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Life and death

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1 Overview

The best laid schemes o' Mice an' Men, / Gang aft agley

or translated from the Scots

the best laid plans of mice and men often go awry

As Wiktionary notes, this is a proverbial expression used to signify the futility of making detailed plans when the ability to fully or even partially execute them is uncertain.

One could easily think that Robert Burns was reflecting on a succession planner with a recalcitrant client in a changing legislative environment.

Our practice is not involved in estate planning. We come on the scene after someone has died and are involved from a tax perspective in the implementation of the plan (such as it is) that the deceased had made, sometimes many years previously. One thing we've learned is that if tax is important to a succession plan, it is vital that the plan be reviewed regularly, otherwise the tax result could well be one that was not intended or ever contemplated.

As this paper demonstrates, no matter how tax effective a succession plan was when originally devised, many things can affect its effectiveness by the time the plan comes to be implemented:

- legislative changes – like those that were made to section 102AG of the ITAA 1936 which affect the use of mirror trusts; or the FIRB changes which may mean that leaving real property to a foreigner may not be such a good idea
- changes to (or simply an expression of) the ATO view of the law – the publication of TDs 2017/23 and 2017/24 demonstrated the effect of appointing a foreign LPR
- the emergence of new issues – I'd include in this category, the effect of Regulation 6.21(2)(a) of the SIS Regulations
- changes in underlying facts and circumstances – for example, a Will may establish a special disability trust for an individual but is that going to be enough to cover all their needs as those needs change.

2 Deceased Estates and Testamentary Trusts

2.1 Background – trust taxation 101

We are often asked: 'who pays tax in a deceased estate, the LPRs or the beneficiaries?'. If only it was that simple! As you will appreciate, the answer is non-binary and depends on a range of factors including the stage which the administration of the estate has reached.

For tax purposes, an LPR is treated as a trustee, and the estate that they are administering is treated as a trust estate. This means that the general trust taxation rules will apply to a deceased estate. A testamentary trust is a tax entity separate from a deceased estate.

Traditionally, the rules about trust taxation were found mainly in Division 6 of Part III of the ITAA 1936. Following amendments in 2011 to allow for the streaming of trust capital gains and franked dividends, trust capital gains are now brought to assessment by Subdivision 115-C of the ITAA 1997 and franked dividends are assessed under Subdivision 207-B of the ITAA 1997.[1]

Broadly the trust taxation rules apply as follows.[2]

Beneficiaries who are specifically entitled to capital gains[3] or franked dividends[4] are assessed on those components of the trust's net income. A trustee can sometimes choose to be specifically entitled to trust capital gains.[5] If the choice is made the trustee is assessed on those gains. Commonly a trustee may choose to be assessed if an income beneficiary who is not entitled to the benefit of a capital gain would otherwise be assessed on it. The result is produces an equitable outcome as tax is effectively borne by those who will ultimately benefit from the gain.

The way that the remaining net income is taxed will depend on whether there are beneficiaries who are presently entitled to the trust's income. ['Income' is determined according to the terms of the particular trust.[6] It is not necessarily the same as the trust's 'net income' as defined in the ITAA 1936.[7]]

If there are beneficiaries who are presently entitled to a share of the income of the trust, they will be assessed on that same percentage share of the trust's net income.[8] This is the case even if the income has not actually been paid to them.

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[1] Division 6E of Part III of the ITAA 1936 adjusts the operation of Division 6 to ensure that amounts are not taxed twice.

[2] This analysis assumes that the trustee and all of the beneficiaries are residents. Other issues arise if they are not. These are considered in more detail in another booklet that the author has written, *The Australian Tax Pitfalls of Administering an Estate with International Connections*

[3] section 115-228 of the ITAA 1997

[4] section 207-58 of the ITAA 1997

[5] section 115-230 of the ITAA 1997

[6] *Commissioner of Taxation v Bamford* [2010] HCA 10

[7] The ATO's view about the meaning of income of a trust estate is set out in Draft Taxation Ruling TR 2012/D1.

[8] section 97 of the ITAA 1936

However, the trustee will be taxed on a beneficiary's behalf if the beneficiary is under a legal disability.[9] Beneficiaries with a legal disability include minors, bankrupts and people with legal incapacity due to mental conditions. A separate assessment notice will be issued to the trustee for each such beneficiary. If the amount is also assessed to the beneficiary,[10] they will be allowed a credit for the tax paid by the trustee.[11] Similar rules apply in respect of a beneficiary that is a non-resident at the end of the income year

If there is no trust income, or there is some net income that is not assessed to a beneficiary, the trustee is assessed under section 99 or 99A.

Section 99A/99

A trustee will be assessed under section 99A of the ITAA 1936, unless the Commissioner exercises his discretion to tax the trustee under section 99. The discretion can apply to trusts created under a Will if the Commissioner considers that it would be unreasonable to apply section 99A.

Trustees assessed under section 99A are taxed at the top marginal rate. They are also denied access to the CGT discount and small business reduction. [12] Trustees assessed under section 99 on the other hand are taxed at marginal rates (albeit without the benefit of the tax-free threshold).[13] They also have access to the CGT discount and 50% small business reduction. This differential treatment, particularly access to the CGT discount is one of the reasons behind the explosion in recent times of the use of testamentary discretionary trusts.

As a matter of practice, most trustees of deceased estates or testamentary trusts will not formally seek an exercise of the discretion to apply section 99. Under the self-assessment system, the Commissioner accepts returns as lodged. It would only be in cases of an audit or review that the application of section 99 is likely to be called into question. We see many cases where the administration of an estate is delayed ostensibly to obtain the benefit of the rates that apply for the first three years of administration and in other case the marginal rates that apply after that time. We warn our clients that this is potentially a situation where the Commissioner would not consider it unreasonable to apply section 99A, which after all was introduced to avoid accumulations of income.

2.2 Some surprises

Although the focus of this paper is not on issues related to the residence of the trustee or beneficiaries of an estate or trust, it is nonetheless worth noting the different treatment for capital gains that apply in relation to a non-resident trust. [If the sole trustee of a trust is a foreign resident and the trust is controlled and managed outside of Australia, the trust is not a resident trust estate for Australian taxation purposes. [Surprisingly the tax outcomes of the estate of a deceased resident

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[9] subsection 98(1) of the ITAA 1936

[10] subsection 100(1) of the ITAA 1936

[11] subsection 100(2) of the ITAA 1936

[12] subsection 115-222(4) of the ITAA 1997

[13] This is the case from the first income year for a testamentary trust, even if that year is less than three years from the deceased's death. The trustee of a deceased estate is entitled to the tax-free threshold for the first three income years following death.

taxpayer, can depend on the residence of their LPR. This is different from the case in the UK, where the LPR is taken to have the same residence as the deceased]

Capital gains and losses from assets that are not 'taxable Australian property' are not included in the net income (effectively the taxable income) of a non-resident trust.[14] In broad terms, taxable Australian property (TAP) is an interest in land in Australia (including certain indirect interests held via a company or trust).[15] Other assets such as shares in listed companies in Australia or overseas or land in a foreign country are not TAP.

Although capital gains from assets that are not TAP assets are excluded from the net income of a non-resident trust's net income in the year they are made, amounts attributable to those gains will be fully assessed to an Australian resident beneficiary when distributed. [Amounts distributed to a non-resident beneficiary are not assessable in Australia.] Further, the Tax Office takes the view that the amounts which are assessed on distribution from a non-resident trust do not take the nature of capital gains and accordingly the resident beneficiary does not qualify for the CGT discount[16] they would otherwise be entitled to.

2.3 Section 102AG

Another reason for the increased use of testamentary trusts (vis a vis *inter-vivos* trusts) is the concession in afforded to the unearned trust income of minors[17]. This means the higher tax rates that usually apply to the unearned income of minors by virtue of Division 6AA of the ITAA 1936 will not apply to the income of certain testamentary trusts. Rather, that income will be assessed at individual marginal rates (with the benefit of a tax-free threshold of $18,200).

Originally section 102AG of the ITAA 1936 was worded similarly to the exclusion from section 99A, that is, it applied simply to the income of a trust that arose from a Will or intestacy. Although section 102AG contained anti-avoidance rules, they were not considered sufficient to deal with arrangements where assets were being funnelled from outside of the estate to a testamentary trust. For example, they might not have applied where a trustee of an inter-vivos discretionary trust made a distribution to the testamentary trust.

Amendments that operate from 1 July 2019 have the effect that income is excepted trust income only to the extent that it is from property transferred from the estate of the relevant deceased person or represents accumulations of income or capital from that property[18]. The following examples from the ATO website show the intended effect of the change. [19]

Example: Distribution from a family trust to a testamentary trust

Lavender Trust is a testamentary trust established under a will of which Alex is a beneficiary. Alex is 14 years old. As a result of the will, $100,000 is transferred on 17 July 2020 to the trustee of Lavender

[14] See Taxation Determination TD 2017/23 which discusses the application of section 855-10

[15] Taxable Australian property is defined in section 855-15 of the ITAA 1997

[16] See Taxation Determination TD 2017/24 which takes the view that section 99B of the ITAA 1936 would apply.

[17] subsection 102AG(2) of the ITAA 1936

[18] subsection 102AG(2AA) of the ITAA 1936

[19] QC16509

Trust from the deceased estate. Shortly after, the trustee of a family trust makes a capital distribution of $1 million to the trustee of Lavender Trust. The trustee of Lavender Trust invested the entire amount of $1.1 million in listed shares

In the 2020-21 income year, the trustee of Lavender Trust derives $110,000 of dividend income from the investment in the listed shares. The net income of Lavender Trust for that year is $110,000. Alex is made presently entitled to 50% of that amount, which is $55,000.

Alex's excepted income is $5,000. This amount is the extent to which the $55,000 of income resulted from the $100,000 transferred from the deceased estate (worked out as $100,000 ÷ $1.1 million × $55,000). The remaining $50,000 is income that resulted from the $1 million capital distribution from the family trust, which is unrelated to the deceased estate. It is not excepted income

Example: Trust income reinvested

Assume the trustee of Lavender Trust (from the example above) did not pay Alex her share of the net income of the trust (being $55,000, comprising $5,000 excepted income and $50,000 not excepted income). The trustee, instead, reinvests that amount in more listed shares in the 2021–22 income year. For the 2021–22 income year, that investment derives income of $5,500 and Alex is made presently entitled to that amount reinvested

Alex's excepted income is $500 (worked out as $5,000 ÷ $55,000 x $5,500). This amount is the extent to which the $5,500 of income resulted from Lavender Trust reinvesting previously excepted income. The remaining $5,000 is attributable to assets unrelated to the deceased estate and is not excepted income.

Example: Rental property acquired with borrowed money, trust distribution and money from deceased estate

Johnston Trust is a testamentary trust established under a will into which $500,000 is transferred from the deceased estate on 22 August 2020. A trustee of a family trust then makes a capital distribution of $500,000 to Johnston Trust. The trustee of Johnston Trust borrows $1 million from a bank and purchases a rental property for $1.9 million. The remaining $100,000 is used as working capital for the rental property.

In the 2020–21 income year, the trustee of Johnston Trust receives $50,000 of net rental income. The net income of the trust for that year is $50,000. Michael, who is under 18 years old, is made presently entitled to 50% of the $50,000 net income, being $25,000.

Michael's excepted income is $6,250. This amount is the extent to which the $25,000 of income resulted from the $500,000 transferred from the deceased estate (worked out as $500,000 ÷ $2 million × $25,000). The remaining $18,750 of income is attributable to assets unrelated to the deceased estate and is not excepted income.

Other issues have been raised with the ATO in respect of which guidance could be usefully provided:

- How are deductions/expenses to be allocated if they relate to both excepted and non-excepted income?

- Assume mixed funds used to acquire assets, what records are required to show that the growth is from the deceased's assets?
- What if the trustee acquired a property that was subject to a loan that the deceased had taken out? What is the value of the amount contributed to the trust (the value less amount of loan).

2.4 FIRB changes

If you are advising about tax for an estate with a foreign beneficiary, you should be aware of the recent FIRB changes. While the application of those rules is not a tax question, the effect of the changes as we understand it will be that assets may have to be sold rather than transferred to the foreign beneficiary.[20]

This information is from Guidance Note 2[21] available on the FIRB website.

From 1 January 2021, a foreign person who acquires interests through a Will (for example, an interest in Australian land or a substantial interest in securities in an Australian entity) is no longer exempt from the foreign investment review framework. They should contact the Treasury or the Australian Taxation Office (ATO), as applicable, where they become aware of or acquire an interest under a Will.

The point at which a foreign person is considered to have taken a notifiable action is generally the time at which the legal interest is acquired on completion of administration of the Will.

In some circumstances, a foreign person may not be certain they will actually receive an interest under a Will until the administration of the Will has been completed, meaning they could not be expected to seek foreign investment approval prior to acquiring the interest. In these circumstances, the foreign person is expected to submit their relevant foreign investment notification/application within 30 days after the interest has been acquired.

Example

John is a foreign person. On 1 December 2020, his sister Mary, who is a resident of Australia dies. In her Will, Mary bequeaths to John an established residential dwelling in Sydney. The executor of Mary's estate obtains probate. The administration is completed when all the debts are satisfied and bequeaths transferred to beneficiaries. The title of the Sydney property is registered with the land titles office in John's name on 30 June 2021. John has 30 days from 30 June 2021 to submit a foreign investment application.

Alternatively, John could apply prior to 30 June 2021 if he is certain he will acquire the legal interest, for example if he is advised by the executor that administration has been completed and that he will acquire the interest, or where transfer of the interest has been executed and the only remaining step is finalisation of the registration of the signed transfer of title.

Example

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[20] Treasury is undertaking a review of the effect of the changes. STEP Australia has made a submission about this aspect: https://stepaustralia.com/wp-content/uploads/2021/10/STEP-Australia-Submission-FIRB.pdf

[21] https://firb.gov.au/guidance-resources/guidance-notes/gn2

Luke is a foreign person and is bequeathed an interest in an established dwelling in a Will. The Will has been administered and Luke is now registered as the title holder of the established dwelling. He will be required to notify of his interest in the Australian land. Luke is generally not permitted to hold an interest in an established dwelling, unless there is an exemption that applies (such as having an Australian resident spouse). Where there is no applicable exemption, conditions may be imposed on the interest, which may include requiring Luke to dispose of his interest within six months of acquiring the legal interest in the land.

Example

Ella is a foreign person and is bequeathed an interest in vacant land in a Will. The Will has been administered and Ella is now registered as the title holder of the established dwelling. She will be required to notify of her interest in the Australian land. If Ella is approved to hold the interest, this may be subject to the vacant land development conditions.

The Executor of a Will will not generally require foreign investment approval to perform their duties as Executor, as the vesting of interests with the Executor following a death is covered by the devolution by operation of law exemption

The term 'devolution' contemplates a legal consequence flowing from an involuntary act. The essential aspect of an interest being acquired through devolution by operation of law is that it cannot be acquired by voluntary action or agreement of the parties; absence of voluntariness is essential to the concept of devolution.

The devolution by operation of law exception is intended to cover acquisitions of interests in the property of a deceased estate by personal representatives (in that capacity), where they do not have a beneficial interest in the property of a deceased estate and their control of such property is temporary.

The devolution by operation of law exemption would also likely cover interests acquired by beneficiaries of intestate estates, where the deceased persons assets are distributed according to laws of succession.

For information on how the Government responds to instances of failing to notify, including in cases where the non-compliance is inadvertent, see:

- the *Compliance – Residential* Guidance Note[22] (with respect to interests in residential land).

[22] https://firb.gov.au/sites/firb.gov.au/files/guidance-notes/G14ComplianceResidential_0.pdf

The FIRB fees are significant and would be payable by the beneficiary:

Consideration for the action			Applicable fee	
Residential land	Agricultural land	Commercial land, tenements, businesses and entities	Fee for single action	Fee for single Reviewable national security action [(a)]
Less than $75,000 [(b)]	Less than $75,000 [(b)]	Less than $75,000 [(b)]	$2,000	$500
$1 million or less	$2 million or less	$50 million or less	$6,350	$1,587.50
$2 million or less	$4 million or less	$100 million or less	$12,700	$3,175
$3 million or less	$6 million or less	$150 million or less	$25,400	$6,350
$4 million or less	$8 million or less	$200 million or less	$38,100	$9,525
$5 million or less	$10 million or less	$250 million or less	$50,800	$12,700
…	…	…	…	…
Over $40 million	Over $80 million	Over $2 billion	$503,000 maximum fee	$125,750 maximum fee

3 Philanthropy

We are seeing more cases where tax exempt beneficiaries are challenging LPRs about their approach to the estate's tax issues.

This can arise, for example from:

- a failure to consider whether the beneficiary should be made presently entitled to the income of the estate or specifically entitled to the estate's capital gains during the estate administration, or
- a decision by the LPR whether to sell or transfer estate assets to a beneficiary.

3.1 Interim distributions

Remember that the 'net income' of a trust is assessed to those beneficiaries who are presently entitled to the trust 'income'. In an estate, the income would be ordinary income (that which a life interest holder would be entitled to). To the extent that there is some income to which no beneficiary is presently entitled (or if there is no trust income), the trustee will be assessed.

A beneficiary is presently entitled to trust income if they have a present or immediate right to demand payment of it from the trustee. The ATO views about present entitlement in the context of a deceased estate are set out in Income Tax Ruling IT 2622. That ruling acknowledges that a beneficiary can be presently entitled to trust income prior to the completion of the administration of an estate.

In some instances, a failure by an LPR to make an interim distribution can result in tax being paid unnecessarily. Consider this simple example.

Example

Daryl is the executor of his brother Monty's Will. Monty left his entire estate to a gift deductible charity.

For various reasons, including the settlement of family maintenance claims, the administration of the estate was delayed. The income of the estate for a particular year was $250,000 and its net income was $250,000.

Near the end of that year it was clear that Daryl would not need the $250,000 estate income to satisfy debts or other claims, however he did not make the charity entitled to the income. Daryl was assessed on the net income of the trust and paid tax of $89,055.

However, if Daryl had made the charity presently entitled to the income (and complied with section 100AA and 100AB of the ITAA 1997)[23] no tax would have been payable. The charity, being presently entitled to all of the estate income, would have been assessable on all the net income however no tax

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[23] Considered later in this paper

would have been payable because it was an exempt entity. In effect, the charity lost $89,055 of the bequest that Monty had left it.

3.2 Sell or transfer

3.2.1 Transfer

A question often arises whether an LPR should transfer assets to a tax-exempt beneficiary or sell the assets and pay the proceeds to the beneficiary. This involves consideration of CGT event K3 and whether the LPR is able to create a relevant entitlement in the beneficiary.

CGT event K3 happens if an asset that a person owned just before they died passes to a beneficiary in their estate that is, when the asset passes, an exempt entity[24]. The time of the event is just before the deceased person died which means that any resulting capital gain or loss is accounted for in the final income tax return of the deceased[25].

There is a question whether assets pass to a beneficiary prior to their transfer. That is, the ATO takes the view in Tax Determination TD 2004/3 that an asset can 'pass' to a beneficiary of an estate if the beneficiary becomes absolutely entitled to the asset. A beneficiary may be absolutely entitled to particular assets if, for example, the executors make an assent in relation to the distribution of those assets to the beneficiary. So, for example, if an executor determined that shares were available for transfer to an exempt beneficiary or sale, those assets would have passed to the beneficiary (and CGT event K3 happened) even if the beneficiary requests that they be sold rather than transferred.

CGT event K3 will result in a capital gain if the value of the asset at the time of death exceeds the asset's cost base or a capital loss if that value is less than its reduced cost base.

If the asset was acquired by the deceased before 20 September 1985, any capital gain or loss from it is disregarded.[26]

Importantly, a capital gain or loss is also disregarded if the asset passes to an exempt entity that is a deductible gift recipient (DGR).[27]

There is a timing issue in relation to the status of an entity as exempt, this is relevant where the Will of a deceased person creates a trust for charitable purposes. CGT event K3 will only happen if a relevant entity is exempt when an asset passes to it. An exempt entity is an entity whose ordinary and statutory income is exempt from income tax because of Division 50 of the ITAA 1997[28].

However, an entity cannot self-assess as being income tax exempt. Instead, the entity must meet the requirements for charity registration and then become endorsed by the ATO to be income tax exempt (see Division 426 in Schedule 1 to the *Tax Administration Act* (TAA)). The ATO has previously

[24] paragraph 104- 215(1)(a) of the ITAA 1997
[25] subsection 104-215(3) of the ITAA 1997
[26] subsection 104-215(5) of the ITAA 1997
[27] section 118-60 of the ITAA 1997
[28] subsection 995-1(1) of the ITAA 1997

indicated[29] that because the Commissioner has the power to specify the date from which endorsement takes effect and that the date can be retrospective[30], a testamentary charitable trust would be an exempt entity from the time the assets pass to it – thus potentially triggering CGT event K3.

Industry practice largely has been to fall in line with the ATO interpretation given the risk of the Commissioner otherwise seeking to apply the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936*. However, we make the following observations about the ATO view:

- The application for endorsement form available on the ATO website asks the question, From what date do you wish your organisation to be endorsed for income tax exemption? The example on the form also suggests that the exemption “can” apply earlier, not that it must do so.
- The Explanatory Memorandum to Division 426 indicates that the requirement for endorsement preserves the right of the entity not to be endorsed if they choose.
- Treasury had previously identified the timing issue as a defect in the operation of CGT event K3 and had proposed that the law be amended (see Minor amendments to the capital gains tax law, Proposals Paper May 2011). Ultimately, however the amendment did not proceed

3.2.2 Sale

Alternatively, the LPR might decide to sell the shares (before they pass to the beneficiaries). If the tax-exempt beneficiaries are made specifically entitled to the capital gains, then the gains will be ‘assessable’ to those entities (although they will pay no tax as they are exempt) rather than to the LPR. It does not matter whether or not the entity is a DGR.

In our experience, the ATO has accepted that a power of appropriation like that in section 46 of the *Trustee Act 1925 (NSW*) is sufficient to enable streaming of capital gains by an executor.

For a beneficiary to be specifically entitled to a capital gain the following conditions must be met:

- The beneficiary must have received, or reasonably expect to receive, the net financial benefits 'referable to the capital gain'. To have such an expectation, the estate administration must have reached a point where the executors do not require the ‘gain’ amounts (not necessarily the total capital proceeds) for the payment of liabilities.

- The beneficiary's entitlement to the amount must be 'recorded in its character' as an amount referable to the capital gain in the accounts or records of the trust **by 31 August** following the end of the income year in which the gain was made.[31]

‘Net financial benefit’ means an amount equal to the financial benefit referable to the capital gain after the application of trust capital losses (consistent with the application of those losses for the purposes

[29] PBR 1011636336172
[30] section 426-30 of the TAA 1953
[31] subsection 115-228(1)

of the method statement in section 102-5 of the ITAA 1997) but before the application of the CGT discount.

Unlike for franked dividends (which can be treated as a single franked dividend for streaming purposes[32]), capital gains **must be streamed on a gain-by-gain basis**. While this might be easy if the asset is land, it becomes more administratively arduous if there are many parcels of shares and multiple beneficiaries. In one case we are aware of, there were over 40 exempt beneficiaries. The LPR thought it would be difficult to explain to them why some were being made entitled to gains from BHP shares and others CSL share gains despite the fact that arithmetically they were all getting the same amount.

Alternatively, the LPR could make each exempt entity presently entitled to the estate's 'adjusted net income' **before 30 June** in the relevant income year. The beneficiaries would be 'assessable' on the estate's net income, but again no tax would be payable because they are exempt (again it would not matter that whether or not the beneficiary was a DGR).

However, in certain situations, a tax-exempt beneficiary may be taken to **not** be presently entitled to for tax purposes. Anti-avoidance rules were introduced at the same time as the rules to allow streaming of capital gains and franked distributions. While the rules were aimed at discretionary trusts, they nonetheless apply to deceased estates and testamentary trusts. So, an LPR making an exempt beneficiary presently entitled to income must ensure that they satisfy these rules.

For tax purposes, a tax-exempt beneficiary is treated as not being presently entitled to income of a trust if the trustee failed to pay or notify the beneficiary of their entitlement within two months of the end of the relevant income year. If the 'pay or notify' rule applies, the trustee is taxed on the beneficiary's share of the net income.

However, the Commissioner has the discretion not to apply the rule when the trustee fails to pay or notify on time. In exercising the discretion, the Commissioner must consider the following factors:

- the circumstances that led to the trustee failing to notify or pay the amount within two months of the year end.
- the extent to which the trustee has taken actions to try to correct the failure and how quickly those actions were taken.
- whether the trustee has applied to the Commissioner to exercise his discretion previously.
- any other relevant matters.

In the earlier example, Daryl would need to pay the income to the charity or at least notify it of its entitlement by 31 August or he will be assessed on all of the net income (unless the Commissioner exercises his discretion to extend the two month period).

A search of the ATO legal database shows the Commissioner has exercised the discretion in the following circumstances:

[32] section 207-59

- the trustee had died and a new trustee could not act until probate of the deceased trustee's estate had been granted[33]
- there was an issue about the formal identification of a beneficiary which was resolved by a Supreme Court application[34]
- there was a miscommunication between the trustee and the financial advisor about who was to pay the exempt entity[35]
- the trustee did not pay or notify the entity of its entire entitlement, *but the* shortfall was a minor amount and represented a small percentage of the exempt entity's present entitlement[36].

A trustee of a testamentary trust can inadvertently trigger the 'pay or notify' rule and be forced to rely on the Commissioner exercising his discretion. For example, on the death of a life tenant, the trustee may overlook the obligation to notify tax exempt remainder beneficiaries of their entitlements within the two-month period after the end of the financial year.

Section 100AB is designed to overcome the exploitation of the proportionate approach whereby an exempt entity can be made presently entitled to all of the income of a trust so that tax can be avoided on a capital gain that is enjoyed by another entity. It operates by comparing the exempt entity's entitlements to trust income and adjusted net income. If the entitlement to adjusted net income is lower, the beneficiary is taken to be presently entitled only to that percentage of the trust income, with the result that the trustee will be assessed.

Generally, in an estate, we would not expect section 100AB to apply because the exempt beneficiary will enjoy the capital gain as well as the income. However, there is a technical issue about present entitlement that means that in some instances, an application may need to be made for the exercise of the Commissioner's discretion.

The concept of present entitlement to the trust estate (that is reflected in the adjusted net income of the trust) is a new concept and is relevant only for section 100AB purposes. The present entitlement can be an entitlement to income and/or capital.

'Present entitlement to trust income' is a concept that has been considered by the Courts on many occasions. The High Court decision in the Union Fidelity Case[37] determined amongst other things that:

> 12. …..When a beneficiary has been paid his share of the income of the estate in respect of a tax year he no longer satisfies the description of a beneficiary who is entitled to a share of the net income of the estate for that year. …

As a consequence of that decision, the ITAA 1936 was amended to introduce subsection 95A(1) which provides that a beneficiary will continue to be presently entitled to trust income notwithstanding that it has been paid to them or applied for their benefit.

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[33] Authorisation Number: 1051760637680
[34] Authorisation Number: 1051346488294
[35] Authorisation Number: 1051630156354
[36] Authorisation Number: 1051346488294
[37] *Union Fidelity Trustee Co of Australia Ltd v Federal Commissioner of Taxation* [1969] HCA 36; 119 CLR 177; 69 ATC 4084

However subsection 95A(1) was not amended to provide that a beneficiary's entitlement to trust capital exists for a year notwithstanding that it has been paid to them.

So, for example, if an entitlement to trust capital was created by an executor and paid to the beneficiary before the end of the income year, it may be that there is a mismatch between the relevant percentages and the executor would need to seek an exercise of the discretion in subsection 100AB(5) in order to avoid an assessment by reason of section 100AB.

In exercising the discretion, the Commissioner is to consider:

- the circumstances that led to the difference between the Division 6 percentage exceeding the benchmark percentage
- the extent of mismatch between the exempt entity's adjusted Division 6 percentage and the benchmark percentage
- the extent to which the exempt entities actually received distributions from the trust estate in respect of the year of income
- the extent to which the exempt entity and other beneficiaries were entitled to benefit from amounts representing the net income of the trust.

Example

Taking the previous example, assume that the LPR had also made a non-discount capital gain of $200,000 from the sale of a property. The income of the trust remains $250,000 but the net income is now $450,000.

The trustee, Daryl, determines that he does not require the $450,000 for the purposes of the estate administration and makes an interim distribution to the charity before 30 June. At year end the charity is presently entitled to 100% of the income of the trust (by viture of subsection 95A(1)); however its present entitlement to the adjusted net income may be 55% [($250,000/$450,000) x 100].

Without the exercise of the discretion, the exempt entity's entitlement to income would be taken to be 55%. Therefore, Daryl would be assessed on 45% of the net income. (45%x $350,000 = $157,000)

Clearly the case is one in respect of which it was intended that the discretion should be exercised:

- the discrepancy arose as a result of the operation of the deceased's Will and the general law of succession and the fact that there is no deemed present entitlement rule in respect of an amount of capital paid to a beneficiary during the year
- the exempt entity will benefit from amounts attributable to the capital gain as the residuary beneficiary of the estate
- no other entity will benefit from an amount attributable to the capital gain
- a similar result could be achieved by making the entity specifically entitled to the capital gain.

4 Superannuation

It is important to start this topic by clearly stating that superannuation proceeds do not automatically form part of a deceased estate. Rather, those proceeds (known as superannuation death benefits) only form part of an estate when

- a valid binding death benefit nomination (BDBN) is made by the deceased in favour of the LPR, or
- the trustees of the superannuation fund use their discretion or, are otherwise obliged under the terms of fund's trust deed, to pay the lump sum death benefit to the estate.

The focal point of this section of the paper is limited to the tax treatment of death benefit proceeds being received by the LPR of a deceased member. The treatment of those proceeds is the same whether it is paid from an industry or self-managed superannuation fund.

As the fund trustees are only responsible for income tax when they remit death benefits payments directly to beneficiaries, there appears to be a growing trend of industry funds to pay lump sum death benefits directly to a member' s estate. This effectively transfers the responsibility for determining any taxation obligations from the fund trustee directly to the LPR.

4.1 Core concepts of death benefits

Upon the passing of a fund member, trustees are required to pay out the member's death benefits as soon as 'practicable' after the member's death.[38] There is no definition or guidance in the SIS Act or ITAA as to what this might mean; it will depend on the facts of each case. While there is little evidence of the ATO questioning the time taken to make a payment, it should be remembered that a failure to satisfy the requirement technically results in the fund being non-compliant.

In determining to whom a death benefit payment is to be paid, the trustee must ensure that they are authorised by both the trust deed and superannuation law to make the payment. Each trust deed is different and it is essential that the trust deed be examined carefully.

If permitted by the deed, a member of a superannuation fund may elect to provide the trustee with specific instructions in advance of their death via either a valid BDBN or through the establishment of a reversionary pension. On the member's death, the trustee would be obliged to operate in accordance with those directions. It should however be noted that many BDBNs lapse after three years and it is necessary to refresh these on a regular basis.

Where a member has left no valid BDBN or reversionary pension nomination, the superannuation fund trustee has the sole discretion to decide to whom the benefits are paid. A trustee is only able to make a payment to non-dependants after they have made reasonable enquiries to try and locate dependants or the deceased's LPR.[39] Accordingly, the non-existence of specific instructions may lead to a significant delay in the payment of benefits.

[38] Regulation 6.21 (1) of the Superannuation Industry (Superannuation) Regulations 1994 (SIS Regulations).
[39] Regulation 6.22 of the SIS Regulations

Further, it should be noted that a non-binding DBN is not an enforceable document, but rather a statement of wishes the superannuation trustee may consider in determining who will benefit from the death benefit.

4.2 How is tax levied?

The taxation of superannuation death benefits is governed by Division 302 of the ITAA 1997. As noted above, where a fund trustee pays a lump sum death benefit payment to an LPR, the responsibility to assess and remit any associated income tax, will rest with the LPR.

Where an LPR receives a superannuation death benefit, it will be taxed in the estate as though it were income to which no beneficiary is presently entitled.[40]

The extent of the LPR's taxation obligation is determined by both the components of the deceased's superannuation account, and the relationship of the ultimate beneficiary to the deceased (that is, as a tax dependant or non- dependant of the deceased).

Where lump sum payments are to flow to either a testamentary trust or a superannuation proceeds trust, it is necessary for the LPR to look through these entities to determine whether the benefiting beneficiary is a dependant of the deceased.

This table summarises the tax treatment of lump sum death benefit payments. If the amount is to benefit a dependant the receipt will be tax free in hands of the LPR, whereas an amount that will benefit a non-dependant will be taxed as noted below.

Component	Dependant	Non-dependant
Taxable (taxed)	Tax free	Lower of MTR or 15%
Taxable (Untaxed)	Tax free	Lower or MTR or 30%
Tax free	Tax free	Tax free

The tax residency of either the LPR or beneficiary does not alter these tax rates.

As the LPR will have declared and paid any tax on the death benefit, the beneficiary will not subsequently be required to report this income in their personal income tax return. Similarly, where lump sum payments flow to either a testamentary trust or a superannuation proceeds trust, these trusts are not required to report the receipt of the death benefit income in their tax returns.

So who is a dependant?

[40] Section 101A ITAA 1936

Determining whether an individual is a dependant for taxation purposes is a complex process, as is clearly demonstrated by a review of the significant number of PBRs on the ATO legal database on this matter.

The following table summarises who is a dependant for taxation purposes.

Relationship to the deceased	Tax Dependant?
Spouse (including de facto and same sex)	Yes
Former Spouse	Yes
Child under 18 (including ex-nuptial adopted & Stepchild	Yes
Child over 18 (financially independent)	No
Financial Dependent at time of death	Yes
In an interdependent relationship with deceased	Yes

The status as a dependant or non-dependant is determined as at the date of death. For example, a child who was under 18 when the deceased died will be regarded as a dependant notwithstanding that they are older than 18 when the death benefit is paid to the LPR.

It is interesting to note that the definition of dependant for tax law purposes differs from the definition of dependant for superannuation purposes. The superannuation legislation essentially determines who can receive a benefit, whilst the tax legislation determines how that benefit will be taxed.

A 'financial dependant' is not specifically defined in either the superannuation or tax legislation. From a taxation perspective it is necessary to turn to the ATO's interpretative decisions, case law and Administrative Appeal Tribunal decisions. These provide a mixed view of the definition of dependant from that of providing the '*necessities of life'*, to a position of maintaining a *'standard of living*' to which the suggested dependant has been accustomed.

The 'interdependent relationship' definition is however identical for both superannuation and income tax law purposes and could include grandchildren who live with grandparents, and parents caring for a disabled child.

Two people have an interdependency relationship if:

- they have a close personal relationship
- they live together
- one or each of them provides the other with financial support; and
- one or each of them provides the other with domestic support and personal care.

In determining whether two people have a close personal relationship, the ATO considers whether there is evidence of a commitment to a shared life rather than two caring family members who otherwise lead independent lives.

Regulation 302-200.01 sets out the following matters which must be taken into account in determining whether two persons have an interdependency relationship:

(a) all of the circumstances of the relationship between the persons, including (where relevant):

  - (i) the duration of the relationship
  - (ii) whether or not a sexual relationship exists
  - (iii) the ownership, use and acquisition of property
  - (iv) the degree of mutual commitment to a shared life
  - (v) the care and support of children
  - (vi) the reputation and public aspects of the relationship
  - (vii) the degree of emotional support
  - (viii) the extent to which the relationship is one of mere convenience
  - (ix) any evidence suggesting that the parties intend the relationship to be permanent; and

- (b) the existence of a statutory declaration signed by 1 of the persons to the effect that the person is, or (in the case of a statutory declaration made after the end of the relationship) was, in an interdependency relationship with the other person.

Where a close personal relationship exists, but is otherwise not satisfied due to a physical, intellectual or psychiatric disability, an interdependency relationship can still exist[41].

Given the personal exposure of LPRs to unpaid estate income tax after the distribution of the estate assets[42], an LPR might obtain a PBR to confirm the Commissioners view on the status of a beneficiary prior to finalisation of the estate.

4.3 Timing of superannuation death benefit payments to estate

The ITAA does not specify a time when the test about dependants benefiting or expecting to benefit, must be satisfied. However, given the reference in paragraph 302-10(2)(b) of the ITAA 1997 to present entitlement and the link to subsection 101A(3) of the ITAA 1936, implicitly the test must be satisfied at the latest by 30 June in the year in which the superannuation proceeds are paid to the trustee of the estate. Informal discussions with the ATO confirm this view.

Accordingly, the timing of the payment of death benefits to the trustee of an estate could be crucial where there is some prospect of a family provision claim being made. Such a claim can be made by a person for whom the deceased had a responsibility to provide. A person wishing to make a claim for provision must do so within strict time limits that vary from State to State. In Victoria, this is generally within six months from the date probate was granted; in Queensland it is generally within nine months from death.

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[41] Section 302-200(2) ITAA 1997

[42] Refer to https://bnrpartners.com.au/wp-content/uploads/2021/05/The-tax-obligations-of-a-Legal-Personal-Representative_V2.pdf by Mark Morris and Ian Raspin

Example

The deceased (Bradley) died on 1 April 2019. He was survived by 2 adult children and his (second) wife Beverley. By his Will, Bradley left his entire estate to Beverley if she survived him, but otherwise it was to be divided equally between the children.

Superannuation death benefits in the amount of $200,000 were paid to the LPR on 28 June 2019.

As at 30 June 2019, no amount had actually been paid to Beverley but it can be argued that as at that date she would be expected to benefit from all of them (as having survived Bradley, she was the sole beneficiary of his estate).

However, the answer may be different if the benefit was paid to the estate in the 2020 income year by which time a claim has been made for family provision. If that claim is not settled before the end of the income year, it is difficult to predict who may benefit from the payment. In these circumstances, it might be safest to assume that the payment will benefit a non-dependant (or seek a ruling from the ATO).

We have seen cases where a Deed has been entered into to settle a family provision claim in a year after the payment of a death benefit which purportedly makes a dependant entitled to the death benefit. This does not seem to be effective for tax purposes.

Another issue that arises in applying section 302-10 is determining if a person benefits from a death benefit as opposed to some other amount. A similar issue arises in a different context when applying section 99B of the ITAA 1936 (which exempts certain distributions of trust corpus). The latter provision was considered by the AAT in *Campbell v Commissioner of Taxation* [2019] AATA 2043. The Tribunal found that the trust records were unreliable as evidence and consequently the Taxpayer could not show that the relevant distributions fell within the corpus exception.

Example

Using the previous facts, assume that Bradley's daughter Bambi made a claim for family provision on 31 July 2019.

Assume also that the death benefit was paid to the LPR on 1 August and that the LPR was holding $200,000 from the sale of shares that Bradley had owned.

On 1 December 2019 all relevant parties entered into a Deed, by which it was agreed that Bambi would receive $150,000. The LPR paid Bambi that amount on 10 December 2019.

The test time for section 302-10 purposes is 30 June 2020. It is important that the LPR be able to identify which money is used to satisfy Bambi's entitlement. If the LPR cannot show that Bambi's payment consists solely of the sale proceeds, then some part of the payment made to her may be regarded as a payment of the death benefit. As Bambi is not a death benefits dependant, the LPR may well be subject to tax (depending on the components of the payment). If it can be shown that all of the death benefit was paid to Beverley no tax would be payable (regardless of the components) as Beverley is a death benefit dependant.

For example, the LPR might consider keeping the death benefit payment in a separate bank account. Alternatively, if Bambi had been paid her entitlement before the death benefit was received by the trustee of the estate, it clearly could not have been a payment of that benefit.

4.4 *In Specie* transfer of assets

Under the SIS Regulations, death is considered a cashing event for a fund – that is, the deceased member's benefits must be cashed as a soon as practicable after their death.[43] The regulations however contain no requirement that the payment needs to take the form of cash. This can be very advantageous for SMSF's which hold real property, such as primary production land.

There are however various matters that trustees and their advisors should consider in advance of implementing an *in-specie* transfer.

4.4.1 Limitations of SIS Regulations

The regulations require that the in respect of each person to whom a benefit is cashed that it be paid in either a single lump sum payment, or alternatively in the form of an interim lump sum payment and a final lump sum not exceeding the balance of the members account upon death.[44] This means essentially that payments of lump sum death benefits are limited to two lump sum payments per recipient. This has been confirmed in informal discussions with the ATO.

This is problematic. Fund trustees following a member's direction to transfer particular assets or investments to a beneficiary (or their LPR) may be in breach of regulation 6.21(2)(a) of the SIS Regulations[45] (on the basis that each asset transfer amounts to a separate lump sum payment). On another view, it might be considered that a BDBN requiring that more than two assets be transferred to a person is invalid. This would mean that the transfer of those assets would have to be undertaken in accordance with the trust deed

Whilst the writers are aware of examples of trustees of both SMSFs and small APRA funds undertaking multiple transfers in such situations, they do so at the risk receiving a qualified audit report for a breach of the superannuation regulations or making themselves potentially liable to a claim by those entitled under the deed in the absence of a valid BDBN.

A workaround that has been deployed in these situations, is for a death benefit pension to be commenced before the assets are transferred. However, such a strategy is clearly limited to beneficiaries that are able to commence a pension as a result of the death of the deceased and by transfer balance caps.

It is in the writer's view that consideration should be given to allowing multiple lump sum payments where asset transfers are involved. [If the limitation on the number of lump sum payments is linked to the as soon as practicable test, it may be prudent to legislate a time limit in that regard and abandon the number of transfers' test.]

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[43] Reg 6.21 SIS Regulations 1984

[44] Reg 6.21(2)(a) SIS Regulations 1984

[45] Section 58 SIS Act 1993

4.4.2 Limitations of trust deed

As much as it sounds like a scratched record, it is essential to always read the trust deed. When considering an *in-specie* transfer, always review the deed to ensure it provides a power to distribute 'in specie' and is able to pay the benefits to the proposed recipient. It may likewise be necessary to consider the powers of amendment, to enable the deed to be amended to facilitate such a transfer

States duties

As with any asset transfers, it is always prudent to assess and quantify any state or territory duties that could be payable upon an *in-specie* transfer. Mr Michael Butler presented an excellent paper at the Tax Institutes 2021 Death and Taxes Conference[46] on this very topic.

A discussion on these duties is outside the scopes of this paper, however the writer does note that in his paper, Mr Butler states that exemptions could exist on *in specie* transfers from self-managed superannuation funds to beneficiaries in Victoria, Western Australia, and South Australia only. In Victoria, it is the writer's understanding that the provisions are strictly interpreted and that an assessing officer may require that the deceased member was a member when the assets was initially acquired by the fund.

For ease of reference, a table from Mr Butler's paper, which summarises the likely duty in each state and territory is included below.

As exemptions, rates and surcharges vary in each jurisdiction, it is highly recommended that local specialist advice be obtained.

[46] '*Death and Navigating State and Territory Taxes, (a/k/a Getting Assets Out of SMSF's and Trusts)*', by Mr Michael Butler of Finlaysons Lawyers, The Tax Institute 2021 Death and Taxes Conference.

Table: summary of state taxes

	Max Rate	Dutiable or exempt?	Comments
ACT	5%	Likely dutiable	Possibly rely on family farm exemption (if relevant)
NSW	5.5%	Likely dutiable	Transfers to SMSFs exempt (§62A, $500 duty) But no express exemption for transfers to SMSF b/fees except if primary production land (§274) applies
NT	5.95%	Likely dutiable	Unless can come within Sch 2, item 6(c) (conveyance by t/ee to individual b/fee who becomes absolutely entitled)
QLD	5.75%	Likely dutiable	Possibly rely on family farm exemption (if relevant)
SA	5.5% [not commercial land]	Potentially exempt	RevenueSA accept that §71(5)(e) can apply
TAS	4.5%	Likely dutiable	Transfers to SMSFs exempt (§49) but no express exemption for transfers to b/fees of SMSF, unless can rely on family farm exemption (if relevant)
VIC	6.5%	Potentially exempt	Transfers by super funds to beneficiaries exempt (§41A)
WA	5.15%	Potentially exempt	Transfers to super fund w/out consideration exempt (§122) Transfers from super funds to members, dependent or relative exempt (§127)

Three potential levels of tax

Parties need to be aware that there may be up to three levels of income tax or duty when undertaking *in specie* transfers.

Fund Level

Where a fund is either partly, or fully in accumulation mode, the *in specie* transfer of an asset from the fund will trigger a CGT event within the fund. It is essential that the trustees provide for any tax liability.

Where a fund is fully or partly in pension mode, then from the 1 July 2012, a pension's pre-existing tax exemption will continue post death until it is practicable to distribute the deceased's benefits in the

fund[47]. Prior to this date, pensions were deemed to have ceased on death and any subsequent income or capital gains deemed taxable.

Estate Level

The estate may be subject to different levels of taxation on an *in-specie* transfer:

- Tax may be payable by the LPR upon receipt of the lump sum death benefit payment[48], if the ultimate beneficiaries are not considered to be dependents of the deceased.

- The rollover relief of Division 128[49] provided for deceased estates will not apply to any incremental growth that occurs whilst the assets are held by the LPR prior to distribution to the beneficiaries.

- State based duties or surcharges may be payable upon transfer of real property from the fund.

Beneficiary Level

Beneficiaries may be subject to state or territory duties or surcharges upon the transfer of the asset from the estate to them.

Case study

The deceased and his wife established and operated an abattoir business for many years in rural South Australia. They both retired and their self-managed superannuation fund continued to hold the business freehold, which their sons continued to lease from the fund as they continued to operate the family business. This rent essentially had been funding their parents' pensions.

The husband had survived his wife and upon his own death a few years later, the fund still in full pension mode now consisted of the business freehold and a relatively small bank account.

The deceased had left a valid BDBN in favour to this estate and the terms of his will established a discretionary testamentary trust to which it was intended the real property would be transferred, for the benefit of the sons and their families.

The sons, as LPR and trustees, proceeded to pay a lump sum death benefit payment by way of an in-specie transfer of the freehold from the fund to the estate. As the fund was fully in pension mode, the transfer of the land from the fund did not in itself trigger a taxable CGT event for the fund.

However, the LPRs had not recognised that as non-dependants, the estate would need to fund the lump sum death benefits tax of circa $100k. The estate had very little liquidity remaining as a result of payment of various bequests and a much earlier interim distribution having been made to the sons.

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[47] Reg. 995-1.01 of the *Income Tax Assessment Regulations 1997*
[48] Section 101A ITAA 1936
[49] Division 128 ITAA 1997

The estate accordingly sold a 25% interest in the real property to an investment company owned by the brothers and the remaining 75% of the property was transferred to the testamentary trust as intended albeit it as tenants in common.

Stamp duty was payable on the transfer from the estate.

This outcome could have been worse still had the fund not been in full pension mode, as the transaction would been subject to tax at the above two levels. Namely, once within the fund for the tax payable on the disposal as a result of the in-specie transfer of the real property to the estate, and secondly within the estate on the lump sum death benefit payment to non-dependents of the deceased.

Options would have had to be explored had this been an issue. A couple of possible solutions that come to mind may be to that the fund could explore directly selling a fractional interest within the real property, or that if they had the liquidity or super balances that the sons could have become members of the fund by making either member contributions or undertaking rollovers into the fund.

This example settled well for all parties, but it does highlight the need for holistic estate planning and that LPRs need to understand all their tax obligations prior to making interim distributions.

4.5 Other Observations

The following observations are provided to draw high level awareness to what I perceive are interesting and relevant related matters to be aware of.

- If the deceased was a member of an SMSF, the LPR cannot avail themselves of PCG 2018/4, which provides LPRs with greater certainty as to their liability for the deceased pre-death affairs, by reducing the period of audit exposure to a period of six months for small and less complex estates.[50]

- If an income stream is commuted within six months from the date of death or three months from the grant of probate, the commutation will continue to be treated as a death benefit payment. Any payment after this period will be treated as a normal superannuation proceeds lump sum payment and taxed accordingly. A similar exemption applies if there has been a delay in making payment as a direct result of legal action or difficulties in contacting or identifying beneficiaries.

- Death is a ‘compulsory cashing event[51] and benefits must be paid to either the deceased’s dependants or their LPR[52]. Accordingly, it is not possible to roll proceeds directly into a beneficiary’s personal superannuation account[53], in order to retain the funds within a superannuation environment.

[50] If the deceased was a member of a SMSF, the estate is specially excluded from the scopes of this PCG.

[51] Reg. 6.21 SIS Act 1994

[52] Reg. 6.22 SIS Act 1994

[53] ATO ID 2105/53

- Apportionment rules apply to superannuation lump sums or income streams from 1 July 2007[54], which essentially prohibit an LPR from streaming the tax-free components to a non-dependant and the taxable components to a dependant, but rather requires that the payments are proportionally allocated. It is interesting to note that the ATO does not appear to have indicated how they would treat such an arrangement if it was directed by the testator within the terms of their will.

- In the case of an SMSF and subject to the terms of the deed, an LPR can appoint themselves as a successor trustee of the deceased[55], albeit, is not required to. It is of note however that the Act provides for a six month effective grace period where the fund will not become non-compliant as a result of the trustee / member rules not being satisfied. As such, arguably, if a member's balance was paid out within this six month period by other existing trustees, it may not be necessary for the LPR to become a trustee for SIS purposes.

- With the introduction of transfer balance caps on the 1 July 2017, it is important to note that where a surviving spouse intends to commence an income stream from a deceased member's account, the value of such an income stream is credited to the dependant's transfer balance account. Where the income stream in combination with the surviving individual's own superannuation income stream exceeds their transfer balance cap, that beneficiary will need to decide which of these superannuation income streams needs to be partly or fully commuted so as to satisfy the prevailing general transfer balance cap.

[54] Division 307 of the ITAA 1997

[55] Subsection 17A(3)(a) of the SIS Act 1993

5 Special Disability Trusts

Special disability trusts (SDT) are intended to assist families make financial provision for the care and accommodation needs of a family member with a severe disability. They can be created *inter-vivos* or by Will.

These trusts are described as 'special' because of the social security and tax concessions that apply to them, not the nature of the disability affecting the principal beneficiary of the trust.

The Taxation Statistics for 2018-19 show that SDTs are a very small component of the total trust population lodging tax returns (908 of a population of almost 908,000 or 0.1%).[56] One reason for this may be the perceived difficulty in complying with the many conditions that apply to SDTs or perhaps there is a limited understanding of the tax and other advantages that they confer.

Our firm is seeing an increase in enquiries about special disability trusts, although generally in the context of how a poorly drafted Will might have been written to achieve the deceased's desire to make provision for a person with a severe disability.

First, let's run through the requirements for creating a valid SDT. Then we will consider the tax benefits.

5.1 What is a Special Disability Trust?

A trust qualifies as an SDT if it satisfies the definition in the *Social Security Act 1991* or the *Veterans Entitlements Act 1986.* This paper focuses on the social security definition in section 1209L.

A trust is a special disability trust if all of the following requirements are met:

- the beneficiary requirements (section 1209M)
- the trust purpose requirements (section 1209N)
- the trust deed requirements (section 1209P)
- the trustee requirements (section 1209Q)
- the trust property requirements (section 1209R)
- the trust expenditure requirements, if any (section 1209RA)
- the reporting requirements (section 1209S)
- the audit requirements (section 1209T).

[56] https://data.gov.au/data/dataset/taxation-statistics-2018-19/resource/879629ca-af02-45da-9685-df24ace4e89c?inner_span=True.

5.1.1 The beneficiary requirements

Apart from any residuary beneficiary, an SDT must have only one beneficiary (the principal beneficiary).

The principal beneficiary must have a severe disability. If the beneficiary is over 16[57] this means that the beneficiary:

- has a level of impairment that would qualify them for Disability Support Pension or who is already receiving a Department of Veterans' Affairs Invalidity Service Pension or Department of Veterans' Affairs Invalidity Income Support Supplement, and
- has a disability that would, if they had a sole carer, qualify the carer for Carer Payment or Carer Allowance, or who is living in an institution, hostel or group home in which care is provided for people with disabilities and for which funding is provided under an agreement between the Commonwealth, states and territories, and
- has a disability which meant they have no likelihood of working for more than seven hours per week at or above the relevant minimum wage.

A trust can't be a special disability trust if at time it is created, an SDT already exists for the principal beneficiary.

A trust can only be a SDT while the principal beneficiary is alive.

5.1.2 Trust purpose requirements[58]

The primary purpose of an SDT during the lifetime of the principal beneficiary, must be to meet the reasonable care and accommodation needs of that beneficiary.

An SDT may have other purposes that are ancillary to the primary purpose and necessary or desirable to facilitate the achievement of that purpose or which are primarily for the benefit of the principal beneficiary.

What is reasonable is determined by having regard to all of the circumstances and, in particular, the principal beneficiary's care and accommodation needs that are necessary because of their disability and the trust's total assets.

A care need may be reasonable if:

- the need arises as a result of the disability of the principal beneficiary, and
- the need is for:

[57] There are similar rules for children under 16.

[58] This information is contained in section 4.14.3.30 of the Social Security Guide, https://guides.dss.gov.au/guide-social-security-law/4/14/3/30

    - medical-related and dental costs of the principal beneficiary, including but not limited to health insurance and ambulance cover, medicines, surgery, specialist and general practitioner services, or
    - the daily care fee and any additional itemised fees charged by an approved provider in relation to the principal beneficiary's care and accommodation in a residential care service or in certain supported care accommodation, and

- the need is met in Australia.

Examples of reasonable care needs include:

- professional care and case management required for, or because of, the principal beneficiary's disability,
- therapy (including alternative therapy) that is approved, in writing, by a medical practitioner as required for, or because of, the principal beneficiary's disability,
- specialised food specified by a medical practitioner as essential for the principal beneficiary's health,
- mobility aids, prostheses and positioning aids required for, or because of, the principal beneficiary's disability,
- sleeping and sensory aids required for, or because of, the principal beneficiary's disability,
- personal care aids required for, or because of, the principal beneficiary's disability,
- transport required for, or because of, the principal beneficiary's disability,
- training for transitional or independent living skills of the beneficiary.

An accommodation need may be reasonable if:

- it arises as a result of the disability of the principal beneficiary, or
- the need is to pay for property (whether purchased in part or full, or rented) for the accommodation needs of the beneficiary AND the property is acquired or rented from a person who is not an immediate family member of the principal beneficiary. Property not used for the accommodation needs of the principal beneficiary can be rented at market value provided the income is used for the benefit of the principal beneficiary, or
- the need to pay rates and taxes or maintenance /upkeep on a property is a reasonable accommodation need if the property:
    - is owned by a special disability trust, and
    - is used for the accommodation of the principal beneficiary of the special disability trust, or

- is rented at market value and the income from the rent is used for the benefit of the beneficiary.

Examples of reasonable accommodation needs include, but are not limited to:

- modification to the principal beneficiary's place of residence arising from his or her disability,
- payment for the purchase of the principal beneficiary's place of residence if the payment is not made to an immediate family member of the principal beneficiary,
- payment of rental for the principal beneficiary's place of residence if the payment is not made to an immediate family member of the principal beneficiary,
- payment of accommodation bond for the principal beneficiary if the payment is not made to an immediate family member of the principal beneficiary,
- any itemised fees which specifically relate to the accommodation of the principal beneficiary residing in a residential care service.

An SDT can undertake a level of discretionary spending for the benefit of the principal beneficiary that is not directly related to their care and accommodation needs. This provides SDTs with some flexibility to meet costs relating to the beneficiary's health, wellbeing, recreation, independence and social inclusion.

The discretionary spending limit was initially set at $10,000 on 1 January 2011. It is indexed each year for inflation. For the 2020-21 year the limit was $12,500.

The following are examples expenditure that is regarded as discretionary (these items are not considered to be reasonable care needs):

- food
- household items for the beneficiary
- toiletries such as toothpaste, toilet paper, soap, shampoo, sanitary pads and tampons
- vehicle registration, insurance and petrol
- recreation and leisure activities
- life skills and social inclusion workshops
- therapy that is not required for, or because of, the principal beneficiary's disability or that is not approved in writing by a medical practitioner
- capital improvements to the principal beneficiary's place of residence not arising from his or her disability
- building and content insurance, utilities charges and cleaning charges
- clothing and footwear that is not required for, or because of, the principlal beneficiary's disability.

5.1.3 Trust deed requirements

The trust deed for an SDT must contain certain compulsory clauses from the Model Trust Deed prepared by DSS. These clauses are set out in *Social Security (Special Disability Trust — Trust Deed, Reporting and Audit Requirements) (FaHCSIA) Determination 2013* and are listed below. Other provisions can be added to an SDT Deed provided they are not inconsistent with the compulsory clauses or have the effect of overriding them.

Item	Matter	Clause of model trust deed
1	Date on which trust is made	P.1
2	Parties to the trust	P.2
3	Description of the Principal Beneficiary	1.1
4	Declaration of trust	1.2
5	Name of trust	1.3
6	Application of operative provisions	1.4
7	Duration of trust	1.5
8	Exclusion of settlors	1.7
9	Primary and other purposes of the trust	2.1
10	Priority of Principal Beneficiary	2.2
11	Power to accumulate income	2.4
12	Contributions	3.1
13	Non-acceptable contributions	3.2
14	Restrictions on use of trust funds	3.3
15	Prohibition on borrowing	3.4
16	Further prohibitions with regard to related parties	3.5
17	Prohibition on lending to Principal Beneficiary	3.6
18	Donor register	3.7
19	Qualifications of the trustee	5.1
20	Extent of trustee responsibility	5.5
21	Powers of trustee	6.1
22	Standard of care	6.2
23	Investment strategy	6.3
24	Requirement to keep accounts	8.1
25	Financial statements and reporting	8.2
26	Audit requirements	8.3
27	Amending the trust	9.2
28	Definitions	9.3
29	Interpretation	9.4
30	Applicable law	9.5
31	Execution	E.1

5.1.4 Trustee requirements

A trustee who is an individual must be an Australian resident and not have been convicted of an offence involving dishonest conduct or under the Social Security or Veterans Entitlements Acts and must not have been disqualified from managing a company.

Similarly, if there is a corporate trustee, each director must satisfy these requirements.

5.1.5 Trust property requirements

The principal beneficiary or their partner can only contribute assets to an SDT if

- the assets are a bequest or a superannuation death benefit, and
- the assets are transferred to the trust within three years of their receipt.

Other amounts, such as compensation payments cannot be contributed to the SDT.

There are also rules that prevent payments being made to an immediate family member or child of a beneficiary for:

- care, or
- services related to the beneficiary's accommodation, or
- the purchase of lease of a property.

5.1.6 Reporting requirements

By 31 March each year, the trustees must provide to Social Security a copy of the trust's written financial statements for the previous financial year ending on 30 June[59].

The financial statements must be prepared by a qualified accountant who is not a relative of the trustee or a trust beneficiary. They must include a statement to the effect that, all amounts paid out of the trust (other than reasonable administration expenses and taxation) were paid to meet the reasonable care and accommodation needs of the principal beneficiary; a purpose ancillary to that or for purposes primarily for the benefit of the principal beneficiary

The Act[60] provides for the Secretary of the department administering the Act to make a determination for the reporting requirements of special disability trusts. Clause 3.2(b) makes it a requirement to comply with the relevant accounting standards. With the introduction of AASB 2020-2, there is no carve out for SDT, which by default suggests they should be GPFS for the 2021 financial years onwards

A research report undertaken by the AASB[61] into the then proposed SDT legislative and regulatory financial reporting requirements, indicated the Board's thinking was that SDTs would not be captured

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[59] section 1209S of the *Social Security Act 1991* and section 3.2 of the *Social Security (Special Disability Trust – Trust Deed, Reporting and Audit Requirements (FaHCSIA) Determination 2013* (Determination). S3.2(2)(b) of the Determination requires that the financial statements "comply with the relevant Australian Accounting Standards". S3.2(1) of the Determination defines the financial statements as "a profit and loss statement", "a balance sheet with applicable notes" and "if necessary, a depreciation schedule for each class of trust asset

[60] Section 1209S of the *Social Security Act 1991 (Cth)*

[61] AASB Research Report 10 – Legislative and Regulatory Financial reporting requirements, March 2019, page 36 https://www.aasb.gov.au/admin/file/content102/c3/AASB_RR10_03-19Legislation.pdf

by the proposed changes and that it would consider SDTs for this purpose to be classified as not for profit entities.

The professional bodies are currently seeking clarification about this matter from the Board of Tax and the Department of Social Security. It is the writer's view, that any requirement for GPRS reporting would be onerous, costly and unnecessary given the limited range of users of the reports and the comparatively small balance of funds held within these trusts held for the specific beneficiary.

In addition, the trustees must provide a statutory declaration to the effect that all relevant information is true and correct.

5.1.7 Audit requirements

The trustees of an SDT must request cause an audit to be carried out, within a reasonable time after receiving a request from a principal beneficiary, an immediate family member, guardian or financial administrator of the principal beneficiary or DSS. Again there are rules about who is qualified to carry out the audit.

5.2 Benefits of SDT

5.2.1 Social security benefits

A lot of material published about SDTs focuses on the associated social security concessions, including issues that arise following the death of the principal beneficiary.

For example, assets held in an SDT up to the concessional asset value limit ($700,250 as at 1 July 2021) are exempt from the assets test for the principal beneficiary. And no income from an SDT is taken into account under the principal beneficiary's income test (regardless of the total value of the SDT's assets).

There is also a gifting concession for immediate family members of the principal beneficiary who are receiving a relevant pension. They can gift up to a combined amount of $500,000 (unindexed) into an SDT without the money being assessed under normal gifting rules.

5.2.2 Tax benefits

While the value of the social security benefits will depend on the net worth of the principal beneficiary and the family members contributing to the SDT, the tax benefits are not so limited.

Perhaps the most important benefit is the exemption that applies when an asset becomes an asset of an SDT. Section 118-85 of the ITAA provides that any capital gain or loss from a CGT event that happens when an asset is transferred for no consideration to a SDT or a trust that becomes a SDT as soon as practical after the transfer is disregarded.

Further, the trustee acquires the asset for market value, including if it passes to the trustee as the result of the death of the owner of an asset.

Example

Janet has 2 children, Glenn and Frank. Glenn suffers from a severe disability. She is concerned to ensure that he is well taken care of when she dies. Glenn's condition is such that he must live in a residential care facility.

Janet's Will effectively divides her estate equally between the two children. Glenn's share is to be held on the terms of two trusts, one a special disability trust (of which Glenn is the principal beneficiary and Frank is nominated as the residuary beneficiary) and the other a discretionary trust. The SDT will hold

80% of Glenn's share. The funds in the discretionary trust are intended to be used to for expenses that are not allowable in an SDT – such as food and entertainment

When Janet dies her estate consists of:

- *her main residence (valued at $2.5 million)*
- *a holiday home in rural NSW that she acquired pre-CGT (valued at $1 million)*
- *an extensive share portfolio (the total of the cost bases of her shares is $750,000 and their market value is $3 million)*
- *cash ($1million)*

The executor of her estate seeks advice about the tax consequences of selling or appropriating the assets between the beneficiaries. Each child's share of the estate is $3.75 million.

The executor will acquire the main residence and holiday home for their market values. The cost base of the shares will depend on whether they are appropriated to:

- *Frank or Glenn's discretionary trust – they will be acquired for the deceased's cost base; or*
- *the SDT – market value.*

There is a potential future tax saving to the extent that the assets with an inherent capital gain can be appropriated to the SDT. For example, the total gains inherent in the shares after CGT discount is approximately $1.125 million. Tax on that amount could be saved; @ 47% that would be $528,750.

The other potential tax benefits that can apply to an SDT are:

- The trustee is assessed under section 98 of the ITAA 1936 on all of the trust's net income. This is achieved by the assumption in section 95AB of the ITAA 1936 that the beneficiary is presently entitled to all of the income whether or not there is income. This means that the all of the net income is assessed at individual marginal rates.
- This is perhaps only a benefit if the SDT was created inter-vivos and the trustee would otherwise be assessed under section 99A at the top marginal tax rate. If the SDT is created under a Will, the trustee would be assessed on the net income not otherwise assessed under section 98. If the trustee is assessed under section 99, marginal rates apply (although withour the benefit of the tax-free threshold.
- Finally, the trustee of an SDT may qualify for a main residence exemption for a capital gain from a dwelling occupied by the principal beneficiary. Again, a similar result can be achieved under a testamentary trust if the beneficiary is provided with a right to occupy a dwelling. The benefit here is again mostly for a trust created inter-vivos.

6 Conclusion

Whilst each of the four topics covered in this paper could be a paper and presentation of its own, the brief for this particular paper was to provide a high-level awareness of four issues that can arise in implementing a succession plan following the death of an individual.

Estate taxation has nuances that are not regularly encountered by many practitioners and which can leave executors and their advisors personally exposed. In full disclosure, even as a practice that has specialised in estates for over 20 years, we encounter almost on a weekly basis, issues that result in often unexpected, undoubtedly legislatively unintended, and certainty unplanned costly taxation and administrative outcomes.

As this paper has demonstrated, even the most comprehensive and best laid estate plan can quickly become undone by legislative change, interpretative changes and changes to personal circumstances examples of this are the changes to the FIRB rules, the more recent changes to section 102AG and the ATO’s views in relation to the calculation of the net income of a foreign trust.

In closing, it is interesting to note that our famous Scottish poet and lyricist Robert Burns was a revisionist. Although he is often attributed one of the most recognisable poems and songs ever written ‘*Auld Lang Syne*’, it is almost certain that it was based on an older song and modified somewhat by Burns.

Should auld acquaintance be forgot,

And never brought to mind?

Should auld acquaintance be forgot,

And auld lang syne!

Chorus. For auld lang syne, my dear,

For auld lang syne.

We’ll tak a cup o’ kindness yet,

For auld lang syne.