Death duties again? Really?

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There has been an increasing level of discussion about the feasibility of reintroducing death duties or similar taxes in Australia as a way of bolstering government revenue and addressing growing income and wealth inequality. Death duties have in the past created considerable resentment among affected parties, have been easily avoided by the well-advised, and have not produced significant revenues. International experience suggests that, while some countries have retained them over time, a significant number have removed them, and the case for reintroduction does not suggest international best practice. This article argues that, rather than reintroduce a whole new tax with a whole new set of potential problems and complexities, it may be better to consider broadening the existing tax base, fixing technical issues, and providing greater certainty both in terms of revenue and ease of compliance and administration. In particular, changes could be targeted in the area of estate income and capital gains taxation, or even more broadly in CGT.

Introduction

> "The art of taxation consists of plucking the goose so as to obtain the most feathers with the least hissing."
> – Jean-Baptiste Colbert, 1619 to 1683

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-19 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, death duties were ditched at both levels by the early 1980s, but that does not stop people advocating for their reintroduction.

On 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-19 recession. The creativity, innovation and drive of the small and medium-sized enterprise market will be critical in that phase. But if there has to be a whole new tax on wealth or capital (and, as stated below, the authors do not think that 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 the "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.

First, there are serious questions as to whether death duties exhibit "good" tax policy credentials — in particular, would they become (like the previous versions) essentially "voluntary taxes" for the well-advised[1] while hitting others particularly hard, and how complex would they be to comply with and for the ATO to administer?

Second, death duties would face considerable "political" opposition and lobbying, doubtless coming, at least in part, from those who supported their removal throughout the 1960s and 1970s, 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 of whether they would bring in enough tax revenue (or otherwise sufficiently enhance our society and economy) to justify the pain.

But before we look at whether such a "big new tax" is needed, it is important to bear in mind that:

- 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
- 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, the authors believe that all possibilities should be considered, including what have to date 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 (eg the CGT discount).

This article focuses on changes which could be targeted in the area of death and estate taxation, but the authors acknowledge the possibility of wider and more generic reforms.

Existing aspects of the tax base that look like death duties

Some say that the fact that the legal personal representative (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 one example. The superannuation death benefit is only tax-free if it goes to dependants and financially dependent offspring. If it goes to non-dependent

adult beneficiaries, the benefits are generally taxed to the estate. This is similar to a death tax. However, some may argue 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 (although 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. The tax is *theoretical* because it will not be collected if the asset passes to the charity or to a non-resident outside the two-year (or sometimes four-year) amendment period for date of death return assessments. This is a 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 two years of death. This is 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 two-year tax-free selling window. Further, the LPR can rent out any dwelling during that two-year period (whether pre-CGT or post-CGT to the deceased) with zero effect on the exemption. This period can be extended with the "okay" 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's 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 two-year window.

When one examines examples like this, the existing tax arrangements after death, but as a result of death, reflect different policy considerations and sometimes reveal 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 involve simply 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 roll-over in ss 128-10 and 128-15 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) 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 the CGT discount if they sold Australian land, but the CGT discount is available if their 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 the 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 a resident of a different country from that of the deceased.

Bigger change approach

The full range of tax concessions which are currently enjoyed by deceased estates could be reviewed, including the concessional tax rates that are available to estates under s 99 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), 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 Div 6AA ITAA36 (broadly, to income from the deceased's own assets and superannuation proceeds etc) by trying to divert income from discretionary trusts through the deceased estate itself. While the Commissioner may seek to apply s 99A ITAA36 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, the death roll-over in ss 128-10 and 128-15 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 one of the reasons why Australia introduced a pre-CGT/post-CGT regime rather than the United Kingdom'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 while avoiding 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 tax to those who realise estate assets with accrued gains.

Serious consideration could then be given to what assets should be taxed at death and what are not taxed at death. 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 who resided in the property should remain relevant if the property passes to beneficiaries who do not 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 exclusion (to government revenue) from the CGT base. For example, it was estimated to cost the budget $74b in the 2017-18 forecast, and $327.5b over the forward estimates.[2] The removal of the exemption for non-residents is estimated to result in a revenue saving of $155m in 2020-21.[3]

No doubt, removal of the main residence exemption would be 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 extraordinarily 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 take trusts and companies back to a neutral playing field. However, a better option may be 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.

The "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 1980s, notwithstanding the fact that countries with similar taxing regimes retained them (and some, like the United States and the UK continue to have them (at about 40%). The OECD average rate is 15%.

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

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

Prior to the 1980s, 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 1960s and early 1970s 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 of 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 — Western Australia previously assessed some duties on the estate and some on successors!

The Henry review[4] 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 into account the fact that some recipients receive a number of substantial inheritances over the course of their lives and that they 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. This is 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.

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

The Henry review concluded that, while there were arguments in favour of both an estate tax and an inheritance tax, 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 noted[5] that an estate tax would avoid the lifetime complexity of the accessions tax and be 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 to minimise the tax payable.

Such an outcome is consistent with the reforms proposed under ch 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-1970s than they are today (today, there are approximately one 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 Henry review 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 Henry review'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.

What assets?

The Asprey report 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 their death, which then becomes part of the estate administered by the LPR. However, the report also proposed that the base on which estate duty is levied should also include property that the deceased had power to acquire 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 their death, which could have been exercised in their own favour. While 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 duty regime.

The Asprey report also suggested that, in relation to certain illiquid assets (such as farming land), LPRs should have an option to spread the 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 to cause the least harm to economic efficiency, provide equity (horizontal, vertical and intergenerational), and minimise complexity.

The Henry review also pointed out[6] 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.

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 that 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 the merits of introducing a bequest tax should 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 that the only way in which an estate or inheritance tax could generate a significant amount of revenue in Australia is where it is imposed on a broad base at a low rate of tax. Currently, there is no modelling 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, an interesting article published by the Australian Institute for Business and Economics of the University of Queensland does discuss the economic merits of such a broad-based proposal.[7]

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 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 that bequests are from assets that 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 in order 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 the *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 report suggested, however, that there should be a monetary limit on a spousal transfer exemption.

Complexity, structuring and costs

One of the major concerns about the reintroduction of inheritance taxes is that they become very complex and encourage advisers to design 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, which is unlikely to be desirable from either a compliance cost or administration perspective.

Practitioners would be concerned about the effect that the tax would have on the scale of compliance work needed to get estate (and sometimes beneficiary) tax issues satisfactorily sorted, in a reasonable time frame.

International dimension

Would any 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 that 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 would inevitably be complex because of the different ways that countries levy death duties and inheritance taxes. More cases would also arise because, pre-COVID-19 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.

> *"... a death duty or inheritance tax may address wealth inequality to some extent."*

Other considerations

The Henry review noted[8] that any option for taxing bequests and gifts would require consideration of the following:

- the cash-flow implications for estates that are held predominantly in the form of liquid assets;
- the treatment of bequests to charities, which are concessionally taxed in many countries;
- how any such tax would interact with CGT;
- 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 report, *The role and design of net wealth taxes in the OECD*,[9] 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 the revenue collected had been very low. However, the report argued that there was 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 addressing wealth inequality.

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 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 former prime minister Paul Keating's recent proposal in the aged care royal commission for an alternative basis to fund aged care (a repayable loan system, like HECS, after death) was met with a question from Commissioner 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 many people trying to make sure that there would be no assets left to repay the loan.

Conclusion

Many significant impediments 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. 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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