

Death and no testamentary trusts – is it too late for minor children?



INTRODUCTION

Testamentary trusts are recommended by practitioners engaged in estate planning for asset protection reasons and also, in some part, for the concessional tax treatment afforded to income of the testamentary trust distributed to or applied for the benefit of beneficiaries under the age of 18 years (minor beneficiaries). This article looks beyond the use of testamentary trusts in estate planning and analyses opportunities that may or may not exist for concessional tax treatment to be afforded to income derived by minor beneficiaries from a trust estate that is not a testamentary trust (ie an inter vivos trust).

DIVISION 6AA

Division 6AA of the *Income Tax Assessment Act 1936* (ITAA36) provides special rules for determining the tax payable on the eligible assessable income of a minor. For the purposes of Div 6AA, a minor is defined as a person who is less than 18 years of age on the last day of the year of income and who is not an “excepted person” in relation to the year of income (s 102AC).

The special rules provide that a lower tax free threshold and special rates of tax apply to the taxable income derived by the minor. The rate of tax applicable to the Div 6AA income is prescribed in the *Income Tax Rates Act 1986* and is currently set at 47 per cent. The tax free threshold is reduced to \$416. The special rules apply to the minor beneficiary’s share of income of a trust estate that is not “excepted trust income” (subs 102AG(1)). The types of excepted trust income are listed in s 102AG.

“INCOME OF A TRUST ESTATE THAT RESULTED FROM A WILL” – THE TESTAMENTARY TRUST

One type of excepted trust income is assessable income of a trust estate that resulted from a will. Subpara 102AG(2)(a)(i) states:

“(2) Subject to this section, an amount included in the assessable income of a trust estate is excepted trust income in relation to a beneficiary of the trust estate to the extent to which the amount:

- (a) is assessable income of a trust estate that resulted from:
 - (i) a will,....”

Accordingly, as the income of a testamentary trust is “income of a trust estate that resulted from a will”, the income is excepted trust income and the special rules in Div 6AA will not apply to income distributed by the testamentary trust to a minor beneficiary. That is, income of a testamentary trust distributed to a minor beneficiary is taxed at normal adult marginal rates with the benefit of the standard adult tax free threshold of \$6,000.

OTHER PROVISIONS ALLOWING INCOME TO BE “EXCEPTED TRUST INCOME”

Sub-paragraph 102AG(2)(d)(ii) provides that, in certain circumstances, income of a trust (which is not a testamentary trust) may be afforded concessional tax treatment where the income is distributed to or applied for the benefit of a minor beneficiary. Sub-paragraph 102AG(2)(d)(ii) (the provision) states:

“(2) Subject to this section, an amount included in the assessable income of a trust estate is excepted

trust income in relation to a beneficiary of the trust estate to the extent to which the amount:

- (d) is derived by the trustee of the trust estate from the investment of any property:
 - (i);
 - (ii) that was transferred to the trustee for the benefit of the beneficiary by another person out of property that devolved upon that other person from the estate of a deceased person and was so transferred within 3 years after the date of the death of the deceased person;...”

The provision is qualified by subs 102AG(2A) which provides that the above provision:

“Does not apply unless the beneficiary of the trust will, under the terms of the trust, acquire the trust property (other than as a trustee) when the trust ends.”

The nature of this qualification will require careful drafting of the trust deed of the relevant trust. Consideration may be given to Taxation Ruling TR 98/4 which deals with a similar qualification that applies to trusts that may be established on a family breakdown.

The provision allows a person to whom property has passed under a will a three year window following the death during which the person may transfer property to a trust. Income of that trust can, from then on, attract the same concessional tax treatment as the income of a testamentary trust. The opportunity provided by the provision is illustrated in the following example.

Example

Harry dies suddenly and, rather than providing in his will for the establishment of one or more testamentary trusts for his three children: Alice (7), Ben (4) and Cassie (2), Harry left all his assets to his spouse, Wanda. If Wanda executed an appropriately drafted trust deed (i.e. the terms of which provide that the children will acquire the trust property, other than as a trustee, when the trust ends) under which she declared herself trustee of the estate assets on behalf of Alice, Ben and Cassie within three years of Harry's death, any income distributed from the trust to the children may (subject to the limitation in subs 102AG(7) discussed below) be taxed at normal adult marginal rates of tax, not 47 per cent. The children would also be entitled to apply the standard adult tax free threshold of \$6,000 in determining their tax liability and not the reduced threshold of \$416.

DEVOLVE?

One question arising from the operation of the provision is how the word "devolved" is to be interpreted. The meaning of "devolve" was considered in the decision of Sir John Leach M.R. in *Parr v Parr*¹, where he said:

"To devolve means to pass from a person dying to a person living."

The above definition was expanded on by the High Court of Australia in *O'Brien v Komesaroff*² in which Mason J addressed cases in which the term had been considered before concluding that "[an] absence of voluntariness is essential to the concept of devolution...the word devolution therefore contemplates a legal consequence flowing from an involuntary act".

The term "devolution" is defined in Butterworths Australian Legal Dictionary³ as "the involuntary passing of property from one person to another by operation of law: for example, upon death, bankruptcy or insolvency. Devolution occurs when the estate becomes vested in the personal representative, official receiver or trustee". The latter sentence and the comments of Mason J above may suggest an interpretation of "devolve" that is limited to an involuntary passing of property, being the passing of property under an intestacy or under a will to the deceased's legal personal representative, and does not extend to the subsequent passing of property to the beneficiaries named in a will.

The context of the provision suggests, however, that the term "devolved" extends to the passing of the property to the

beneficiaries under the will. If this were not the case there would be limited scope for the operation of the provision as the provision would only afford concessional tax treatment to the income of trusts to which the deceased's legal personal representative transferred property in administering the will rather than trusts to which the beneficiaries under the will may have transferred property. The wider interpretation of the term 'devolved' is supported by para 189 of CICTM 884, which was issued by the Commissioner of Taxation in May 1981 and includes in its contents an explanation of the operation of Div 6AA. Paragraph 189 discusses the application of sub-para 102AE(2)(c)(ii) of the ITAA 1936 which reads:

"102AE(2) [Excepted assessable income] Subject to this section an amount included in the assessable income of a person (in this subsection referred to as the 'minor') is excepted trust income to the extent to which the amount:

- (a)
- (b)
- (c) is derived by the minor from the investment of any property:
 - (i)
 - (ii) that was transferred to the minor by another person out of property that devolved upon that other person from the estate of a deceased person and was so transferred within 3 years after the date of the death of the deceased person."

Sub-paragraph 102AE(2)(c)(ii) uses the same terminology as the provision.

Paragraph 189 of CICTM 884 addresses its application and states:

"Subparagraph (ii) of paragraph (c) covers certain cases where property comes indirectly to a child as a result of a person's death, eg, where a husband does not make provision for his children in his will, but dies leaving all of his estate to his widow, who shortly after makes provision for the children by transferring to them all or part of property she has acquired from the estate. By this subparagraph, income from property transferred to a minor by another person out of property that devolved upon the later from a deceased estate is excepted assessable income, provided that the property was transferred within 3 years after the date of death ...".

It is clear from the above and the context of the provision that "devolved" includes the passing of property to beneficiaries under a will and is not restricted in its application to the passing of property to a deceased's legal personal representative or the passing of property under an intestacy.

LIMITATIONS ON THE PROVISION

The application of the provision must be considered in light of subs 102AG(7) which limits the amount that may be treated as excepted trust income under the provision to the amount that:

"... in the opinion of the Commissioner, would have been included in the assessable income of the beneficiary of the year of income in respect of an amount or amounts derived by the beneficiary from property that, in the opinion of the Commissioner, would have devolved directly upon that beneficiary if that deceased person had died intestate ..."

Further, the amount of any excepted trust income derived from a testamentary trust created by the will of the same deceased person is to be taken into account in determining how much of the otherwise excepted trust income is to be disqualified under subs 102AG(7).

The proportions of an intestate estate which may pass to children may be significant. For example, in Victoria a surviving spouse is entitled under an intestacy to the first \$100,000 (plus personal chattels) and then one third of the balance of the estate (if any)⁴. The children of the deceased are then entitled to two thirds of the balance of the estate. The situation in the other States and Territories is similar but the provisions of the relevant State or Territory legislation should be reviewed if the provision is to be relied upon.

Returning to the example, at the time of his death and, after payment of all liabilities, Harry's assets consist of an investment property worth \$500,000 and shares worth \$100,000. The trust deed of the new trust is drafted so that the requirements under subs 102AG(2A) are satisfied. During the year ended 30 June 2006 the trust earns income of \$60,000 to which the three children are presently entitled. As the trust complies with subpara 102AG(2)(d)(ii) and subs 102AG(2A), the income will, prima facie, be excepted trust income in the minor beneficiaries' hands. However, under subs 102AG(7), the Commissioner determines that the children would have derived two-thirds of the income (\$40,000) on an intestacy and, therefore, only that amount is taxed as excepted trust income and the remaining one third (\$20,000) is taxed at 47 per cent under the Div 6AA rules.

CONCLUSION

Practitioners should be mindful that, if a deceased person has failed to establish a testamentary trust for the benefit of his minor children, the opportunity to access concessional tax treatment for income of the deceased's estate through trusts may not be lost. Subparagraph 102AG(2)(d)(ii) may allow income to be distributed to such minor children in a tax-effective manner if the estate assets are transferred by a surviving spouse or other person to an appropriately structured trust.

Unfortunately, subs 102AG(7) effectively limits the usefulness of the provision to surviving spouses who have children under 18 years. Grandchildren will usually obtain nothing on a notional intestacy and, therefore, if a client is seeking to benefit minor grandchildren rather than surviving children, a testamentary trust is required to access the concessional tax treatment. ●

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Reference notes

1 (1833) 39 ER 826

2 (1982) 150 CLR 310

3 2nd edition at page 356

4 Administration and Probate Act 1958 (Vic) section 51