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Tax 101 – the prequel

Equity Trustees: Sir Ninian Stephen Lecture

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Speaker profile

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Ian is the Managing Director of BNR Partners and has specialised in the taxation of deceased estates since 2000. He commenced his career in public practice in Tasmania working predominantly with SME's, prior to 'migrating' to Australia in 1998 and commencing his career with BNR Partners.

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 held 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 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.

He is actively involved in the professional arena and was a 2017 finalist in the Tax Institute of Australia's SME Tax Advisor of the year Awards and the recipient of CPA Australia's 2016 Henry Fox Award for services to Public Practice.

Ian is a fellow of both CPA Australia and of Chartered Accountants Australia and New Zealand. He is also a Certified Tax Advisor of the Taxation Institute of Australia, a member of the Society of Trusts and Estate Practitioners and a graduate member of the Australian Institute of Company Directors.

Ian is a current sitting member of CPA Australia Taxation Centre of Excellence, the immediate past Chair of the Society of Trust and Estate Practitioners Australia Limited and sits on the Planning Advisory Committee for the College of Law for their Master of Applied Law programs.

Tax issues arise throughout the administration of a deceased estate

When you mention 'tax' to many estate practitioners they think of tax file numbers, tax returns, tax-free thresholds and tax liabilities (in short something for the estate accountants). Tax in this sense is often one of the last things practitioners turn their minds to as part of the estate administration process.

But tax in a broader sense can be relevant from the first time you meet with a client about a new estate.

Through a series of common scenarios, this paper highlights how tax-related issues arise and why it is important to be alert to them throughout the entire administration process. [We've called this paper 'Tax 101: the prequel' because it covers a range of issues not covered by people's basic idea of tax in a deceased estate context.]

The scenarios are ones which often arise in practice. While not all issues will be relevant in every estate, it is best to have actively considered an issue and rejected it than to have simply ignored it and relied on chance.

Scenario 1 - probate application

Imagine you are meeting with a new client whose surviving parent has recently passed away. Your client who moved to the United States more than 30 years ago, is named as executor of the Will.

The estate consists of a large share portfolio with significant inherent capital gains. 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.

What tax-related warning lights should be flashing in your mind?

The main issue you should be alert to is the residency of the estate for tax purposes. An estate (which is treated as a trust for tax purposes) will be resident in Australia if there is a 'trustee' (that is, a legal personal representative) who resides here or if the central management and control of the estate is in Australia at any time during an income year.

In this scenario, as the proposed executor is a non-resident the estate will be a non-resident trust estate if the nominated child proceeds to obtain probate. We understand that often a foreign LPR may appoint an attorney in Australia to make an application for /letters of administration . The ATO regards the attorney as a resident trustee with the result that the estate would be a resident trust in these circumstances.

So, before you apply for probate, you should discuss the tax consequences of the estate having a non-resident LPR or a resident LPR.

One consequence of being a non-resident estate is that to the extent the LPR is taxable by assessment, a foreign LPR will pay tax at a higher rate than a resident LPR.

Another consequence is that capital gains from assets that are not taxable Australian property[1] are not required to be included in the net income of a foreign trust. [Significantly, shares in Australian listed companies will generally not be taxable Australian property.]

So, in this scenario, if your client is the sole executor of the estate, any capital 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 your client the distribution will not be assessable in Australia. The downside however is that a distribution of an amount attributable to a capital gain to a resident beneficiary is potentially assessable to the beneficiary under section 99B of the ITAA 1936 without the benefit of the CGT discount.

Section 99B has been part of the tax law for a long time but is only now receiving real attention from the ATO. The ATO has indicated that it intends to publish guidance on the application of the provision by mid-2024. In a private ruling, the ATO recently ruled that section 99B operated to tax part of a legacy payable under a deceased's Will. That case highlighted the importance of solicitors who are acting for a non-resident LPRs keeping their accounts in a manner which could identify the source of funds used to pay legacies.

By comparison, if the estate were a resident estate, the capital gains (reduced by the 50% CGT discount) would be assessed to the LPR or the beneficiaries (depending on the operation of the general rules that apply to assessing trust capital gains).

We are not suggesting that the tax tail should wag the estate administration dog. But issues associated with the residency of the LPR should be canvassed at the outset. There is no one answer that is 'right' (from a tax perspective) in every case. Much will depend on the residence of all of the beneficiaries, the assets that form part of the estate and the capital gains that would otherwise arise from the sale of the assets.

Scenario 2 - identifying beneficiaries that particular tax considerations

Now imagine that your client is the daughter of a deceased individual and has come to see you about her father's Will and the estate administration process.

The Will provides that the deceased's shares are to benefit certain charities, his land in Australia and overseas is to benefit his son and the remainder is to benefit your client.

At the time the Will was drafted (2010), the son lived in Australia but he has lived in the United Kingdom since 2015. Your client and the deceased have always been Australian tax residents.

[1] Taxable Australian property is defined in section 855-15 of the ITAA 1997. Mainly it refers to interests in Australian land including some indirect interests held via companies and trusts.

What tax-related issues come to mind from these facts?

The first thing that likely springs to mind is the fact that a CGT event might happen in the deceased's final income tax return if land in Australia is transferred to a foreign resident or assets of the deceased are transferred to a charity (noting that there is an exception if the charity is also a deductible gift recipient.

FIRB rules

Many people however are not aware that the Foreign Investment Review Board (FIRB) rules now apply to the acquisition by a foreign person of relevant assets under a Will (though not as a result of an intestacy). These rules are not tax rules, (even though those relating to residential properties are administered by the ATO) but they can have tax consequences if an asset is sold in order to comply with them.

We understand that there is a degree of uncertainty about the meaning of 'foreign person' in this context. THE FIRB website[2] says:

> An Australian citizen who is living overseas **may be a 'foreign person'** as defined in the Act. There is no specific rule in the Act for determining whether or not an Australian citizen is ordinarily resident in Australia.

On the other hand, the ATO website[3] says:

> Broadly, the definition of a foreign person extends to:
>
> - an individual who is not an Australian citizen or permanent resident..

The FIRB rules will most commonly apply to Australian real estate and they apply differently depending on the type of property (agricultural, business, commercial or residential).

A foreign person who acquires an interest in residential property under a Will is considered to have taken a notifiable action and must notify the Register of Foreign Ownership of Australian Assets within 30 days. Notification fees for established residential properties are broadly in the range of $44,100 for acquisitions of $1 million or less to $3,514,800 for acquisitions of more than $40 million. [4]

In respect of residential property, non-residents generally will not be able to retain an existing dwelling that passes to them under a Will but may be able to retain vacant land subject to conditions relating to construction of a dwelling within five years. A failure to give notice of a relevant acquisition also carries penalties.

[2] See Guidance Note 2
[3] QC72880
[4] Fees are indexed annually.

It's important to understand the rules because your clients won't thank you if you transfer a property and they then have to pay significant notification fees only to be told they have to sell it.

FIRB Guidance Note 2[5] indicates that a beneficiary is taken to acquire a relevant interest on completion of the administration of the estate. That is, FIRB acknowledges that they could not be expected to seek foreign investment approval prior to that time.

These examples are from Guidance Note 2[6]

> *Example 50*
>
> *John is a foreign person. On 1 December 2020, his sister Mary, who is a resident of Australia, dies. In her will, Mary bequeaths to John an interest in vacant residential land and an established dwelling in Sydney. The executor of Mary's estate obtains probate. The administration is completed when all the debts are satisfied and bequeaths transferred to beneficiaries. The title of each of the Sydney properties (sic) are registered with the land titles office in John's name on 30 June 2021. John has 30 days from 30 June 2021 to submit a foreign investment application for each interest respectively.*
>
> *John could apply prior to 30 June 2021 if he is certain he will acquire the legal interests, for example if he is advised by the executor that administration has been completed and that he will acquire the interests, or where the transfer of each interest has been executed and the only remaining step is finalisation of the registration of the signed transfers of title for each interest.*
>
> *If John's application for an interest in vacant residential land is approved, it will generally be approved subject to several factors and approval conditions. See Guidance Note 6: Residential Land for general approval conditions for vacant residential land.*
>
> *John would also be required to apply for approval regarding the interest in an established dwelling. This will generally not be approved unless an exemption applies (such as having an Australian resident spouse) or the acquisition is not contrary to the national interest. Where there is no applicable exemption, but the acquisition is within the national interest, for example if the established dwelling is being redeveloped to increase the Australian housing stock, conditions relating to the redevelopment may be imposed. If John is a temporary resident holding the correct visa type, he will generally be eligible to acquire an established dwelling as his principal place of residence. Where there is no applicable exemption and the acquisition is considered contrary to the national interest, John would generally be required to dispose of his interest within six months of acquiring the legal interest in the land. See Guidance Note 6: Residential Land for general approval conditions for established dwellings.*
>
> *Example 51*
>
> *Ella is a foreign person and is bequeathed an interest in vacant land in a Will. The Will has been administered and Ella is now registered as the title holder of the vacant land. She will be required to notify of her interest in the Australian land. If Ella is approved to hold the interest, this may be subject to the vacant land development conditions. See the Residential Land Guidance Note, for further information.*

[5] Available on the FIRB website
[6] Dated 4 July 2023

Charity beneficiaries

We are seeing more cases where tax-exempt beneficiaries are challenging LPRs about their approach to the estate's tax issues. In fact, there are bodies such as Bequest Assist whose function is to assist charities maximise their estate entitlements.

Issues can arise, for example from:

- *a failure by the LPR to consider whether the beneficiary should be made presently entitled to the income of the estate or specifically entitled to the estate's capital gains during the estate administration, or*
- *a decision by the LPR whether to sell or transfer estate assets to a beneficiary.*

These are discussed in more detail in scenario 6.

The take-away message is simply to be alert to the possibility of tax issues arising simply because of the characteristics of the beneficiaries and have a plan to address them.

Scenario 3.1 - understanding the ownership history of the estate assets

The deceased appointed your client as executor of his estate to avoid disputes between his children in relation to the estate administration.

Your client is looking for tax advice in relation to the sale of a holiday home that has been 'in the deceased's family for years'. Its current value is $3 million. The children have advised your client that the property was purchased by their parents in 1968.

You are aware that if a pre-CGT dwelling is sold within two years of the death of an owner that there are no CGT consequences.[7] But if you advise your client that this will be the situation for the beach house, you might be leaving yourself exposed.

What questions should come to mind?

If the property was originally owned jointly by the deceased and his spouse, how did the deceased become the sole owner?

For example, if he acquired his wife's interest on her death after 19 September 1985, the deceased would be treated for CGT purposes as owning two separate interests in the property (one pre-CGT the other post-CGT).

The pre-CGT interest would be taken to have been acquired the LPR (your client) for market value on the deceased's date of death ($1.5 million).

[7] Section 118-195 of the ITAA 1997

Your client would acquire the other 50% interest for the deceased's cost base (based on market value on the date the deceased's wife died). If the wife died in 1987 when the property was valued at $500,000, there is a big discrepancy between the actual acquisition cost of the post-CGT interest ($250,000) and the one you might have assumed applied ($1.5 million).

If the property is sold within two years, only the gain from the deceased's pre-CGT interest will be disregarded. The capital gain before CGT discount from his wife's interest would be $1.25 million [$1.5 million - ($250,000 + other eligible cost base items like selling costs).] As the post-CGT interest was acquired before 1991, the deceased's holding costs cannot be added to the cost base, although those incurred by your client can be (because your client acquired the interest when the deceased died - well after 1991).

By way of contrast, if the deceased had acquired his wife's interest as the result of a marriage breakdown rollover, both of the deceased's interests would have been pre-CGT interests when he died.

So, probe the ownership history a bit further and do a full title history search if necessary.

Scenario 3.2 - record keeping obligations

Imagine that you have been appointed by the Court to administer an estate because there is a dispute about how that should be done.

The deceased owned many assets but there is little in the way of records to establish the cost bases of those assets.

You are hoping to simply distribute the assets to the beneficiaries having regard to their current market values and leave the beneficiaries to sort out the cost bases when they choose to sell the assets.

You wonder whether you have any CGT record keeping responsibilities as the LPR.

Subsection 121-20(1) of the ITAA 1997 provides that: 'you' must keep records that are or can reasonably be expected to be relevant to working out whether you make a capital gain or loss from a CGT event. It does not matter that the event may happen in the future. Subsections (2) (3) and (4) contain further information about the form the records must take. The relevant 'you' is the person who owns the asset and to whom a CGT event may happen. In this instance, you as executor, are the relevant 'you'.

Section 121-30 of the ITAA 1997 provides an exception to the requirement in section 121-20 to keep records. Essentially, the exception applies if any capital gain or loss 'you' make is disregarded

(except because of a roll-over[8]). While it is arguable that the provision could apply to an executor if all of the estate assets are to be transferred to beneficiaries, it is not clear that it can apply where some are sold (as not all capital gains or losses be disregarded).

The bad news is that a failure to keep relevant records carries various penalties. [It is not clear to us how the penalties might be applied – that is, whether it would be on a per asset basis or on the basis of each missing record! Even if it is on a per asset basis, remember that a parcel of shares is not one asset but many.]

The good news on the other hand is that the provisions recognise that records can be reconstructed. Subsection 121-20(5) indicates that if the necessary records do not exist, then you ***must*** reconstruct them or have someone else reconstruct them.

Where records have been reconstructed, we would assume that a penalty would only be applied for a future failure to keep the reconstructed records for the required period, not the original failure to keep records originally.

If you are required to establish or reconstruct the cost base of an estate asset, you must retain those records for five years after it is certain that no further CGT event will happen to you in respect of the asset. To translate, you must keep the records for five years after you have transferred an asset to a beneficiary or sold it. A failure to do so also potentially carries penalties!

If you are really concerned about possible penalties, you might apply for a private ruling to ensure that the ATO will accept your cost base reconstruction. A search of the ATO legal database indicates that it has given private rulings about the operation of subsection 121-20(5) mostly in the context of the cost of building improvements.

Scenario 4 - Timing issues

This scenario is intended to highlight various timing issues that you should be alert to throughout the administration of the estate.

You have been administering an estate for about five years, the deceased having died in July 2018. To date your main role has been to advise the executor in respect of various claims brought by other beneficiaries.

Your client hasn't done anything about lodging the deceased's final income tax return as none was required because the deceased's income was below the tax-free threshold.

[8] While the provisions in Division 128 operate like a roll-over and are colloquially referred to as the 'death roll-over', they are not are not a roll-over for the purposes of the legislation. This is explained in section 100-33 (which operates as a guide).

The estate has derived some dividend income in the intervening years, but again is probably entitled to a refund due to franking credits. In July 2021, superannuation death benefits were paid to the estate of the deceased.

The parties have now (2023) agreed to settle the litigation with your client being required to:

- transfer certain shares to a beneficiary resident in the United Kingdom
- pay the death benefit to the deceased's former spouse
- sell the main residence and divide the proceeds amongst the deceased's spouse and children.

Deceased's final income period

The share transfer will trigger capital gains under CGT event K3 which happens (amongst other things) when a share (being non-taxable Australian property) that the deceased owned is transferred to a non-resident beneficiary. Capital gains and losses from CGT event K3 are taken into account in the deceased's date of death assessment.

Imagine that the transfer triggers a CGT liability of $100,000. This has to be funded from the estate. However, there is a well-known defect with the provision. Effectively, if the CGT event happens outside the amendment period for the deceased's final assessment, the tax cannot be collected.

In this instance the liability could have been avoided if a final tax return had been lodged for the period from 1 July 2018 to 18 July 2018 (effectively the deceased's 2019 return).. Any amendment to include the capital gain would be outside the amendment period. [Note that a nil assessment constitutes an assessment for amendment period purposes.]

Death benefits

An LPR pays tax on a death benefit paid to the deceased's estate. Different rates of tax apply to the LPR depending on whether the death benefit will benefit a 'dependant' of the deceased.

The ITAA does not specify a time when the test about a dependant benefiting or expecting to benefit, must be satisfied. However, given the reference in paragraph 302-10(2)(b) of the ITAA 1997 to present entitlement and the link to subsection 101A(3) of the ITAA 1936, 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. The ATO has confirmed this view on their website recently.[9]

[9] QC45254 Paying superannuation death benefits.

For example, if at 30 June in the year a death benefit is paid to an LPR, it is not possible to determine who would benefit from it because of on-going litigation, the LPR will be taxable on the basis that it would not benefit a dependant. The fact that the parties subsequently agree to pay the amount to the deceased's spouse does not change the tax outcome for the relevant year. It might have been preferable to seek to defer payment of the death benefit to the estate until after the litigation had been resolved.

Main residence

Assuming that the spouse has not continued to reside at the property, you will have to seek an exercise of the Commissioner's discretion to extend the two-year period within which a main residence must be sold in order to qualify for a full main residence exemption. You should keep records explaining the delay.

Scenario 5 - Charity beneficiaries

Now imagine that your client is the executor of a Will where the estate has been left to one or more charities. You have been proceeding with the administration and certain assets have been sold and income derived. In mid-August, you decide to refer the preparation of the estate tax return to an accountant. But should you have been thinking about tax before 30 June?

For tax purposes an estate is treated as a trust. At a broad level the 'net income' of a trust (essentially its taxable income) is assessed to those beneficiaries who are presently entitled to the trust 'income'. In an estate, the income would be ordinary income (that which a life interest holder would be entitled to). To the extent that there is income to which no beneficiary is presently entitled (or if there is no trust income), the trustee will be assessed on the net income.

A beneficiary is presently entitled to trust income if they have a present or immediate right to demand payment of it from the trustee. The ATO views about present entitlement in the context of a deceased estate are set out in Income Tax Ruling IT 2622. That ruling acknowledges that a beneficiary can be presently entitled to trust income prior to the completion of the administration of an estate.

In some instances, a failure by an LPR to make an interim distribution can result in tax being paid unnecessarily. Consider this simple example.

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 and its net income was also $250,000.

Near the end of that income year it was clear that Daryl would not need the $250,000 estate income to satisfy debts or other claims, however he did not make the charity entitled to the income. Daryl was assessed as executor on the net income of the trust and paid tax of $89,055.

However, if Daryl had made the charity presently entitled to the income (and complied with section 100AA and 100AB of the ITAA 1997) no tax would have been payable. That is, the charity, being presently entitled to all of the estate income, would have been assessable on all of the net income however no tax would have been payable because the charity is tax exempt. In effect, the charity lost $89,055 of the bequest that Monty had left it.

In one case we were involved with, the executors of an estate 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 ten beneficiaries; many were friends of the deceased but one was a tax-exempt hospital. As there was no estate income in this case, the LPR was prima facie liable to pay tax on the net capital gain (the capital gain after the CGT discount).

However, the executors streamed the capital gain to the hospital (in partial satisfaction of its entitlement under the Will) with the result that no tax was payable on the gain by the executors or the other beneficiaries.

That is, if a capital gain is streamed to a beneficiary, that beneficiary is taxed on it (rather than the estate tax being determined on the basis of present entitlement to trust income). In this case, the beneficiary who was otherwise assessable did not pay tax because they were tax-exempt.

Another alternative 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.
In effect because the LPR was 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 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 our experience, the ATO has accepted that a power of appropriation in a Will or like that in section 46 of the *Trustee Act 1925 (NSW*) is sufficient to enable streaming of capital gains by an executor.

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, 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.

- 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.[10]

'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 section 102-5 of the ITAA 1997) but before the application of the CGT discount.

Conclusion

Hopefully these few scenarios demonstrate that tax in an estate context isn't just about getting tax returns prepared (sometimes at the end of the administration!).
You should create a checklist for issues to consider throughout the administration. Our 'back pocket guide' can help in this regard.

[10] subsection 115-228(1)