TR 2006/14 - Income tax: capital gains tax: consequences of creating life and remainder interests in property and of later events affecting those interests

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Taxation Ruling

Income tax: capital gains tax: consequences of creating life and remainder interests in property and of later events affecting those interests

Contents Para

BINDING SECTION:
What this Ruling is about 1
Ruling 9
Examples 121
Date of effect 176
NON BINDING SECTION:
Appendix 1:
***Explanation* 177**
Appendix 2:
***Detailed contents list* 224**

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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 between living persons – *inter vivos* – or by testamentary provision) and of any subsequent dealings in those interests.

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

3. This Ruling distinguishes between life and remainder interests in the property held on trust (referred to in this Ruling as *equitable interests*) and life and remainder interests in land that is not held on trust (referred to in this Ruling as *legal interests*). This Ruling does not deal with life and remainder interests in personal property that is not held on trust. (Paragraphs 187 to 193 of this Ruling explain the differences between these various interests.)

4. The CGT consequences for equitable life and remainder interests are usually different from those for legal life and remainder interests in real property. That is, equitable life and remainder interests being interests in trusts, attract the operation of specific CGT provisions dealing with trusts (for example, the CGT events in Subdivision 104-E of the *Income Tax Assessment Act 1997*[1]).

5. Equitable life and remainder interests are more common than legal life and remainder interests. Care should be taken to ascertain the precise nature of the life or remainder interest being considered before applying this Ruling.

6. 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 not held on trust/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 not held on trust/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).

7. This Ruling does not deal specifically 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. However, CGT event K6 in section 104-230 (which applies to certain shares or trust interests) may happen in respect of equitable life and remainder interests.

8. Also, this Ruling does not deal with the consequences arising from the assignment, during the life of an individual, of the right to future income from property without the assignment of the property itself.

[1] Unless otherwise specified all legislative references are to the *Income Tax Assessment Act 1997.*

Ruling

9. In respect of both equitable and legal interests, this Ruling considers the consequences for each affected party arising from:

- the creation of the interests;
- a disclaimer of an interest;
- the death of the person by whose life the life interest is measured; and
- other events affecting the interests.

10. Equitable interests being the most common are considered first.

Equitable life and remainder interests

Creation of trust

11. The creation of equitable life and remainder interests involves the creation of a trust over an original asset(s). There are consequences for the original owner of the asset, the trustee and the life interest and remainder owners.

Consequences for original owner

12. If a trust over an original asset is created by declaration or settlement, CGT event E1 in section 104-55 happens at the time the trust is created. The event happens if the trust was created between living persons or under the will of a deceased person.

13. 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).

14. 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.

15. If the trust is created under the will of a deceased person then CGT event E1 happens when the administration of the deceased's estate in respect of the original asset is completed. Any capital gain or loss made by the deceased from the event happening is disregarded under section 128-10.[2]

16. 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 happens. The consequences for the original owner of that event happening are similar to those set out above in relation to CGT event E1.

Consequences for trustee

17. 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). The trustee's acquisition cost is the market value of the original asset at that time: subsections 104-55(4) and 104-60(4).

18. 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). The trustee's acquisition cost is determined under subsection 128-15(4).

19. Subsection 128-15(4) 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.

20. The trustee may make a capital gain or loss from a CGT event happening to an original asset after it commences to be held on trust for life interest and remainder owners.

21. Importantly (in the context of this Ruling), a trustee of a trust may be able to disregard a capital gain or loss from certain CGT events happening to a dwelling occupied by an individual who was given a right to occupy the dwelling under the deceased's will: sections 118-195 and 118-210.

22. Note that the main residence exemption in Subdivision 118-B will not apply to a capital gain or loss the trustee makes from CGT events E5, E6 or E7 happening to a dwelling because those events are not relevant event for the purposes of those provisions: paragraph 118-195(2)(a). See also subsection 118-210(5).

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[2] CGT event E1 does not happen when an individual dies because there is no trust created by declaration or settlement at that time. CGT event A1 happens at that time because there is a change of ownership of the deceased's assets by operation of law.

23. Any capital gain or loss the trustee makes 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 Subdivision 115-C.

Consequences for life interest and remainder owners

24. Equitable life or remainder interests are acquired when they commence to be owned: subsection 109-5(1). 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 to determine the time of acquisition of the interest because the trust is not a unit trust.

25. The first element of the cost base and reduced cost base of an equitable life or remainder interest is the sum of any money and the market value of any property given to acquire it: subsection 110-25(2).

26. If, as is generally the case, no money or property is given to acquire an equitable life or remainder interest, section 112-20 provides that the first element of the cost base and reduced cost base of the interest is its market value at the time it was acquired.

27. However a market value cost base cannot be obtained for an equitable life interest that arose other than as a result of someone's death) if:

- nothing is actually paid or given to acquire it; and
- it is not acquired by way of assignment from another entity.

(See item 1 in the table in subsection 112-20(3).)

28. Note that for the purpose of paragraph 112-20(1)(a), equitable life and remainder interests are considered to have been acquired as the result of CGT event E1 happening. That is, a market value acquisition cost is not denied on the basis that the interests resulted from CGT event D1 happening or no CGT event at all happening.

Life interest or remainder owner disclaims interest

29. No CGT event happens to a life interest or remainder owner in respect of the effective disclaimer of their interest.

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

31. Further, if the life interest is disclaimed the CGT consequences arising from the creation of the trust may need to be reconsidered if the original owner is the owner of the remainder interest. That is, CGT event E1 will 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 was created by settlement, the exception to CGT event E1 happening in paragraph 104-55(5)(a) may apply. That exception 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.

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

Deed of arrangement to vary terms of deceased's will

33. Beneficiaries in a deceased estate who have been granted life and remainder interests may be dissatisfied with the provision that the deceased person made for them under their will. The beneficiaries may enter into a deed of arrangement under which they agree to share the deceased's assets rather than their life and remainder interest.

34. Assets may pass to them as a beneficiary in the estate under paragraph 128-20(1)(d). If this occurs, 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.

35. A deed of arrangement will be effective for the purposes of paragraph 128-20(1)(d) provided that it is entered into:

- to settle a claim to participate in the estate; and
- any consideration given by the beneficiary consisted only of the variation or waiver of a claim to an asset or assets that formed part of the estate.

36. For the purposes of paragraph 128-20(1)(d) a deed of arrangement must be entered into prior to the administration of the estate being completed unless the beneficiary can demonstrate that a court would, at the time the deed was entered into, have entertained their application for family provision, or an extension of time in which to make such an application. (Paragraphs 209 to 223 of this Ruling further explain this requirement. Importantly, determining whether a Court would entertain applications such as these depends on the succession laws in each State.)

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

Death of person by whose life a life interest is measured

38. The death of the person by whose life a life interest is measured will cause the life interest to end. There will be consequences for the life interest owner and there may also be consequences for the trustee and remainder owner.

Consequences for life interest owner

39. CGT event C2 in section 104-25 happens if ownership of an intangible asset ends in one of a number of ways including by satisfaction or expiry.

40. CGT event C2 happens when the asset ends: subsection 104-25(2). In the case of an equitable life interest, CGT event C2 happens when the measuring life for the life interest dies because the interest expires at that time.

41. 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.

42. 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).

43. 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).

44. 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. 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

45. 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 may happen.[3] The event does not happen if the trust is a unit trust or a trust to which Division 128 applies. (The extent of the exception for 'a trust to which Division 128 applies' is considered in paragraphs 77 to 81 of this Ruling. Note that the exception requires more than the existence of a trust that was created by a deceased person.)

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

47. 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).

48. Any capital gain or loss from CGT event E5 happening to the trustee 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 ITAA 1936 and taxed in accordance with Subdivision 115-C.

49. 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).

50. 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). In the context of this provision, expenditure means actual expenditure not an amount which the remainder owner may be taken to have paid because of the operation of sections 112-15 and 112-20.

[3] 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 Taxation Ruling TR 2004/D25.

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

51. 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.[4]

Transfer of asset to life interest owner

52. CGT event E6 in section 104-80 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. (The extent of the exception for 'a trust to which Division 128 applies' is considered in paragraphs 77 to 81 of this Ruling. Note that the exception requires more than the existence of a trust that was created by a deceased person.)

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

54. 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).

55. Any capital gain or loss from CGT event E6 happening to the trustee 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 ITAA 1936 and taxed in accordance with Subdivision 115-C.

56. 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).

57. 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 actual expenditure.

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

58. The main residence exemption in section 118-110 cannot apply to disregard a capital gain or loss that a life interest owner makes from the ending of their interest (even where that interest entitled them to occupy a property) because CGT event E6 is not an event which attracts the operation of the main residence exemption: paragraph 118-110(2)(a).

Transfer of asset to remainder owner

59. CGT event E7 in section 104-85 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.

60. The extent of the exception for 'a trust to which Division 128 applies' is considered in paragraphs 77 to 81 of this Ruling. (Note that the exception requires more than the existence of a trust that was created by a deceased person.)

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

62. 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).

63. Any capital gain or loss from CGT event E7 happening to the trustee 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 ITAA 1936 and taxed in accordance with Subdivision 115-C.

64. 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).

65. 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). In the context of this provision, expenditure means actual expenditure not an amount which the remainder owner may be taken to have paid because of the operation of sections 112-15 and 112-20.

Dealings between life interest and remainder owners

66. If a life interest or remainder owner surrenders or releases their interest CGT event A1 (in section 104-10) rather than CGT event C2 (in section 104-25) happens. The Commissioner considers 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.

67. 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 .... 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.

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

69. 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).

70. 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).

Dealings between life interest owner and third party

71. CGT event A1 in section 104-10 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).

72. 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 will apply to determine the capital proceeds from the event.

Dealings between remainder owner and third party

73. CGT event E8 in section 104-90 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.

(The extent of the exception for 'a trust to which Division 128 applies' is considered in paragraphs 77 to 81 of this Ruling. Note that the exception requires more than the existence of a trust that was created by a deceased person.)

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

75. 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).

76. 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 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'

77. CGT events E5 to E8 (in sections 104-75 to 104-100) contain an exception for trusts 'to which Division 128 applies'. If the exception applies, the Commissioner takes the view that it is not necessary to consider whether any other CGT event has happened.

78. Division 128 does not appear to apply to trusts. It contains rules about the passing of an asset from a deceased individual's legal personal representative to a beneficiary in the estate.

79. In the context of CGT events E5, E6 and E7, the exception will apply if, as part of the administration of a deceased estate, an asset the deceased owned when they died passes to a beneficiary in accordance with section 128-20. (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).

80. CGT event E8 does not involve the passing of any asset to a beneficiary – it happens if a beneficiary disposes of their interest in trust capital. The exception to CGT event E8 will therefore apply if, during the administration of a deceased individual's estate, a beneficiary disposes of their interest in trust capital. The exception applies however only to the extent that trust assets owned by the deceased when they died might pass to the beneficiary, that is these assets are excluded when calculating the trusts net asset amount or reduced net asset amount under subsections 104-95(2) and 104-100(2).

81. Paragraphs 197 to 208 of this Ruling explain the Commissioner's view about the meaning of the words 'a trust to which Division 128 applies'.

Application of section 118-20

82. Both the trustee and life or remainder owner may make a capital gain from CGT event E5, E6 or E7 happening. In these circumstances, subject to the operation of Subdivision 115-C, the life or remainder owner may (in addition to the capital gain they have made from CGT event E5, E6 or E7 happening) also be taken to have an additional capital gain referable to the relevant trust capital gain.

83. Subsection 118-20(1) 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.

84. However section 118-20 is precluded from applying to reduce a beneficiary's capital gain from CGT event E5, E6 or E7 by any amount of trust capital gain assessed to them as a result of the operation of Subdivision 115-C. This is because both of these amounts are included in the beneficiary's assessable income under Part 3-1 and so section 118-20 is not invoked.

Legal life and remainder interests

85. Bringing a legal life interest into existence involves a disposal of part of an existing CGT asset in a similar way to the disposal of a percentage interest in it. The part of the original asset that is not disposed of to the life interest owner is the legal remainder interest.[5]

Granting an interest inter vivos

86. CGT event A1 in section 104-10 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.

87. 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.

88. The market value substitution rule in section 116-30 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.

89. Subsections 112-30(2) and (3) 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:

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

90. The reduced cost base is worked out similarly.

91. A 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).

[5] The distinction between legal life and remainder interests and equitable life and remainder interests is explained in further detail at paragraphs 187 to 193 of this Ruling.

92. Commentators[6] 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 argue 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).

93. However, the Commissioner takes the view that both the original and rewritten provisions do operate to apportion the cost base of the original asset to the legal life and remainder interests. The disposals 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.

94. 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). 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.

Granting an interest under the will of a deceased person

95. In some cases an individual may, by will, give legal life and remainder interests in land that they owned when they died. 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).[7]

96. CGT event E6 in section 104-80 and CGT event E7 in section 104-85 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.

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[6] 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, 209 at 223-224.

[7] Note the legal personal representative will acquire the asset for its market value if the deceased acquired it before 20 September 1985: subsection 128-15(4).

97. 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.

98. 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), 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.[8]

99. 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). 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

100. 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.[9] 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.

101. 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 (*inter vivos* case) or in residuary beneficiaries (deceased estate case).

Death of life interest owner

102. On the death of the life interest owner, CGT event C1 in section 104-20 happens. The Commissioner does 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.

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[8] 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.

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

103. 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

104. 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 happening. The market value substitution rule section in 116-30 may apply to determine the capital proceeds from that event. Also, the market value substitution rule in section 112-20 may apply to determine the cost base of the acquired interest.

Mere right of occupancy

105. A right to reside in property for life (or a term of years) is not equivalent to a legal or equitable life interest. The right is a mere personal right which cannot be assigned. CGT event D1 in section 104-35 happens when such a right is granted. These arrangements should be contrasted with mere informal family arrangements where relatives may reside at each other's dwellings for a period but where there is no intention to create legal relations. In these circumstances CGT event D1 will not happen.

Position of grantor

106. The grantor of the right 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).

Capital proceeds

107. 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.

108. If the grantor received *no capital proceeds* from CGT event D1 the grantor is *not taken to have received capital proceeds equal to the market value of the created rights*: subsection 116-30(3).

109. However, if there are *some* capital proceeds, and the grantor and the party in whom the right has been created do not deal with each other at arm's length, the grantor will be taken to have received the market value of the right rather than the money or property actually received if these amounts are different: subsection 116-30(2).

110. The market value of a lifetime right to reside in a dwelling will depend on a number of factors including the life expectancy of the person who is the subject of the right and the nature and location of the dwelling. It will be relevant to have regard to what a willing but not anxious buyer would be prepared to pay for such a right even if there were no actual market for it.

Incidental costs

111. Incidental costs are defined in section 110-35 and include remuneration for the services of a legal adviser, accountant or valuer.

112. No part of the acquisition cost of the property in respect of which the right of occupancy is granted (or other costs relating to that property) can be treated as incidental costs.

Main residence exemption

113. Any capital gain or loss the grantor might make from granting a right to occupy a dwelling which, at the time of the grant, was their main residence cannot be disregarded under Subdivision 118-B. Subsection 118-110(2) lists the CGT events which are relevant for the purposes of the main residence exemption – CGT event D1 is not included in that list.

Position of grantee

114. The person who is granted a right of occupancy (the grantee) acquires the right when the contract granting the right is entered into or the right created: subsection 109-5(2).

Cost base

115. The acquisition cost of the right is the amount of money paid and the market value of any property given, or required to be paid or given in respect of its acquisition: subsection 116-20(2).

116. If the grantee did *not incur any expenditure to acquire the right*, they are *not taken to have acquired the right for its market value:* subparagraph 112-20(1)(a)(i).

117. If the expenditure incurred by the grantee to acquire the right was more or less than its market value, the grantee will be taken to have incurred market value expenditure if they did not deal with the grantor at arm's length in relation to the granting of the right: paragraph 112-20(1)(c).

118. As indicated above, the market value of a lifetime right to reside in a dwelling will depend on a number of factors.

Main residence exemption

119. A licence or right to occupy a dwelling constitutes an ownership interest in a dwelling for the purposes of the main residence exemption in Subdivision 118-B: subsection 118-130(1).

120. A capital gain or loss that the grantee of a right of occupancy may make from a later CGT event happening to the right may be disregarded: section 118-110.

Examples

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

121. 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. Jarrod's will provided that the shares were 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.

122. Lauren 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 the relevant state law regulating the apportionment of income. Jessica and Harry were entitled to the remainder of the dividends paid to the trustee during the 2005 income year.

123. The trustee transferred the shares to Jessica and Harry in June 2005.

124. When Jarrod's estate was administered CGT event E1 happened in relation to the shares. However any capital gain or capital loss was disregarded under section 128-10. The trustee acquired Jarrod's shares for his cost base/reduced cost base: subsection 128-15(4).

125. When Lauren died, CGT event C2 happened to her life interest. Again, any capital gain or capital loss Lauren made from that event is disregarded under section 128-10.

126. There are no CGT consequences for the trustee or Jessica and Harry when the trustee distributes the shares to them in satisfaction of their remainder interests. 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.[10] Jessica and Harry acquire the shares for the trustee's cost base and reduced cost base. They are taken to have acquired the shares on the day that Jarrod died – subsection 128-15(2).[11]

127. Assume that the trustee acquired other shares after Jarrod died.

128. CGT event E7 would happen when those shares were distributed to Jessica and Harry. Any capital gains or losses the trustee made from CGT event E7 happening would be taken into account in working out the trustee's net capital gain or loss. For the 2004-05 income year, a net capital gain is included in the net income of the trust in accordance with subsection 95(1) of the ITAA 1936 and taxed in accordance with Division 6 of Part III of the ITAA 1936 and Subdivision 115-C.

129. In determining how the net capital gain is taxed, it is necessary to determine firstly who was presently entitled to the income of the trust for the 2005 income year. In this case, the income of the trust consists of the dividends that were paid to the trustee. Lauren, her estate, Jessica and Harry were each entitled to some of the trust income.

130. Under the proportionate approach to the taxation of trust income, a beneficiary is assessed on a capital gain included in the net income of a trust in proportion to their entitlement to trust income. Under this approach a portion of the capital gain would be included in the assessable income of Lauren, Lauren's estate, Jessica and Harry.

131. However former Law Administration Practice Statement PS LA 2005/1 (GA) set out other approaches that the Commissioner would accept for the taxation of capital gains included in the net income of a trust in income years prior to 2010-11. These other approaches involved the assessment of the capital beneficiary or trustee, rather than an income beneficiary who did not have any entitlement to the trust capital.

132. Any capital gain or capital loss Jessica or Harry makes from the ending of their interests in the trust capital is disregarded because they acquired them for no expenditure and other than by way of assignment.

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[10] See Law Administration Practice Statement PS LA 2003/12.

[11] Note that for the purposes of determining their entitlement to the CGT discount, Jessica and Harry are taken to have acquired the shares when they were acquired by Jarrod – see item 8E in the table in section 109-55.

Note: if the events which happened in 2005 instead happened in the 2010-11 or a later income year, changes to the law introduced by the *Taxation Laws Amendment (2011 Measures No. 5) Act 2011* would change the outcome in paragraphs 129-131. Pursuant to those changes, the beneficiaries would be assessed via Subdivision 115-C on so much of the capital gain to which they were specifically entitled, and only proportionately assessed on the balance (if any) to which no one was specifically entitled.

Former PS LA 2005/1 (GA) would have no application and the trustee could not elect to be assessed on the capital gain pursuant to section 115-230 because trust property representing the capital gain was distributed to Jessica and Harry.

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

133. 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.

134. The executor acquires Jarrod's land on 1 February 2000 for $200,000 (as determined by subsection 128-15(4)). No CGT event happens when the legal life interest 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.

135. 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. Assume that in this case that it is reasonable to apportion $50,000 to the life interest and $75,000 to each of the remainder interests.

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

137. There are no CGT consequences for Jessica and Harry arising from Lauren's death, though their interests are thereby enlarged. If they were to sell the land for $250,000 they would each make a capital gain of $50,000 ($125,000 - $75,000).

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

138. Craig owns a large share portfolio. Some shares were acquired pre-CGT and some post-CGT. Craig declares that he holds the shares on trust to pay the income to his favourite great aunt, Genevieve, for life and the remainder for himself and his wife Jane.

139. 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.

140. The trustee (Craig) acquires the shares for their market value when CGT event E1 happened.

141. 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 and Jane each acquire a capital interest in the trust for no consideration. However the market value substitution rule operates so that their remainder interests are taken to have been acquired for their market value at the time CGT event E1 happened to Craig.

142. If Genevieve assigns her interest (whether for valuable consideration or not) CGT event A1 will apply. If Craig or Jane dispose of their interest, CGT event E8 (not CGT event A1) will apply.

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

143. Hector's will provided that his 50 hectare 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.

144. 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 that time was $175,000.

145. 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 (that is, each obtained a ¼ interest in the property). At this time the market value of the property was $1,200,000. Hector's wife was presently entitled to the trust income for the 2005-06 income year.

146. 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.

147. 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. The interests in the land are not passing under the will nor are they passing under a deed of family arrangement entered into to settle a claim to participate in the estate. The courts in Queensland would not have granted an extension of time in which to which to apply for family provision as the administration of Hector's estate had been completed.

148. The trustee of the testamentary trust will make a capital gain of $200,000 from CGT event E6 happening ((¼ × $1,200,000) - (¼ × $400,000)). 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 ((¼ × $1,200,000) - $175,000).

149. The trustee of the testamentary trust will make a capital gain of $600,000 (¾ × $1,200,000 - ¾ × $400,000) from CGT event E7 happening in relation to the disposal of the remaining ¾ of the land to Hector's daughters to satisfy their interests 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).

150. Hector's wife and daughters acquire their ¼ interests in the land for market value (that is, $300,000).

151. The capital gains from CGT event E6 and E7 happening to the trustee is taken into account in working out the trustee's net capital gain or loss for the 2005-06 income year. For the 2005-06 income year, a net capital gain is included in the net income of the trust in accordance with subsection 95(1) of the ITAA 1936 and taxed in accordance with Division 6 of Part III of the ITAA 1936 and Subdivision 115-C.

152. In determining how the net capital gain is taxed, it is necessary to firstly determine who was presently entitled to the income of the trust for the 2005-06 income year. In this case, Hector's wife is presently entitled to all of the trust income.

153. Under the proportionate approach to the taxation of trust income, a beneficiary is assessed on a capital gain included in the net income of a trust in proportion to their entitlement to trust income. Under this approach, Hector's wife would be taxed on the net capital gain.

154. However former Law Administration Practice Statement PS LA 2005/1 (GA) set out other approaches that the Commissioner would accept for the taxation of capital gains included in the net income of a trust in income years prior to 2010-11. These other approaches involved the assessment of the capital beneficiary or trustee, rather than an income beneficiary who did not have any entitlement to the trust capital.

155. If the $200,000 gain made by the trustee from CGT event E6 happening is included in Hector's wife's assessable income under section 97 of the ITAA 1936, section 118-20 will apply to reduce the capital gain she made from that event happening to her trust interest to nil.

Note: if the events which happened in 2005 instead happened in the 2010-11 or a later income year, changes to the law introduced by the *Taxation Laws Amendment (2011 Measures No. 5) Act 2011* would likely change the outcome in paragraphs 152-155.

Pursuant to those changes, the beneficiaries would be assessed via Subdivision 115-C on so much of each capital gain to which they were specifically entitled, and only proportionately assessed on the balance (if any) to which no one was specifically entitled.

Former PS LA 2005/1 (GA) would have no application and the trustee could not elect to be assessed on the capital gain pursuant to section 115-230 because trust property representing the capital gains has been paid or applied for the benefit of Hector's wife and daughters.

Example 5: would the position in Example 4 be different if the parties entered into a deed of family agreement to vary the terms of the will prior to the estate being fully administered?

156. Yes. In that case, the land would be considered to pass to them in terms of paragraph 128-20(1)(d) 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 arise.

157. 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 would be acceptable.

Example 6: grant of legal life interest *inter vivos*

158. 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.

159. CGT event A1 in section 104-10 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.

160. As 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). The cost base attributable to the life interest is determined in accordance with the apportionment rules in subsections 112-30(2) and (3). The cost base remaining is attributed to his interest in reversion: subsection 112-30(4).

161. 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

162. 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.

163. The first element of the cost base of Georgia's life interest (that is, its market value at the time the administration of the trust was completed) was $90,000. The first element of the cost base of each of Dylan and Thomas' remainder interests is $200,000.

164. 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.

165. CGT event A1 will happen when Georgia surrenders her life interest. The cost base/reduced cost base of Georgia's life interest will be $95,000 (that is, $90,000 + $5,000).

166. 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 $5,000 (that is, $100,000 - $95,000).

167. Dylan and Thomas each acquire a life interest with an acquisition cost of $50,000.

Example 8: disclaimer of equitable life interest

168. 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.

169. CGT event E1 happens when Alice creates the trust. Alice made a capital gain from CGT event E1 happening as the capital proceeds from the creation of the trust are more than the cost base of the shares.

170. 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.

171. 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 Lynette who, as a sole beneficiary, is absolutely entitled as against the trustee to them.

Example 9: surrender of legal life interest

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

173. 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.

174. 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 to Hermione.

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

Date of effect

176. This Ruling applies to years of income commencing both before and after its date of issue. However, the Ruling does 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 Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
29 November 2006

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

177. The first part of the Explanation looks at the general nature of life and remainder interests, including the distinction between equitable and legal interests and rights of occupancy. The second part explains the Commissioner's view of the words 'a trust to which Division 128 applies' as relevant to CGT events E5 to E8. The final part of the Explanation explains when, for the purposes of paragraph 128-20(1)(d) an asset passes to a beneficiary under a deed of arrangement.

General nature of life and remainder interests

178. 'Life interest' and 'remainder interest' are terms used to describe the interest that an entity has as either a beneficiary of a trust (equitable interest) or, less commonly, as the owner of a freehold estate in land (legal interest).

179. While successive interests in personal property are not able to be created *inter vivos* they may be created by will. However the general nature of interests created in this way is not clear.

180. Halsbury's Laws of England provides:[12]

> The early common law regarded personal property, whether chattels real or chattels personal[13] as essentially the subject of absolute ownership and incapable of being held for successive interests.
>
> (Under the modern law) successive interests in personal chattels may be created by will with or without the interposition of trustees. The precise nature of interests so created is uncertain, but it would seem that the modern tendency has been to regard the first holder as having the absolute property, subject to an executory interest of a contingent character in the ultimate donee and to a fiduciary duty to preserve the property for him.
>
> A trust, whether created by will or set up inter vivos, is the usual mode of creating successive interests in personalty, the trustees being the legal custodians of the property; and a trust is essential in settlements of personal property inter-vivos.

181. This Ruling does not consider legal life and remainder interests in personal property because of the uncertainties surrounding them and the limited cases in which they arise.

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[12] Halsbury's Laws of England, 4th edition, Vol 35, Butterworths, London, 1994 at paragraph 1229.

[13] Chattels real include interests in land for a fixed term of years such as leaseholds and annuities issuing out of such interests. Chattels personal include all other forms of personal property, both corporeal and incorporeal: see Halsbury's Laws of Australia, Classification of personal property at paragraph 315-10.

182. 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.

183. 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.[14]

184. 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.[15] The life interest ends on the death of the individual who is the measuring life. Except in the 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.[16]

185. 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.

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

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[14] Butt, P 2001, *Land law*, 4th edition, Lawbook Co, Sydney, paragraph 1019.
[15] *Pur autre vie*.
[16] Butt, P 2001, *Land law*, 4th edition, Lawbook Co, Sydney, paragraph 1007.

Equitable interests

187. As for other trusts where there is no absolutely entitled beneficiary,[17] 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.

188. The beneficiaries each have separate CGT assets (their trust interest) – 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

189. Paragraphs 16 to 18 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.[18]

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[17] 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. *(Remainderman has the same meaning as remainder owner.)*

[18] The references in this extract are to the provisions in the ITAA 1936 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.

190. As 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.

191. Much academic debate has been had about whether this treatment also applies to legal life and remainder interests.[19]

192. The Commissioner considers 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.

193. 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.

Grant of lifetime right to reside in property

194. 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 interest or right to occupy is created.

195. 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 (that is, they have the rights to rents and profits) 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.[20]

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[19] 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, 209.

[20] Butt, P 2001, *Land law*, 4th edition, Lawbook Co, Sydney, paragraph 1004.1.

196. A lifetime right to reside in a property can be granted in a family situation where for example, a parent sells their main residence and pays a lump sum to a child for the right to reside in the child's dwelling and to have the child provide domestic assistance such as washing, cooking and cleaning. This is more than a mere family or social arrangement. The arrangement is usually formal and documented in writing to provide evidence of the creation of the right to reside which may be needed if the family's circumstances change. Accordingly, CGT event D1 happens when these rights are created. Whether an arrangement creates these rights will depend on the particular facts and circumstances of the case and the intention of the parties.

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

197. CGT events E5 to E8 contain an exception which provides that the events do not happen if the trust is a unit trust or a trust to which Division 128 applies.

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

199. 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'*.

200. 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.[21]

[21] Paragraph 2 of TD 93/35. Section references in this quote are to the ITAA 1936.

201. As 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 cannot be relied on in interpreting the new expression.[22]

202. 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).

203. Accordingly, 'a trust to which Division 128 applies' requires more than the identification of the trust as a deceased estate. The Commissioner considers 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 and so on).

204. 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.

205. 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: Law Administration Practice Statement PS LA 2003/12. This is relevant for the scope of the exception in CGT events E5 to E7 which deal with such a passing of an asset.

206. On the other hand, CGT event E8 does not involve any passing of an asset by the trustee to a beneficiary. 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 or loss from the event is worked out by reference to the trust's assets and liabilities (net asset amount/reduced net asset amount).

[22] The application of section 1-3 was considered in *Re Sherlinc Enterprises Pty Ltd and Federal Commissioner of Taxation* [2004] AATA 113; (2004) 2004 ATC 2022; (2004) 55 ATR 1001:
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.

207. The exception for a 'trust to which Division 128 applies' is relevant if, during the administration of a deceased estate, the intended remainder owner disposes of their trust interest. However the exception only applies to the extent that an asset owned by the deceased might pass to that beneficiary – these assets are not taken into account in working out the trust's net asset amount or reduced net asset.

208. Law Administration Practice Statement PS LA 2003/12 does not apply in relation to CGT event E8 because it does not involve the passing of an asset.

Deed of arrangement to vary terms of deceased's will

209. Paragraph 128-20(1)(d) provides that for CGT purposes an asset passes to a beneficiary in the estate of a deceased person if the beneficiary becomes the owner of the asset under a deed of arrangement provided that:

- the beneficiary entered into the deed to settle a claim to participate in the estate; and
- the consideration given by the beneficiary consisted only of the variation or waiver of a claim to an asset or assets that formed part of the estate.

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

211. Prior to 1992, an asset could not pass to a beneficiary under a deed of arrangement. The Explanatory Memorandum to the amending legislation provided:[23]

> In some cases a dispute may arise between claimants to the assets of a deceased estate. The dispute may lead to litigation which eventually results in an order of the court to vary the will. Alternatively, the parties to the dispute may reach a compromise agreement, which binds the parties to an agreement setting out their respective entitlements to assets. This agreement is reached without recourse to litigation and results in the execution of a deed of settlement; alternatively known as a deed of family arrangement or a deed of compromise. Because such a deed does not constitute an order of a court in terms of section 160J, the rollover under section 160X does not apply.

[23] Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 2) 1992. Section references are to ITAA 1936.

212. The law was changed to recognise a deed of arrangement as an alternative to a court order as a means of varying a will. Therefore the Commissioner takes the view that for the purposes of paragraph 128-20(1)(d) a deed of arrangement must be entered into in circumstances when a court might consider an application to vary the deceased's will. That is, the deed must be made to settle a claim made by a person eligible to make an application for family provision and be entered into within the relevant timeframes for the making of an application to a court.

213. Under relevant family provision legislation,[24] the courts in each state and territory have power to make provision from the estate of a deceased person for members of the deceased's family and certain other people who have not been adequately provided for in the deceased's will or under the intestacy provisions.

214. All jurisdictions provide time limits within which an application may be made – some periods run from the date of death (in Queensland the period is 9 months after death) and others run from date of grant of representation (in the ACT the period is 12 months from the date of grant).

215. The courts in each jurisdiction have power to extend the time limit within which an application for family provision must be brought. There is no limit to the length of the extension which can be granted, for example, an extension of 14 years was granted in *Easterbrook v. Young* (1977) 136 CLR 308.

216. However a primary consideration in any application for family provision or an extension of time in which to make such an application is whether the estate has been distributed.

217. Traditionally, only property which was vested in the deceased's legal personal representative *in that capacity* at the date of an application to the Court could be made the subject of an order for family provision. In this regard, the comments of Barwick CJ, Mason and Murphy JJ in *Easterbrook v. Young* are relevant:

> …so soon as the executor by use of his executorial powers has completed his tasks and assented to the beneficiaries, the testator's will begins to operate and the powers of a trustee are activated in relation to property then subject to the terms of the will.

218. Thus, an order could not be made in relation to property in respect of which the legal personal representative had made an assent in favour of those entitled under a will or intestacy (because the legal personal representative was no longer in possession of the asset in their capacity as legal personal representative but as a trustee).

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[24] *Succession Act 1981* (Qld); *Family Provision Act 1970* (NT); *Inheritance (Family and Dependants Provision) Act 1972* (WA*); Inheritance (Family Provision) Act 1972* (SA); *Testator's Family Maintenance Act 1912* (Tas); *Administration and Probate Act 1958* (Vic); *Family Provision Act 1982* (NSW); *Family Provision Act 1969* (ACT).

219. In *Easterbrook v. Young* the High Court held that a family provision application could be brought even though the legal personal representative had completed their duties and held the estate assets as trustee, provided there had not been a physical parting of possession and a complete removal of the assets from their hands.

220. Although the Court in *Easterbrook v. Young* asserted that its decision [in respect of the NSW provisions] would determine the meaning and effect of comparable provisions elsewhere in Australia, it is unclear to what extent the decision actually applies in other jurisdictions.

221. It has no application in Queensland such that an order for family provision or an extension of time in which to make an application will not be granted where the legal personal representative has ceased to hold assets in that capacity and commenced to hold them as trustee (see for example in *Re Whitta* [1984] 2 Qd R 356). Commentators[25] suggest it is unlikely that *Easterbrook v. Young* would have application in Tasmania and note that it is of no practical relevance in Western Australia, South Australia, the ACT and NT where legislation allows an order to be made after a distribution of assets only if the claim is made within the relevant time limits.

222. Accordingly, the Commissioner considers that for the purposes of paragraph 128-20(1)(d) a taxpayer must generally enter into a deed of family arrangement in respect of an asset prior to the legal personal representative completing the administration of the estate in respect of that asset.

223. In limited cases, an asset may, for CGT purposes, pass under a deed entered into after administration of the estate in respect of that asset has been completed. However the beneficiary must be able to demonstrate that a court would have been likely to entertain an application for family provision or an extension of time in which to make such an application at the time the deed was entered into.

[25] de Groot, JK and Nickel, BW, 2001, Family Provision in Australia, Second Edition Butterworths, Australia at page 164.

Appendix 2 – Detailed contents list

224. The following is a detailed contents list for this Ruling:

	Paragraph
What this Ruling is about	**1**
Ruling	**9**
Equitable life and remainder interests	11
Creation of trust	11
Consequences for original owner	12
Consequences for trustee	17
Consequences for life interest and remainder owners	24
Life interest or remainder owner disclaims interest	29
Deed of arrangement to vary terms of deceased's will	33
Death of person by whose life a life interest is measured	38
Consequences for life interest owner	39
Consequences for trustee/remainder owner	45
Life interest and remainder owners request the trustee to wind up trust and distribute assets to each of them	51
Transfer of asset to life interest owner	52
Transfer of asset to remainder owner	59
Dealings between life interest and remainder owners	66
Dealings between life interest owner and third party	71
Dealings between remainder owner and third party	73
Scope of exception in CGT events E5 to E8: 'trust to which Division 128 applies'	77
Application of section 118-20	82
Legal life and remainder interests	85
Granting an interest inter vivos	86
Granting an interest under the will of a deceased person	95
Disclaimer of legal life or remainder interest	100
Death of a life interest owner	102
Dealings between life interest and remainder owners	104
Mere right of occupancy	105
Position of grantor	106
Capital proceeds	107
Incidental costs	111

Main residence exemption 113
Position of grantee 114
Cost base 115
Main residence exemption 119
Examples **121**
Example 1: equitable life and remainder interests created under will – no dealings with interests – life tenant dies 121
Example 2: legal life and remainder interests created under will – no dealings with interests – life tenant dies 133
Example 3: equitable life and remainder interests created *inter vivos* – interests assigned 138
Example 4: equitable life interest created by will – later agreement between the parties 143
Example 5: would the position in example 4 be different if the parties entered into a deed of family agreement to vary the terms of the will prior to the estate being fully administered? 156
Example 6: grant of legal life interest *inter vivos* 158
Example 7: surrender of equitable life interest 162
Example 8: disclaimer of equitable life interest 168
Example 9: surrender of legal life interest 172
Date of effect **176**
Appendix 1 – Explanation **177**
General nature of life and remainder interests 178
Equitable interests 187
Legal interests 189
Grant of lifetime right to reside in property 194
Scope of exception CGT events E5 to E8: 'trust to which Division 128 applies 197
Deed of arrangement to vary terms of deceased's will 209
Appendix 2 – Detailed contents list **224**

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Previous draft:
TR 2005/D14

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TR 2004/D25; TR 2006/10;
TD 93/35; TD 93/235; IT 2561

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- capital gains
- capital gains tax
- capital losses
- CGT capital proceeds modification market value substitution rule
- CGT cost base
- CGT cost base modification market value substitution rule
- CGT event A1 - disposal of a CGT asset
- CGT events C1-C3 - end of a CGT asset
- CGT events D1-D3 - bringing into existence a CGT asset
- CGT events E1-E9 - trusts
- CGT reduced cost base
- CGT event E5 - becoming entitled to a trust asset
- CGT trust distributions
- deceased estates
- deeds of arrangement
- legal personal representatives
- life interest
- non arms length transactions
- remaindermen
- testamentary trust
- trust assets
- trust beneficiaries
- trustees
- trusts

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