# TAX TALKS

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## 115 | Life and Remainder Interest

A life and remainder interest is more common than we first thought. But what is it? And who pays the tax?

### Life and Remainder Interest

In this episode Michael McCarthy of Tax & Super Australia will give you an overview of the CGT implications of life and remainder interests. Here is what we learned.

*We can't talk tax without talking law, but we are not lawyers. So please ask your lawyer for proper advice. The following is to give you a first insight.*

A life and remainder interest (LRI) can be set up inter vivos or in the context of a deceased estate. It can be set up over property or other assets. And any of these variations might have very different CGT outcomes.

To simplify things let's just look at an LRI over a main residence in a deceased estate. This is the most common scenario of an LRI.

### Example

Let's say the title for your family home is only in your name. You bought the house post 1985 for $1m, now worth $3m. But now you are close to the end of the road. You want to make sure your wife is alright when you die. You want her to have your house as long as she lives. But after that you want your house to go to your children. And not to a potential future second husband.

So you set up a life and remainder interest in your will. You give your wife a life interest in the family home that entitles her to any income from the house and allows her to live in the house as long as she lives.

And you give your children a remainder interest, meaning your children get the house after your wife dies. So the house is safe from a potential second husband.

### Life Interest

A life interest is not just a right to occupy. A right to occupancy just gives a right to reside in a particular property. It does not include any right to income from the property.

A life interest on the other hand carries a right to use and occupy the property. This includes any income from the property.

The interest is generally measured by the life of the life interest owner – so in our example your wife – but it could be measured by the life of another individual – for example another relative – but this is quite rare. The life interest ends on the death of the individual who is the measuring life.


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When the interest owner is the measuring life, the life interest does not form part of the estate of the life interest owner, since it expired upon their death.

However, if the measuring life is somebody else's and the life interest owner dies before the individual who is the measuring life, then the life interest does form part of the interest owner's estate.

### Remainder Interest

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

### TR 2006/14

So now you spend some precious time with your family, say good-bye and let go.

Your executor takes over and manages the administration of your deceased estate that includes the house. In accordance with your will, a trust is created under your will. Your house is the trust asset. The trustee becomes the legal owner of your house. And your wife has a life interest and your children have a remainder interest in your house. But how is all this treated for tax purposes?

To find an answer you need to look into Taxation Ruling TR 2006/14. TR 2006/14 deals with the CGT consequences of creating life and remainder interests ("LRIs") in property and any subsequent dealings in those interests.

### CGT Event E1

When the trust is created over your house in the context of your deceased estate, CGT event E1 happens. CGT event E1 is the creation of a trust over a property.

Since there are no capital proceeds and you deal not at arm's length, you are taken to have received the market value of the house being $3m. Since your cost base is $1m, you make a capital gain of $2m.

However, that capital gain from CGT event E1 is disregarded under section 128-10 ITAA97 in your final tax return.

> *s128-10: When you die, a capital gain or capital loss from a CGT event that results for a CGT asset you owned just before dying is disregarded.*

For you this CGT event E1 is all there is from this. Everything else from now on affects the trustee, your wife and children, but no longer you.

### Trustee

The trustee of the trust over your house could be your excecutor but it could also be somebody else. This trustee is now the owner of your house for CGT purposes. They receive the house at the date of your death.

The trustee's acquisition cost in respect of your house is deemed to be – since it was your main residence when you passed away – the market value of your house at the time of your death.

If it hadn't been your main residence, then your cost base and reduced cost base would become the trustee's since you acquired the house after September 1985.


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The normal trust rules in Part III ITAA36 apply now. Any net capital gain is included in the net income of the trust per ss 95 (1) ITAA 1936 and taxed in accordance with Division 6 ITAA36.

## Main Residence Exemption

The main question is whether the main residence exemption still applies, even though your wife is not the legal owner of the house. And the answer is Yes.

The equitable right of a life interest in the house is sufficient to give an interest in the land that will attract the main residence exemption. But please check this with your lawyer and tax adviser. The slightest nuances in all this can result in a completely different outcome.

## Asset Protection

The trust created through your will is a fully discretionary trust – assuming it is properly structured. So no beneficiary has any interest in the trust asset. That means that if your wife and children who are simply beneficiaries suffer financial calamity or are sued personally, the trust asset will not be available to satisfy their debts. Meaning their creditors can't touch your house.

## Life and Remainder Interest

Neither your wife nor your children are absolutely entitled to the trust asset aka the house during the existence of the trust. However, they do hold life and remainder interests. Your wife has an interest. And your children have an interest. These are two separate equitable rights and hence two separate CGT assets.

The CGT assets are acquired when they commence to be owned. So the life and remainder interests are acquired when the trust is created through CGT event E1.

With an LRI in a deceased estate no money usually exchanges hands. And so the rights are deemed to have been acquired at market value thanks to the market value substitution rule in s112-20(1)(a).

## Life Interest Expires

After many more years your wife passes away (and just in case you wondered she never married again). Her life interest in your house had been measured by her life. She had been the measuring life. So her death will bring the life interest to an end. And this is CGT event C2.

Since 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. So no capital gain or loss from the life interest will hit your wife's final tax return.

## Remainder Interest Expires

So now your children receive the house just as you had intended. The trustee distributes the trust asset to your children as the remainder owner and the trust comes to an end. What now follows is a round-robbin but the end result is simple: Any capital gain or loss is disregarded.

## CGT Event E5

So here is the round-robin: When a life interest ends and the remainder owner becomes absolutely entitled against the trustee to a trust asset, CGT event E5 usually happens. CGT event E5 is about a beneficiary becoming entitled to a trust asset.


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> *s104-75 (1): CGT event E5 happens if a beneficiary becomes absolutely entitled to a CGT asset of a trust … as against the trustee…*

But there is an exception. CGT Event E5 does not apply when Division 128 applies.

> *s104-75 (1): CGT event E5 happens if a beneficiary becomes absolutely entitled to a CGT asset of a trust* ***(except … a trust to which Division 128 applies)*** *as against the trustee …*

So this sounds like we don't have a CGT event E5 on our hands since your wife died and hence you would think that Division 128 ITAA 97 would apply.

> *Division 128: This Division sets out what happens when you die and a CGT asset you owned just before dying devolves to your legal personal representative or passes to a beneficiary in your estate.*

But Division 128 doesn't apply at face value. Division 128 is about an asset passing from a deceased individual via their LPR directly to a beneficiary in their estate. It doesn't talk about an asset passing through a testamentary trust like the LRI to the ultimate beneficiary.

The Commissioner points this out in para 78 of TR 2006/14. And so CGT event E5 and hence the capital gain is back on the table.

## PS LA 2003/12

But there is PS LA 2003/12. In this Law Administration Practice Statement the Commissioner affirms his longstanding practice of treating the trustee of a testamentary trust – of which a life and remainder interest is one – in the same way as an LPR for s128-15 (3) purposes.

> *s128 – 15 (3): Any capital gain or capital loss the legal personal representative makes if the asset passes to a beneficiary in your estate is disregarded.*

In consequence, any capital gain or capital loss that arises when an asset owned by you as a deceased person passes to the ultimate beneficiary of the trust – your children – created under your will is disregarded.

And so we got CGT event E5 but PS LA 2003/12 allows us to disregard the capital gain. And so the house passes from your LPR to your children without any capital gain being picked up.

## Summary

So after all this the end result is straight forward. But the devil is in the detail. There are many variations that would result in a different outcome.

But the bottom line is that the tax consequences going through an LRI are identical to leaving the assets directly to your children as the end beneficiaries – in this scenario.

If you had directly given the house to your children in your will, you would have disregarded any capital gain or loss in your final tax return thanks to Div 128. And your children would have received your house with a cost base of the market value at the time of your death, since the house had been your main residence.

An LRI gives you the same outcome. You disregard any capital gain in your final tax return under Div 128. Your trustee disregards any capital gain in the trust's tax return under Div 128. And your children receive the house with the market value at your time of death as their cost base.

All this is just our brief take on the issue, but please listen to the episode above. Michael McCarthy explains all this in a much better way than we ever could.


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