SUCCESSION LAW CONFERENCE

Taxation Considerations for Succession Lawyers

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Executive Summary

This paper provides practitioners with a summary of recent changes to tax laws that may impact the administration of estates and also outlines clauses that should be considered for inclusion in wills. Most of the recent developments relate to new rulings or guidelines: a new practical compliance guideline (PCG) on personal representatives' tax liabilities; a draft PCG on extensions to the 2-year period for disposing of the main residence; and rulings on trust splitting and the vesting of trusts. The final recent development is a new GST withholding tax triggered by the sale of new residential premises or potential residential land. The paper then discusses clauses that drafters should consider including in wills to deal with tax issues that may arise in administering estates.

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INTRODUCTION

My paper is in two parts: recent developments and tips for will drafting. The recent developments that I will cover are as follows –

(a) A new practical compliance guideline (PCG) on the Commissioner's approach to collecting the deceased's tax debts from personal representatives;

(b) A new draft PCG on the Commissioner's power to extend the 2-year period for disposing of the main residence.

(c) A draft determination on the tax consequences of splitting trusts.

(d) A final ruling on the tax consequences of vesting a trust.

(e) A new GST withholding tax payable by purchasers of residential real estate.

RECENT DEVELOPMENTS

(a) New guidance to personal representatives concerning tax liabilities

Twelve months ago I spoke at this conference about draft Practical Compliance Guideline PCG 2017/D12, which provided guidelines about the steps a personal representative was required to take to ensure that the Commissioner would not sue them payment of tax debts owed by the deceased. On 22 August 2018, the Commissioner issued Practical Compliance Guideline PCG 2018/4, which finalises Draft PCG 2017/D12 and contains some minor changes from the draft.

To recap, s 260-140 of Schedule 1 of the *Taxation Administration Act* 1953, makes personal representatives responsible for paying any tax debts owed by the deceased at the date of death. If there is an outstanding tax related liability, s260-140(2) provides that the Commissioner may deal with the personal representative as if they were the deceased person.

Although s 260-140 indicates that personal representatives are liable for the deceased person's tax liabilities, a number of High Court cases indicate that this liability is imposed solely in a representative capacity. Therefore, a personal representative is only liable to the extent of the estate assets in their hands.

PCG 2018/4 –

- only applies to smaller and less complex estates;

- only applies in relation to liabilities of the deceased person (that is, it says nothing about potential liabilities that arise from the derivation of income, or the disposal of assets by the estate); and

- is intended to give personal representatives greater certainty about when they will be treated as having notice of a claim, or potential claim, by the ATO.

"Notice" is important, because the Commissioner acknowledges that a personal representative is not liable for any tax obligations of which they did not have notice at the time they distributed the estate's assets. The leading decision on the importance of "notice" is *DCT v Taylor* (1968) 12 FLR 173 and on appeal *Taylor v DCT*, (1969) 123 CLR 206.

In *Taylor's* case, after executors distributed the estate's assets the Deputy Commissioner issued assessments to them in respect of the deceased. The personal representative had advertised in compliance with NSW legislation that protected personal representatives from creditors of the deceased. The High Court found that the executors were protected by the relevant legislation, because they had no notice of any claim, contingent or otherwise, against the estate by the Deputy Commissioner when they distributed the estate assets.

In *Taylor's case* the High Court relied on the executors' having advertised in accordance with the relevant legislation before they distributed the estate's assets. Interestingly, the High Court said (at 123 CLR 211) that the defence of *plene administravit* –

> does not adequately protect a legal personal representative where he has distributed assets among the beneficiaries even though he has done so without notice of any outstanding claim.

But according to the Court, the statutory defence provided a good answer to the Commissioner's claim provided the estate's assets had been distributed to the beneficiaries and, at the time of the distribution, the executors had no notice of the Commissioner's claim.

According to PCG 2018/4 paragraphs 9 and 10, a personal representative has notice of –

- the deceased person's tax debts;

- any debts arising from tax returns lodged before they died but for which assessments had not issued at the date of death; and

- any liabilities arising in respect of outstanding income tax returns that the personal representative is required by law to lodge.

If the Commissioner notifies the personal representative that he has decided to review or examine the affairs of the estate he will also treat the personal representative as having notice of any liabilities that arise as a result of the review or examination: see para 12.

But according to paragraphs 13 and 14, if a personal representative has –

- acted reasonably in lodging all the deceased's outstanding returns (or provided an advice that lodgment is not required);
- advised the Commissioner in writing of any material irregularity in any of the deceased's prior returns, or has brought such irregularity to the ATO's attention; and
- waited for 6 months to pass after the lodgment of the final return (or advice that lodgment is not required) or advice of a material irregularity, without the Commissioner issuing an amended assessment or notifying them that he will be examining the deceased's affairs –

then, subject to certain exceptions, the Commissioner will treat the personal representatives as having no notice of a claim and therefore the personal representatives can distribute the estate without risk of being sued by the Commissioner.

Personal Representatives who can rely on PCG 2018/4

The guideline is confined to executors and administrators in circumstances where:

- the deceased did not carry on a business, was not assessable on a share of the net income of a discretionary trust and was not an SMSF member in the 4 years prior to death;
- the estate assets consist only of cash, personal assets such as cars and jewellery, public company shares or other interests in widely held entities, death benefit superannuation and Australian real property; and
- the total market value of the estate assets at the date of death was under $5 million and none of the estate assets are intended to pass to a foreign resident, a tax-exempt entity or a complying superannuation entity.

The $5 million threshold limits significantly the application of the draft PCG. In addition, any estate that includes an interest in a private company or trust is excluded.

Final observations

PCG 2018/4 is not a binding ruling but although it is only "administratively binding" personal representatives can expect the Commissioner to comply with it.

A striking feature of the PCG is that "notice" is only relevant if a personal representative complies with the statutory requirements for obtaining protection before distributing. In Victoria those requirements are set out in Trustee Act 1958, s 33. But many personal representatives, particularly personal representatives of smaller estates, fail to comply with the s 33 before distributing. Despite this, it appears that personal representatives can rely on PCG 2018/4 regardless of whether they comply with s 33.

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(b) Commissioner's Discretion to Extend 2-Year Period to Dispose of Deceased's Main Residence

Under s 118-195(1) of the ITAA 1997 if a dwelling is an individual's main residence when they die, a sale by the personal representatives or a beneficiary within 2 years of death is exempt from capital gains tax (CGT). Some years after this exemption was introduced, commencing on 21 March 2012, Parliament gave the Commissioner a power to extend the 2-year period. Applications to extend the period have become very frequent.

On 22 August 2018, the Commissioner issued Draft Practical Compliance Guideline PCG 2018/D6 about the Commissioner's discretion to extend the 2-year period. The draft Guideline outlines the factors the Commissioner considers when deciding whether to exercise the power to allow a longer period and also outlines a "safe harbour" compliance approach that allows taxpayers to take advantage of the extension of time without making a formal request to the Commissioner to exercise the power.

Factors favourable to the exercise of the Commissioner's discretion

The draft PCG indicates that the Commissioner will allow a longer period where the dwelling could not be sold within two years of the deceased's death due to reasons beyond the taxpayer's control that existed for a significant portion of the first two years. The following is a non-exhaustive list of factors that would weigh in favour of allowing a longer period:

- the ownership of the dwelling, or the will, is challenged;
- a life or other equitable interest given in the will delays the disposal of the dwelling;
- the complexity of the deceased estate delays the completion of administration of the estate, or
- settlement of the contract of sale of the dwelling is delayed or falls through for reasons outside of your control.

Factors adverse to the exercise of the Commissioner's discretion

The following is a non-exhaustive list of factors which would weigh against allowing a longer period:

- waiting for the property market to pick up before selling the dwelling;
- delay due to refurbishment of the house to improve the sale price;
- inconvenience on the part of the trustee or beneficiary to organise the sale of the house, or

- unexplained periods of inactivity by the executor in attending to the administration of the estate.

Safe harbour conditions

A taxpayer (the personal representative or a beneficiary of the deceased estate) may treat the period as being extended without formally applying to the Commissioner if five conditions are satisfied:

- during the first two years after the interest in the dwelling passed to the taxpayer, more than 12 months was spent addressing one or more of the circumstances described above as factors favourable to the exercise of the discretion;
- the dwelling was listed for sale as soon as practically possible after those circumstances were resolved (and the sale was actively managed to completion);
- the sale completed (settled) within six months of the dwelling being listed for sale;
- the circumstances described above as factors adverse to the exercise of the discretion were immaterial to the delay in disposing of your interest, and
- the longest period for which the taxpayer would otherwise need the discretion to be exercised is no more than 12 months.

The draft guideline includes 7 examples covering life interests, family members residing in the dwelling, renovations due to storm damage, subdivisions, challenges to the will (including inactivity after the dispute is resolved) and illness.

The draft states that if a taxpayer decides to use this safe harbour but is later chosen for an audit, the Commissioner "will seek to ensure that you satisfy the relevant conditions including checking that the additional period is no longer than 12 months". The Commissioner will not seek to determine whether the Commissioner's discretion would have actually been exercised.

Closing observations

My experience has been that the Commissioner takes a relatively generous approach to granting extensions of time to the 2-year period. I have seen him grant quite lengthy extensions if the delay is due to circumstances outside the personal representatives' control.

The draft PCG is helpful in identifying the circumstances that the Commissioner will consider in deciding whether or not to grant extensions. It is also helpful in providing taxpayers with the opportunity to determine that they are entitled to a relatively short extension of time without the need to apply to the Commissioner. Personal representatives and beneficiaries will need to wait until the draft guideline is issued as a final PCG before applying the safe harbour rule.

(c) Trust splitting

A beneficiary sometimes wishes to separate their interests from those of their fellow beneficiaries. Ideally they would do this by removing assets from a trust and either acquiring those assets in their own name or by placing them in a new trust that they control. But removing assets from a trust often triggers material CGT and stamp duty liabilities. One strategy for separating without triggering tax liabilities is to "split" the trust; that is, insert a new trustee who acquires legal title to some of the trust assets. The new trustee is controlled by the beneficiary who wishes to separate, but the assets continue to be governed by the terms of the original trust. This strategy may be adopted for testamentary or *inter vivos* trusts.

Draft Taxation Determination TD 2018/D3, issued on 11 July 2018, sets out the Commissioner's preliminary view that certain trust split arrangements cause CGT event E1 to happen. This CGT event happens when a trust is created over a CGT asset by declaration or settlement: s 104-55(1) of the ITAA 1997.

The draft describes an arrangement where the parties to an existing trust (typically a discretionary trust that is part of a family group) "functionally split" its operation so that some trust assets are controlled and held by the existing trustee for the benefit of one class of beneficiaries, while other trust assets are controlled and held by a new trustee for the benefit of others. According to the draft determination, such an arrangement will exhibit all or most of the following features:

- the removal of the existing trustee as trustee of part/some of the assets of the existing trust and the appointment of a new trustee to hold those assets;
- control of the original trustee passing to a subset of the beneficiaries of the original trust, with a different subset of beneficiaries controlling the new trustee;
- the appointment of different appointors for each trustee;
- segregation of the trustees' rights of indemnity such that each trustee can only be indemnified out of the assets it holds;
- an expectation that each trustee will exercise its powers in respect of the assets it holds for the benefit of a subset of beneficiaries to the exclusion of others. This is case even if the range of beneficiaries that can benefit from particular assets is expressly limited;
- a single trust deed governing the rights, obligations and powers of the trustees and beneficiaries; and
- separate books of account kept by the existing trustee and the new trustee.

Closing observations

The draft determination is deficient in concluding that trust split arrangements necessarily cause CGT event E1 to happen. My main criticism of the draft ruling is that it assumes that trust split arrangements take a particular form, whereas in practice many trust split arrangements do not share all the features described in the draft ruling.

(d) Trust vesting ruling

Taxation Ruling TR 2018/6, issued on 15 August 2018, finalises the Commissioner's views on the income tax consequences of a trust vesting, which are the same as those contained in the draft (TR 2017/D10).

A trust's "vesting" or "termination" date is the day on which the beneficiaries' interests in the property of the trust become "vested in interest and possession". The trust deed should specify the vesting date and the consequences of that date being reached (eg that the trust property will be held from that date for the takers on vesting in equal shares absolutely). The Commissioner notes that vesting does not, of itself, ordinarily cause the trust to come to an end or cause a new trust to arise. If the trustee continues to hold property for the takers on vesting, the property will be held on the same trust (although the nature of the trust relationship will change).

The key points made in TR 2018/16 are that:

- before vesting it may be possible to extend the vesting date (by applying to a court or by the trustee exercising a power to nominate a new vesting date). A proposed alteration by a trustee without court intervention will be subject to any specific requirements in the trust deed about how and when any alteration to the vesting date can occur;
- it is too late to change the vesting date once it has passed and the Commissioner says it is unlikely that a court would agree to do so due to the interests in the trust property becoming fixed at law; and
- continuing to administer the trust in a way that is inconsistent with the vesting terms can have significant tax consequences (eg potentially CGT event E1).

CGT consequences of trust vesting

TR 2018/6 considers whether various CGT events may occur on vesting or post-vesting, noting that the terms of the trust deed are particularly relevant. The Commissioner says that:

- CGT event E1 (creation of a new trust) "need not happen merely because a trust has vested". This is because vesting does not, of itself, ordinarily cause a trust to come to an end and its

property to settle on the terms of a new trust. However, CGT event E1 may occur if the parties to a trust relationship subsequently act in a manner that results in a new trust being created by declaration or settlement. This is illustrated in Example 4 (set out below);

- CGT event E5 (beneficiary becoming absolutely entitled) may occur if the takers on vesting become absolutely entitled as against the trustee to CGT assets of the trust; and
- CGT event E7 (disposal to a beneficiary to end a capital interest) may happen on actual distribution of CGT assets to beneficiaries, but will not occur to the extent that the beneficiaries are already absolutely entitled to the CGT assets as against the trustee.

The ruling includes six examples, covering effective and ineffective extensions of the vesting date, the consequences of ignoring the vesting date and the entitlements of beneficiaries.

Closing observations

This ruling and the draft that preceded it do not contain any real surprises. The ruling appears to have been issued primarily to reject a suggestion by some practitioners that the tax consequences of a trust vesting could be avoided by reviving it after it had vested.

(e) New withholding tax on sale of real estate

At previous conferences I have spoken about the CGT withholding tax on property sales. As from 1 July 2016, purchasers of real estate worth $2 million or more were obliged to withhold 10% of the purchase price, unless the vendor could provide the purchaser at settlement with a clearance certificate from the Australian Taxation Office. From 1 July 2017 the rate of withholding was increased from 10% to 12.5% and the CGT withholding threshold was reduced from $2 million to $750,000.

From 1 July 2018 the Government has introduced a requirement on purchasers of newly constructed residential premises and new subdivisions[1] to withhold GST from the purchase price and remit it to the Taxation Office. The legislation specifies that

- purchasers of new residential property are required to withhold 1/11th of the purchase price and pay this to the ATO;
- the developer receives a credit for this GST through the normal GST business activity statement lodgment;

[1] Strictly, “new residential premises” or “potential residential land”.

- a reduced withholding tax rate of 7% can be used where the margin scheme has been applied;
- developers are now required to provide purchasers with information that assists them in determining whether the withholding applies; and
- special transitional provisions are included for project delivery agreements.

While the changes take effect on 1 July 2018, a transitional rule excludes contracts signed before 1 July 2018, provided the sale settles before 1 July 2020.

A vendor must provide a notice in writing to the buyer before selling any new residential premises or potential residential land stating whether the buyer needs to withhold GST or not. The vendor's notice may either be in the contract for sale, or in a separate document.

A failure by the vendor to provide the notice doesn't affect the buyer's obligation to withhold an amount if the property is a taxable sale of new residential premises or potential residential land.

Penalties may apply to a vendor for failing to provide the required notification and/or the required details. If the buyer is required to withhold, the supplier must provide:

- their name and ABN;
- the amount that must be withheld;
- when it is due to be paid to the ATO.

The buyer must make a payment to the ATO on or before the day which settlement occurs.

A buyer (or their conveyancer) needs to lodge Form 1: *GST property settlement withholding notification* using the details provided by the vendor. This form is lodged online before settlement and enables a buyer to obtain a unique payment reference number (PRN) and lodgment reference number (LRN).

The PRN and LRN are required to enable the buyer to complete and lodge Form 2: *GST property settlement date confirmation* when the withholding obligation becomes due, either when the first instalment is paid or at settlement or as soon as practical after settlement.

TIPS FOR WILL DRAFTING

There are three provisions I suggest you consider including in wills:

(a) provision for death benefits to be paid to death benefits dependants;

(b) streaming of different types of income; and

(c) payment of CGT.

(a) Gift death benefits to death benefits dependants

If the estate receives a death benefit (usually from a superannuation fund) tax on the estate can be avoided if the money is gifted to a death benefit's dependant. A death benefit that is payable to a deceased estate is exempt from tax to the extent that one or more beneficiaries of the estate who were "death benefits dependants" of the deceased have benefited, or may be expected to benefit, from the superannuation death benefit: see s 302-10 of the *Income Tax Assessment Act* 1997 (**the ITAA 1997**). Dependants for the purposes of obtaining the tax exemption are defined as:[2]

- a spouse or former spouse of the deceased member;[3] or
- a child[4] under the age of 18 years of the deceased member; or
- a person who is financially dependent on the deceased;
- any other person who was in an "interdependency relationship" with the deceased member.[5]

The tax exemption is only available if the terms of the will make it plain that only death benefits dependants may benefit from the death benefit.

Another consideration is that if some of the intended beneficiaries are death benefits dependants but others are not, a gift of the proceeds from the superannuation fund to the beneficiaries who are death benefits dependants may unfairly benefit them in comparison to the other beneficiaries (for example, the testator may have children, some of whom are adults no longer financially dependent but others of whom are minors or who are still studying and who are therefore financial dependants). In those circumstances the drafter should consider giving the trustee power to augment the gifts to the non-

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2 ITAA 1997, s 302-195 definition of "death benefits dependant", applicable from 1 July 2007.

3 "Spouse" includes married or de facto spouses: ITAA 1997, s 995-1 definition of spouse.

4 "Child" includes an adopted child, a step-child or an ex-nuptial child of a person: ITAA 1997, s 995-1 definition of child.

5 Various factors, including a close personal relationship and financial support, apply for determining whether two individuals have an "interdependency relationship": see ITAA 1997, s 302-200.

death benefits dependants to compensate them for the additional gifts that the death benefits dependants receive from the proceeds of the superannuation fund.

(b) Streaming different types of income

In the final year of administration the beneficiaries may become taxable on the estate's income. If the estate has different types of income, for example, capital gains and franked dividends, the personal representatives and the beneficiaries may wish to "stream" the income, that is, allocate different types of income to different beneficiaries.

Arguably, it is necessary for the will to include a power to enable the personal representatives to do this. Often quite elaborate clauses are included to empower the trustee to distribute particular types of income selectively, but the clause need not be lengthy. For example –

> If -
>
> (a) the estate has income that is derived from a number of different sources, or consists of a number of different types of income; and
>
> (b) one or more of the beneficiaries become presently entitled to all or a part of such income -
>
> the Trustees may choose the type or source of the share of the income to which each beneficiary is entitled.

(c) Empower estate to pay CGT

In some circumstances a beneficiary may become liable to pay CGT on a gain from an asset even though they do not receive the proceeds from the sale of the asset. It is therefore good practice to include a clause in the will empowering the personal representative to pay a beneficiary's CGT liability from estate assets.

Testamentary trust clauses

In addition to the clauses set out above, if the will creates one or more discretionary testamentary trusts there are two further provisions that might usefully be included.

Main residence exemption

If a beneficiary, other than the deceased's spouse or the devisee of the dwelling, is likely to occupy the deceased's principal residence, the testator should consider giving that individual a right to occupy the dwelling under the testamentary trust. It is common for the trustee to possess power to permit a beneficiary to occupy any house forming part of the trust property, but if the testamentary trust fails to confer a right on the beneficiary to occupy the house, the trustee will fail to satisfy one of the

requirements for the main residence exemption in s 118-195(1) of the ITAA 1997. Conferring a right on the beneficiary to occupy the house is unnecessary if the beneficiary is the testator's spouse.

Therefore, if the testator wishes to leave their home to their trustees to hold on a discretionary trust it is worth giving some thought to the possibility that one or more specific beneficiaries may wish to occupy the house. If this is a possibility it may be appropriate to draft a provision in the will that gives the beneficiary likely to occupy the dwelling an explicit right of occupancy.

Definition of "income" or "net income".

It is common in an *inter vivos* discretionary trust to include a definition of "income" that modifies the common law meaning of the expression.

Before amendments in 2011 designed to allow streaming it was common to define income for the purposes of the trust to mean the "net income" under s 95 of the ITAA 1936. But in Draft Taxation Ruling TR 2012/D1 the Commissioner noted that such a definition would exclude from distributable income some amounts that would otherwise be included, such as tax-exempt income and the discount component of a taxable capital gain.

The draft ruling also asserts, somewhat controversially, that the distributable income of a trust must be reflected in accretions to the trust property.[7] Hence, it argues that equating trust income with taxable income is ineffective to the extent that taxable income includes notional amounts recognised as income only for tax purposes, for example, a capital gain where the capital proceeds are deemed to be the market value of the asset, or the franking credits attached to a franked dividend.[8]

In response it has become common in *inter vivos* trusts to provide that the income of the trust is such amount as the trustee determines before year-end. A determination by the trustee would need to be based on some systematic criteria - the trustee could not simply pluck a figure from out of the air. The Commissioner accepts that such a provision is effective,[11] provided the income and capital beneficiaries are the same.[12]

The same considerations that guide drafters of *inter vivos* trusts apply to discretionary testamentary trusts, but it should be noted that such a definition should not be adopted for a testamentary trust that

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[7] Citing the decision of Stone J in *Colonial First State Investments Limited v FCT* (2011) 192 FCR 298; [2011] FCA 16 at 88.
[8] Although franking credits can be described as "notional", they have economic value: see *Symond v Gadens Lawyers Sydney Pty Ltd* [2013] NSWSC 95; (2013) 96 ATR 658.
[11] See Decision Impact Statement for *Commr of Taxation v Bamford & Ors*, *http://law.ato.gov.au/atolaw/view.htm?locid=LIT%2FICD%2FS310%2F2009%2F00001 and Taxation Determination TD 2012/22*.
[12] Draft Ruling TR 2012/D1 at 66 - 68.

creates life and remainder interests because exercising the power would potentially undermine the interest of either the life beneficiary or the remainder beneficiary.

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