TR 2005/D14 - Income tax: capital gains tax: consequences of creating, and dealing in, life and remainder interests in property

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This document has been finalised by TR 2006/14.

This ruling contains references to repealed provisions, some of which may have been rewritten. The ruling still has effect. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten. The legislative references at the end of the ruling indicate the repealed provisions and, where applicable, the rewritten provisions.

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Draft Taxation Ruling

Income tax: capital gains tax: consequences of creating, and dealing in, life and remainder interests in property

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Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office.*

What this Ruling is about

1. This Ruling is about the capital gains tax (CGT) consequences of creating life and remainder interests in property (whether *inter vivos* or by testamentary provision) and of any subsequent dealings in those interests.

2. The CGT consequences for *equitable* life estates and remainders are usually different from those arising out of *legal* life estates and remainders. That is because equitable life estates and remainders are interests in trusts (and creating such interests involves putting assets on trust), attracting the operation of specific CGT provisions dealing with trusts (for example the CGT 'E' events, CGT events E5 to E8). Equitable life estates and remainders are more common. Care should be taken to ascertain the precise nature of the life interest or remainder being considered before applying this Ruling.

3. The Ruling also considers the CGT consequences of granting a lifetime right to reside in property.

4. In this Ruling the following terms are used to describe the various CGT assets and parties that own them:

- original asset/original owner – the asset in respect of which life and remainder interests are created/the entity that owned the asset immediately before it became trust property or was transferred to life and remainder owners;
- life interest/life interest owner – an interest in the income of a trust for life or an estate for life in real property/an entity who owns a life interest;

- remainder interest/remainder owner – an interest in the capital of a trust or an estate in remainder in real property/an entity that owns a remainder interest. (In this Ruling, a remainder should be read as including a reversion unless the context suggests otherwise.); and
- trustee – the legal owner of an asset held on trust for the benefit of life interest and remainder owners (including a legal personal representative of a deceased estate where the deceased's assets are to be held on trust for the benefit of life interest and remainder owners).

5. This Ruling does not specifically deal with the treatment of pre-CGT acquired original assets or life and remainder interests. Any capital gain or loss arising from these assets is usually disregarded.

Date of effect

6. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. However, the final Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the final Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Previous Ruling

7. This Ruling replaces Taxation Determination TD 93/35 which is withdrawn on and from the issue date of this draft Ruling.

Ruling

8. There may be different CGT consequences depending on whether the life and remainder interests are equitable or legal.

Equitable life and remainder interests

9. The creation of equitable life and remainder interests in respect of an original asset involves the creation of a trust over the asset or the transfer of the asset to an existing trust.

Trust created

10. Accordingly, when the asset starts to be held for the benefit of the life and remainder owners, the original owner may make a capital gain or loss from CGT event E1 in section 104-55 of the *Income Tax Assessment Act 1997* (ITAA 1997) or from CGT event E2 in section 104-60 of the ITAA 1997. (Note that all modifications to the general capital proceeds rules, including market value substitution if no capital proceeds are received, may apply: section 116-25 of the ITAA 1997).

11. If the trust is created under the will of a deceased person, then any capital gain or loss made by the deceased from CGT event E1 or E2 happening is disregarded under section 128-10 of the ITAA 1997.

Acquisition of asset by trustee

12. If the trust is created *inter vivos*, the trustee acquires the asset for its market value when the trust is created or when the asset is transferred (subsections 104-55(4) and 104-60(4) of the ITAA 1997).

13. If the trust is created by a will over an asset the deceased owned at death, the trustee of their estate acquires the asset for an amount determined under subsection 128-15(4) of the ITAA 1997. Broadly, this means that a post-CGT acquired asset of the deceased (other than their main residence just before death or an item of trading stock) is acquired for the deceased's cost base and reduced cost base.

Acquisition of life or remainder interest

14. An equitable life or remainder interest is a created interest acquired when it starts to be owned. Its first element of cost base and reduced cost base is limited to the sum of any money and market value of property given to acquire it, except where it is not acquired under an arm's length dealing. If no expenditure is incurred to acquire it, paragraph 112-20(1)(a) of the ITAA 1997 has the effect that the interest is not treated as having been acquired for its market value.

Later dealings with life or remainder interests

15. In determining, for the purposes of section 102-25 of the ITAA 1997, the most relevant CGT event that applies in respect of a dealing with an equitable life or remainder interest, regard must be had to Subdivision 104-E of the ITAA 1997 (about trusts) in particular, to CGT events E5 to E8.

Scope of exception in CGT events E5 to E8: 'trust to which Division 128 applies'

16. CGT events E5 to E8 (in sections 104-75 to 104-100 of the ITAA 1997) contain an exception for trusts 'to which Division 128 applies'.

17. Division 128 of the ITAA 1997 contains rules about the passing of an asset from a deceased individual's legal personal representative to a beneficiary in the estate.

18. In the context of CGT events E5, E6 and E7, the exception will therefore apply if, as part of the administration of the deceased's estate, an asset the deceased owned when they died passes to the beneficiary in accordance with section 128-20 of the ITAA 1997. (Note that in certain circumstances where an asset passes to a beneficiary the Commissioner treats the trustee of a testamentary trust in the same way as he treats a legal personal representative: Law Administration Practice Statement PS LA 2003/12).

19. CGT event E8 may apply in relation to the disposal by a beneficiary in the trust capital. The event does not involve the passing of any asset to a beneficiary, so PS LA 2003/12 is inapplicable. Hence, in the context of CGT event E8, the exception could apply only if, during the administration of a deceased individual's estate, a beneficiary disposes of their interest in trust capital. The exception would apply only to the extent that the trust assets were owned by the deceased when they died and may pass to a beneficiary of the estate.

20. In the context of equitable life estates and remainders, the exception in CGT event E8 has no application because such interests are in testamentary trusts which arise after the administration of the estate.

21. Paragraphs 108 to 118 discuss this exception in more detail.

Legal life and remainder interests

22. The 'creation' of a legal life interest constitutes a disposal of part of an existing CGT asset in a similar way to the disposal of a percentage interest in it. Similarly, the 'creation' of the remainder interest is a later disposal of an entire asset being what is left after the life interest is carved out.

Granting an interest inter vivos

23. The original owner may make a capital gain or loss from CGT event A1 happening on the creation of a legal life or remainder interest in another entity.

24. To work out the amount of any capital gain or loss from CGT event A1 happening on the creation of the legal life interest, the cost base and reduced cost base of the original asset are apportioned between the part disposed of in creating the life interest and what remains of the original asset. This happens in accordance with subsections 112-30(2) to (4) of the ITAA 1997. The remainder of the cost base and reduced cost base of the original asset becomes the cost base and reduced cost base of the remainder interest.

25. If no capital proceeds are received by the original owner, they are taken to have received the market value of the interest disposed of. The original owner is also taken to have received market value capital proceeds if the proceeds received from the life interest or remainder owner are more or less than the market value of the life or remainder interest and the original owner did not deal at arm's length with them: section 116-30 of the ITAA 1997.

26. If the life interest and remainder owners did not incur any expenditure to acquire their interests, or they did not deal at arm's length with the original owner in relation to the acquisition of those interests, the market value substitution rule in section 112-20 of the ITAA 1997 applies to determine the first element of their cost base and reduced cost base (that is, the acquisition cost).

Legal life and remainder interests created by will

27. If legal life and remainder interests are created by will, the legal personal representative is taken to have acquired the original asset at the deceased's date of death for the amount determined by subsection 128-15(4). No CGT event happens when the legal life and remainder interests are transferred to the beneficiaries in accordance with the will, and they each acquire their interests at the date of death for an appropriate portion of the legal personal representative's cost base and reduced cost base: subsections 128-15(4) and (5).

Mere right of occupancy

28. A right to reside in property for life (or a term of years) is not equivalent to a legal or equitable life interest. CGT event D1 in section 104-35 of the ITAA 1997 happens when such a right is granted.

Explanation

29. The first part of the Explanation looks at the general nature of life and remainder interests, including the distinction between equitable and legal interests. The second part explains the specific CGT consequences for such interests.

General nature of life and remainder interests

30. 'Life interest' and 'remainder interest' are terms used to describe the interest that an entity has in an asset as either a beneficiary of a trust (equitable interest) or, less commonly, as the owner of a freehold estate in land (legal interest). (It is generally accepted that legal life and remainder interests cannot be created in personal property.)

31. Life and remainder interests usually arise in the context of deceased estates where, for example, the testator wishes to make adequate provision for their spouse while, at the same time, ensuring that all or a substantial portion of their assets are available to their children in due course. However life and remainder interests can arise in *inter vivos* dealings.

32. A life interest in an asset entitles the owner of that interest to any income from that asset. If the asset is land, the life interest owner may also be entitled to possession of the property. As explained by Professor Butt in his text *Land Law:*

> A legal life tenant (that is, a tenant for life of a legal estate) is entitled to possession of the property, since the right to possession follows the legal estate. Whether an equitable life tenant (that is a tenant for life of an equitable estate) is entitled to possession, is more complex. It seems that an equitable life tenant is entitled to possession where the trustees have no active duties to manage the property. But where the trustees have active duties to perform – such as to maintain the property and collect the income – an equitable life tenant is not entitled to possession as of right, unless the instrument creating the life interest confers that right expressly or by implication. However, such an equitable tenant may apply to the court for an order granting possession and the right to manage the property, and the court will normally make the order if the life tenant gives security or an undertaking to indemnify the trustees and preserve the property for the benefit of those entitled after the life estate comes to an end.[1]

33. A life interest is generally measured by the life of the life interest owner although it can be measured by the life of another individual (*pur autre vie*). The life interest ends on the death of the individual who is the measuring life. Except in the very limited case where the life interest owner dies before the individual who is the measuring life, the life interest does not form part of the estate of the life interest owner.[2]

34. The remainder owner is entitled to an interest which vests in possession only when the prior life interest ends. Unlike a life interest, the remainder forms part of the remainder owner's estate for distribution in accordance with their will, or upon intestacy.

35. The distinction between equitable and legal interests is important because each type of interest is treated differently for CGT purposes.

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[1] Butt, P 2001, *Land law,* 4th edn, Lawbook Co, Sydney, paragraph 1019.
[2] Butt, P op cit, paragraph 1007.

Equitable interests

36. As for other trusts where there is no absolutely entitled beneficiary,[3] a trustee who holds assets for the benefit of life interest and remainder owners is, for CGT purposes, the relevant 'owner' of the trust assets.

37. The beneficiaries each have separate CGT assets being their trust interests – the equitable life and remainder interests. The CGT events in Subdivision 104-E apply to those interests and apply in priority to more general events such as CGT event A1 or C2 that could also apply. Some of the events in Subdivision 104-E have particular rules that apply in respect of capital gains and capital losses from trust interests. For example, a capital gain or capital loss from an interest in trust capital may be disregarded if it was acquired for no expenditure.

Legal interests

38. Paragraph 16 of Taxation Ruling IT 2561 provides that certain interests in real property are to be treated as created interests for CGT purposes:

> An easement, profit a prendre or licence (*or other comparable right*) (emphasis added) is an asset created at the time it is granted. The asset is taken by paragraph 160M(5)(c) of the Act to have been acquired by the grantor. Subsection 160C(2) then treats the grantor as owning the asset. The time of acquisition is determined by section 160U.
>
> Where the ownership of the asset changes – i.e., where the grantee becomes the owner of the easement, profit a prendre or licence (or other comparable right) – there is a disposal of the asset by the grantor (and an acquisition of the asset by the grantee) in terms of subsection 160M(1). Alternatively, the grant of the easement, profit a prendre or licence (or other comparable right) may, by reason of subsection 160M(6), constitute the disposal of the asset created by the grantor.
>
> It follows that, if the grant of the easement, profit a prendre or licence (or other comparable right) occurs on or after 20 September 1985, there is an acquisition by the grantor of a new asset created after that date. Therefore, the capital gains provisions apply on the disposal of the new asset. This is so notwithstanding that the underlying asset, for example the land, may have been acquired before 20 September 1985.[4]

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[3] Taxation Ruling TR 2004/D25 discusses when a beneficiary is absolutely entitled to a trust asset. Paragraph 63 states: The remainderman will not be absolutely entitled until the death of the life tenant or the surrender by the life tenant of their interest. Until then the remainderman cannot demand the transfer of the whole of the asset to them because such a transfer would defeat the interest of the life tenant.

[4] The references in this extract are to the provisions that applied prior to amendments which took effect on 26 June 1992. Taxation Determination TD 93/235 is about the effect of those amendments. The provisions were rewritten as CGT event D1 in the ITAA 1997.

39. Because the grant of these rights is not treated as a part disposal of the underlying asset no part of the cost base of that asset can be taken into account in working out the amount of any capital gain or loss from the grant.

40. Much academic debate has been had about whether this treatment also applies to legal life and remainder interests.[5]

41. We consider that legal life and remainder interests are not comparable to easements, profits a prendre or licences. Legal life and remainder interests are carved out of the existing fee simple and not superimposed on it in the way that rights attaching to these other interests are. Together legal life and remainder interests represent the entire freehold interest in the land. By 'creating' a life interest, the original owner is actually disposing of part of the freehold interest in the land in a similar way to the disposal of a percentage interest in the property.

42. Therefore, the creation of legal life and remainder interests involves disposals of the original asset by the original owner if created *inter vivos* or disposals by the legal personal representative or trustee of a deceased estate if the interests were bequeathed under the deceased's will.

Equitable life and remainder interests

43. The CGT provisions are relevant when an equitable life or remainder interest is created or subsequently dealt with.

Trust created

44. The creation of an equitable life or remainder interest in respect of an original asset involves the creation of a trust. There are consequences for the original owner of the asset, the trustee and the life interest and remainder owners.

Consequences for original owner

45. If a trust over an original asset is created by declaration or settlement, CGT event E1 in section 104-55 of the ITAA 1997 happens at the time the trust is created. The event happens if the trust was created *inter vivos* or under the will of a deceased person.

46. The original owner of the original asset makes a capital gain if the capital proceeds from the creation of the trust are more than the cost base of the asset. They make a capital loss if those capital proceeds are less than the reduced cost base of the asset: subsection 104-55(3).

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[5] See for example Barkoczy, S and Cussen, P, 'Capital gains tax and the grant of life and remainder interests under wills: the debate between the creation and part disposal views', *Australian Tax Review*, 1993, Volume 22, p. 209.

47. If no capital proceeds are received by the original owner, they are taken to have received the market value (at the time the trust is created) of the original asset. The original owner is taken to have received market value capital proceeds if the proceeds received are more or less than the market value of the original asset and the original owner and the trustee did not deal at arm's length in connection with the event: section 116-30 of the ITAA 1997.

48. If the trust is created under the will of a deceased person then any capital gain or loss made by the deceased from CGT event E1 happening is disregarded under section 128-10 of the ITAA 1997.

49. If an asset is transferred to an existing trust to be held for the benefit of life interest and remainder owners, CGT event E2 in section 104-60 of the ITAA 1997 happens. The consequences of that event happening are similar to those set out above in relation to CGT event E1.

Consequences for trustee

50. If the trust is created *inter vivos*, the trustee acquires the original asset when the trust is created or the asset is transferred: subsection 109-5(2) of the ITAA 1997. The trustee's acquisition cost is the market value of the original asset at that time: subsections 104-55(4) and 104-60(4) of the ITAA 1997.

51. If the trust is created as a result of the death of an individual, the trustee acquires the original asset at the date of the deceased's death: subsection 128-15(2) of the ITAA 1997. The trustee's acquisition cost is determined under subsection 128-15(4) of the ITAA 1997.

52. Subsection 128-15(4) of the ITAA 1997 provides that assets which the deceased acquired on or after 20 September 1985 (other than trading stock and their main residence) are acquired by the trustee for an amount equal to the deceased's cost base or reduced cost base. A dwelling that was the deceased's main residence just before they died or an asset that the deceased acquired before 20 September 1985 is acquired for market value at the date of death. An asset that was part of the deceased's trading stock is acquired for an amount worked out under section 70-105 of the ITAA 1997.

Consequences for life interest and remainder owners

53. Being trust interests, the life and remainder interests are created interests that are acquired when they commence to be owned: subsection 109-5(1) of the ITAA 1997. The interests are not acquired pursuant to Event number E1 in the table in subsection 109-5(2) because this is only relevant to the trustee's acquisition of the original asset. Further item 3 in the table in section 109-10 does not apply because the trust is not a unit trust.

54. The first element of the cost base and reduced cost base of a life or remainder interest is limited to the sum of any money and the market value of any property given to acquire it, except where it is not acquired under an arm's length dealing. The market value substitution rule does not apply in calculating the first element of the cost base and reduced cost base of life and remainder interests acquired for no expenditure: paragraph 112-20(1)(a) of the ITAA 1997.

Disposal of asset by trustee to a third party

55. CGT event A1 in section 104-10 of the ITAA 1997 happens if a trustee disposes of an original asset held on trust for life interest and remainder owners.

56. A trustee of a trust created by will may be able to disregard a capital gain made from the disposal of:

- a dwelling that the deceased acquired before 20 September 1985; or
- one that was acquired after that date and which was the deceased's main residence when they died,

if the dwelling is occupied by an individual who has a right to occupy the dwelling under the deceased's will: sections 118-195 and 118-200 of the ITAA 1997.

57. Any capital gain or loss from CGT event A1 happening is taken into account in working out the trustee's net capital gain or loss. A net capital gain is included in the net income of the trust in accordance with subsection 95(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) and taxed in accordance with Division 6 of Part III of the ITAA 1936. (Note the existence of Practice Statement PS LA 2005/1 (GA)).

Life interest or remainder owner disclaims interest

58. A beneficiary may disclaim their interest in a trust. An effective disclaimer must be intentional and show unequivocally that the beneficiary rejects their interest. The right to disclaim is lost if the beneficiary has engaged in positive conduct indicating an acceptance of the interest. The right may also be lost if it is not exercised within a reasonable time, in that a beneficiary who remains silent beyond the time when they may be expected to disclaim the interest may be presumed to have accepted it. If a beneficiary effectively disclaims their trust interest, they are retrospectively disentitled to it.

59. Accordingly, no CGT event happens to a life interest or remainder owner in respect of the disclaimer of their interest as they are taken never to have acquired it.

60. Further, if the life interest is disclaimed, the trustee would hold the trust assets *ab initio* for the benefit of the remainder owners. The CGT consequences arising from the creation of the trust may need to be reconsidered if the original owner is also the owner of the remainder interest (reversion). That is, CGT event E1 may not happen if the original owner purported to create the trust by declaration (because there can be no trust if the trustee is the sole beneficiary). If the trust is created by settlement, the exception to CGT event E1 happening in paragraph 104-55(5)(a) of the ITAA 1997 may apply. That exception broadly applies if the entity creating the trust is the sole beneficiary of the trust and is absolutely entitled to the trust asset as against the trustee.

61. If the remainder interest is disclaimed, the interest will vest *ab initio* in the original owner (*inter vivos* trust) or residuary beneficiaries (deceased estate trust).

Death of person by whose life the life interest is measured

62. The death of the person by whose life the life interest is measured will cause the life interest to end. There are consequences for the life interest owner and the trustee and remainder owner.

Consequences for life interest owner

63. CGT event C2 in section 104-25 of the ITAA 1997 happens if ownership of an intangible asset ends in one of a range of ways including by satisfaction or expiry.

64. Stroud's Judicial Dictionary (Sixth Edition) defines expiry as 'for the term to run itself out by effluxion of time, or otherwise in due course, as distinguished from being forcibly put to an end.' The ending of a life interest because of the death of the relevant individual is an example of an expiry: no deliberate action is taken to bring the interest to an end.

65. CGT event C2 happens when a contract that results in the ending of the asset is entered into or, if there is no contract, when the asset ends: subsection 104-25(2) of the ITAA 1997. CGT event C2 happens when the measuring life for the life interest dies because the interest expires at that time.

66. A capital gain is made from CGT event C2 happening if the capital proceeds from the ending of the asset are more than its cost base and a capital loss is made if those proceeds are less than the asset's reduced cost base: subsection 104-25(3) of the ITAA 1997.

67. Where no capital proceeds are received, the market value substitution rule will not apply because CGT event C2 has happened as a result of the expiry of the asset: subparagraph 116-30(3)(a)(i) of the ITAA 1997. However, the market value of the life interest will be substituted for the capital proceeds from CGT event C2 if proceeds have been received and they are more or less than the market value. The market value of the life interest is worked out as if the event had not occurred and was never proposed to occur: subsection 116-30(3A).

68. If the interest has no acquisition cost and no capital proceeds are received for it, the life interest owner is likely to make a capital loss equal to the amount (if any) included in the second, third, fourth and fifth elements of the reduced cost base of the life interest under section 110-55 of the ITAA 1997.

69. If the life interest was measured by the life of its owner, any capital loss from CGT event C2 happening is disregarded under section 128-10 of the ITAA 1997. That section disregards gains and losses from CGT events that happen to assets owned by an individual as a result of their death.

Consequences for trustee/remainder owner

70. If, on the ending of the life interest, the remainder owner becomes absolutely entitled, as against the trustee, to a trust asset CGT event E5 in section 104-75 of the ITAA 1997 may happen.[6] The event does not happen if the trust is a unit trust or a trust to which Division 128 applies. Paragraphs 108 to 118 discuss the meaning of 'a trust to which Division 128 applies' in more detail.

71. CGT event E5 can have consequences for both the trustee and the remainder owner.

72. The trustee makes a capital gain from the event happening in respect of each trust asset if the market value of the asset (at the time the remainder owner becomes absolutely entitled to it) is more than its cost base. The trustee makes a capital loss if that market value is less than the asset's reduced cost base: subsection 104-75(3) of the ITAA 1997.

73. The remainder owner makes a capital gain if the market value of the asset at the time they become absolutely entitled to it is more than the cost base of their interest in the trust capital to the extent it relates to the asset. They make a capital loss if the market value is less than the reduced cost base of the interest in the trust capital to the extent it relates to the asset: subsection 104-75(5) of the ITAA 1997.

[6] If there are two or more remainder owners they would not usually become absolutely entitled to the trust assets on the death of the life interest owner, unless the assets were fungible and certain other requirements were met: see TR 2004/D25.

74. However, if the remainder owner did not pay anything to acquire their interest in the trust capital and did not acquire it by assignment, then any capital gain or loss the remainder owner makes will be disregarded: paragraph 104-75(6)(a) of the ITAA 1997.

75. If both the trustee and remainder owner make a capital gain from CGT event E5 happening, the anti-overlap rule in section 118-20 of the ITAA 1997 applies to reduce the remainder owner's capital gain by the amount of the trust capital gain included in their assessable income under a provision of Division 6 of Part III of the ITAA 1936 (for example section 97).

76. Subsection 118-20(1) of the ITAA 1997 relevantly provides:

> A capital gain you make from a CGT event is reduced if, because of the event, a provision of this Act (outside of this Part) includes an amount (for any income year) in your assessable income or exempt income.

77. Section 118-20 is not precluded from applying merely because the CGT event has happened to two different parties (that is, the trustee and the remainder owner). In addition, the fact that an amount equal to the amount included in assessable income under section 97 of the ITAA 1936 is deducted from the remainder owner's assessable income for the purposes of applying the rules in Subdivision 115-C does not prevent the anti-overlap rule in section 118-20 of the ITAA 1997 from applying.

Life interest and remainder owners request the trustee to wind up trust and distribute assets to each of them

78. The life interest and remainder owners may request the trustee to bring the trust to an end and transfer the trust assets to one or to both of them.[7]

Transfer of asset to life interest owner

79. CGT event E6 in section 104-80 of the ITAA 1997 happens if the trustee of a trust (except a unit trust or a trust to which Division 128 applies) disposes of a CGT asset of the trust to a beneficiary in satisfaction of the beneficiary's right, or part of it, to receive income from the trust. Paragraphs 108 to 118 discusses the meaning of 'a trust to which Division 128 applies' in more detail.

80. If CGT event E6 happens there are consequences for the trustee and for the life interest owner.

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[7] Meagher, RP and Gummow, WMC, 1997, *Jacobs' law of trusts in Australia*, 6th ed, Butterworths, Sydney, paragraph 2308.

81. The trustee makes a capital gain from CGT event E6 if the market value (at the time of the event) of the asset disposed of is more than its cost base. The trustee makes a capital loss if that market value is less than the asset's reduced cost base: subsection 104-80(3) of the ITAA 1997.

82. The life interest owner makes a capital gain from CGT event E6 if the market value of the asset they acquire from the trustee is more than the cost base of their right to income (that is, their life interest). They make a capital loss if the market value of the asset is less than the reduced cost base of the life interest: subsection 104-80(5) of the ITAA 1997.

83. If the beneficiary did not incur any expenditure to acquire their trust interest, paragraph 112-20(1)(a) of the ITAA 1997 ensures that the market value substitution rule will not apply to determine the first element of its cost base or reduced cost base. In the case where consideration was given to acquire the life interest, the first element of the cost base and reduced cost base of the asset will be limited to the sum of any money or property given, except where the beneficiary was not dealing at arm's length.

84. Unlike the case for a capital gain or capital loss from a remainder interest, a capital gain or capital loss made by a life interest owner is not disregarded merely because the interest was acquired (other than by way of assignment) for no expenditure.

Transfer of asset to remainder owner

85. CGT event E7 in section 104-85 of the ITAA 1997 happens if the trustee of a trust (except a unit trust or a trust to which Division 128 applies) distributes an asset to a remainder owner in satisfaction of their interest in the trust capital. Paragraphs 108 to 118 discuss the meaning of 'a trust to which Division 128 applies' in more detail.

86. If CGT event E7 happens there may be CGT consequences for both the trustee and the remainder owner.

87. The trustee makes a capital gain if the market value of the asset at the time of the disposal is more than its cost base. The trustee makes a capital loss if that market value is less than the asset's reduced cost base: subsection 104-85(3) of the ITAA 1997.

88. The remainder owner makes a capital gain if the market value of the asset at the time of the disposal is more than the cost base of the remainder interest or the part of it being satisfied. They make a capital loss if that market value is less than the reduced cost base of that interest or part: subsection 104-85(5) of the ITAA 1997.

89. However, any capital gain or loss the remainder owner makes is disregarded if they acquired their trust interest (except by way of an assignment from another entity) for no expenditure: paragraph 104-85(6)(a) of the ITAA 1997.

Deed of arrangement to vary terms of deceased's will

90. It may be that beneficiaries who have been granted life and remainder interests in the assets of a deceased estate are dissatisfied with the provision that the deceased person made for them under their will. During the administration of the estate, the beneficiaries may enter into a deed of arrangement to settle their claims to participate further in the distribution of the estate.

91. As a result of the agreement the trustee may transfer particular assets to the intended life interest and remainder owners. If the only expenditure given by them for the asset consists of the variation or waiver of a claim to one or more other assets that formed part of the deceased's estate then the asset transferred to the beneficiary will pass to them as a beneficiary in the estate under paragraph 128-20(1)(d) of the ITAA 1997.

92. A taxpayer is not required to commence legal proceedings in order to establish, for the purposes of paragraph 128-20(1)(d) of the ITAA 1997, that they have a valid claim to participate in the distribution of the assets of the estate. A valid claim may be established by a potential beneficiary communicating to the trustee their dissatisfaction with the will.

93. By entering into the deed of arrangement, the deceased's will is effectively varied and the nominated life interest and remainder owners are treated as if they had not been bequeathed those interests.

Dealings between life interest and remainder owners

94. If a life interest or remainder owner surrenders or releases their interest CGT event A1 (section 104-10) rather than CGT event C2 (section 104-25) happens. We consider that CGT event A1 is the applicable event, as there is a change of ownership of the interest from one party to the other, rather than a mere ending of it.

95. Whether the surrender of a life interest constitutes a conveyance of that interest was considered in *Platt and others v. Commissioners of Inland Revenue* (1953) 46 TC 418. The Court held that deeds, described as deeds of surrender and release operated as conveyances or transfers of the life interests which were the subject of the deed:

> It seems to me to be, on principle, perfectly plain that these documents… did operate as voluntary dispositions *inter vivos*; they had the effect of accelerating or bringing into operation interests which, but for their execution, would not have existed ..The question of whether they are conveyances or transfers can equally be solved, I think, with no greater measure of doubt than the first. I think they were conveyances or transfers, and no less so because they have chosen to be described as surrenders or releases or deeds, or by any other name; they did in fact operate as voluntary dispositions *inter vivos*, and if authority be required for that proposition it is undoubtedly to be found in the case … *Stanyforth v. Commissioners of Inland Revenue* [1930] AC 339….

96. If the surrender or release is for no capital proceeds the market value substitution rule in subsection 116-30(1) of the ITAA 1997 applies to determine the amount of capital proceeds from the event.

97. If capital proceeds are given for the surrender, the market value substitution rule applies if those proceeds are more or less than the market value of the interest surrendered and the parties did not deal at arm's length: subsection 116-30(2) of the ITAA 1997.

98. The party acquiring the interest may be taken to have paid market value if no expenditure is given to acquire it or they did not deal at arm's length in relation to the acquisition: subsection 112-20(1) of the ITAA 1997.

99. At law, when a lesser estate became vested in the same person in whom a greater estate was vested, the lesser estate was merged in the greater and was extinguished. However, in equity, a merger will occur only if that is the intention (actual or presumed) of the person in whom the interests become united.[8]

100. Accordingly, a merger of equitable life and remainder interests will be presumed not to have occurred for CGT purposes unless there is an indication to the contrary.

Dealings between life interest owner and third party

101. CGT event A1 in section 104-10 of the ITAA 1997 happens if a life interest owner sells or otherwise assigns their life interest to a third party. The life interest owner makes a capital gain if the capital proceeds from the disposal are more than the cost base of their interest in the trust. They make a capital loss if those capital proceeds are less than the reduced cost base of the trust interest. See subsection 104-10(4) of the ITAA 1997.

102. Subsection 112-20(1) of the ITAA 1997 ensures that the market value substitution rule does not apply to determine the cost base of the life interest owner's interest if no expenditure was incurred to acquire the interest. Otherwise, the first element of cost base and reduced cost base is limited to the sum of any money and property given by the life interest owner to acquire it, except where the interest was not acquired under an arm's length dealing.

103. If the assignment occurs for no capital proceeds or, if the capital proceeds are more or less than the market value and the parties are not dealing at arm's length, then the market value substitution rule in section 116-30 of the ITAA 1997 will apply to determine the capital proceeds from the event.

[8] See Halsbury's Laws of England paragraph 765 – merger of estates.

Dealings between remainder owner and third party

104. CGT event E8 in section 104-90 of the ITAA 1997 happens if a remainder owner disposes of a post-CGT acquired interest in the capital of a trust (except a unit trust or a trust to which Division 128 applies) provided they:

- did not give any money or property to acquire their remainder interest; and
- did not acquire it by assignment.

Paragraphs 108 to 118 discuss the meaning of 'a trust to which Division 128 applies' in more detail.

105. If CGT event E8 happens the remainder owner calculates their capital gain in accordance with the method statement in section 104-95 of the ITAA 1997. They calculate their capital loss in accordance with the method statement in section 104-100 of the ITAA 1997.

106. If no capital proceeds are received from the disposal or, if the capital proceeds are more or less than the market value of the interest and the parties are not dealing at arm's length, the market value substitution rule will apply: section 116-30. The interest that is relevant for the purposes of CGT event E8 is the interest in the trust capital (that is, the remainder interest), not the interest in the underlying assets: subsection 116-30(4) of the ITAA 1997.

107. If CGT event E8 does not happen because the remainder owner paid to acquire their interest or acquired it by way of assignment, then CGT event A1 in section 104-10 of the ITAA 1997 happens when the interest is disposed of to the third party.

Scope of exception in CGT events E5 to E8: 'trust to which Division 128 applies'

108. The expression 'a trust to which Division 128 applies' replaces two expressions used in the ITAA 1936.

109. Subsection 160ZX(1) of the ITAA 1936 (rewritten as CGT event E5) excluded *'an estate of a deceased person'*. Subsection 160ZX(2) of the ITAA 1936 (CGT event E7), section 160ZYA of the ITAA 1936 (CGT event E6) and section 160ZYB of the ITAA 1936 (CGT event E8) contained exclusions for *'a trust that arose upon or resulted from the death of a person'*.

110. The earlier expressions were considered in Taxation Determination TD 93/35 (in the context of assets that a deceased person did not own at the time of death) as follows:

> In paragraph 160ZX(1)(a), the phrase 'estate of a deceased person', in contrast to the phrase 'a trust that arose upon or resulted from the death of a person' used elsewhere in Div 6 of Part IIIA, is taken to mean the estate of the deceased person while it is being administered by the executor or administrator. It does not include a testamentary trust which may arise after administration of the estate is completed.

> Prior to the death of the life tenant (and given that the administration of the estate is complete, at least in respect of that asset), the asset is held by a trustee of a trust which is not 'the estate of a deceased person'. On the death of the life tenant, the remainderman will become absolutely entitled to the asset. Accordingly, subsection 160ZX(1) deems the trustee to have disposed of the asset to the remainderman at the time the remainderman became absolutely entitled.

111. Because one expression has replaced two different expressions, the new expression cannot be interpreted as expressing the same ideas as the ITAA 1936 albeit in a different form of words. Although a change to the provisions may not have been intended, section 1-3 of the ITAA 1997 cannot be relied on in interpreting the new expression. Section 1-3 was considered in *Re Sherlinc Enterprises Pty Ltd and Federal Commissioner of Taxation:*[9]

> They [explanatory memoranda, records of parliamentary debates and other secondary materials relating to the legislation under consideration] are silent on the change to the law introduced by s 123-10 of the ITAA 1997. Although it may be inferred from this fact that no change to the law was intended it cannot displace the clear meaning of s 123-10 and reinstate the position that prevailed under Div 17A of the ITAA 1936.

112. Division 128 applies to the passing of an asset from a deceased individual's legal personal representative to a beneficiary in their estate (provided the asset was owned by the deceased individual at the time of their death).

113. Accordingly, 'a trust to which Division 128 applies' requires more than the identification of the trust as a deceased estate. We consider that the words 'a trust to which Division 128 applies' should be interpreted as a deceased estate to the extent that it is a trust over an asset originally owned by a deceased individual and which may pass to the beneficiary in accordance with section 128-20 (that is, under the will, by intestacy etc.).

114. In the context of CGT events E5, E6 and E7 this means that the exception applies if subsection 128-15(3) applies to relieve any capital gain or capital loss that arises (or would apply in that way if there were a capital gain or capital loss) when an asset passes from the deceased's legal personal representative to a beneficiary in their estate.

115. In certain circumstances the Commissioner treats 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.

116. This is relevant for the scope of the exception in CGT events E5 to E7 which deal with such a passing of an asset.

117. On the other hand, CGT event E8 happens if a beneficiary under a trust (except a trust to which Division 128 applies) disposes of their interest in the trust capital. A capital gain from the event is worked out by reference to the trust's assets and liabilities (net asset amount).

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[9] [2004] AATA 113; (2004) 2004 ATC 2022; (2004) 55 ATR 1001.

118. CGT event E8 does not involve any passing of an asset by the trustee to a beneficiary. PS LA 2003/12 does not apply in relation to that event. Also, because a trust with a life and remainder interest created under a will arises *after* administration of the deceased estate, the CGT event E8 exception for a 'trust to which Division 128 applies' cannot in fact apply to the disposal of such an interest.

Legal life and remainder interests

119. The CGT provisions are relevant when a legal life or remainder interest is created or subsequently dealt with.

Granting an interest inter vivos

120. CGT event A1 in section 104-10 of the ITAA 1997 happens if an original owner of real property disposes of a legal life interest to another person, that is, there is a change of ownership of part of the original asset from the original owner to the life interest owner.

121. The original owner makes a capital gain from the disposal if the capital proceeds from the event exceed the portion of the cost base of the original asset attributable to the carved out asset that becomes the life interest. They make a capital loss if the capital proceeds are less than that part of the reduced cost base of the original asset.

122. The market value substitution rule in section 116-30 of the ITAA 1997 applies to determine the capital proceeds if:

- no capital proceeds are received for the disposal of the life interest; or
- the proceeds are more or less than the market value of the interest and the original owner and life interest owner did not deal with each other at arm's length.

123. Subsections 112-30(2) and (3) of the ITAA 1997 contain cost base rules that apply if, a CGT event happens to some part only of an asset. Specifically, the cost base of that part of the asset to which the CGT event happens is worked out using the following formula:

$$\frac{\text{cost base of asset} \times \text{capital proceeds from CGT event}}{\text{capital proceeds from CGT event + market value of the remaining part of the asset}}$$

124. The reduced cost base is worked out similarly.

125. The disposal of the remainder interest also results in CGT event A1 happening. The original owner determines the cost base of the remainder in accordance with the apportionment rule in subsection 112-30(4) of the ITAA 1997.

126. Commentators[10] have suggested that section 160ZI of the ITAA 1936 (the ITAA 1936 equivalent to subsections 112-30(2)-(4)) could not operate where an asset was disposed of in separate parts and no part was retained by the original owner. They argued that in these circumstances there is no part of the asset that remains undisposed of (or in the context of subsection 112-30(2) it is not the case that a CGT event happened to part of the asset, but not to the remainder of it).

127. However, we take the view that both the original and rewritten provisions do operate to apportion the cost base of the original asset of legal life and remainder interests. The disposal of the life and remainder interests do not occur simultaneously. The disposal of the life interest must, as a matter of law, precede that of the remainder (that is, the law cannot recognise a remainder without the corresponding life interest). Accordingly, at the instant that the life interest is disposed of, the remainder is undisposed of and therefore a CGT event has happened to part of the asset but not to all of it.

128. The life interest and remainder owners acquire their respective interests at the time CGT event A1 happens to the original owner: subsection 109-5(2) of the ITAA 1997. If no money or property was given to acquire the interest, or the life interest or remainder owner did not deal at arm's length with the original owner in relation to the acquisition of the interest and the total market value of money or property given was not the same as the market value of the interest, its first element of the cost base and reduced cost base is its market value at the time of acquisition: section 112-20 of the ITAA 1997.

Granting an interest under the will of a deceased person

129. In some cases an individual may wish to create legal life and remainder interests in beneficiaries under their will. In these circumstances, the deceased's legal personal representative is taken to have acquired the original asset on the date of the deceased's death, for an amount determined by reference to the table in subsection 128-15(4) of the ITAA 1997.[11]

130. CGT event E6 in section 104-80 and CGT event E7 in section 104-85 of the ITAA 1997 do not happen when the trustee transfers a legal life and remainder interest to the beneficiaries in accordance with the deceased's will because of the exception for trusts to which Division 128 applies.

131. Further, no other CGT event is considered to happen as a result of the transfers by the legal personal representative to the life interest and remainder beneficiaries. That is, a specific exception to CGT events E6 and E7 having applied, it is not considered appropriate to apply CGT event A1.

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[10] Barkoczy and Cussen op cit page 44.

[11] Note the LPR will acquire the asset for its market value if the deceased acquired it before 20 September 1985: subsection 128-15(4) of the ITAA 1997.

132. While any capital gain or capital loss the legal personal representative would make from CGT event A1 happening would be disregarded by subsection 128-15(3) of the ITAA 1997, there is no provision to disregard capital gains or capital losses that the life interest or remainder owners may make in respect of the ending of their trust interest. It is improbable that the legislature would have intended that a beneficiary in a deceased estate be in a worse position than one who acquired their interest for no expenditure in an *inter vivos* trust.

133. The life interest and remainder owners acquire their interests in the property at the date of death based on a reasonable apportionment of the legal personal representative's cost base and reduced cost base: subsections 128-15(4) and (5) of the ITAA 1997. This is no difference in principle from what happens when other interests in an estate asset pass to beneficiaries. An apportionment based on the relative market values of the interests created would be considered reasonable.

Disclaimer of legal life or remainder interest

134. If a legal life or remainder interest is transferred to a person, the property vests immediately in that person even if they have no knowledge of the transfer, subject to their right to disclaim it when later informed of the transfer to them.[12] If a legal life interest or remainder owner effectively disclaims their interest, the transfer to them is void. No CGT event happens if a life interest or remainder owner disclaims their interest as they are taken never to have acquired it.

135. If the life interest is disclaimed, the disclaimer has the effect of leaving the remainder owner with the entire fee simple. If the remainder interest is disclaimed the remainder revests in the original owner.

Death of life interest owner

136. On the death of the life interest owner, CGT event C1 in section 104-20 of the ITAA 1997 happens. We do not consider that CGT event C2 happens in this case because the legal life interest is not an intangible asset. If the life interest owner makes a capital gain or capital loss from CGT event C1 happening, it is disregarded under section 128-10 of the ITAA 1997.

[12] *Standing v. Bowring* (1885) 31 ChD 282.

137. The death of the life interest owner has no CGT consequences for the remainder owner. The remainder owner does not acquire any asset from the life interest owner, their existing interest is merely enlarged. Consequently, no additional amount can be included in the first element of the cost base of the remainder owner's asset (now a fee simple interest unencumbered by the life interest).

Dealings between life interest and remainder owners

138. The transfer of a legal life interest or remainder to the owner of the other interest (commonly called a surrender or release) results in CGT event A1 in section 104-10 of the ITAA 1997 happening. The market value substitution rule section in 116-30 of the ITAA 1997 may apply to determine the capital proceeds from that event. Also, the market value substitution rule in section 112-20 of the ITAA 1997 may apply to determine the cost base of the acquired interest.

139. If the legal life interest holder sells or assigns their interest to the remainder interest holder or vice versa then the interests may merge. However, where the land is Torrens title, the merger does not occur until the register is altered to reflect the acquisition of the life estate.[13]

140. If the assets merge there is no CGT event for the owner of the interest that enlarges. Each element of the cost base and reduced cost base of the new merged asset is the sum of the corresponding elements of each original asset: subsection 112-25(4) of the ITAA 1997.

Grant of lifetime right to reside in property

141. A life interest is different from a mere personal right to occupy a property for life. A right of occupancy does not carry with it a right to any income from the property. The distinction is important because different CGT consequences arise depending on whether a life estate or right to occupy is created.

142. Whether a life estate or right to occupy is created depends on all the facts and circumstances of a particular case. Generally, if a taxpayer is granted a right to 'use and occupy' a property this indicates that a life estate is created. However if a taxpayer is merely permitted to reside in a particular property then this would more likely be treated as the grant of a right to occupy the property.[14]

143. A lifetime right to reside in a property is commonly granted in a family situation where for example, an elderly parent sells their main residence and pays a lump sum to her daughter for the right to reside in the daughter's dwelling and to have the daughter provide domestic assistance such as washing, cooking and cleaning.

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[13] See for example *Shell Co of Australia v. Zanelli* [1973] 1 NSWLR 216; *Buchanan Borehole Collieries Pty Ltd v. NSW Coal Compensation Review Tribunal* (1997) 9 BPR 16,253.

[14] Butt, P op cit 1004.1.

144. In these circumstances, CGT event D1 in section 104-35 of the ITAA 1997 is considered to have happened to the grantor (the daughter in the above case) when the right is created. The grantor makes a capital gain if the capital proceeds from creating the right are more than the incidental costs incurred that relate to the event. They make a capital loss if the capital proceeds are less than the incidental costs: subsection 104-35(3) of the ITAA 1997.

145. The capital proceeds the grantor receives from the CGT event include the amount of money and the market value of any property they receive, or are entitled to receive in respect of the event happening: section 116-20 of the ITAA 1997. However, if the grantor and the party in whom the right has been created do not deal with each other at arm's length, the capital proceeds are taken to be the market value of the right rather than the money or property received if these amounts are different: subsection 116-30(2) of the ITAA 1997.

Examples

Example 1: equitable life and remainder interests created under will – no dealings with interests – life tenant dies

146. *Jarrod died on 1 February 2000. At the time of his death he owned shares in Australian public companies which he acquired after 19 September 1985. Under Jarrod's will the income from his estate was to be held on trust and paid to his sister Lauren for life and the capital of the trust was to be accumulated for Jarrod's children, Jessica and Harry. Lauren died in September 2003 and the trustee of the testamentary trust distributed the shares to Jessica and Harry in the 2005 income year.*

147. *When Jarrod died CGT event E1 happened in relation to the shares. However any capital gain or capital loss is disregarded under section 128-10 of the ITAA 1997. The trustee acquires Jarrod's shares for his cost base and reduced cost base: subsection 128-15(4).*

148. *When Lauren dies, CGT event C2 happens to her life interest. Again, any capital gain or capital loss Lauren makes from that event is disregarded under section 128-10 of the ITAA 1997.*

149. *There are no CGT consequences for the trustee or Jessica and Harry when the trustee distributes the shares to them in satisfaction of their interest. CGT event E7 in section 104-85 does not happen because of the exception for a trust to which Division 128 applies – that is, the trust assets being disposed of by the trustee were owned by Jarrod when he died and are passing to Jessica and Harry under section 128-20 of the ITAA 1997.*[15] *Jessica and Harry acquire the shares for the trustee's cost base and reduced cost base.*

[15] See PSLA 2003/12.

150. *If some of the shares were acquired by the trustee after death, CGT event E7 happens when those shares are disposed of by the trustee to Jessica and Harry. The trustee may make a capital gain or capital loss. Any capital gain or capital loss Jessica or Harry makes from the ending of their interest in the trust capital is disregarded because they acquired it for no expenditure and other than by way of assignment.*

Example 2: legal life and remainder interests created under will – no dealings with interests – life tenant dies

151. *Assume the facts in Example 1, except that Jarrod's asset is land and that his will requires his executor/trustee to transfer legal life and remainder interests to the beneficiaries of his estate.*

152. *The executor acquires Jarrod's land on 1 February 2000 for an amount determined by subsection 128-15(4). No CGT event happens when the legal life estate and remainder interests are transferred to Lauren, and to Jessica and Harry respectively because of the exceptions for trusts to which Division 128 applies in CGT event E6 and CGT event E7.*

153. *Lauren, Jessica and Harry acquire their interests under subsections 128-15(4) and (5) based on a reasonable apportionment of the cost base and reduced cost base of the land. An apportionment based on the relative market values of the interests created at the time of creation would be reasonable.*

154. *On Lauren's death, CGT event C1 happens. Any capital gain or capital loss made by her is disregarded by section 128-10.*

155. *There are no CGT consequences for Jessica and Harry arising from Lauren's death, though their interests are thereby enlarged.*

Example 3: equitable life and remainder interests created inter vivos – interests assigned

156. *Craig declares that he holds a large share portfolio in trust for his favourite great aunt, Genevieve, for life. Craig retains the reversion. Some of the shares were acquired pre-CGT and some post-CGT.*

157. *CGT event E1 happens to Craig in relation to all the shares. Any capital gains or capital losses he makes in relation to the pre-CGT shares are disregarded.*

158. *Genevieve acquires a CGT asset, being an income interest in the trust, for no consideration. The first element of her cost base is nil. Similarly, Craig acquires a capital interest in the trust for no consideration. The first element of his cost base is also nil.*

159. *If Genevieve assigns her interest (whether for valuable consideration or not) CGT event A1 will apply. If Craig assigns his interest, CGT event E8 (not CGT event A1) will apply.*

160. *If Genevieve dies, the trust ends (because there can be no trust if the trustee, Craig, is the sole beneficiary). CGT event E7 happens with the result that capital gains or capital losses may arise to the trust in relation to the shares.*

161. *Any capital gain or loss that Craig makes in his capacity as beneficiary as a result of CGT event E7 happening (in relation to the ending of his capital interest in the trust) would be disregarded: subsection 104-85(6).*

Example 4: equitable life interest created by will – later agreement between the parties

162. *Hector's will provided that his 50 hectare farming property 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 and died in 2000.*

163. *In 2005, Hector's wife and daughters get together and decide to wind-up the trust and have the property distributed to them as tenants in common in equal shares (that is, four interests).*

164. *Hector's wife and daughters acquired their interests in the testamentary trust for no consideration. Their first elements of cost base and reduced cost base are nil.*

165. *The ending of the trust results in CGT event E6 happening in relation to the part of the land transferred to Hector's wife and CGT event E7 happening in relation to the parts of the land transferred to Hector's daughters.*

166. *The exceptions for trusts to which Division 128 applies have no relevance in this case because the land is not passing to the beneficiaries in terms of section 128-20. That is, the interests in the land are not passing under the will nor are they passing under a deed of family of family arrangement entered into to settle a claim to participate in the estate.*

167. *The trustee of the testamentary trust and Hector's wife may make a capital gain or capital loss from CGT event E6 happening. Depending on the application of Division 6 of Part III of the ITAA 1936, and on section 118-20 and subsection 118-20(1A) of the ITAA 1997, any capital gain made by Hector's wife may be reduced to the extent of amounts referable to the trustee's capital gain included in her assessable income under Division 6 (see also PS LA 2005/1 (GA)).*

168. *The trustee of the testamentary trust may make a capital gain or capital loss from CGT event E7 happening in relation to the parts of the land used to satisfy the interests of the daughters in the trust. CGT event E7 also happens on the ending of the capital beneficiaries trust interests. Because the daughters did not pay anything for their interests, or acquire them by assignment, any capital gain or capital loss they may make on the ending of their interests in the trust is disregarded by subsection 104-85(6).*

169. *The beneficiaries acquire their interests in the land for their market values at the time it was disposed of to them.*

Example 5: would the position above be different if the parties made the agreement during the period the estate was being administered?

170. *Yes. In that case, the land would be considered to pass to them in terms of section 128-20 and therefore the exceptions to CGT events E6 and E7 in relation to trusts to which Division 128 applies would apply. No taxing points would be generated.*

171. *The beneficiaries would acquire their interests in the land for a reasonable apportionment of the cost base and reduced cost base of the land in terms of subsection 128-15(4) and (5). An apportionment based on a four-way split of the total cost would be acceptable.*

Example 6: grant of legal life interest inter vivos

172. *Jamie was the owner of an estate in fee simple of land registered under the Torrens system. In the 2005 income year he transferred a life interest in the property to his eldest sister Melissa. He retained the reversion.*

173. *CGT event A1 in section 104-10 of the ITAA 1997 happens when Jamie disposes of the life interest. Jamie works out the amount of his capital gain from this event by reducing his capital proceeds by a portion of the cost base of the land.*

174. *Because Jamie did not receive any money or property from Melissa, he is taken to have received an amount equal to the market value of the life interest at the time he transferred it to Melissa: subsection 116-30(1) of the ITAA 1997. The cost base attributable to the life interest is determined in accordance with the apportionment rules in subsections 112-30(2) and (3) of the ITAA 1997. The cost base remaining is attributed to his interest in reversion: subsection 112-30(4) of the ITAA 1997.*

175. *Melissa acquires her life interest for an amount equal to its market value at the time of the transfer.*

Example 7: surrender of equitable life interest

176. *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.*

177. *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 it was surrendered was $100,000.*

178. *CGT event A1 will happen when Georgia surrenders her life interest. The cost base/reduced cost base of Georgia's life interest will be limited to any incidental costs incurred on acquisition and disposal.*

179. *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. Therefore Georgia's capital gain is $95,000 (that is, $100,000 - $5,000).*

180. *Dylan and Thomas each acquire an interest in the income of the trust with an acquisition cost of $50,000.*

Example 8: disclaimer of equitable life interest

181. *On 15 August 2004 Alice created a trust over some shares in an Australian public company that she acquired after 19 September 1985 for $10,000. At the time the trust was created the shares had a market value of $20,000. The trustee of the trust held the shares for Alice's friend Mabel for life with the remainder interest held for Mabel's daughter Lynette.*

182. *CGT event E1 happens when Alice creates the trust. Alice will make a capital gain from CGT event E1 happening if the capital proceeds from the creation of the trust are more than the cost base of the shares.*

183. *Shortly after the trust was created, Alice and Mabel had a disagreement and stopped speaking to each other. When the trustee advised Mabel that Alice had created a life interest in the trust for her, Mabel decided to disclaim it.*

184. *There will be no CGT consequences for Mabel as a result of disclaiming her interest as she is taken never to have acquired it. The trustee will thereupon hold the assets on trust for the Mabel's daughter Lynnette who, as a sole beneficiary, becomes absolutely entitled as against the trustee to them. As a result, CGT event E5 happens to the trustee in relation to the trust assets, and to Lynette in respect of her capital interest in the trust. Any capital gain or capital loss that Lynette makes is disregarded because she acquired the interest for no expenditure, and did not acquire it by way of assignment.*

Example 9: surrender of legal life interest

185. *Hilda owns a legal life interest in a property and Henry owns the legal remainder interest. Hilda agrees to surrender her life interest to Harry for its market value.*

186. *CGT event A1 will happen at the time the contract between Hilda and Henry was made. Hilda may make a capital gain or loss from the event happening.*

187. *Henry acquires the life interest for its market value. Henry does not register a merger of the life and remainder interests on the title to the property. Henry sells the property (comprising his interests in life and remainder) to Hermione.*

188. *CGT event A1 will happen in respect of the disposal of the life interest and also in respect of the disposal of the remainder.*

Example 10: grant of lifetime right to reside in a property

189. *Antonio's elderly parent, Lucia sold her main residence. Lucia gave Antonio $500,000 in exchange for Antonio providing Lucia with a lifetime right to reside in a 'granny flat' located at the rear of a property owned by Antonio, and domestic assistance (such as washing, cleaning, cooking and shopping) for the rest of her life. No formal written contract was entered into between the parties to evidence this arrangement and therefore Antonio did not incur any incidental costs in connection with granting the right. The market value of the right was approximately $150,000.*

190. *In this situation CGT event D1 in section 104-35 of the ITAA 1997 happens as Antonio has created a right in Lucia to reside in the granny flat located on his property. As the parties did not deal at arm's length in relation to the arrangement, the capital proceeds is taken to be the market value of the right rather than the lump sum received: subsection 116-30(2) of the ITAA 1997. Accordingly, Antonio makes a capital gain of $150,000 from CGT event D1 happening.*

Your comments

191. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date.

Due date: **11 November 2005**
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Detailed contents list

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Subject references:

- beneficiaries
- capital gains
- capital gains tax
- capital losses
- CGT capital proceeds modification market value substitution rule
- CGT cost base modification market value substitution rule
- CGT event A1 – disposal of a CGT asset
- CGT event E5 – beneficiary becoming entitled to a trust asset
- CGT events C1-C3 – end of a CGT asset
- CGT events E1-E9 - trusts
- CGT trust distributions
- deceased estates
- deeds of arrangement
- legal personal representatives
- life interest
- non arms length transactions
- remainderman
- testamentary trusts
- trust assets
- trust beneficiaries
- trustees
- trusts

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