

# Death and taxes: taxation issues and consequences that arise on the final frontier

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**Abstract:** Complex taxation issues can arise on and following the death of a taxpayer, in relation to diverse areas of revenue law, and because of inconsistency between the treatment at general law and taxation law of some of the key relationships that arise on the death of a taxpayer. Another factor is the proposed reform of Div 128 of the *Income Tax Assessment Act 1997* (Cth). This article discusses some of the income tax, CGT and superannuation issues, by reference to a case study. The article considers the issues that arise in relation to three distinct phases after a taxpayer's death, namely, the period between death and administration of the deceased estate, the period during which the executor distributes assets to the beneficiaries, and the period following the asset being distributed to the beneficiary, including an analysis of the issues that arise on the establishment and maintenance of a testamentary trust.

## Introduction

The taxation issues that arise on and following the death of a taxpayer can be considerably complex. This complexity arises for three main reasons:

- the multiplicity of taxation issues that arise in relation to diverse areas of revenue law, for example, taxation administration, capital gains tax (CGT), superannuation, goods and services tax (GST), land tax and duties;
- the inconsistency between the treatment at general law and taxation law of some of the key relationships that arise on the death of a taxpayer; and
- the proposed reform of Div 128 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) as enunciated in two proposal papers (both titled "Minor amendments to the capital gains tax law") released in May 2011 and June 2012 and, more broadly, the proposed reform of the taxation of trusts.<sup>1</sup>

The importance of estate planning to clients, coupled with the fact that there will be a large transfer of wealth between generations in the next decade, means that tax professionals need to give careful consideration to the practical tax issues that arise on the death of a taxpayer, despite the inherent complexity of some of those issues.<sup>2</sup> The Henry Tax Review final report predicted that the amount of bequests passed on in Australia would rise from \$22b in 2010 to \$85b in 2013.

This article will discuss some of the income tax, CGT and superannuation issues that

will arise on and after the death of an individual, by reference to a case study as presented below. Specifically, the article considers the taxation issues that arise in relation to three distinct phases after the death of an individual, namely, the time period:

- between the death of an individual and administration of the deceased estate;
- during which the executor distributes assets to the beneficiaries; and
- following the asset being distributed to the beneficiary, including an analysis of the issues that arise on the establishment and maintenance of a testamentary trust.

Throughout the article, reference will be made to the proposed amendments to Div 128 in the two proposal papers noted above.

Notably, this article does not discuss the implications of death in relation to GST and state taxes.

To comprehensively explore and illustrate the types of practical issues that arise on the death of an individual, the following case study will be referred to throughout this article. The case study focuses substantially on the CGT issues associated with the death of an individual.

## Case study – Phillip Brown

Phillip Brown died on 1 March 2012. He left a detailed valid will appointing his wife Hazel as executor and making the following specific bequests:

- his red collectable Ferrari to be left to his "car fanatic" cousin Burt;
- two blocks of land in Eagle Bay held solely in his name to be left to his wife Hazel. The first block of land (Eagle Bay Block One) was purchased by Philip on 1 August 1977, while the other block of land (Eagle Bay Block Two) was purchased by Philip on 30 September 1990;
- a large portfolio of shares to be left to a charitable institution (ABC Limited) that provides for sick and homeless cats;
- an investment property in Paris to be left to his sister Kathy who is a resident of Canada;
- an interest Phillip has in a partnership with his best friend John Smith running the local delicatessen to be left to his wife Hazel. The partnership agreement does not deal with the death of a partner and there is no valid buy/sell agreement;
- Phillip and Hazel are the members and trustees of the Brown Self-Managed Superannuation Fund (SMSF). Phillip made a binding death nomination to leave his interest in the superannuation fund to his wife Hazel. At the time of his death, Phillip was receiving a pension from the SMSF; and
- an investment portfolio to go into a testamentary trust for his son Jack, daughter in law Ruby, and grandson Toby. Jack has a history of substance abuse. He recently married recovering addict Ruby who he met in rehabilitation.

Philip was concerned about a relapse and did not want to leave the investment portfolio to Jack outright and he also wanted to ensure that his grandson Toby was provided for. Toby is to be a capital beneficiary. He nominates Jack, Ruby and Toby as beneficiaries of the trust. The trustee of the testamentary trust will be his wife Hazel, who is also the executor of his estate.

Philip's main residence in Nedlands (a suburb in Perth) was held as a joint tenant with his wife Hazel and, on the specific advice of his lawyer, he did not include this in his will.

Phillip also has some outstanding taxation obligations, including a failure to lodge his tax returns for the previous two financial years.

### Phase one: taxation issues arising between the death of the individual and the administration of the estate

The first stage in administering a deceased estate, where there is a valid will, is obtaining probate.<sup>3</sup> When a taxpayer dies, legal title of their property will devolve to their legal personal representative (LPR).<sup>4</sup> Therefore, in the case of Philip, legal title of his property will vest in his wife Hazel, as executor of the estate.

As executor, Hazel must carry out the instructions of Philip as listed in his will, and she will become responsible for the proper administration of his estate or winding up of his affairs. Some of the key tasks for Hazel include collecting Philip's assets, paying off his debts or liabilities, and distributing assets.<sup>5</sup> Significantly, in the taxation context, Hazel will also be responsible for finalising Philip's tax affairs.

#### Finalising Philip's tax affairs

The LPR (in this case Hazel as executor) must finalise the deceased's tax affairs. This includes preparing and lodging the deceased's final or death tax return and any outstanding prior year returns, and ensuring the payment of tax assessed in respect of the final year and any tax debts in relation to the prior year.<sup>6</sup> In relation to undertaking these obligations, the LPR stands in the shoes of the deceased and can deal with the Australian Taxation Office (ATO) in relation to these matters.<sup>7</sup>

The ATO is informed of the executor's (or administrator's) details when they apply for the tax file number (TFN) of the estate. It is a requirement that the executor's personal TFN or a certified copy of the death

certificate is supplied before the ATO can liaise with them regarding the deceased's taxation affairs.<sup>8</sup> Thus, in relation to finalising Philip's tax affairs, Hazel must take three distinct actions:

- lodge Philip's two outstanding tax returns;
- lodge a tax return from 1 July immediately preceding the date of Philip's death until the date of his death (1 March 2012); and
- lodge a tax return for the estate from the date of death until the date that administration of the estate is finalised. This is discussed in further detail below. However, notably, a deceased estate tax return is required to be lodged each year until the estate is wound up.

#### Income derived while the estate is being administered

Depending on the complexity of the estate, administration could take some time and, during this period, the executor (or LPR) must pay tax on the income of the deceased estate. In relation to Philip's estate, this could include, for example, income from the partnership or investment portfolio that accrues during the period that the estate is being administered. After the date of death, Hazel will need to obtain a separate TFN for the deceased estate.<sup>9</sup> The first estate return will be for the period from the date of the deceased's death (1 March 2012) until the end of the financial year (30 June 2012).

For taxation purposes, the definition of a trustee in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) includes an "executor or administrator" and, hence, for tax law purposes, a trust relationship comes into existence immediately on death. Interestingly, there is a disconnect between the general law position and the taxation position in this regard. The general law position is that the LPR does not hold the assets on trust for beneficiaries and a trust relationship does not form until administration of the estate is completed.<sup>10</sup>

This was well-illustrated in *Commissioner of Stamp Duties (Qld) v Livingston*.<sup>11</sup> In that case, Mr Livingston died in Australia in 1948 leaving a will in which he appointed executors to administer his estate. He directed them to transfer the residue of his estate, after paying all of his debts and other liabilities, to trustees to hold on trust for his widow and their children. However, prior to his executors completing the task,

Mr Livingston's widow had remarried and then died herself. In Australian law, as is the case with English law, the property of someone who dies having left a will automatically vests in the deceased's executors until they complete the administration of the estate and transfer the assets to those entitled under the deceased's will.

Accordingly, at the time when Mr Livingston's widow died, the title to all of Mr Livingston's property was therefore still held by his executors because they had not yet had time to complete the administration and transfer everything to the trustees to hold on trust for his widow. The question before the court in this case was whether at that time, when the executors still held Mr Livingston's Queensland property, his widow had any beneficial interest in it. The question arose because, under Queensland's tax law, succession duty would have been payable on all of Mr Livingston's Queensland property on his widow's death if she had a "beneficial interest" in it when she died. The Privy Council held that she did *not* have a beneficial interest and therefore no succession duty was payable on her death.

Given that a deceased estate is treated as a trust, the provisions of Div 6 ITAA36 must be consulted. Pursuant to Div 6, when looking at the estate tax return, the following must be ascertained:

- the "net income" of the trust estate. This is defined in s 95 ITAA36 as the "total assessable income of the trust estate calculated ... as if the trustee were a taxpayer in respect of that income and were a resident less all allowable deductions ..."; and then
- who is presently entitled to that income of the trust under s 97 or 98 ITAA36. Where no beneficiary is entitled to the net income of the trust, the trustee will be liable for tax on the income of the trust estate either under s 99A or s 99 ITAA36. Relevantly, a beneficiary of an incompletely administered estate cannot be presently entitled to income of the trust estate and only has a right to see the estate administered properly.<sup>12</sup> Administration is generally held to occur once all debts and liabilities have been satisfied.

Undistributed income of a trust estate is normally taxable under s 99A (at the highest marginal tax rate). However, the estate will generally only be taxed at normal rates under s 99 where, at the

discretion of the Commissioner, it is considered that the application of s 99A would be unreasonable and the trust estate resulted from:

- a will, a codicil or an order of a court that varies or modifies provisions of a will or a codicil; or
- an intestacy or an order of a court varying or modifying the application in relation to the estate of a deceased person or the provision of the law relating to the distribution of the estate of persons who die without a will.

The rates that apply under s 99 depend on whether the deceased person died less than three years before the end of the year of income being considered.<sup>13</sup> If the deceased died less than three years before the end of the income year, ordinary marginal tax rates apply. For a deceased estate, where the deceased died more than three years before the end of the income year, ordinary marginal tax rates apply, but the tax free threshold is not available. When the beneficiary eventually obtains the trust income on which the trustee has paid tax, no further tax liability crystallises on distribution.<sup>14</sup>

Notably, pursuant to IT 2622, the ATO will accept an apportionment of the income of the deceased's estate in the income year when the estate is fully administered in circumstances where the LPR and beneficiaries can show the quantum of income derived in the periods before and after the day on which administration was completed.

It is important to note that there is a review into modernising the provisions of Div 6 and, therefore, this is an area which must be monitored carefully by professionals.<sup>15</sup>

### Phase two: passing assets from the executor to the beneficiary

An estate is generally held to be fully administered where all of the liabilities are ascertained. Once the estate is fully administered, the beneficiaries are normally assessed on all of that year's income

### Overview of the CGT implications of death

Depending on the terms of the will, LPRs can dispose of specific assets to beneficiaries (for example, a block of land), or they can dispose of assets to third parties to raise money to pay the debts of the deceased estate or to distribute the funds to beneficiaries.

While the death of a taxpayer is a CGT event in respect of CGT assets held by the deceased, the general rule for income tax purposes is that any capital gain or loss is disregarded.<sup>16</sup> Notably, a bequest of cash has no CGT consequences because cash is not a CGT asset.<sup>17</sup> Likewise, the general position is that when property passes<sup>18</sup> under a will to a beneficiary or an LPR or directly from the deceased to a beneficiary (for example, in a joint tenancy), any capital gain or loss will also be disregarded.<sup>19</sup>

Rather, an automatic roll-over applies under Div 128 ITAA97 on the value of the assets transferred on death and, therefore, any capital gain or loss is deferred until there is a disposal by the ultimate beneficiary of the asset or by the LPR (to a third party other than the nominated beneficiary). Given that the roll-over is automatic, the LPR cannot choose to crystallise a capital loss at the date of death.<sup>20</sup> Therefore, for CGT assets that are likely to prove a capital loss on sale, the taxpayer should consider selling or gifting the assets with attached capital losses during their lifetime to utilise the losses, as otherwise they will lapse on the death of the taxpayer.

Significantly, the 2011 proposal paper recommends a principles-based rewrite of Div 128. There are also a number of issues with the application of Div 128 to certain scenarios identified in the proposal paper.

It is noted in the 2011 proposal paper that, on a strict interpretation of the law, Div 128 would not apply where two (or more) beneficiaries acquire the deceased's asset. This would be the position because each beneficiary would only obtain an "interest" in the CGT asset rather than the whole asset. While the ATO applies the law in a manner that allows roll-over relief in this scenario,<sup>21</sup> the 2011 proposal paper suggests amending the legislation to unequivocally extend the roll-over in Div 128 to a situation where two or more beneficiaries each acquire an interest in an asset of the deceased.<sup>22</sup>

It is further noted in the 2011 proposal paper that when an intended beneficiary of an estate dies before the administration of the estate is complete and an asset owned by the deceased passes to that intended beneficiary's LPR (or trustee of a testamentary trust) or to a beneficiary of the intended beneficiary, Div 128 will not apply. However, it is proposed to amend the law to reflect the fact that the asset will be treated as though it had passed to the intended beneficiary before they died and

therefore the roll-over will apply.<sup>23</sup> The 2012 proposal paper notes that this change will apply retrospectively to the 2006-07 and later income years to ensure that existing practices are covered.

Where a beneficiary inherits a CGT asset under a will, they are treated as acquiring the asset for CGT purposes from the date of death.<sup>24</sup> The tax cost base inherited on the death of an individual then depends on whether the asset is a pre- or post-CGT asset. Where an asset was acquired before 20 September 1985 and therefore is a pre-CGT asset, the beneficiary is deemed to have acquired the asset at the date of the testator's death. This means that the "pre-CGT" status of the asset will expire and they will be deemed to have acquired a post-CGT asset, with the cost of acquisition being the market value of the asset at the date of the testator's death. Accordingly, on disposal, the beneficiary will be sheltered from any gain on the asset that was accumulated before the death of the original owner of the asset.

Where a post-CGT asset is acquired, the cost base of the asset is the cost base of the asset on the date of the deceased's death.<sup>25</sup> Section 128-15(5) ITAA97 provides that the cost base will include any expenditure that the LPR would have been able to include at the time the asset passes to the beneficiary. This could include rates paid by the LPR, and legal costs incurred by the deceased estate.<sup>26</sup>

### Philip and Hazel's main residence held as joint tenants

Philip's main residence in Nedlands is held as a joint tenant with his wife Hazel. Notably, this property will never become part of the deceased estate, as a joint tenancy means that, on the death of Philip, the right of survivorship operates and the whole of the property will remain with the surviving joint tenant Hazel, who then becomes the sole owner of the asset.<sup>27</sup>

Again, there is a disconnect between this general law position and the taxation position of the treatment of the interests of joint tenants.

For taxation purposes, the CGT regime treats joint tenants as if they are tenants in common, each holding a fractional interest in the joint asset.<sup>28</sup> Each joint tenant's fractional interest in the cost of the entire asset will be their cost base. Where a joint tenant dies and the surviving joint tenant becomes the sole owner, no CGT event will occur, as they are covered by the

roll-over in Div 128.<sup>29</sup> However, the survivor will be deemed to have acquired the asset at the date of the deceased's death. Where (such as in the case of Philip) the asset was acquired after 20 September 1985, the cost base of the survivor will be the cost base of the deceased taxpayer.<sup>30</sup>

### Passing of Eagle Bay Block One and Block Two to Hazel

An in specie distribution of Eagle Bay Block One and Block Two to Hazel will not crystallise any CGT liability.<sup>31</sup> However, the cost base of each block of land inherited by Hazel must be considered. The first thing to note is that there will be a difference in the rules regarding the cost base of Eagle Bay Block One and Block Two.

Given that Philip purchased Eagle Bay Block One in 1977, it is a pre-CGT asset. However, as Eagle Bay Block Two was purchased by Philip in 1990, it is a post-CGT asset.

As discussed above, where a beneficiary inherits an asset, they are treated as acquiring the asset for CGT purposes from the date of death.<sup>32</sup> Thus, in relation to Eagle Bay Block One and Block Two, Hazel will be deemed to have acquired the assets at the date of Philip's death. This means that the "pre-CGT" status of Eagle Bay Block One will expire and Hazel will be deemed to have acquired a post-CGT asset and the cost base will be the market value of the asset at the date of Philip's death.<sup>33</sup> In this respect, on disposal, Hazel will be sheltered from any gain in the asset accumulated before the death of Phillip.

In relation to Eagle Bay Block Two, Hazel will inherit Philip's cost base at the time of his death.<sup>34</sup>

This scenario presents a timely reminder to tax professionals that they should ensure during their client's lifetime that they assist them in maintaining a CGT register for the purchase and disposal of assets. This will ease the burden on the executor when they are required to pass asset cost bases to beneficiaries who have inherited the property, as a record certified by the tax professional can be provided, with all the relevant information required.

Furthermore, in relation to pre-CGT assets such as Eagle Bay Block One, executors should ensure that a market valuation of pre-CGT assets is undertaken as soon as possible, so that the market cost base of those assets can be ascertained. Those authorised to provide valuations would include a registered valuer, a member

of a recognised professional valuation body, or a person without formal valuation qualifications whose assessment is based on reasonably objective and supportable data.<sup>35</sup>

### Bequests to foreign residents and tax-advantaged entities

As noted above, Philip left a large portfolio of shares to ABC Limited (an institution that provides for sick and homeless cats), and an investment property in Paris to his sister Kathy (who is a foreign resident). These bequests are considered together because both of them require consideration of any tax implications that arise in relation to CGT event K3.

The Div 128 roll-over discussed above will not apply where a CGT asset passes to a beneficiary who is a tax-advantaged entity (that is, exempt from tax or subject to concessional rates of tax) or where an asset that is not taxable Australian property<sup>36</sup> passes to a non-resident.<sup>37</sup> In these circumstances, CGT event K3 arises. The capital gain or loss is the difference between the market value of the asset at the date of death and the cost base of the asset.<sup>38</sup> Notably, CGT event K3 applies immediately prior to the death of the taxpayer and, therefore, happens to the deceased and must be incorporated into the taxpayer's death return.<sup>39</sup> The 2012 proposal paper states regarding the purpose of CGT event K3:<sup>40</sup>

*"The rationale for having this exception is to prevent assets with an embedded capital gain escaping taxation (or being taxed at a reduced rate) when they are later disposed of by the concessional taxed entity."*

**Tax-advantaged entities:** An important exception to CGT event K3 is that a capital gain or loss will be disregarded if the gift would have been deductible under s 30-15 ITAA97 if it was not a testamentary gift.<sup>41</sup> If the gift does not meet this criterion, CGT event K3 will be triggered. Thus, it must be ascertained if the charity for sick and homeless cats is a deductible gift recipient (DGR).<sup>42</sup> A DGR is an organisation that is entitled to receive income tax deductible gifts and contributions. The majority of DGRs need to be endorsed by the ATO.

It should be noted that there are a number of suggestions in the 2011 and 2012 proposal papers to amend the application of CGT event K3. The first situation outlined in the 2011 proposal paper is where an entity would be entitled to tax-exempt status but has not been endorsed by the ATO until

after an asset has passed to it. For example, this could happen where an entity delays seeking such status until after the asset passes to it.

The 2011 proposal paper suggests that the legislation should be amended so that CGT event K3 will happen if, at the time the asset passes to an entity, the entity satisfies all of the conditions required for exempt entities, despite not having been officially endorsed.<sup>43</sup>

The second situation is where an asset does not pass to an entity listed in the event until after the deceased's amendment period has expired. In these circumstances, if the deceased's return cannot be amended, no capital gain or loss can be recognised.

Initially, the 2011 proposal paper proposed to ensure that a capital gain or loss will be subject to tax when an asset is transferred to an entity that is impacted outside the deceased's standard amendment period. It was proposed that that could be achieved by excluding CGT event K3 from the standard amendment period.<sup>44</sup> However, in the 2012 proposal paper, it was noted that this may require the deceased's return (in some circumstances) to be amended decades after the amendment period and would add to already significant compliance costs. Therefore, it was suggested that CGT event K3 should occur to the entity, for example, the LPR, that passes the asset to the concessional taxed entity, thereby ensuring that the tax liability is crystallised but the compliance costs are minimised. It is suggested that such an amendment will occur prospectively.

It was further suggested in the 2012 proposal paper that CGT event K3 would not occur where a concessional taxed entity received the asset via survivorship. It is proposed to amend the legislation so that CGT event K3 will apply in such circumstances.

**Foreign residents:** In relation to the disposal of the apartment in Paris to Kathy, CGT event K3 will occur. This is because it is a gift of non-taxable Australian property to a non-resident. CGT event K3 is limited to the disposal of non-taxable Australian property<sup>45</sup> because, if taxable Australian property is disposed of, this type of property will remain in the CGT net even after its disposal to a non-resident.

The government is proposing to amend CGT event K3 which will mean that liability



will fall on the LPR or the testamentary trustee rather than the event being included in the deceased's final tax assessment.<sup>46</sup> Furthermore, if an asset passes to an entity that has satisfied all of the conditions of exempt entities but has not been endorsed by the Commissioner, the gift will be taxable. It will also apply if it is transferred to a tax-exempt entity after the standard amendment period has expired.

In this regard, Flynn remarks on the issues that CGT event K3 poses for testators and advisers.<sup>47</sup> Evidently, as a gift of a non-taxable Australian property to a foreign resident will cause a CGT liability (ultimately borne by the estate), thought should be given by advisers to gifting that same asset to an Australian beneficiary who will not crystallise a CGT liability in respect of that particular asset.<sup>48</sup>

### Passing of the interest in the partnership to Hazel

In relation to Philip's interest in the partnership, Hazel will need to review the partnership agreement that will set out the rights and obligations of each of the partners. A partner can provide in the will for succession of their interest, but it must also be reflected in the partnership agreement.

Generally, the assets and liabilities of the partnership are shared between the partners in accordance with the terms of the partnership agreement. Under partnership law, when a partner dies, the partnership will dissolve unless there is an agreement in place that provides otherwise (for example, that the executor can continue as a partner). If there is no partnership agreement, the executor will have a number of options:

- to call on the value of the deceased's partners' interest in the partnership and the other partner will effectively need to "buy out" the partnership interest of the deceased;
- alternatively, to enter into a new partnership with the existing partner;
- if the existing partner does not have sufficient funds to buy out the existing partner, the partnership assets would need to be sold and the funds distributed to each of the partners.

Therefore, in this fact scenario, there are three options: John will be required to pay Phillip's share of the partnership to his estate. Hazel could choose to continue a new partnership with John. Alternatively, if John does not have sufficient funds to buy

out Hazel, the partnership assets will need to be sold and the funds divided between Hazel and John (in proportion to their interests in the partnership assets).

This scenario could have been made significantly easier by the use of a buy/sell agreement. Consideration should be given to employing a buy/sell agreement to ensure that the partnership can continue operating and to give existing partners the opportunity to purchase the interest. A buy/sell agreement is an agreement under which the proprietors of a business contract to buy the interest or equity of another proprietor if a trigger event such as death occurs. This will generally be associated with the purchase of an insurance policy that is linked to the "trigger" events enumerated in the buy/sell agreement. This enables funds to be provided to the surviving proprietors to purchase the business from the deceased's estate. There are several ways this can be done, for example, cross-insurance (where the partners insure one other) and self-insurance (where partners insure their own lives). Whatever option is considered, it is important to consider any CGT issues that can arise due to the disposal of equity and the receipt of insurance proceeds.

Tax professionals should advise clients to consider buy/sell agreements and to consult the appropriate professionals, as it can significantly assist in succession planning should a sudden death by a partner occur.

In the case of this partnership, as there is no buy/sell agreement, the death of Phillip will result in the disposal of the partner's share of the underlying assets of the business to the executor. Notably, if there was a buy/sell agreement, the sale of the deceased's share of the business assets by the LPR doesn't give rise to a Div 128 roll-over because the assets don't pass to a beneficiary of the estate.<sup>49</sup> Therefore, CGT would be payable on this transaction and consideration should be given to the general CGT discount in Div 115 and the small business concessions in Div 152. This is discussed below.

If Hazel decides to sell the partnership to John, there will need to be a valuation of the partnership assets. This will entail working out the stock value at the date of death and considering whether the business has any goodwill value.

The issue that can arise in this regard is that each partner may have a competing agenda. For example, the partner buying

out the other partner may prefer a lower valuation than the partner receiving that payment. This could lead to disputes over the valuation of the assets.

John can be disadvantaged here in two ways. First, he may not have the funds available to pay the estate, and second, Hazel may prefer to be in partnership with John, despite the fact that this may not be what John wants. If John does not have the funds, the business (the delicatessen) would need to be sold and each partner would receive their share based on their partnership interest.

As noted above, a buy/sell arrangement (referred to above) would have assisted John, as it would have provided the funds to pay out Philip's estate and allow him to continue to run the business in his own right.

If the assets are sold, any capital gain or loss in the partnership will be made by the partners individually, with each partner having a separate cost base and reduced cost base for their interest in each of the CGT assets in the partnership.<sup>50</sup> In respect of the partners remaining, they will acquire a separate CGT asset to the extent that they acquire a share of the departing partners' interest in a partnership asset.<sup>51</sup>

The consequences of Hazel disposing of her interest in the partnership assets are discussed further below.

### Passing of the Ferrari to cousin Burt

The passing of the Ferrari to cousin Burt will not have any ramifications for CGT purposes. Section 118-5(a) ITAA97 provides an exemption for capital gains or losses that arise from cars, motor cycles or similar vehicles.<sup>52</sup> Similarly, if Burt chooses to sell the Ferrari at some point in the future, no CGT implications will arise.

### Superannuation issues in relation to the Brown SMSF

Philip and Hazel are members and trustees of the Brown Self-Managed Superannuation Fund (SMSF). On the death of a member, the LPR (or executor, who in this case is Hazel) steps into the shoes of the trustee until a death benefit is payable.<sup>53</sup>

A binding death nomination will be binding on a trustee if the person falls within the definition of a dependent under the superannuation legislation. Section 302-195 ITAA97 states that a dependent includes a spouse, a child, a dependent of the member, or another person with whom

that member has an interdependency relationship. Hazel clearly falls within the definition of a dependent.

The trust deed is the most important document in an SMSF. Accordingly, it must be carefully drafted to ensure that it encapsulates the express wishes of the members and to allow trustees to accept an instruction under a valid binding death nomination. The trust deed can list the beneficiaries to whom the deceased wants their death benefit paid to; this ensures that the trustee cannot override the wishes of the deceased.

A problem for trustees is the funding of the death payment benefit. Self-managed superannuation fund assets are often tied up in investments such as real property, shares, geared installment warrants and other forms of non-cash assets. A trustee can use temporary borrowings to fund the payment of a death benefit, but the borrowing period cannot exceed 90 days and the amount borrowed should not exceed 10% of the value of assets of the fund.<sup>54</sup> This restriction usually requires that assets within the fund be sold, and there is a concern that CGT may apply to those assets.

If a member is in receipt of an income stream, the trustees are not required to pay income tax on the earnings from assets being used to support the payment of this income stream.<sup>55</sup> However, an issue could arise when the member dies, as the earnings and sale of those assets could result in income tax and CGT issues while the trustee finalises the payout of the death benefit to the beneficiary.

The government recently announced in the 2012-13 Mid-year Economic and Fiscal Outlook that it would move to provide tax certainty for superannuation funds on the death of a member in receipt of a superannuation income stream. The government has indicated that the tax-free status mentioned above will continue after the member's death to allow the trustee to sell the assets to fund the payment of the death benefit to the nominated beneficiary.<sup>56</sup>

Hazel will be able to take the death benefit either as a lump sum or via an income stream as she is a tax dependent. Hazel will also need to address who she wants to nominate as the beneficiaries of her superannuation entitlements on her death. In this regard, the role of a tax professional will be to advise her on the most tax-effective mechanism for doing this, since her adult children will not be

classified as tax dependents and unwanted tax consequences may arise.

### Phase three: after the asset has been distributed to the beneficiary

The next phase concerns the beneficiary's dealings with the asset after distribution and the management of a testamentary trust.

#### Overview of the CGT issues

While the passing of an asset from the LPR to a beneficiary will not trigger a CGT event, a subsequent disposal by the beneficiary of a deceased estate will trigger CGT and this is discussed below.

#### Disposal of Eagle Bay Block One and Block Two by Hazel

Despite the fact that Phillip purchased Eagle Bay Block One pre-CGT, once it passes to Hazel, it is brought into the CGT net. Therefore, on the disposal of Eagle Bay Block One and Block Two, Hazel would need to pay CGT on any capital gain.

Hazel should consider the CGT 50% discount in Div 115. In this regard, she must consider the requirement of a 12-month holding period to access this discount. If the deceased acquired the asset pre-CGT (which is the case with Eagle Bay Block One), the beneficiary's holding period will commence at the date of the death of the deceased.<sup>57</sup> However, if the beneficiary acquired the asset post-CGT, the holding period will start from the date the deceased acquired the asset.<sup>58</sup> Therefore, Hazel will need to be aware of the different calculations for when the 12-month holding period will begin. In relation to Eagle Bay Block One, she will need to hold the property for at least a year after the death of Phillip to access the 50% discount.

#### Disposal of the main residence in Nedlands

Where a dwelling was the deceased's main residence at the date of the death and was not used to produce income or it was acquired pre-CGT, a taxable capital gain or loss is not recognised on a disposal by the beneficiary where the disposal occurs less than 24 months after the death of the deceased. To ensure that a beneficiary who acquires a dwelling through survivorship is able to apply the main residence concessions, s 118-97 ITAA97 provides that the ownership interest was acquired from the deceased joint tenant as if they were a beneficiary of the deceased estate.

Furthermore, a disposal is also exempt where the dwelling is not sold within 24 months but the beneficiary of the sale is the deceased's spouse and it is also their main residence. Note that, under ID 2002/52, even if Hazel moves out, she can continue to treat the home as her main residence for up to six years. Therefore, in the case of her home in Nedlands that Hazel has acquired via the right of survivorship, she will be able to sell the dwelling free of CGT if she continues to use this as her main residence. If the house was purchased on or after 20 September 1985, it must be the case that the house was not used for the purpose of producing assessable income just before the deceased's death.

Notably, the 2011 proposal paper points out an anomaly in relation to the cost base of land adjacent to the main residence of a taxpayer. The market value cost base rule will not extend to land adjacent to the dwelling even if it would be eligible for the main residence concession because it is not specifically noted in Div 128. The 2011 proposal paper states that the law will be amended to ensure that the cost base modification will take into account adjacent land to the extent that the land would be eligible for the main residence exemption.<sup>59</sup>

#### Disposal of Philip's share in the partnership assets

The disposal of the partnership assets could necessitate considering the availability of the 50% CGT discount in Div 115 and the CGT small business concessions in Div 152.

The CGT small business concessions can apply if the deceased would have been eligible for the concession prior to their death and the event happens within two years of the death of the deceased (or such further time as the ATO may allow).<sup>60</sup> Notably, the small business concessions cannot apply to capital gains that arise on the disposal of an asset that was a pre-CGT asset in the hands of the deceased.<sup>61</sup>

In order to be eligible for the small business concessions, the deceased taxpayer must have met the basic conditions contained in s 152-10(1) ITAA97. These conditions include that a CGT event happens in relation to a CGT asset of the taxpayer. The CGT asset in question must be an active asset and the taxpayer must satisfy either the \$6m maximum net asset value test or be a small business entity. Additional requirements also apply

to the majority of the small business concessions.<sup>62</sup> A comprehensive analysis of these requirements is beyond the scope of this article.

The small business concessions are contained in Subdiv 152-B to Subdiv 152-E ITAA97 and there are special conditions that apply for deceased individuals, including:

- (1) the 15-year exemption in Subdiv 152-B. This concession disregards any capital gains on the disposal of an active asset if the asset has been continuously held for 15 years by the taxpayer, who is aged at least 55 years at the time of the event, and the CGT event occurred in relation to the taxpayer's retirement. In relation to a deceased estate, the need for retirement is removed and the concession can be applied by the LPR;
- (2) the active asset reduction in Subdiv 152-C. There are no special conditions that exist in relation to this test for deceased estates;
- (3) the retirement exemption in Subdiv 152-D. This concession allows a taxpayer to disregard all or part of a capital gain relating to the sale of an active asset, up to a lifetime limit of \$500,000. If the taxpayer is under the age of 55 years, the capital gain must be paid to a superannuation fund. In relation to a deceased estate, the need to contribute to a superannuation fund is removed; and
- (4) the small business roll-over relief in Subdiv 152-E. This concession allows a taxpayer to defer some or all of a capital gain towards the cost base of another active asset. Special conditions will exist under CGT event J5 or J6 if the LPR does not deal with the replacement assets.

Where the deceased acquired the assets in question post-CGT, the time period for determining the holding period is the date that the assets were acquired by the deceased.<sup>63</sup> As per the operation of Div 128, the deceased's cost base will be inherited by the LPR, resulting in CGT applying at a later stage. In this regard, the use of the small business concessions (if applicable) is paramount. Capital gains on the sale of pre-CGT assets are not subject to the small business concessions and the inherited cost base is the market value at date of death.

As long as Philip met the basic conditions under Div 152, Hazel will be able to utilise

the CGT small business concessions on any capital gains that may arise on the sale of his interest in the partnership assets.

### Establishment of the testamentary trust for Jack, Ruby and Toby

On Philip's death, the testamentary trust will be established and Hazel (as executor) will need to arrange the transfer of the investment portfolio into the testamentary trust.

There will be no CGT consequences for the estate on the transfer of the assets to the testamentary trust and the testamentary trust will inherit the cost bases of each of the individual shares held within the investment portfolio. It will be within the testamentary trust environment that CGT will arise when these investments are ultimately sold.

A testamentary trust is a trust that is established by will and commences after the death of the taxpayer. Testamentary trusts are also subject to the provisions of Div 6 ITAA36.

One of the most significant advantages of establishing a testamentary trust is that Philip is protecting the capital assets from being used by his son Jack and daughter-in-law Ruby for purposes that he may not approve of. It also gives Philip a way of providing for his grandson. While he is allowing the trustee (Hazel) to provide his son and daughter-in-law with income during their lifetime, he has restricted their ability to obtain the capital of the trust.

Another advantage of utilising a testamentary trust is that minor beneficiaries are taxed at normal adult rates on "excepted trust income" that is distributed to them and are not taxed at the penalty rates applying to minors.<sup>64</sup> Division 6AA applies the highest marginal tax rates to the income of a minor. However, there is an exception to the application of Div 6AA for income derived through testamentary trust estates.<sup>65</sup> Trust income from a testamentary trust would fall within the definition of "excepted trust income".<sup>66</sup>

A further advantage is that, where there is income that no beneficiary is presently entitled to, the trustee will be taxed under s 99 (unless the Commissioner exercises his discretion to apply s 99A). The rates pursuant to s 99 are ordinary marginal tax rates. Where the deceased estate is more than three years after death, for testamentary trusts, the rates are set out in a schedule which taxes the trustees at ordinary marginal rates.<sup>67</sup>

The ATO accepts that, for the purposes of applying Div 128, the LPR includes the trustee of a testamentary trust and, therefore, s 128-15(3) applies on the transfer of an asset of the deceased from the trustee of the testamentary trust to a beneficiary.<sup>68</sup> It should be noted that the 2011 proposal paper states that a specific CGT roll-over will be provided where the deceased asset passes from a trustee of a testamentary trust to a beneficiary of the trust, and this will essentially codify the ATO's existing position in relation to Div 128.<sup>69</sup>

Another advantage of utilising a testamentary trust is that it can be used to stream different income types like franked dividends and capital gains. However, if Hazel wanted to stream capital gains, she would also need to consider the specific requirements of the streaming provisions in Div 6E and the need to make a beneficiary specifically entitled to the amount of a franked dividend or capital gain.

A further issue to be considered in this situation is Hazel's age, and that she has been appointed the trustee and may also be the appointer of the testamentary trust. In this regard, Hazel will need to be counseled about a possible replacement trustee at some point in the future, and it is imperative that she choose someone who will carry out the wishes of Philip once she is deceased. This can be discussed at a point in time when Hazel is required to update her own affairs and may be timely now that she has sole ownership of the other properties discussed above.

### Summary of Philip's position

The above discussion looked at some of the relevant CGT consequences in relation to specific bequests; these are summarised in Table 1.

### Conclusion

Administration of a deceased estate can be an onerous task that continues for a substantial amount of time. From a practical perspective, it is vital that the executor be chosen wisely as they need to be aware of the broad range of responsibilities that they must undertake. For example, executors must be aware of their fiduciary duty to the beneficiaries and they must also be cognisant of the taxation implications of any decisions that they make in respect of the estate. For most executors, it will be pivotal that they consult extensively with experts in the area to ensure that all legal (including

Table 1: Identifying tax-effective approach

Bequest	Taxation implications	Cost base in the hand's of the beneficiary	Available discounts
Ferrari to cousin Burt	Nil – not a CGT asset.	N/A	N/A
Eagle Bay Block One to Hazel	No taxation implications on the passing of the asset to Hazel pursuant to Div 128. However, on vesting in Hazel, the asset loses its pre-CGT status and CGT will be payable on the ultimate disposal by Hazel.	Market value at the date of Philip's death (1 March 2012).	Division 115 (50% discount).
Eagle Bay Block Two to Hazel	No taxation implications on the passing of the asset to Hazel pursuant to Div 128. CGT will be payable on the ultimate disposal by Hazel.	Inherits Philip's cost base at the date of his death.	Division 115 (50% discount).
Shares to the cat home	This depends on whether the cat home is registered as a DGR. If it is, CGT event K3 will not occur. If it is not, CGT event K3 will occur in the deceased's tax return.	N/A as exempt entity.	If the cat home is a DGR, CGT event K3 will not apply and this is not taxable. If the cat home is not a DGR, CGT event K3 will apply and the discount in Div 115 must be considered.
Apartment in Paris to sister Kathy who is a foreign resident.	CGT event K3 will occur in the deceased's tax return.	N/A because it will be outside Australia's taxing jurisdiction once it vests in Kathy and, on her subsequent disposal, there will be no CGT consequences.	Division 115 (50% discount).
Main residence of Hazel and Philip	Joint tenancy – the right of survivorship will pass to Hazel.	Inherits Philip's cost base in his part of the asset.	Main residence exemption.
Disposal of partnership assets by Hazel	CGT event A1 for the assets of the partnership.	Inherits Philip's cost base in his share of the partnership assets.	Division 115. Division 152.

tax) consequences are anticipated and satisfied.

Tax professionals also play a pivotal role assisting their clients both before and after their death. Many tax professionals will be called on to provide tax advice to the executor or administrators of the deceased client's estate. The advice can range from simply completing the deceased's tax affairs, in the form of lodging income tax returns, to establishing and running testamentary trusts and unwinding complex business transactions. It is therefore necessary for tax professionals to be acutely aware of the multiplicity of tax issues that they will face. As discussed above, advice on areas such as income tax, CGT and superannuation will be necessary. There will also be consequences for GST and state tax (that have not been discussed above) and, where multiple states or jurisdictions are involved, there

may be different stamp duty or estate duties that must be considered.

It is also necessary for advisers to consider providing additional succession planning advice to beneficiaries who, after the death of an individual, now hold additional assets and responsibilities such as trusteeships. They will then need to review their own will and consider whom they want to pass key responsibilities on to.

As Benjamin Franklin opined, "In this world nothing is certain but death and taxes". With the assistance of appropriate planning for the final frontier, the process can be made significantly less burdensome.

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References

- 1 The taxation of trusts has been an area of significant change in recent times. For example, Treasury is proposing to rewrite the taxation of trusts rules as a result of the recommendations of the Henry Report; see the November 2011 consultation paper, "Modernising the taxation of trusts"; the October 2012 discussion paper, "Taxing trust income – options for reform"; the interim reforms to Div 6 and new Div 6E of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). In relation to specific amendments to Div 128, see the May 2011 and June 2012 proposals papers, "Minor amendments to the capital gains tax law".
- 2 B O'Sullivan, *Estate & business succession planning 2011-12*, ¶1-100, p 2 states: "Over the next 29 years there will be the biggest intergenerational transfer of wealth ever. It is estimated that the number of Australians aged over 65 will increase by 40% in the next 10 years and almost 90% over the next 20 years."
- 3 In circumstances where the individual is intestate, a person that wishes to be an administrator must apply to the court for the letters of administration.
- 4 The legal personal representative is defined in s 995-1 ITAA97 to include the executor in the case of a taxpayer who dies with a will, and the administrator in the case of a person who dies intestate.
- 5 This will be in accordance with the will where there is one or, where the individual dies intestate, it will be in accordance with the relevant legislation.



- 6 This includes the payment of any penalties and interest.
- 7 S 260-140(2) of Sch 1 of the *Taxation Administration Act 1953* (Cth) provides that the Commissioner may deal with the LPR as though they were the deceased taxpayer. For the ATO practice regarding forms etc that are completed to notify the ATO of LPRs, go to [www.ato.gov.au/individuals/keywordlist.aspx?sid=42&k=Legal%20personal%20representative](http://www.ato.gov.au/individuals/keywordlist.aspx?sid=42&k=Legal%20personal%20representative).
- 8 NAT 3236: Tax file number – application for a deceased estate.
- 9 For information on the process of obtaining a TFN for a deceased estate, go to [www.ato.gov.au/individuals/content.aspx?doc=/content/22579.htm](http://www.ato.gov.au/individuals/content.aspx?doc=/content/22579.htm) under the general TFN provisions of Pt VA ITAA36. Also see NAT 3236 (ibid n 8).
- 10 *Commissioner of Stamp Duties (Qld) v Livingston* [1965] AC 694.
- 11 [1965] AC 694.
- 12 *FCT v Whiting*(1943) 68 CLR 199.
- 13 Pt I of Sch 10 to the *Income Tax Rates Act 1986* (Cth). Also see IT 2622.
- 14 *Union Fidelity Trustee Co of Australia v FCT* (1969) 119 CLR 177.
- 15 See the October 2012 discussion paper, "Taxing trust income – options for reform" (see also references above in n 1).
- 16 S 128-10 ITAA97.
- 17 See TD 2002/25.
- 18 The term "passes to a beneficiary" is defined in s 128-20 and includes where the beneficiary becomes the owner of the asset under a will, by operation of intestacy, because it is appropriated to the beneficiary by the LPR in satisfaction of an interest in the estate or under a deed of arrangement or in circumstances where the will is challenged and is subsequently varied by a court order.
- 19 The general rule is stated in s 128-15. Note that it will result in a CGT event where the gift is made to an exempt entity, a complying superannuation entity, or a foreign resident. In that case, it will be a disposal for CGT purposes (see s 128-10 ITAA97); this is discussed further below. Also see PS LA 2003/12.
- 20 S 128-10 ITAA97. Also see TD 95/47.
- 21 See TR 2004/25 and PS LA 2003/12.
- 22 See the May 2011 proposal paper (above n 1), p 11.
- 23 Ibid p 12.
- 24 S 128-15(2) ITAA97.
- 25 S 128-15(4) ITAA97.
- 26 See ID 2004/425 and ID 2001/729.
- 27 This is to be contrasted with a tenancy in common, where each person is treated as holding a separate fractional interest in the property. Each person's interest in the property can be dealt with in the will.
- 28 S 108-7 ITAA97.
- 29 S 128-50 ITAA97.
- 30 S 128-50 ITAA97.
- 31 S 128-15(3) ITAA97.
- 32 S 128-15(2) ITAA97.
- 33 S 128-15(4), Item 4 ITAA97.
- 34 S 128-15, Item 1 ITAA97
- 35 Australian Taxation Office, *Market valuation for tax purposes*. Website at [www.ato.gov.au/corporate/content.aspx?doc=/content/00161737.htm](http://www.ato.gov.au/corporate/content.aspx?doc=/content/00161737.htm).
- 36 Taxable Australian property is defined in s 855-15 ITAA97. It includes, for example, taxable Australian real property (for example, land or mining rights), indirect real property interest or a CGT asset that is used in carrying on a permanent establishment in Australia).
- 37 S 104-215 ITAA97.
- 38 S 104-215(4) ITAA97.
- 39 S 104-215(3) ITAA97.
- 40 See the 2012 proposal paper (above n 1).
- 41 Note that it will also be exempt if it is made under the cultural bequests program.
- 42 S 118-60 ITAA97.
- 43 See the 2011 proposal paper (above n 1), p 13.
- 44 Ibid.
- 45 S 104-215(1)(c) ITAA97; s 855-15 ITAA97 lists assets that are taxable Australian property.
- 46 One of the proposed changes will ensure that, where an asset passes via survivorship (in a joint tenancy situation) to a concessionally taxed entity, CGT event K3 will still occur. This will ensure consistency of CGT treatment.
- 47 M Flynn, "Death and taxes", The Tax Institute Breakfast Club (Victorian Division), 20 September 2012.
- 48 Ibid.
- 49 S 128-20(1) ITAA97.
- 50 S 106-5 ITAA97.
- 51 S 106-5(3) ITAA97.
- 52 Panel vans or utilities designed to carry one tonne or more are excluded from exemption (*Case 13* (1977) 22 CTBR (NS)).
- 53 S 17A(3) of the *Superannuation Industry (Supervision) Act 1993* (Cth).
- 54 S 67(2) and (2A) of the *Superannuation Industry (Supervision) Act 1993*.
- 55 S 295-385 ITAA97.
- 56 Media release 030/2012, "Government reforms boost super savings and lower industry costs", by the Minister for Financial Services and Superannuation, the Hon. Bill Shorten.
- 57 S 115-30(1) ITAA97.
- 58 S 115-30(1) ITAA97.
- 59 See the May 2011 proposal paper (above n 1), p 11.
- 60 S 152-80 ITAA97.
- 61 S 152-80(1)(c) ITAA97.
- 62 For example, see whether the CGT asset is a share in a company or an interest in a trust (s 152-10(2) ITAA97).
- 63 S 115-30(1) ITAA97 (when the deceased acquired the asset).
- 64 Div 6AA of Pt III ITAA36.
- 65 S 102AG(2)(a) ITAA36.
- 66 S 102AG(2) ITAA36.
- 67 Note that the tax-free threshold is only \$416. Note also that the CGT discount of 50% will not apply.
- 68 PS LA 2003/12.
- 69 See the 2011 proposal paper (above n 1), p 10.