Testamentary trusts: bespoke planning opportunities

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Abstract: In recent years, the need for effective structuring of business and personal assets has been brought into sharp focus for high net worth individuals and business owners. Fundamental changes to the taxation regime, the vast amounts of wealth accumulated within superannuation funds and the increasing tendency for both business and personal relationships to be relatively short term, as opposed to life long, have meant that traditional estate planning has been revolutionised. This article focuses on the creative use of testamentary trusts in the context of estate planning. The article considers assets that do not form part of an estate, testamentary trusts, tax treatment of testamentary trusts, the attitude of the Australian Taxation Office towards testamentary trusts, trust cloning, trust splitting, bespoke company constitutions and fettering of a trustee's discretion, and changing of domicile.

Introduction

In recent years, the need for effective structuring of business and personal assets has been brought into sharp focus for high net worth individuals and business owners. Fundamental changes to the taxation regime, the vast amounts of wealth accumulated within superannuation funds and the increasing tendency for both business and personal relationships to be relatively short term, as opposed to life long, have meant that traditional estate planning has been revolutionised.

A significant factor to note in the changing face of estate planning is the transfer of wealth from Australia's "baby boomer" generation. Statistically, this segment of the population is by far the wealthiest and best educated in Australia's history, and consequently far more sophisticated estate planning strategies are being developed in order to minimise the ability for wealth to be attacked by creditors, former spouses, business associates and (in some instances) disgruntled beneficiaries.

While tax effective strategies incorporating complex will arrangements and testamentary trusts continue to be of relevance, recent developments in estate planning have been more focused on the protection of underlying wealth. In particular, additional structures are now being utilised in conjunction with wills to ensure wealth passes efficiently to the intended recipients and that the transfer takes place at the intended time. Often the desire to ensure a suitable tax outcome needs to be balanced against a desire to ensure assets are protected from family disputes, spendthrift beneficiaries and creditors in deciding on an estate plan.

Asset protection strategies and the use of special purpose trusts are important issues to consider in estate planning, particularly where potential beneficiaries are in occupations, professional practice or in business, or where there is a risk that a personal relationship of a beneficiary may degenerate in the future. Potential beneficiaries that fall into any of these "at risk" categories will be exposed to losing assets unless appropriate structures are put in place.

The difficulty in many estate planning exercises is that serious attempts to devise and implement a plan are often not made until some "triggering event" stimulates action. Often the triggering event is itself an issue that may jeopardise the ability to implement appropriate strategies, for example financial or matrimonial misfortune or life-threatening illness.

Given that the first wave of the baby boomer generation is now nearing 60, it is likely that the increased importance placed in recent years on appropriately structuring intergenerational wealth transfers will continue to intensify.

There are an enormous number of aspects to a comprehensive estate plan. This article will focus on the creative use of testamentary trusts in the context of estate planning. In particular, the article will consider the following:

(1) assets that do not form part of an estate;
(2) testamentary trusts – a refresher;
(3) tax treatment of testamentary trusts;
(4) the attitude of the Australian Taxation Office (ATO) towards testamentary trusts;
(5) trust cloning;
(6) trust splitting;
(7) bespoke company constitutions and fettering of a trustee's discretion; and
(8) changing of domicile.

Each of the above issues is dealt with in turn below.

Assets which do not form part of the estate

Perhaps one of the most important aspects of modern estate planning is in relation to those assets which do not in fact pass pursuant to a person's will. It is vital in any estate plan for both the client and their advisers, from as early as possible in the estate planning process, to clearly understand which assets are regulated by the person's will and which assets will need to be regulated utilising other strategies.

A brief summary of the main types of assets that do not pass pursuant to a person's will are set out in Table 1.

Table 1 is not intended to be an exhaustive list of assets that fall outside a person's will, but rather is used to highlight the importance for clients to work with all their advisers including their financial planner, lawyer, accountant and insurance broker in devising a comprehensive estate plan.

There are an increasing number of examples where a failure to establish legal ownership and the structure of a testators affairs prior to advising them in regard to the distribution and preservation of assets upon death has meant that a testator's objectives are not met. Similarly, there seems to be an increasing number of disgruntled beneficiaries who readily seek to apportion blame where unintended consequences arise.

The various intricacies involved in relation to assets that fall outside a person's estate could be the subject of an entire article in themselves. For the purposes of this article, it is noted simply that the appropriate starting point for any estate plan should be a thorough analysis of those assets which will in fact pass pursuant to a person's will and, in turn, implementing steps to deal with those assets which will not pass pursuant to the will.

Testamentary trusts – a refresher

Overview

Testamentary trusts are simply trusts established pursuant to a will. In recent years, numerous different types of testamentary trusts have included fixed, unit, discretionary (family), hybrid, resulting (constructive), bare, lineal descendent and superannuation proceeds trusts. The various types of trusts have a number of different features and specific uses, but fundamentally the legal structure of all testamentary trusts is very similar.

Structure of testamentary trusts

Essentially, the share of the estate intended for each beneficiary can be managed via a testamentary trust by the trustee appointed by the testator in their will (often the trustee and a beneficiary of the trust may be the same person although the advantages and disadvantages of this approach are dealt with in more detail below).

During each year, the trustees of the trust may have complete discretionary power to choose which beneficiary takes what share of income for that year. They may also have the absolute discretion as to the distribution of capital, but often the distribution of capital can be limited to set amounts and for a limited range of direct descendants, or otherwise as instructed by a testator.

A will maker (or testator) sets out the terms of the trust in their will and can give the trustee complete discretion as to who should receive capital and income from the trust, or alternatively the testator can restrict the trustee's discretion as much as they like.

A "lineal descendant" trust is simply a specific type of testamentary trust whereby the testator may restrict the ability of the trustee so that they may only distribute income or capital (or both) to the testator's children and grandchildren and so on, excluding any spouse of the children and/or grandchildren. The main attraction to excluding spouses as potential beneficiaries is that in the event of a matrimonial (or de facto) relationship breakdown, it is unlikely that a lineal descendant trust would be taken into account by the Family Court as anything other than a resource of the relevant marriage. Thus, the assets of the testamentary trust are likely to be protected in such a scenario.

Conversely, many people argue that the flexibilities normally associated with a trust structure are significantly diminished if a whole class of potential beneficiaries are

Table 1: Identifying tax-effective approach

Asset type	Control	Documents regulating
Joint tenancy (as opposed to tenants in common)	Survivor	Position at law
Superannuation (binding nomination)	Member within three years of death	Valid binding nomination
Superannuation (no binding nomination)	Fund trustee post death	Trust deed or terms of pension
Discretionary trust (individual trustee)	Appointor/principal, or in the absence of both, surviving trustee. If no surviving trustee, then legal personal representative of estate	Trust deed or Trusts Act
Discretionary trustee (corporate trustee)	Appointor/principal, or in the absence of both, remaining directors of corporate trustee, subject to the shareholder's power to remove	Trust deed or constitution for corporate trustee
Unit trust	As above for discretionary trusts	Ultimate benefit in trust regulated by trust deed and unitholdings
Private company	Director subject to appointment by shareholders	Constitution or shareholders agreement. Transfer of shares may be pursuant to will depending on other documentation
Loan to company or trust	Lender or legal personal representative of lender	Loan agreement may override will
Business interests	Remaining business owners/trustee of will	Business succession agreement/ Partnership Act
Life insurance	Policy owner or nominated beneficiary	Insurance policy

excluded. In recent times, many people have adopted a "hybrid" approach to testamentary trusts so that spouses can be potential income beneficiaries from year-to-year but that in relation to any capital distributions from the trust, these distributions may only be made to lineal descendants of the original will maker.

Advantages of testamentary trusts

The main advantages of an appropriately drafted testamentary discretionary trust (TDT) established by a will are as follows:

(1) the flexibility given to the trustees to allocate income and capital with reference to the facts at the time, rather than a testator's prediction (no matter how careful) of the future. It allows the trustee to make a greater distribution for a testator's child with a special need, such as (in particular) wastrel children, as well as those with a disability;

(2) if an estate was left to a child absolutely, then it is their property and could be jeopardised by their financial position at the time of death or after. In addition, should that child suffer matrimonial or financial misfortune at some time in the future, the trust at least provides a facility whereby the inheritance can be kept separate. As indicated above, it is unlikely (particularly where spouses are not potential beneficiaries) that the assets of the TDT would be seen as anything more than a resource for the relevant beneficiary and not part of the assets of the matrimonial pool which are physically distributed between the parties to the marriage breakdown;

(3) the TDT can be drafted such that it complies with the requirements set out in s 102AG(2)(a)(i) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) so that income each year allocated to minor children is not subject to the same tax rates as if it were a normal family discretionary trust established during a person's lifetime (where the first $772 distributed to a child is tax free but then any further income is taxed at the highest rate which could be up to 66%);

(4) where income is derived under the section quoted above, infant children are assessed at the normal, individual rates (approximately $22,000 tax free and the balance at normal adult rates) which may be a significant saving in tax when you look at the gross income for a family unit. The Commissioner does have some discretion in these cases, but generally the discretion is exercised in favour of the TDTs as they are a "traditional" form of trust; and

(5) even if, for any reason, the trust does not come into effect through the operation of law, or it fails, then the will can include a fall-back provision whereby the capital vests in the intended beneficiary anyway, with provision for their children if necessary, or even revert to trusts established for other beneficiaries.

Ultimately, TDTs are particularly useful structures in the following circumstances:

(1) to ensure concessional tax treatment is available to distributions of capital and income to minor beneficiaries;

(2) to protect accumulated wealth from wastrel or spendthrift beneficiaries;

(3) to provide for infant children and disabled beneficiaries; and

(4) to protect inheritances from attack by the family law courts and trustee in bankruptcy.

Disadvantages of testamentary trusts

There are a number of potential disadvantages to TDTs, including:

(1) once income is determined to be distributed to an infant and is then not applied in payment of the infant's needs, there will be an accumulating debt owing to that infant by the TDT. Thus, when the time comes to wind up the trust and for the beneficiaries to take the capital, they may find the capital substantially eroded by the necessity to pay these debts to the children or other beneficiaries, unless of course they are in some way forgiven. Alternatively, when the relevant child reaches the age of majority, it may be that they seek repayment of the loan owed to them;

(2) the TDT structure requires a reasonable degree of control, similar to a normal family discretionary trust, including recourse to competent accountants and lawyers for trust administration advice. This all involves a cost;

(3) the taxation aspects of a TDT have not been ably and forcefully contested in a court in recent years. Notwithstanding this, the language of s 102AG(2)(a)(i) is clear and there are income tax rulings (both private and public rulings) given in favour of the establishment of TDTs; and

(4) where the beneficiary of a trust is also a trustee, they should for safety's sake always have at least one trustee with them when undertaking trust-related issues, so the beneficiary will need to be able to work with their co-trustee/s. Protection against creditors or former spouses is diminished when a beneficiary is the sole trustee of the trust, as that beneficiary has power as trustee to distribute the whole of the income and/or capital to themselves. Finding suitable co-trustees can be a difficult exercise, and can also cause increased expenses where a professional is appointed.

Tax treatment of testamentary trusts

Is Div 6AA limited to income derived from estate assets?

Section 102AG(2)(a)(i) and (2)(d)(i) of Div 6AA ITAA36 make it clear that the provisions are not limited to income derived from estate assets. Under s 102AG(2)(a)(i), excepted trust income is the amount which is assessable income of a trust estate that resulted from a will, codicil or court order varying a will or codicil. Importantly, the subsection only prescribes how the trust estate is deemed to have arisen and does not place any limitations on the management of the trust estate, or on the assets which the trust may hold.

The fact that estate assets forming part of the trust estate may be realised and others may be acquired has no implications on the validity of a testamentary trust, nor the ability of the trustee of a testamentary trust to treat the income as excepted. Similarly, if the trustee decides to borrow money and acquire assets which earn income, then Div 6AA applies to that income.

What limitations might be imposed

Section 102AG(3) contains an exception for non-arm's length arrangements. In particular, it provides that if any two or more parties to:

(1) the derivation of the excepted trust income mentioned in s 102AG(2); or

(2) 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

of income, 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.

Essentially, this means that if, say, the loan was not at arm's length, but at a more favourable interest rate compared with the market, then the income derived would have been less, and therefore the amount which can be treated as excepted trust income is reduced.

The case of *The Trustee for the Estate of the Late AW Furse No. 5 Will Trust v FCT*[1] is one of the few reported decisions dealing with Div 6AA. In this case, a will made in July 1974 established multiple testamentary trusts, each for a capital of $1 after the testator passed away shortly after making the will. A trustee was then appointed over one of the testamentary trusts and proceeded to borrow small amounts of money and acquire a unit in a unit trust. The ATO did not consider the income from the unit as excepted income and argued that the income derived by the trustee was not assessable income of a trust estate that "resulted from a will".

Justice Hill rejected the ATO's argument and held that it was only necessary that the parties be dealing on an arm's length basis and that it was not necessary that they be arm's length parties. The court noted that provided the trust estate was created by a will and the arm's length test applied, then any income of a testamentary trust would be considered as excepted trust income.

A secondary issue that was not explored by the ATO was the potential for a Pt IVA ITAA36 argument given the circumstances where the testator created a will shortly before his death establishing a number of testamentary trusts with nominal capital. That said, testators and trustees must, therefore, take care when establishing testamentary trusts under a will to ensure that the arrangement does not fall within the anti-avoidance provisions.

In addition, income from distributions by trusts established prior to death will not enjoy excepted trust income status because the parties are not dealing at arm's length, unless the trustee gives arm's length consideration for the payment.

Testamentary trust distributions to infant beneficiary via inter vivos trust

Where there is a distribution of income from a testamentary trust to an inter vivos trust and then to an infant beneficiary, the better view appears to be that the distribution does not have the status of excepted trust income.

Section 102AG(1) requires that a trust have a prescribed person (essentially an infant, subject to certain exceptions in s 102AC(2) ITAA36) as a beneficiary. Although it could be argued that a testamentary trust has, as its ultimate beneficiary, an infant, and although s 102AG(1) does not expressly exclude an indirect interest as a beneficiary, s 102AG(1) is likely to be construed as dealing only with direct beneficiaries of a testamentary trust.

Having said this, there is an argument that the income of the "trust estate" contemplated in the opening words to s 102AG(2) need not be the same trust estate, and that the income received by an infant beneficiary via an existing family trust is excepted trust income "in relation to a beneficiary of the trust estate (that is the family trust) to the extent to which the amount — (a) is assessable income of a trust estate (that is the testamentary trust) that resulted from — (i) a will".

> "The ATO did not consider the income from the unit as excepted income."

Distributions following Bamford

One of the critical outcomes of the High Court's decision in *Bamford*[2] is the determination of the meaning of the term "income" under s 97 ITAA36. As has been well documented, the High Court concluded that in determining the "income of the trust estate" for the purposes of s 97, consideration needs to be given to the deed, rather than the ordinary concept of income. In the context of a testamentary trust, the deed obviously is the terms set out under the will. Support for this position was garnered from, among other sources, the distinct wording incorporated within s 97 between "income of the trust estate" and "net income of the trust estate".

Practically, therefore, all testamentary trust wills must incorporate powers for a trustee to determine what is and what is not included as income for the trust. Among other things, this should include the ability for the trustee to determine whether or not to include net or gross capital gains as trust income. While this should be possible for newly crafted testamentary trust wills, for any testamentary trusts established under deceased estates careful reviews should be undertaken.

The other main component of the decision in *Bamford* related to the appointment of trust distributions to beneficiaries. The High Court considered the meaning of the term "share" for the purposes of s 97.

A "percentage" approach simply assigns a set proportion or percentage of the income to individual beneficiaries. In contrast, a "fixed amount" approach involves the trustee resolving to appoint a fixed amount of income to an individual beneficiary. Thus, fixing the amount of the distribution of income for say, two of three beneficiaries of the trust with the remaining being distributed to the third beneficiary means that any increase or decrease in assessable income would only affect the distribution to the third beneficiary.

The High Court in *Bamford* held that "share" in the context of s 97 referred to the proportionate entitlement of each beneficiary to the income of the trust estate. Thus, it is the proportion that determines the amount of assessable income that is attributed to the beneficiary, even if fixed amounts have been appointed to the beneficiaries under the trust.

Assuming that trustee resolutions (or minutes) are appropriately crafted in the context of the High Court's decision in *Bamford*, there should not be any particular concern for distributions out of testamentary trusts as a result of this aspect of the *Bamford* decision.

Having said this, in relation to a testamentary trust where the income and

capital beneficiaries are different (a classic example in this regard would be a "lineal descendant" testamentary trust where the income beneficiaries are crafted far more widely than the capital beneficiaries), there is potential for significant adverse consequences to arise.

Furthermore, in situations where a testamentary trust already exists because the relevant will maker has died, the relevant parties involved will need to be very careful to ensure in fact that they hold the requisite powers as, speaking generally, it is often not possible to amend the trust instrument following the death of the will maker.

Main residences

Generally, a main residence will be either exempt or fully exempt from capital gains tax (CGT) on its disposal. This position is effectively maintained where a property was the main residence of a deceased immediately prior to their death.

The two key rules are:

(1) if a property was exempt under the main residence exemption before the death of the deceased owner, and a beneficiary moves into the dwelling and it becomes that beneficiary's main residence, the main residence exemption will continue to be fully available; and

(2) if a beneficiary sells the dwelling within 24 months of the date of death of the deceased person whose main residence the dwelling was, whether or not that beneficiary resides in the property, the property will be exempt from CGT (under what is known as "the 24-month rule").

Where assets are held as joint tenants, the surviving joint tenant is treated as if the dwelling had passed to the surviving owner "as a beneficiary in a deceased estate".[3] The calculation of the 24-month period will be from the date of death until settlement of the disposal, rather than exchange of contracts.

It should be noted that under s 118-195 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), it does not matter that the dwelling was not the deceased's main residence, or it was used for income-producing purposes, for a period of time during their ownership. The only requirement is that the dwelling was the deceased's main residence just before their death and was not being used for income-producing purposes at that time.

Main residence exemption and testamentary trusts

As outlined above, the CGT main residence exemption in s 118-195 will apply to capital gains made in relation to dwellings owned by individuals whose interest in the dwelling was passed to them as "a beneficiary in a deceased estate, or as trustee of a deceased estate". A "trustee of a deceased estate" would include only the legal personal representative (LPR) and not a testamentary trust trustee.

Unfortunately, there is no statement from the ATO similar to that in PS LA 2003/12 (discussed below) which confirms that a testamentary trust trustee will be treated the same way as an LPR for the purposes of Div 118 ITAA97. Therefore, the only certain way for the main residence exemption under s 118-195 to apply will be to either to ensure that:

(1) the property is disposed of by either the LPR or an individual beneficiary (ie without passing to a testamentary trust) within 24 months of the date of death of the deceased; or

(2) the deceased's main residence does not pass to a testamentary trust with the remainder of the estate assets and is instead passed directly to an individual beneficiary as owner, and to have the deceased's spouse or a person with a right to occupy the house as their main residence.

However, it would be open to argument that, if a deceased's main residence passed to an individual testamentary trust trustee who then held that property on trust solely for the benefit of either:

(1) the deceased's spouse; or

(2) a person with a right to occupy the house under the deceased's will,

and those persons did occupy the dwelling as their main residence, the exemption would remain available to the testamentary trust trustee on a subsequent disposal of the dwelling.

In practice, it is often the case that multiple testamentary trusts are established where a main residence is involved. One (or more) testamentary trust would be established to hold the residuary estate and those testamentary trusts would generally have a wide range of beneficiaries.

An additional testamentary trust would then also be established to hold only the main residence of the deceased. The beneficiaries of the testamentary trust would be limited to:

(1) the deceased's spouse; or

(2) a person with a right to occupy the house under the deceased's will.

It is vital that if a person other than the deceased's spouse is to live in the dwelling, that that person is given the right to occupy the house under the terms of the will.

Main residence – partial exemptions

The general rules regarding absences from a main residence are set out in s 118-45 ITAA97 and apply in deceased estate cases equally as in the case of disposals during a person's lifetime.

The general rule for post-CGT dwellings is that the exemption is pro-rated by reference to the number of days that were non-main resident days of both the deceased and the beneficiary (or LPR) over the total ownership period of the dwelling by the deceased and the beneficiary.[4]

Section 118-200 ITAA97 sets out a partial exemption for a beneficiary or LPR where the full main residence exemption under s 118-195 is unable to be accessed. The partial exemption will generally apply in situations where:

(1) a beneficiary did not occupy the dwelling for their entire ownership period commencing from the date of death of the deceased where the dwelling was either a pre-CGT asset of the deceased or was the deceased's main residence immediately prior to their death; or

(2) although the dwelling has been the beneficiary's main residence for the entire period of time since the death of the deceased, it was not the main residence of the deceased just before the deceased's death.

Where a dwelling or family home has been used for income-producing purposes by either the deceased or a beneficiary or LPR, a partial exemption may apply where the income-producing activity does not constitute the entire usage of the dwelling. These exemptions are set out in ss 118-190 and 118-92 ITAA97 and will not be discussed in further detail in this article.

ATO attitude to testamentary trusts

Transfer of assets

On the death of a will maker, each asset of the estate will potentially be transferred three times:

(1) from the will maker to the LPR;

(2) from the LPR to the beneficiary of the estate, which may be the trustee of a testamentary trust; and

(3) from the testamentary trust to a beneficiary either as a capital distribution during the lifetime of the trust or as a distribution of corpus upon vesting.

The CGT consequences of each of the abovementioned transfers must be separately considered.

Distributions from will maker to LPR

The first roll-over to examine is the initial transfer of a deceased's assets from the deceased person to their LPR for distribution under the terms of the deceased's will. As a starting point, the general position is that, when a taxpayer dies, any capital gain or loss from any event relating to a CGT asset owned by the deceased is disregarded under s 128-10 ITAA97. This means that the distribution from the deceased to their LPR does not result in a CGT liability for the deceased and there are effectively no other CGT consequences for the deceased.

As to the consequences to the LPR, the CGT assets are taken, under s 128-15 ITAA97 to have been acquired by the LPR on the date the deceased died. The cost base of the CGT asset (other than for a property which was a main residence for the deceased immediately before they died, which is discussed below) for the LPR is modified under s 128-15(4) so that:

(1) for pre-CGT assets in the hands of the deceased — the first element of the LPR's cost base (and reduced cost base) is the market value of the asset on the day the deceased died (meaning that pre-CGT assets in the hands of the deceased become post-CGT assets in the hands of the LPR); and

(2) for post-CGT assets in the hands of the deceased — the first element of the LPR's cost base (and reduced cost base) is the deceased's costs base (or reduced costs base) at the date of their death (ie the deceased effectively passes their cost base and reduced cost base to the LPR).

Distributions from LPR to testamentary trust

From a CGT perspective, a testamentary trust is treated much the same as other trusts. However, it should be noted that CGT event E1[5] does not apply to a testamentary trust since that event only applies to the creation of a trust "by declaration or settlement". In the testamentary trust scenario, there is no such declaration of trust and there is no initial settlement sum.

The CGT rules which apply to the distribution from the deceased to the LPR apply equally to subsequent distributions from the LPR to a "beneficiary". It would appear that "beneficiary" for the purposes of the ITAA97 includes the trustee of a testamentary trust (however, you will see later in this article that, for the purpose of Div 128 ITAA97, the trustee of a testamentary trust is also treated the same as an LPR by the ATO).

> "It would appear that 'beneficiary' … includes the trustee of a testamentary trust."

A CGT asset is taken to have passed to a beneficiary of a deceased's estate if the beneficiary (or in this case, the trustee of the testamentary trust) becomes the owner of the asset whether under the terms of:

(1) the deceased's will;

(2) under the intestacy laws; or

(3) under a deed of arrangement.[6]

As with the initial transfer from the deceased to the LPR, on a subsequent distribution from the LPR to a testamentary trust, any capital gain or loss that the LPR (rather than the deceased) makes is disregarded (although this time, the relevant provision is found in s 128-14(3) ITAA97, rather than s 128-10 ITAA97).

Again, the testamentary trust trustee is taken to have acquired the CGT assets of the deceased at the date of the deceased's death (rather than on the date they were distributed by the LPR) and the first element of the cost base (and reduced cost base) for the testamentary trust trustee will be:

(1) for pre-CGT assets in the hands of the deceased — the market value of the asset on the day the deceased died; and

(2) for post-CGT assets in the hands of the deceased — the deceased's costs base (or reduced cost base) at the date of their death.[6]

The testamentary trust trustee is also able include in its cost base any expenditure the LPR has incurred, up to the time of the disposal by the LPR, that the LPR would have been entitled to include in its cost base had it retained the asset.[7]

Distributions from testamentary trust

In 2003, the ATO released PS LA 2003/12, which states that its purpose is to inform ATO staff that the Commissioner will not depart from the long-standing administrative practice of treating the trustee of a testamentary trust in the same way as an LPR is treated for the purposes of Div 128 (and in particular s 128-15(3)). This is generally accepted to mean that there is an exemption from CGT covering the "transfer" from the LPR to the trustee of the testamentary trust in the first instance as well as the subsequent transfer to an eventual beneficiary of the estate. This subsequent transfer may either involve a capital distribution being made by the trustee of the trust to a beneficiary during the lifetime of the trust, or a payment of capital upon vesting of the trust.

The result of PS LA 2003/12 is that, on the subsequent disposal of a CGT asset from a testamentary trust trustee to a beneficiary of the testamentary trust:

(1) any capital gain or loss that the testamentary trust trustee makes is disregarded under s 128-15(3); and

(2) the beneficiary will be taken to have acquired the CGT assets of the deceased at the date of the deceased's

death (rather than on the date they were distributed by the LPR) and the first element of the cost base and reduced cost base for the beneficiary will be:

(a) for pre-CGT assets in the hands of the deceased — the market value of the asset on the day the deceased died; and

(b) for post-CGT assets in the hands of the deceased — the deceased's cost base (or reduced cost base) at the date of their death.[8]

Ultimately, under PS LA 2003/12 s 128 (in particular s 128(2), (3) and (4)) effectively applies twice:

(1) initially, when the LPR is the "LPR" for the purposes of Div 128 and the testamentary trust trustee is the "beneficiary"; and

(2) subsequently, when the testamentary trust trustee is treated as an "LPR" for the purposes of Div 128 and the beneficiaries of the testamentary trust are treated as the "beneficiaries".

CGT event K3

The ATO has indicated that the position in PS LA 2003/12 is subject to CGT event K3, which covers assets passing to tax-advantaged entities. CGT event K3 operates to ensure that, where assets pass to concessional taxed entities from a deceased estate, a capital gain or loss is recognised in the deceased's final tax return, preventing assets with embedded capital gains from avoiding capital gains when they are later disposed of by the concessionally taxed entity. CGT event K3 has, in the past, been avoided by ensuring an asset does not pass to a concessionally taxed entity until after the deceased's standard amendment period (generally four years after the assessment) has expired.

As part of the 2011-12 Budget measures, it was announced that amendments would be made to ensure that where CGT event K3 happened outside of the deceased's standard amendment period, a CGT liability still arose in the deceased's tax return. It was proposed this could be achieved by excluding CGT event K3 from the standard amendment period.

In particular, the CGT event would have been deemed to happen to the relevant entity that passed the asset to the concessionally taxed entity (rather than with the beneficiary), avoiding the need to amend the deceased's tax return. This change would have allowed the entity to which CGT event K3 applied to be able to utilise their realised capital losses against CGT event K3, instead of the deceased utilising their capital losses against their capital gain from CGT event K3.

The change would have been is consistent with how Div 128 operates under PS LA 2003/12 where an LPR or testamentary trust trustee sells an asset to a third party, rather than passing the asset to the intended beneficiary of the estate.

However, as with other proposed changes mentioned below, the announced changes to CGT event K3 were abandoned in late 2013.

Legislating CGT exemption for testamentary trust distribution of asset

In the 2011-12 and 2012-13 federal Budgets, it was proposed that the current ATO practice set out in PS LA 2003/12 of allowing a testamentary trust to distribute an asset of a deceased person without a CGT taxing point occurring would be codified. While draft legislation to effect the change was prepared, the 2013 federal Coalition government announced that it was reviewing the progress of a large number of unenacted legislative announcements and ultimately confirmed the amendments would not be implemented.

It is assumed that the ATO will continue to adopt the approach set out in PS LA 2003/12. However, there remains a clear risk that the ATO may abandon the approach on the basis that it arguably has no basis at law given that s 128-15 only refers to an LPR, not the trustee of a testamentary trust expressly.[9]

Where an intended beneficiary dies before administration is completed

The federal government released a proposal paper "Minor amendments to the capital gains tax law" in June 2012 which specifically addressed the circumstance where the intended beneficiary dies before administration of an estate is completed. Generally, in that situation, s 128-15 provides a CGT roll-over provided that the asset passes from the first deceased's LPR to the beneficiary's LPR.

However, no CGT roll-over exists where the asset passes (ultimately) from the first deceased's LPR via the second deceased's LPR to the trustee of a testamentary trust or a beneficiary of the intended beneficiary's (ie the second deceased) estate because the asset was not one which the intended beneficiary owned when they died.

The Labor federal government in power until July 2013 proposed to introduce measures to allow the intended beneficiary's LPR to access the roll-over where the intended beneficiary dies before an asset that the first deceased owned passes to them, regardless of whether it passes first to a testamentary trust trustee. Again, however, the 2013 federal Coalition government confirmed the amendments will not be implemented.

Trust cloning and trust splitting

Where assets have been built up in one trust, there is often a desire for the assets to be divided among different trusts. This may be for a number of reasons, including:

(1) to allow some assets to be controlled by certain family members and other assets to be controlled by different family members;

(2) to separate passive investments or valuable capital assets from the risks associated with carrying on a business; or

(3) to separate multiple business activities and quarantine the risks associated with each.

Transactions of this nature can have a number of consequences, including:

(1) CGT on asset transfer;

(2) stamp duty; and

(3) trust resettlement due to variations of the trust deed.

Trust cloning and splitting can offer pathways to achieve a restructure of testamentary trust assets while minimising adverse transaction costs.

Trust cloning is synonymous with trust "mirroring". That is, assets of a trust are transferred to a separate identical trust or trusts, with no changes to the meaning or effect of the trust deed. This provides for different trust estates.

In contrast, trust splitting is where the assets of the trust are split (within the same trust) so that different trustees are appointed for each part. The ability to split a trust will depend largely on whether the trust deed includes a power to appoint a separate trustee in respect of those assets to be separated from the remaining assets.

For both cloning and splitting, care must be taken to identify the location of each asset of the trust for duty purposes, as different states have different requirements for each potential exemption.

Trust cloning

While the heyday of trust cloning ended with the abolition of the CGT "cloning" exemption (other than in relation to certain forms of fixed trusts), trust cloning is still potentially relevant for all forms of trusts, including testamentary trusts. Although in many instances cloning itself may no longer be effective from a tax perspective, it is important to understand its history from a tax perspective and its future from a stamp duty perspective.

Cloning was (and to some extent still is) an effective tool regularly used in succession planning, asset protection and arranging finance. A properly crafted trust clone arrangement can still be effective from a Queensland duty perspective. Cloning may therefore be worth considering if the tax consequences of the transfer can be otherwise managed, for example if:

(1) there has not been a significant increase in the market value of the asset since it was purchased;

(2) the small business CGT concessions in Div 152 ITAA97 are available; or

(3) the assets to be transferred are non-CGT assets which might otherwise be subject to duty and the income tax consequences can be managed.

As discussed in more detail below, trust splitting does not provide the same level of asset protection as trust cloning. As a result, trust cloning may still be appropriate in some circumstances if the CGT consequences of cloning can be otherwise managed.

Trust splitting

The practical uses of trust splitting are broadly the same as those of trust cloning. As there are different mechanisms required for trust splitting, however, the asset protection afforded is not as substantial as that from trust cloning.

As discussed above, trust cloning involves establishing a separate, discrete trust and transferring assets between the two trusts. Trust splitting, on the other hand, involves establishing a "sub-trust" within the original trust, so there is still only one trust, but different trustees are appointed for different assets held within that trust. The splitting of a trust does not involve a change to the beneficiaries or to the powers conferred on the trustee. The ability to split a trust will depend on the powers provided in the trust deed (which for most testamentary trusts is the will) to appoint a separate trustee in respect of those assets which have been split.

Diagram 1 illustrates the broad structural differences between the two approaches.

Trust splitting may not be ideal from a succession planning perspective, as there can be practical difficulties in relation to separating the control of the original trust and the sub-trust. In particular, as a minimum the following issues would need to be addressed:

(1) how any principal, appointor or guardian roles are structured under the trust deed;

(2) the effect of any family trust election (the potential ability to make a one-off change to a family trust election does not generally assist with trust splitting, as only one family trust election can be made for the trust as a whole); and

(3) the ability (or inability) to obtain separate tax file numbers and GST registrations for the original trust and the sub-trust, if required.

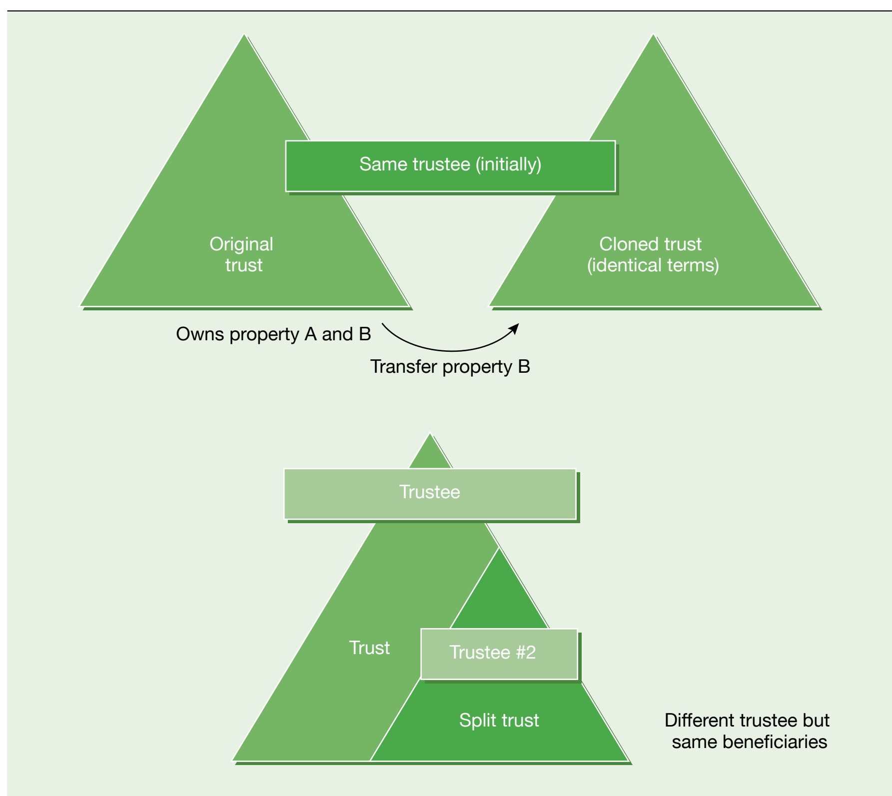
In some cases, where liability and asset protection issues are not important and some ongoing co-operation amongst the trustees of the original trust and the sub-trust is feasible, trust splitting can be a useful tool in succession planning.

As the assets are still held in the same trust, albeit with different trustees appointed, this effectively limits the CGT consequences of trust splitting. In particular, while there is a change of legal owner when a new trustee is appointed, the exception under the CGT rules regarding a mere change of trustee should be available.

The more difficult issue in most cases is that the terms of the will must permit splitting (ie allowing separate trust funds) and the power to appoint more than one trustee for those separate funds.

For trusts established outside a will, generally, it should be possible to insert the required powers into an existing trust deed without triggering a resettlement. This issue needs to be considered as part of a careful review of the trust deed and in the context of the ATO's position following the withdrawal of its statement of principles

Diagram 1



(SOP) on creation of a new trust (further comments in this regard are set out below).

In relation to testamentary trusts, the issues in this regard are more problematic because:

(1) many testamentary trusts have no variation power; and

(2) even if there is a variation power, use of it for any purpose may be invalid on public policy grounds (ie as it allows a will maker's directions to be changed after death).

Stamp duty

In relation to the stamp duty consequences of a trust clone or trust split, the rules in each state are different, in some instances depending on the underlying assets that are to be the subject of the rearrangement. It is therefore important to seek specialist advice before embarking on a trust clone or trust split. In broad terms:

(1) Queensland allows trust cloning of dutiable property without triggering stamp duty;

(2) it is possible to perform a trust clone in New South Wales in relation to shares in a land rich company (regardless of where that company is registered). There will, however, still be marketable securities duty payable if the company is registered in New South Wales or South Australia; and

(3) other states allow some form of trust splitting to occur without triggering a stamp duty liability, however, the exact mechanisms vary not only between jurisdictions, but also depending on the underlying assets involved and the terms of the existing trust deed.

Specific comments on the taxation consequences of splitting

As noted above (other than in relation to some forms of fixed trusts), the CGT exemption on trust cloning is no longer available. Generally CGT relief should be available on trust splitting and the basis for this is outlined in more detail below.

CGT events

The CGT events which may have potential application to a trust split are A1, E1 and E2.

CGT event A1 arises on a disposal of an asset. However, where there is a disposal as a result of a new trustee being appointed for particular assets, the exception regarding a mere change of trustee should be available.

CGT event E1 arises if a trust is created over a CGT asset. Splitting does not generally create a new declaration of trust or settlement. A new trust should not arise merely by appointing a new trustee in respect of particular assets held by the trust, and therefore CGT event E1 should not apply.

CGT event E2 occurs where an asset is transferred to a trust. With a trust split, CGT event E2 does not occur as the assets are still held in the same trust, although different trustees are appointed.

In ID 2009/86, it was decided that a trust split did trigger CGT event E1 on the basis that there was a "fundamental change to the rights and obligations attaching to the trust assets". In these particular circumstances, there were a number of factors which gave rise to the ATO's conclusion that a new trust had been created, namely:

(1) there was a release by the original trustee of its right of indemnity against the assets transferred;

(2) there was no right of indemnity by the new trustee against the assets which the original trustee retained;

(3) a separate appointor was nominated for the assets transferred to the split trust; and

(4) there was a narrowing of the class of beneficiaries who could benefit from the assets transferred to the split trust, by way of a family agreement in which beneficiaries agreed to limit the distributions of the split trust to particular beneficiaries, to the exclusion of others.

In summary, the ATO gave the following reasons for its conclusion that CGT event E1 occurred, namely:

(1) the trustee's rights were altered by excluding the transferred assets from its right of indemnity; and

(2) the rights of beneficiaries were altered in that the class of persons who could benefit from the transferred assets had been narrowed.

Resettlement

Trust resettlement is an area that continues to be important for trust splitting, especially where the original trust needs to be varied before the splitting takes place. The consequences of a resettlement include:

(1) all assets are treated as having been disposed of by the original trust and settled on the new trust (ie CGT event E1 occurs); and

(2) any losses in the trust are trapped and cannot be carried forward to offset income in the "new" trust.

> "A resettlement will arise where there has been an alteration … sufficient to constitute a new trust."

The ATO in its SOP provided an outline of what it believed may give rise to a resettlement of the trust. The guidance provided by the SOP indicated that a resettlement will arise where there has been an alteration to the trust sufficient to constitute a new trust relationship. The SOP confirmed that a mere change of trustee does not trigger a CGT event. However, the SOP noted that "a change in the trustee or the control of the trustee may be an element in arrangements which in their entirety amount to the creation of a new trust".

The ATO withdrew its SOP following the decision of the Full Court of the Federal Court of Australia in *FCT v Clark* (*Clark*)[10] in 2011. In that case, the trust in question was a unit trust which had been substantially changed over several years by changing the trustee, the beneficiaries and the trust property. In rejecting the Commissioner's argument that these amendments had amounted to a resettlement of the trust, the court held that the three factors to consider in determining whether there has been a continuum of the trust are:

(1) the terms of the trust deed (which as noted above, are normally set out in a will for testamentary trusts);

(2) the trust property; and

(3) the membership of the trust.

Further, the court confirmed that where the changes are within the scope of the variation power in the relevant trust deed, changes over time to the trust property and beneficiaries should not trigger a resettlement, provided that they can be identified at all times and there has not been a severance which would lead to the termination of the trust.

Following the withdrawal of its SOP, the ATO released TD 2012/21. This determination states the ATO's position formerly set out in its SOP was unsustainable following the court's decision in *Clark* and that:

> "Neither CGT event E1 nor CGT event E2 ... happens unless:
>
> the change causes the existing trust to terminate and a new trust to arise for trust law purposes, or
>
> the effect of the change ... is such as to lead to a particular asset being subject to a separate charter of rights and obligations such as to give rise to the conclusion that that asset has been settled on terms of a different trust."

Following the court's decision in *Clark* and the subsequent removal of the ATO's SOP, the risk of a resettlement on a trust split has clearly reduced. When structuring splitting transaction, however, it is arguably still the case that:

(1) the trustee indemnity provisions should be retained;

(2) no steps should be taken towards limiting the range of beneficiaries entitled to the assets of the trust, and in particular:

(a) no steps be taken by particular beneficiaries to renounce their entitlements in respect of the assets held in the split trust or the original trust; and

(b) no agreements should be made in respect of future distributions from the split trust or the original trust, ie the trustee of each trust should retain full discretion as to distributions in each year; and

(3) the trust deed should contain an express power permitting a separate trustee to be appointed to particular trust assets. As set out above, for testamentary trusts, this aspect may be particularly difficult to address, unless the relevant powers are in the will before the will maker dies.

Bespoke trustee company constitutions

As mentioned earlier in this article, one of the critical aspects of any estate planning exercise is determining what assets will in fact form part of the personal wealth to be distributed under a will. Set out below are specific comments in relation to the way in which personally owned assets can be controlled via tailored trustee company constitutions, where those companies are appointed as trustees for a testamentary trust. Virtually all of the comments are equally applicable to similar style control mechanisms for pre-existing discretionary trusts. Therefore, although the article will focus on testamentary trusts, many of the principles are likely to be relevant for similar trust structures established during a will maker's lifetime.

Control of testamentary trusts

Control of a testamentary trust will usually rest with two key roles, namely:

(1) the trustee; and

(2) the appointor (sometimes referred to as the principal, guardian, nominator or protector), if such a position exists.

The transfer of control of a testamentary trust can generally be dealt with through:

(1) providing for the succession of the role of appointor or individual trustee (if applicable), and in this regard, reviewing the terms of the will is imperative to ensure that control of the trust passes to the intended and appropriate successor or successors;

(2) transferring the shares in a corporate trustee (including the possibility of a share split in the corporate trustee); and

(3) careful drafting of the constitution or shareholders' agreement (if one exists) of the corporate trustee (where applicable).

"Corporatising" a discretionary trust

It is possible to provide for quasi corporatisation of a testamentary trust by appointing a corporate trustee and implementing a number of control mechanisms in the governing documentation of the company, for example a shareholders' agreement or bespoke company constitution.

It is generally accepted that it is not possible for a beneficiary of a testamentary trust to prescribe how the trustee can exercise its discretion, as this will contravene the fundamental principle of trust law that the discretion of a trustee of a discretionary trust cannot be fettered.

However, it is possible to utilise the rules in the *Corporations Act 2001* (Cth) (Corporations Act) as they apply to the corporate trustee to implement a specific framework in which the trustee can operate. This framework is often outlined in the constitution for the corporate trustee, or in a shareholders' agreement, which will often operate in conjunction with an interfamily agreement or a family constitution.

By inserting control mechanisms in the governing documents for a corporate trustee, it is possible to create specific levels of control over the trust and to ensure that the controllers of the trust exercise their discretion in a manner which is consistent with the family succession strategy.

Corporations Act

The Corporations Act provides that a company's constitution is a contract between the directors and the company (ie the members). Section 136(2) of the Corporations Act permits a constitution to impose additional obligations on directors and members, in addition to the requirements set out in the Corporations Act, provided that the constitution only varies the replaceable rules.

Generally, the director and decision-making control mechanisms hardwired into a bespoke constitution will only alter the replaceable rules, and as such, should be valid under the Corporations Act.

Further, the sections in the Corporations Act governing the transfer of shares are also replaceable rules, and therefore any requirements in a constitution confirming, for example, that a member may only transfer their shares to their lineal descendants will be valid under the Corporations Act.

Examples of control mechanisms which may be appropriate to include in a bespoke trustee company constitution:

(1) specifying how shareholder and director decisions should be made, including for example, that particular decisions may only be made by unanimous or special majority decision;

(2) a requirement that each shareholder should be entitled to appoint and remove a representative director;

(3) restrictions on the transfer of shares;
(4) restrictions on the class of people entitled to be a shareholder or director, for example limiting shareholders to lineal descendants of nominated family members;
(5) naming of specific successor directors upon the occurrence of specified events;
(6) the involvement of any independent (ie non-family) advisers in the management of the company and the extent of their involvement; and
(7) any triggers for the transition of control to particular people, for example, on family members reaching a specified age.

Achieving certainty in relation to distributions of wealth (ie trust distributions) is often an important part of the family succession strategy and this can be addressed in a number of ways, for example:

(1) inserting a distribution policy into an interfamily agreement or a family constitution, shareholders' agreement or constitution — for example, formulas or specific guidelines; or
(2) leaving discretion to the controllers of the wealth, but requiring that decisions in this regard be made unanimously, with reference to the guidance that is provided by, for example, a family council or professional advisers.

It is also necessary to ensure that the appointor roles align with the control mechanisms implemented for the corporate trustee. In some circumstances, it may be appropriate for the appointor provisions to be removed completely to centralise control with the corporate trustee, determined by its shareholding. In other circumstances, it may be appropriate to retain the appointor role and ensure that the succession of this role is "hardwired" into the terms of the will.

Where there are joint appointors, it is important to review the decision-making mechanisms and ensure that these align with the approach implemented at the trustee level. Where the appointor is a natural person, it is critical to understand how the will provides for the succession of this role on death or incapacity.

Domicile

As mentioned earlier in this article, stamp duty exemption from a true "cloning" perspective is only available in Queensland. Similarly, South Australia is unique currently as it is the only Australian jurisdiction that has effectively abolished the rule against perpetuities.

The question as to whether the controllers of a testamentary trust can "forum shop" the jurisdiction that they wish to be subject to is an area of some uncertainty. The main issues that would need to be considered are as follows:

(1) it is generally accepted that in order for a trustee to change the relevant jurisdiction, it must have the power to do so under the trust instrument;
(2) as mentioned above, given many testamentary trusts do not have any power to vary, this may in a practical sense, prevent a change of relevant law;
(3) in relation to the changing of jurisdiction to South Australia for perpetuity periods, in addition to the variation to change the relevant law, it would also be necessary in most testamentary trust instruments to formally amend the vesting date definition — again this may be prohibited for the reasons outlined above;
(4) even if a testamentary trust has a power to vary, it may be that a purported attempt to change the relevant law is held to be invalid on public policy grounds or, alternatively, due to the various rules prohibiting the delegation of testamentary powers;
(5) there remains some residual risk, despite *Clark*, that any change of relevant law may of itself (or when combined with other changes) constitute a resettlement for CGT purposes of the trust;
(6) depending on the underlying assets of the relevant trust, any purported change to the relevant law may not provide the intended benefits. For example, if there is a desire to transfer real property under a trust clone and that real property is located outside Queensland, even if the testamentary trust is regulated by Queensland laws there will still be an obligation to arrange for stamping in the jurisdiction the property is physically located; and
(7) this said, the practical restrictions on changing jurisdiction may not be as problematic in relation to trusts seeking to be subject to South Australian law for perpetuity purposes, although the issue in this regard remains largely untested.

Conclusion

In many respects, the ability to use creative planning for testamentary trusts is analogous to similar strategies for any other form of trust. There are, however, some fundamental differences in the way testamentary trusts can be adjusted. It is therefore critical to adopt a methodical approach that addresses all potential issues.

Given the increasing prevalence of testamentary trusts in the estate planning process and the massive amount of wealth that is likely to be subject to intergenerational transfer over the next 20 years, the planning opportunities in relation to testamentary trusts will in all likelihood only continue to become increasingly important.

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Disclaimer

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

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