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## Tax & Life Interest

▶ By Michael Norbury, Partner

*A life interest is created under a will when the willmaker leaves the benefit of property to a nominated person for life (the life tenant), with the benefit passing to another (the remainderman) on the death of the life tenant.*

Life interests are a widely used estate planning tool. For instance, a life interest can be useful in balancing the interests of a second spouse with the children of the first marriage, or perhaps assisting to protect assets where a surviving spouse is potentially at risk from creditors.

Depending on the drafting of the terms of the life interest, it may be possible to transpose the assets the subject of the life interest. For instance, where a share portfolio is the subject of a life interest, prudence might dictate that in changing market conditions, the share portfolio should be reviewed and perhaps rearranged. Or perhaps a beach house, which is held subject to a life interest, is no longer required. A sale, in either case, might result in a taxable capital gain.

Who bears the tax on the capital gain?

One of the effects of the capital gains tax provisions of the Income Tax Assessment Act is that a taxable capital gain is deemed to be a form of assessable income, added to and dealt with as all other assessable income. Case law states that in a trust the beneficiaries receiving trust income also receive all the assessable income. If a trust has no trust income then it is not possible for the trust to distribute assessable income.

In the case of a life interest, during the continuation of the life interest, the only person capable of receiving trust income is the life tenant, the remainderman has no interest in the income of the life tenancy until the death of the life tenant. Thus, the life tenant is the only beneficiary legally

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capable of receiving the assessable income which is referable to the taxable capital gain. In other words, the life tenant pays the capital gains tax.

This leads to a serious inequity. The remainderman will receive the benefit of the accretions to the capital of the life estate when the life tenant dies, but it is the life tenant who must bear the tax burden consequent upon those accretions occurring. The drafting of many life interest provisions contained in wills will lead to this result, where the assets subject to the life tenancy are sold.

However, some relief can be gained by providing the life tenant with a right of recoupment for the tax liability from the capital of the estate. ■

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# Special Disability Trusts

► By Sue Harris, Senior Associate

**Special disability trust** is the name given to a trust created to benefit a person with a severe disability:

1. which meets the criteria set out in the Social Security Act 1991 (Cwth) (the Act);
2. to trigger Centrelink concessions for:
  - i) the severely disabled person who is the principal beneficiary of the trust; and
  - ii) the donor of assets to the trust.

Special disability trusts are the result of a Federal Government scheme designed to encourage families to make provision for the long-term care of a family member with a severe disability. In general terms a person will be regarded as having a severe disability where the person is:

- Under 16 and a profoundly disabled child; or
- Over 16 and qualifies for a disability support pension or its equivalent, has no likelihood of working for a wage at or above the minimum wage and requires institutional or carer's assistance with day-to-day living.

The **advantages to the principal beneficiary** of a Special Disability Trust are that for the purposes of the Act and any entitlement to benefits under the Act:

- The assets of the trust up to a limit of \$500,000 (indexed annually) plus the value of the principal beneficiary's home if it is an asset of the trust are not included in the assets of the beneficiary;
- Income that a special disability trust derives is not attributed to the beneficiary and any income distribution made by such a trust to a principal beneficiary is not counted as income.

The **advantage to a donor** who makes a gift to a special disability trust and who is an immediate family member and in receipt of a social security or veteran's affairs pension, is that the gift may not be taken to be a disposal for the purposes of the deprivation rules when

determining the donor's entitlement to his or her social security or veteran's affairs pension.

The scheme came into operation in September 2006 and new guidelines, which set out what qualifies as the reasonable care and accommodation needs of a severely disabled principal beneficiary, were laid down in 2008.

**To qualify as a special disability trust, a trust must:**

- Comply with the model trust deed provisions as determined by the Act;
- Have more than one trustee or a professional trustee (ie a trustee company, solicitor or accountant);
- Be established by a settlor who must be someone other than the donor;
- Have a principal beneficiary who has a severe disability;
- Have only one principal beneficiary (that is the person with the severe disability);
- Be the only such trust for the principal beneficiary; and
- Have as its sole purpose during the lifetime of the principal beneficiary, meeting the reasonable care and accommodation needs of the beneficiary.

**The assets of the trust must not:**

- Include any asset transferred to the trust by the principal beneficiary unless the asset is all or part of a bequest or a superannuation death benefit and was received by the principal beneficiary within the last 3 years;
- Be used to pay an immediate family member of the principal beneficiary for provision of care services or repair or maintenance of the beneficiary's accommodation; or
- Be used to purchase or lease property from an immediate family member even if the property is used for the beneficiary's accommodation. ■



# Trust Busting

► By **Charlotta van Otterdyk, Special Counsel**

Over recent years, the use by the Family Court of its powers relating to the property of parties to a marriage has sat uncomfortably with older common law notions of the rights and legal status of the various parties in a discretionary trust.

It is well-established law that trustees, beneficiaries and appointors of a discretionary trust have no proprietary right over unallocated assets held in the trust. However, this does not prevent the Family Court from considering such assets to be the property of one or both of the parties to a marriage for the purposes of a property settlement between them on the marriage ending.

The recent High Court decision of *Kennon v Spry* [2008] HCA 56 handed down in December last year confirms the Family Court's ability to reach into the trust and add trust assets to the pool of assets available for division between the parties.

The Family Court permits access to the assets in a discretionary trust in a number of ways including:

- Making orders and directions against the controller of the trust;
- Setting aside a trust as a "sham";
- Considering those assets to be the property of one or other or both of the parties to the marriage;
- Considering those assets as a resource available to one or other of the parties to the marriage; or
- Setting aside transactions considered to be designed to avoid the Family Law Act

The Court has also recently been given wider powers which include the power to make orders against third parties.

In *Kennon v Spry*, the majority of the High Court concluded that the assets which were held in a family discretionary trust amounted to property for the purposes of the Family Law Act. Therefore the Court was able to take that property into account in making orders as to the division of property between the parties.

Very briefly, the facts of *Kennon v Spry* were:

- Dr Spry created a discretionary trust some ten years before he was married;
- He was Trustee and Settlor;
- The beneficiaries of the trust were Dr Spry, his siblings and the issue and spouses of all of them;
- Dr Spry married in 1978. The marriage lasted over twenty years and produced four children;
- The Trust acquired substantial assets from Dr Spry during the marriage;
- Some five years after his marriage Dr Spry excluded himself as a beneficiary of the trust;
- When the marriage was in difficulty but the parties had not separated or divorced, Dr Spry excluded his wife as a beneficiary of the trust;
- After separation from his wife Dr Spry set up four discretionary trusts, one for each child of the marriage and distributed the assets of the initial trust equally between the children's trusts;
- Dr Spry retired as trustee of the children's trusts; and
- Dr Spry's wife sought orders setting aside some of the transactions and arguing that the trust assets should be included in the pool of assets available for distribution in the property settlement with her former husband.

The High Court confirmed orders setting aside the transactions removing his wife as a beneficiary and distributing the assets of the trust (as to capital and income) into the children's trusts and held that the assets in the discretionary trust amounted to property of the wife for the purposes of the Family Law Act.

Although the Court did not order Dr Spry or the Trustees of the children's trusts to make distributions of the assets from the trust, it was aware that Dr Spry would need to access those assets to enable him to comply with the property settlement.

When discussing asset protection and the use of discretionary trusts (be they inter vivos or testamentary) with clients it is important therefore to keep in mind the High Court's ratification of the Family Court's powers. Whether the increasing reach of the Family Court into trust assets will be taken up in other areas (such as bankruptcy) remains to be seen. ■



# Protecting a Surviving Spouse's Pension with Smart Ownership

► By John Currie, Consultant, MacDonnells Law

Most couples own their main residence as joint tenants. This means that if one party dies, the survivor automatically becomes the sole owner of the property.

Many couples have adopted the same approach to ownership of second homes – whether holiday homes or investment properties – and also own these assets as joint tenants.

In some cases, however, consideration should be given to transferring titles of second homes from joint tenancy to tenants in common. This is particularly the case where the parties are either at, or approaching, pensionable ages.

One reason for considering altering the form of ownership of title to second homes to tenants in common is that this form of ownership allows an ownership interest (generally 50%) to be transferred by will.

In many cases, where one spouse dies and title to a second property transfers by survivorship to the surviving spouse, the additional asset value means that pension or pension related benefits are either reduced or terminated under the assets test.

In the usual case, many couples prepare their wills on the basis that (say) all their assets are bequeathed to the surviving spouse or, if there is no surviving spouse, to the surviving children equally as tenants in common.



By altering title to a second home to tenants in common, and making corresponding changes to wills so that (say) a half interest in that property is bequeathed directly to the surviving children, the surviving spouses pension entitlements may be protected.

The process of changing a property title from joint tenancy to tenancy in common is relatively cheap and straight forward. There are no income tax or capital gains tax consequences to the alteration of title from joint tenancy to tenancy in common [see s108-7 ITAA97 and TD 13].

The logic here is that the children would end up with the property in any event, so the transfers of title from each parents' wills under tenancy in common is simply a two step approach to the outcome that would result in any event. The advantage being that the surviving parent may be able to better protect pension and pension related benefits during his or her lifetime.

Clearly, altering title form and changing wills are steps that should only be undertaken after a close consideration of the family relationships. Whilst these steps will not be right for all cases, in the appropriate cases it can give significant benefits at little cost. ■

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