Budget attack on excepted trust income: what's it likely to mean?

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The announcement in the 2018-19 Federal Budget that "*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*" (see 2018 WTB 19 [535]) was for many a surprise.

As is usually the case with Budget announcements attacking perceived arbitrage revenue opportunities, the exact impact of the changes will revolve almost entirely around how the legislation is crafted - the 2017 Budget changes to the small business CGT concessions being a recent a high-profile example of what appeared at announcement to be a narrowly focused change that in fact has proven to be significantly wider.

Thus, advisers in the estate planning industry should likely be concerned as to what the Government means by suggesting that the mischief to be addressed is "*that some taxpayers are able to inappropriately obtain the benefit of (a) lower tax rate by injecting assets unrelated to the deceased estate into testamentary trusts*."

In turn, the Budget statement that the "*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 proceeds of the disposal or investment of these assets)*" also has the distinct prospect of having much wider consequences than might otherwise be expected.

Excepted trust income rules currently

One of our previous articles in this *Bulletin* (see 2015 WTB 40 [1475]) explained that pursuant to Div 6AA of the ITAA 1936 and, in particular, subs 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.

Where income is excepted trust income and it is distributed to minors, those minors are taxed as adults, instead of the normal penal rates that otherwise apply to unearned income.

Currently, subss 102AG(2)(a)(i) and 102AG(2)(d)(i) of Div 6AA make it clear that the provisions are not limited to income derived from estate assets.

Importantly, the subsections only prescribe how the trust estate is deemed to have arisen and do 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 on behalf of the testamentary trust to borrow money and acquire assets which earn income, then it has generally been accepted that Div 6AA applies to that income.

Current limitations

Section 102AG(3) currently contains an exception for non-arm's length arrangements. In particular, it provides that if any 2 or more parties to:

(1) the derivation of the excepted trust income mentioned in subsection (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.

Furthermore, s 102AG(4) provides that an amount will not be treated as excepted trust income if it was derived by a trustee as a result of an agreement entered into for the purpose of securing that the income would be excepted trust income.

Furse's case

The Trustee for the Estate of the late AW Furse No 5 Will Trust v FCT (1990) 21 ATR 1123 ("Furse") 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 with 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 also be arm's length parties.

The Court noted that provided the trust estate was created by a will and the arm's length test was satisfied, then any income of a testamentary trust would be considered as excepted trust income.

What might new rules attack?

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 willmaker.

In theory, this type of probation would be similar to what is currently the case with post death testamentary trusts (often referred to as estate proceeds trusts) set up to comply with s 102AG. Indeed, this style of tracking mechanism is analogous to that which trustees are meant to undertake in relation to ensuring trust assets vest within the perpetuity period.

Thus, any further assets gifted or settled on a testamentary trust, other than by the willmaker, would be segregated from excepted trust income purposes.

Depending on the drafting approach adopted, however, some areas that may be impacted (potentially unintentionally) by the new rules include:

- 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?
- 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?

In conclusion: some further questions

Testamentary trusts (and, in turn, access to excepted trust income) only arise because someone has died.

Traditionally, in Australia, death has not been seen as a tax planning strategy.

The 2018 Budget announcement arguably changes the position in this regard.

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 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.