from the life interest (ie fewer assets may be needed to give her sufficient income)

What will the testamentary trust achieve for Beneficiary 2?

Children's tax break while under 18

What will the testamentary trust achieve for Beneficiary 3?

Maximum protection from property distribution in case of divorce(s)

Children's tax break for grandchildren/great grandchildren under 18

What will the testamentary trust achieve for Beneficiary 4?

Maximum protection from losing assets in professional negligence claim

What will the testamentary trust achieve for Beneficiary 5?

Maximum protection from losing assets in professional negligence claim

Children's tax break for grandchildren/great grandchildren under 18

What will the testamentary trust achieve for Beneficiary 6?

In this case, life interest in either investment property or some or all shares not discretionary trust

5. Assuming separate trusts in each case, who should be trustee/appointor and why? These are not fixed or "right" answers but indicate what should be considered

Name	**Appointor**	**Trustees**	**Comment**

1. Michao(r)5..33 d(8Tc-0.0c.d(8 d(8c6i4.4(op“0.41998 23.82 refBT/3.82 r)-11.64(at 7(ull T refBTillrsef22A8

			sensible siblings are joint trustees with him.
6. Melanie	No	Don't want her to get more assets.	Don't want her to get more assets.

Consider if these choices -which might look good on paper- will nevertheless cause family problems especially if Oscar or Melanie think they are being patronized.

Once you have decided what priorities can be best satisfied by a testamentary trust, then it should be drafted to provide for that priority (or with a range of aims).

Again, I know it is tempting to use a pro forma testamentary trust deed maybe modified a little but this may be the very worst of all options. The trust, by trying to be "all things to all people" may actually allow the very thing the testator doesn't want.[52]

If the priority is to protect the assets from the gambling oldest child, then control of the trust (via appointor and trustee) needs to be elsewhere. If it is to maximise the income splitting benefits including those for minor children, then the appointor and trustee can be the relevant child.

If it is to ensure maximum flexibility for the financial needs and desires of the income beneficiaries, it can be drafted accordingly.

What is to happen with trustee –is aim to hand it over at some time to child or grandchildren? Is this consistent with asset protection?

CLAUSES:

Don't include:

- Any agreement with trustee.
- Any settlor clause as the Will itself is the settlement of the gift.

Do include as appropriate for the particular needs of the testator:

- The 28 or 30 day survivor issue (for the sake of ensuring clarity where the same event cause death of testator and spouse or child),
- Property to be held in the trust.
- Initial trustee of each trust with careful consideration of current and successor trustees. This depends on relationship between spouse and children (especially where the spouse is a second or third).
- Change of trustee.
- Removal of trustee and appointor on events such as bankruptcy.
- Trustee's right to distribute income or capital to self (if intended to be a possible beneficiary) or, if professional or non beneficiary, trustee's right to charge fees.
- Appointor clause with careful consideration of current and successor appointors including final control back to children etc. Who is to control the trust ultimately? There is an inherent conflict between the desire to give the children control and to protect these assets from creditors and ex spouses. Control can be given to other

- Is the trust to be set up whatever age the children (and so is a trust for the grandchildren as well) or is the gift absolute if child is over 18 or 21 or 30 or whatever?
- When trust is to end and rights of trustee to end earlier (including by distribution of all income and capital so there is no trust property left) - this may require consent of spouse or some beneficiaries.
- Definitions especially for meaning of spouse and child (to give maximum flexibility if desired for children not yet conceived, foster children, 'test tube' children,[53] pre-adopted children, same sex partners etc) and income (including power to treat income as capital as vice versa).
- Who is to get a child's share if child dies before testator?
- Discretionary appointment of and distribution of income and capital.
- Streaming income from particular types or specified assets. This is essential if new assets are added to the trust and income from those assets is distributed to minors.
- Usual powers of trustee to sell, invest, borrow, lend generally and lend specifically to beneficiary at interest or otherwise, permit use of property by beneficiary free of charge etc.
- Usual protections to trustee for liability and indemnities.
- Power to accept gifts?? In the absence of such a clause can the trustee do so?
- Right to accumulate income (and whether it remains as income or is treated as capital).
- Investment powers including the preferred balance (if any) between investing for income or capital growth or total flexibility.
- What happens with any after acquired property eg through issue of bonus shares.
- Variation of terms including beneficiaries? Do you direct the trustee to get tax advice before exercising this?
- Perpetuity clause (if needed in your state/territory).
- Any specific requirements such as specific powers where vulnerable beneficiaries (especially if a professional trustee instead of a family one is used. For example, to specify the capital can be used for things for comfort and enjoyment eg holidays, travel).
- Add clause specifically negating any act that would be the delegation of testamentary power (and severing any act).

A couple of more points about the Will:

Does the Will create separate testamentary trusts for each child (and their descendants if any), with the spouse as first appointor and the relevant child as successor in each case. This allows the surviving spouse to control all the income and property during his or her life and then each child gains control on mum or dad's death.

At least in the States which prohibit delegation of testamentary power, the Will should

The effect of the deferral of CGT given by Division 128 is simply that, the CGT liability is deferred and taken into account when the shares are finally sold. In either case the total CGT of $25 gets paid some time (assuming the shares do not decrease in value).

Life interest ended 5 years later for nil consideration

When the executor is able to do so once the estate's debts are paid etc, he commences holding the shares on the trust with the income for life to Rosie. Ryan is the remainder beneficiary.

When Rosie starts to hold the life interest, CGT event E1 occurs and she has a new CGT asset which was not owned by the deceased. The deceased has no CGT due to sec 128-10.

Rosie's interest is property and has a market value.[57]

It has no cost base (because she paid nothing for it and there is no deemed cost base). This is explained in TR 2005/D14:

> 14. An equitable life or remainder interest is a created interest acquired when it starts to be owned. Its first element of cost base and reduced cost base is limited to the sum of any money and market value of property given to acquire it, except where it is not acquired under an arm's length dealing. If no expenditure is incurred to acquire it, paragraph 112-20(1)(a) of the ITAA 1997 has the effect that the interest is not treated as having been acquired for its market value.

Sec 112-20 provides:

> SECTION 112-20 Market value substitution rule
>
> 112-20(1)
>
> The first element of your *cost base and *reduced cost base of a *CGT asset you *acquire from another entity is its *market value (at the time of acquisition) if
>
> (a) you did not incur expenditure to acquire it, except where your acquisition of the asset resulted from:
>
> (i) *CGT event D1 happening; or
>
> (ii) another entity doing something that did not constitute a CGT event happening; or
>
> (b) some or all of the expenditure you incurred to acquire it cannot be valued; or
>
> (c) you did not deal at arm's length with the other entity in connection with the acquisition.
>
> The expenditure can include giving property: see section 103-5.
>
> 112-20(2)
>
> Despite paragraph (1)(c), if:

Capital proceeds	96 (in this case this is real)
Less cost base	nil
Capital gain	96
CGT, say 25%[59]	**$24**

In this case, Ryan is in the same position except he has paid Rosie to end the trust early. Ryan gets $120 worth of shares for $80. Does he have his father's entire cost base of $20 as well as the $80 he paid? Why not?

Life interest ended 5 years after death by in specie transfer of shares owned by deceased

This becomes very interesting. Where Rosie ends her right to income by receiving an in specie distribution CGT event E6 would have occurred with the result that, as the shares being transferred are shares that were owned by Robert at death (and so are covered by Div 128), E6 does not apply. Rosie receives the shares as if gifted in the Will and any CGT liability is rolled over. CGT event E6 provides:

> SECTION 104-80 Disposal to beneficiary to end income right: CGT event E6
>
> 104-80(1)
>
> CGT event E6 happens if the trustee of a trust (except a unit trust or a trust to which Division 128 applies) *disposes of a *CGT asset of the trust to a beneficiary in satisfaction of the beneficiary's right, or part of it, to receive *ordinary income or *statutory income from the trust.
>
> 104-80(2)
>
> The time of the event is when the disposal occurs.
>
> Trustee makes a capital gain or loss
>
> 104-80(3)
>
> The trustee makes a capital gain if the *market value of the asset (at the time of the disposal) is more than its *cost base. It makes a capital loss if that market value is less than the asset's *reduced cost base.
>
> Exception for trustee
>
> 104-80(4)
>
> A *capital gain or *capital loss the trustee makes is disregarded if it *acquired the asset before 20 September 1985.
>
> Beneficiary makes a capital gain or loss
>
> 104-80(5)
>
> The beneficiary makes a capital gain if the *market value of the asset (at the time of the disposal) is more than the *cost base of the right, or the part of it. The beneficiary makes a capital loss if that market value is less than the *reduced cost base of the right or part.
>
> Note:

happening in relation to the parts of the land transferred to Hector's daughters.

166. The exceptions for trusts to which Division 128 applies have no relevance in this case because the land is not passing to the beneficiaries in terms of section 128-20. That is, the interests in the land are not passing under the will nor are they passing under a deed of family of family arrangement entered into to settle a claim to participate in the estate.

167. The trustee of the testamentary trust and Hector's wife may make a capital gain or capital loss from CGT event E6 happening. Depending on the application of Division 6 of Part III of the ITAA 1936, and on section 118-20 and subsection 118-20(1A) of the ITAA 1997, any capital gain made by Hector's wife may be reduced to the extent of amounts referable to the trustee's capital gain included in her assessable income under Division 6 (see also PS LA 2005/1 (GA)).

168. The trustee of the testamentary trust may make a capital gain or capital loss from CGT event E7 happening in relation to the parts of the land used to satisfy the interests of the dau9E7 hato6.4(fre)5.9u fre(t)-7.4(s5(l)5.9( )]TJ0 -1.15es a.9(s)8.sesn

> and the money or securities or the proceeds of the sale calling in and conversion are not by statute or in equity considered as land.
>
> (6) This section applies only and if and as far as a contrary intention is not expressed in the instrument, if any, creating the trust, and shall have effect subject to the terms of that instrument and to the provisions therein contained.

Also consider if any of the potential beneficiaries have a valid bona fide claim under the family provisions statute. Although it is not necessary to commence court proceedings,[65] the claim must surely be bona fide (and provable as such).[66]

If that fails, would Rosie be satisfied with an in specie transfer of shares owned by Robert? Obviously the longer the life interest has been active, the more post death assets will usually exist. As a partial balance, the older the life tenant, the less the market value of their interest! At this stage, if the answer is yes, seek a private ruling (until TR 2005/D14 is finalised).

Another possible approach is set out below.

Other possible solutions: Over to the ATO!

The different results for the ending of the life interest over investment assets appear to have no logical reason. The overall policy of Div 128 is to allow gifting of assets with deferred CGT liability. Where there will be no CGT liability (eg on the ending of the life interest by death) then why not interpret the CGT trust provisions in such a way (even generously) to achieve the aim. The draft ruling is a noble effort to try to deal with the issue in a relatively abstract manner by trying to make sense of the trust law implications of starting and ending life interests (including those left in Wills). It tries to do too much by dealing with legal and equitable life interests and does not face the practical inconsistencies that I refer to above.

The life tenant has no CGT

Why not accept that a life tenant can surrender the life interest whether for full market value consideration or not, "tax free". There is no loss to the Revenue as the remainder

eg in PS LA 2003/12 (also concerning Div 128) and eg TR 95/35 which was necessarily to make CGT on compensation receipts work at all!

The relevant parts of sec 110-25(2) are set out below so you can check my claim. In summary, the cost base rules deal with amounts incurred etc. in acquiring the asset. If Ryan spent the money for a reason other than acquiring the asset (ie the shares), the cost base rules don't apply.

5 elements of the cost base -

> 110-25(2)
>
> The first element is the total of:
>
> (a) the money you paid, or are required to pay, in respect of *acquiring it; and
>
> (b) the *market value of any other property you gave, or are required to give, in respect of acquiring it (worked out as at the time of the acquisition).
>
> [Note 1: There are special rules for working out when you are required to pay money or give other property: see section 103-15.]
>
> [Note 2: This element is replaced with another amount in many situations: see Division 112.]
>
> 110-25(3)
>
> The second element is the *incidental costs you incurred. These costs can include giving property: see section 103-5.
>
> [Note: There is one situation to do with options in which the incidental costs

The only difference here is the deemed market value for the first element of the cost

A.

whether she was dealing with them at arm's length or not. Furthermore, and as a further illustration of how impossible it is to use the general CGT provisions with assets held on death, it is also likely that **in fact** Rosie did not deal with Robert at all – she may have no knowledge of the life interest until after his death. Even if she was aware, this is surely not the type of "dealing" that the CGT provisions are meant to tax.

Another (almost) solved CGT problem for life tenants

A life tenant of an active testamentary trust is the sole income beneficiary and is an558 s0.00.7(t the

> trustee's acquisition of the original asset. Further item 3 in the table in section 109-10 does not apply because the trust is not a unit trust.
>
> 54. The first element of the cost base and reduced cost base of a life or remainder interest is limited to the sum of any money and the market value of any property given to acquire it, except where it is not acquired under an arm's length dealing. The market value substitution rule does not apply in calculating the first element of the cost base and reduced cost base of life and remainder interests acquired for no expenditure: paragraph 112-20(1)(a) of the ITAA 1997.

The problem for the life tenant arises in part because there is no cost base and no deemed cost base. This results in almost the entire capital proceeds or deemed capital proceeds (that is the other problem) being subject to CGT.

Could Robert was treated as owning not only the shares but also each interest that he can leave in the shares. So when the life interest commences, the life interest and remainder interest each have a percentage of the cost base of the shares etc over which the interests exist.

So if Rosie's life interest is worth 80%, she has 80% of the cost base. If she surrenders the interest for market value, she has 80% of cost base. In the above example, this was worth $16.

If she surrenders the interest when its value is $80 the result would be as if she was left shares with that value and sold them. In practical terms as far as she is concerned that is what should have happened.

If Robert leaves an interest in shares to Rosie then while she has that interest, the shares themselves will either:

- Be disposed of by trustee and he/she will use Robert's cost base and replace investment with new market value cost base. These shares formerly owned by Robert will never pass to Ryan and so the Div 128 cost base rules are irrelevant for those shares.
- Be held by trustee until interest ends (and so no one makes use of their cost base during this time) and when the interest ends, then if the shares pass to Ryan as

base but there is CGT on the balance of the deemed consideration which is a bonus to the Revenue (caused by the early ending of the life interest).

She "sells" her life interest. If she accepts shares, then Ryan only acquires the shares left over. If Ryan funds this out of his funds, then he acquires all the shares.

Comment on "solutions"

These ideas are offered as just that - ideas! I release these balloons of hot air in the hope one of them will be found to hold a better answer than the current position for the life tenant especially one who wishes to be generous and let the remainder beneficiaries receive their inheritance early.

CONCLUSION

There once was a man named Flowers
Whose wealth was from building showers
He made his own Will
The silly old dill
So "gave" all of his assets to lawyers

Well, after reading all of this, do you think testamentary trusts are just another trust? There are undoubtedly some interesting and difficult tax questions unique to trusts arising from Wills and as much as I hope