Important Changes Affecting Trusts

COMMENTS AND RECOMMENDATIONS

Section 102AG ITAA 1936: Changes to the excepted (exempt) income for minor beneficiaries under a testamentary trust

- In practice, this is an area mainly dealt with by accountants and financial advisors and I am not sure that any particular amendment needs to be made to existing Wills which include testamentary discretionary trusts unless there is any obvious potential breach by any wording in the Wills.

- Clients will need to be advised that income distribution to minors may be more limited in effectiveness in the future. There is a question as to whether income derived from substituted assets (i.e., assets which are derived from the deceased's assets owned time of death) is exempt. I note, however, that the Explanatory Memorandum accompanying the **Treasury Laws Amendment (2019 Measures N0. 3) Bill 2019** which resulted in the new subsection, says:

  "Schedule 1 to the Bill amends the ITAA 1936 to ensure the tax concessions available to minors in relation to income from a testamentary trust only apply in respect of income generated from assets of the deceased estate that are transferred to the testamentary trust (or the proceeds of the disposal or investment of those assets)".

  The words in brackets suggest that income derived from "the proceeds" of sale or disposal of deceased assets will be exempt. These words do not appear in the subsection itself and it is not clear whether "proceeds" are limited to cash or extend to replacement assets. Tracing may be an important factor in terms of future reliance on the subsection.

Section 104JA Duties Act 1997 (NSW): The impact upon all trust deeds regarding foreign persons as beneficiaries

- In general terms, the Section relates to transfers to foreign persons of residential land.

- The Section automatically deems a trustee of a discretionary trust to be a foreign trustee unless the trust deed prevents a foreign person from being a beneficiary of the trust. This appears to apply to all trusts including testamentary discretionary trusts.

- Accordingly, if there is any likelihood that a current or potential beneficiary (e.g., an unnamed, and possibly even unborn as yet, child, grandchild, spouse, etc) is likely to be a beneficiary of a trust, then it would appear that the trust will be charged land tax and duty rates applicable to a foreign beneficiary (possibly even whether that beneficiary is transferred the land or not).

  [Please see the examples above which highlight the issue.]

- Urgent consideration needs to be given to amending existing trust deeds to exclude foreign persons as beneficiaries and for that change to be incapable of being amended in the future. The changes must be in place by **31 December 2020**!

Further Detail

Section 102AG ITAA 1936: Changes to the excepted (exempt) income for minor beneficiaries under a testamentary trust

The one change which has been made in respect of testamentary trusts including testamentary discretionary trusts (**TTs**), effective from June this year, is that the benefit of adult marginal tax rates applying to distributions from TTs to minor beneficiaries is only available for income generated from assets placed in the TT by the deceased or the proceeds of the disposal or investment of those assets. **Section 102AG ITAA 1936** was amended by the insertion of subclause **(2AA)** to qualify what amounts to excepted (exempt) income in relation to distributions to minors from TTs. The section reads as follows:

"***(2AA)*** *For the purposes of paragraph (2)(a), assessable income of a trust estate is of a kind covered by this subsection if:*

(a) the assessable income is derived by the trustee of the trust estate from property; and

(b) the property satisfies any of the following requirements:

(i) the property was transferred to the trustee of the trust estate to benefit the beneficiary from the estate of the deceased person concerned, as a result of the will, codicil, intestacy or order of a court mentioned in paragraph (2)(a);

(ii) the property represents accumulations of income or capital from property that satisfies the requirement in subparagraph (i);

(iii) the property represents accumulations of income or capital from property that satisfies the requirement in subparagraph (ii), or (because of a previous operation of this subparagraph) the requirement in this subparagraph."

I have not seen any papers on this issue at this stage.

Section 104JA Duties Act 1997 (NSW): The impact upon all trust deeds regarding foreign persons as beneficiaries

Section 104JA Duties Act provides as follows:

"***DUTIES ACT 1997 - SECT 104JA***
Special provisions for discretionary trusts
104JA Special provisions for discretionary trusts

(1) The trustee of a discretionary trust is taken to be a foreign trustee for the purposes of this Chapter unless the trust prevents a foreign person from being a beneficiary of the trust.

(2) If a discretionary trust prevents a foreign person from being a beneficiary of the trust, the trustee of the trust is not in that capacity a foreign trustee for the purposes of this Chapter.

(3) A discretionary trust is considered to prevent a foreign person from being a beneficiary of the trust if (and only if) both of the following requirements are satisfied—

*(a) no potential beneficiary of the trust is a foreign person (the **"no foreign beneficiary requirement"**),*

*(b) the terms of the trust are not capable of amendment in a manner that would result in there being a potential beneficiary of the trust who is a foreign person (the **"no amendment requirement"**).*

***Note :** Under the transitional arrangements for this section in Schedule 1, the no amendment requirement does not apply to a trust that satisfies the no foreign beneficiary requirement immediately before the commencement of this section.*

*(4) A person is a **"potential beneficiary"** of a discretionary trust if the exercise or failure to exercise a discretion under the terms of the trust can result in any property of the trust being distributed to or applied for the benefit of the person.*

***Note:** A potential beneficiary is not limited to persons named in the trust instrument and extends to the members of any class of persons to whom or for whose benefit trust property can be distributed or applied pursuant to the discretions of the trust.*

(5) For the removal of doubt, a person is not a potential beneficiary of a discretionary trust if the terms of the trust prevent any property of the trust from being distributed to or applied for the benefit of the person.

*(6) In this section, **"property"** includes money, and a reference to the distribution or application of property includes a reference to the payment of money.*"

This then raises the question of what "the Chapter" refers to. ***Section 104G*** *reads as follows:*

"***Introduction and overview***
104G INTRODUCTION AND OVERVIEW

(1) This Chapter charges duty on certain dutiable transactions in respect of residential land that are, or are taken to be, transfers to foreign persons.

(2) The duty charged by this Chapter is additional to any duty charged by Chapter 2.

*(3) The duty charged by this Chapter is referred to as **"surcharge purchaser duty".***"

Commissioner's Practice Note ***004 v2*** has issued and reads as follows:

[https://www.revenue.nsw.gov.au/help-centre/resources-library/foreign-surcharges-and-discretionary-trusts]

"*Purpose*

This practice note outlines how surcharge purchaser duty and surcharge land tax will be applied in situations where land is held by a discretionary trust. The note also explains what you need to do in order to be exempt from foreign surcharge.

Note: Failure by a trustee to advise the Chief Commissioner that the trust is a discretionary trust could result in interest and penalties.

Note: Chapter 11A (Tax avoidance schemes) of the Duties Act 1997 potentially applies to the avoidance of both surcharge purchaser duty and surcharge land tax[1].

Background

Surcharge purchaser duty applies to acquisitions of NSW residential land by foreign persons, and surcharge land tax applies to foreign persons who are owners of residential land in NSW. Surcharge purchaser duty and surcharge land tax (together, the foreign surcharges) are payable in addition to any other duty or land tax payable.

Where an interest in a property is acquired directly or indirectly by or held through a discretionary trust, the trustee of the trust may be liable for foreign surcharges if any one of the potential beneficiaries is a foreign person.

Each beneficiary in a discretionary trust is deemed to have the maximum percentage interest in the income or property over which the trustee may exercise a discretion to distribute[2].

This Commissioner's Practice Note clarifies the workings of section 104JA of the Duties Act 1997 and section 5D of the Land Tax Act 1956.

Commissioner's practice note

Potential beneficiaries are not limited to persons named in the trust instrument. The term extends to the members of any class of persons to whom or for whose benefit trust property can be distributed or applied pursuant to the exercise of the discretions of the trustee under the trust.

Potential beneficiaries are often nominated by class rather than name for a number of reasons, including change of circumstances or they do not exist at the time the trust deed is executed. They could be foreign persons for the purposes of surcharge purchaser duty and surcharge land tax. In such circumstances, it follows that the trustee of a discretionary trust will be a foreign person.

A person is a 'potential beneficiary' of a discretionary trust if the exercise or failure to exercise a discretion under the terms of the trust can result in any property of the trust being distributed to or applied for the benefit of the person.

To avoid being a foreign trustee, the discretionary trust must meet both of the following requirements:

- *no potential beneficiary of the trust is a foreign person (the "no foreign beneficiary requirement"); and*

- *the terms of the trust must not be capable of amendment in a manner that would result in a foreign person being a potential beneficiary (the "no amendment requirement").[3]*

Note: The "no foreign beneficiary requirement" can (and will usually) be satisfied in respect of a person if the terms of the trust prevent any property of the trust from being distributed to or applied for the benefit of the person.

Example 1

Mr and Mrs Jones (both Australian citizens) are primary beneficiaries of the Jones Family Trust. Other primary beneficiaries include their two children Mark and Peter who are under the age of 10. The trust has potential beneficiaries who include future spouses and children of Mark and Peter and no other potential beneficiaries.

The trust has no existing foreign beneficiaries, but future spouses and children of Mark and Peter could be foreign persons. The trustee is taken to be a foreign person. To be exempt from foreign surcharges, the trust must be amended to exclude any foreign beneficiaries and the amendment must be irrevocable.

Example 2

Mr and Mrs Jones (both Australian citizens) are primary beneficiaries of the Jones Family Trust. Potential beneficiaries include their children, their spouses, grandchildren, aunts and uncles (all Australian citizens), and an Australian charity operating in Australia for the benefit of residents in Australia.

Although the trust has no existing foreign beneficiaries and no potential foreign beneficiaries, the trust must still be amended to exclude any future foreign potential beneficiaries and the amendment must be irrevocable.

Note: As the charity is operating in Australia, the exclusion of foreign beneficiaries does not exclude the charity. See Australian Charities and Not-for-profit Commission (ACNC) register. A charity will also not be considered to operate overseas if its activity overseas is directly related to its purposes in Australia, and the activity is incidental to its operations in Australia[4].

Example 3

Mr and Mrs Jones (both Australian citizens) are primary beneficiaries of the Jones Family Trust. Potential beneficiaries include their children, their spouses, grandchildren, aunts and uncles (all Australian citizens), the lineal descendants of the specified beneficiaries and any entities in which Mr and Mrs Jones holds an interest whether formed in Australia or elsewhere such as corporations, charities etc.

The trust had no land in New South Wales and therefore the terms of the trust did not need to contain a prohibition on foreign persons being beneficiaries.

In June 2020 the trust purchased residential property in NSW. The trust will be liable for surcharge purchaser duty. The trust will also be liable to surcharge land tax for the 2021 tax year. In order for the trustee not to be liable for foreign surcharges, the trust will need to be amended to exclude any foreign potential beneficiaries and the amendment must be irrevocable.

Example 4

Mr and Mrs Jones (both Australian Citizens) are beneficiaries of the Jones Family Trust. Potential beneficiaries include their children, their spouses, grandchildren, aunts and uncles (all Australian citizens), the lineal descendants of the specified beneficiaries and any entities whether formed in Australia or elsewhere such as eligible corporations, charities etc. The trust also has an excluded class of beneficiaries and this class includes any beneficiary who is a foreign person.

As all foreign persons, entities and charities are excluded and the terms of the trust are incapable of amendment, the trustee will not be liable for foreign surcharges.

<u>Example 5</u>

ABC Pty Ltd, an Australian Corporation, enters into a contract for the purchase of residential property in NSW. All the shares in ABC Pty Ltd are owned by a discretionary trust. ABC Pty Ltd will be liable to surcharge purchaser duty if the trust does not contain a provision to exclude foreign beneficiaries.

Corporations are foreign persons if a shareholder who is a foreign person has a substantial interest in the corporation. For a discretionary trust, each beneficiary that the trustee has discretion to distribute the income or property to is deemed to have the maximum percentage interest in the income or property that the trustee may exercise a discretion to distribute to them. It follows that as the discretionary trust is the shareholder of the company then the company is a foreign person. However, if the trust is amended to exclude foreign beneficiaries and the terms of the trust is incapable of being amended to allow a foreign person to become a potential beneficiary, then no surcharge purchaser duty is payable.

Similar rules apply to a unit trust where the units held in the trust are held by a trustee of a discretionary trust.

<u>Example 6</u>

Mr Jones is the principal beneficiary of the Jones Trust. This trust is set up as the result of injury claims in the Supreme Court. The general beneficiaries include the trustee, the parents, spouse and children of the principal beneficiary. The date of determination is the death of the principal beneficiary or 80 years after the date of the deed. Any payment made to the general beneficiaries is made for the benefit of the principal beneficiary.

The principal beneficiary is the only person who benefits from the trust. The general beneficiaries will only benefit after the death of the principal beneficiary either as a beneficiary under the will or arising on an intestacy. Therefore, the trust does not need to be amended and will not be liable to foreign surcharges as the status of the general beneficiaries does not matter.

Note: Generally, superannuation trusts and special disability trusts do not need to contain a prohibition on foreign persons becoming beneficiaries.

A superannuation trust will generally not qualify as a discretionary trust.

A special disability trust is a concessional trust where the primary purpose is for the reasonable care and accommodation of the principal beneficiary and is not discretionary in nature. This is because the trustee does not have the discretion to benefit anyone else other than the principal beneficiary.

Some trusts, such as the special disability trust and the trust set up in example 6, cannot be amended and therefore will comply with the 'no amendment requirement'. Other trusts that *cannot be amended and are not covered in this practice note will be dealt with on a case by case basis. A request for a private ruling should be lodged. The factors that Revenue NSW will consider in determining such a ruling include:*

- *nature of the trustees' power to amend the trust;*
- *nature of the trust;*
- *the rights of the beneficiaries.*

Named beneficiaries

Should the trust contain named or specified beneficiaries that are foreign persons, the Chief Commissioner will usually require that such beneficiaries are removed from the trust as beneficiaries. If the named foreign beneficiaries are not removed, the trustee will generally be liable for foreign surcharges.

Note: It is generally not sufficient that named beneficiaries are merely prevented from receiving distributions, e.g. through a general clause excluding foreign persons from receiving distributions. This is because the named beneficiaries might have the power to appoint a new Appointer or appoint or remove trustees and the trust may still be capable of amendment in a manner that would result in a foreign person being a potential beneficiary[5].

Transitional Provisions

No Foreign Beneficiary Requirement

If the trustee of a discretionary trust is liable for surcharge purchaser duty on a transfer of dutiable property that occurred before 24 June 2020 or after that date but before midnight on 31 December 2020, the trustee will still not be liable if the terms of the trust have been amended before midnight on 31 December 2020. If surcharge purchaser duty was paid, the trustee is entitled to a refund if the amendment is made before midnight on 31 December 2020.

If the trustee of a discretionary trust is liable to pay surcharge land tax in respect of the 2017, 2018, 2019 and/or 2020 land tax year, the trustee will still not be liable if the terms of the trust have been amended before due date for the payment of land tax or after the due date but before midnight on 31 December 2020. If surcharge land tax was paid, the trustee is entitled to a refund if the amendment is made before midnight on 31 December 2020.

Example 7

Mr and Mrs Jones (both Australian citizens) are beneficiaries of the Jones Family Trust. Potential beneficiaries include their children, their spouses, grandchildren, aunts and uncles, the lineal descendants of the specified beneficiaries, corporations in Australia and elsewhere.

The trust was liable for surcharge land tax and surcharge land tax was paid for 2017, 2018 and 2019 tax years.

If the trust is not amended by midnight on 31 December 2020 to exclude foreign persons from being beneficiaries and the terms of the trust are not amended to make the exclusion irrevocable, the trustee will still be liable for surcharge land tax for the 2020 tax year.

However, if the trust is amended before midnight on 31 December 2020 and as surcharge land tax was paid, then the trustee is entitled to a refund for the 2017, 2018 and 2019 tax years.

No Amendment Requirement

If, before 24 June 2020, a trust satisfied the no foreign beneficiary requirement under section 104JA of the Duties Act 1997 or section 5D of the Land Tax Act 1956, the trustee will be exempt from surcharge purchaser duty and surcharge land tax without having to satisfy the no amendment requirement.

Example 8

Mr and Mrs Jones (both Australian citizens) are primary beneficiaries of the Jones Family Trust. Potential beneficiaries include their children, their spouses, grandchildren, aunts and uncles (all Australian citizens), the lineal descendants of the specified beneficiaries and a company whose shareholders and directors are Mr and Mrs Jones.

The trust has no existing foreign beneficiaries, but potential future descendants could be foreign persons. The trustee is taken to be a foreign person. The trust was amended in March 2020 to exclude any future potential foreign beneficiaries, but the terms of the trust were not amended to satisfy the no amendment requirement. As the trust was amended prior to 24 June 2020, the trustee will be exempt from surcharge purchaser duty and surcharge land tax without having to satisfy the no amendment requirement.

Testamentary trust

An Australian testamentary trust is a discretionary trust arising from a will or codicil or the administration of an intestate estate where the deceased was not a foreign person immediately before death.

The trustee of an Australian testamentary trust is not a foreign trustee even if the trust does not prevent a foreign person from being a beneficiary of the trust if:

(a) the will or codicil was executed on or before 31 December 2020, or

(b) the deceased died intestate before, or within two years after 24 June 2020, or

(c) an order of a court varying the application of the provisions of a will or codicil or of the rules governing the distribution of an intestate estate was made on or before 31 December 2020.

Footnotes

1. ^ Section 5D(7) of the Land Tax Act 1956
2. ^ Section 18(3) of the Foreign Acquisitions and Takeover Act 1975 (Cth) (FATA)
3. ^ See transitional provisions in the ruling.
4. ^ https://www.acnc.gov.au/for-charities/manage-your-charity/governance-hub/acnc-external-conduct-standards/when-do-external
5. ^ If in doubt request for a private ruling"

If you have any enquiries please contact Mark Squire at Atkinson Vinden Lawyers.