

“Absolute entitlement” and its importance for beneficiaries of deceased estates

THE EXISTENCE OF AN ABSOLUTE ENTITLEMENT ENABLES A BENEFICIARY TO TERMINATE A TRUST IN RESPECT OF A PARTICULAR ASSET.



INTRODUCTION

This article considers the issue of “absolute entitlement” in the context of deceased estates. The existence of an “absolute entitlement” may be important if one beneficiary is seeking the distribution of a certain asset in circumstances where there are also other beneficiaries with an entitlement to the estate.

Whilst the existence of an “absolute entitlement” in favour of a beneficiary gives a beneficiary the right to call for the asset to be transferred to them by the trustee, it also has significant capital gains tax (“CGT”) consequences. An absolutely entitled beneficiary is considered for CGT purposes to be the taxpayer, rather than the trustee. Therefore, knowing when an absolute entitlement exists is important.

WHAT IS AN “ABSOLUTE ENTITLEMENT”?

The legal concept of absolute entitlement is derived from the decision in *Saunders v Vautier*¹. The longstanding rule established by this case is that the test of absolute entitlement is not whether the beneficiaries can together agree to end the trust, but whether a particular beneficiary can terminate the trust, or at least terminate the trust in respect of a particular asset.

The point in time when a beneficiary becomes absolutely entitled to a CGT asset of a trust as against the trustee has been considered by the Commissioner in draft taxation ruling TR 2004/D25 (“**Draft Ruling**”). The Draft Ruling was released on 15 December 2004 and at the date of writing this article has not been finalised. The latest comment on the position of the Draft Ruling is in the ATO’s public ruling program monthly update dated 9 May 2007 which states that

there are ongoing discussions with Treasury and industry occurring. Those discussions are taking place through the National Tax Liaison Group’s (NTLG) Trust Consultation Group where the impact of the recent High Court decision in *CPT Custodian*² and related cases is still being considered.³ Although the issue has now been removed from the public rulings program, the rulings program comment states that “TR 2004/D25 will not be withdrawn and still represents the Tax Office view of the law”.

The time when an “absolute entitlement” arises is significant as it gives rise to CGT event E5 (s 104-75 of the *Income Tax Assessment Act 1997* (“**ITAA97**”). There are tax consequences for both the trustee and the beneficiary. The trustee makes a capital gain if the market value of the asset is more than its cost base and the asset is a post-CGT asset. The beneficiary makes a capital gain if the market value of the asset is more than the cost base of the beneficiary’s interest in the trust.

However, there are a number of important exceptions. CGT event E5 does not arise where a beneficiary of a deceased estate, to which Div 128 applies, becomes absolutely entitled to an asset of the estate. Further, the beneficiary will not derive a capital gain or capital loss if the beneficiary acquired his or her interest for no expenditure, for example an interest in a discretionary trust.

After an absolute entitlement is established, s 106-50 of the ITAA97 provides that if you are absolutely entitled to a CGT asset as against the trustee, then any act done by the trustee in relation to the asset will be treated as if the beneficiary had done it. This highlights the importance of a beneficiary being able to recognise when they have an absolute entitlement so they can control when a tax liability will arise.

HOW DO YOU ESTABLISH AN “ABSOLUTE ENTITLEMENT”?

For a beneficiary to establish an absolute entitlement the following factors must be present:

- The beneficiary must establish that he or she has an interest in the trust. This will be impossible if the beneficiary is a beneficiary of a discretionary trust. In this case an absolute entitlement will only arise after an appointment in favour of the beneficiary is made by the trustee.
- The beneficiary’s interest must be vested in possession and not contingent or conditional upon an event occurring in the future. This requires that the beneficiary has an immediate right to possession of the asset of the trust.
- The interest must not be defeatable by any actions or events.
- The beneficiary is the sole beneficiary, or if there are multiple beneficiaries the trust assets are:
 - Fungible
 - The principles of equity would allow a beneficiary to have their interest satisfied by an allocation of a specific number of assets
 - There is a clear understanding by the beneficiaries that a beneficiary is exclusively entitled to particular trust assets.

“ABSOLUTE ENTITLEMENT” IN THE CONTEXT OF A DECEASED ESTATE

The starting point for deceased estates is that a beneficiary does not have an interest in any estate assets until the administration of the estate is complete. This occurs when

the executor has provided for all debts and for the distribution of specific assets or legacies and can therefore ascertain the residue with certainty.

At the completion of the administration, if there is a single beneficiary and no restrictions on the entitlement to the estate assets then the single beneficiary will have an absolute entitlement. CGT event E5 will not occur due to the specific exception for assets acquired from deceased estates.

The existence of multiple beneficiaries of a deceased estate makes the issue more complicated. Assuming that there are no conditions or restrictions placed upon the beneficiaries' entitlements, an absolute entitlement for a beneficiary will only exist if:

- the assets are fungible; or
- the will clearly sets out which beneficiary is to get which asset; or
- the trustee or executor and beneficiaries agree that particular assets be set aside for particular beneficiaries to the exclusion of the others.

An estate is comprised of fungible assets if each asset has the same characteristics, for example shares in a particular company. This means that assets such as land, furniture and jewellery will rarely be fungible.

The tax consequences of the will setting out how particular assets are to be distributed is that an absolute entitlement arises without CGT event E5 occurring as the trust is one to which Div 128 of the ITAA97 applies.

An agreement reached between the trustee or executor and beneficiaries will not receive the same concessional treatment unless the agreement is a deed of arrangement of the type described in s 128-20 of the ITAA97. This requires that the agreement is reached to settle a claim to participate in the estate and requires genuine dissatisfaction on the part of a beneficiary. Without these characteristics the arrangement is not covered by Div 128 of the ITAA97 and CGT event E5 will arise when the beneficiaries and trustee reach arrangement about the distribution of the assets.

Therefore, it is clear that if assets of an estate are not fungible it is important for a will to state specifically how the assets are to be distributed. In the absence of such direction each beneficiary will have an interest as tenant in common in each asset and the disposal or exchange of these interests to enable a beneficiary to own a whole asset may give rise to further unintended tax consequences.

Practitioners should continue to monitor these issues, particularly as the Commissioner, Treasury and members of the NTLG's Trust Consultation Group work towards clarifying the meaning of "absolute entitlement".

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Reference notes

1 (1841) 49ER 282

2 [2005] HCA 53

3 NTLG draft minutes for 7 December 2006 page 102