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Response to TPSG consultation paper Part 2 (Advice & Guidance)

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Response to TPSG consultation paper – Part 2

Advice and guidance

Many years ago the ATO's CGT Cell conducted a series of summits with practitioners to discuss various CGT issues relevant to particular topics (one topic was deceased estates). This led to the publication of a number of tax determinations on each topic. It might be useful to have another summit to consider issues that have arisen since then (not necessarily just CGT).

Further, advice/guidance on the following matters would also be useful (regardless of the view ultimately taken). Having an understanding of the ATO view whether it is favourable or otherwise, provides people with certainty in relation to their succession planning and estate administration.

- ***Timing of determination of status of death benefit recipient***

This is an issue that arises frequently. Many people enter into a Deed of Arrangement after the end of the income year in which a death benefit is paid to an LPR in order to change the tax outcomes. We do not think that this is effective. A view on this issue would create a level playing field for all taxpayers. See further discussion below.

The law requires that a member's benefits in a regulated superannuation fund be cashed as soon as practicable after the member dies. If the benefit is paid to the deceased person's legal personal representative (LPR), the tax treatment may depend not only on who may be expected to benefit from the death benefit but also on the precise timing of the payment of the benefit.

Section 302-10 of the ITAA 1997 applies where death benefits are paid to the trustee of a deceased estate. It provides that to the extent that 1 or more beneficiaries of the estate who were death benefits dependants of the deceased *have benefited, or may be expected to benefit*, from the superannuation death benefit:

> (a) the benefit is treated as if it had been paid to the trustee as a person who was a death benefits dependant of the deceased;[1]and
>
> (b) the benefit is taken to be income to which no beneficiary is presently entitled.

The provision operates in a similar way to the extent that a beneficiary of the estate is not a death benefits dependant.[2] This effect is that no tax will be payable by the LPR to the extent that a tax dependant may be expected to benefit from the death benefit but tax may be payable at up to 30% depending on the component of the benefit if the payment may be expected to be made to a non-dependant.

The provision does not specify a time when the test about dependants benefiting or expecting to benefit, must be satisfied. However, given the reference in paragraph 302-10(2)(b) to present entitlement and link to subsection 101A(3) of the *Income Tax Assessment Act 1936* (ITAA 1936), we

[1] Subdivision 302-B of the ITAA 1997 sets out the consequences
[2] Subdivision 302-C of the ITAA 1997 sets out the consequences

consider that implicitly the test must be satisfied at the latest by 30 June in the year in which the superannuation proceeds are paid to the trustee of the estate. We have spoken informally to the ATO and they expressed a similar view.

On this view, the timing of the payment of death benefits to the trustee of the estate can be crucial where there is some prospect of a family provision claim being made. Such a claim can be made by a person who the deceased had a responsibility to provide for. A person wishing to make a claim for provision must do so within strict time limits that vary from State to State. In Victoria, this is generally within six months from the date probate was granted; in Queensland it is generally within nine months from death.

Consider these scenarios.

> *Example 1*
>
> *The deceased (Bradley) a resident of Queensland died on 1 May 2019. He was survived by 2 adult children and his (second) wife Beverley. By his Will, Bradley left his entire estate to Beverley if she survived him, but otherwise it was to be divided equally between the children. The deceased had made a binding death benefit nomination in respect of his interest in a superannuation fund, nominating that the proceeds be paid to his legal personal representative.*
>
> *Superannuation death benefits in the amount of $200,000 were paid to the LPR on 28 June 2019. As at 30 June 2019, no amount had actually been paid to Beverley but it can be argued that as at that date she would be expected to benefit from all of them (as having survived Bradley, she was the sole beneficiary of his estate.*
>
> *However, the answer may be different if the benefit was paid to the estate in the 2020 income year by which time a claim has been made for family provision. If that claim is not settled before the end of the income year, it is difficult to predict who may benefit from the payment. In these circumstances, it might be safest to assume that the payment will benefit a non-dependant (or seek a ruling from the ATO).*
>
> *We have seen cases where a Deed has been entered into to settle a family provision claim in a year after the payment of a death benefit which purportedly makes a dependant entitled to the death benefit. We do not think that this can be effective for tax purposes.*

Another issue that arises in applying section 302-10 is determining when a person benefits from a death benefit as opposed to some other amount. A similar issue arises in a different context when applying section 99B of the ITAA 1936 (which exempts certain distributions of trust corpus). The latter provision was considered by the AAT in *Campbell **v** Commissioner of Taxation* [2019] AATA 2043. The Tribunal found that the trust records were unreliable as evidence and consequently the taxpayer could not show that the relevant distributions fell within the corpus exception. It would be helpful if the ATO could explain what taxpayers need to do to satisfy this requirement.

> *Example 2*
>
> *Using the previous facts, assume that Bradley's daughter Bambi made a claim for family provision on 31 July 2019.*
>
> *Assume also that the death benefit was paid to the LPR on 1 August and that the LPR was holding $200,000 from the sale of shares that Bradley had owned.*

On 1 December 2019 all relevant parties entered into a Deed, by which it was agreed that Bambi would receive $150,000. The LPR paid Bambi that amount on 10 December 2019.

The test time for section 302-10 purposes is 30 June 2020.

It is important that the LPR be able to identify which money is used to satisfy Bambi's entitlement. If the LPR cannot show that Bambi's payment consists solely of the sale proceeds, then some part of the payment made to her may be regarded as a payment of the death benefit. As Bambi is not a death benefits dependant, the LPR may well be subject to tax (depending on the components of the payment). If it can be shown that all of the death benefit was paid to Beverley no tax would be payable (regardless of the components) as Beverley is a death benefit dependant.

For example, the LPR might consider keeping the death benefit payment in a separate bank account. Alternatively, if Bambi had been paid her entitlement before the death benefit was received by the trustee of the estate, it clearly could not have been a payment of that benefit.

- ***Refresh IT 2622***

IT 2622 was published many years ago to outline when a residuary beneficiary might be regarded as presently entitled to the income of an estate (this affects how the estate's net (or taxable) income is assessed). There have been changes to the law since then – most importantly, the notion of specific entitlement to franked dividends and capital gains has been introduced. A refresh would be useful – particularly as it would bring the ruling within the scope of the public ruling provisions of the Tax Administration Act 1953.

In this regard, we also note that we have seen a growing trend of beneficiaries who are deductible gift recipients looking to maximise the extent of their testamentary gifts and threatening legal action against LPR's (and their advisors) who diminish the estate by paying tax unnecessarily. Refreshing the ruling might usefully address this issue by reminding LPR's to consider whether the stage has been reached during the estate administration when the charity can be made presently entitled to some of the trust income (or specifically entitled to capital gains or franked dividends). To the extent that the beneficiaries can be made so entitled, there may be a tax saving for the LPR.

Furthermore, while an LPR may not be taxable because they can access franking credits to reduce tax that is otherwise payable, the charity would be entitled to a full refund of franking credits on dividends to which they were specifically entitled.

Example Phoebe leaves her entire estate to her favourite charity (which is also a DGR). Her LPR sells the estate assets and makes capital gains totalling $2.5 million (after the application of the CGT discount).

The estate administration is ongoing and the LPR does not consider making the charity specifically entitled to the capital gains. The LPR is assessed on the capital gain under section 99 and pays tax on the $2.5 million (almost $1.1million).

However, if the LPR had instead waited until the administration was completed and transferred the asset to the charity, no tax would have been payable.

See further comments in attachment IT2622.

- ***Availability of CGT discount for LPR assessed under section 99***

It would be useful to confirm in an ATO view document that the CGT discount is available under section 99 regardless of the residency of the deceased and their LPR. The issue can arise where the deceased was a resident who appoints a foreign resident LPR who makes a gain from TAP or where the deceased was a foreign resident who appoints a resident LPR. [See 1051756645843]

- ***The approach that people should take to Division 128 roll-over where a beneficiary contributes funds to acquire an estate asset***

Say a legacy of $100,000 is left to a particular beneficiary and the residue (including a house) is left to another. There are no funds to pay the legacy apart from those that would come from the sale of the house (it is worth $1m).

The residuary beneficiary actually wants to keep the house so they provide $100,000 to the LPR to pay the legacy.

As we understand it, some stamp duty rules regard this as a part disposal of the house (10%) – that is, it is not passing in accordance with the Will. So, conservative taxpayers have adopted that approach for CGT. Others seem to treat the house as passing under the Will, (with or without a cost base up-lift for the additional amount paid). The rest probably ignore the issue.

We think that a clear view from the ATO is warranted to put taxpayers on a level playing field.

- ***The circumstances when the Commissioner will not exercise the discretion in section 99A of the ITAA 1936 to assess the trustee under section 99***

A search of edited versions of private rulings indicates that one of the most common questions asked in the context of deceased estate is whether the Commissioner will exercise the discretion to assess the LPR under section 99 of the ITAA 1936. If the discretion is not exercised, the trustee will be assessed at the highest marginal tax rate and perhaps more significantly, will be denied the benefit of the CGT discount.

It would be useful if the Commissioner could publish some practical compliance guidance about the circumstances in which he might refuse to exercise the discretion (similar for example to PCG 2019/5 about the discretion to extend the two year period in section 118-195 of the ITAA 1997).

This will lead to reduced compliance costs for LPRs who will not have to seek a private ruling to gain certainty about their tax exposure and also result in administrative savings for the ATO.

- ***Legal expenses***

A number of edited private rulings have been published about the sorts of legal expenses incurred by an LPR or beneficiary that can be deducted or included in the cost base of an estate asset (and those which cannot). Perhaps these could be compiled into an advice product.

- ***Can an LPR make an absence choice in respect of the deceased's dwelling?***

It is understood that, routinely, choices are made by LPR's to maximise the CGT exemption applying to an estate, and the Commissioner does not challenge this. There is a question, however, whether the law actually permits this. The wording of section 118-145 of the ITAA 1997, for example, contemplates that the person making the choice is the 'you' whose main residence it was. Compare by way of contrast section 118-155 of the ITAA 1997 which specifically refers to the deceased's LPR making a relevant choice.

A TD to confirm this approach or a PCG about when compliance resources will be applied would provide certainty to LPRs.

- ***Double death – assets of first estate not owned by second deceased when they died***

When assets pass from the estate of one deceased person to that of another, roll-over under Division 128 does not apply when they pass to beneficiaries of the second estate. This issue arises on a not infrequent basis and again results in very different outcomes depending on the level of awareness that advisors have about the issue.

More importantly there is a question about the cost base of the asset in the beneficiary's hands. It has been suggested that because the rollover does not apply, the second LPR/ beneficiary acquires the asset for market value as they pay no consideration for it – that is , the Division 128 cost base transfer rules do not apply.

At one time, Treasury had proposed that the law be amended to ensure that assets which were not owned at death but came to be estate assets as a result of a distribution from another deceased estate would come within the scope of Division 128. The Treasury Proposals Paper, Minor amendments to the Capital Gains Tax Law, issued in May 2011 contained the following item:

Issue 4. Death before administration

Current Law	Proposed Law
Division 128 does not provide a roll-over when the intended beneficiary of a deceased estate dies before administration is completed and an asset owned by the first deceased person passes from the intended beneficiary's LPR to a trustee of a testamentary trust or a beneficiary in the intended beneficiary's estate. This is because the asset was not one which the intended beneficiary owned when they died.	In cases where an individual (the first deceased) dies and the intended beneficiary also dies before an asset which the first deceased owned passes out to them, the asset will be treated as though it had passed to the intended beneficiary before they died. This ensures that a roll-over will apply when an asset passes from the intended beneficiary's LPR to a trustee of a testamentary trust or a beneficiary in their estate.

This proposal was abandoned as part of the then government's *Announced But Unenacted Measures Review*. It has subsequently been rejected as an issue that could be resolved by an exercise of the Commissioner's remedial power.

Inheritance taxing point – CGT event E7	Where an asset passes from a deceased individual (first deceased) to a second individual who dies (second deceased) without the affairs of the first deceased having been concluded before the death of the second deceased, the beneficiaries of the second deceased incur a CGT liability. While the asset passes from the first deceased's estate to the second deceased's beneficiaries under their wills, the rollovers available in these situations are available to those who 'own' the	Unsuitable – inconsistent with the intended purpose or object of the relevant provision.

	asset at the time of death. As no probate or letters of administration are granted for the first deceased before the second deceased dies, the asset is not 'owned' by the second deceased at the time of their death and the rollovers do not apply. It was proposed to apply the CRP to allow a rollover in these circumstances. However, subparagraph 1 of paragraph B of Chapter 2.18 of the Explanatory Memorandum to the Tax Laws Improvement Bill (No 1) 1998 states that the rollover does not apply to assets that were acquired by the legal personal representative during administration of the first deceased estate. Therefore, the CRP cannot be exercised to modify the law in these circumstances.	

- ***Right to occupy a dwelling***

Section 118-195 of the ITAA 1997 provides a main residence exemption for a dwelling owned by a deceased person. One of the conditions relevant to the exemption is that the dwelling is occupied by someone with a right to occupy it under the deceased's Will.

There is an issue whether this requires the person to be identified in the Will, or whether it would include anyone who a trustee allows to reside in the property under the terms of a widely-drawn testamentary discretionary trust. Does it include a third party who rents the dwelling where the trustee is given a power to rent the dwelling? Does it include a relative of the deceased who pays less than market value rental?

We understand that the ATO view may be stricter than that applied in practice. If this is the case, LPRs should understand what the ATO view is so that they can properly assess their risk.

- ***The approach that the ATO takes to the use of a dwelling between death and occupancy by beneficiary and also the period after death of the person with a right to occupy***

Period prior to occupancy by beneficiary

Strictly the legislation seems to require that the beneficiary occupy the dwelling from the date of death of the deceased in order to obtain a full exemption, although the ATO takes the view that the exemption is available if the beneficiary moves in as soon as practicable. There appears to be some confusion regarding the application of the two year rule (which is a separate rule that confers an exemption if the deceased's dwelling is sold within 2 years of death) in this circumstance.

The Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Bill 2019 (that removes the main residence exemption for foreign residents) which was introduced into the House of Representatives on 23 October 2019, contains the following example which highlights this issue.

> Example 1.7— Resident beneficiary inheriting a dwelling from a deceased person who was a foreign resident at the time of death
>
> Edwina acquired a dwelling on 7 February 2011, moving into it and establishing it as her main residence as soon as it was first practicable to do so. Edwina used the property as follows:

- residing in the dwelling until 25 September 2016 whilst an Australian resident; and

- renting the property out from 26 September 2016 at which time Edwina moved to Johannesburg.

Edwina passed away on 20 January 2018. At the time of her death, Edwina was a foreign resident for taxation purposes. However, as Edwina was a foreign resident for less than six years, she is not an excluded foreign resident.

Rebecca, an Australian resident, inherits the dwelling from Edwina. Rebecca moves into the dwelling and establishes it as her main residence on 21 April 2018. She continues to reside in it and use it as her main residence until she sells it. She signs the contract to sell the dwelling on 2 February 2021 with settlement occurring on 2 March 2021.

Rebecca is able to access the main residence exception for the whole period of ownership because:

- Edwina was not an excluded foreign resident at the time of her death. This means that the main residence exemption she accrued while she used the dwelling as her main residence is available to Rebecca; and
- the whole period between when Edwina passed away and when Rebecca moved into the dwelling and established it as her main residence is less than two years.

Rebecca is also able to access the main residence exemption for the period from when she moved into the property until she signed the contract for sale as she used the property as her main residence at all times and was an Australian resident at the time of the sale.

Therefore, Rebecca is able to access the main residence exemption for the entire ownership period.

Period after death of beneficiary with a right to occupy

It seems from a review of edited versions that the ATO will consider exercising the discretion to extend the two-year rule to cover a period after the death of a person who has a right to occupy. It would be helpful if this could be added to PCG 2019/5.

- ***Deed of arrangement***

The ATO has published a view that is very helpful about when an asset passes under a Deed of Arrangement for the purposes of section 128-20 of the ITAA 1997. However, it is part of a much larger ruling about life and remainder interests and is often overlooked. Perhaps it might be useful if this particular information could be extracted/duplicated into a standalone product.

- ***Deceased estate main residence exemption and first income producing use rule***

There are different views about how the first income producing use rule applies in the context of a deceased estate. This can result in significant tax differences. Publishing a view about this issue would create a level playing field and would result in compliance and administrative savings if private rulings do not have to be obtained. Consider this example in respect of which a private ruling has been issued [1051734293578].

Background

- Joy and her husband Ron acquired a dwelling as joint tenants prior to 20 September 1985.
- Ron died on 11 September 2006. Joy acquired his half interest in the dwelling under the rule of survivorship. At that time, the property had a market value of $3,550,000.
- Joy continued to reside in the dwelling until she moved into care on 7 May 2009.
- The dwelling was first rented on 3 August 2010 at which time the market value of the property was $3,135,000. Relevantly, the property continued to be rented until Joy's death on 27 March 2019.
- The dwelling was sold by the executor of Joy's estate for $5,375,000. Settlement of the contract of sale took place on 21 November 2019.
- The executor made a choice under section 118-145 of the ITAA 1997 to treat the dwelling as Joy's main residence until 3 August 2016 (that is, until six years after it was first used to produce income). The market value of the property on 3 August 2016 was $4,570,000.

Analysis

For CGT purposes, Joy had two separate ownership interests in the dwelling.

Joy's original interest

- Joy's original 50% joint tenant interest in the dwelling was acquired pre-CGT. Her executor therefore acquired it for market value at the date of her death under item 4 in the table in subsection 128-15(4) of the ITAA 1997.
- As Joy's executor sold the dwelling within 2 years of her death, any capital gain that arose after her death is disregarded under subsection 118-195(1) of the ITAA 1997.

Ron's interest

- For the purposes of the main residence exemption, section 118-197 operates to treat a surviving joint tenant in the same way as a beneficiary in a deceased estate.
- Joy's executor will not be entitled to a full main residence exemption in respect of any gain from the 50% interest that she is taken to have acquired from Ron. That is, item 1 in column 2 of the table in subsection 118-195(1) of the ITAA 1997 is not satisfied because the property was not Joy's main residence when she died. Although the absence choice made under section 118-145 of the ITAA 1997 applied to treat it as her main residence for six years of income producing use, the period after 3 August 2016 is not covered by that choice.
- Joy's executor will be entitled to a partial main residence exemption under sections 118-200 and 118-205 of the ITAA 1997.

Q. What is Joy's executor's cost base for the 50% interest in the dwelling she acquired from Ron?

- Joy's executor acquired this interest in the dwelling for an amount equal to Joy's cost base on the day that she died: item 1 in the table in subsection 128-15(4) of the ITAA 1997. It is therefore necessary to establish what her cost base was when she died.

- *Prima facie*, Joy's acquisition cost for the interest she acquired from Ron would be its market value on that day $1,775,000 (that is 50% of $3,550,000): subsection 128-50(4) of the ITAA 1997.

- However, there is an issue whether the first income producing use rule in section 118-192 of the ITAA 1997 applies to treat that interest as having been reacquired by Joy for market value on 3 August 2016 (when the absence choice ceased to apply).

On one view, section 118-192 of the ITAA 1997 does not apply when working out a capital gain to which sections 118-200 and 118-205 of the ITAA 1997 apply. That is, the ***CG/CL amount*** in the formula in subsection 118-200(2) is defined to be the capital gain or loss that would have been made ***apart from this Subdivision***. Clearly, section 118-192 is part of Subdivision 118-B of the ITAA 1997. This suggests that the income producing use rule does not apply in working out the capital gain to which the partial exemption applies.

Further, it appears to be the case that section 118-192 of the ITAA 1997 cannot apply independently to a disposal by Joy's executor when the first income producing use occurred during Joy's period of ownership, not the executor's (that is, the provision refers to **your** ownership period, which for an LPR would start at Joy's death).

However, if section 118-192 of the ITAA 1997 applies, it appears to apply from the end of the six-year period of income producing use (that is, 3 August 2016) at which time the dwelling was valued at $4.57 million. Further, if the rule applies, it would seem to have the effect of deeming an acquisition by Joy at that date. This deemed acquisition is relevant to the application of paragraph (a) in the *non-main residence days* component of the formula in subsection 118-200(2) of the ITAA 1997.

- ***What days are taken into account in applying sections 118-200 and 118-205?***

This issue is discussed below in the context of the previous example. Again, the response to the private ruling while favourable seems to be inconsistent with the intended policy. However if this is the ATO view, then it should be published to level the playing field for all taxpayers and save compliance and administrative costs.

As there has been a chain of 'deceased estates' involved in the ownership of this dwelling both sections 118-200 and 118-205 of the ITAA 1997 potentially apply to work out the amount of the capital gain to which the main residence exemption does not apply.

Firstly, subsection 118-200(2) of the ITAA 1997 is relevant. The *non-main residence days* component in the formula includes the number of days during Joy's ownership period when the dwelling was not her main residence. But it is not clear whether her ownership period starts on 11 September 2006 (when Ron died) or 3 August 2016 (when the absence choice ended). [We are aware that the period after death is also included by paragraph (b) – although it is able to be ignored by subsection 118-200(3) of the ITAA 1997 because Joy's executor sold the dwelling within two years of her death.]

Similarly, the *total days* component of the formula is the number of days in the period from when Joy acquired the interest until her executor's ownership ends. It is not clear when this period starts. [Again, we are aware that subsection 118-200(3) of the ITAA 1997 will be relevant.]

Secondly, subsection 118-205(1) of the ITAA 1997 provides that the formula in subsection 118-200(2) of the ITAA 1997 is adjusted if Joy's ownership interest passed to her as a beneficiary of a deceased estate (noting the effect of section 118-197 of the ITAA 1997). Again, the application of section 118-192 of the ITAA is relevant. While the interest may have originally passed to Joy as a beneficiary for the purposes of the provision, it is unclear whether section 118-192 of the ITAA 1997 treats her as not having acquired it on 3 August 2016 in that capacity.

Assuming that section 118-192 of the ITAA 1997 does not apply to treat Joy as having acquired the interest other than as a beneficiary, subsection 118-205(2) of the ITAA 1997 requires an amount to be added to *total days* in the formula in subsection 118-200(2) of the ITAA 1997. The amount to be added is the fewer of the number of days described paragraphs 118-205(2)(a) and (b) of the ITAA 1997.

While the wording of those paragraphs is awkward, it appears that the number of days under paragraph 118-205(2)(a) of the ITAA 1997 are those in the period from 20 September 1985 to 11 September 2006 (the day the interest passed to Joy as a beneficiary).

In terms of paragraph 118-205(2)(b) of the ITAA 1997, there was no acquisition by someone other than as a beneficiary before the dwelling passed to Joy. It seems therefore that paragraph 118-205(2)(b) of the ITAA 1997 is not relevant and so the number of days under paragraph 118-205(2)(a) of the ITAA 1997 must apply.

However, if paragraph 118-205(2)(a) of the ITAA 1997 applies to include in total days the days in the period from 20 September 1985 to 11 September 2006, that appears to be inconsistent with the note to subsection 118-205(1) of the ITAA 1997. The Note explains that the purpose of section 118-205 of the ITAA 1997 is to adjust the formula to take account of that part of the most recently deceased individual's capital gain that is attributable to a capital gain of an individual earlier in the inheritance chain if the dwelling was the main residence of that earlier individual.

Because Ron (the individual earlier in the inheritance chain) acquired his interest prior to 20 September 1985, there is no capital gain included in Joy's executor's capital gain for which an adjustment is required. However unlike the predecessor provision, section 160ZZQ(20B) of the ITAA 1936, there is no mechanism in section 118-205 of the ITAA 1997 for the Commissioner to adjust the amount to achieve the intended policy.

- ***Separate estates in different jurisdictions***

With increasing migration rates and difference in circumstances of those now coming to reside in Australia we are seeing an increase in cases where a deceased individual may have more than one Will to deal with assets in various jurisdictions. It would be useful if the ATO could confirm that each Will establishes a separate trust for Australian tax purposes. [See 1051658665187]

Also a PCG that the ATO would not seek to recover tax from CGT event K3 gains (which are recognised in the deceased's DoD assessment) against a resident LPR if the assets that gave rise to the gains are part of the trust established by the non-Australian Will. [Again, see 1051658665187.] This could have the effect of making the resident estate insolvent.

- ***Commercial debt forgiveness***

There is no guidance product on what constitutes a debt forgiveness effected by a Will which results in a debt falling outside the commercial debt forgiveness rules under Division 245. This may be straightforward in many cases but it would be useful to have some guidance product which illustrates the operation of this exemption under paragraph 245-40(d).