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Testamentary options: beware

This article appeared in this month's edition of the Law Society Journal (NSW).

You're making a will for Jack Brown, whose wife died some years ago. He has three children Tom, Indi and Lochie. He wants to treat the children equally but isn't sure what to do about his beach house. He bought it in the late 1980s when the children were quite young. It has been the centre of family holidays ever since, at least for some of the family.

While nowadays neither Tom nor Indi have much interest in the beach house. Lochie has a young family and is pretty keen. On the other hand Lochie is struggling a bit financially so Jack isn't sure whether he would actually like the house. He is quite sure that Tom and Indi would want to sell it and realise the proceeds. He wants to make sure that Lochie has the opportunity to end up with it if he wants to.

You therefore suggest that in his will Jack give Lochie an option to buy the beach house at market value. You point out that this would prevent Tom and Indi forcing a sale against Lochie's wishes.

If Lochie does want the beach house, he can buy it at market value so that Tom and Indi would be no worse off. If he doesn't want the beach house Jack's executors can sell it and divide the proceeds three ways. Either way equality will be achieved with no reason for unhappiness between the kids.

Jack is also unsure what to do about executors. There is some disharmony between the children which he feels would get in the way. He asks if you would do the job for him. You agree.

## The sting

Jack later dies and the family consult you about the estate. Lochie decides he would like to get the beach house so, within the relevant time limits after probate has been granted, he exercises the option.

As executor you have the beach house valued. When distributing the estate you transfer the beach house to Lochie with an appropriate cash adjustment in favour of Tom and Indi.

A year or so after Jack's death his estate is picked for a random audit by the ATO. A tax assessment is issued to you as the executor of his will claiming CGT on transfer of the beach house to Lochie. Great embarrassment follows because the estate was distributed to the three kids on the understanding that the CGT exemption on death applied.

The problem is that the CGT exemption on death only applies to assets that pass under a will. Although it may not be immediately obvious, the ATO in Tax Ruling IT 2664 has for some time taken the view that where an asset is purchased from a deceased estate under a testamentary option, the asset passes under the exercised option rather than the deceased's will.

It therefore follows that because the beach house was acquired after CGT commenced in 1985, the disposal will be subject to CGT.

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