

# Special disability trusts – tax and State duty treatment changes

RECENT AND PROPOSED CHANGES ARE ADDRESSING SHORTCOMINGS IN THE TAX AND STATE DUTY TREATMENT OF SPECIAL DISABILITY TRUSTS.



## INTRODUCTION

As from 20 September 2006 amendments to the Social Security Act 1991 (**SSA 1991**) have allowed for the establishment of special disability trusts (**SDTs**) designed to assist those with special disabilities and their immediate families to provide for the care and accommodation of those with special disabilities without adversely affecting any existing pension entitlements.

Since the birth of SDTs, and as their use has become more widespread, a number of shortcomings have become apparent which have made them less attractive than they might otherwise have been.

This article will focus on three major areas where these shortcomings have been identified in the light of recent and proposed changes. These three areas are:

- the taxation treatment of income within SDTs;
- the capital gains tax (**CGT**) treatment of CGT assets held in SDTs; and
- the State duty treatment of deeds establishing SDTs and, more importantly, the treatment of transfers of dutiable property into SDTs.

This article is not intended to include any detailed analysis of the provisions of the SSA 1991 and the relevant rules and guidelines governing the operation of SDTs and the requirements for them to qualify as SDTs. Those rules have remained largely unchanged since commencement. For a detailed analysis of the rules see Ron Jorgensen's article in the November 2006 TIA Journal.<sup>1</sup>

## THE SDT RULES – A QUICK SUMMARY

In order to understand the context of the tax and State duty treatment issues, it is necessary to have a basic understanding of the rules governing SDTs and so the following is a brief summary of the core provisions which make up the framework of the SDT regime:

- There must be a person who is identified as being a person with a disability. For the purposes of the SSA 1991 (and in this article) this person is referred to as the principal beneficiary (**PB**).
- Each SDT established can only have one PB.<sup>2</sup>
- Each PB can only have one SDT.<sup>3</sup>
- If the PB is 16 years of age or over then the PB must already qualify for a disability support pension, carer pension and not be working or be able to work at or above the relevant minimum wage as a result of the disability.<sup>4</sup>
- If the PB is less than 16 years then the PB must have a severe disability or a severe medical condition, have relevant certification from treating health professionals and be assessed and certified as having a severe disability by the Department of Social Security.<sup>5</sup>
- Upon a PB's death the SDT can no longer be an SDT.<sup>6</sup>
- Income and capital of the SDT can only be used for the care of, and accommodation for, the PB.<sup>7</sup>
- The income of an SDT is not income of the PB for the purposes of SSA 1991 and so does not affect the PB's pension entitlements.<sup>8</sup>

- The value of assets of the SDT are not attributed to the PB for the purposes of the SSA 1991 up to a maximum asset value (excluding the PB's principal residence) indexed annually and currently \$551,750.<sup>9</sup>
- The value of any assets transferred to an SDT by a PB's immediate family member (parent, step-parent, legal guardian, grandparent or sibling) will not be treated as a disposal which would otherwise affect the pension entitlement of the immediate family member who made the transfer to the extent of an (unindexed) amount of \$500,000<sup>10</sup> but such transfers may affect the immediate family member's pension later if the SDT ceases to exist within five years of the transfer.<sup>11</sup>
- A PB and his or her spouse can transfer assets into an SDT but only if made from a bequest or superannuation death benefit within three years of receipt.<sup>12</sup>

## INCOME TAX TREATMENT

The tax treatment of income derived by an SDT currently depends on a number of issues, principally:

- Whether or not the PB is under a legal disability; and
- Whether or not all of the income of the SDT is expended so that the PB can be said to be presently entitled.

Is the PB under a legal disability?

Whilst the PB must have some kind of disability in order to qualify to have an SDT, this does not necessarily mean that the PB is under a legal disability for the purposes of Div 6 of Part III of the Income

Tax Assessment Act 1936 (ITAA 1936). If the PB is under 18 years of age then he or she is under a legal disability because of their age. If the PB is 18 years or over he or she may still have sufficient mental capacity to be able to provide a proper receipt to the trustee of a trust and therefore not be under a legal disability. In other words, if the disability is physical with no mental incapacity then the PB will not be under a legal disability.

#### Has all income of the SDT been expended?

This question is relevant because of the requirement that the income and capital of an SDT be used for the care and accommodation of the PB. If all of the income in a relevant tax year is applied towards the costs of care and accommodation for the PB then the PB will be presently entitled to the income for the purposes of Div 6 of ITAA 1936. If however it is not possible for the trustee of the SDT to expend all income on the care and accommodation expenses of the PB (ie where the income of the SDT is greater than the expenses) then the amount not expended cannot be distributed and the PB will not be able to be treated as being presently entitled to that portion of the income.

#### Analysis and application of section 99A

The answer to the first of these questions only has relevance in identifying the person who is liable to tax on the SDT income, however the answer to the second question could have a significant effect on the rate of tax payable on the income. The reason for this lies in the operation of s 99A of ITAA 1936 which effectively provides for tax to be paid on income of a trust at the top marginal rate plus Medicare levy, where no person is presently entitled to the income and the Commissioner is not of the opinion that it would be unreasonable for s 99A to apply.

This issue only arises in the context of an SDT established *inter vivos* (ie by settlement of money or property from a living person). If the SDT was established under a will then s 99A will not apply.<sup>13</sup>

#### Proposed change

This shortcoming in the operation of SDTs was the subject firstly of a Government announcement in the 2009/10 Federal

Budget but more recently, and in more detail, in the recent Federal Government Consultation paper<sup>14</sup> (the consultation paper). The section in the consultation paper dealing with this issue makes it clear that, in the case where not all of the income of an SDT is expended in any one year then the trustee of the SDT will be subject to tax at the top marginal rate plus Medicare levy on the unexpended income under s 99A ITAA 1936. The consultation paper then goes on to detail the proposed change to address this issue as follows:

#### “Proposed changes to the Income Tax Law

To ensure that in all cases, the unexpended income of an SDT is taxed at the relevant beneficiary’s personal income tax rates it is proposed that the trustee of an SDT be the primary taxing point for the income of the SDT.

Under this proposal:

- the trustee would be assessable on the net income of the trust, whether or not the beneficiary is presently entitled to any part of the income of the trust in the income year (that is, whether or not the trustee has applied any of the income of the trust to pay for the reasonable care and accommodation costs of the beneficiary of the SDT);
- the trustee would pay tax on the net income of the trust as if it were income of an individual (that is, at personal rates of tax);
- the beneficiary would also include the amount of the net income of the trust in their assessable income (but not a tax loss). However, the beneficiary would be entitled to a credit for the tax paid by the trustee. If the beneficiary has no other taxable income, it may

be open to the Commissioner of Taxation not to require the beneficiary to lodge a tax return (given that the correct amount of tax would have been paid by the trustee).

To give effect to this outcome, it is proposed that special rules dealing specifically with SDTs established in accordance with the *Social Security Act 1991* be inserted into Div 6 of the ITAA 1936.”

A summary of the current and proposed taxation treatment of income within an SDT is set out in Tables 1A and 1B below.

#### CGT TREATMENT

Currently there are no special rules which apply to SDTs for the purposes of CGT exemptions and concessions. This means that:

- If the trustee of an SDT disposes of an asset there may be a net taxable gain to the trustee if the value of the asset at the time of its disposal exceeds the asset’s cost base in the hands of the trustee.
- No main residence exemption is claimable by the trustee of an *inter vivos* SDT upon the sale of the main residence of the PB.
- The main residence exemption may be applicable to the disposal by the trustee of a testamentary SDT of the main residence of the PB.<sup>15</sup>

#### ANALYSIS AND PROPOSED CHANGE

It would not be uncommon for a PB’s residence to be held or purchased within an SDT and it has been largely viewed

Table 1A

Income tax treatment of inter vivos SDTs – current		
	PB not under legal disability	PB under legal disability
Expended Income	PB taxed at individual marginal rates under s.97	T taxed at individual marginal rates under s.98
Unexpended Income	T taxed at top marginal rate plus Medicare levy under s.99A	T taxed at top marginal rate plus Medicare levy under s.99A

Table 1B

Income tax treatment of SDTs – proposed (inter vivos and testamentary)		
	PB not under legal disability	PB under legal disability
Expended Income	T taxed at individual marginal rates under s.97	T taxed at individual marginal rates under s.98
Unexpended Income	T taxed at individual marginal rate under new special provisions	T taxed at individual marginal rate under new special provisions

as unfair that the CGT main residence exemption is lost where this occurs within an *inter vivos* SDT, whereas if the PB had held the main residence in their own name (if that were possible) then the main residence exemption would apply. This issue was also identified within the Budget announcement and subsequent consultation paper referred to above and, again, the proposed change as set out in the consultation paper is re-produced below for convenience:

**“Proposed changes to the capital gains tax law**

Under the proposal, the trustee of an SDT will be able to disregard a capital gain or capital loss where a CGT event happens in relation to a dwelling that is used by the beneficiary as their main residence, to the extent that would be allowable if the beneficiary was able to own the dwelling directly.

To give effect to this outcome, it is proposed to modify subdiv 118-B of the ITAA 1997.”

A summary of the current and proposed CGT treatment of SDTs as discussed above is set out in Table 2 below.

**STATE DUTY TREATMENT**

There are a number of areas where State duty may be payable in relation to the establishment, operation and termination of SDTs as follows:

- Flat rate duty on the deed establishing the SDT (ie where the trust is established with a nominal settled sum).
- *Ad valorem* duty (duty calculated according to value) on the value of dutiable property<sup>16</sup> forming part of the initial trust fund of an *inter vivos* SDT (eg where parents of a PB own property which they wish to put in the SDT but they are also trustees of the SDT so the SDT is established by a declaration of trust over the property by the parents).
- *Ad valorem* duty on the transfer of dutiable property from immediate family members to the SDT.

- *Ad valorem* duty on the transfer of dutiable property from an SDT to the PB by way of in specie distribution whilst the SDT continues or at its termination.
- *Ad valorem* duty on the transfer of dutiable property from an SDT in specie to a residuary beneficiary of the SDT upon termination of the SDT as a result of the death of the PB.

To date only two jurisdictions (Victoria and Western Australia) have enacted any legislation specifically dealing with special disability trusts and these provisions relate only to the first three of the above potential duty issues, each of which is discussed more fully below.

**Flat rate trust deed duty**

For SDTs established by deed on or after 6 May 2008 in Victoria the trust deed will be exempt from the usual \$200.00 trust deed duty where the settlor or settlors of the trust is or are immediate family members of the PB.<sup>17</sup>

Table 2

CGT treatment of SDTs			
	Current position inter vivos SDTs	Current position Testamentary SDTs	Proposed position all SDTs
Disposal of main residence of PB	Taxable	Exempt	Exempt
Disposal of other CGT assets	Taxable	Taxable	Taxable

Table 3

State duty treatment of SDTs								
	VIC	NSW	QLD	SA	WA	TAS	ACT	NT
Flat rate trust deed duty on establishment	Exempt (1) (usual duty \$200)	\$500	Nil	Nil	\$2.00 per deed	\$20	Nil	\$20 plus \$5 per copy
<i>Ad valorem</i> duty on declaration of trust over dutiable property	Exempt up to \$500,000 (2)	Market value of property transferred	Market value of property transferred	Market value of property transferred	Market value of property transferred	Market value of property transferred	Market value of property transferred	Market value of property transferred
<i>Ad valorem</i> duty on transfer of dutiable property to SDT	Exempt up to \$500,000 (3)	Market value of property transferred	Market value of property transferred	Market value of property transferred	Exempt (unlimited value)	Market value of property transferred	Market value of property transferred	Market value of property transferred

(1) If settlor is immediate family member of PB

(2) If person declaring trust is immediate family member of PB

(3) If person transferring to SDT is immediate family member of PB

In all other jurisdictions in Australia the trust deed establishing the SDT will be subject to trust deed duty (if any) in the usual way. For a summary of this see Row 1 in Table 3.

#### Ad valorem duty on establishment of an SDT by a declaration of trust

In Victoria, a declaration of trust over dutiable property which establishes an SDT is wholly exempt if the market value of the dutiable property transferred does not exceed \$500,000.<sup>18</sup> If the market value of the dutiable property transferred exceeds \$500,000 then duty is payable on the excess of the market value over and above \$500,000.<sup>19</sup>

In all other jurisdictions in Australia, a declaration of trust over dutiable property to establish an SDT will give rise to liability for *ad valorem* duty on the market value of the property the subject of the declaration. For a summary of the potential duty position in the relevant States see Row 2 in Table 3.

#### Ad valorem duty on transfer of dutiable property to an SDT

In Victoria, a transfer of dutiable property made on or after 6 May 2008 to the trustee of a special disability trust by an immediate family member will be wholly exempt from duty if the market value of the dutiable property does not exceed \$500,000.<sup>20</sup>

If the market value of the dutiable property exceeds \$500,000 then duty will be payable on the excess of the market value over and above \$500,000.<sup>21</sup>

In Western Australia, no duty is chargeable on a transfer of, or an agreement for the transfer of, dutiable property to a special disability trust if there is no consideration for the transfer.<sup>22</sup>

In all other jurisdictions in Australia the usual provisions as to the liability for duty on transfers of dutiable property into trusts will apply with the result that *ad valorem* duty will be payable on the market value of the property transferred. For a summary of the potential duty position in the relevant States, see Row 3 in Table 3.

#### Ad valorem duty on *in specie* distributions from SDTs

There are no special rules applying in any jurisdictions in Australia to the *in specie* distribution of dutiable property from

an SDT whether to a PB or a residuary beneficiary. A detailed discussion of the relevant provisions in each State and Territory jurisdiction applying to *in specie* distributions from trusts generally is beyond the scope of this article. Suffice to say that whilst there are a number of exemptions which could apply to transfers of Victorian dutiable property in these circumstances, in most other Australian jurisdictions liability to *ad valorem* duty on the market value of the property distributed is likely to arise.

### CONCLUSION

The State duty exemptions in Victoria and Western Australia referred to above are already in force and obviously are of significant potential benefit to those persons who have, or are contemplating the establishment of, SDTs in those jurisdictions.

Whilst the proposed changes to the income tax and CGT treatment of SDTs set out in the consultation paper are yet to become law, it would seem to be unlikely they would be voted against by any party or independent. Further, it would seem to be reasonable to expect that the proposed changes will be legislated in the current tax year. According to the budget announcement (and repeated in the consultation paper) the income tax changes will apply to income derived from the 2008/09 year onwards and the CGT charges will apply to capital gains made in the 2009/10 year or later years.

In particular the proposed tax changes will make the establishment of *inter vivos* SDTs as attractive as those set up within a will. This will assist persons with disabilities and their immediate families in being able to bring forward the potential benefits of SDTs by establishing them now rather than waiting until the death of an immediate family member.

Given the above, it would be reasonable (and in fact recommended) for those with special disabilities and their immediate families to seek advice now on either of the potential for transfer of assets to existing SDTs or the establishment of new SDTs once the proposed tax changes become law.

Philip Lambourne  
Harwood Andrews Lawyers

### Reference notes

- 1 "Social Security Special Disability Trusts" by Ron Jorgensen, *Taxation in Australia* Vol. 41 No. 5, November 2006
- 2 Section 1209M(1) SSA 1991
- 3 Section 1209M(6) SSA 1991
- 4 Section 1209M(2) SSA 1991
- 5 Section 1209M(4) SSA 1991
- 6 Section 1209M(5) SSA 1991
- 7 Section 1209N SSA 1991
- 8 Section 1209X SSA 1991
- 9 Section 1209Y SSA 1991
- 10 Section 1209Z SSA 1991
- 11 Section 1209ZD SSA 1991
- 12 Section 1209R SSA 1991
- 13 Section 99A(2)(a)(i) ITAA 1936
- 14 "Greater fairness and equity in the taxation of Special Disability Trusts, Consultation Paper August 2009"
- 15 Section 118-195 of *Income Tax Assessment Act 1997* (ITAA 1997)
- 16 What is or is not "dutiable property" varies in each State or Territory. In Victoria for example it is largely limited to land and certain interests in land, however in other jurisdictions dutiable property also includes most non-land business assets.
- 17 Section 38A(1)(a) of *Duties Act 2000* Victoria
- 18 Section 38A(1)(a) and s 38A(4) *Duties Act 2000*
- 19 Section 38A(5) *Duties Act 2000*
- 20 Section 38A(1)(b) and s 38A(4) of the *Duties Act 2000*
- 21 Section 38A(5)
- 22 Section 111 of *Duties Act 2008* (WA)