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Life and Remainder Interests in Property and the CGT Taxing Points

With:

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Information provided is general in nature; precise application depends on specific circumstances



Overview

- Use of life interests in an estate plan
- CGT and death – a general overview
- Different types of life interests available and the difference of a right to reside
- CGT consequences of a life interest:
 - Granting
 - Variations to the terms of the Will
 - Death of life interest owner
 - Ending of the life interest early
 - Impact on main residence exemption
- NB: Paper supplementary



Some defined terminology

- Life interest owner – Person who is entitled to the income (and use) of an asset subject to a life interest
- Remainder owner – Person who is entitled to the asset following the end of the life interest
- Original owner – Person who originally owned asset who creates a life interest over the asset
- Trustee/LPR – Person who may hold the original asset on trust for the life interest owner and remainder owner (if applicable)
- LRIs – Life and remainder interests (I may refer to them as life interests casually)



Use of life interests

- Ability to ensure a life interest owner is able to use and benefit from an asset for their lifetime before the asset reverts to the remainder owner has uses
- Blended families:
 - Providing for a current spouse (from a second marriage) whilst ensuring children (from a first marriage) benefits after the current spouse
- Providing for an incapacitated beneficiary
 - Providing a spouse or elderly parent with the certainty of a 'place to live', whilst ensuring children (whether from first or second marriage) ultimately receives the assets
- Protecting from a spouse remarrying post-death



Use of life interests - problems

- Too inflexible – what happens if life interest owners and remainder owners are not happy with the allocation or wish to end things early
- Taxation outcomes not always consistent, particularly when a main residence is involved (discussed today)
- Difficulty to further provide for life interest owner once established
- Need for appropriate persons to manage asset subject to life interest to reduce competing interests from life interest owners (who would like more use today) compared to remainder owners (who wish for the underlying value of the asset to increase in contemplation of their benefit).



Use of life interests – to consider

- Need for Will to contain all necessary provisions
- Extent to which the life interest owner may use and occupy an asset
- Who is responsible for outgoings and how much monies should be set aside for the benefit of the life interest owner?
- Should the life interest owner be entitled to benefit from any gain in the capital value accruing in the asset?
- The circumstances where a life interest can be terminated.
- The inclusion of sufficient trustee powers (if applicable).
- Whether contingent interests exist.

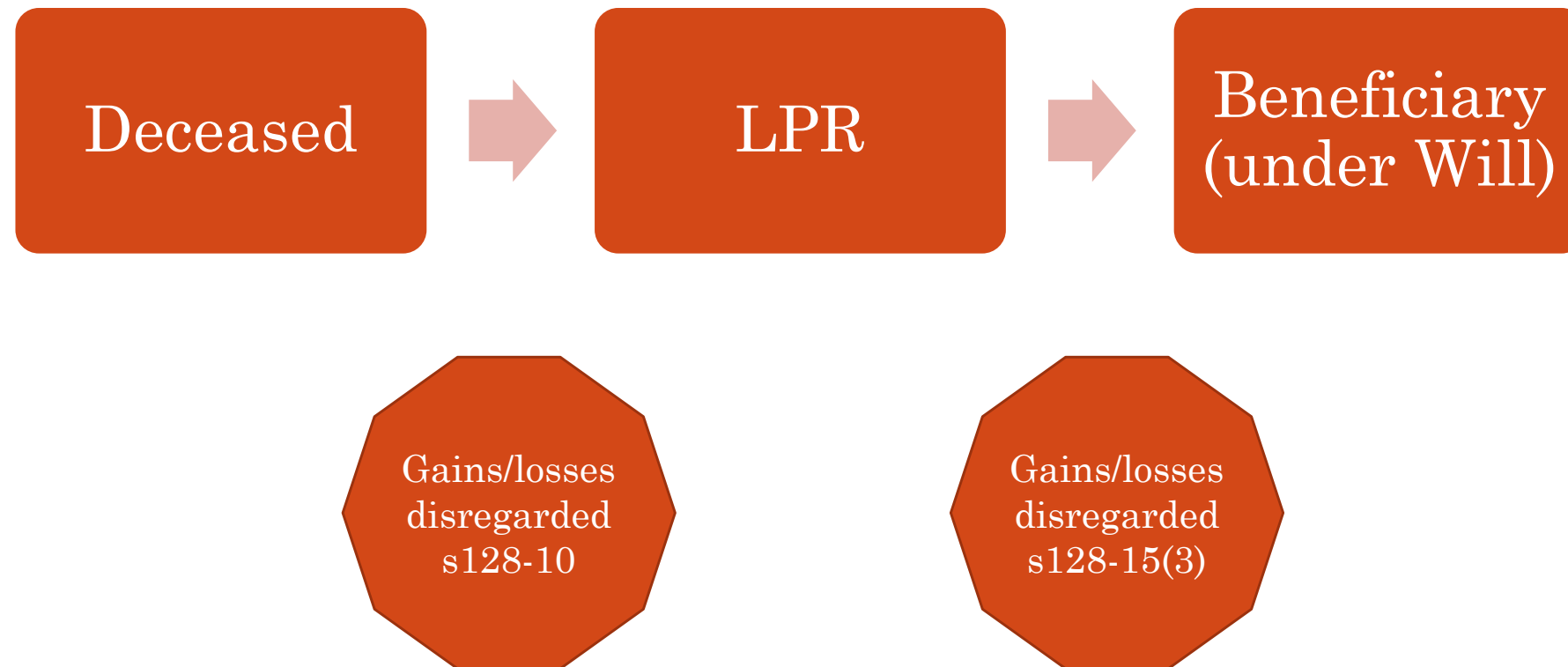


Right to occupy/reside

- Different from life interests
- Does not carry a right to any income from the asset
- Does not allow grantee to create additional interests over the asset
- Contains some similar considerations
- Due to 'weaker' rights, taxation implications are simplified

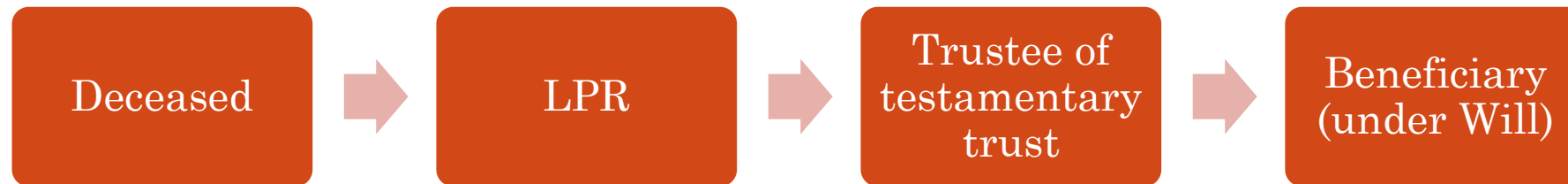


CGT on death (simple)





CGT on death (with trust)



Gains/losses
disregarded
s128-10

Gains/losses
disregarded
s128-15(3)

Gains/losses
disregarded
PSLA 2003/12



Cost base on death



- If pre-CGT asset – LPR/beneficiary receives cost base equal to market value of the asset at the date of death of the deceased.
- If post-CGT asset – LPR/beneficiary receives cost base deceased held in asset.
- If main residence – LPR/beneficiary receives cost base equal to market value on the date of death of the deceased.



CGT during administration

- LPR holds estate assets on trust for beneficiaries under the Will.
- Whilst no beneficiary presently entitled to income/capital gains (due to uncertainty as to amounts) LPR assessed on such income based on either section 99A (highest tax rate) or section 99 (marginal rates).
- Section 99A does not generally apply when dealing with a trust estate resulting from a Will.
- Streaming rules may apply and IT2622 acknowledges that where payments made specifically to beneficiaries, such beneficiaries may be specifically entitled to such amounts.



Market value substitution rules

- Applies to capital proceeds and cost base calculation
- If:
 - No proceeds received/amounts paid;
 - Some proceeds received/amounts paid **and** parties did not deal with each other on arm's length terms
- Treated that capital proceeds equal to market value was made
- Treated that cost base of asset equals market value



CGT events applicable

- A1 – transfer/disposal of an asset
- C1 – Loss or destruction of a CGT asset
- C2 – Cancellation or surrender and similar endings
- D1 – Creation of a right
- E1 – Creating a trust over a CGT asset
- E2 – Transferring a CGT asset to a trust
- E5 – Beneficiary becoming entitled to a trust asset
- E6 – Disposal to beneficiary to end income right
- E7 – Disposal to beneficiary to end capital right
- E8 – Disposal by beneficiary of capital interest

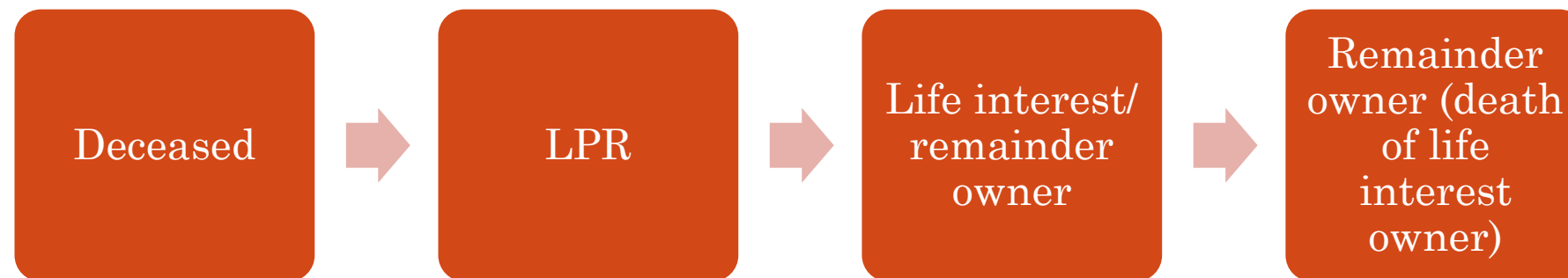


Different life interests

- Equitable v legal
 - Equitable LRI – trustee holds assets for the benefit of life interest owners and remainder owners
 - Legal LRI – legal title of asset is disposed by original owner of the asset to be held by the life interest owner
- Equitable LRI involves trusts
- LRIs can be established *inter vivos* or via Will
- Contentious whether legal LRI can be put in place over personal property



Legal LRI – via Will



Gains/losses
disregarded
s128-10

Gains/losses
disregarded
CGT event
E6/E7 does not
happen to trust
which Division
128 applies

Gains/losses
disregarded
for life interest
owner from
CGT event C1
Division 128
applies



Example

- Jarrod's Will provides for his LPR to transfer legal life and remainder interests in land to Lauren (life interest owner) and Jessica and Harry (remainder owner).
- The LPR acquires the land on 1 February 2000 with a cost base of \$200,000.
- No CGT is payable on the transfer of the land to the LPR.
- Lauren (life interest owner), Jessica and Harry (both the remainder owners), acquire their interests under a reasonable apportionment of the cost base of the land.
- Following Lauren's death, there are no CGT consequences for Jessica and Harry. Any capital gain made by Lauren on her death would be disregarded under Division 128.



Grant of right to reside



- Estate asset to trust (for LRI) – CGT event E1 or CGT event E2 (disregarded – Division 128)
 - Cost base dependent on whether pre-CGT or post-CGT asset
- Right to occupy results in CGT event D1 happen (creation of a right)
 - No capital proceeds received by LPR for grant means no capital gain as market value substitution rule deemed not to apply (s116-30(3)(b))
 - Grantee receives nil cost base **but** right to reside constitutes an ownership interest in dwelling for purposes of main residence exemption



Grant of equitable life interest



- Estate asset to trust (for LRI) – CGT event E1 or CGT event E2 (disregarded – Division 128)
 - Cost base dependent on whether pre-CGT or post-CGT asset
- Separate CGT assets for life interest and remainder interests being acquired
 - Cost base equal market value of interest



Deed of arrangement to vary

- An asset is taken to pass to a beneficiary if the beneficiary becomes the owner of the asset under the Will (or Court varied Will), by way of intestacy or a deed of arrangement (if entered into to settle a claim) – section 128-20 ITAA 1997.
- Reflected TR 2006/14 at paragraph 43, noting:
 - Legal proceedings are not required to commence (communication of a beneficiary's dissatisfaction of the Will is sufficient).
 - Deed of arrangement must be entered into prior to the administration of the estate being finalised, unless the beneficiary can demonstrate that an extension of time would have been entertained by the Courts.



Example - facts

- The deceased acquired the main residence before 20 September 1985 and was the main residence of the deceased until the time of death.
- Probate was granted, appointing F as Executor.
- The Will established a life interest over the property for C.
- C lived in the house as their main residence from before the deceased's death until the settlement of the property.
- Prior to the administration of the estate, C initiated proceeds seeking a provision from the deceased's estate which resulted in Court Orders made.
- The Court Ordered the sale of the property and the balance of the proceeds to be paid to C pursuant to the relevant Family Provision Act in lieu of the provisions of the Will.



Example - outcome

- TR 2006/14 provides guidance on life and remainder interests. Where the assets pass to a taxpayer as beneficiary under a deed of arrangement, there will be no consequences for the life and remainder interests as the intended owners of those interests are treated as if they had not been bequeathed them. The same principle applies for a variation by Court order.
- Private binding ruling 1051337361226.

Trust to which Division 128 applies



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- Division 128 applies to:
 - the passing of an asset from a deceased individual's LPR to a beneficiary in their estate;
 - provided the asset was owned by the deceased individual at the time of their death.
- Can apply to trusts which CGT events E5, E6 and E7 happens when an asset passes from the deceased's LPR to a beneficiary in the deceased's estate.
- NB PS LA 2003/12 where the Commissioner may treat the trustee of a testamentary trust in the same way as he treats a legal personal representative in relation to the passing of an asset of the deceased to a beneficiary.
- PS LA 2003/12 does not apply to CGT event E8 as it does not involve the passing of an asset.



Example – relevant facts

- Person A passed away and Person A's Will provided for Child Two to reside in a dwelling (which was Person A's main residence) as long as they met certain conditions in the Will.
- Should Child Two cease to reside in the dwelling, Person Two, Child One and Child Two (the remainder owners) will each be entitled to a one-third ownership interest in the dwelling.
- A Trust was established to administer the right to occupy.
- A few years later, Child Two sought to relinquish their right to occupy (as Child Two found a new property they were in the process of relocating to).
- Child Two did not receive consideration for their relinquishment of their right to occupy.
- The dwelling was transferred to the remainder owners (CGT event E7 – discussed further below).



Example – outcome

- Division 128 applies to the passing of an asset from a deceased individual's LPR to a beneficiary in their estate.
- A trust to which Division 128 applies requires more than the identification of the trust as a deceased estate and includes a trust over an asset originally owned by a deceased individual and which may pass to the beneficiary in accordance with section 128-20 ITAA 1997.
- The ATO's practice is to not recognize any taxing point in relation to assets owned by a deceased person until they cease to be owned by the beneficiaries named in the Will (in this case, the remainder owners).
- The Trustee will transfer the dwelling to the remainder men to satisfy their interest or share in the estate.
- Therefore, Division 128 ITAA 1997 will apply to the Trust and capital gains are disregarded).
- Private binding ruling 1051774412944



Life interest owner dies



- CGT event C2 happens to **life interest owner** and market value substitution rules do not apply on the expiry of the asset (life interest) and Division 128 may apply (general)
- CGT event E5 or E7 happens to the **remainder owner/LPR** if the asset is distributed. Where CGT event happens to a trust which Division 128 applies – capital gains and losses are disregarded



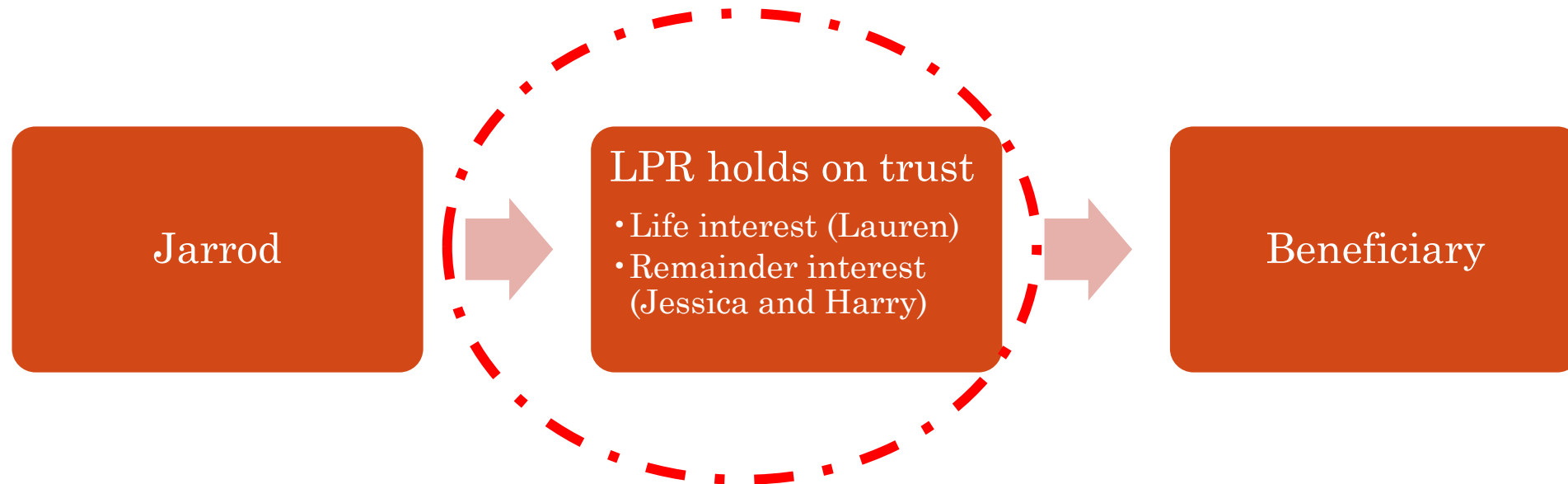
Example – relevant facts

- Jarrod died on 1 February 2000.
- At the time he owned shares in Australian public companies (acquired post 19 September 1985).
- Jarrod's Will provides that his shares are to be held on trust with the income to be paid to his sister Lauren for life and the remainder to his children, Jessica and Harry.
- Lauren subsequently died in February 2005. During the period from 1 July 2004 to the time of Lauren's death, dividends that had been derived by the trust were paid to Lauren. Lauren's estate was also entitled to a portion of the dividends paid to the trustee after her death by virtue of certain apportionment provisions. Jessica and Harry were entitled to the remainder of the dividends paid to the trustee during 2005 income year.
- The trustee transferred the shares to Jessica and Harry in June 2005.

Example – CGT on death of deceased



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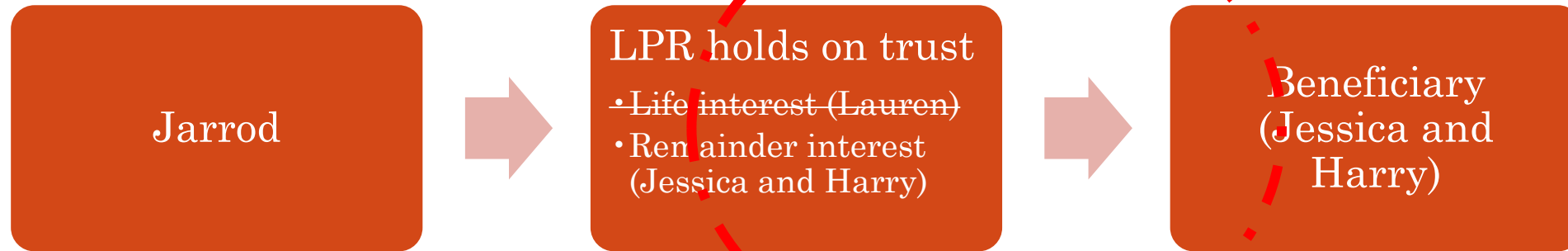


- When Jarrod's estate was administered CGT event E1 happened but was disregarded under section 128-10 ITAA 1997. The trustee acquired Jarrod's cost base in the shares.
- Lauren, Jessica and Harry acquired cost base for the life interest and remainder interest in the shares.

Example – CGT on death of life interest owner



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- When Lauren died, CGT event C2 happened to her life interest and any capital gain resulting was disregarded under Division 128.
- CGT event E7 is also as the distribution of the shares from the trustee to Jessica and Harry (as remainder owners) was in relation to a trust which Division 128 applies.
- Jessica and Harry acquires the shares for the trustee's cost base and they are taken to have acquired the shares on the day that Jarrod died.
- TR 2006/14 at Example 1



Ending a life interest early

- Disclaimers:
 - No CGT event taken to happen
 - More than mere silence.
 - Rejection of interest as soon as possible (before claimed that beneficiary consented to the distribution.
 - Effect on other interests?
 - Asset transferred to remainder owner in event life interest owner disclaims?
 - Who are the new remainder owner if the remainder owner disclaims?
- Agreement to wind up and have assets distributed
- Surrenders of life interests

LRI owners agree to wind up trust



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- **Life interest owner** - CGT event E6. If happens to a trust in which Division 128 applies, then capital gains/losses are disregarded. Otherwise, calculated in the usual manner.
- **Remainder owner** – CGT event E7. If happens to a trust in which Division 128 applies, then capital gains/losses are disregarded. If remainder owner acquired interest for no expenditure, capital gain/loss disregarded. Otherwise, calculated in the usual manner.



Example – relevant facts

- Hector's Will provided his farming property in Queensland be held on trust for his wife for life, and for his three daughters in remainder in equal shares.
- Hector acquired the property in 1993.
- At the time of his death in 2000, the cost base of the property was \$400,000.
- Hector's wife and daughters acquired their interests in the testamentary trust for no consideration. Their interests are taken to have been acquired for their market value. The market value of the life interest at the time was \$175,000.
- At the end of the 2005-06 income year, Hector's wife and daughters agree to wind-up the trust and have the property distributed to them as tenants in common in equal shares (i.e. $\frac{1}{4}$ share held by each of them).
- The market value of the property at this time was \$1,200,000. Hector's wife was presently entitled to the trust income for the 2005-06 income year.



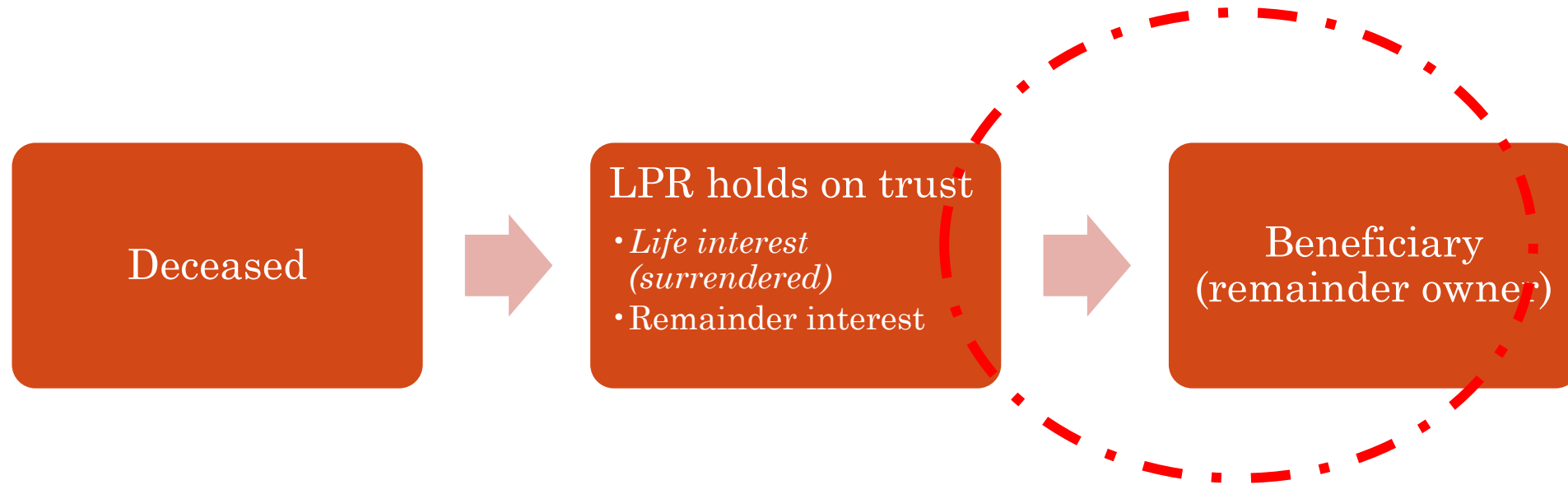
Example – outcome

- CGT event E6 happens in relation to the land transferred to Hector's wife and CGT event E7 happens in relation to the land transferred to Hector's daughters.
- In these particular facts, the land is not passing in a manner consistent with Hector's Will (as Hector's wife is receiving a share of the capital) and therefore Division 128 does not apply. It is noted that the land is also not passing under a deed of arrangement (and either way, the timeframe for such deed has since passed).
- In relation to Hector's wife (the life interest owner):
 - the trustee of the testamentary trust will make a capital gain of \$200,000 from CGT event E6 happening upon distribution of the land to Hector's wife;
 - Hector's wife will make a capital gain of \$125,000 as a result of CGT event E6 happening to her interest in the trust.
- Section 118-20 ITAA 1997 can apply to reduce Hector's wife capital gain from \$125,000 to nil.
- In relation to Hector's daughters (the remainder owners):
 - the trustee of the testamentary trust will make a capital gain of \$600,000 from CGT event E7 happening upon distribution of the land to Hector's daughters;
 - CGT event E7 is exempted for Hector's daughters as each daughter acquired their remainder interest for no expenditure
- TR 2006/14 at Example 4.

Life interest owner surrenders interest



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- **Life interest owner** - CGT event A1. Capital gain/loss calculated in the usual manner.
- **Remainder owner** – CGT event E5 or E7. If happens to a trust in which Division 128 applies, then capital gains/losses are disregarded (unusual for life interest to contemplate an early surrender). Otherwise, calculated in the usual manner upon the transfer.



Example – relevant facts

- Jack died on 1 January 2001. At the time of his death he owned a property which, under his Will, he left on trust for his daughter Georgia for life and his grandchildren Dylan and Thomas in remainder.
- The administration of the estate was completed in 2002.
- The first element of the cost base of Georgia's life interest was \$90,000. The first element of the cost base of Dylan and Thomas' remainder interests is \$200,000.
- Georgia surrendered her life interest to Dylan and Thomas in 2003. Georgia incurred \$5,000 in legal expenses associated with the surrender. The market value of the life interest at the time was surrendered was \$100,000.



Example – outcome

- CGT event A1 will happen when Georgia surrenders her life interest. The cost base of Georgia's life interest is \$95,000 (being the \$90,000 original cost base and \$5,000 expenditure incurred as part of the surrender).
- As Georgia did not receive any capital proceeds as a result of the surrender, she is taken to have received the market value of the life interest equal to \$100,000.
- Georgia has made a capital gain of \$5,000.
- Dylan and Thomas have each acquired a life interest with an acquisition cost of \$50,000 each.
- TR 2006/14 at Example 4. Does not consider implication for remainder owner (Dylan and Thomas).



Main residence CGT exemption

Ownership

- Ownership of 'dwelling' or 'ownership interest' must be held by individual or trustee of a deceased estate

Acquisition date

- Deceased acquired ownership interest on or after 20 September 1985 and dwelling was deceased's main residence just before deceased's death and was not then used for income producing purposes
- Deceased acquired ownership interest before 20 September 1985

End of ownership

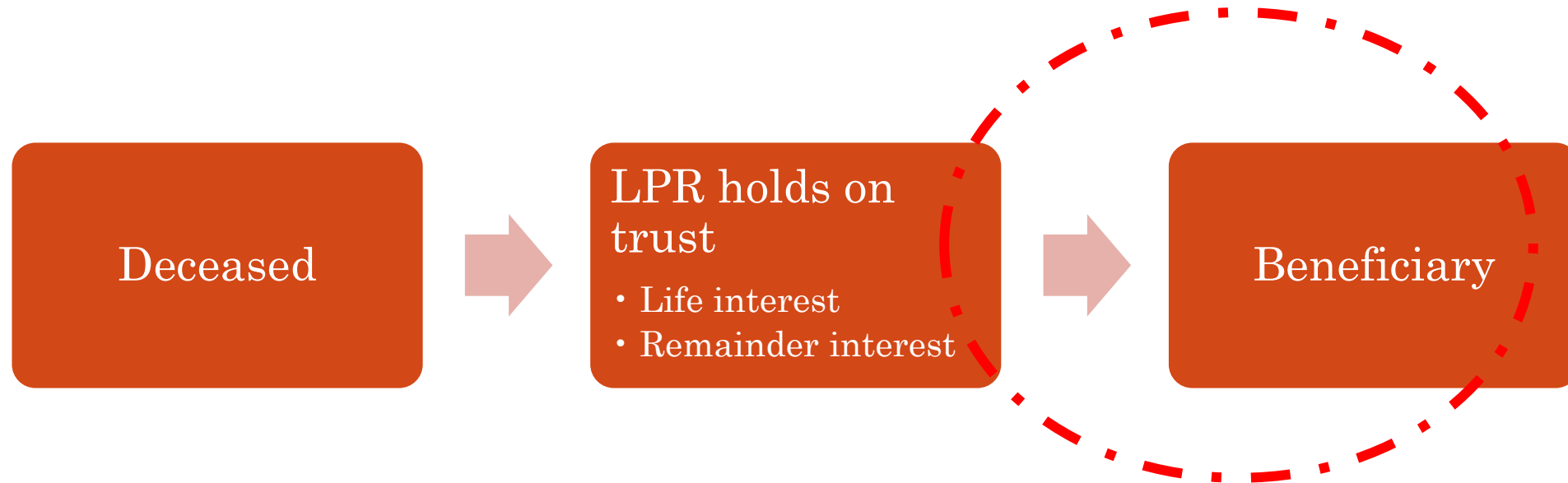
- Ownership interest ends within 2 years of deceased death, or within a longer period allowed by the Commissioner
- Dwelling was, from deceased's death until end of ownership interest, the main residence of one or more of the spouse of deceased, an individual with a right to occupy or individual who is a beneficiary of an ownership interest

- Only available for CGT events A1, B1, C1, C2, E1, E2, F2, K3, K4 and K6.

LRI owners agree to wind up trust – main residence



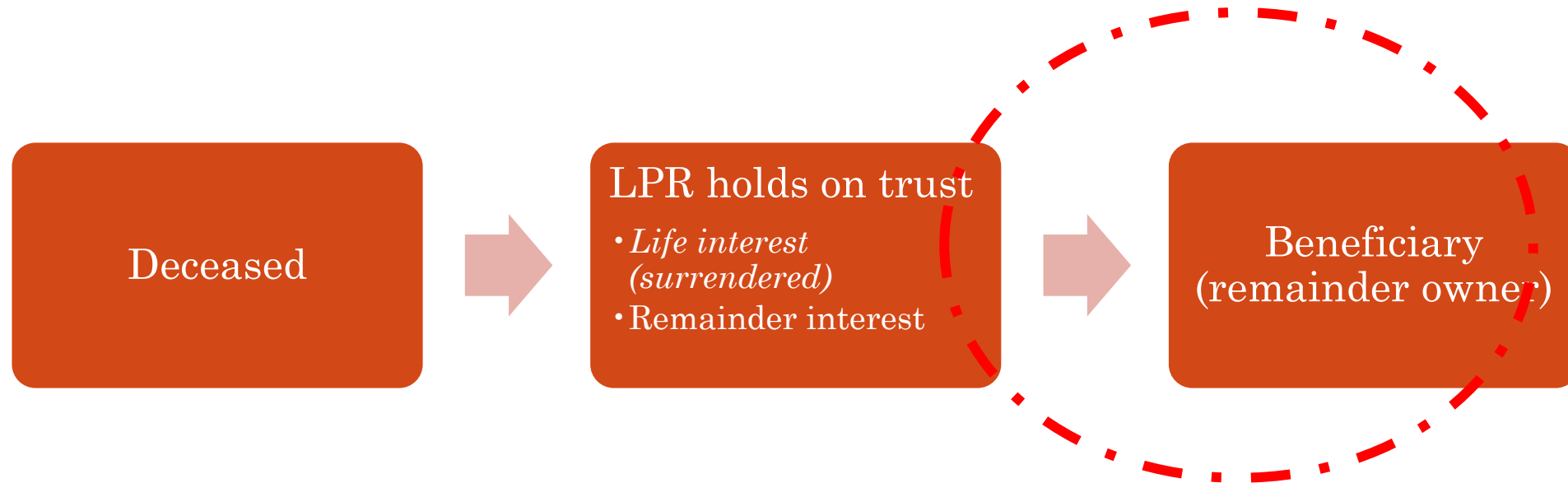
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- **Life interest owner** - CGT event E6.
- **Remainder owner** – CGT event E7.
- If capital gain not disregarded, then main residence exemption not available.



Life interest owner surrenders interest – main residence



- **Life interest owner** - CGT event A1. Capital gain/loss calculated in the usual manner. Main residence potentially available.
- **Remainder owner** – CGT event E5 or E7. If capital gains not disregarded, then main residence not available.
- Difference if LPR sells main residence in trust prior to distribution?



Example – Situation A facts

- Andrew's Will provided for the main residence to be held on trust for Beth for life, with his children (Carmen and Derek) to benefit as remainder owners in equal shares.
- At the time of Andrew's death on 1 January 2012, the cost base of the property was \$200,000.
- At all times following Andrew's death until 1 January 2021, Beth resided in the property.
- Beth wished to surrender her life interest for no consideration as her children found a retirement village for her.
- On 1 January 2021, the market value of the property was \$1,000,000.
- The LPR transferred the main residence to the remainder owners on 1 January 2022. The market value of the property was \$1,200,000.



Example – Situation A outcome

- CGT event A1 happens to Beth's surrender of her life interest and she would be eligible for the main residence CGT exemption as at 1 January 2021.
- CGT event E7 happens on the transfer of the property to the remainder owners.
- The market value on 1 January 2022 is treated as the capital proceeds (\$1,300,000).
- The cost base of the property was \$200,000.
- The main residence CGT exemption is not available for CGT event E7.
- A capital gain equal to \$1,000,000 is made and assessable to the remainder owners.



Example – Situation B

Varied facts

- Same facts as Situation A other than the LPR selling the property on 1 January 2022 before distributing the proceeds.

Varied outcome

- Same outcome for Beth.
- CGT event A1 occurs to the LPR on 1 January 2021.
- A capital gain of \$1,000,000 is made by the LPR.
- A partial main residence CGT exemption is available for the 9/10 years in which Beth (as life interest owner) resided in the property.
- The capital gain is reduced to \$100,000.



Granny flat provisions

- Provides that a CGT event does not happen when certain granny flat arrangements are entered into, varied or terminated.
- No restriction to certain CGT events like the main residence CGT exemption.
- Requires:
 - Granny flat interest in dwelling individual has right to occupy for life.
 - Individual either has met pension age or has a disability.
 - The arrangement to be in writing and indicates an intention for the parties to the arrangement to be legally bound by it.
 - Arrangement not of a commercial nature.
- Introduced in 2021 so guidance is light.
- Consider provisions may apply in a similar manner as main residence CGT exemption, but noting the difficulty to satisfy an 'agreement in writing' requirement and whether such provisions are needed to be drafted in the Will.



Concluding tips

- Life interests can be inflexible and results in multiple CGT taxing points and interests when utilised as part of an estate plan.
- While some scenarios are taxed in a consistent manner as the general deceased estate rules:
 - Where the life interest owner dies.
- Other scenarios result in potential CGT implications due to venturing away from the Will provisions:
 - Where life interest owner surrenders interest early and Will provisions do not cater for such circumstances.
 - Where life interest owner and remainder owners wind the interests up early and distribute the subject assets in a manner inconsistent with the provisions of the Will.
 - Main residence exemptions may also be lost in the above scenarios (in addition to the Division 128 exemption).

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