Estate proceeds trusts: benefits for families

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The poor cousin of proper planning, estate proceeds trusts are an underutilised reactive device enabling the creation of a trust where the deceased failed to do so.

Unless a testamentary trust (TT) is incorporated in the terms of the will, it cannot be established after the willmaker has died.

In limited circumstances, estate proceeds trusts (EPTs) can be utilised to establish a trust where a deceased has not done so, either under their will or as a result of intestacy. Estate proceeds trusts derive from s 102AG of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). The section allows a trust to be established outside a will utilising assets from a deceased estate in a narrow set of circumstances. This section has been applied very little in practice, but could be of great benefit to a deceased person's family.

Estate proceeds trusts are a post-death mechanism and a limited device, whereas TTs are a proactive estate planning tool. Estate proceeds trusts are not an adequate substitute for the benefits provided by a fully fledged TT.

Testamentary trusts are created by the willmaker through the terms of his or her will. Whereas an EPT is created by the beneficiary of the estate after the death of the person in question and utilising the deceased person's assets for the benefit of another person, where there is an outright gift of assets to the beneficiary either through a will or under intestacy.

An EPT can be of significant benefit when the deceased person leaves minor children and where extra income is needed to support the family.

Although EPTs have a narrow application, their advantages in the right circumstances should not be underestimated.

Advantages of EPTs

The key advantage of establishing an EPT is that income earned on the beneficial entitlement transferred to the EPT and distributed to minors is taxed at the adult marginal rate, instead of the usual penalty rate applicable to income distributed to minors, such as from family discretionary trusts. Section 102AG treats income derived by an EPT as excepted trust income, the same as TDTs. This can be of significant benefit where the deceased person's spouse is left caring for, and financially responsible for, minor children.

Another key benefit, and one that is often overlooked, is that the assets in an EPT are protected for the child as against their surviving parent's creditors. This is explained in more detail below.

Example of an EPT

The narrow circumstances where an EPT can be established involve a person dying and leaving minor children. The children can claim reduced tax rates on the share of the income derived from an investment or property originating from their deceased parent to the extent to which the child would be entitled under intestacy.

For example, an EPT could be set up and be of advantage where a husband (Steve) dies leaving all of his assets (worth $1m) to his wife (Naomi) via a will. Steve and Naomi have two minor children, Isabella, aged 7, and Tom, aged 3.

Using Victorian[1] intestacy laws as an example, if Steve died intestate, Naomi would have received (roughly) the first $100,000 plus a third, and Isabella and Tom would share the balance.

Accordingly, even though Naomi is entitled to the entire $1m pursuant to Steve's will, she can choose to deal with the $1m as follows:

- take the first $100,000 plus a third ($300,000) for herself as a direct benefit;
- establish an EPT for Isabella, with $300,000 as the trust capital; and
- establish an EPT for Tom, with $300,000 as the trust capital.

Naomi can choose to transfer less than $300,000 to each EPT, but not more.

Each child must be the sole beneficiary of their EPT and would be entitled to all of the income derived from their own EPT. The income will be taxed in the child's hands at the adult marginal tax rates.

For the 2016-17 financial year, the tax rates (excluding the Medicare levy) applicable to residents are as follows:

- $0 – $18,200: nil;
- $18,201 – $37,000: 19%;
- $37,001 – $80,000: 32.5%;
- $80,001 – $180,000: 37%; and
- $180,001 and over: 47%.

These rates will apply to Isabella and Tom's income derived from the EPTs on $300,000, but not on any excess income.[2] Income derived from any excess over the $300,000 capital would be subject to normal income tax rules for minors.

If Naomi is a high income earner, this can be a substantial tax saving for her.

If, 10 years after establishing the EPTs, Naomi went bankrupt, went through a divorce or had died and her own will was the subject of a dispute, the assets of Isabella and Tom's EPTs should not be exposed to these creditors or claimants or would be extremely difficult to challenge.

EPTs explained in detail

Estate proceeds trusts can only be established for minors who have lost a parent. An EPT cannot be established from a grandparent's or another person's will or intestacy, as the minor would not have an interest under intestacy.[3]

The specific intestacy rules of each state and territory are critical to determining whether an EPT is worthwhile or available.

The Victorian rules are set out roughly above and show the advantage to Naomi's family. Similar advantages would be seen in Queensland,[4] South Australia,[5] the ACT,[6] the Northern Territory[7] and Western Australia,[8] where the spouse and children share the deceased's estate under intestacy. No such opportunities or advantages would exist in NSW[9] and Tasmania[10] in a situation where the children are of the relationship, but would be available where the children are from another relationship.

Estate proceeds trusts are fixed trusts — the capital beneficiaries of the trust can only be those persons who would receive a share of the estate under intestacy laws that apply in that state or territory, and these beneficiaries will only receive the proportion of income derived from the capital that they would have been entitled to under an intestacy. The trust is fixed both as to beneficiary and as to shares of income and capital to which each beneficiary is entitled in every period.

The trust is also fixed in time, in other words it has an end date,[11] either when the beneficiary turns 18, a later age specified in the trust deed, or when the beneficiary dies. Contrast this with standard TTs which can exist for up to 80[12] years (perpetuity period) and can continue for the benefit of children, grandchildren etc.

If the beneficiary is under a disability, the EPT can continue until the capital runs out or the beneficiary dies. However, where the terms of the EPT do not end the trust when the beneficiary turns 18, the beneficiary can invoke the rule in *Saunders v Vautier*[13] to demand that the proceeds of the trust be released to them.

The only discretionary element for a trustee of an EPT is with respect to investment style and decisions, but this is curtailed by the requirement that the EPT must earn at arm's length income, eg it is questionable whether income derived from family members renting the child's holiday house would be excepted income. McDonald[14] states with some certainty that income in excess of market rates would not be excepted income.

Estate proceeds trusts can apply over assets found in a deceased estate or deriving from a life insurance policy or superannuation where they are paid to the estate. They cannot be established over assets which were received by a person directly; for example, if Naomi received Steve's superannuation or life insurance directly (rather than via the estate) or assets by survivorship as the surviving joint proprietor, these could not be transferred to the EPT.

The EPT can be a trust already in existence or freshly established for this purpose. It is advisable that Naomi should not be the settlor of the trust and the trustee, so an independent person should be asked to be the settlor and to deposit an initial sum, the trust may be topped up by Naomi with Steve's funds or assets she intends for the children.

If using an existing trust, careful consideration is required of changes which may be needed to the trust deed, such as the ability to accept excepted income property to be held on a separate trust for the children, and that such changes do not cause a resettlement of the entire trust.

Practically, the transfer of the assets to the EPT is done after the estate is administered and does not require a variation to the will or renunciation of an interest.

Other noteworthy facts about EPTs are:

- the trust must be established and assets transferred within three years of the date of death by a person who receives assets from the deceased estate;
- when the trust comes to an end, the EPT beneficiary must acquire the assets. This means that the assets of Isabella's EPT do not revert back to Naomi, but must be distributed to Isabella and become her property absolutely;
- an EPT cannot contain a term diverting the trust assets anywhere else other than to the child's estate, on their death. Accordingly, if Isabella dies before the EPT vests, the assets form part of her estate and flow through her will or under her intestacy;
- depending on what assets are transferred into the EPT, there may be stamp duty and capital gains tax payable on the transfer to the EPT and also on vesting; and
- EPTs enjoy the very careful scrutiny of the ATO as the ATO is keen to prevent abuse of the excepted income provisions.

Conclusion

It is of course preferable that a properly crafted TT is inserted into the will where circumstances warrant it. However, in the right circumstances, an EPT may be perfectly sufficient and provide great benefits to the family of a deceased person for many years.

Accordingly, EPTs should not be overlooked and should be given careful consideration when administering the estate of a deceased person who leaves minor children.

Practitioners should also be aware of other available tools, important ones being: first, assets left to minors directly in a will or directly under intestacy are subject to the expected trust income rules in s 102AE(2)(c)(ii) ITAA36; and second, s 102AG also allows trusts to be established to hold superannuation, life insurance and employment benefits which can also be of benefit to the deceased's family.

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References

1. S 51 of the *Administration and Probate Act 1958* (Vic).
2. S 102AG(2)(d)(ii) ITAA36.
3. A McDonald, "Not just another trust?", (2006) *eJITaxR* 10; s 102AG(7).
4. Pt 3 of the *Succession Act 1981* (Qld) – roughly, the spouse receives the first $150,000 of the estate plus one-third of the residue, with the children sharing the balance.
5. Under s 72G, Pt 3A of the *Administration and Probate Act 1919* (SA). If the estate is more than $100,000, the spouse receives the first $100,000 plus one-half of the residue, with the issue sharing the balance.
6. S 49 of the *Administration and Probate Act* 1929 (ACT).
7. S 66 of the *Administration and Probate Act* (NT).
8. S 14 of *Administration Act* 1903 (WA).
9. Pt 4.2 of the *Succession Act 2006* (NSW).
10. S 13 of the *Intestacy Act 2010* (Tas).
11. S 102AG(2A) ITAA36.
12. Unless it is domiciled in South Australia, in which case, there is no perpetuity period.
13. [1841] EWHC Ch J82.
14. A McDonald, "Not just another trust?", (2006) *eJITaxR* 10.