ESSENTIAL INFORMATION FOR BUSINESS PEOPLE

BUSINESS ESSENTIALS®

JULY 2017 | EDITION 396

the extras

A word from our sponsor, subscription information and contact details of all our featured speakers.

WELCOME TO THE JULY 2017 EDITION OF BUSINESS ESSENTIALS.

If this is the first time you've received a Business Essentials CD, we hope it will be a thoroughly enjoyable experience for you - and that you'll come back for more!

We suggest that you put this CD straight into your car's CD player and start listening. These CDs are designed to inform, update, motivate and inspire.

And we know they work. Just check out what others say about us on our website at www.be.com.au and you'll see why Business Essentials has become such a valuable learning tool for thousands of business operators around Australia for over 30 years.

CONTACT THIS MONTH'S INTERVIEWEES

For more information about the topics discussed on this program, please contact the relevant organisations listed below.

MID-YEAR ECONOMIC REVIEW
Professor Neville Norman, Melbourne University
neviile.norman@unimelb.edu.au

KEEPING CYBER CRIME AT BAY
David Caldwell, Forensic IT
03 9691 0804
david.caldwell@forensicit.com.au
forensicit.com.au

KNOWING WHAT YOUR CUSTOMERS WANT
Kylie Rogers, Mamamia Women's Network
www.mamamia.com.au

LIFTING YOUR INNOVATION GAME
Andrew Hutchinson, Alchimie
03 9728 6688 / 0413 761 474
andrew.hutchinson@alchimie.com.au
alchimie.com.au

GOOD HOUSEKEEPING FOR THE NEW TAX YEAR
Michael Jones, Cummings Flavel McCormack
03 9252 0800
enquiries@cfmc.com.au

FROM TOXIC TO "EMERGENT": DRIVING CHANGE IN YOUR BUSINESS
Stephen Scott Johnson, Author, *EMERGENT: Ignite Purpose , Transform Culture, Make Change Stick*
Contact Gaya +61 (4) 97 078 889
gaya@stephenscottjohnson.com
stephenscottjohnson.com

SHAREMARKET UPDATE
Elio D'Amato, Lincoln Stock Doctor
1300 676 333 / 03 9854 9444
lincolnindicators.com.au

REGAINING CONTROL OF YOUR LIFE
Angela Lockwood, Author, *Switch Off*
0421 029 370
angela@angelalockwood.com.au
To order a copy of Angela's book, *Switch Off*, visit her website, angelalockwood.com.au

BE MEDIA PRODUCTION

Managing Director **Nick Schildberger**
Executive Producer **Heather Dawson**
Director Audio/Video **Peter Letts**
Producer/Business Development Manager **Chris Ashmore**
Subscriptions Manager **Maureen Payne**

Publisher BE Media Production Pty Ltd ABN: 98 006 144 449
106/12 Cato Street
Hawthorn East Vic 3123
Telephone: 03 9882 8333
Facsimile: 03 9882 8017
Email: info@be.com.au

cummings mccormack flavel

Accountants Who Help You See Further

Cummings Flavel McCormack are accountants who provide accounting, auditing and business advice to business owners Cummings Flavel McCormack also provides tax consulting services.

Tax Consulting

Tax law is relevant to every major business and investment decision. Understanding the latest developments in tax is difficult.

The Cummings Flavel McCormack tax consulting practice works with clients to evaluate the taxation risks and benefits applicable to their business and investment plans.

We are proud of our ability to untangle the complexities of tax law to produce commercially practical tax advice that the client can understand and act on with confidence.

We have significant breadth of experience, having worked with successive governments in tax law development and holding key positions on advisory and education committees with professional tax bodies.

David Kent, Michael Jones and Neil Flavel lead a group of dedicated taxation professionals.

see further

Individual resident marginal tax rates for the year ended 30 June 2018

TAXABLE INCOME	TAX ON THIS INCOME
$0 – $18,200	Nil
$18,201 – $37,000	19c for each $1 over $18,200
$37,001 – $87,000	$3,572 plus 32.5c for each $1 over $37,000
$80,001 – $180,000	$19,822 plus 37c for each $1 over $87,000
Over $180,000	$54,232 plus 45c for each $1 over $180,000

The tax rates do not include the Medicare Levy of 2%. Your Medicare levy is reduced if your income is below a certain threshold and in some cases you may not have to pay the levy at all. The thresholds are higher for seniors. If your income is above the thresholds, you may still qualify for a reduction based on your family taxable income.

For more visit our website, www.cfmc.com.au

Office Details
Level 15, 390 St Kilda Road
Melbourne VIC 3004
T: 61 3 9252 0800 F: 61 3 9252 0801
E: enquiries@cfmc.com.au
E: careers@cfmc.com.au

www.cfmc.com.au

cummings mccormack flavel



Taxation of Testamentary Trusts: Understanding the Benefits

September 2016

Michael Jones & Evan Beissel
Cummings Flavel McCormack
Chartered Accountants & Business Advisors

Level 15, 390 St Kilda Road
Melbourne Vic 3004
Tel: (03) 9820 3925
Fax: (03) 9866 6161
mjones@cfmc.com.au

cummings flavel mccormack

1. Testamentary trusts in your Will: - Why bother?

Often people are keen to have a simple Will that is easily understood, which is certainly a legitimate goal, so there is wariness about adding additional features to a Will such as a testamentary trust. Why bother with the cost and extra pages?

Testamentary trusts allow a Will-maker more control over the future use and management of estate assets – in particular there are certainly two specific advantages in having a testamentary trust that are worth understating –

- asset protection
- lower taxes

2. What is a testamentary trust?

Any trust is an arrangement where a person or company holds assets for someone else – so a trust exists when you have a trust asset held by a trustee for a beneficiary. A testamentary trust is the same – the trustee of the testamentary trust will administer the assets of the testamentary trust on behalf of the beneficiaries. The difference is in how the trust was created.

A trust is created when a person transfers legal ownership of property to a trustee, and the trustee holds the property on trust for others, subject to obligations under the trust relationship. The more common discretionary trusts are created when a person transfers property while they are alive (inter vivos trust). A testamentary trust is created by a person transferring property to a trustee upon his or her death.

So a testamentary trust is simply a trust created by a Will. The trust comes into existence after the executor has completed the administration of the estate, i.e. distributed specific gifts, paid debts and expenses and ascertained the residual assets. At this point some or all of the residual assets will be subject to the testamentary trust. This new trust is separate and distinct from the deceased estate. It's certainly not a new concept, it's been around for centuries.

3. How does a testamentary trust assist with asset protection?

My view is that asset protection is the most important reason for having a testamentary trust in a Will. If a Will leaves assets to an individual who is in some sort of financial risk -the inherited assets simply become more assets exposed to that risk. It might be risk from creditors from carrying on a business, or risk of litigation from anyone who is chasing the individual for money.

We live in a world of increased litigation. Someone carrying on a business, or a company director, is someone at risk. Many professions have potential litigation as a normal part of their business environment. If a Will simply gifts assets to a beneficiary who is at risk, then those assets are plonked straight into the line of fire and there is nothing that can be done.

A testamentary trust on the other hand will help protect the inheritance. The inheritance is gifted to trustees who holds the assets on behalf of beneficiaries. This trust arrangement provides the beneficiary of the estate access to a pool of assets that is otherwise out of reach of creditors.

3.1 Recent changes make testamentary trusts more protective than inter vivos trusts

The Bankruptcy Act 1966 was amended in 2005 to expand powers of a trustee in bankruptcy to access assets held in trust. In certain circumstances a trustee in bankruptcy can access assets held in trust. Courts have also treated the person who can dismiss and appoint a trustee as owning assets held by the trustee of a discretionary trust. Kennan v Spry (2008) 238 CLR 366.

Arguably these developments do not have a direct impact on assets held by executors and trustees in well drafted testamentary trusts.

3.2 Parents protecting assets from marital disputes

Many Inheritances received may be included in the matrimonial property pool to be divided between separating couples. Many parents are attracted to using testamentary trusts to help protect family assets from matrimonial disputes in future generations. However the ability of trusts to separate beneficiaries from the ownership of assets is being eroded. The Family Law Act 1975 was amended in 2005 to give the Family Court access to assets held in trust.

Again, it is argued that these developments do not have a direct impact on assets held by executors and trustees in testamentary trusts. While legally none of the beneficiaries of a testamentary trust have a right to any particular portion of the assets or income until the trustee resolves to pay them, the Family Court has stated that if a potential beneficiary under a trust has demonstrated a willingness and ability to control the trust then the Court will include the property in the pool to be divided. So if a testamentary trust is established and run in a manner that demonstrates control by a particular person, there must be a risk that the assets of the testamentary trust would be included in pooled assets to be divided between a separating couples.

A well drafted testamentary trust may help keep assets out of the matrimonial pool, however ultimately it will depend on the particular circumstances.

4. Tax advantages

Like the more common inter-vivos trust, a testamentary trust has the same flexible ability to distribute income to beneficiaries each year depending on the particular circumstances of that year. That in in itself is powerful assistance with managing family income.

Testamentary trusts have some extra tax advantages. The key tax advantage is that is that lower tax rates can apply to beneficiaries that are children under 18 years old.

4.1 Exception to high tax rate that applies to children on investment income

Since 1980, trust income of children is taxed at a flat tax rate equal to the highest individual tax rate currently 49%.

However the government recognises that it is inappropriate to tax income from testamentary transfers to children at such a high rate, so there is an exception to the childrens' tax for income derived through testamentary trusts. So a distribution from a testamentary trust to a child under 18 is taxed at marginal rates, including the tax-free threshold.

A great advantage of the exception to children's tax is that it applies to income from assets acquired after the commencement of the testamentary trust – it's not restricted only to assets that originally formed part of the deceased's estate.

Tax advantages also exist when income is accumulated in a trust, see section 7.2

5. Example of the tax benefit from distributions to minors

Darcy's Will provides that his entire estate is left to his wife Elizabeth. The estate produces income of $80,000 a year. Assuming no other income or deductions, Elizabeth will pay tax around $19,000 in tax.

If instead of leaving his entire estate to Elizabeth, Darcy established a testamentary trust for the benefit of Elizabeth and their three young children, the combined tax liability after sharing the income equally amongst the four beneficiaries would be NIL. This is an annual saving of $19,000.

6. The CGT benefits of testamentary trusts

CGT rollover relief exists for assets of the deceased. The CGT roll over under sec 128-10 of ITAA 1997 that applies to the initial transfer from the deceased person to the deceased estate also applies to a subsequent transfer from the deceased estate to a testamentary trust.

This means no capital gains or losses are realised on the transfer of an asset of the deceased from the deceased estate to the testamentary trust.

Furthermore CGT rollover applies on the transfer of an asset of the deceased from the testamentary trust to a beneficiary.

Although this is not expressly provided for under the CGT provisions, this is a long-standing administrative treatment adopted by the ATO. See ATO Practice Statement Law Administration PS LA 2003/12. A proposal to formalise this treatment was scrapped on the basis that existing arrangements were considered adequate.

7. The application of division 6

7.1 Basics of tax on trust income: Net income & present entitlement

- Net income: 'taxable income' of the trust calculated as a hypothetical resident individual.
- Present entitlement: 'present title in possession' to income, not dependant on the availability of funds to pay.
- Beneficiaries tax on income to which they are presently entitled – included in assessable income and taxed at beneficiary's marginal rates.
- 'Flow-through' treatment of trust income allows for flexibility to maximise tax effective outcomes – where appropriate this may be equally useful in testamentary trusts as it is in other trusts.

7.2 Treatment of accumulated income when no beneficiary of the testamentary trust is presently entitled

- Accumulated trust income is taxed at highest marginal rate (currently 49%) under section 99A.
- During the deceased estate's administration, income will be treated as accumulated and tax paid by the estate.
- A deceased estate and a testamentary trust may be taxed as if it were an individual under section 99 if the Commissioner decides that it would be unreasonable for section 99A to apply.
- A deceased estate in the first three years will be taxed at individual rates with no concession tax offsets, and no Medicare Levy.
- In subsequent years income accumulated in the deceased estate is taxed at individual rates but without the tax free threshold. This is a less concessional treatment but still favourable compared to ordinary treatment of accumulated trust income.
- Income accumulated in a testamentary trust is taxed at individual rates but without the tax free threshold. There is no different treatment in the first three years.

8. The streaming rules and testamentary discretionary trusts

The tax rules for streaming trust income also apply to testamentary trusts. Streaming of trust income is the direction of income with particular attributes or source to particular beneficiaries. Although any type of income can be streamed from a <u>trust</u> law perspective, from a <u>tax</u> perspective only franked dividends and capital gains can be streamed effectively (i.e. streamed so that the tax characteristics of these amounts are passed on to the desired beneficiary).

Income can only be streamed if permitted by the trust deed. A deed that is silent on streaming may implicitly permit it, but ideally deeds should include specific provisions to allow streaming. If a deed does not currently allow streaming, usually it is possibly to amend to allow this.

Streaming may be beneficial to testamentary trusts that derive franked dividends and capital gains – e.g. stream franked dividends to lower-income individuals who will receive part-refunds of franking credits. In order to pass franking credits on to beneficiaries, the testamentary trust needs to make a family trust election and identify the test individual. See comments in section 10 regarding family trust elections.

9. Tax losses and testamentary discretionary trusts

Testamentary trusts are subject to usual trust loss rules in respect of tax losses incurred, e.g.:

- 50% stake test
- Pattern of distribution test
- Continuity of control test
- Income injection test

Testamentary trusts with beneficiaries who are relatives may be able to make a family trust election, which substantially reduces the requirements for losses to be recouped (only modified income injection test), however this should be considered in the context of the possible implications for other related entities (e.g. if a testamentary discretionary trust were to distribute to a company or other trust – there is a need for family trust elections by those beneficiaries, with flow-on implications for other related entities)

10. Testamentary trusts and property acquired after the creation of the trust

Subject to anti-avoidance provisions (see section 12), testamentary trusts can acquire property after creation (e.g. surplus cash used to buy shares), and not affect the tax treatment of income distributed to minor beneficiaries.

Warning: However, property acquired after the testamentary trust has been created is not eligible for CGT rollover relief when the testamentary trust vests – this can be an issue if the trust has a fixed vesting date e.g. when the youngest beneficiary turns 21. If considering acquiring property in a testamentary trust, consider tax benefits in short term compared to possible CGT consequences

11. Can a testamentary trust be established outside of the Will after death?

A testamentary trust cannot be established except from the estate of a deceased person, however in some circumstances a trust with testamentary trust type tax benefits can be created after death even when the trust has not been provided for under the deceased's will.

Concessional tax treatment of distributions to minor beneficiaries can apply where a person inherited property and then transferred the inherited property to a trustee for the benefit of another person within 3 years of the death of the deceased (s 102AG(2)(d) (ii)). This provides opportunities for adults who inherent significant assets to create a testamentary trust for the benefit of their minor children and receive the benefit of concessional tax treatment even though no provision for a testamentary trust was made under the deceased's will.

Where available, a post-death testamentary-like trust may allow the family members who control the inherited assets to place assets in a trust with terms and flexibility that best suits their needs and circumstances at that time.

Warning There are two limitations to these trusts compared to testamentary trusts:

1. An exemption from childrens' tax is limited to the amount of income, which in the opinion of the Commissioner, the minor would have received had the deceased died intestate. For example, if a relative of a minor died intestate in a particular State, and under the intestacy laws in that State the estate devolved entirely to the minor's father, then the exemption from childrens' tax will not apply.
2. The beneficiary must be entitled under the terms of the trust to acquire the property.

12. Anti-avoidance rules and testamentary trusts

There are two anti-tax avoidance provisions designed to prevent exploitation of concessional treatment of minor beneficiaries of testamentary trust:

- s 102AG(3) – non-arm's length income: this would prevent injection of income including distributions from other trusts.
- s 102AG(4) – income from agreement where a purpose of the agreement is to treat income as excepted trust income.

Other anti-tax avoidance rules:

- Section 100A - reimbursement agreements in a testamentary trust could attract the application of section 100A.

- A testamentary trust could be taxed on distributions to a tax exempt entity where the tax exempt beneficiary was not promptly notified of the entitlement.

- Anti avoidance rules aimed to prevent Australian tax payers using off shore trusts to accumulate their foreign income would apply to testamentary trusts. [s 99B and the transferor trust rules in Div 6AAA]

THE END