Testamentary Trusts and Excepted Trust Income - The New Normal

- by Matthew Burgess, Director, View Legal

One of the main advantages of a testamentary trust ("TT") set up under someone's will is that the terms can be drafted such that it complies with the requirements set out in s 102AG(2)(a)(i) of the ITAA 1936.

This means the income allocated to minor children each year 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 $700 distributed to a child is tax-free, but then any further income is taxed at the highest rate which could be up to 66%).

Instead, infant children are assessed at the normal, individual rates (approximately $22,000 tax-free and the balance at normal adult rates).

The historical advantages of TTs have, however, been undermined by changes first announced by the Government as part of the May 2018 Budget.

2018 Budget changes

The announcement in the 2018 Federal Budget that the long-standing rules in this area would be attacked was a surprise for many.

The Government at the time stated *"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"*.

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.

Pursuant to Div 6AA of the ITAA 1936 and in particular, s 102AG(2)(a)(i), excepted trust income ("ETY") 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.

As is usually the case with Budget announcements that attack perceived arbitrage revenue opportunities, the exact impact of the changes revolved almost entirely around how the legislation is crafted.

Legislative provisions

With the unexplained retrospective effect from 1 July 2019, the new rules were crafted as follows:

(2AA) For the purposes of paragraph (2)(a), assessable income of a trust estate is of a kind covered by this subsection if:

(a) the assessable income is derived by the trustee of the trust estate from property; and

(b) the property satisfies any of the following requirements:

(i) the property was transferred to the trustee of the trust estate to benefit the beneficiary from the estate of the deceased person concerned, as a result of the will, codicil, intestacy or order of a court mentioned in paragraph (2)(a);

(ii) the property represents accumulations of income or capital from property that satisfies the requirement in subparagraph (i);

(iii) the property represents accumulations of income or capital from property that satisfies the requirement in subparagraph (ii), or (because of a previous operation of this subparagraph) the requirement in this subparagraph.

Key planning issue

A key question in relation to the rules was focused on the way in which the restrictions operate in the context of a husband and wife preparing wills incorporating TTs. In particular, are there any tax consequences that flow from preparing (say) the husband's and wife's wills to reflect that, in the event the husband predeceases the wife (for example), the wife's will provides that her assets will be gifted into the TT previously set up under the husband's will.

Focusing solely on the ETY position, the new rules unfortunately make it clear that in this situation, the income earned on the wife's assets gifted to the husband's TT will not give rise to ETY.

The reason for this is that the legislation mandates that the "*property (must be) transferred to the trustee of the trust estate to benefit the beneficiary* ***from the estate of the deceased person*** *concerned*". [Emphasis added]

It is understood many industry specialists made submissions on the draft legislation on this point (which were ignored) along the following lines:

"The draft legislation is focused on "the deceased person concerned", and it is unclear why this restriction is relevant.

For example, for most couples who both implement testamentary trusts, it will be the case that they will die at different times and there will often be a desire to transfer assets between testamentary trusts.

It is clearly the case that the excepted trust income rules should continue to apply in situations where a couple both implement testamentary trusts.

To argue otherwise would again see the proposed amendments extend significantly beyond the stated intent of the announced measure and impact taxpayers in a range of circumstances where there is no inappropriate tax benefit received by a beneficiary."

Conclusion

Unfortunately then, for all advisers in this space, there is now a further complication that needs to be managed that potentially increases the tax-related administration aspects of deceased estates.

This said, despite the changes, TTs are likely to remain a key tax planning strategy for many advisers and their clients.