Deceased estate taxation: Frankenstein's monster?

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The taxation of deceased estates sits at the intersection of succession and trust taxation laws. As wills and estates become more complex, so to do the related tax issues. Given that executors may be personally liable for payment of the deceased's outstanding tax and that of their estate, the complexity can become the stuff of nightmares. Those nightmares are made worse by the general uncertainty that exists in relation to the application of the tax law and the lack of guidance from the ATO as to how it believes the law operates. With the increasingly rapid changes to people's personal circumstances, for example, through migration, greater wealth and asset mix, those nightmares are not likely to abate. This article considers some specific complexities that arise in scenarios that are not uncommon.

Overview

You could be forgiven for thinking that the taxation of a deceased estate is something that is relatively straightforward. After all, since the CGT provisions were introduced in 1985, there have not been any major changes to the relevant legislation.

While that may be true for many estates, the tax position for others can be far from clear (even akin to Frankenstein's monster). Uncertainty can arise for a range of reasons, including:

- deficiencies in the law;
- changes to related legislation;
- changes in the interpretation of the law by the courts;
- the changing personal circumstances of deceased individuals – greater wealth, asset mix, migration patterns etc; and
- a lack of guidance by the ATO as to how it believes the law applies.

This article considers some specific complexities in the following contexts:

- present entitlement and who pays the tax;
- residency of an estate and foreign resident beneficiaries;
- the main residence exemption; and
- specific legacies and life and remainder interests.

Present entitlement and who pays tax

Estate taxation overview

For tax purposes, a deceased estate is treated as a trust and the legal personal representative (LPR) a trustee.

A trust is not a separate taxable entity in the same way as a company. Rather, liability for tax on a trust's "net income" (which is essentially the amount that would be the taxable income of the trust if it were assumed that the trustee was a resident taxpayer) is allocated to the trustee or the beneficiaries depending on the "entitlement" of beneficiaries to the estate's income or capital gains.

If there is no beneficiary that is specifically entitled to the trust capital gains and there is some income to which no beneficiaries are presently entitled (or if there is no income), the trustee will be assessed on some (or all) of the net income.

While that sounds simple enough, it masks many complexities, which are considered immediately below, as well as in the "Residency of an estate and foreign resident beneficiaries" section of this article.

When is a beneficiary relevantly entitled?

Traditionally, the trust assessing provisions[1] have operated by looking at the extent to which beneficiaries are presently entitled to the income of the trust for a particular tax year. However, amendments were made in 2011 to allow for the streaming of capital gains and franked distributions.[2] The effect of the streaming rules is that beneficiaries to whom amounts are validly streamed are assessed on those amounts (with the character of a capital gain or franked distribution) and only the remaining net income is assessed under the present entitlement rules.

Present entitlement: what is income?

The "income" and "net income" of a trust are two separate concepts. As noted above, net income is a tax concept and is defined in legislation.[3] However "income" is a trust law concept.[4] Generally, the income of a trust will be determined in accordance with the trust deed. In the context of a deceased estate during administration, there is no such deed.

In the authors' experience, it is rare for a will to specify how the estate income is to be determined. Having said that, they have noticed some cases recently where a will did define the income of the estate. This may be a new trend.

If there is no definition of "income" in the will, it will take its ordinary trust law meaning (under the trust apportionment rules for income and capital entitlements). An analogy that is commonly used to distinguish income from capital is that income is like the fruit from a tree and the tree is capital. That is, interest from a bank deposit or rent from a property would be regarded as income.

Present entitlement: when is a beneficiary presently entitled to income?

A beneficiary is presently entitled to trust income for an income year if they have, by the end of that year, a present or immediate right to demand payment of the income from the trustee. The application of the rules in the context of a deceased estate is considered by the ATO in IT 2622.[5]

IT 2622 is outdated and needs to be rewritten as a matter of priority to address things like the specific entitlement rules. It was also written before the decision of the High Court in *Bamford's* case which confirmed the proportionate approach to trust taxation.

IT 2622 adopts the approach of the High Court in *Whiting's* case[6] which says broadly that a residuary beneficiary cannot be presently entitled to income until the administration of an estate is complete. However, that is qualified such that a residuary beneficiary can be presently entitled when provision has been made for the payment of debts.

Whiting's case was unusual in the sense that, although the trustees had paid the funeral expenses and death duties (and had set aside money for further duties that would arise on the death of the deceased's spouse), the trustees were not in a position to pay their share of the significant debts of a partnership of which they were a partner. Accordingly, although the trustee purported to make the residuary beneficiaries presently entitled to the estate income, it was not clear that those beneficiaries would ever be paid the amount (because of the existence of the debts). Thus, the court concluded that, although the beneficiaries had a vested interest in the residue, they could not presently demand the estate income and could not therefore be presently entitled for tax purposes.

The authors see many estates where executors refrain from paying a small debt, with a view to ensuring that tax on the estate net income is assessed to the LPR. The LPR's argument is that as all of the estate debts have not been paid, the administration is not complete, and the beneficiaries cannot be presently entitled to estate income.

However, the authors question whether this is a proper application of the test. In their view, present entitlement can exist prior to the administration as a whole being complete (since the executors can always discover other assets, it may be that administration is never really complete). The better view seems to be that the test looks to the administration of the estate vis à vis particular amounts of income. If the LPR has assented to the distribution of an amount of income to a beneficiary, the beneficiary can demand payment of it and can be presently entitled for tax purposes.

Present entitlement: proportionate approach

Under the present entitlement rules, a beneficiary who is presently entitled to a share of trust income is taxed on that same proportionate share of the trust's net income. So, for example, if a beneficiary is presently entitled to 50% of the income of a trust, they will be assessed on 50% of the net income.

The *Greenhatch*[7] case clarified the effect of the *Bamford* decision on the streaming of trust amounts. It confirmed that, regardless of the character of the amount that a beneficiary's share of income was attributable to, that character is not used to determine, in a causative sense, the components of the share of net income.

Example

A trustee derived $50,000 rent and made a $50,000 capital gain (after discount) in a year of income. The deed equated the trust income with its net income (in this case, both were $100,000).

As it was able to do under the deed, the trustee made an individual presently entitled to the capital gain and a company entitled to the rental income. The trustee assumed that the tax provisions operate such that the individual includes the $50,000 capital gain in its assessable income and the company includes the $50,000 rent in its assessable income.

The effect of the *Greenhatch* decision is that both the company and the individual have $25,000 rent and $25,000 capital gain. As the company is not entitled to the CGT discount, it is taxed on $75,000 ($25,000 rent and $50,000 capital gain). The individual's share of the net income represents a $25,000 capital gain and $25,000 rent.

Present entitlement: is presently entitled beneficiary tax-exempt?

In certain situations, a tax-exempt beneficiary may be taken to *not* be presently entitled to income for tax purposes. Anti-avoidance rules were introduced at the same time as the rules to allow the streaming of capital gains and franked distributions. While the rules were aimed at discretionary trusts, they nonetheless apply to deceased estates and testamentary trusts. So, an LPR making an exempt beneficiary presently entitled to income must ensure that they satisfy these rules.

Section 100AA. For tax purposes, under s 100AA ITAA36, a tax-exempt beneficiary is treated as not being presently entitled to the 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 the beneficiary's share of the net income.

However, the Commissioner has the discretion not to apply the rule when the trustee fails to pay or notify on time. When exercising the discretion, the Commissioner must consider the following factors:

- the circumstances that led to the trustee failing to notify or pay the amount within two months of the year end;
- the extent to which the trustee has taken actions to try to correct the failure and how quickly those actions were taken;
- whether the trustee has applied to the Commissioner to exercise his discretion previously; and
- any other relevant matters.

A search of the ATO legal database shows that the Commissioner has exercised the discretion in the following circumstances:

- the trustee had died and a new trustee could not act until probate of the deceased trustee's estate had been granted;[8]
- there was an issue about the formal identification of a beneficiary which was resolved by a Supreme Court application;[9]
- there was a miscommunication between the trustee and the financial adviser about who was to pay the exempt entity;[10] and
- the trustee did not pay or notify the entity of its entire entitlement, but the shortfall was a minor amount and represented a small percentage of the exempt entity's present entitlement.[11]

A trustee of a testamentary trust can inadvertently trigger the "pay or notify" rule. For example, on the death of a life tenant, the trustee may overlook the obligation to notify tax-exempt remainder beneficiaries of their entitlements within the two-month period after the end of the financial year.

Section 100AB. Section 100AB ITAA36 is designed to overcome the exploitation of the proportionate approach whereby a charity can be made presently entitled to all of the income of a trust so that tax can be avoided on capital that is enjoyed by another entity. This is demonstrated in the following example (taken from the explanatory memorandum to the Tax Laws Amendment (2011 Measures No. 5) Bill 2011). Without s 100AB, the income that is capitalised in the example that actually benefits Emma would not be taxed.

Example

In the 2010–11 income year, the Bell Trust generated $100,000 of rental income and $70,000 of franked distributions (with $30,000 franking credits attached). The trust had no expenses. The taxable income of the trust is $200,000 (being the $100,000 rental income, the $70,000 franked distributions, and the $30,000 franking credits).

The trust deed does not define "income" for the purposes of the trust deed. However, there is a clause that allows the trustee to treat receipts as income or capital of the trust at its discretion. The trustee determines to exercise this power to treat $95,000 of the rental receipts as capital and so the income of the trust estate is $75,000. Casey Pty Ltd, Mark and Emma

Example (cont)

are within the class of discretionary objects. Casey Pty Ltd is an exempt entity.

The trustee specifically allocates all of the franked distributions to Mark and appoints all of the remaining income of the trust estate to Casey Pty Ltd ($5,000). The trustee notifies Casey Pty Ltd of its entitlement by 31 August 2011. The trustee appoints all of the capital in respect of that year to Emma ($95,000).

Casey Pty Ltd's adjusted Division 6 percentage is 100% (($75,000 − $70,000/$5,000) × 100) as it is presently entitled to all of the income of the trust estate after disregarding the $70,000 of franked distributions to which Mark is specifically entitled. However, Casey Pty Ltd's benchmark percentage is 5% (($5,000/$100,000) × 100).

The franked distributions to which Mark is specifically entitled and the attached franking credits (because they do not represent net accretions of value to the trust fund) are excluded from the adjusted net income for the purposes of calculating the benchmark percentage.

Casey Pty Ltd's adjusted Division 6 percentage exceeds the benchmark percentage by 95%. The trustee of the Bell Trust is therefore assessed and liable to pay tax on $95,000 (0.95 × $100,000) under s 99A ITAA36. Casey Pty Ltd's share of the Bell Trust's taxable income is confined to Casey Pty Ltd's entitlement of $5,000.

Section 100AB applies if there is a difference between a beneficiary's present entitlement to trust income (as a percentage) and their present entitlement to the trust estate reflected in the trust's adjusted net income (as a percentage). The provision operates by assessing the trustee, having regard to the amount by which the percentage entitlement to the income exceeds the entitlement to the adjusted net income.

The concept of present entitlement to the trust estate (that is reflected in the adjusted net income of the trust) is relevant only for s 100AB purposes. The present entitlement can be an entitlement to income and/or capital.

"Present entitlement to trust income" is a concept that has been considered by the courts on many occasions. The High Court decision in the *Union Fidelity* case[12] determined, among other things, that:

> "12. … When a beneficiary has been paid his share of the income of the estate in respect of a tax year he no longer satisfies the description of a beneficiary who is entitled to a share of the net income of the estate for that year."

As a consequence of that decision, the ITAA36 was amended to introduce s 95A(1) which provides that a beneficiary will continue to be presently entitled to trust income, notwithstanding that it has been paid to them or applied for their benefit.

However, s 95A(1) was not amended to provide that a beneficiary's entitlement to trust capital exists for a year, notwithstanding that it has been paid to them.

So, for example, if an entitlement to trust capital was created by an executor and paid to the beneficiary before the end of the income year, it may be that there is a mismatch between the relevant percentages. As such, the executor would need to seek an exercise of the discretion in s 100AB(5) in order to avoid an assessment by reason of s 100AB.

When exercising the discretion, the Commissioner must consider:

- the circumstances that led to the difference between the Division 6 percentage exceeding the benchmark percentage;
- the extent of the mismatch between the exempt entity's adjusted Division 6 percentage and the benchmark percentage;
- the extent to which the exempt entity actually received distributions from the trust estate in respect of the year of income; and
- the extent to which the exempt entity and other beneficiaries were entitled to benefit from amounts representing the net income of the trust.

Example

Daryl is the executor of his brother Monty's will. Monty left his entire estate to a gift deductible charity.

For various reasons, including the settlement of family maintenance claims, the administration of the estate was delayed.

The income of the estate for a particular year was $250,000. The LPR also made a discount capital gain of $200,000 from the sale of a property. The net income of the trust is $350,000.

The trustee, Daryl, determines that he does not require the $450,000 for the purposes of the estate administration and makes an interim distribution to the charity before 30 June. At year end, the charity is presently entitled to 100% of the income of the trust (by virtue of s 95A(1)); however, its present entitlement to the adjusted net income may be 55% [($250,000/$450,000) x 100].

Without the exercise of the discretion, the exempt entity's entitlement to income would be taken to be 55%. Therefore, Daryl would be assessed on 45% of the net income (45% x $350,000 = $157,000).

Clearly, the case is one in respect of which it was intended that the discretion should be exercised:

- the discrepancy arose as a result of the operation of the deceased's will and the general law of succession, and the fact that there is no deemed present entitlement rule in respect of an amount of capital paid to a beneficiary during the year;
- the exempt entity will benefit from amounts attributable to the capital gain as the residuary beneficiary of the estate;
- no other entity will benefit from an amount attributable to the capital gain; and
- a similar result could be achieved by making the entity specifically entitled to the capital gain.

Specific entitlement: background

Some people think that the streaming rules for capital gains and franked dividends are as ugly as Frankenstein's monster and tend not to use them. While the provisions can appear complex, they operate in a fairly predictable fashion. As will become obvious, anyone who doesn't at least consider the provisions does so at their own peril.

The specific entitlement rules for capital gains were introduced:

- to overcome the unfairness that arises under the proportionate approach whereby a person entitled to all of the trust income for a year (say, $100) was assessable on all of the net income of the trust (say, $100,000). That is, the income beneficiary can be assessed on a much larger amount from which they will never benefit; and
- to ensure that an amount of franked dividend or capital gain allocated to a beneficiary for trust purposes had the same character for tax purposes.

For a beneficiary to be specifically entitled to a capital gain, the following conditions must be met:

- the beneficiary must have received, or reasonably expect to receive, the net financial benefits "referable to the capital gain". To have such an expectation in the context of a deceased estate, the estate administration must have reached a point where the executors do not require the "gain" amounts (not necessarily the total capital proceeds) for the payment of liabilities; and
- the beneficiary's entitlement to the amount must be "recorded in its character" as an amount referable to the capital gain in the accounts or records of the trust *by 31 August* following the end of the income year in which the gain was made.[13]

"Net financial benefit" means an amount equal to the financial benefit referable to the capital gain after the application of trust capital losses (consistent with the application of those losses for the purposes of the method statement in s 102-5 ITAA97) but before the application of the CGT discount.

Specific entitlement: example

In one case, in respect of which the authors gave advice, the executors made a capital gain from the sale of an estate asset. The proceeds of sale formed part of the estate residue and were to be divided among 10 beneficiaries; many were friends of the deceased but one was a tax-exempt hospital.

As there was no estate income in this case, the executors were prima facie liable to pay tax on the net capital gain (the capital gain after the CGT discount). That is, none of the beneficiaries could be assessed as they were not presently entitled to income by 30 June of the income year in which the capital gain arose.

One approach might have been to stream one-tenth of the capital gain to each beneficiary. Under this approach, the hospital, being a tax-exempt entity, would not have had to pay tax on its share of the gain, but the other beneficiaries would have been assessable on their share. However, when one considers that a purpose of the streaming provisions was to enable tax-effective distributions, streaming all of the capital gain to a tax-exempt entity is consistent with that purpose.

Accordingly, the executors streamed the entire capital gain to the hospital (in partial satisfaction of its entitlement under the will). As the hospital was tax-exempt, it did not pay tax on the capital gain, nor was any tax payable by the executors or the other beneficiaries (those beneficiaries' estate entitlements were not attributable to the capital gain).

In this case, the entire "estate pie" was enlarged for the benefit of all of the beneficiaries. Because the executors were not taxed on the capital gain, the residue was not reduced by tax so each of the 10 beneficiaries received more. And because the capital gain was able to be streamed entirely to the hospital, each of the other residuary beneficiary's share of the residue was not taxable.

The executors in this case (like most executors) were conservative and obtained a favourable private ruling from the ATO.

If you were to contemplate making a tax-exempt entity specifically entitled to a capital gain, you should ensure that the LPR has an express or implied power to stream capital gains. In the authors' experience, the ATO has accepted that a power of appropriation in a will, or like that in s 46 of the *Trustee Act 1925* (NSW), is sufficient to enable the streaming of capital gains by an executor.

In order to avoid the expense of having to make private ruling applications in cases like this, it is hoped that the rewrite of IT 2622 deals with the streaming rules in contexts like this.

Residency of an estate and foreign resident beneficiaries

Residency of an estate

The residency of a deceased estate for tax purposes is determined in accordance with the rules that apply for other trusts. Broadly,[14] a trust will be a resident trust estate for an income year if:

- a trustee was a resident of Australia at any time during an income year; or
- the trust was centrally managed and controlled in Australia at any time during the year.

A trust that is not a resident trust is a non-resident trust.

The residency of an estate is relevant to determining:

- the amount of net income that may be assessed to the trustee (if the trustee rather than a beneficiary is assessable on a share of the net income);[15]
- the rates of tax that may be payable by the trustee; and
- the calculation of the net income of the trust (despite the definition in s 95(1) ITAA36).

In this article, only the last point is considered further.

Non-resident trust: calculation of net income

Despite the fact that s 95(1) specifies that the net (or taxable) income of a trust is required to be calculated on the assumption that the trustee is a resident, an issue arises as to how that provision interacts with s 855-10 ITAA97 which exempts a capital gain or loss that a trustee of a foreign trust makes from an asset that is not taxable Australian property (TAP).

In TD 2017/23, the ATO concludes that, if the assumption in s 95(1) were applied for the purposes of s 855-10, the latter provision would have no operation at all in relation to foreign trusts, despite its express reference to them. This cannot have been the intention of the legislature.

Pursuant to the general rule of statutory interpretation that a specific provision overrides a general provision where there is a conflict, the ATO concludes that s 855-10 prevails. This means that, in a non-resident deceased estate, capital gains from assets that are not TAP[16] are not required to be included in the net income of a foreign trust.[17]

It is fairly clear that this produces some unintended tax outcomes where a resident individual dies and appoints a foreign person as their executor.[18] This is best demonstrated by an example.

Example

The deceased has always lived in Australia and all of the deceased's assets are there. Their estate consists of a large share portfolio with significant inherent capital gains.

The deceased's will appoints his eldest child as executor. That child moved to the United States more than 30 years ago and is not an Australian tax resident.

The estate has been left in equal shares to the deceased's three children. The other children reside in Australia.

It is proposed that the estate assets will be sold and the proceeds distributed evenly among the children.

Most people would expect that, because the deceased was a resident, capital gains from the sale of the shares (reduced by the 50% CGT discount) would be included in the "taxable income" of the estate in the year that the shares are sold and assessed to the LPR or beneficiaries (depending on whether the beneficiaries are presently entitled to income, or made specifically entitled to the capital gains). Broadly, this is the approach that would apply if the executor was a resident.[19]

However, because the estate is not resident, the effect of TD 2017/23 is that gains from the sale of the shares would not form part of the estate net income for the year the shares are sold. Further, to the extent that the proceeds attributable to the capital gain are distributed to a foreign beneficiary, the distribution will not be assessable income in Australia.[20]

The Inspector-General of Taxation, in her report on the administration by the ATO of deceased estates, recommended that the ATO explore this issue with external stakeholders, with a view to making recommendations for law change.[21] BNR Partners has raised with the ATO and government a simple approach that might address this issue. That approach is to treat the estate as having the same residence as the deceased. There is a precedent in the United Kingdom. However, to date, the idea has not gained any traction.

What is more worrying is the treatment of distributions to resident beneficiaries. The ATO is likely to treat a distribution of an amount attributable to a beneficiary's "share of the estate capital gains" as an amount to which s 99B ITAA36 applies.

Section 99B(1) includes in a beneficiary's assessable income an amount, being property of a trust, that is paid to, or applied for the benefit of, the beneficiary[22] if they were a resident at any time during the income year.[23]

There are exceptions to the application of s 99B.[24] Perhaps the most important exception is for a distribution of trust corpus. However, that exception does not apply to so much of a corpus distribution that would have been assessable had it been derived by a resident taxpayer. Accordingly, TD 2017/24 takes the view that a distribution from corpus that is attributable to a capital gain does not fall within the corpus exception.

Further, TD 2017/24 takes the view that the amount made assessable by s 99B(1) does not have the character of a capital gain for Australian tax purposes, nor is there any linkage between s 99B(1) and Subdiv 115-C ITAA97. This means that an amount which is included in assessable income under s 99B cannot be reduced by a capital loss or the CGT discount.

Section 99B was originally introduced to tax, on distribution to a resident beneficiary, amounts of trust income that had been accumulated tax-free in a foreign trust. While it has been around for a long time, the ATO has not issued any advice about how the provision applies in particular contexts (for example, is a strict tracing of funds required?). The authors understand that the ATO is working on a draft public ruling, but it is not clear when this will be released. Private rulings which BNR Partners lodged more than a year ago on the application of s 99B have yet to be issued.

Taxation of foreign resident beneficiaries

With the rates of migration that we have experienced in the last decade, it is becoming much more common for tax issues to arise in multiple jurisdictions in respect of the estate of a deceased individual. The previous section of the article highlights how a choice of executor can affect the Australian tax outcomes. This section of the article considers the treatment of foreign beneficiaries of a resident trust estate. In particular, whether such a beneficiary's share of estate capital gains from non-TAP assets is tax-free in Australia.

Sections 855-10 and 855-40

You are no doubt familiar with the Full Federal Court decisions in *Greensill*[25] and *Martin*.[26] The court found that a foreign beneficiary's share of a trust capital gain from a non-TAP asset cannot be disregarded under s 855-10 ITAA97. This view is now reflected in TD 2022/13.

While the trusts in those cases were discretionary, the reasoning appears to apply equally to a foreign beneficiary's share of the non-TAP capital gains of a resident deceased estate.

Example

Alexia was an Australian resident for tax purposes. Her will, which appointed her sister Astrid (who resides in Australia) as her executor, provided that her assets were to be sold and the proceeds distributed among her three children (Benita, Chloe and Dudley). Dudley lived overseas. The estate assets included shares in numerous companies and properties in Australia and overseas.

Astrid had sold some of the shares and the administration had reached the stage where she knew that she would not need the proceeds to satisfy estate liabilities, so she made an interim distribution of the proceeds of sale to the three beneficiaries in equal shares (making them specifically entitled to the various gains for CGT purposes).

Dudley's share of the capital gains cannot be disregarded under s 855-10. Even though the gains were attributable to non-TAP assets, they were not gains from a CGT event that happened to Dudley.

An interesting question is whether the result in the example would be different if the administration of the estate had been completed and the beneficiary entitlements had crystallised before the distributions were made.

Section 855-40 ITAA97 exempts a foreign beneficiary's share of a trust capital gain from a non-TAP asset if the trust is a fixed trust. For the purposes of the ITAA97, a fixed trust is one in which entities have fixed entitlements to all of the trust income and capital. A fixed entitlement is one that is vested and indefeasible.[27]

BNR Partners has obtained private rulings in some cases where the ATO has agreed that, in the final year of administration, the relevant estate would be regarded as a fixed trust for the purposes of that section, that is, the beneficiaries under the will would have vested and indefeasible interests in the income and capital of the trust. Accordingly, non-resident beneficiaries' shares of non-TAP capital gains were exempt under s 855-40 ITAA97.[28]

In the absence of a public ruling on the topic, the authors recommend applying for a private ruling if you find yourself in a similar situation. Be aware that the fixed entitlement test is much harder to satisfy than, for example, the present entitlement to income or specific entitlement to capital gains tests. That is because the fixed entitlement test must be satisfied in respect of all interests in the trust. Without planning, you might find that a capital gain is taken to arise in a different year than the one in which the beneficiary interests become fixed.

Section 99D

While s 99D ITAA36 has not received must attention in the past, para 22 of TD 2022/12 indicates that, in some cases, where a trustee has paid tax in respect of a foreign-sourced capital gain, a non-resident beneficiary may be able to obtain a refund of the tax under s 99D.

In broad terms, s 99D applies where a trustee of a resident trust has been assessed under s 99 or 99A ITAA36 and paid tax on a foreign-sourced amount that is subsequently distributed to a foreign beneficiary. The beneficiary must apply for a refund within 60 days of the date on which the distribution was made to them (or such further period as the Commissioner allows).

The beneficiary must satisfy the Commissioner that the distributed amount:

- is attributable to a period when the beneficiary was a non-resident (query what this means in the context of the capital gain of a deceased estate – does the beneficiary have to be a non-resident throughout the period that the LPR owned the asset; presumably, they would not have to also be a non-resident when the deceased owned the asst?);
- was taken into account when calculating the net income of the trust; and
- is not an amount to which s 100A ITAA36 applies.[29]

Any entitlement under s 99D(1) ITAA36 is subject to the discretion of the Commissioner under s 99D(2) to refuse a refund where there was a purpose of enabling the beneficiary to obtain the refund of tax.

Using the example above (under the heading "Sections 855-10 and 855-40"), if Astrid paid tax on the capital gains from the Australian shares rather than making the beneficiaries specifically entitled to the gains, Dudley would probably not be able to obtain a refund of his share of the relevant gains from the Australian shares. These gains are not likely to be foreign sourced.[30] However, s 99D could potentially apply in respect of tax that Astrid paid on capital gains from the sale of the foreign properties owned by the deceased or foreign shares.

BNR Partners has made one application for a tax refund under s 99D. The ATO took a literal reading of the provision and concluded that no refund was available to the beneficiaries because the capital gains in respect of which tax was paid by the trustee did not form part of the income of the trust estate. This interpretation puts deceased estates in a much worse position than discretionary trusts because wills have generally not modified what will be income of the estate. Will drafters may want to think about whether it is possible and advisable to give an LPR a power to treat capital gains as income of an estate.

It does seem ironic that, on the ATO view, a non-resident beneficiary of a non-fixed trust is assessable on their share of a trust capital gain from a non-TAP asset, but is entitled to a refund of tax if the trustee is assessed on the gain and the proceeds attributable to the gain distributed to the beneficiary. But that result appears to be because the streaming amendments for capital gains in 2011 which removed consideration of the source concept for s 98 purposes did not apply to s 99D.

Main residence exemption

Main residence: full exemption

At its simplest, a full main residence exemption applies to a capital gain from a dwelling that was the main residence of the deceased when they died if:

- the dwelling was not being used to produce income when the deceased died; and
- settlement of the sale of the dwelling occurs within two years of the deceased's death.

Because an LPR, and a beneficiary to whom the dwelling passes, obtain a market value acquisition cost, the effect of the exemption is really in respect of the two-year period (or such period as extended by the Commissioner) after death.

Further, a full main residence exemption can apply to any pre-CGT dwelling of the deceased (whether or not it was ever the deceased's main residence) if sold by the LPR or beneficiary in the two years after death.

It has never been explained why "pre-CGT" dwellings qualify for the main residence exemption. Originally, with the two-year period of grace being just 12 months and house prices steadier, it probably wasn't much of an issue. But if someone today dies with several pre-CGT residential rental properties in their portfolio, some real tax advantages may accrue over a two-year period.

While the main residence provisions (not unlike those for streaming) look unattractive, they contain some hidden gems.

Cost base for deceased's main residence

To save compliance costs for the LPR or beneficiary, the law was amended in 1996 to provide a cost base uplift to market value for a deceased person's main residence. Prior to that, the LPR acquired the deceased's property for the deceased's cost base and had to work out any main residence exemption, having regard to the actual use that the deceased made of the property when alive.

You can see how difficult this would have been for the LPR. Often the deceased would not have kept any cost base records (on the assumption that they would qualify for a main residence exemption), and the LPR would have little way of establishing how the deceased had used the property.

The market value cost base applies automatically (there is no choice for this) and has no regard as to how the dwelling was previously used by the deceased. It is a point in time test. The dwelling could have been a rental property for most or almost all of the ownership period. There are also no adverse consequences that apply (as is the case with, say, the absence choice), such that no other dwelling may be treated as the deceased's main residence for the period prior to death.

> **Example**
>
> Agatha owns two post-CGT houses, one in country Victoria which she has always lived in, and one in the Melbourne CBD which she has always rented out.
>
> Agatha becomes ill and decides to relocate to the Melbourne CBD property to be closer to medical treatment, leaving the country property vacant. Unfortunately, after eight months, she passes away in the CBD home.
>
> The CBD property would get a market value cost base and could be sold within two years tax-free. The country property would get an almost total main residence exemption as well, based on actual use. In some cases, it may be possible to use the "six-month two dwelling rule" in s 118-140 to get two complete exemptions.

Partial exemption: counting the days

If an LPR (or beneficiary) does not qualify for a full main residence exemption, they may be entitled to a partial exemption. The example below considers where a full exemption is not available because there was a delay of more than two years in selling the property and the Commissioner would not grant an extension of that period.[31]

> **Example**
>
> George acquired his main residence at the beginning of 2010 and it was still his main residence when he died at the end of 2013 (three years). When he died, the property had a market value of $2m. For the next three years, the trustee rents the property out waiting for the value to increase. The trustee then sells the property for $5m.

The market value at the date of death gives proper recognition to the dwelling's status in George's hands as a main residence. Effectively, any gain or loss arising before death is disregarded. After that, the dwelling is simply used to produce income and held to maximise the sale price.

The dwelling was not sold within two years of the date of death and the Commissioner is unlikely to agree to extend the period in these circumstances.

If you didn't know better, you might assume that the capital gain of $3m was fully taxable.

However, the partial exemption in s 118-200 appears to confer a partial exemption. That is, there is nothing in the formula which "restarts" the period of "total days" and "non-main residence days" from the time of the market value uplift.[32] There was such a provision in the ITAA36, but it seems it was accidentally not rewritten.

If you apply the provision literally, the total days are six years (in days), and the non-main residence days are three years (in days). So only 50% of the $3m capital gain is taxable!

It appears that the ATO interprets s 118-200 literally in published guidance and in private rulings, such that a double dip (a cost base uplift and an exemption for the period that the dwelling was the deceased's main residence) is available.

Whatever the answer is, and of course the ATO may be correct, it is evident that a literal approach to the law must be leading to some degree of revenue leakage from a policy perspective.

Specific legacies and life and remainder interests

Specific legacies

Background

In a straightforward case, the CGT rules[33] that apply to a post-CGT[34] asset that a person has left in their will are simple. Effectively there is a tax roll-over. That is, there is no tax payable on death or when the asset passes to the deceased's LPR or a beneficiary in their estate. Rather, the LPR and later the beneficiary are taken to have acquired the asset for an amount equal to the deceased person's cost base at the time of death. There are different cost base rules for other assets, including those that the deceased acquired pre-CGT and the deceased's main residence.

The roll-over is only for assets that the deceased person owned when they died. So, if the LPR acquires an asset during the estate administration (for example, shares may be acquired under a dividend reinvestment plan that the deceased had entered into), a capital gain or loss will be recognised when the asset passes to a beneficiary.

There is no roll-over if an asset passes to a tax-exempt entity that is not a deductible gift recipient. Similarly, there is no roll-over if an asset that is not TAP passes to a foreign beneficiary. Rather, in these cases, a capital gain or loss from CGT event K3[35] is recognised in the deceased individual's final income tax return. The gain is worked out having regard to the market value of the asset on the day the individual died.

Specific legacies: double death

As always, the devil is in the detail. Who would expect, for example, that the roll-over would not apply in a case where an intended beneficiary dies before an asset that they were entitled to under the will of another person passes to them.

As noted above, the roll-over only applies in respect of an asset that the deceased person owned when they died. However, in many cases, you will find that, following the death of a person, a beneficiary of their estate (the first estate) will die before that estate is administered. A beneficiary who has an interest in an unadministered estate when they die did not "own" any of the assets that may ultimately pass from the first estate to the beneficiary's estate (the second estate). The result is that gains and losses are not able to be disregarded when estate 1 assets pass from the LPR of the second estate to a beneficiary of that estate.

Treasury had long ago identified this as an unintended policy outcome. The Treasury paper, *Minor amendments to the capital gains tax law*, issued in May 2011, outlined the following proposed amendment to the law:

"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."

However, this proposal was abandoned as part of the then government's announced but unenacted measures review.[36] More recently, the issue was raised, and rejected, as a matter in respect of which the Commissioner's remedial power could be exercised, on the basis that the policy was clear.[37]

So, "what's the problem?", you say. While a law change would be nice, we've all been managing ok.

For one thing, it appears that different views have been taken about the cost base of the asset in the hands of the LPR/ beneficiary of the second estate in these cases. Traditionally, most people seem to have adopted the approach that assets owned by the first deceased passed to the LPR of the second estate for an amount determined in the table in s 128-15(4) ITAA97. That is, the roll-over applied at the level of the first estate, with the effect that the LPR's cost base is determined under the usual deceased estate rules.

However, there is an alternative view. On that view, as Div 128 does not apply to an asset of the first deceased in the hands of the LPR or beneficiary of the second estate, it is argued that the asset's cost base is not determined under Div 128 ITAA97. Rather, because the second LPR acquired the asset for no consideration, they are taken to have acquired it for market value under s 112-20 ITAA97. Under this approach, any gain inherent in the asset when the deceased person died falls out of the tax system.

If you are advising the LPR of a second estate about their potential liability from the sale of an asset that passed from the first estate, the authors would urge caution and suggest a private ruling be obtained. Remember that the LPR of estate 2 is liable for any tax that would be payable if a taxable capital gain arose from the transfer of the asset by the LPR of estate 2 to a beneficiary of that estate.

For another thing, it seems that the ATO occasionally forgets what its approach is. In January 2022, a private ruling[38] was issued which indicated that roll-over could apply in double death cases. This created much uncertainty in relevant legal and accounting circles: had the ATO changed its long-held view?[39]

Recently, the edited version of that private ruling has been annotated to indicate that it is misleading or incorrect and that the view it expresses does not represent the ATO's view of the relevant law. While the rulees can continue to rely on the private ruling that was issued to them, it is a useful reminder that private rulings only provide protection to those to whom they are issued. Anyone else who has applied the view to their own case should now reconsider their position and, if necessary, amend any relevant tax assessments.

Much consternation and expense could have been avoided if the law had been made clear as originally proposed, or the ATO had published a public ruling on the issue which presumably its staff would have located in coming to a view on the recent private ruling.

Life and remainder interests: some discrete issues

When we talk about life and remainder interests, we are generally referring to a situation where an asset is held on trust for the benefit of an individual for their life, with the remainder interests held for someone else (interests held via a trust are commonly referred to as "equitable life and remainder interests"). On the death of the life tenant, the remainder beneficiary generally becomes entitled to have the asset transferred to them.[40]

Trusts that create life and remainder interests often arise under a person's will. For example, a will may provide that a dwelling is to be held on trust for the benefit of the individual's second spouse for life, with the remainder to benefit the children of the individual's first marriage.

There is a difference at law between a life interest and a simple right to occupy. For example, a life interest carries an entitlement to income from the property and a right to occupy if that is specifically provided for. And each has different tax consequences. There is often a difference of views between the parties as to the nature of the interest that the deceased's will creates. This is a legal question that must be resolved before the tax consequences can be determined.

The ATO's views about the CGT consequences of life and remainder interests are set out in TR 2006/14. The ruling effectively ended a debate that had been raging since the CGT provisions were introduced in 1985 about how those provisions applied to life and remainder interests. TR 2006/14 is relatively comprehensive and considers a range of scenarios, including the creation of the trust, a disclaimer of a life interest, and the death of a life tenant. But there are things that it doesn't address and it would be useful for the ATO to revisit the ruling with a view to giving a view about them.[41]

Surrender of life interest

It often happens that the beneficiaries in a life/remainder trust will seek to bring the trust to an end after a number of years. TR 2006/14 addresses cases where, in doing so, the life tenant and remainder beneficiaries each acquire an interest in the trust assets.[42] However, it often happens that the life tenant will simply surrender their interest for no consideration.

Are there any CGT consequences for the life tenant from the surrender in these circumstances?[43]

CGT event E6[44] will not happen as there is no trust property being transferred to the life tenant in respect of the ending of the right to trust income. Accordingly, it is necessary to consider how CGT event C2 (the ending of an intangible asset) might apply. Before doing so, however, it is useful to consider how CGT event E6 might apply if the trustee paid the life tenant a nominal amount of consideration (say, $10).

CGT event E6 happens if the trustee of a trust disposes of a CGT asset of a trust to a beneficiary in satisfaction of the beneficiary's right to income of the trust. The trustee will make a capital gain or loss in respect of the asset. Also, the beneficiary will make a capital gain or loss in respect of their trust interest if the market value of the trust asset it receives is more than the cost of the base/reduced cost base of the life interest.

First, it needs to be determined whether the $10 is a relevant "CGT asset" that would trigger the operation of the provision. The ATO had for many years indicated on its "advice under development" website page that it intended to provide advice about whether Australian currency, or Australian currency denominated assets, were CGT assets for the purposes of CGT events E5 to E7. Recently, the ATO has removed those topics from the website on the basis that they were no longer a priority for them!

If the $10 is an asset, the trustee will make no gain or loss from it. The beneficiary will presumably make a capital loss on their interest equal to the difference between the $10 and the market value of the interest at the time it was acquired.[45] This loss could be considerable if, for example, the interest was acquired many years ago when the life tenant was relatively young. The main residence exemption would not apply to disregard the capital loss.[46]

Are the consequences the same if CGT event C2 is the relevant event?

CGT event C2 happens if your ownership of an intangible asset ends in one of a number of ways, including by surrender. You make a capital gain if the capital proceeds from the ending are more than the asset's cost base, or a capital loss if the proceeds are less than the asset's reduced cost base.

Unlike for CGT event E6, the market value substitution rule in s 116-30 ITAA97 will apply to determine the capital proceeds if there are no proceeds, or if the proceeds are more or less than the value of the asset if the parties did not deal at arm's length.

Also, unlike for CGT event E6, the main residence exemption applies to a capital gain or loss from CGT event C2. Although it is an issue for another day, one wonders how the main residence exemption applies where the trust assets consist of more than the property in which the life tenant has a relevant ownership interest for main residence purposes. Presumably, an apportionment would be appropriate.

Conclusion

As a practice that has specialised in the taxation of deceased estates and trusts for over 23 years, it is rare that a week goes by where BNR Partners does not encounter a little tax monster.

These "Frankensteins" often arise from the particular circumstances of each individual estate, be that from the affairs of the deceased, the assets they owned, or the geographical locations of the beneficiaries and executors. But many problems have, at their core, a failure by government to amend the law or of the ATO to provide clear guidance on how it considers the law to operate.

Anomalies in the tax law expose executors and administrators, as well as tax practitioners, to unnecessary risk and often come at a significant cost to revenue. While governments tend to be reluctant to make law changes that affect deceased estates, the Robodebt issue has highlighted that defective laws should be reviewed to protect those that are affected by them.

And while that may take some time to achieve, we should surely be able to look to the ATO to provide updated guidance on such matters as those highlighted in this article within a reasonable time frame.

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References

1 Div 6 of Pt III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

2 Subdiv 115-C and Subdiv 207-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

3 S 95(1) ITAA36.

4 *FCT v Bamford* [2010] HCA 10.

5 IT 2622 was introduced prior to the introduction of the self-assessment regime. The views in the ruling are not binding on the ATO in the same way as public rulings in respect of which the rules in Div 358 of the *Taxation Administration Act 1953* (Cth) apply.

6 *FCT v Whiting* [1943] HCA 45.

7 *Greenhatch v FCT* [2013] HCATrans 104; *FCT v Greenhatch* [2012] FCAFC 84.

8 PBR 1051760637680.

9 PBR 1051346488294.

10 PBR 1051630156354.

11 PBR 1051346488294.

12 *Union Fidelity Trustee Co of Australia Ltd v FCT* [1969] HCA 36.

13 S 115-228(1) ITAA97.

14 S 95(2) and (3) ITAA36. There is another definition that applies for CGT purposes, but it is not relevantly different in this instance.

15 Compare, for example, s 99(4) which applies to resident trusts, and s 99(5) which applies to non-resident trusts.

16 "Taxable Australian property" is defined in s 855-15 ITAA97. Mainly, it refers to interests in Australian land, including some indirect interests held via companies and trusts.

17 Significantly, shares in Australian listed companies will generally not be TAP.

18 If the deceased were a foreign resident, their assets were always outside the Australian tax net. If they appoint an Australian resident as their executor, the executor is taken to have a market value acquisition cost (based on the value at the date of death).

19 Some people might wonder if the full discount is available to the trustee or in respect of the non-resident beneficiary's share of the capital gains. These are valid questions, but topics for another day.

20 Section 99B (discussed below) does not apply if a beneficiary is a foreign resident for the entire income year in which a distribution is paid.

21 Inspector-General of Taxation, Australian Government, *Death and taxes: an investigation into ATO systems and processes for dealing with deceased estates*, July 2020, recommendation 6.

22 Section 99C ITAA36 sets out when an amount will be taken to have been applied for the benefit of a beneficiary.

23 The provision is drafted broadly and could apply to any trust, although it appears to be the ATO practice to apply it mainly to foreign trusts or trusts that were at one time foreign trusts.

24 S 99B(2) ITAA36.

25 *Peter Greensill Family Co Pty Ltd (trustee) v FCT* [2021] FCAFC 99.

26 *N & M Martin Holdings Pty Ltd v FCT* [2020] FCA 1186.

27 S 272-5(1), Sch 2F ITAA36. Subdivision 272-A, Sch 2 ITAA36 contains rules about determining whether beneficiaries have fixed entitlements.

28 For completeness, it is noted that, if the executor had transferred shares to Dudley, CGT event K3 would have happened, with possible gains and losses being recognised in the deceased's final income tax return.

29 Section 100A is about reimbursement agreements. For more information, see TR 2022/4.

30 ATO ID 2010/55.

31 Note that PCG 2019/5 outlines the circumstances where a taxpayer can self-assess an extension of the two-year period in s 118-195 ITAA97.

32 The rule for pre-CGT dwellings that are taken to be acquired for market value is different. It makes the appropriate adjustments to the non-main residence and total days periods.

33 Div 128 ITAA97.

34 One acquired on or after 20 September 1985.

35 S 104-215 ITAA97.

36 For more information, see the Hon. Arthur Sinodinos, the then Assistant Treasurer, "Integrity restored to Australia's tax system", media release, 14 December 2013.

37 QC 58416.

38 See edited version of PBR 1051943938848.

39 See, for example, T Donlan and A Manapakkam, "Tax on dying of a broken heart …two years on", (2023) 57(7) *Taxation in Australia* 419.

40 Life and remainder interests can also be legal interests, but these are not considered in this article.

41 Michael Flynn has written extensively on this topic. His papers would also be a useful starting point for the ATO.

42 See example 4 in TR 2006/14.

43 The ATO issued a private ruling in February 2023 (PBR 1052085239358) indicating that a capital gain from the surrender of a life interest was disregarded. It is unclear from the face of the edited version how this conclusion was reached. Possibly, it might have been on the basis that the main residence exemption applied to the gain from CGT event C2 happening to the interest (the main residence exemption does not apply to a capital gain from CGT event E6).

44 S 104-80 ITAA97.

45 The value of life interest is something that must be determined by actuarial calculation.

46 S 118-110(2) ITAA97. Note that, even though s 118-195 ITAA97 may apply in relation to the trustee's ownership interest in a dwelling, the life tenant has a different ownership interest which is to be considered under s 118-110.