ESTATE & TRUST TAXATION SPECIALISTS

TAX AFTER DEATH

ESSENTIALS FOR EXECUTORS

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Ian is the Managing Director of BNR Partners who have specialised in the taxation of deceased estates since 2000. BNR provides outsourced estate taxation solutions and advice to both legal practices and listed trustee companies across Australia and has one of the only dedicated teams of accountants in the country that specialise in this niche, and often complex, area of taxation.

BNR was the 2019/20 global winner of 'mid-sized accounting firm of the year' in the prestigious Society of Trust and Estate Practitioners private client awards in London.

Ian is recognised both nationally and internationally on Australian estate taxation matters. He is both a published author on estate taxation and a frequent presenter at both legal and accounting conferences and events, including for various Law Societies, the Society of Trusts and Estate Practitioners (STEP), CPA Australia, the Tax Institute and for the College of Law. Ian also regularly provides in-house training sessions for legal firms and trustee companies, and consults with professional bodies, regulators and the private sector on estate taxation issues.

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Lyn joined BNR Partners as a Senior Tax Consultant after a career of 34 years in the Australian Tax Office. She brings a wealth of experience and innovative problem solving to the role and is uniquely placed to get clients the best outcomes possible.

Lyn is a Full Member of the Society of Trust and Estate Practitioners and is a member of its National Advocacy Committee. She has also written, and is currently teaching, a course about death and taxation for the College of Law.

At the ATO, Lyn worked in a range of law roles where she gained considerable experience as an administrator particularly in the context of the capital gains tax and trust provisions.

Some of her career highlights include:

- instructing on the development of the streaming rules for capital gains and franked dividends
- participating in the broad review of the trust taxation provisions
- authoring numerous significant public rulings and advice products
- leading the development of the ATO's arguments in many litigation cases including before the High Court:
- Secretariat and member of the Trust Consultation Sub-group throughout the period of its existence

Lyn is admitted as a solicitor of the Queensland Supreme Court and has post-graduate tax qualifications from UNSW.

In her spare time, Lyn works as a volunteer for the RSPCA in Brisbane. She also enjoys gardening, reading crime fiction, Scottish country dancing and travel.

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1. Introduction

The taxation of deceased estates involves an interplay between the succession laws of the various Australian States and Territories[1] and the Commonwealth taxation laws. While the succession rules operate similarly in most jurisdictions, there are variations which can sometimes affect tax outcomes. As an accountant working with estates, it is important to have a high-level understanding of the process of estate administration.

When a person dies, their estate must be administered, that is, their debts must be paid, and the remaining estate assets distributed to those entitled to them under the deceased's Will or the relevant intestacy laws.

The administration is undertaken by either the executor of the deceased person's Will or their administrator if the deceased died without a Will or the person named as executor was unable or unwilling to act in that role. In this paper, the term legal personal representative (LPR) is used to refer to someone acting as either executor or administrator.

Usually, an LPR's authority to act will come from a grant of probate or letters of administration. That is, the grant will vest the ownership of the deceased's assets in their LPR and enable the LPR to deal with them. However, in Queensland for example, the property of a deceased person automatically vests on their death in their executor (so probate may not necessarily be required). In other jurisdictions a grant may not be required for low value estates.

It is important to understand that not every asset a person owned will form part of their estate. The most common example is property that the deceased owned as a joint tenant. On the death of a joint tenant, ownership of the relevant asset passes by survivorship to the remaining joint tenants.

Similarly, a person's interest in their superannuation does not automatically become part of their estate. It will depend on a range of things including the terms of the superannuation fund deed, the Superannuation Industry Supervision (SIS) regulations and any death benefit nomination that the deceased person made.

Finally, and somewhat surprisingly to many people who control assets via a company or trust, the assets owned by those entities are not part of their estate although shares or interests in the entities will be. If the trust is a discretionary trust - unpaid trust entitlements would form part of estate as would shares in a trustee company.

As an aside, some practical difficulties arise if the deceased was the sole shareholder/director of a trustee company. Delays in the estate administration could result in a delay in the appointment of a replacement director[2] so that a valid resolution cannot be made to appoint the trust income by 30 June.

From a tax perspective, an LPR has at least two distinct roles. One is in relation to the tax affairs of the deceased person up until the time of their death. The other is in relation to the administration of their estate (the period after death). In some cases, an LPR may also be the trustee of one or more trusts created under the deceased's Will, so that involves them in further roles.

[1] This paper assumes that the deceased was a resident of Australia and their LPR is a resident of Australia.

[2] section 201F of the *Corporations Act*

2. Tax affairs of the deceased person

The tax law imposes responsibilities on an LPR to finalise the tax affairs of the deceased individual. However, technically those responsibilities only arise if probate or letters of administration have been obtained.[3] This is an example of how the succession law in the various jurisdictions can affect tax outcomes.

For tax purposes, the LPR is treated as if they were the deceased person[4] and requires them to provide any returns and information that the deceased would have been required to provide if they were still alive. The Commissioner also has the right to recover tax, general interest charges and fines etc, from the LPR who is made personally liable for the deceased's outstanding tax liabilities.

The LPR should:

- notify the ATO that the taxpayer has died and that they are now attending to the deceased's affairs. This will ensure that the LPR receives all correspondence from the ATO and that the family is not unnecessarily burdened with ATO correspondence. [Note however that the ATO will only disclose information to an LPR who has obtained probate or letters of administration.]

- prepare and lodge any outstanding tax documents that the deceased had failed to submit. This could include income tax returns, business activity or instalment activity statements.

- prepare and lodge a date of death/final income tax return for the period from 1 July[5] to the date of death of the deceased person. Should a return not be required due to low income, a 'Non-Lodgement Advice' should be submitted to the ATO that is clearly marked as a 'Final Return' and declaring the deceased's date of death.

  [The 'safe-harbour' provided by Practical Compliance Guideline PCG 2018/4 which we will consider shortly, only commences from the time when all of the deceased's outstanding returns are lodged or the ATO is advised that those returns are not necessary.]

- cancel any Australian Business Number (ABN) or Goods and Services Tax (GST) registration. A final business activity statement (BAS) may also be required.

- pay all outstanding tax obligations, including PAYG on any wages for staff the deceased may have employed.

There are some circumstances where a return should be lodged for an income year even though the deceased's income was below the tax-free threshold. For example, if the deceased had carried on a business as a sole trader or in partnership, the ATO requires a return even if the business made a loss.

More importantly, from the perspective of the beneficiaries, a return should be lodged if tax was withheld from the deceased's income or they had an entitlement to franking

[3] section 260-140 in *Schedule 1 to the Tax Administration Act 1953* (TAA). If probate is not required under the succession law of a particular State, then section 260-140 of the TAA does not apply.
[4] subsection 260-140(2) in Schedule 1 to the TAA
[5] Assuming the deceased had a standard accounting period.

credits[6]. This ensures that the refund or entitlement is paid to the estate. We have seen this overlooked by both the deceased and subsequently their LPR. Over several years, such an oversight can easily amount to thousands of dollars.

2.1 Liability of LPR in respect of deceased individual's tax

Historically, an LPR was able to write to the Commissioner for a 'Tax Clearance' letter. The letter essentially enabled the LPR to distribute the estate assets without fear of further tax obligations. However, following the introduction of the self-assessment system, the ATO stopped this practice.

As noted previously, the LPR of an estate is personally liable for the deceased's outstanding tax liabilities. This is a representative liability, which means that the Commissioner cannot recover more from the LPR than the value of assets that came into their hands. Because the income was not derived by the LPR, it would be inappropriate to make them responsible for payment of tax that exceeded the value of the estate. [By way of contrast, the liability of an LPR to tax on deceased estate income is not so limited because the LPR has actually derived the income.]

It is interesting to note that in *DCT v Brown*[7], the Court confirmed that the Commissioner cannot recover tax from a beneficiary to whom the estate's assets have been distributed.

2.2 Practical Compliance Guideline PCG 2018/4

In 2018, the ATO published PCG 2018/4 which strikes a balance between appropriately protecting the revenue and providing LPRs with greater certainty about the scope of their potential liability in relation to the deceased person's tax obligations. [It does not apply in relation to the estate liabilities.]

The PCG applies if:

- the estate is valued at less than $5 million (and none of the estate assets is intended to pass to a foreign resident, a tax-exempt entity or a complying superannuation entity)
- the estate assets consist of Australian real property, listed company shares or units, cash, personal effects and superannuation death benefits
- the deceased did not carry on a business or was not assessable on a share of the net income of a trust in the four years before their death; and
- the deceased was not a member of a self-managed superannuation fund.

The PCG provides that the LPR will only be liable for amounts of which they have notice. The PCG outlines when the ATO considers that an LPR has notice of a liability and the circumstances in which it will treat the LPR as not having notice.

The ATO considers that an LPR will have notice of the following liabilities:

- amounts owing by the deceased at the time of death
- amounts that arise after death in respect of returns the deceased lodged prior to death
- amounts owing in respect of returns that the LPR is required to lodge.

[6] Alternatively, a refund can be obtained by lodgement of an Application for Franking Credit Refund form
[7] (1958) 100 CLR 32

The ATO will treat the LPR as not having notice of an amount owing in respect of an amendment if:

- for returns lodged by the deceased – the LPR brings any material irregularity to the attention of the ATO and the ATO does not issue an amended assessment (or advise that it intends to undertake a review) within 6 months
- for returns lodged by the LPR – the LPR acted reasonably in lodging the returns or advising they were not necessary and the ATO has not notified the LPR that it intends to review the deceased's taxation affairs within 6 months of the last lodgement.

> *Example*
>
> *Bill died on 31 August 2017. Probate of his Will was obtained on 30 October 2017. At the time he died, Bill had lodged his 2016/2017 and all earlier income tax returns Bill's LPR determines, reasonably, that no return is necessary for the period from 1 July 2017 to 30 August 2017 and advises the ATO of this on 30 November 2017.*
>
> *The LPR was not aware of any material irregularity in returns lodged by Bill. If by 1 June 2018, the ATO does not advise the LPR that Bill's tax affairs are being reviewed, the LPR can distribute the estate without risk of personal liability.*
>
> *However, if the LPR failed to advise the ATO that Bill's final return was not necessary, the ATO could seek to amend Bill's assessments that were not outside the relevant amendment period.*

2.3 Self Help

There are real risks in this area that demand the full attention of the LPR. We have seen a case where an executor had distributed the assets of the estate, only to be served two years later with an assessment from the Commissioner for an amount in excess of $50,000 relating to a prior year. The executor had not made a provision for the tax liability prior to final distribution.

To mitigate an LPR's risk, especially in relation to estates not covered by the PCG, we recommend:

- where it is necessary to distribute some of the estate's assets in advance of finalising the administration, a clear understanding of any tax obligations is first obtained, and an amount, including a generous provision, is placed aside to provide for such obligations. [As discussed in the next segment, be aware that in some circumstances the deceased's final tax return may include capital gains from the passing of an asset to a non-resident beneficiary.]

- that enquiry be made directly of the ATO if any uncertainty exists about the deceased's tax affairs or that of their estate. The ATO records all correspondence they receive from taxpayers, so at the very least this would assist in demonstrating that the LPR has made an effort to ensure that the taxation affairs were adequately addressed.

- an indemnity be obtained from all beneficiaries prior to finalising the distribution of the estate. It goes without saying that there are holes in this practice, for example, if the beneficiary has no assets if you come to call on the indemnity.

2.4 Trading Stock and GST

The treatment of trading stock and the impact of GST in the Date of Death Return depend on whether the LPR continues to operate the deceased's business or enterprise within the estate.

Generally, trading stock is taken to have been disposed of for market value at the date of death.[8] However if the LPR continues to carry on the business, they can choose to include in the date of death return the amount that would have been the tax value (e.g. cost) of the trading stock (eliminating any immediate tax effect).[9]

If the deceased was registered for GST, and the enterprise is not carried on after death, an increasing adjustment is included within the final BAS in relation to assets for which the deceased previously had an entitlement to input tax credits. This means that 1/11th of the market value of any business assets that are subject to GST would need to be declared and remitted in the final BAS prepared by the LPR. This is even though the assets may not have been sold.

However, no increasing adjustment is required if[10] the LPR continues to carry on the enterprise. An example of an enterprise that an individual may have operated is the ownership of commercial real estate on which rent in excess of $75,000 pa. is collected. Such a situation would have required the deceased to register, collect and remit GST to the ATO on the rental income. An estate that continues to collect this rent would therefore almost certainly be required to register for GST. It should also be noted that the GST Act deems the tax period of an individual who dies to have ceased at the end of the day prior to their actual date of death.[11]

Caution should be taken if an asset that the deceased was using in conducting an enterprise registered for GST is distributed *in specie* to beneficiaries who do not carry on the enterprise after death (although the enterprise is continued). Such a transfer would be treated as a sale for GST purposes and a GST obligation created to the value of 1/11th of the market value of the transferred asset.

[8] subsection 70-105(1) of the ITAA 1997

[9] subsection 70-105(3) of the ITAA 1997

[10] section 138-17 of *A New Tax System (Goods and Services) Act 1999* (Cth) (GST Act)

[11] section 27-40 of the GST Act

3. Capital Gains Tax

It's always hard to know where to start talking about capital gains tax. As you'll see, there can be CGT implications for both the pre and post death periods. So, we've decided to talk about CGT in between them.

Generally a capital gain or loss that arises on death from an asset that the deceased owned is disregarded.[12] Effectively, any gain or loss is recognised when the asset is disposed of by either the LPR, the beneficiary to whom it passes, or by a surviving joint tenant.[13]

Assets that a deceased person owned are generally taken to be acquired by their LPR (and subsequently a beneficiary), on the date of death. Unlike other roll-overs, this rule also applies to assets that the deceased acquired prior to 20 September 1985.[14] That is, the pre-CGT status of an asset is not preserved on death.

However, there are specific rules that apply when determining when an asset is acquired by an LPR or beneficiary for the purposes of the CGT discount.[15] For example, an LPR or beneficiary is taken to acquire a post-CGT asset (that is, one acquired on or after 20 September 1985) when the deceased person acquired it.[16] This ensures that if the combined period of ownership of the deceased, the LPR (and beneficiary) exceeds 12 months, then the CGT discount will apply to reduce the capital gain.

The acquisition cost for the LPR and beneficiary of most post-CGT assets that the deceased owned is taken to be the deceased's cost base/ reduced cost base on the date of death.[17] However, a dwelling that was the deceased's main residence at death is taken to be acquired for its market value at the date of death provided it was not being used to produce income at that time.[18]

An asset acquired by the deceased prior to 20 September 1985 (pre-CGT) is also taken to be acquired for market value at the date of death.[19]

As discussed before a joint tenant's interest in an asset does <u>not</u> form part of their estate, so the rules in section 128-15 of the ITAA 1997 do not apply to determine the cost base etc of the interest in the hands of the surviving joint tenant. However, section 128-50 of the ITAA 1997 operates similarly in relation to the interest that the surviving joint tenant is taken to acquire for CGT purposes. However, there are important differences. In particular, there is no rule conferring a market value acquisition cost rule for an interest in a dwelling that was the deceased's main residence when they died.[20]

[12] section 128-10 of the ITAA 1997
[13] section 128-15 of the ITAA 1997
[14] subsection 128-15(2) of the ITAA 1997
[15] see the table in subsection 115-30(1) of the ITAA 1997
[16] items 3 and 4 in the table in subsection 115-30(1) of the ITAA 1997
[17] item 1 in the table in subsection 128-15(4) of the ITAA 1997
[18] item 3 in the table in subsection 128-15(4) of the ITAA 1997
[19] item 4 in the table in subsection 128-15(4) of the ITAA 1997
[20] Nor are there rules that replicate item 2 or 3A in the table in subsection 128-15(4) of the ITAA 1997

3.1 Exclusions from roll-over

There is no roll-over when an asset passes to a beneficiary that is:

- a tax-exempt entity, unless it is a registered deductible gift recipient (DGR).
- the trustee of a complying superannuation entity
- a non-resident (if the asset is not 'taxable Australian property').

In these instances, CGT event K3 happens and may trigger a capital gain or loss to arise in the deceased individual's date of death return. [21]

The policy behind CGT event K3 is to ensure that tax on any unrealised gain in an asset at the time that the deceased person died is not avoided (or reduced).

3.2 Assets passing to a tax-exempt entity

Tax-exempt entities[22] include charities and certain other entities. They can be divided into two categories; those that hold DGR status[23] and those that are simply tax exempt. Basically, entities that hold DGR status are those in respect of which you can deduct donations of $2 dollar or more, such as the Red Cross and Salvation Army[24].

Capital gains and losses that would otherwise arise from CGT event K3 happening on the passing of an asset to an exempt entity are able to be disregarded if that entity is a DGR.[25]

As an aside, it is important to emphasise that testamentary gifts are not tax deductible[26] even when made to a DGR. It is not uncommon to see such gifts incorrectly deducted within estate tax returns. If an estate was audited by the ATO, the LPR (or beneficiary) would be liable for additional tax, general interest charges and possible penalties. On the other hand, a beneficiary that chose to donate inherited money or assets could claim a deduction if the donation was made to a DGR.[27] There would be a CGT event on the beneficiary's disposal of the inherited asset, but any gain could be offset by the related deduction.

[21] see section 104-215 of the ITAA 1997
[22] see Division 50 of the ITAA 1997
[23] You can check the status of an entity on ABN Look-up
[24] refer to subsection 30-15(2) of the ITAA 1997 and Taxation Ruling TR 2005/13 (including its Addendum)
[25] section 118-60 of the ITAA 1997
[26] subsection 30-15(2) of the ITAA 1997
[27] section 30-15 of the ITAA 1997

DGRs – sell or transfer asset?

We have seen a growing trend of DGRs looking to maximise the extent of their testamentary gifts and threatening legal action against LPRs (and their advisors) who diminish the estate by paying tax unnecessarily.

> *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 $1.1 million).*
>
> *However, if the LPR had instead waited until the administration was completed and transferred the asset to the charity if it was not required to pay debts, no tax would have been payable! [This is because the capital gain from CGT event K3 is disregarded.]*

3.3 Assets passing to a complying superannuation fund

Apart from CGT event K3, a testamentary gift to a superannuation fund is an area to be mindful of due to the rigorous nature of the provisions of the *Superannuation Industry (Supervision) Act 1993* (SIS Act). The areas to be aware of include:

- the prohibition on acquiring assets from related parties[28]
- the 5% cap placed on in-house assets[29]
- the age-based contributions caps on what can be contributed to a member's fund in any given year.

It is important to note that family members are seen as related parties of the deceased and moreover that the ATO has flagged this as a possible issue when individuals are also acting as LPRs.

3.4 Assets passing to foreign residents

When an asset previously owned by a resident deceased individual that is not taxable Australian property passes to a non-resident beneficiary, CGT event K3 will happen. This is because the beneficiary will not be taxable on gains and losses from non-TAP assets when they are sold.[30] [If TAP assets pass to a foreign resident beneficiary, the gains from those assets can later be taxed in Australia, so there is no need for CGT event K3 to apply.]

[28] section 66 of the SIS Act
[29] section 71 of the SIS Act
[30] Further information about the taxation of foreign resident beneficiaries is contained in our book *The Australian Tax Pitfalls of Administering an Estate with International Connections.*

Assets that are categorised as TAP include[31]:

- real property (i.e. real estate) situated in Australia, and rights to minerals or petroleum situated within Australia.
- a non-portfolio interest (10% or greater) in certain companies or trusts that own Australian real property.
- assets used to conduct a business in Australia.

3.5 Technical deficiencies with CGT event K3

As anyone working with estates would attest, the difficulties encountered in fully administering an estate can be many and varied. They can often substantially delay the administration of the estate.

An issue arises when CGT event K3 happens (because the asset 'passes') outside the period in which the assessment for the deceased's final income period can be amended (usually either 2 or 4-years from the date of the assessment).[32]

Although any capital gain or loss from CGT event K3 is included in the deceased's assessable income for the period to the date of the event, the event may not happen until many years after an assessment was issued for that period. Because an amended assessment cannot be made, any gain or loss from CGT event K3 is effectively disregarded.

This problem is known to regulators and was proposed to be addressed by Treasury in their 'Minor Amendments to the Capital Gains Tax Law – Proposal Paper 2012', by legislating to capture a gain or loss from this CGT event in either the estate or testamentary trust return at the time the asset passed to the beneficiary, albeit at the market value at the date of death of the deceased person. However, on 15 December 2013, the then government announced that it would not be proceeding with this (and other) announced but not enacted measures.

The same issue arises when assets are held within a testamentary trust for the benefit of a life tenant and later pass to a tax-advantaged entity.

3.6 Other CGT issues

This list is not exhaustive, but highlights some of the more generic issues that arise in practice.

- The deceased, a deceased estate and a testamentary trust are all separate entities for tax purposes. So, for example, if a deceased person had substantial net capital losses when they died, those losses cannot be used to reduce capital gains that their LPR might make from selling assets as part of the administration of the deceased's estate. The losses are lost forever[33].

[31] section 855-15 of the ITAA 1997

[32] subsection 170(1) of the ITAA 1936. Note too that there is nothing in subsection 170(10AA) that provides an unlimited amendment period to give effect to CGT event K3.

[33] If CGT event K3 is triggered for some reason, this would put a capital gain into the deceased's income tax return to date of death.

- Division 128 does not provide rollover for an asset that a beneficiary acquires from the LPR under a power of sale such as a right to acquire the asset under the terms of a Will. This is treated as a CGT event A1 in the estate tax return.[34]

- Special rules apply to a deceased person's main residence. If the dwelling was on less than 2 hectares of land and was not being used to produce income at the date of death, any capital gain is disregarded if settlement of the sale occurs within two years of death. The Commissioner can extend the two-year period and has offered a safe harbour in Practical Compliance Guideline PCG 2019/5. A full exemption can also apply if the dwelling is occupied by the deceased's spouse or a person with a right to occupy under the deceased's Will.

- If a deceased person would have been entitled, immediately prior to their death, to apply the Small Business CGT concessions in Division 152 of the ITAA 1997 to a capital gain from an asset, their LPR, and a beneficiary to whom the asset passes, can apply those concessions to a gain that is made within two years of the death. The Commissioner can extend this two-year period.[35]

- Trying to reconstruct or obtain CGT details for estates can be a very time consuming and expensive exercise that we have seen run into thousands of dollars. The value of obtaining historic CGT information from clients when initially undertaking estate planning cannot be over-emphasised.

4. Taxation of the net income of a deceased estate

4.1 General

An LPR should, if necessary:

- apply for a tax file number (TFN) for the estate (note: the TFN for the estate is different from the deceased's TFN)
- prepare and lodge income tax returns for the estate as required
- apply for a new ABN and GST registration on behalf of the estate where the LPR continues to run a business previously conducted by the deceased as a sole trader. The GST turnover threshold requiring a taxpayer to register for GST is $75,000 p.a
- pay all tax obligations relating to the estate; and
- advise any beneficiary who is presently entitled to income of the estate, or specifically entitled to capital gains or franked distributions of the estate, how much they must include in their personal income tax returns.

[34] subsection 128-20(2) of the ITAA 1997
[35] section 152-80 of the ITAA 1997

If the estate administration exceeds five years, the LPR will also have to comply with their obligations under the trust loss rules[36] and closely held trust TFN withholding rules.[37]

Trust returns will not be necessary for a resident deceased estate for an income year if:

- the net income[38] is less than the tax-free threshold
- the deceased person died less than 3 years before the end of the income year
- no beneficiary is presently entitled to a share of the income of the estate, and
- there are no non-resident beneficiaries.

Previously, the Commissioner required all resident trusts that had derived income in Australia to lodge an income tax return. However, as a compliance savings initiative, returns were dispensed with from the 2015 income year provided the above conditions are satisfied[39].

To the extent that an LPR is assessable on the net income of the estate, they are generally[40] taxed using standard adult marginal rates for a period of up to three years[41] (although they are not required to pay Medicare Levy[42]).

After that time, the LPR loses the benefit of the tax-free threshold but is otherwise still subject to progressive marginal tax rates.[43]

The Commissioner can deny this treatment where, for example, the estate administration has been delayed intentionally or tax avoidance is involved. In this case, the LPR will be assessed at the top marginal rate [44] (and any CGT discount denied[45]).

4.2 More detail

For tax purposes, an LPR is treated as a trustee, and the estate they are administering is treated as a trust estate. This means that the general trust taxation rules will apply to a deceased estate. These rules can be quite complex and confusing. Originally the trust assessing provisions were contained in Division 6 of Part III of the ITAA 1936. Following the streaming amendments that apply to the 2011 and later income years, trust capital gains and franked distributions are now taxed under Subdivisions 115-C and 207-B of the ITAA 1997 respectively.[46]

[36] paragraph 272-100(c) in Schedule 2F to the ITAA 1936

[37] sections 12-175 and 12-180 in Schedule 1 to the TAA

[38] 'Net income' is defined in subsection 95(1) of the ITAA 1936.

[39] Legislative instruments requiring certain tax returns to be lodged are published annually. This link is to legislative instrument LODG 2019/1 (see in particular – Tables E and O) <https://www.ato.gov.au/law/view/view.htm?docid=%22OPS%2FLODGE20191%2F00001%22>

[40] see Part 2 of Schedule 10 to the *Income Tax Rates Act 1986* if the trust estate is non-resident

[41] clause 1 of Part I of Schedule 10 to the *Income Tax Rates Act 1986*

[42] paragraph 251S(1)(c) of the ITAA 1936

[43] clause 2 of Part I of Schedule 10 to the *Income Tax Rates Act 1986*

[44] section 99A of the ITAA 1936

[45] section 115-222 of the ITAA 1997

[46] Rules in Division 6E of the ITAA 1936 ensure that the amounts are not taxed twice.

There are also special rules that apply to the taxation of superannuation death benefits paid to an LPR which we are discussed later in the paper.

The Commissioner published IT 2622 in 1990, it deals with present entitlement during the course of administration of an estate. But it has not been updated to reflect changes to the law since than time.

A suggested approach to the trust assessing rules is outlined in broad terms below.[47]

What is the 'net income' of the estate?

This is the amount that would have been the taxable income of the trustee on the assumption that the trustee was a resident taxpayer. If there is no beneficiary relevantly entitled, the entire net income will be assessed to the LPR.

Are there beneficiaries who are specifically entitled to capital gains[48] or franked dividends[49] included in the estate's 'net income'? Or has the LPR chosen to be specifically entitled to trust capital gains?[50]

If yes, then the beneficiaries and/or the trustee will be assessed on those amounts.

To be specifically entitled a beneficiary must receive or must reasonably expect to receive, the financial benefits attributable to the capital gain or franked distribution and their entitlement must be recorded in the estate records as attributable to a gain or franked distribution.

If the administration has reached as stage where a beneficiary can be made specifically entitled to franked dividends, there may be advantages in doing so in terms of franking credits.

You should also be aware that a specific entitlement to trust capital gains can be satisfied from trust corpus.

Are there beneficiaries who are presently entitled to the income of the estate?

Note that 'income' is not necessarily the same as the trust's 'net income'.[51] Because a deceased estate is taken to be a trust, there is no trust document defining its income so an estate's income will be determined according to ordinary concepts (which for example would not include capital gains).

If there are beneficiaries who are presently entitled to a percentage share of the income of the trust, they will be assessed on that same percentage share of the trust's net income.[52]

[47] This analysis assumes that the trustee and all of the beneficiaries are residents. Other issues arise if they are not. These are considered in more detail in another booklet that the author has written, *The Australian Tax Pitfalls of Administering an Estate with International Connections*

[48] section 115-228 of the ITAA 1997

[49] section 207-58 of the ITAA 1997

[50] section 115-230 of the ITAA 1997

[51] The ATO's view about the meaning of income of a trust estate is set out in Draft Taxation Ruling TR 2012/D1.

[52] section 97 of the ITAA 1936

However, the trustee will be taxed on a beneficiary's behalf if the beneficiary is under a legal disability.[53] Beneficiaries with a legal disability include minors, bankrupts and people with legal incapacity due to mental conditions. A separate assessment notice will be issued to the trustee for each such beneficiary. If the amount is also assessed to the beneficiary,[54] they will be allowed a credit for the tax paid by the trustee.[55]

4.3 Exempt beneficiary presently entitled

To the extent that an exempt entity is made presently entitled to income of the estate, it is important to bear in mind the rules in section 100AA and section 100AB of the ITAA 1936.

Under section 100AA, a tax-exempt beneficiary is treated as not being presently entitled to income of a trust if the trustee failed to pay or notify the beneficiary of their entitlement within two months of the end of the relevant income year. If the 'pay or notify' rule applies, the trustee is taxed on that respective share of the net income.[56] The Commissioner has a discretion not to apply the rule when the trustee fails to pay or notify on time.

Section 100AB applies if the exempt entities share of net income is disproportionate to their share of net income. Again, if the section applies, the trustee will be assessed on a share of the net income.

4.4 Present entitlement to estate income during administration

The High Court considered present entitlement in an estate in *FCT v Whiting*[57]. Justices Latham and Williams stated that:

> *A beneficiary under a will may become entitled to a share of such income as an annuitant, legatee or a residuary beneficiary. His right to share in such income would be determined by the trusts in the will, these trusts being administered in accordance with such rules of equitable administration …….The evidence shows that, in the year of income, the administration of the estate had only reached the initial stage during which the whole of the available net income could only be properly applied (as it was in fact applied) in reduction of debts. The second stage will be reached when it will become proper for the executors to apply the estate or some part of it in satisfaction of the annuity and in payment of interest on or the capital of the legacies. The annuitant and the legatees may then become presently entitled to an immediate share in the income of the trust estate within the meaning of s. 97, but it will only be at the third stage, when the debts, the annuity and the legacies have been paid or provided for in full, that there will be any income to which the residuary beneficiaries as such will be presently entitled.*

[53] subsection 98(1) of the ITAA 1956
[54] subsection 100(1) of the ITAA 1936
[55] subsection 100(2) of the ITAA 1936
[56] subsection 100AA(3) of the ITAA 1936
[57] (1943) 68 CLR 199

IT 2622 adopts the same staged approach:

Stage	Tax Treatment
Initial Stage	
The income of the estate is used to reduce debts such as the testator's outstanding accounts, and funeral expenses etc.	During this stage no beneficiary will be presently entitled to the income of the estate. The LPR will be assessed on all of the net income.
Intermediate Stage	
At this point, the LPR may have identified that part of the estate is not required to pay debts etc. and may decide to pay an interim distribution to beneficiaries.	An LPR may identify that part of the income of the estate will not be required to meet the estate's debts and obligations. In these situations, the LPR sometimes makes an interim distribution to beneficiaries. Where this occurs, beneficiaries will be presently entitled to the trust income to the extent that it is actually paid to them or paid on their behalf. This could include, for example, the payment of rent on behalf of a beneficiary in accordance with the terms of a Will. This means that beneficiaries will be assessable on a proportionate share of the net income and the LPR will be assessed on the balance of the net income.
Final Stage	
All debts are paid for in full and income is available for distribution to beneficiaries.	Where an estate has been fully administered, the beneficiaries will be presently entitled to the income, as they will have an indefeasible and vested interest in the estate. This applies even if the LPR has not yet physically transferred all the entitlements to the beneficiaries. Essentially, the estate assets are then held in trust on their behalf. Where beneficiaries are presently entitled to all of the estate income, no amount is assessed to the LPR.

4.5 Final Year of Administration

Present entitlement is ordinarily determined on the last day of an income year (i.e. 30 June) and a beneficiary would ordinarily be assessed on their proportionate share of trust net income for the <u>full</u> income year based upon their entitlement at 30 June.

> *Example*
>
> *Assume that an LPR derived $10,000 interest income on 1 August. On 30 October, the LPR completed the administration of the estate and paid the residue to Bob (the sole beneficiary). As Bob is presently entitled to the $10,000*[58]*, he would generally be assessed on it.*

[58] subsection 95A(1) of the ITAA 1936

However, it has been a long-standing practice of the ATO to permit an apportionment of income between the LPR and beneficiaries in the year that the estate is fully administered.

Income Derived	Assessment
Income derived in the period between the beginning of the income year and the day administration was completed.	Assessed in the hands of the LPR usually under section 99 of the ITAA 1936.
Income derived in the period between the day administration was completed and the end of the income year.	Assessed to the beneficiaries presently entitled to the income in the manner required by sections 97 or 98 of the ITAA 1936.

Example

Continuing the previous example, as the interest was derived prior to completion of the administration, the Commissioner will accept an assessment of the LPR rather than of Bob.

Adequate evidence must be maintained to show when income was derived during an income year to support the apportionment. The ATO has made it clear that it will not accept income an apportionment based over time.

To the extent that an exempt entity is made presently entitled to income of the estate, it is important to bear in mind the rules in section 100AA and section 100AB of the ITAA 1936. These rules can result in the entitlement being disregarded and the trustee assessed.

5. Superannuation

One of the biggest assets that most people now have an interest in is their superannuation. A trustee of a superannuation fund must pay a member's entitlements as soon as practicable after their death.[59]These payments are referred to as superannuation death benefits.

In determining to whom death benefit payments are to be paid, the trustee must ensure that they are authorised by both the trust deed and superannuation law.

If permitted by the deed, a member of a superannuation fund may elect to provide the trustee with specific instructions in advance of their death via either a Binding Death Benefit Nomination (BDBN) or through the establishment of a Reversionary Pension. The trustee would then be obliged to operate in accordance with those directions. It should however be noted that most BDBN's lapse after three years and it is necessary to refresh these on a regular basis. Moreover, the estate of the deceased may be nominated as the beneficiary.

Where a member has left no BDBN or Reversionary Pension nomination, then the superannuation fund trustee has the sole discretion to decide to whom the benefits are paid. A trustee is only able to make a payment to non-financial dependants after they have made reasonable enquiries to try and locate dependants or the deceased's LPR.[60] Accordingly, the non-existence of specific instructions may lead to a significant delay in the payment of benefits.

[59] Regulation 6.21 (1) of the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations)
[60] Regulation 6.22 of the SIS Regulations

5.1 Taxation of death benefits

The taxation of superannuation death benefits is governed by Division 302 of the ITAA 1997. There are a number of key questions when determining how payments are taxed. These include:

- Are the benefits being paid to a dependant or non-dependant of the deceased?
- Is the benefit being paid as a lump sum or a superannuation income stream?
- Of what components is the superannuation balance made up - are they taxable or tax free?
- How old was the deceased and how old is the person receiving the benefit?

5.2 Dependant

There are tax concessions available to dependants of the deceased that are not available to non-dependants. But you should note that the definition of dependant for tax law purposes differs from the definition for superannuation purposes. [The superannuation legislation essentially determines who can receive a benefit, whilst the tax legislation determines how that benefit will be taxed.]

Super and Tax Death Benefits Dependants		
	Super	**Tax**
Spouse (including de facto & same sex)	Yes	Yes
Former spouse	No	Yes
Child under 18 (including ex-nuptial, adopted & stepchild)	Yes	Yes
Child over 18 (financially independent)	Yes	No
Financial dependant at time of death*	Yes	Yes
In interdependent relationship with deceased**	Yes	Yes

* 'Financial dependant' is not defined in the superannuation or tax legislation. the ATO's interpretative decisions, case law and Administrative Appeal Tribunal decisions provide a mixed view of a dependant from that of providing the 'necessities of life', to a position of maintaining a 'standard of living' to which the suggested dependant has been accustomed.

** Two people have an interdependency relationship if:

- they have a close personal relationship
- they live together
- one or each of them provides the other with financial support; and
- one or each of them provides the other with domestic support and personal care.

5.3 Form of Payment

Superannuation Death Benefits can be received in the form of either a lump sum or income stream such as a reversionary pension. The table below details the dependents that can receive these:

Payment Options		
	Lump Sum	**Income Stream**
Spouse including de facto & same sex but not former spouse	Yes	Yes
Child under 18*	Yes	Yes
Child over 18 and financially independent	Yes	No
Child 18-25 and financially dependent	Yes	Yes
Disabled child- any age	Yes	Yes
Financial dependant at time of death	Yes	Yes
In interdependent relationship with deceased	Yes	Yes
***Includes ex-nuptial, adopted or step-child of the deceased or their spouse*		

5.4 Components

The tables below set out the taxation consequences for the different components of either a lump sum or income stream payment made to either a dependant or non-financial dependant of the deceased.

Lump Sum Payments		
Component	**Dependant**	**Non-Dependant**
Taxable (taxed)	Tax free	Lower of MTR or 15%
Taxable (untaxed)	Tax free	Lower of MTR or 30% #
Tax Free	Tax free	Tax free

Death Benefit Income Stream		
	Component	**Tax Payable**
Beneficiary OR Deceased is over 60 years old	Taxable (taxed)	0%
	Taxable (untaxed)	MTR less 10% tax offset*
	Tax Free	0%
Beneficiary AND Deceased are both under 60 years old	Taxable (taxed)	MTR less 15% tax offset*
	Taxable (untaxed)	MTR
	Tax Free	0%
**** Plus Medicare Levy***		

5.5 Payment of death benefit to LPR

There are special rules that apply if a death benefit is paid to an LPR and which modify the tax treatment that we mentioned before. 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;[61]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.[62]

The 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 the link to subsection 101A(3) of the ITAA 1936, we 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.

Example

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 could be expected to benefit from all of them (as having survived Bradley, she was the sole beneficiary of his estate.

[61] Subdivision 302-B of the ITAA 1997 sets out the consequences
[62] Subdivision 302-C of the ITAA 1997 sets out the consequences

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.

6. Conclusion

It is critical that both executors and practitioners ensure that they adequately identify and address the taxation obligations relating to any estate that they are administering.

With an increasingly ageing population, those working in estate planning and/or administration are working in a rapidly growing market. It is however a market that is also seeing one of the fastest growing rates of litigation in Australia. It is more critical than ever that practitioners ensure that their quality assurance systems and professional relationships are of the highest standard.

We frequently see and hear of examples that involve thousands of dollars of unpaid taxes and other costs which expose the LPRs to disputes with the ATO and ultimately deplete the corpus of the estate.

How can we assist?

BNR have one of the only professionally qualified teams of accountants in the country who specialise in this niche and often complex area; an area we have practiced in since 2000. Incorporated in 1990, the firm's history commenced as a typical SME business advisory practice, which enables the us to still provide these services and also the ability to work with the often complex structures that can form part of many estates.

We work directly with Wills and Estate/Succession legal practitioners and trustee companies across Australia providing reliable specialist estate and trust taxation services and advice from the preparation of simple to complex estate income tax returns to the provision of letters of advice on more complex estate taxation matters.

By partnering with us, you can be assured that you are dealing with a team who understands the idiosyncrasies in this field of taxation and equally as important, the terminology and fundamental legal principles of estate administration.

Our service offerings include:

Specialised tax advice

We provide written opinions on more complex taxation matters where there is uncertainty about the interpretation of taxation legislation in relation to deceased estates and testamentary trusts, and any associated entities of the deceased. This advice if often used in mediation processes or alternatively, is purely sought by executors and trustees alike to give comfort that the tax issues have been reviewed by a tax professional specialising in this domain.

We can also prepare and lodge private binding ruling requests where it would be in the best interest of the estate and the executor to seek clarification as to how the Commissioner would assess a given arrangement or situation. Receiving a private binding ruling provides clarity to the executor on how to report certain events whilst managing their exposure to personal liability for income tax post distribution of an estate's corpus.

Voluntary disclosures

BNR Partners regularly attend to voluntary disclosures directly with the ATO on behalf of our clients where uncertainty exists as to the tax history of the deceased, or where there are retrospective compliance issues that the executor has been unable to address satisfactorily and wishes to do so prior to distribution the estate's corpus.

Date of death tax and personal tax obligations

BNR Partners can assist in preparing and lodging the deceased's final income tax return and any outstanding prior years' tax returns. We are also able to attend to the ongoing tax obligations of estate and trust beneficiaries.

As the executor is held personally responsible for the management of any outstanding tax obligations of the deceased, it is essential that an executor obtain an understanding of the historical tax affairs of the deceased. To assist you with this, BNR Partners can provide a summary of the deceased's tax return history and any outstanding obligations.

Deceased estate and testamentary trusts

The BNR Partners team specialises in preparing estate and testamentary trust tax returns. We have extensive experience in preparing tax returns for estates under all stages of administration.

Our team is also familiar with the nuances of preparing financial statements and tax returns for testamentary trusts, including trusts with life tenants, special disability trusts, testamentary discretionary trusts, minor's trusts, superannuation proceeds trusts and testamentary charitable trusts. Our services also include preparation of beneficiary tax statements.

BNR Partners can also manage the process of obtaining a tax file number for a deceased estate, a testamentary trust or other entities.

Estate closure

On the pending closure of an estate or testamentary trust, BNR Partners can prepare and provide executors or trustees with a letter of advice prior to the final distribution of the estate or trust. This letter outlines outstanding tax obligations (if any) and gives comfort to the executor or trustee that the tax issues have been reviewed by tax professionals specialising in the domain.

Testamentary charitable trusts

BNR Partners can manage the registration process for testamentary charitable trust endorsements with the appropriate regulatory bodies such as the ATO and ACNC, prepare annual financial reports in accordance with statutory obligations, plus complete and lodge business activity statements and franking credit refund applications.

Withholding tax obligations

Executors and trustees are responsible for the withholding and submission of tax for foreign beneficiaries, or when a beneficiary fails to quote their tax file number to the trustee. We can assist in both the registration process and the calculations of the correct withholding tax amount.

Private companies, trusts and self-managed superannuation funds

Although not estate assets, many people pass away leaving behind private companies, trusts and self-managed superannuation funds which need to be attended to. Our team can assist with the preparation of financial reports and income tax returns for entities both as a result of estate administration and ongoing compliance obligations.

In addition, we are often engaged by LPRs to provide an independent review of financial reports prepared by the deceased's accountant.

Seminars / in-house training

Our team has presented at a numerous seminars and in-house client training sessions across the country. We would be happy to discuss with you how we may be able to assist with your training needs.

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