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Sent: Friday, 22 November 2019 9:32 AM
To: Ian Raspin
Subject: Thanks for submitting an idea to Sounding Board community

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Idea #87: **Partial main residence: section 118-200.**

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There is a defect in the way that the main residence exemption applies if a deceased person's legal personal representative (LPR) or beneficiary is taken to have acquired the deceased's main residence for market value at the date of death: item 3 in the table in subsection 128-15(4) of the ITAA 1997. The defect is that the rewritten partial main residence rules in section 118-200 of the ITAA 1997 fails to incorporate the effect of subsection 160ZZQ(20AA) of the ITAA 1936.

It was an important policy principle underlying the introduction of the market value cost base rule for a dwelling that was just before death the deceased's main residence and not used for income production, that there should be no further account taken of the use of the property prior to death.

This is because the market value 'wipes the slate clean' and effectively builds in an exemption up to this point for compliance cost saving purposes.

Example

Assume that the deceased owned and lived in a post-CGT acquired dwelling for three years just before death and it was not used to produce income at that time. The settlement of the sale of the dwelling occurred 3 years after the date of death. For the period after death, the dwelling was not the main residence of any person.

Assume the dwelling was purchased for $400,000, had a market value of $600,000 at the time of death, and was sold on arm's length terms 3 for $900,000.

If the Commissioner does not exercise the discretion in section 118-195 of the ITAA 1997 to extend the relevant two year period, the way the legislation is intended to operate is that the gain arising between death and sale ($900,000 less $600,000 = $300,000) should be fully subject to CGT (disregarding CGT discount etc.)

Under the ITAA 1936, the calculation would have been as follows. Under subsection 160ZZQ(19), before modification by subsection 160ZZQ(20AA), the formula AB/C would have been as follows:

A = $300,000 (capital gain)

B = number of days dwelling not main residence of deceased and of relevant person (after death)
C = number of days from deceased's acquisition until day of disposal.

In other words $300,000 x (in days) 3 years/8 years = $150,000.

This would of course be wrong as a matter of policy because the fact that the deceased used the dwelling as a main residence would be counted more than once (once in the market value step up and then again in the pro-rata calculation in relation to a post death gain). The calculation would only partly bring to tax the gain post death, whereas it should all be brought to account.

However, in the ITAA 1936 subsection 160ZZQ(20AA) modified the formula outcomes in subsection 160ZZQ (19) by ignoring the days before death (treating these as zero) and taking as the denominator the period from death not from acquisition. Hence $300,000 x (in days) 3 years/3 years = $300,000.

Under the ITAA 1997, however, the effect of subsection 160ZZQ(20AA) is not replicated in section 118-200.

Of course, the outcome under a literal reading of the ITAA 1997 may not necessarily favour taxpayers. For example, if on the above facts the dwelling was the deceased's main residence for only ½ year during the period before death (including immediately before death), and it was the main residence of a relevant person for the entire period after death until sale, the assessable gain should be nil, but the formula would produce $300,000 x (in days) 2.5 years 6 years = $125,000.

It is understood that many taxpayers are likely to be calculating partial exemptions mechanically and without regard necessarily to the appropriateness of the outcome.

Given the fact that the provisions are rewritten law, there is some uncertainty as to the outcome that a court, before whom the issues were fully explored, would come to. On one view this sort or rewrite problem goes beyond section 1-3 (as discussed in Sherlinc Enterprises Pty Ltd v Federal Commissioner of Taxation [2004] AATA 113), but the outcome produced is clearly one the legislature cannot have intended. But it is unclear whether a court would be able to find a way to read the provisions in a way that they would make any sort of purposive sense. It may be the defect is one the courts just cannot fix (for example, see Paule v Commisioner Taxation [2019] FCA 394) and section 15AA of the Acts Interpretation Act 1901 (Cth)).

The result of this is uncertainty and high compliance costs for estates in debating the issue and requesting private rulings or simply taking the view (where favourable) that no other approach may be taken to the law.

An exercise of the CRP must be considered unlikely as it could not close off opportunities to exploit inappropriately the literal effect of the provisions.

Solution

In subsection 118-200(2) of the ITAA 1997:

- non-main residence days (a) after '20 September 1985' add ' and it is not one to which item 3 in the table in subsection 128-15(4) applies'
- total days (a) after '20 September 1985' add ' and it is not one to which item 3 in the table in subsection 128-15(4) applies'

• total days (b) delete 'if the deceased acquired the ownership interest after that date' and replace with 'otherwise'.

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