- international business and procurement;
- tax compliance and documentation approaches;
- business systems which drive recordkeeping; and
- human resources.

Affected entities should look to co-ordinate their actions across tax risk management, financial reporting and business processes, as well as the compliance systems. The work streams need to start now, but will take time to implement a quality outcome.

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[1475] **Testamentary trusts and excepted trust income**

- by Matthew Burgess and Patrick Ellwood, Directors, View Legal

The recent Tax Office Private Binding Ruling Authorisation number 1012846046513 (**Ruling**), reported at para [1477] of this *Bulletin*, considers a number of key issues relating to the distribution of assets via testamentary trusts under deceased estates.

The Ruling largely follows the well-publicised Practice Statement Law Administration PS LA 2003/12 (**PSLA 2003/12**), which was republished in April 2014 (reported at 2014 WTB 16 [561]), and then updated in August 2015 to the new LAPS format and style.

The Ruling is a timely reminder of the need to ensure care is taken with any intended distributions from a testamentary trust.

Overview of questions answered

The Ruling confirms the following, in each instance largely applying PSLA 2003/12:

- Div 128 of the ITAA 1997 applies to disregard any capital gains tax on the distribution of assets from a testamentary trust directly to individual beneficiaries of a testamentary trust;
- a valid variation of a testamentary trust to allow distributions to inter vivos trusts, that were not originally potential beneficiaries of the testamentary trust, would not trigger a CGT event; and
- Div 128 of the ITAA 1997 also applies to disregard any CGT on the distribution of assets from a testamentary trust directly to inter vivos beneficiaries of a testamentary trust.

Aside from also making comments about the non-application of the anti-avoidance provisions under Pt IVA of the ITAA 1936, the Ruling specifically considers whether s 102AG(2) of the ITAA 1936 would apply to treat any income derived from the assets received by an infant beneficiary via an inter vivos trust as excepted trust income.

Excepted trust income arguments

As is well understood, pursuant to Div 6AA, and in particular, s 102AG(2)(a)(i), excepted trust income 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.

The case of *The Trustee for the Estate of the late AW Furse No 5 Will Trust v FCT* (1990) 21 ATR 1123 (**Furse**) is one of the few reported decisions dealing with Div 6AA.

In that case, the Federal Court noted that provided a trust estate was created by a will, then any income of the trust estate (including a testamentary discretionary trust) is excepted trust income. The only particular limitation placed on the provisions by Justice Hill in *Furse* was that the parties must be dealing on an arm's length basis when deriving the income. Importantly, the requirement was not that the parties must in fact be arm's length but that the income was equal to an amount that would be derived had they been dealing at arm's length.

Section 102AG(1) requires that a trust have a prescribed person (relevantly in most situations, an infant, subject to certain exceptions in s 102AC(2)) as a beneficiary.

Importantly, s 102AG(1) does not expressly exclude an indirect interest as being a beneficiary for the purpose of the provisions.

Therefore, it is often argued that the income of the "trust estate" contemplated in the opening words to s 102AG(2) does not need to be the same trust estate.

This in turn means that any income received by an infant beneficiary derived from assets originally sourced from an estate, via an inter vivos trust (ie after distribution of certain assets from a testamentary trust to an inter vivos trust) should be treated as excepted trust income.

That is, the relevant income will be income that is excepted trust income "*in relation to a beneficiary of the trust estate* (that is, an inter vivos trust) *to the extent to which the amount - (a) is assessable income of a trust estate* (that is the testamentary trust) *that resulted from - (i) a will* (that is the will of the willmaker that created the testamentary trust)".

Section 102AG(4) does provide that an amount will not be treated as excepted trust income if it was derived by a trustee as a result of an agreement entered into for the purpose of securing that the income would be excepted trust income.

Arguably this restriction does not apply in the factual scenario outlined above because the income derived via the assets transferred to an inter vivos trust would have been excepted trust income in the testamentary trust.

The above arguments are largely supported by Private Ruling authorisation number 1012603789935.

Tax Office position

In rejecting the above arguments, the Tax Office confirms in the Ruling that income distributed by the inter vivos trust would not be excepted trust income.

In particular, the Ruling states as follows –

- *Furse* is authority for the proposition that excepted trust income can be sourced via a testamentary trust under a will with assets not necessarily the property of the willmaker at the date of their death;
- *Furse* is also authority for saying that inter vivos trusts can never create access to excepted trust income, unless the relevant trust is mentioned in the will; and
- this essentially means assets would need to be distributed directly under a will pursuant to a specific direction to an inter vivos trust before the income of the inter vivos trust will be considered excepted trust income.

Lessons

A number of lessons can be taken from the Ruling, including:

- The Tax Office, as has been long assumed, is likely to take a relatively narrow view to interpreting the excepted trust income rules under the ITAA 1936.
- This narrow interpretation is despite the longstanding and widely accepted principles set out by Justice Hill in *Furse*.
- Where possible, if access to excepted trust income is important to a willmaker, personally owned assets should be distributed to a trust created under a will (ie a testamentary trust), not a pre-established inter vivos trust.
- Willmakers not domiciled in South Australia looking to create a "perpetual trust" (ie set up under South Australian law to potentially avoid the need to have a vesting date) need to accept there will be risks with also accessing excepted trust income via the structure, if the Tax Office continues to look for ways to narrow the interpretation of s 102AG of the ITAA 1936 and the decision in *Furse.*
- Depending on the situation, and in particular the terms of the will, for trustees of existing testamentary trusts wanting to restructure assets and still maintain access to the excepted trust income concessions, a form of trust cloning relying on PSLA 2003/12 may be appropriate.

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