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Death duties again? really??

Introduction

> 'The art of taxation consists of plucking the goose so as to obtain the most feathers with the least hissing' (Jean-Baptiste Colbert).

Murmurings abound at the moment about different ways that the Federal Government may want to bring in more tax revenue to pay off post-Covid debt, or to better fund aged care in the future, or to do both.

Inevitably, when base broadening and wealth taxes come up, death duties enter (or re-enter) the discussion. Having been part of Australia's tax mix since before Federation at a colonial level, and since 1914 at a Federal level, they were ditched at both levels by the early 1980's, but that does not stop people re-advocating for their reintroduction.

In one view, any form of wealth tax, or any new form of tax on capital for that matter, may inappropriately stifle economic recovery following the Covid recession. The creativity, innovation and drive of the SME market will be critical in that phase. But if there has to be a whole new tax on wealth or capital (and as we say below, we don't think there does have to be), at least a death duty or inheritance tax, properly targeted to inter-generational wealth transfer with decent concessions for active business assets, may be the least of evils.

That said, however, any serious proposal to reintroduce death duties (imposed on the estate) or inheritance/succession taxes (imposed on beneficiaries), or any combination of the two, would face significant challenges.

Firstly, there are serious questions over whether they exhibit 'good' tax policy credentials – in particular would they become (like the previous versions) essentially 'voluntary taxes' for the well-advised (Asprey Committee 1975) but hitting others particularly hard; and how complex would they be to comply with and for the ATO to administer?

Secondly, they would face considerable 'political' opposition and lobbying, doubtless coming at least in part from those who supported their removal throughout the 1960's and 1970's such as farmers and those advocating for newly impoverished widows.

And, if finding a new source of significant revenue is the main requirement, there is the question whether they would bring in enough tax revenue (or otherwise sufficiently enhance our society and economy) to justify the grief.

But before we look at whether such a 'big new tax' is needed – a really 'big' change – we think it is important to bear in mind that:

> (a) the income tax law already has a number of features that look and feel like a 'death' tax and these could readily be tweaked or expanded if desired without the need for a 'whole new tax'; and
>
> (b) there are many smaller easily implemented changes to estate taxation that could expand the existing tax base to pick up some of the revenue likely to be generated by a conventional set of death duties.

If significant tax changes in the wealth tax space are in contemplation, this firm believes that all possibilities should be considered, including what to date have been seen as 'sacred cows'. Loopholes in the existing base could be fixed, the breadth of the base could be adjusted (including exemptions, such as the main residence exemption) and one could also tinker with tax rates that apply to different parts of the base (e.g. the CGT discount).

Because our firm specialises in estate 'tax' issues, this special newsletter focuses on changes which could be targeted in that area, but we of course acknowledge the possibility of wider more generic reforms.

Existing aspects of the tax base that look like death duties

Some say that the fact that the LPR is liable for tax on the deceased's date of death income tax return (to the extent of assets in the estate) is akin to a 'death' duty because it is tax imposed after the taxpayer has died. But there are perhaps better examples.

Superannuation provides an example. The superannuation death benefit is only tax free where it goes to dependants and financially-dependent offspring under the age of 25. If it goes to non-dependent adult beneficiaries, the benefits are generally taxed to the estate. This is akin to a death tax. Some might say, though, that tax on superannuation should apply more broadly unless the benefit goes to the surviving spouse.

Now to CGT. Unrealised capital gains to the deceased are not generally taxed at death (though there are exceptions to this) and the LPR or beneficiaries usually inherit the deceased's cost base exposing them to tax on disposal (again there are exceptions). So, in a sense, tax on capital gains is 'inherited'.

If an asset is left to a charity (other than a deductible gift recipient), or if something other than Australian land is left to a non-resident, there is *theoretically* a taxed capital gain under CGT event K3 at death (a ' death duty') on the basis that if unrealised gains are not captured at that time, they will disappear from the tax net after death. We say the tax is *theoretical* because it won't be collected if the asset passes to the charity or to a non-resident outside the two (or sometimes four) year amendment period for date of death return assessments. This is a really big loophole.

Existing aspects that look like a 'free kick'

On the other hand, there are CGT concessions that perhaps go too far. A dwelling that was the main residence of the deceased *just before* death, and not used to produce income at that time, can be sold by the LPR or beneficiary completely tax free within 2 years of death. Irrespective of how the dwelling was used before '*just before'* death or even whether it had been the deceased's main residence for much (if any) of that period. Indeed, there seems to be nothing to prevent the claiming of another dwelling as an *actual* main residence of the deceased for that period. A real double dip! This is a case of an intended compliance cost concession for estates that is poorly targeted and arguably goes 'too far'.

There are other examples where the CGT base is curiously narrower than good policy would suggest. Pre-CGT dwellings that were never the main residence of the deceased also enjoy a 2 year tax free selling window. Further, the LPR can rent out any dwelling during that 2 year period (whether pre-CGT or post-CGT to the deceased) with zero effect on the exemption. This period can be extended with the 'ok' of the Commissioner. When CGT began, the window was only 12 months.

The current main residence exemption and death rules also have some drafting deficiencies which may permit (and in the ATO view do indeed permit) taxpayers to 'double up' on exemptions – for example, by obtaining a market value cost base on a main residence at death (which eliminates any pre-death capital gain or capital loss) AND taking account of main residence days *before* death to reduce any capital gain over that market value if the dwelling is not sold within the 2 year window.

When one examines examples like this, it can be seen that the existing tax arrangements 'after death, but as a result of death' reflect different policy considerations and sometimes betray inconsistencies. Small changes can be made to 'tidy up the rules for estates and beneficiaries' to bring in the tax they should.

Small change approach

A small change approach could just involve fixing loopholes (such as those involving CGT event K3 and the main residence exemption as outlined above) and making minor policy changes or clarifications where necessary.

For example, it has never been clear whether the death rollover in sections 128-10 and 128-15 is meant to come to an end once an estate asset passes to a testamentary (often discretionary) trust, or whether it is meant to continue until the asset finally reaches the hands of an individual beneficiary from a testamentary trust (and perhaps other intervening trusts). Literally, the law exempts only an LPR, and **not** a trustee of a testamentary trust. The ATO's administrative approach (see PS LA 2003/12) exempts transfers from testamentary trusts (including discretionary testamentary trusts). However, if the beneficiary is the trustee of another trust, the practice does not extend to a transfer to any beneficiary of *that* trust.

Curiously, a foreign resident deceased would not be eligible for CGT discount if he or she sold Australian land, but the CGT discount is available if his or her estate has an Australian resident LPR who sells the asset.

On the flipside, a resident deceased person whose estate has a non-resident LPR can avoid CGT on non-Australian land assets even though CGT event K3 should apply.

A more recently observed phenomenon is the concept of 'multiple' estates for the one deceased person whereby foreign sited assets are kept out of the hands of Australian resident trust rules.

An approach that treated the deceased and their estate as a continuing entity, thereby removing the estate from the trust assessing rules, might overcome some of the anomalous outcomes where the LPR is resident in a different country from the deceased's.

Bigger change approach

The full range of tax concessions which are currently enjoyed by deceased estates could also be reviewed even including the concessional tax rates available to estates under section 99 assuming that 'sacred cows' are no longer 'sacred'.

It appears that people are already trying to subvert the recent amendments to restrict the 'excepted income' concession for minors in Division 6AA (broadly to income from the deceased's own assets and super proceeds etc.) by trying to divert income from discretionary trusts through the deceased estate itself. While the Commissioner may seek to apply section 99A to such arrangements, it is a blunt instrument. There is a broader question about the need for a policy rethink because the nature of deceased estate planning has changed from relatively simple trust arrangements for surviving spouses and minor children to highly intricate succession plans involving (in the main) discretionary trusts, including multi-generational arrangements.

When CGT was introduced with effect from 20 September 1985, the Federal Government was keen to avoid the impression that it was, in any sense, a reintroduction of death duties by stealth. Hence, as mentioned above, we have the death roll-over in sections 128-10 and 128-15 which usually defers recognition of any capital gain or loss until an LPR or beneficiary sells the deceased's assets.

Of course, it would be relatively simple in terms of drafting to remove the roll-over either fully, or partly.

The impact of such a change, would, however, be considerable in terms of the sheer number and cost of valuations required at death (noting that this was probably an issue as to why Australia introduced a pre-CGT/post-CGT regime rather than the UK's original 1965 valuation date approach).

This change could also generate real cash flow issues where illiquid assets are concerned.

Notwithstanding the problems, this sort of change would be a *de facto* death duties regime without the need for a new and separate piece of legislation but would at the same time avoid interactions between CGT and death duties that may otherwise have to be addressed.

Unlike a real death duty that would tax the value of assets rather than accrued gains on assets, this approach would just bring CGT collection forward, but that may be more palatable than a duty on estate value and capital gains also taxed to LPRs and beneficiaries who realise assets with accrued gains.

Serious consideration could then be given to what assets should be taxed at death and what are not. A case would no doubt also be made to continue to defer CGT on agricultural land and small business assets. There would also be a good argument for leaving a concession for spousal transfers of all (or some) assets (such as a main residence).

Some may query at this point whether the fact that the deceased resided in the property should remain relevant if the property passes to beneficiaries who don't also live there.

In fact, a bigger change approach, beyond death duties, would be to consider whether the main residence exemption should continue at all. It is a very costly (to government revenue) exclusion from the CGT base. For example, it apparently was estimated to cost the budget $74 billion in the 2017-18 forecast, and $327.5 billion over the forward estimates. The removal of the exemption for non-residents is estimated to result in a revenue saving of $155 million in 2020-21.

No doubt, removal of the main residence exemption would be very politically difficult and raise concerns over 'lock-in' and further decreases in housing availability (and affordability). But the main residence has become an important (if not the most important) store of wealth for many individuals under all but the highest wealth brackets, and so may well feature in any wealth tax that is introduced.

Partial removal of the main residence exemption might also be considered, but the difficulty there has always been fairly balancing the treatment of individuals in different housing markets (that is, Sydney and Melbourne as opposed to the rest of Australia).

If all of this looks just too hard, the 50% CGT discount, which was originally to be a replacement for cost base indexation, has become much more than that in low inflationary times. It is extra-ordinarily generous and encourages saving and investment to generate capital rather than income returns which are subject to progressive income tax.

Some advocate the return of indexation (but, please, not the rounded to 3 decimal place indexation factors), and this would return trusts and companies to a neutral playing field. However, a better option may be just to reduce the discount rate to a smaller percentage, say 5% or 10%. Or, as applied in other jurisdictions, the discount rate could increase on a 'stepped' basis the longer the asset is held. A lesser change might involve removing or reducing the CGT discount for assets which taxpayers have negatively geared.

'Big Bang' – reintroduce death duties or a similar wealth tax

If none of the above appeals, and the government really does want to 'bite the bullet', what can be said about a reintroduction of death duties/inheritance taxes?

The first thing of interest is, as previously mentioned, that Australia had got rid of death duties by the early 1980's notwithstanding the fact that countries with similar taxing regimes retained them (and some, like the US and UK continue to have them (at about 40%). The OECD average rate is 15%.

The US has a very high threshold (currently US$11.4 million (inflation adjusted), but returning to US$5 million in 2026) and the UK reasonably high (325,000 GBP or thereabouts).

However, 15 countries have no taxes on property passing to lineal heirs, and 13 countries repealed them between 2000 and 2015. NZ repealed their estate duties in 1992, and their gift duties in 2011.

Prior to the 1980's, Australia's duties were at both a State and Federal level, full of complexity, with a combination of relatively low exemptions, moderate to high rates, and, except towards the end, not much in the way of concession for spousal transfers. Death duties were extremely unpopular.

Strong inflationary pressures in the late 1960's and early 1970's had brought ever smaller estates into the net, increasing the overall costs of administration and compliance. Death duties were relatively easy to avoid with the use of trusts, especially discretionary trusts, so high wealth individuals in the main did avoid the duties, but duties fell harshly on business people who died unexpectedly and on people who operated through partnerships and owned assets in their own names. Impoverished widows ended up relying on State pensions and farmers, who had high value but low income producing and hard to sell assets, were often worst hit of all. The duties did not produce much government revenue for all the pain.

These factors would surely have to be addressed in any possible reintroduction?

What are some of the other issues?

Federal or State or (God forbid) both?

It seems highly unlikely that the previous arrangement of both State and Federal duties would come to pass, although that does remain the approach in the US. In Australia it would presumably be at a Federal level only (if at all).

Estate tax or Inheritance tax (or a bit of both)?

Should duties be levied on the estate or on those who inherit (or a bit of both). Don't laugh! – the State of Western Australia previously assessed some duties on the estate and some on successors.

The Henry Review report[1] pointed to the possibility of introducing an estate tax, an inheritance tax or an accessions tax.

Broadly, an estate tax would apply to the whole of an individual's estate, regardless of how many recipients there were. It could be modified to favour bequests to spouses or to other categories of dependent recipient as such bequests could be concessionally valued or be subject to a flat percentage discount.

By contrast an inheritance tax would apply separately to each inheritance received by an individual which would typically be levied at progressive tax rates.

An accessions tax would essentially tax gifts and inheritances received by a particular person on a cumulative basis. It would take account of the fact that some recipients receive a number of substantial inheritances over the course of their lives and should be taxed cumulatively on the value of those amounts. Ireland has such a system (Capital Acquisitions Tax, or CAT), with a hefty 33% tax applying once the threshold is reached, and the record keeping required for a lifetime system may present some challenges.

Prima facie an inheritance tax is more aligned with the progressive income tax system as it taxes the bequest in the hands of the recipient rather than the estate of the donor.

However, it would provide tax planning opportunities as the deceased may be able to reduce the overall tax burden by allocating the inheritance differentially among such beneficiaries compared to the total tax that would be payable on the entire estate under an estate's tax. In the same way, broadly, that discretionary trusts are now used to split tax liability for income tax, or for CGT purposes where to avoid CGT event K3 cash or pre-CGT assets are given to non-residents with residents taking the bulk of other assets.

[1] Page 145

Regardless of whether an estate tax or inheritance tax was implemented, there would need to be rules for gifts. For example, the former Commonwealth estate duty aggregated gifts made within 3 years of the deceased's death with the value of the estate for the purposes of that tax.

The Henry Review report concluded that whilst there were arguments in favour of both estate and inheritance tax that an estate tax would be the best model for Australia if a bequest tax was to be introduced.

In reaching that conclusion the Henry Review committee noted[2] that an estate tax would avoid the lifetime complexity of the accessions tax and is simpler to administer than an inheritance tax. It also accords with the tax system structure under which income savings are subject to relatively uniform low rates of tax and it removes incentives for donors to split up their estates in order to minimise tax payable.

Such an outcome is consistent with the reforms proposed under Chapter 24 of the Asprey Report in 1975 which similarly concluded that there were merits to taxing under both proposals but that an estate tax would be administratively simpler and would more easily control tax avoidance. Interestingly, discretionary trusts were much less prevalent in the mid 1970's than they are today (today, approximately a million such trusts, split roughly 50/50 investment and business), so an estate tax may possibly be used as a lever against discretionary trusts.

Recommendation 25 of the final Henry Review report stated that while no recommendation was made on the possible introduction of a tax on bequest, the Commonwealth Government should nonetheless promote further study and community discussion on the options available.

Nonetheless the committee's findings that the preferred form of any reform should be in the nature of an estate tax is clearly influenced by the detailed findings of the Asprey report in 1975.

What assets?

The Asprey Committee (1975) suggested that the tax base of an estate duty should at least include the real and personal property owned by the deceased at the time of his or her death which becomes part of the estate administered by the legal personal representative. However, the committee also proposed that the base on which estate duty be levied should also include property the deceased had power to acquire as at the time of their death. Thus, it would include property the subject of a power of appointment which the deceased had at the time of his death which could have been exercised in his or her own favour. Whilst not directly referred to, this would appear to place a constraint on the use of discretionary trusts as a possible means of avoiding duty as was the experience under the former estate's duty regime.

The Asprey Committee also thought that in relation to certain illiquid assets (such as farming land), LPRs should have an option to spread payment of duty over a number of years to minimise the cash flow effect of the duty.

Threshold, rate and revenue potential?

Now we get to the nitty gritty!

The Henry Review pointed out that raising revenue should be done so as to cause least harm to economic efficiency, provide equity (horizontal, vertical and intergenerational), and minimise complexity.

The Henry Review also pointed out[3] that no OECD country regards wealth transfer taxes as a major source of revenue and that on average OECD countries only raised 0.41% of their total tax revenue from such taxes.

[2] Page 146
[3] Page 143 of its Final Report

If the tax has a large threshold, and therefore fewer cases, a high rate is needed to ensure a reasonable revenue take. This is broadly the current approach Federally in the US. But a high rate means there are big incentives to get around the impost.

Too small a threshold, even with a smaller rate, could bring too many small estates into the net and lead to an increase in administration, compliance complexity and costs as was the case with the old death duties in Australia.

That seems to leave a large threshold so only large estates are caught, and a low rate to minimise efficiency distortions and discourage avoidance. But will this produce much revenue?

The Henry review recommended that should the merits of introducing a bequest tax be considered, and that if it was introduced, it should only be levied at a low flat rate and be designed to affect only large bequests.

It seems the only way in which estate or inheritance taxes could generate a significant amount of revenue in Australia is where it is imposed on a broad base at a low rate of tax. There is not currently any modelling identified which indicates what level of revenue would be generated by the introduction of such a tax which would also be contrary to international trends. However, a very interesting article published by the Australian Institute for Business and Economics of the University of Queensland in August 2018 entitled '*Back from the dead: Australian inheritance tax*' does discuss the economic merits of such a broad-based proposal.

One of the arguments is that even if significant revenue is not generated, a death duty or inheritance tax may address wealth inequality to some extent. As people are now living longer, assets are increasingly left to financially secure spouses and children, causing wealth inequality (and the economic and social disadvantages that creates) to increase. A tax may help to reduce these effects.

Any revenue raised from the tax could also be used to increase opportunities, for example with spending on education and scholarships and the tax may be reasonably efficient. It may not 'distort' the behaviour of the deceased to the extent bequests are from assets the testator kept for a 'rainy day' but in the end were not needed, or where the deceased died unexpectedly. Even if testators decide to spend rather than save to leave to others, there may be a positive effect on demand, as well as helping to break down stores of wealth. To the extent that the tax did discourage some saving and investment by living people, at least the actual impost is deferred until after death.

Spousal transfer exemption?

Politically, duties with a spousal transfer exemption would be easier to sell, as there would then be a clear focus on *inter-generational* transfer of wealth. This would be essentially a deferral of tax in relation to many spousal transfers, as is the case in the UK (which also allows any unused threshold to be passed to surviving spouses). The Asprey Committee suggested, however, that there should be a monetary limit on a spousal transfer exemption.

Complexity, structuring and costs

One of the major concerns about reintroduced inheritance taxes is that they become very complex and attract advisers designing structures to get around the tax. For example, by using chains of trusts to separate the assets from the true owners. One of the key issues is that these structures will have an impact on the effectiveness of other taxes as well, which is unlikely to be desirable from either a compliance cost or administration perspective.

As a leading estate tax practice, we would be very concerned about the effect the tax would have on the scale of compliance work needed to get estate (and sometimes beneficiary) tax issues satisfactorily sorted, in a reasonable timeframe.

International dimension

Would any introduced new tax be like income tax and assess residents on worldwide wealth, and non-residents on Australian assets? If so, similar complexities would arise – for example:

- *how would the ATO track overseas gifts that were relevant for a resident's tax-free concession?*
- *what structuring would be entered into by non-residents to ensure they were not sufficiently 'connected' to Australian assets?*

There would also be the question of foreign tax credits and the need to amend the scope of treaties. Treaty interactions generally would inevitably be complex because of the very different ways that countries levy death duties and inheritance taxes. More cases would also arise because, pre-Covid at least, there have been significant increases in the international mobility of income and capital.

Interaction with other taxes

It goes without saying that interactions with other taxes and duties would be needed, especially CGT and stamp duties.

Other considerations

The Henry committee noted[4] that any option for taxing bequests and gifts would require a consideration of the following:

- The cash flow implications for estates held predominantly in the form of a liquid assets;
- The treatment of bequests to charities, which are concessionally taxed in many countries;
- How any such tax would interact with capital gains tax;
- How the tax would interact with the taxation of superannuation benefits on death;
- The treatment of non-resident donors and property located outside Australia; and
- The design of the gift tax to accompany the request tax.

Other wealth taxes

Of course, death duties are not the only 'wealth tax' around. There are many others.

Land holdings have sometimes been targeted because they can easily be identified and (usually) valued, but clearly that is highly distortional and inequitable.

In the OECD's 2018 report on the *'Role and Design of Net Wealth Taxes in the OECD'*, it was observed that there had been a renewed interest in wealth taxation for collection and wealth redistribution purposes, although fewer OECD countries then levied them than in the past.

The Report observed that repeal had often been because of administrative and efficiency concerns, redistributive goals had not been met, and revenue collected had been very low.

However, the Report argues there is a strong case for addressing wealth inequality through the tax system – that it is far greater than income inequality and tends to be self-reinforcing. The question was whether a wealth tax was the most effective way of address wealth inequality.

[4] Page 147 of its Final Report

Australia already has progressive income tax and a CGT regime where net capital gains are taxed essentially as income (thus progressively), but as noted above CGT contains some very significant exemptions and rate concessions that weaken its potential effect on addressing wealth inequality. For example, non-assessable distributions from discretionary trusts are not taxed either as income or as capital gains.

It may well be that, if there is a desire to reduce wealth inequality, instead of imposing a new wealth tax via a death duty or something similar, fixing base and rate erosion in CGT may provide much of the answer.

It must be remembered too that wealth taxes tend to be very complicated in nature, and this leaves them open to abuse and avoidance. Even Paul Keating's recent proposal in the Aged Care Review for an alternative basis to fund aged care (a repayable loan system, like HECS, after death) was met with a question from Commissioner the Hon Tony Pagone QC, a noted former tax lawyer and judge, as to whether the proposal could be seen as a death tax. Mr Pagone observed that, putting on his former tax lawyer hat, he could see lots of people trying to make sure they don't have the assets there that can be called upon.

Conclusion

It would seem that there are many significant impediments that would be faced by any serious proposal to reintroduce death duties. A better approach may lie in making smaller policy and technical changes to the existing tax base, especially the CGT rules that apply to deceased estates, and if this is done well a greater degree of progressivity could be achieved on 'capital' income with a consequent effect on wealth inequality.

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