Expert warns new tax rules offer only 'fragile' protection for inheritances

Treasury has announced a fix for its broken trust tax laws – but the repair hasn't made it into legislation yet, leaving families in limbo, writes Noel Whittaker.

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Noel Whittaker says Treasurer Jim Chalmers' federal budget tax changes have been rushed.

It's now more than three months since the May Budget was handed down, and the fallout continues unabated. This legislation reminds me of an architect under pressure to get a building up in a hurry: the design is poor, construction rushed, and the cracks appear almost immediately. Treasury has been racing around with the toolbox, patching one crack after another. The trouble is that every time it fixes one problem, another appears somewhere else. This isn't sensible tax reform; it's emergency maintenance on legislation that should never have left the drawing board.

The first example is testamentary trusts. These are trusts created under your will, so an inheritance can be managed for a beneficiary rather than simply handed to them.

Take a family with four children and a $4 million estate. The eldest son is a builder, the second a gambler, the daughter is in a rocky marriage, and the youngest is sixteen. Hand each $1 million and imagine the possibilities. The builder goes broke and his creditors take the lot. The gambler does what gamblers do. The daughter's marriage collapses and a large chunk disappears with the departing husband. And nobody in their right mind would hand $1 million outright to a sixteen-year-old.

The solution has always been to establish four testamentary trusts. The money is still there for the children; it simply has protection. As estate-planning lawyer Rachael Rofe puts it: “A testamentary trust is not a tax dodge. It is a set of protective walls around an inheritance.”

Then Treasury came along with its new 30 per cent minimum tax on discretionary trusts. The Budget exempted existing testamentary trusts, but a testamentary trust doesn’t normally exist until somebody dies. You may have a perfectly valid will containing testamentary trusts, but if you were still alive on Budget night, those trusts didn’t yet exist and could therefore be caught.

There was an immediate uproar: estate-planning specialists pointed out that these trusts aren’t elaborate tax dodges but long-established structures designed primarily to protect beneficiaries. Treasury suggested people could use fixed trusts instead, but this misses the point: it’s their flexibility that makes discretionary testamentary trusts so useful.

So out came the repairs toolbox: Treasury announced an exemption from the proposed 30 per cent minimum tax on discretionary trust income for testamentary trusts. One crack has been patched, but there are plenty more appearing.

And it’s unfinished business. This exemption has been announced by Treasury but has not yet appeared in legislation. As always with tax reform, the announcement is the easy part. The legislation is where you find out what devils are hiding in the detail.

What the latest exposure draft does do is give testamentary trusts, along with deceased estates, an exemption from the proposed 30 per cent minimum tax on capital gains.

The less good news is that two obvious problems – what happens when assets transfer on death or divorce without a sale – have been identified but left for another day.

The new CGT regime starts on July 1, 2027. It replaces the general 50 per cent CGT discount for individuals and trusts with cost-base indexation and introduces a 30 per cent minimum tax on capital gains. For assets already owned, the gain is divided between the periods before and after 1 July 2027, with any resulting liability deferred until a later realisation event.

The problem comes when an asset changes hands without being sold – commonly from a deceased estate to a beneficiary or between separating spouses. Nobody has cashed out, yet the transfer can trigger the deferred gain, and the tax on it. Treasury agrees that shouldn't happen, as no money has changed hands, but has left the fix to yet another tranche of amendments.

Business columnist Noel Whittaker. Picture: Tara Croser.

Strangely, the same problem has already been dealt with under the proposed negative gearing rules. A surviving spouse, co-owner or family-law transferee can inherit the previous owner's status and retain the negative gearing exemption. The principle has therefore been accepted in one part of the legislation but not yet dealt with in the CGT provisions.

Under the draft, qualifying capital gains attributed to an individual beneficiary of a testamentary trust or deceased estate won't automatically be pushed up to the new 30 per cent minimum tax rate. Broadly, the concession applies to assets coming from the deceased estate and investments derived from them, not from unrelated family assets subsequently dumped into the trust.

But who sells, and when, can now carry a significant tax cost. Rofe puts it neatly: "The concession is real, but it is fragile." Sell inside the estate and the concession can apply; hand the asset over first and it may be lost.

That makes estate planning more important, not less. Rofe says wills containing testamentary trusts should be reviewed, where possible, because the tax rules around them have moved dramatically. Her point is particularly important for older wills: the structures may still work perfectly well, but they were drafted for a different tax regime.

Experts have recommended that existing wills be reviewed by a professional.

And then there's record-keeping. Under the proposed continuity rules, a beneficiary receiving an asset in specie will generally be treated as having acquired it when the deceased did. Executors may therefore need records of purchase, improvements and previous rollovers going back decades; a valuation at death will most likely no longer be enough. So keep the paperwork.

Where does this leave us? Testamentary trusts already provide valuable protection for beneficiaries, and they will secure an important CGT concession when the legislation amendment passes. But whether an asset is sold inside an estate or trust, or distributed first and sold later, will become much more important.

Government has acknowledged that these problems exist and promised that the legislative tools will arrive later. We are left to wait and see what will actually be delivered.