

Budget backflip on testamentary trusts not all that it seems

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By confusing taxpayers into actively avoiding taking any estate planning steps until the proposals are finalised, which appears to have been the case since budget night in May, tax revenue targets may in fact be achieved more easily, writes Matthew Burgess.

Last week's backflip by the federal government over the proposed attack on testamentary trusts has received widespread support from specialists across the profession.

Already, however, there are concerns that the announcement is simply part of a wider pattern of tactics akin to a form of '3D chess'. That is, proposing particularly draconian taxes, and then watering them down to allow an easier pathway for the passage of the truly intended changes.

Certainly, following the hugely controversial proposal to tax unrealised capital gains, the lobbying to prevent that one aspect of the attack on self-funded retirees, meant that few (if any) of the aspects of the proposals faced any level of successful resistance.

And so too, the detail of the apparent backdown on the budget's 'death tax by stealth' may mean that the majority of the government's objectives may be achieved.

Death may still be tax evasion

Douglas Adams (of 'The Hitchhiker's Guide to the Galaxy' fame) once claimed he needed to 'spend a year dead for tax purposes'.

The government's headline backdown on its proposed changes to the taxation of testamentary trusts came with potentially far-reaching fine print that appears to treat the Adams' quote as a 'true fact'. That is, the backdown will only exempt testamentary trusts that the Tax Office concludes are for 'genuine testamentary purposes'.

Given that testamentary trusts can only be established under a will, and a will can only have legal effect on death, there are already concerns that the government has retained the flexibility to push through death-tax-style outcomes via sleight of hand.

Furthermore, a previous government attack on testamentary trusts which was pushed largely unnoticed, continues to adversely impact taxpayers.

A quiet but powerful change

The 2018 budget announced that concessional tax rates for minors receiving income from testamentary trusts would be restricted. Specifically, those rates would apply only where the income was derived from assets that originated from the deceased estate, or from proceeds or reinvestments of those assets.

At face value, the measure appeared targeted. However, when the legislation was finally introduced, it took effect retrospectively from 1 July 2019, a move that has drawn ongoing criticism from lawyers for lacking clear policy justification.

The practical consequence is that many long-standing strategies involving the injection of new assets into testamentary trusts, often a cornerstone of flexible family tax planning, have been neutralised, and will remain so despite last week's wind back.

Spousal planning under pressure

Perhaps the most significant impact has been on traditional "second-to-die" strategies.

Historically, it has been common for a surviving spouse to direct assets into a testamentary trust under their will, allowing income to be streamed tax-effectively to children and grandchildren.

Under the revised 2018 rule that remains in place, however, this approach can result in the loss of concessional tax treatment for minors if the assets were not originally derived from the first deceased estate. Advisers say this effectively imposes an additional layer of tax, reshaping outcomes that had long been considered settled.

In some cases, practitioners argue the effect is akin to a "quasi death duty" – not through an explicit tax on the estate itself, but through the erosion of expected tax outcomes across generations.

Structural tensions with family trust rules

Compounding the issues highlighted by the 2018 and (proposed) 2026 budget changes, however, is the interaction with Australia's separate family trust election (FTE) regime, an area already known for its complexity.

Where a trust seeks to access benefits such as franking credits, it will often need to make an FTE and nominate a "test individual". Crucially, at least according to the Tax Office, that individual must be alive at the time of the election.

This creates a structural tension for testamentary trusts, which by definition only come into existence upon death.

Misalignment in FTE settings or family group definitions can expose trusts to the Family Trust Distribution Tax (FTDT), currently imposed at the top marginal rate.

The risk is not theoretical. High-profile disputes, including one involving a prominent South Australian family (founders of Thomas Foods International), have highlighted how technical FTE missteps can trigger FTDT liabilities exceeding \$13 million.

Broad exposure across families

Although such cases attract attention due to their scale, advisers emphasise that the underlying issues are far more widespread.

Almost any family that uses discretionary trusts, particularly testamentary discretionary trusts, is potentially affected.

The challenge lies in the cumulative effect of multiple rules: the limitation on concessional treatment for minors, the constraints on asset flows between estates and trusts, and the strict boundaries imposed by family trust elections.

Causing chaos to achieve a revenue grab

Perhaps most insidiously, the pattern of radically attacking legitimate and long-standing structuring arrangements, and then announcing wind-backs by press release, arguably achieves much of what is actually intended.

That is, for taxpayers and advisers alike, the complexity and uncertainty created means that in an area that already struggles with willmakers delaying implementation, inertia becomes the default response.

Could it be the government, in another 3D chess play, knows that the tax revenue generated by taxpayers failing to put in place any estate planning arrangements is materially higher than anything that would have been generated by the budget attack on testamentary trusts?

By confusing taxpayers into actively avoiding taking any estate planning steps until the proposals are finalised, which appears to have been the case since the budget night in May, the tax revenue targets may in fact be achieved more easily.

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