

## WILLS & ESTATES BULLETIN – ISSUE #15



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## The Goldilocks Trust® - providing for the blended family in a testamentary discretionary trust

### Background

1. It is a tired trope in estate planning practice that the most difficult family to provide a certain and secure estate plan for, is the blended family.
2. The spouses wish to provide for each other, but they also wish to provide for their own children who are not the children of their partner.
3. When "I love you wills" are used, whereby each spouse gives everything to the other and then if their spouse predeceases them, to their children in equal shares, there is a lingering doubt in their mind that their spouse may not, over time, do the same thing. The survivor may change their mind, and instead divert what assets were meant for their step-children, to their own children.
4. This doubt is not caused by a lack of faith or a lack of love. It is the reality that sometimes, one's moral and emotional connections to one's own children are greater than that to their step-children. There can be enormous pressure brought to bear by family members. Good intentions are difficult to maintain, particularly if decades pass and the surviving spouse does not have a continued relationship with their (former) step-children.
5. Traditionally a life interest was used in these circumstances. The property owner might grant a life interest in a property to their spouse. This way the surviving spouse is entitled to reside in the property and receive any income from the property. However, these interests are inflexible, almost impossible to refinance, cannot be sold and difficult to deal with in general. Life interests are generally unsuitable for modern life.
6. There is also the little brother to the life interest, being the right to reside, which does not grant an interest in property but merely the personal right to reside in the property on certain terms. This is useful and appropriate in some circumstances, but does not provide any income for your spouse.
7. There is also the mutual will / contractual will. Each spouse enters into a binding legal contract whereby they promise not to change their wills. The contract says that they will give the whole of their estate to their spouse, and their spouse promises that on their later death they will honour the wishes of their predeceased spouse to provide for that predeceased spouse's children in their will.
8. Mutual wills/contractual wills are legally enforceable but are practically restrictive and inflexible. A contractual will can spell disaster when a simple change in life is enormously difficult to cater for with the wills bound up tight in a contractual will. The other issue with a contractual will is though it might be legally enforceable, if the relevant assets are dissipated by the surviving spouse, then the right in contract law to have those assets is in practice worthless.

## The Goldilocks Trust<sup>®</sup>

9. The Goldilocks Trust<sup>®</sup> has been developed as a potential answer to the difficulties of estate planning for blended families<sup>[1]</sup>.
10. The Goldilocks Trust<sup>®</sup> is named after the habitable zone around planets, close enough to the sun for warmth but not so close as to get burned. It is a testamentary trust for use in a will which sits on the spectrum between having a certain, but restrictive and inflexible, estate plan (e.g. a mutual will) at one end and, at the other end, having a "I love you will" which are substantially flexible but ultimately uncertain.
11. It is the happy medium between providing little for your spouse through fear that they may not honour your wishes or that they may have their will over-borne by their own children; and the other end of the spectrum being providing everything to your spouse but having a lingering doubt in your mind as to your own children's future prosperity.
12. It works as follows:
  - (1) The Goldilocks Trust<sup>®</sup> is a testamentary trust set up in your will<sup>[2]</sup>.
  - (2) Your spouse is the life income beneficiary, and is entitled:
    - (a) to all income from the trust (noting that related trusts and companies are also entitled to receive income);
    - (b) to occupy / reside in any main residence property owned by the trust;
    - (c) but is not entitled to receive capital distributions from the trust.
  - (3) Your children are the remainder beneficiaries<sup>[3]</sup>. On the death of your spouse, the trust then becomes a standard modern testamentary discretionary trust, with your children as the primary beneficiaries. There is flexibility for your children, as controllers of the trust, to pay capital and income to themselves or to their family members or to related trusts and companies.
13. An example scenario for the Goldilocks Trust<sup>®</sup>:
  - (1) Jane Green is in her 50s, has 3 adult independent children and is divorced. She meets and marries John Brown. John is also in his 50s, has 2 adult independent children and is recently divorced.
  - (2) Jane has the following assets:
    - (a) a house on the top of a hill in a leafy suburb worth \$1M debt free; and
    - (b) cash and investments of \$1.5M.

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<sup>[1]</sup> Cameron Cowley, Business Law Accredited Specialist and Special Counsel with Moin Morris Schaefer is the author of the Goldilocks Trust<sup>®</sup> deed and is the owner of the Goldilocks Trust<sup>®</sup> registered trademark, used under licence by Moin Morris Schaefer.

<sup>[2]</sup> The Goldilocks Trust<sup>®</sup> can be set up during life if desired.

<sup>[3]</sup> Note "remainder beneficiary" and "life income beneficiary" may have different meanings in different trust deeds.

- (3) John has the following assets:
    - (a) \$450,000 in listed shares held personally by him.
  - (4) They are living together in Jane's house.
  - (5) In her estate plan, Jane wants to provide that John can live in her home for as long as he likes but ultimately she wants the home to pass to her children.
14. Jane receives an advice on a range of options open to her<sup>[4]</sup>, and decides upon utilising a Goldilocks Trust<sup>®</sup>. She sets up her will as follows:
- (1) She establishes a Goldilocks Trust<sup>®</sup> and gifts her home and \$1M into the trust. She gives the remainder of her assets to her children.
  - (2) She appoints John, and one of her children, as trustees of the Goldilocks Trust<sup>®</sup>. Her children will represent their own interests in the trust.
  - (3) John is entitled to income from the \$1M, and may reside in the home rent free for his life.
15. Jane is pleased with the outcome because:
- (1) John can enjoy the home for his life whilst preserving it for Jane's children;
  - (2) her children can have some involvement in the maintenance and preservation of the family home; and
  - (3) income can be provided to John without there being a risk that the asset is part of his estate or at risk of being taken by his creditors or distributed to a later partner of John's. If John remarries, then divorces, the property of the trust is not available for distribution to that person in the family law proceedings<sup>[5]</sup>.
16. The trust could lend moneys to John to assist with his aged care if thought appropriate.
17. The decision of the controllers of the trust (i.e. the trustees) and the appointors is the most critical decision in the establishment of a Goldilocks Trust<sup>®</sup>. Family dynamics and personal dynamics between the parties would need to be considered. It may not be appropriate to have a John and his stepchildren together as trustees and, instead, it may be better that an independent person be trustee with John and in some rare cases it may be that John is not a trustee at all.

### Tailoring the Goldilocks Trust<sup>®</sup>

18. The Goldilocks Trust<sup>®</sup> is tailored to meet the needs of your family. You can choose:

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<sup>[4]</sup> Estate planning rarely has one right answer.

<sup>[5]</sup> A full discussion of the family law permutations is not the aim of this article.

- (1) Would you like your spouse to have access to capital of the trust in the event of certain life exigencies? This might include, for example, medical costs. This could be require approval by your children if you think appropriate.
  - (2) Should your children be income beneficiaries during the life of your spouse? This would allow your spouse to distribute some income to them if they so considered. This would be unusual but is done sometimes when the family wishes to split income for tax purposes.
  - (3) Should there be any termination events other than the death of your spouse? For example, if your spouse remarries would that bring the trust to an end?
19. Typically the trustees of the trust would include your spouse and another person to represent the interests of your children. We have faith in human goodwill and moral nature and we lock our car doors when leaving our car in a public space.
20. The Goldilocks Trust<sup>®</sup> is an expression of faith in your spouse whilst providing for your children.

### **The Goldilocks Trust<sup>®</sup> and family law**

21. What happens if your spouse inherits from you by a Goldilocks Trust<sup>®</sup> and then remarries?
22. The Goldilocks Trust<sup>®</sup> assets will be clearly separated from the marital assets of your former spouse and their new partner. The assets were not created or developed by either of the parties to the relationship. Therefore it is highly likely that the assets of the Goldilocks Trust<sup>®</sup> will be completely safe from any property division proceedings. However there may be circumstances, depending on a range of factors, including how the Goldilocks Trust<sup>®</sup> is used, who the trustees are, the age of the parties, whether the relationship bears children, where the assets are taken into account. That said, we are confident that the assets will be much more likely to be retained if they are within a Goldilocks Trust<sup>®</sup> compared to if they are owed absolutely by your former spouse, because of the trust structure.

### **What are the disadvantages of a Goldilocks Trust<sup>®</sup>**

23. The Goldilocks Trust<sup>®</sup> is not a once size fits all estate planning tool. It is most effective in specific circumstances. Your advisor will consider your family's circumstances before they make a recommendation to use a Goldilocks Trust<sup>®</sup>.
24. The main disadvantage to your spouse inheriting via a Goldilocks Trust<sup>®</sup> is that as with a family trust, there are some modest running costs for the trust. These running costs only commence in the event of your death and the trust is established.
25. Your spouse does not have absolute control of all of their inheritance. Whilst this may be a disadvantage for them, it is the purpose of the structure so that you can secure your own children's future.

### Launch of the Goldilocks Trust<sup>®</sup>

26. The Goldilocks Trust<sup>®</sup> is now available for the estate planning needs of you and your clients.

Cameron Cowley

August 2020

Moin Morris Schaefer Wills & Estates Bulletin

## Testamentary trusts and reimbursements agreements – do I actually have to pay my children the declared distributions?

### Background

1. One of the attractive features of a testamentary discretionary trust (TT) is that distributions may be made to minors and the minors are taxed as adults. They can access the tax free threshold and progressive tax rates. When Grandmum has a TT in her will for her son or daughter, and there are multiple grandchildren, the income from the inheritance in the TT is able to be spread amongst minor grandchildren to greatly reduce the tax burden for the family.
2. However despite the declaration of distributions to each grandchild, and the entries in the financials of those distributions, it is rare (in my experience) for the cash to be paid to the grandkids. Typically the money is instead reinvested into the TT investment portfolio, or sometimes borrowed by the adults.
3. As the years go by, substantial debts can build up in the TT owing to children. The question arises, do these debts need to be paid, and how are they affected by the reimbursement provisions of the Tax Act?

### Reimbursement agreements

4. Section 100A of the *Income Tax Assessment Act 1936 (ITAA 1936)* provides that where there is a deemed reimbursement agreement between the trustee and a beneficiary, then instead of the beneficiary being taxed on that income, it is the trustee who is taxed at the maximum marginal tax rate plus the Medicare levy, pursuant to s.99A of the ITAA 1936.
5. A reimbursement agreement will exist where:
  - (1) a trustee declares a distribution to a particular beneficiary;
  - (2) a person other than that beneficiary receives the benefit of the distribution whether by way of cash or property; and
  - (3) the purpose of the arrangement was to allow the trustee, or the beneficiary, or both, to have a lower income tax liability.
6. It is important not to become alarmed at this point. The description of a reimbursement agreement immediately brings to mind most family trusts where by Mum and Dad as trustees, or directors of the corporate trustee, declare distributions to themselves but never actually pay themselves because the money is retained in the trust for running the business. TTs are also operated in a somewhat similar fashion with distributions being declared to grandkids but not paid. This however is not at risk of being deemed a reimbursement agreement.
7. This is because s.100A does not apply to any arrangement which is an *ordinary family or commercial dealing*.
8. The Act does not define an *ordinary family dealing* or an *ordinary commercial dealing*. The ATO advises that it considers that just because all the parties are family

members, does not mean the arrangement would automatically be an ordinary family dealing.

9. An agreement does not need to be a document in writing but can be an oral agreement, an understanding, an exchange of correspondence or even simply an arrangement that is repeated over several years without any documentation or agreement whatsoever.
10. Typically, for something to be a commercial dealing it needs to be on arm's length terms. For example, this might mean putting in place a loan agreement and paying interest like what is done under Division 7A. If an arrangement does not make commercial sense then it is unlikely to come with the ordinary commercial dealing exemption.
11. The ATO provides a number of examples on its website of both allowable ordinary commercial or family dealings and one unpermitted dealing.
12. Example 3 from the ATO's website provides that an ordinary family dealing will include where a distribution is declared to a minor but not paid and the income is instead used to make investments. This is permissible.
13. There is no particular timeframe on when the minor must be paid. The beneficiary usually will be legally entitled to call in the debt when they reach 18 but there would not be a problem if the debt held over for a period after this. The ATO has not indicated that it would expect a commercial loan agreement to be signed when the beneficiary reaches 18. Families do not typically do this.
14. Example 4 is also instructive for family trusts or testamentary trusts. In that example, the trustee of a family trust declared distributions to a range of beneficiaries for several years without cash flowing the distributions, except for sufficient cash for the beneficiaries to pay tax on their distribution. The trustee of the family trust, instead of investing the funds, lends the funds to the controller of the trust on commercial terms, requiring the payment of principal and interest over time. This is permitted.
15. The ATO also states that it would not usually apply s.100A where the beneficiary is a minor.

### **Adult children**

16. The following arrangement should be avoided because it is likely to be a reimbursement agreement:
  - (1) the trustee of a family trust or of a testamentary discretionary trust makes a number of distributions to minor or adult children;
  - (2) the distributions are not paid; and
  - (3) at some later time the children (who would be over 18) each sign a deed of forgiveness forgiving those distributions or even a number of years of distributions.
17. The problem with this arrangement is that it is difficult to attribute a purpose to the arrangement other than to be a reimbursement agreement, or more broadly, to

reduce taxation liability. The beneficiary simply doesn't get a benefit if they later forgive the amount.

### Corporate beneficiary

18. Example 5 from the ATO website is as follows:
  - (1) The trust is the sole shareholder in a company (**bucket company**).
  - (2) The trust distributes income to the bucket company.
  - (3) The bucket company pays tax on the income and pays a fully franked dividend to the trustee out of that distribution.
  - (4) The arrangement is repeated in the following years.
19. The ATO describes this, not unfairly, as a perpetual circulation of funds with no commercial purpose. The ATO advises that it will apply s.100A to this arrangement.
20. Where possible, converting an unpaid trust distribution to a complying Division 7A loan will prevent there being any risk of a s.100A issue.
21. Note that there is no limitation period for the Commissioner of Taxation when reviewing previous years of income for s.100A arrangements.
22. Distributions by a testamentary trustee are unlikely to be a reimbursement agreement for the purposes of the Tax Act if they make sense in the context of your family, or in a commercial setting. If the arrangement only makes sense when the tax effects are considered, then you may have a problem.
23. Returning to the title of this article – yes if you have declared distributions to your children from your testamentary trust (i.e. which you inherited from your parents) then you will need to cashflow that distribution at some stage unless you wish to run afoul of the reimbursement agreement provisions.
24. Unpaid distributions also need to be carefully considered from an estate planning perspective – but that will be the subject of another article.

Cameron Cowley

August 2020

## Amendments to section 102AG and testamentary trusts – what about life insurance and super death benefits?

1. *Treasury Laws Amendment (2019 Measures No. 3) Act 2019 (Cth)* received assent on 22 June 2020. It amends section 102AG of the Income Tax Assessment Act 1936 in relation to taxation of minors in receipt of income from a testamentary trust. The purpose of the amendment was to reduce revenue leakage through testamentary trusts.
2. Apparently some taxpayers were injecting income earning assets, or income, which was not owned by the deceased who established the trust, into a testamentary trust (TT) and then taking advantage of the special taxation rules. Essentially, minors in receipt of income from a TT are taxed as adults and can use the usual adult tax thresholds.
3. The new section reads as follows:

*(2AA) For the purposes of paragraph (2)(a), assessable income of a trust estate is of a kind covered by this subsection if:*

*(a) the assessable income is derived by the trustee of the trust estate from property; and*

*(b) the property satisfies any of the following requirements:*

*(i) the property was transferred to the trustee of the trust estate to benefit the beneficiary from the estate of the deceased person concerned, as a result of the will, codicil, intestacy or order of a court mentioned in paragraph (2)(a);*

*(ii) the property represents accumulations of income or capital from property that satisfies the requirement in subparagraph (i);*

*(iii) the property represents accumulations of income or capital from property that satisfies the requirement in subparagraph (ii), or (because of a previous operation of this subparagraph) the requirement in this subparagraph.*
4. The question has arisen – how does this new section affect life insurance and death benefits, which are not part of the estate of deceased at the date of death? E.g. the deceased has a life insurance policy and a superannuation account. On her death, the policy is paid to her estate, as is her superannuation. From there the amounts are paid into a TT for her minor children. Does sub-section (i) exclude these amounts because they not from *the estate of a deceased person or as a result of her will*?
5. There is no guidance from the Australian Taxation Office as to how this section will be applied to life insurance and superannuation death benefits in this scenario.
6. Our view of the amended section is that superannuation death benefits and life insurance, which pass into a deceased estate, and from there pursuant to a provisions

of the will, to a TT, will be included as property of the TT which can produce excepted income. A plain reading of the section allows this.

7. The section is not an anti-injection test for the deceased estate, but instead for the TT. Superannuation death benefits is not paid directly to the TT, but to the estate, and then it forms part of the pool of assets which comprises the deceased estate. The amendment is aimed at people who are distributing money from family trusts or other sources into the TT. The examples in the Explanatory Memorandum (EM) which accompanied the Bill are of this nature. The policy context of the amendment is explained in the EM:

*The existing law does not specify that the assessable income of the testamentary trust be derived from assets of the deceased estate (or assets representing assets of the deceased estate). As a result, assets unrelated to a deceased estate that are injected into a testamentary trust may, subject to anti-avoidance rules, generate excepted trust income that is not subject to the higher tax rates on minors. This is an unintended consequence, which allows some taxpayers to inappropriately obtain the benefit of concessional tax treatment.*

8. Superannuation death benefits and life insurance are considered (somewhat incorrectly) by the deceased as their property and on their death the usual proper course is for these amounts to be paid into the estate.
9. Some commentators have argued a strict reading of the section will prevent superannuation and life insurance from being included. I agree there is at least some small room for argument on the point. This is because there is reference to the property being *as a result of the will, codicil, intestacy or order of a court*. Super death benefits do not arise under a will, but instead from a super fund. However they are regularly and properly transferred to an estate, which then passes pursuant to the will. The Superannuation Industry (Supervision) Act 1993 envisages that super death benefits will often pass under a will, because the LPR is one of the limited number of beneficiaries.
10. There is no specific ATO guidance (at the time of writing) on how the ATO will apply this amended law to superannuation and life insurance. However the examples on the ATO website are aimed at injection type situations.
11. As such Moin Morris Schaefer are proceeding on the basis that the section is an 'anti-injection' test for TTs (not the estate) aimed at capital or income injections. We do not have a concern at this stage that this will catch superannuation or life insurance which passes through an estate. That said, one should not try to use their family trust distributions to inflate a deceased estate – that would invite close scrutiny from the ATO. We are monitoring caselaw and published ATO guidance and will revisit the issue if anything changes.
12. This section is a useful reminder that estate planning and estate administration must be done in a planned and considered manner. For example, if superannuation was paid directly to a trustee of a TT, then it would be caught and would not longer produce excepted income, and would need to be partitioned within accounts. If life insurance or superannuation was paid to a child or spouse, those funds could not then be paid to the TT.

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- Wills and Estate Planning
- Testamentary trusts
- Trusts
- Superannuation including SMSFs
- SMSF nominations
- Taxation issues of estate planning
- Deeds of family arrangement
- Corporate succession



**Greg Moin**

- Wills and Estate Planning
- Powers of Attorney
- Appointment of Enduring Guardians
- NCAT Reviews
- Farm succession
- Advanced Care Directives
- Corporate succession
- Aged Care Law
- SMSF nominations



**Richard Morris**

- Wills and Estate Planning
- Deceased Estates
- Family Provision Claims
- Complex Estates
- Foreign Wills
- Capacity claims
- Informal Will cases
- SMSF nominations
- Special Grants
- Probate/ Administration

*We stand by all of the legal information in this bulletin. However it is important to understand that it is not legal advice for you. Advice must be tailored to your circumstances, and every client's circumstances are unique. If you try to apply the above information to your circumstances it may not lead to the outcome you seek. We would be most happy to provide tailored advice for you suited to your circumstances.*