THE TAX INSTITUTE

# March Roundtable

## Some problems I’ve had with excepted trust income

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# 1 Overview

## 1.1 Origins

The government was concerned to prevent possible splitting of the income earned by the property of a trust, in favour of children. Splitting could potentially gain for each child the benefit of a normal tax-free threshold.

Major reform, to prevent splitting income, occurred in 1980. This was by Act No. 19 of 1980, introduced into parliament as *Income Tax Assessment Amendment Bill (No. 6) 1979*, by the then Treasurer, Mr John Howard. There was an associated Bill to amend rates, the *Income Tax (Rates) Amendment Bill (No. 2) 1979*.

That law has had subsequent revisions and fine tuning.

Further fine-tuning was announced in the 2018 Budget.

Despite the 1980 changes, it was nevertheless felt that some types of income earned by a minor should continue to be treated more concessionally.

To grant those necessary concessions would open up the possibility of tax avoidance. It is plain from the 1979 explanatory memorandum to the Bills, that the possibility of exploitation of exceptions to the new rules was keenly felt.

Hence we see quite difficult legislation drawn to forestall such arrangements.[1]

## 1.2 Outline of Presentation

I cover the following:

- outline of legislation;
- practical issues in getting binding ATO advice;
- technical problems based on a live example.

[1] See particularly the 1994 amendments in the *Taxation Laws Amendment Bill (No. 4) 1994*. This was the subject of heated debate in the Butterworths Weekly Tax Bulletin, Part 1 of 1995, paragraphs 2 & 3. The respective articles are by TM and DR Dwyer, "Penalty taxes on children: an ATO contribution to the International Year of the Family" and by CL Hood, "Taxation Laws Amendment Act (No. 4) 1994: Children's Income".

# 2 Ways in which Legislation can Assist

## 2.1 Current Rules

These provisions are in Division 6AA of Part III of the *Income Tax Assessment Act 1936*.

I principally come across them in the context of deceased estates. I will therefore focus on that.

However, I do not wish to give the impression that the provisions are restricted to that.

The first thing to note is that there are two classes of "excepted" income:

- Excepted assessable income under section 102AE(2); and
- Excepted trust income under section 102AG.

Section 102AE looks at income derived by the minor through investments in the minor's own name. It also treats as excepted assessable income the employment income or business income of the minor, income from the minor being in a partnership, and certain other amounts.

The cases with which I have dealt have involved children of tender years, often in tragic circumstances. The children are incapable of conducting investments in their own names.

Absent interventions such as appointment as a guardian under respective State legislation, what people have tended to do is look to section 102AG, concerning excepted trust income.

Excepted trust income falls into several classes:

- Assessable income of a testamentary trust (including where modified by court order).
- Assessable income of a trust estate resulting from an intestacy (including as modified by court order).
- Curiously - employment income.
- Trust income from investment of property transferred to the trustee for the benefit of the beneficiary in several circumstances, including some which are most relevant here. The circumstances include:
  - Damages claims including for personal injury and loss of parental support.
  - Workers' compensation.
  - Criminal injuries compensation.
  - Life insurance.
  - Death benefits from certain funds including superannuation.
  - Compensation by an employer of a deceased person.

- Money paid from a public fund established and maintained exclusively for the relief of persons in necessitous circumstances.
- As a result of family breakdown.

Finally, and only for completeness, I mention that you can have excepted trust income in relation to genuine lottery winnings by child. And there is, both under section 102AE and section 102AG provision for some limited ability to accumulate income, and thus generate excepted income on accumulations.

Where there is superannuation or life insurance, or compensation for death of a parent from whatever source as listed above, I do see considerable scope for setting up a trust to assist children of tender years.

But for simplicity I will stay with proceeds of deceased estates, simpliciter.

This is represented by the first couple of classes of excepted trust income outlined above, but further by section 102AG(2)(d).

That refers to two classes of income derived by the trustee of a trust estate from the investment of property. In subparagraph (i), it is about property which has devolved for the benefit of the beneficiary from the estate of a deceased person. What is probably contemplated is something which may be as simple as a direction that the executor stands as trustees of the estate, and that they continue to administer the estate at least during the minority of a beneficiary who is left property.

A second limb of section 102AG(2)(d) is subparagraph (ii), which refers to "an amount included in the assessable income of a trust estate … [being] excepted trust income in relation to a beneficiary of the trust estate to the extent to which the amount … is derived by the trustee of the trust estate from the investment of any property … 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 three years after the date of the death of the deceased person".

That is a very difficult provision, but one which is still alive in Queensland (though it has effectively been stripped of meaning in some other States for reasons I will come to.

Unfortunately, there is no simple way of discussing excepted trust income except by reference to the provisions themselves, which I reproduce as an attachment.

I have also included, for completeness, section 102AGA, concerning transfer of property as the result of a family breakdown. I am sure this occurs a bit in practice, but I have not seen it in my own practice.

## 2.2 Provisions and Proposed Changes

In the 2018 Budget, there was a proposal to limit access to the concessional tax rates available to minors receiving income from testamentary trusts. As we will see, there are already safeguards. So I am not sure what this was intended to do, and I have seen no progress with a Bill.

As reported in the *Weekly Tax Bulletin* the proposal was:[2]

> ***Source: Budget Paper No 2 [p 44]***
>
> The concessional tax rates available for minors receiving income from testamentary trusts will be limited to income derived from assets that are transferred from deceased estates or the proceeds of the disposal or investment of those assets. Currently, income received by minors from testamentary trusts is taxed at normal adult rates rather than the higher tax rates that generally apply to minors.
>
> The Government is concerned that some taxpayers are able to inappropriately obtain the benefit of this lower tax rate by injecting assets unrelated to the deceased estate into testamentary trusts. This measure will clarify that minors will be taxed at adult marginal tax rates only in relation to income of a testamentary trust that is generated from assets of a deceased estate (or the proceed of the disposal or investment of these assets).
>
> **Date of effect**
>
> This measure applies from 1 July 2019.

Given that this was said to have an effective date of 1 July 2019, perhaps that is the reason for less urgency in terms of producing a draft Bill. However, it is now becoming critical that we see this.

The proposal generated some discussion in the *Weekly Tax Bulletin.*

An article by Burgess & Whippy, “Budget attack on excepted trust income: what’s it likely to mean?” 2018 WTB 21 [618], indicated that there was uncertainty in the marketplace. Most materially, they indicated that:

> Taken at face value, the new rules will simply create an obligation on trustees to track the source of assets in a testamentary trust and ensure the income to be treated as excepted trust income is sourced from assets passing directly to the trust from the will maker.
>
> …
>
> Thus, any further assets gifted or settled on a testamentary trust, other than by the will maker would be segregated from excepted trust income purposes.

## 2.3 Uncertainties created by lack of a Bill for 2018 Budget proposals

In the article by Burgess & Whippy, mentioned above,[3] succinctly set out several possible queries, and I do not think there is any need to go further than to quote those authors:

- Assets that form part of a testamentary trust that are not owned outright by the willmaker (that is, are subject to existing borrowings) – what happens as the level of debt changes?
- Even if assets that initially form part of the testamentary trust are debt free - what are the consequences if further assets are acquired using the initially contributed assets as security?

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[2] Refer 2018 WTB 19 [535].

[3] Burgess & Whippy, “Budget attack on except trust income: what’s it likely to mean?” 2018 WTB 21 [618].

- If an asset class at the date of death of the willmaker is cash at bank – does the tracing of the assets acquired continue indefinitely?
- If assets acquired using borrowings no longer generate access to excepted trust income – is it appropriate that tax laws essentially directly impact the investment decisions of trustees?
- If an asset acquired is itself tax advantaged (one obvious example in that regard being insurance bonds) - how will the proceeds from the investment be treated?
- In relation to shares - how will dividend reinvestment arrangements be treated?
- How will assets that are acquired by the testamentary trust as a consequence of the willmaker's death, however, are not directly from the willmaker, be treated – for example will superannuation death benefit payments and insurance policy payouts to an estate be considered to be legitimate capital from which to source excepted trust income?
- Particularly for those in life spouse relationships, it is common for testamentary trusts to be established under each person's will and for there to be a subsequent merger of the trusts some years later – what will be the approach in relation to wealth that passes to a testamentary trust sourced from another testamentary trust?

Knowing this author's luck, a draft Bill will probably emerge at 4 pm on the day of this presentation.

However, it is worthwhile noting what Burgess & Whippy say about the merits of amendments in this area in their article:

> If there is, in fact, widespread abuse of the existing rules in this area, it must be asked why there is essentially only one reported case in the area that is now over 25 years old[4] and remains unchallenged, and in turn what aspects of the offensive arrangements are not already addressed by s 102AG itself or, in the alternative, Part IVA.

As we will see below, there are already restrictions on feeding a testamentary or estate proceeds trust, and I was, myself, surprised by this budget announcement. It may be that we have seen no Bill because ATO have been queried by Treasury why they are not using existing provisions, as pointed out by Burgess & Whippy in that article.

[4] Refer *The Trustee for the Estate of the late AW Furse No. 5 Will Trust v FCT* (1990) 21 ATR 1123.

# 3 Quelling Uncertainty

There are 2 problems. First the ATO has retreated from giving binding rulings. Secondly, you are dealing with minors.

## 3.1 A fundamental problem in this field

As is demonstrated by this paper, great uncertainty is caused by the current provisions, before you even begin to think about the possible amendments foreshadowed in the 2018 Federal Budget.

By definition, we are dealing with minors here. Trustees always tend to act cautiously, and will be advised to get binding advice.

Although there may be consequences to competent taxpayers as well, such as trustees (or, where possible to inject other beneficiaries into a trust, those beneficiaries), we nevertheless have to deal with the fact that those primarily affected are intended by the legislation to be minors.

The 2 topics intersect, but I first briefly deal with the retreat from binding advice.

## 3.2 Private Rulings

I was counsel for the taxpayers in the trials of each of *Rosgoe* 2015 ATC ¶20-539 and *Hacon* 2017 ATC ¶20-624.[5] There was an appeal by ATO in *Rosgoe*, but it settled. The ATO won its appeal in *Hacon*, but I was no longer in that at that stage.

The result in *Rosgoe* and in the appeal in *Hacon* must lead to some debate about the usefulness of the private binding ruling system in Australia.

As I was counsel for those two taxpayers, at least at trial in both cases, I confine myself to what I said in my paper to the National Conference of the Australian Institute of Administrative Law in 2017.[6]

In the event, what we decided to do in this recent matter was governed as much by our problems with timing as anything else. We were reaching the end of the three year period allowed to create an EPT, and we could not afford to have the Commissioner come back at the last moment and say that he was unwilling to give a ruling in favour of minors where the mother had signed on their behalf.

The strategy adopted was to apply for Early Engagement, suggesting that a private binding ruling might issue in favour of the minors at the instance of the mother as applicant on their behalf; but acknowledging that, given the time pressure facing everyone, ATO processes might only allow for issue of an old-fashioned administrative advice.

[5] I did not appear in the subsequent appeal in *Hacon* reported at 2017 ATC ¶20-639. The taxpayer lost on appeal.

[6] DW Marks, "Proceeding in certainty: Tax Rulings" (2017) 89 AIAL Forum 91-101.

In a recent matter, ATO advised that they could not give binding advice to the widow and children as the EPT had not yet been settled.

## 3.3 Capacity

There is no such thing as "tax law". There is the general law of Australia.

If a person lacks capacity, only specific legislative direction (or necessary implication) would overcome that.

Minority is generally thought to be an incapacity.

More precisely here, the test for capacity under the general law seems relevant.

Taxation laws do apparently require minors, and indeed others who might be thought to be under disability, to sign documents, despite their disabilities.[7]

But it is surprising that the issue does not come up more.

Nevertheless, any application for a private binding ruling (and indeed most other documents that are sent to the Commissioner) are required to be signed with a particular form of attestation prescribed by the *Taxation Administration Act*.[8]

The test for capacity of children is that in the House of Lords decision of *Gillick v West Norfolk & Wisbech Area Health Authority* [1986] AC 112, approved by the High Court of Australia in *Department of Health and Community Services (NT) v JWB & SMB* (1992) 175 CLR 218.

In *Gillick* the question was how the National Health in the UK was to deal with demand for family planning services, both contraceptive advice and treatment, by young people.

Without going into what is obviously a sensitive question, the important point of principle of general application concerned the rights of minors and the ability of minors to make decisions. The House of Lords decided by majority that (to quote the headnote) "a girl under the age of 16 years had the legal capacity to consent to medical examination and treatment, including contraceptive treatment, <u>if she had sufficient maturity and intelligence to understand the nature and implications of the proposed treatment</u>" (underlining added). It was essentially a question of fact.

In the case I had, the children involved were of very tender years indeed. I did consider whether there was any point attempting to explain to the eldest, perhaps eight years of age, what a trust involved. I thought that a pointless exercise. Thus I thought that the three children in that particular case really had to act by their parent (in circumstances where we did not have time to make application for a legal guardian).

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[7] I remember filing a tax return when I was 16, as I had started part-time work as a counter-jumper in a department store. It never occurred to me that I should not sign the tax return. In fact, I was required to felt able to, and did.

[8] Section 388-75 of schedule 1 to the *Taxation Administration Act 1953* (Cth)

I ask you to bear this mind as it is a practical issue in a difficult area of practice, where the Commissioner’s public binding ruling only deals with matrimonial dissolution (as opposed to death), and you sometimes have to move quickly given time limits involved.

# 4 Setting up EPTs

Testamentary trusts are set up in the Will.

Unfortunately, not everyone dies with a Will. Or the Will may make no provision for a testamentary trust.

This is why s 102AG(2)(d)(ii) makes provision for excepted trust income "in relation to a beneficiary of the trust estate to the extent to which the amount … is derived by the trustee of the trust estate from the investment of any property … 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".

This is an estate proceeds trust, or EPT.

## 4.1 State-based limitations

There is an effective limit to the property that can be transferred to such a trust.

The limit is not on the amount of property transferred.

The limit is on the quantum of income that can be regarded as *excepted trust income*.

Section 102AG(7) limits the excepted trust income to the quantum regarded by the Commissioner as "would have been included in the assessable income of the beneficiary of the year of income in respect of an amount or amounts derived by the beneficiary from property that, in the opinion of the Commissioner, would have devolved directly upon that beneficiary <u>if that deceased person had died intestate</u>". (Emphasis added)

In effect, the limit is then calculated by reference to the various State and Territory laws about intestacy.

Queensland and South Australia are among the States where children of a deceased can take on intestacy where there is a surviving spouse.

That is an important limitation. In NSW and Victoria, if there is a surviving spouse, the children may not take.[9] The outcome depends on whether the issue are children of the surviving spouse, and frankly specialist advice should be sought from the jurisdiction concerned.[10]

There are then complications, as each State that would allow children or grandchildren to take may have some rule about the house; and about the household or personal effects; and may have some rule about the surviving spouse taking a fixed amount from residue first, before dividing the balance.

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[9] There was a recent amendment in Victoria: s 70K *Administration and Probate Act 1958 (Vic).* NSW and Tasmania have had this rule longer.

[10] Mackie *Principles of Australian Succession Law* (3ed) from [10.19]

Complications multiply where there are multiple spouses, predeceasing children who leave grandchildren, and so forth. Queensland & WA have special provisions about the estates of intestate indigenous persons.[11]

But the important messages are these:

- There is a time limit of 3 years from death. This is not a long time, given that you are dealing with grief, in a matter requiring cold financial calculation.
- You may not be able to get money into a tax-effective EPT in some States.
- The calculation requires specialist advice from the jurisdiction connected to the deceased. This is probably domicile on death, for movables.[12] But query if it is law of the situation of the land, for immovables.[13]

## 4.2 Need for uniformity in Australia

Given the last 2 dot points, STEP has on its policy agenda in Australia making representations to ensure that the limits on excepted trust income do not depend on the vagaries of the different internal Australian laws that may impact succession.

## 4.3 Date and mode of calculation

3 years are allowed to feed the EPT.

One issue is how to calculate the hypothetical quantum of property that would have come to the child on intestacy.

In a live matter, the estate included a substantial share portfolio, so the question was pointed.

The vital words are: “would have devolved directly upon that beneficiary if that deceased person had died intestate”.

Do you make a calculation at date of death; at date of transfer to the trustee of the EPT, or some other date?

Worked example

To make this live, I will take facts from a couple of cases I have seen, to illustrate the calculation and timing aspects of the transfer of property. It also tends to show how messy this might be if there are doubts about which State’s laws govern.

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[11] Mackie, above, [10.18]
[12] Mortensen *Private International Law in Australia* [19.34]
[13] Mortensen, above, [19.18]

## 4.4 Worked example

### 4.4.1 Analysis

There is no limit on the property transferred, but rather on the income which is “excepted income”.

Assuming the children are “prescribed persons” in terms of section 102AC, this leads us into section 102AG(1).

That subsection applies the provisions of Division 6AA 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”.

The question then is how to measure the concessional figure, for “excepted trust income”.

Section 102AG(2) provides, subject to the remainder of that section, that 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 falls within enumerated heads.

Section 102AG(2)(d)(ii) applies to such an amount which “is derived by the trustee of the trust estate from the investment of any property … 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 three years after the date of the death of the deceased person”.

I leave to one side several difficult interpretational issues, discussed below, and also leave to one side the anti-avoidance provisions in subsections (3) and (5).

We thus come to specific provisions limiting the scope of section 102AG(2)(d)(ii), in subsection (7).

Subsection (7) occupies most of a page of closely typed text.

It is a provision which limits the extent to which a transfer of property to an estate proceeds trust can gain a beneficial result for the child.

It does so by limiting the quantum of the “excepted trust income” to that which would have been derived from a certain quantum of property.

In other words, the Commissioner would not treat income derived by a trustee of an estate proceeds trust as all being “except trust income” where the surviving parent, as sole beneficiary under the Will, transferred the whole of the estate to the estate proceeds trust.

Effectively, the Commissioner is entitled to limit the benefit of this concession to the income that might have been derived from the child’s share of estate property, if there had been no Will.

### 4.4.2 Operative conditions

Subsection (7) is most material and set out in an attachment.

The operative conditions are derivation, by the trustee of the estate proceeds trust, of assessable income from (or including assessable income from) investment of property transferred to the trustee in circumstances contemplated by section 102AG(2)(d)(ii).

Subsection (7) then deals with possible means of avoidance (e.g. direct gifts to the beneficiary, or gifts to the beneficiary via other trusts).

The resuming words, after paragraph (iii), ask whether the sum of the assessable income derived by the trustee of the estate proceeds trust for the benefit of that beneficiary, and of other amounts derived by that beneficiary in other ways associated with the deceased estate, exceeds a figure.

That figure is "the amount that, in the opinion of the Commissioner, would have been included in the assessable income of the beneficiary of the year of income in respect of an amount or amounts derived by the beneficiary from the property that, in the opinion of the Commissioner, would have devolved directly upon that beneficiary if that deceased person had died intestate".

There are then resuming words after paragraph (b) – that is the last block of text - which limit the concessionally treated amount of assessable income. What would otherwise have been excepted trust income is reduced by the amount of that excess.

In the simplest case where all property of the estate has gone under the Will to the surviving parent, and there are no other arrangements to do with estate property, we must look nevertheless at the quantum of income generated in the estate proceeds trust.

We must ask on a year by year basis whether the amount of assessable income derived by the trustee of the EPT, on behalf of a particular beneficiary, exceeds the amount that would have been generated by property that would have devolved directly on a particular infant beneficiary had the deceased died intestate.

### 4.4.3 State law about intestate succession

In Queensland, under Part 3 Succession Act 1981, there is a scheme for distribution of the estate of a deceased who dies wholly or partially intestate.

There are provisions about the same subject matter in South Australia, in Part 3A *Administration and Probate Act 1919.*

Assume a simple case that does not present as having any of the complications that would make calculation difficult, such as multiple spouses or blended families.

Thus:

- In Queensland we first refer to Schedule 2 Part 1, item 2, sub-item 1 as read with sub-item 3.
- Likewise in SA we refer to s 72G

In essence, if there were a large estate, a surviving spouse, and say 3 surviving children (we will assume them all minors):

- In Queensland, the surviving spouse would have been entitled to $150,000 and the household chattels, and a proportion of the residuary estate then remaining.[14]

- In South Australia, the surviving spouse seems entitled to $100,000,[15] and the intestate's personal chattels.[16] However, I do not presume to tell people in Adelaide what the law of South Australia is, and you should take local advice.

The share of the residue that the spouse would take on intestacy is one-third in Queensland (as there is more than 1 child), but ½ in SA.

Already, you can see that it is vital to make enquiries about the system of law that governs. (If there were a NSW or Victorian connexion, it is possible there would be nothing going to a child on an intestacy.)

Therefore, the quantum of the estate that can be transferred to the estate proceeds trust to generate income equally shared[17] between the infant beneficiaries is

  - In Queensland - two-thirds of the residue, after first subtracting from residue the $150,000 and the value of household chattels (as defined).

  - In South Australia – ½ of the residue, after first deducting the $100,000 and the deceased's personal chattels.[18]

The personal chattels need to be valued. In Queensland, these might be valuable, such as jewellery.

Finally, there can be complications in calculating the value of the estate if the statutory option to purchase the shared dwelling-house is exercised.[19]

### 4.4.4 Time at which valuation to be made

The question is about the point at which a valuation is to be struck.

There is no guidance either in the succession statutes nor in the *Income Tax Assessment Act 1936*.

Moreover, section 102AG(7)(b) speaks of "the opinion of the Commissioner" as to the "property that … would have devolved directly upon that beneficiary if that deceased person had died intestate".

Thus, we must be somewhat conservative here, as it is inherently difficult to challenge formation of an opinion by the Executive.

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[14] "Household chattels" are defined in section 34A. I take the matter no further.

[15] No higher amount is yet prescribed.

[16] Section 72H (SA)

[17] Refer section 36A (Qd), & s 72B (SA)

[18] Again, I am diffident about saying much about SA law, and ask you to take specialist advice from a local law firm.

[19] Section 72L (SA) & s 39B (Qd)

Nevertheless, it seems to me that section 102AG(7) poses the question as to what property would have devolved, and that question is answered directly by the *Succession Act* (Qd) or the *Administration and Probate Act (SA)* subject to powers to appropriate.

It is simply a matter of placing to one side the household chattels, and also placing to one side the first $100,000 (SA).[20]

Looking at the net amount of the estate, and after placing those two things to one side, it seems to me that it is a matter then of notionally distributing ½ (in SA) or 2/3 (in Qld) of the remaining residue, to reach the limit under section 102AG(7).

Doubtless some investments have grown in value, or come off in value, since date of death.

But I doubt section 102AG(7) is supposing distribution to have occurred on a particular day, such as the day after death. Further, I doubt that section 102AG(7) is supposing distribution to have occurred within the usual “executor’s year”, because some estates (such as these) may have proved more difficult in administration than other estates.

Rather, the question must, practically, be what the value of the distributable residue was, at the date that distributions were made (including, presumably, appropriations in favour of the surviving spouse and in favour of the trustee of the intended estate proceeds trust).

I cannot see any other, workable hypothesis upon which the Commissioner’s opinion is meant to be formed.

Any other point of valuation seems artificial, other than the point where the estate was actually distributed, barring unusual events that could be said to have artificially inflated the amount transferred to the EPT.

If there were untoward delay in distribution, such as neglect by the executor or administrator, the answer might differ. But I do not include delay owing to genuine dispute resolution about claims on the estate.

[20] $150,000 in Qld.

# 5 Including adult as beneficiary of an EPT

One recent matter involved naming the surviving parent as a discretionary income beneficiary in an intended EPT.

While possible as a matter of trust law, the issue is about the effect under the taxation law.

The concern was not to jeopardise the tax position of minor beneficiaries, the children of the deceased, in terms of the tax concession available under some EPTs because of section 102AG(2) (definition of “excepted trust income”).

## 5.1 Brief scenario

The father died over 2 years before I was consulted.

By his Will, he left the whole of his estate to the mother, as an absolute gift.

Thus there was no testamentary trust, and we were looking at an EPT in terms of section 102AG(2)(d)(ii).

The estate was substantial, so that the deduction of $150,000 (in Qld) plus household chattels would not affect quantum available for the children materially.

### 5.1.1 Draft deed

A draft trust deed provided for “Primary Beneficiaries”, the named children of the deceased.

A second tier of beneficiaries, to be inserted, named the surviving mother.

There was to be a power of appointment of income in favour of “Beneficiaries”, and that term included the mother.

There was to be an overriding power, by which new trusts would be formed in favour of one or more of the Primary Beneficiaries (the children).

Likewise there was a power to transfer trust property to another trust fund of which one or more of the Primary Beneficiaries was a beneficiary. (I do wonder about such terms, in the light of s 102AG(2A), as read by the ATO under guidance issued as ATO ID 2004/264.[21,22])

There was to be a power of advancement in favour of a Primary Beneficiary.

As to capital, the Trust Fund is to be held in equal shares for the children "absolutely". Were a Primary Beneficiary to die, the trustee is to hold that Primary Beneficiary's share of the trust fund for his or her estate. On termination of the Trust Period, the trustees hold the Trust Property for the Primary Beneficiaries (or the estate of a deceased Primary Beneficiary) in equal shares absolutely.

The "Settlor" was excluded from all benefit. Some care must be taken over selection of the settlor, who obviously should not be a member of the family intended to be benefited.

## 5.2 "For the benefit of the beneficiary"

There are several interpretational issues involved with the surviving mother being an object as to income, of a proposed EPT.

### 5.2.1 Excepted persons

First check that none of the children is regarded as an "excepted person" in terms of section 102AC(2). Quite different considerations apply to such persons.

Minors who are not "excepted persons" are regarded as "prescribed persons" for the purposes of section 102AD, because of section 102AC(1).

### 5.2.2 Structure

The "eligible taxable income of a year of income" of a prescribed person is singled out for attention by this legislation.

By section 102AE, the "eligible assessable income of a year of income" is defined exclusive of "excepted assessable income".

Likewise, and more relevantly to the circumstances here, section 102AG singles out for particular attention trusts where there is a "prescribed person" as a beneficiary.

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[21] That guidance addresses another point, but illustrates the ATO's view that the children must take a vested interest from the beginning, not an interest subject to a contingency (such as death in that case). It says:

> "Subsection 102AG(2A) of the ITAA 1936 was considered by the Commissioner in Taxation Ruling TR 98/4. Paragraph 33 states that subsection 102AG(2A) of the ITAA 1936 requires that the child must, under the terms of the trust, acquire the trust property other than as a trustee when the trust ends. Moreover, the property must pass into the child's estate, should the child die before the trust ends. Accordingly, it is considered that subsection 102AG(2A) of the ITAA 1936 cannot be satisfied where the terms of the trust allow a child's proportional interest in the trust fund to devolve to another beneficiary should the child fail to attain the age of 18."

[22] The Kessler & Flynn precedent includes something like it: p 439 (2ed).

The special rules apply to a portion of the share of that beneficiary of the net income of the trust estate of the year of income.

The portion is decided in the opinion of the Commissioner as that being "attributable to assessable income of the trust estate that is not, in relation to that beneficiary, excepted trust income".

## 5.3 The nub – what is "excepted trust income"

Thus we must look carefully at the definition of "excepted trust income" in section 102AG(2), and particularly in subparagraph (d)(ii).

The primary rule, in that subparagraph, is that:

> … An amount included in the assessable income of the trust estate is excepted trust income in relation to a beneficiary of the trust estate to the extent to which the amount … is derived by the trustee of the trust estate from the investment of any property … 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 the deceased person and was so transferred within 3 years after the date of the death of the deceased person …
>
> [emphasis added, paragraphing changed]

The first question is whether a transfer of property by the sole beneficiary of the estate (the surviving mother), being property she received out of the estate of her husband, can be said to be transferred "for the benefit" of her children where it is in fact transferred to the trustee of the EPT for the potential benefit of the children and her.

I note immediately the limited role that the mother was intended to have as beneficiary.

She was only intended to be named as a discretionary object as to income, and would have no interest in the Trust Fund (the capital).

I leave to one side the potential (it might be said) for her to influence the trustee, by other means, such as through control of a trustee or as appointor. (If necessary, you could deal with that later, by appropriate provisions, perhaps. The case of *Pugachev*,[23] mentioned by me at this Roundtable in March 2018, continues to excite attention in New Zealand.)

Because most of these kinds of trusts are discretionary trusts, there can be difficulty interpreting the phrase "for the benefit of".

Thus, s 102AG(8) states that, for the purposes of s 102AG, where:

- any property is transferred to the trustee of a trust estate; and
- the trustee has a discretion to pay or apply the income derived from that property to (or for the benefit of) specified beneficiaries or beneficiaries included in a specified class of beneficiaries,

[23] [2017] EWHC 2426 (Ch)

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that property shall be taken to have been transferred to the trustee for the benefit of each of those specified beneficiaries or for each of the beneficiaries in that specified class of beneficiaries, as the case may be.

This means that the inclusion of the surviving spouse as an object as to income would perhaps mean that the property is taken to have been transferred to the trustee for the benefit of her and the children.

The statutory history of s 102AG, after enactment, tends to shed some limited light[24] on the requirement that the property have been "transferred to the trustee for the benefit of the beneficiary" in s 102AG(2)(d)(ii).

Section 102AG(8), mentioned above, appears to have been in the legislation from the start, as enacted in 1980. But section 102AG(2A) was only inserted by an Act of 1994. It reads:

> Paragraph (2)(c) or subparagraph (2)(d)(ii) does not apply unless the beneficiary of the trust concerned will, under the terms of the trust, acquire the property (other than as a trustee) when the trust ends.

This led to a deal of controversy, since by then several trusts, purportedly in compliance with the then legislation, had been set up. It seems, from the record of the controversy at the time, that careful trust draftsmen were denying children the right to call for trust assets on turning 18, and presumably used a variety of mechanisms to do that.[25]

The 1994 amendments forced the ATO to characterise section 102AG. They did so, as an apportionment provision. This is now reflected in the ruling on the similar concept of a child maintenance trust arrangement, TR 98/4, paragraph 43.

On the face of it, the provisions result in this:

- If there are 4 persons (mother and, for example, 3 children) as income objects – s 102AG(8) would deem property transferred to the trust to "have been transferred to the trustee for the benefit of each of those specified beneficiaries".
- Excepted income in s 102AG(2)(d)(ii) can only be from "the investment of any property … that was transferred to the trustee for the benefit of the beneficiary".
- Income derived from, say, a share portfolio purchased from cash transferred to the fund, would arguably thus be (as to only one quarter) income from property transferred to the trustee for the benefit of the beneficiary. (Hence precedents setting up separate trusts for each child, perhaps.[26])

There are other possible readings more favourable to the family, but I point out this possibility.

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[24] See Kirby J's summary of this difficult interpretational issue in *Trust Company of Australia v Commissioner of State Revenue* (2003) 197 ALR 297, from [89].

[25] The debate is neatly set out in two articles in the Butterworths Weekly Tax Bulletin, part 1 of 1995, paragraphs [2] & [3]. The respective articles are by TM and DR Dwyer, "Penalty taxes on children: an ATO contribution to the International Year of the Family" and by CL Hood, "Taxation Laws Amendment Act (No. 4) 1994: Children's Income".

[26] This is not explained by Sundar, Rowland & Bailey in *Testamentary Trusts* (2nd ed), but is the pattern in para [8.13].

For example, it is possible that ¾ of the income of the trust income for each child would be "excepted trust income" consistently with one reading of the position apparently taken for child maintenance trusts.[27]

That said, Kessler & Flynn *Drafting Trusts and Will Trusts in Australia* (2ed) clearly contemplate including one or more discretionary income beneficiaries: para 15.20.

In fact, in the field of child maintenance trusts, which is analogous, the Commissioner actually contemplates inclusion of other objects as to income.[28]

That ruling by the Commissioner is not binding on him, when it comes to this part of the law.

I suggest a application for a private binding ruling, or non-binding administrative advice confirming that any planned EPT would be treated analogously with the Commissioner's treatment of child maintenance trusts.

[27] Ruling TR 98/4, paras 43 45
[28] TR 98/4, para 45

# 6 Summary

These matters can be distressing, and there can be real time pressure. We are the professionals, and have to manage the matter with detachment, appreciating those problems.

The language used by these provisions is extraordinarily difficult. The public ruling does not deal with the specific issues I ran across, and was not binding on the Commissioner.

Given the longevity of the structure, and the risk to minors it was desirable to get binding private rulings. But 2 factors conspire against success in doing so.

So we are left with administratively binding advice, for the life of the trusts (up to a couple of decades in some cases). This is so in circumstances where the law is changing (according to the 2018 Budget), in ways that are not announced yet in detail.

Finally, differences in State law make this strategy impossible in some places. The illustration I ran above shows the difference between Qld and SA is also most material, despite the fact that those States have laws that facilitate an EPT.

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# 7 Extract of legislation

### 102AG Trust income to which Division applies

(1) Where a beneficiary of a trust estate is a prescribed person 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.

(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
  - (ii) an intestacy or an order of a court that varied or modified the application, in relation to the estate of a deceased person, of the provisions of the law relating to the distribution of the estates of persons who die intestate;
- (b) is employment income;
- (c) is derived by the trustee of the trust estate from the investment of any property transferred to the trustee for the benefit of the beneficiary:
  - (i) by way of, or in satisfaction of a claim for, damages in respect of:
    - (A) loss by the beneficiary of parental support; or
    - (B) personal injury to the beneficiary, any disease suffered by the beneficiary or any impairment of the beneficiary's physical or mental condition;
  - (ii) pursuant to any law relating to worker's compensation;
  - (iii) pursuant to any law relating to the payment of compensation in respect of criminal injuries;
  - (iv) directly as the result of the death of a person and under the terms of a policy of life insurance;
  - (v) directly as the result of the death of a person and out of a provident, benefit, superannuation or retirement fund;
  - (vi) directly as the result of the death of a person by an employer of the deceased person;
  - (vii) out of a public fund established and maintained exclusively for the relief of persons in necessitous circumstances; or
  - (viii) as the result of a family breakdown (see section 102AGA);
- (d) is derived by the trustee of the trust estate from the investment of any property:
  - (i) that devolved for the benefit of the beneficiary from the estate of a deceased person;
  - (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
  - (iii) being a verifiable prize in a legally authorized and conducted lottery and being a prize of which the beneficiary is the beneficial owner; or
- (e) is derived by the trustee of the trust estate from the investment of any property that, in the opinion of the Commissioner, represents accumulations of:

(i) assessable income derived by the trustee during a year of income in relation to which this Division applies, being assessable income that, in relation to the beneficiary, is excepted trust income;

(ii) assessable income derived by the trustee during a year of income in relation to which this Division does not apply, being assessable income that would, in the opinion of the Commissioner, have been excepted trust income in relation to the beneficiary if this Division were applicable in relation to the year of income during which the assessable income was derived; or

(iii) exempt income derived by the trustee to which subparagraph (i) or (ii) would, in the opinion of the Commissioner, apply if that exempt income had been assessable income.

(2A) Paragraph (2)(c) or subparagraph (2)(d)(ii) does not apply unless the beneficiary of the trust concerned will, under the terms of the trust, acquire the trust property (other than as a trustee) when the trust ends.

(3) 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 of that excepted trust income;

were not dealing with each other at arm's length in relation to the derivation, or in relation to the act or transaction, the excepted trust income is only so much (if any) of that income as would have been derived if they had been dealing with each other at arm's length in relation to the derivation, or in relation to the act or transaction.

(4) 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 person (whether before or after the commencement of this subsection) for the purpose, or for purposes that included the purpose, of securing that that assessable income would be excepted trust income.

(5) In determining whether subsection (4) applies in relation to an agreement, no regard shall be had to a purpose that is a merely incidental purpose.

(5A) In the application of paragraph 102AF(1)(b) for the purposes of the application of paragraph (2)(b) of this section in relation to a beneficiary of a trust estate, payments made for services rendered or to be rendered shall not be taken to be employment income unless the services are rendered or to be rendered by the beneficiary.

(6) Where:

(a) any assessable income is derived by a trustee of a trust estate from the investment of any property transferred to the trustee for the benefit of a beneficiary of the trust estate by way of, or in satisfaction of a claim for, damages in respect of:

(i) loss by the beneficiary of parental support; or

(ii) personal injury to the beneficiary, any disease suffered by the beneficiary or any impairment of the beneficiary's physical or mental condition; and

(b) that property was transferred to the trustee otherwise than in pursuance of an order of a court;

paragraph (2)(c) applies only to so much (if any) of that assessable income as the Commissioner considers fair and reasonable.

(7) Where:

(a) any assessable income is derived by a trustee of a trust estate from the investment of any property transferred to the trustee for the benefit of a beneficiary of the trust estate by another person out of property that devolved upon that other person from

the estate of a deceased person and was so transferred to the trustee within 3 years after the date of death of the deceased person; and

(b) the amount referred to in paragraph (a) or, if the assessable income of that beneficiary of the year of income includes any amount that:

(i) was derived by the beneficiary from property that was transferred to the beneficiary by another person out of property that devolved upon that other person from the estate of that deceased person and was so transferred within 3 years after the date of death of that deceased person;

(ii) was derived by the beneficiary from property that devolved upon the beneficiary from the estate of that deceased person; or

(iii) is included in that assessable income under section 97 or 100 in respect of the share of that beneficiary of the net income of another trust estate, being a trust estate that resulted from a will or codicil of that deceased person, an order of a court that varied or modified the provisions of a will or codicil of that deceased person, a partial intestacy of that deceased person or an order of a court that varied or modified the application, in relation to the estate of that deceased person, of the provisions of the law relating to the distribution of estates of persons who die intestate;

the sum of the amount referred to in paragraph (a) and the amount or amounts applicable by virtue of subparagraphs (i), (ii) and (iii) of this paragraph, exceeds the amount that, in the opinion of the Commissioner, would have been included in the assessable income of the beneficiary of the year of income in respect of an amount or amounts derived by the beneficiary from property that, in the opinion of the Commissioner, would have devolved directly upon that beneficiary if that deceased person had died intestate;

the amount of the assessable income of the trust estate that would, apart from this subsection, have been excepted trust income in relation to that beneficiary by virtue of subparagraph (2)(d)(ii) shall be reduced by the amount of that excess.

(8) For the purposes of this section, where:

(a) any property is transferred to the trustee of a trust estate; and

(b) the trustee has a discretion to pay or apply the income derived from that property to or for the benefit of specified beneficiaries or beneficiaries included in a specified class of beneficiaries;

that property shall be taken to have been transferred to the trustee for the benefit of each of those specified beneficiaries or for each of the beneficiaries in that specified class of beneficiaries, as the case may be.

## 102AGA Transfer of property as the result of a family breakdown

(1) For the purposes of subparagraph 102AE(2)(b)(viii) or 102AG(2)(c)(viii), the transfer of property (the ***subject property***) by a person (the ***transferor***):

(a) to the minor mentioned in subparagraph 102AE(2)(b)(viii); or

(b) to the trustee mentioned in subparagraph 102AG(2)(c)(viii) for the benefit of the beneficiary mentioned in that subparagraph;

is ***as the result of a family breakdown*** if the requirements of subsection (2) or (3) of this section are met.

(2) The transfer will be as the result of a family breakdown if:

(a) a person ceases to live with another person as the spouse of that person; and

(b) at least one of the persons:

(i) is the parent; or

(iv) has legal custody or guardianship;

of the minor or the beneficiary; and

(c) an order, determination or assessment of a court, person or body (whether or not in Australia) is made wholly or partly because the person has ceased to live as the spouse of the other person; and

(d) the effect of the order, determination or assessment is that a person (whether one of the spouses, the transferor or any other person) becomes subject to a legal obligation to maintain, transfer property to, or do some other thing for the benefit of, the minor or beneficiary or one of the spouses; and

(e) the transferor transfers the subject property to the minor, or to the trustee for the benefit of the beneficiary, in giving effect to the legal obligation (including in discharging the legal obligation if it falls on someone else, and whether or not the legal obligation could have been given effect in some other way).

(3) The transfer will also be as a result of a family breakdown if:

(a) when the minor or beneficiary is born, his or her parents are not living together as spouses; and

(b) an order, determination or assessment of a court, person or body (whether or not in Australia) is made wholly or partly because the parents are not living together as mentioned in paragraph (a); and

(c) the effect of the order, determination or assessment is that a person (whether one of the parents, the transferor or any other person) becomes subject to a legal obligation to maintain, transfer property to, or do some other thing for the benefit of, the minor or beneficiary or one of the parents of the minor or beneficiary; and

(d) the transferor transfers the subject property to the minor, or to the trustee for the benefit of the beneficiary, in giving effect to the legal obligation (including in discharging the legal obligation if it falls on someone else, and whether or not the legal obligation could have been given effect in some other way).

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