Death & Taxes Conference

Entitlements and taxation of estate income [and capital gains]

Presented at the Death & Taxes Conference on 23 – 24 October 2025

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The author acknowledges with thanks constructive criticisms and suggestions on a first draft of this paper from his colleagues at BNR Partners, Lyn Freshwater, Dr Kate Roff, Ian Raspin and Irene Liew. Any errors remain those of the author..

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1. Introduction

The rules regarding the taxation of estate income and capital gains could be much clearer and less complex. That they are not is a product of various factors including the often uncertain (or inappropriate) interaction between succession law and tax law; changes in the general trust tax landscape affecting deceased estates (such as streaming); and ambiguous tax law more generally.

Key representative bodies in the deceased estate 'industry', including the Tax Institute and STEP, have made detailed submissions to Government, the Treasury and the ATO dealing with areas of concern, involving both 'technical' and practical administration issues. With respect, it is fair to say that responses to date, in terms of comprehensiveness and timeliness, have fallen short of what was hoped for. No one pretends, however, that many of these issues are easy to resolve. And the ATO has clearly been actively progressing some issues discussed in this paper, such as the 'double death' problem, and the 'right to occupy' test in the main residence exemption for deceased estates.

This paper deals almost exclusively with technical issues. Two types can be identified. Ones where the law is actually defective, and the other where the issue is resolvable by virtue of an interpretative product (e.g. a public ruling), or a practical compliance guidance (PCG).

In relation to defective issues, some were flagged for amendment in budget announcements of years gone by, then later 'ditched' for lack of priority. These have fallen back into the ATO's bailiwick, and in the author's view that is neither reasonable nor fair. These were not 'clarifying' amendments but ones where it was generally agreed the issues could not be satisfactorily administered by the ATO. Curiously, some of these defects have significant revenue consequences, such as weaknesses in CGT event K3. The ATO should, in the author's opinion, not have to administer defective law or 'make it up'. Recent cases such as *BBlood*[1] and *Ausnet*[2] may suggest ways to interpret around some of these problems where the law does not work on a plain reading, but this will not solve everything.

In the author's opinion, the need in Australia for detailed tax legislation (and any corrections) to pass through the parliament is inferior to the approach in the US where the 'main' tax provisions only are in the Code, and a system of draft and final Treasury regulations (which may be challenged in the courts) are where the detail is sorted out.

In relation to issues resolvable by the ATO, it has not in recent years issued sets of Tax Determinations or omnibus Rulings dealing with a range of industry issues (such as those previously issued affecting the horse industry, or the retirement village industry). In the author's view, such products may have usefully covered a range of deceased estate industry issues in one place. On an issue by issue basis, a difficulty for getting priority may lie in the complexity of resolution (including policy questions) and that a major revenue risk cannot be demonstrated.

The answer may lie in the use of PCG's either for particular issues or groups of issues. Flags on the beach where it is safe to swim, or green and red lights, would at least indicate to LPR's and practitioners where the ATO's compliance resources are likely to be devoted. It is hoped that there are not currently too many beaches, or not enough flags, or both!

There are key features of deceased estate tax issues that suggest to the author that significant attention ATO is warranted.

[1] *B&F Investments v FCT* [2023] FCAFC 89 on the s207-35(6) issue. See also Thawley J at first instance (2022] FCA 1112.

[2] *AusNet Services Ltd v CofT [2025] FCAFC 21.* See also Hespe J at first instance [2024 FCA 90.

Firstly, people administering deceased estates, who may bear a personal liability, tend to be highly risk-averse, and this is especially so where they are legal or accounting practitioners (or are advising in that capacity). They want certainty as to tax outcomes. The taxation of deceased estates is highly 'technical', and is not just a mechanical process.

Secondly, and this derives from the first point, is the presence of high compliance and administration costs, and the risk of inadvertent non-compliance. If there is no general ATO advice product, there is the option of a private ruling (or advice from a tax practitioner who can be sued if the advice is wrong). Both processes can involve high compliance costs (and administration costs if the private ruling route is taken). There is also a high risk of non-compliance in areas where there is no ATO product at all and for some reason the person handling the estate does not seek expert tax advice. This is an audit risk for the ATO.

With this context in mind, this paper will provide an overview of many of the key 'technical' issues arising in the taxation of deceased estate income (including gains). It will not deal with GST. It will also not deal with s102AG ITAA 1936 (excepted income and the taxation of minors) as there are many excellent papers already dealing with that area and the changes made to it a few years back.

The paper will start with a discussion of some fundamental general law and tax concepts relating to deceased estates, and then move on to who may be taxed on income and capital gains as the administration of the estate unfolds, and what 'entitlements' may be relevant. The various CGT rules that apply as assets of the deceased (and those acquired by the estate by other means) pass to beneficiaries or are sold will also be briefly covered, with some concluding comments on dwellings and main residences.

This paper will deal only with what are generally referred to as 'tax technical issues' and not with issues such as returns, file numbers, consents etc. except briefly.

In some cases, the paper makes references to trusts as including both deceased estates and testamentary trusts (which is the case for tax purposes). But as explained below this is not so under the general law (including succession law) and where relevant those principles may need to be applied in particular contexts.

The paper refers to legal personal representatives (LPR's) in most instances while noting that in some cases (e.g. intestacy) administrators will perform similar tasks. The paper refers to the ATO or to the Commissioner of Taxation as context dictates. Legislative references are to the Income Tax Assessment Act 1997 (as amended) (ITAA 1997) unless otherwise indicated.

The paper focuses on some of the more nuanced issues on the topic and does not purport to 'cover the field' of estate taxation. For those new to the area, or seeking a refresher, the author can thoroughly recommend the 3rd edition of the BNR publication 'Taxation of Deceased Estates for Estate Practitioners' by Ian Raspin and Lyn Freshwater. This is available from the BNR website (bnrpartners.com.au).

2. Some fundamental concepts

2.1 What happens for tax purposes after death of an individual?

A deceased estate arises immediately after death, although for many tax purposes the conventional wisdom is that there is a 'date of death' and the estate has to be accounted for tax purposes from the next day. A tax return to the date of death may be required for the deceased.

For larger estates, and where transfers of real property may be required, it is often the case that probate is obtained. Probate may not be obtained especially for smaller uncontested estates where real property transfers are not required[3].

The Commissioner's old ruling IT 2622 (Income Tax: Present entitlements during the stages of administration of deceased estates) states that even though a Will may provide beneficiaries with interests in the capital or income of the estate, these interests do not crystallise until probate is obtained. On another view, it is the LPR's assent to a gift that crystalises the interest, and this can occur at different times for different gifts (e.g. the LPR can assent to a gift of a specific asset even though the residue has not been determined). Once the LPR has assented to a specific gift, the beneficiary's interest in it vests at death, and relates back because the Will and not the assent confers the gift. The residue is different because the Will does not confer a right to specific assets. When the residue is ascertained, and the LPR assents to the residuary gifts, the LPR becomes a trustee of the residue for the residuary beneficiaries in their respective shares.

Beneficiaries have no rights to estate income or assets while the estate is being administered. They have a right to enforce due administration only.

2.2 A deceased estate is not a trust at general law but it is for tax purposes.

A deceased estate is not a trust for general law purposes, nor is the LPR/administrator a trustee. It is a fiduciary relationship, subject to succession law and the general law.

A deceased estate is, however, treated as a trust for tax purposes. Primarily, this is the result of the broad definition in the ITAA's of 'trustee' (e.g. see s6(1) ITAA 1936) to include an LPR or administrator and the implicit acceptance in leading case law such as *Whiting*[4] that the deceased estate comprises a trust estate for tax purposes.

While the deceased estate is treated as a trust for tax purposes, what the LPR is able to do with the assets and income of the deceased estate is governed by succession law and the general law, and not (generally) by tax law, though what is done will have tax consequences.

For example, while it might be efficacious for tax minimisation reasons to make interim distributions to some entities but not others, whether that can be done depends not on tax law considerations. If there are four residuary beneficiaries including one charity, and a capital gain you want to give to the charity as an interim distribution, but nothing to the rest, can you do that as a matter of succession law?

[3] The situation varies in each State jurisdiction, with the result that it is hard to handle tax with a 'one size fits all' approach.
[4] *FCT v Whiting* (1943) 68 CLR 199

Particular powers of a trustee e.g. to appropriate assets to satisfy proportional entitlements of beneficiaries, or to give assents, derive from succession law and the general law, not tax law. In many States there are restrictions on making effective appropriations. The law regarding assents is not straightforward either.

The key message is that before considering what might be achieved for tax purposes, it is necessary to see whether it can actually be done.

It should also be noted that Wills, unlike modern testamentary trusts, traditionally have not included provisions aimed at securing more favourable tax outcomes such as streaming provisions or income equalisation clauses (where distributable trust income is equated to s95 ITAA 1936 net income). Whether they can validly be included in Wills is again not a question of tax.

An important thing to observe is that while the estate is being administered, it will not be a fixed trust for tax purposes because beneficiaries will not have a vested and indefeasible interest in all the income and corpus of the estate.

However, once administration is complete, fixed trust status may be obtained which may be relevant for such things as loss utilisation or s855-40 (where non-resident beneficiaries of a resident trust are not taxed on non-taxable Australian property (TAP) asset gains).

2.3 The deceased estate and any testamentary trust arising from the Will are different tax entities

This is the correct technical position and different file numbers will usually be required. Particularly in the past, however, there has been a degree of 'blur' in the way the ATO has approached this – see IT 2622 for example – and the well-known CGT concession for assets of the deceased passing to beneficiaries of testamentary trusts in PSLA 2003/12. Also, the ATO does not seek to contend that once administration of an estate is complete in relation to an asset, the asset is then held on a trust for distribution that is separate from the estate. But a normal testamentary trust established pursuant to the Will – e.g. a life estate, or a discretionary testamentary trust will obviously be a separate tax entity from the estate.

2.4 The tax residence of the deceased estate is a critical issue!

Many implications may flow from the tax residence of a deceased estate[5].

Without getting into all the residency test details, it is sufficient to note that if the LPR (or any one of several LPR's) is tax resident in Australia, then the trust (estate) is tax resident in Australia under domestic tax law. This is so even if that is the only connection the estate has with Australia (i.e. the deceased was a non-resident, and all assets and beneficiaries are located overseas). In terms of taxation of the estate, prima facie, all its income and gains (irrespective of source) **may potentially** be taxable in Australia, subject of course to treaties etc. As discussed later in the paper, foreign source income or gains may not end up being taxable in Australia but complexities can arise.

[5] BNR Partners, STEP and the Tax Institute have advocated for a law change that would give the deceased estate the same tax residence as the deceased. This would ensure the issues here did not arise. Such an approach is consistent with the way the law applies in the UK. .

Sometimes the deceased estate will be a non-resident even though the deceased was resident (e.g. if the LPR is a non-resident and the estate is not centrally managed and controlled in Australia) with the result that foreign source income and capital gains may no longer generally be taxed in Australia. Section 99B may catch amounts distributed to resident beneficiaries, and CGT event K3 issues may arise for non-TAP assets of the deceased that pass to non-resident beneficiaries.

Changes in residence of the deceased estate also produce complex outcomes, especially under the CGT provisions. For example, if the LPR becomes a non-resident this can cause CGT event I2 to happen to all non-TAP post-CGT assets of the estate. This can then raise some interesting issues if the assets are sold and the proceeds paid to estate beneficiaries who are resident, or if the assets are distributed *in specie.* Section 99B will have to be considered.

A change from non-resident to resident status of the estate may result in stepped-up cost bases for non-TAP assets. Again, s99B may have to be considered for subsequent distributions to non-resident beneficiaries because its scope of application is not limited by the ATO to non-resident trusts where the trust has previously had that status.

3. Basic Estate taxation (subject to streaming rules for capital gains and franked dividends)

3.1 Present entitlement to trust income is still the default rule

The basic operation of trust taxation is well understood by most, but not all, so it is useful to provide a brief outline before considering streaming. Note that streaming requires the trustee to do something, so if that hasn't happened what follows is the default position, .

The deceased estate or testamentary trust, being a trust 'entity' for tax purposes, is not a legal person or a taxpayer and so cannot be assessed to tax on income and capital gains. The possible 'taxpayers' are therefore beneficiaries and the trustee.

In general terms, provided there are beneficiaries presently entitled to **all** of the income of the trust estate (trust income), the trustee will not be assessed under s99 or s99A as explained below. In general, the beneficiaries will be assessed (see s97 ITAA 1936). In some cases, as explained below, the trustee may be taxed in a representative capacity under s98 where a beneficiary is under a legal disability (e.g. minority) or is a non-resident at the end of the income year, and the beneficiary may also be taxed with allowance for any tax paid by the trustee.

We know from the *Bamford* case that trust income is a trust law concept, which is the distributable income of the trust according to trust law and what the deed, if relevant, says. Some deeds purport to equate trust income with s95 net income (as explained below), but in the case of a deceased estate it is generally accepted that the distributable trust income will be ordinary gross income less relevant expenses. It would not include capital gains which are capital in nature. Testamentary trusts may (and often do) have their own definitions of 'trust income'.

But it is not the trust income on which the beneficiaries are assessed – that just facilitates a mechanism or 'bridge' to bring another amount to tax. Beneficiaries are actually assessed on all of the trust's net income (a tax law concept, akin to 'taxable income', and defined in s95 ITAA 1936).

In technical terms, each beneficiary is assessed on a 'share' (proportion or percentage, not quantum or amount) of the s95 net income that is the same as the beneficiary's share of the trust income.

Present entitlement means that a beneficiary has a present right to demand and receive trust income from the trustee (*Harmer).* Also, if a beneficiary has a vested and indefeasible interest in trust income they will be deemed to be presently entitled to it (s95A(2) ITAA 1936).

If beneficiaries are not assessed on all the net income of the trust, the trustee will be assessed on some or all of the net income either at progressive rates without the Medicare Levy (under s99) or at the top marginal rate of 45%, plus a 2% Medicare Levy (under s99A ITAA 1936).

In the case of *inter vivos* trusts, most often there are beneficiaries entitled (e.g. under a 'fixed' unit trust) to trust income, or made entitled to it (eg. by the exercise of the trustee's discretion in a discretionary trust).

Deceased estates are usually different. This is because, during the administration period it may be the case that there is no beneficiary presently entitled to the income of the estate.

Hence, it will be the trustee liable for tax on the s95 net income, usually under the progressive rates of s99 but possibly under the top marginal rate of s99A as discussed later. Because the tax outcome will often be lower under s99 (and certain other concessions available for s99 assessments are not available for s99A assessments, such as CGT discount), the LPR and beneficiaries are often keen to know which provision will apply. This is also discussed later.

Finally, it should be emphasised that not all provisions of the ITAA's are drafted in a way consistent with the way the High Court in *Bamford*[6] clarified the meaning of income and share in the context of present entitlement. In particular, there are a number of provisions which assume that a beneficiary presently entitled to an amount of income of a particular character that is included in the net income will include in their own assessable income that amount with that character, rather than a simple percentage of all the net income and hence a percentage of the individual components.

3.1.1 Superannuation death benefits

In the case of superannuation death benefits received by trustees of deceased estates, it is well known that there are no explicit timing rules to work out whether, in the absence of someone already benefiting, someone is expected to benefit. The better view is that this needs to be determined no later than the end of the income year in question.

Different implications flow depending on whether a person(s) expected to benefit is a death benefit dependant(s) of the deceased or not. If they are, they are treated as if paid directly to that dependant(s) and the estate is not assessed (see s302-60). If not, the estate may be taxed depending on the components.

But in each case, under s302-10(1)(b) and (2)(b), the benefit is taken to be income to which no beneficiary is presently entitled. The Explanatory Memorandum to those provisions says the aim is to avoid any double taxation (presumably to the beneficiary and to the estate). The death benefit is not to be taxed according to usual trust taxation rules based on present entitlement to income.

However, the actual effect of deeming the amount to be income to which no beneficiary is presently entitled is unclear, and the provision may well be defective. Firstly, a death benefit may not be ordinary income of the estate, so if not, does this provision deem it to be income? Secondly, if it is income, by deeming no present entitlement, this may affect the way that other amounts of estate net income are taxed, and this is clearly not intended. So, for example, if there is a $100 death benefit treated as income to which no beneficiary is presently entitled and $100 (actual) income which is part of the estate net income and to which there are presently entitled beneficiaries, beneficiaries will be assessed on only $50 of that, and the trustee assessed on $50.

3.1.2 Withholding tax

Another example can be found where resident deceased estates or testamentary trusts make distributions to non-resident beneficiaries. Subsection 128A(3) of the withholding tax (WHT) provisions says that for the purposes of Division 128 ITAA 1936 a beneficiary who is presently entitled to a dividend, to interest or to a royalty included in the income of a trust estate shall be deemed to have derived income consisting of that dividend, interest or royalty at the time when he or she

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[6] *CofT v Bamford* (2010) 240 CLR 481.

became so entitled. This prevents the interposition of a resident trust, for example, to get around the WHT provisions.

Section 128D ITAA 1936 then treats certain income subject to WHT as not assessable or exempt to a person.

These provisions were drafted at a time when it was apparently assumed that if a beneficiary was presently entitled to $X of a dividend, and that dividend was contained in the s95 net income, the $X of dividend 'belonged' to that beneficiary as a component of the net income.

We know now that whether the non-resident would be assessable or not depends **not** on present entitlement to income including that amount, but rather on the non-resident's percentage (share) of all of the net income (including the dividend etc). So unless the dividend etc. is the only income and net income, and there are no other beneficiaries presently entitled, the provisions may not work properly. For example, could a resident beneficiary of a testamentary trust not be taxed on a share of a dividend which had borne WHT in relation to the present entitlement of a non-resident beneficiary to the amount?

3.2 Streaming

As observed above, present entitlement to income of the trust estate (where it exists) will have the effect of allocating components of the s95 net income of the trust on a strictly proportional basis (having regard to a beneficiary's share of the trust income).

That the law operated in this way before the 2011 streaming amendments was confirmed in relation to capital gains in the High Court decision in *Bamford* (Sundberg J had formed the same view earlier on an amount that was not a capital gain in *Zeta Force*[7]). Decisions in *Colonial First State*[8] and *Greenhatch*[9] confirmed that you could not 'segment' the s95 net income amounts for tax assessing purposes, even if you could 'segment' them for general trust law or trust accounting. For example, if a distinction was drawn in a deed between short-term gains and long-term gains, with different beneficiaries entitled to each, for tax purposes if they all had the same share of trust income they each would be taxed on that proportion of **both** sets of gains.

The same issue existed for franked dividends, and in fact for any component of the s95 net income. But people are often most interested in being able to segment capital gains and franked dividends so they can be allocated in a tax-effective way to take account, for example, of differential tax treatments of beneficiaries. For example, taxable residents are assessed on franked dividends (exempt entities are not), and non-residents are not (nor is there any withholding tax). Beneficiaries with their own capital losses may prefer to receive capital gains rather than amounts sourced from dividends.

The inability to stream under the tax law, had that state of affairs persisted, may not have provided a good tax outcome for the beneficiaries of the estate or testamentary trust especially as the court decisions meant the ATO withdrew products or views that had administratively allowed for streaming of capital gains and franked dividends.

[7] *Zeta Force Pty Ltd v CofT* [1998] FCA 728.
[8] *Colonial First State Investments Ltd v CofT* [2011] FCA 16
[9] *FCT v Greenhatch* [2012] FCAFC 84

Example

Let's consider an example. A deceased estate (tax resident in Australia) receives certain amounts which are not needed to meet debts or legacies, and so they form part of the residuary in the income year. This includes rent ($10,000), bank interest ($4,000), franked dividends ($14,000 with franking credits of $6,000), and capital gains from the sale of BHP shares (after-CGT discount) of $10,000.

Assume that the estate's distributable income is $28,000 (ignore any expenses).

There are three residuary beneficiaries – a tax exempt resident charity, a non-resident and a resident individual at a marginal tax rate greater than 30%.

Assume that the LPR could satisfy each beneficiary's interest in the residue by distributing all of the non-dividend income to one beneficiary, the dividend income to the second beneficiary and the capital gain to the third beneficiary. (Whether this distribution works from a succession and general law perspective is vitally important, and it is not a tax law issue. The tax effect will follow. The efficacy from a succession and general law perspective could depend on the particular entitlements of each beneficiary in the corpus and income of the residue under the Will and succession law, taking into account powers of appropriation, beneficiary consents etc).

Assume also that it is determined that the best overall 'tax' outcome (on which all parties agree) can be achieved if the charity receives the rent and interest, the resident receives the franked dividends and the non-resident gets the capital gains (and the discount component).

The logic behind this (which will be elaborated upon later in the paper) is that the rent and interest will not be subject to tax in the hands of the exempt entity, the resident beneficiary will get the benefit of the franking credits even though 'top-up' tax has to be paid, and the trust after administration will most likely be fixed so s855-40 ITAA 1997 will free the capital gain from any tax to the non-resident.

The ordinary operation of the trust taxing provisions will not achieve this even where the LPR purports to allocate the individual items of income and capital gain to the beneficiaries accordingly. This is because, in general, each beneficiary will be potentially assessable on a percentage of each item based on their percentage share of the trust income.

This 'ordinary' operation of Division 6 of Part III of the ITAA 1936 is one many LPR's (and their advisors) will seek to improve upon from a tax perspective, and they will seek to utilise the legislated streaming rules for dividends and capital gains to achieve this.

Note for completeness that while the above example focuses on entitlements to the residuary, in the case of legacies (e.g. to fixed sums) it can be important to determine whether tax payable by the recipient is taken into account. For example, if the legacy is to $100 and a distribution attracts tax of $47 in the hands of the beneficiary. See the case of *Buckeridge*[10] for further discussion on this point.

3.2.1 Specific entitlement

We have looked at present entitlement, which relates to trust income, and we are now going to look at a different entitlement – specific entitlement, which relates to franked dividends and capital gains.

[10] Koh v Buckeridge [2023] WASC 42

Since 2011, the law allows particular beneficiaries (and in some cases the trustee) to be 'streamed' amounts of franked dividends and capital gains displacing the ordinary proportional (beneficiary) or residual (trustee) rules that apply under present entitlement.

Note that if there were only one beneficiary entitled to all the trust income streaming is not needed because present entitlement will mean it is all assessed to them.

In the example above, the LPR may be able to stream all the franked dividends to the one resident beneficiary, all the capital gains to the non-resident, and all the other income to the charity which would be exempt.. By making certain beneficiaries specifically entitled to franked dividends and capital gains, these are taken out of the ordinary proportional rules by the process of establishing specific entitlement, and the remainder of the income (which cannot be streamed) will then flow to the third beneficiary, the tax exempt charity. But, as previously observed, the Will should be carefully examined to make sure there are no constraints which would prevent this, and in some cases consents from beneficiaries may be required. .

The streaming rules are broadly very similar for franked dividends and capital gains. Three points of difference should be noted. Firstly, it is possible to stream classes of franked dividends, whereas capital gains must be streamed individually. Secondly, in order to stream franked dividends to any beneficiary that beneficiary must have some interest (however small) in the trust income containing the franked dividends, whereas capital gains can be streamed to any beneficiary whether they have an interest in the trust income or not. Thirdly, a resident trustee can also choose to be specifically entitled to a capital gain, whereas this option is not available for franked dividends.

Specific entitlement – what is needed

The specific entitlement rules for franked dividends and capital gains are broadly comparable.

The key provisions are to be found in s115-228 (for capital gains) and s207-58 (for franked dividends).

The main requirements are as follows:

- In accordance with the terms of the trust, the beneficiary must receive, or be reasonably expected to receive a share of the net financial benefit that is referable to the franked distribution or capital gain. (In arriving at the 'net' amount, relevant capital losses and expenses are offset against the capital gain or franked distribution respectively provided they are also offset for trust purposes); and
- The amount must be recorded in its character as referable to a franked distribution or capital gain as the case may be in the accounts or records of the trust no later than the end of the income year. For capital gains included in the trust capital, the latest date is 31 August.

It is made clear in explanatory materials that something is done in accordance with the terms of the trust if it is done in accordance with the exercise of a power conferred by the terms of the trust or the terms of the trust deed (if any) and the terms applicable to the trust because of the operation of legislation, the common law or the rules of equity.

In the case of well-drawn testamentary discretionary trust deeds with similar powers as given to trustees of *inter vivos* trusts, there is usually no difficulty satisfying the above.

It is not quite so simple with a deceased estate which is only treated as a trust for tax purposes.

For example, while an LPR clearly has the power (and often the obligation) to account for income and capital (and assets) separately, can it be said that they have the power to distribute certain types of income or capital gains to one beneficiary and certain types to others? In other words, do they have the power to stream. There is some doubt about this, although it is generally considered that the LPR's powers of appropriation and assent (and other powers available under succession law and the general law) are sufficient. The ATO has given private rulings to this effect. However, while some construe the requirements as being met providing there is nothing in the trust documents to *prevent* streaming, as drafted the tax legislation seems to suggest that a positive streaming power may be required.

Two further points should be noted.

In order to stream discount capital gains effectively, it is necessary to confer an entitlement to an amount of the gross **pre-discount** gain (less any applicable capital losses) and not just the gain after discount (which is included in the s95 net income).

So for example, if the gross gain is $100, and there are no losses, the relevant beneficiary must be made specifically entitled to $100 not $50 in order to stream effectively the $50 post discount gain. If the beneficiary is made specifically entitled to only $50, effectively only $25 of the post-discount gain will be streamed and the balance will be shared among beneficiaries in accordance with their entitlements to trust income. As explained earlier, in a deceased estate, the entire gross gain amount will be capital (because trust income is based on ordinary income for a deceased estate[11]) and the LPR will have until 2 months after the end of the income year to make the beneficiary specifically entitled. In the case of a testamentary trust it will depend on its terms and how income is defined. Sometimes there may be restrictions on the distribution of capital amounts (such as the CGT discount) even where there is an income equalisation clause in place.

Franking credits cannot be streamed separately from franked dividends (*Thomas's* case[12]).

Let us now return to the earlier example with the rent ($10,000), bank interest ($4,000), franked dividends ($14,000 with franking credits of $6,000), and capital gains from the sale of BHP shares (after-CGT discount) of $10,000.

The resident beneficiary would be made specifically entitled to the $14,000 franked distribution. They would have to gross it up to $20,000 for the franking credit, and then receive a tax offset for the $6,000. At the top marginal rate, there would be top-up tax and medicare levy payable of $3,400.

The non-resident beneficiary would be made specifically entitled to $20,000 (the pre-discount gain). Pursuant to s855-40, as the trust is fixed after administration, there should be no Australian tax liability in relation to the disposal of non-TAP shares.

The charity would then be presently entitled to all of the remaining (adjusted) trust income of $14,000, which is also the adjusted s95 net income (with the franked dividends and capital gains to which beneficiaries are specifically entitled excluded). The $14,000 would be exempt from tax.

If we changed the facts slightly and made the gain from a TAP asset, the exemption afforded by s855-40 would not apply. The gain would be assessed to the trustee under s98 (and s98A for the beneficiary with an offset for any trustee tax paid). Because the beneficiary is a non-resident a partial CGT discount may not be substantially available depending on how long the deceased owned the asset. In this circumstance, and if minimising tax were the only consideration, it may be preferable for

[11] Some have questioned whether a Will could be drafted to vary this.
[12] *FCT v Thomas* [2018] HCA 31.

the trustee to make a choice to be specifically entitled and assessed under s115-230 (a choice only available for trustees of resident trusts) with the prospect of a s99 assessment and the availability of CGT discount. After any tax is paid by the trustee, a non-taxable distribution could later be made to the non-resident beneficiary as long as it was not before the end of two months after the end of the income year.

At this point you may ask would the Commissioner have a concern about this? Would the Commissioner assess under s99A? We will defer consideration of that question until we have considered s99 assessments in their usual course.

3.3 Section 99 assessments

The issues regarding whether s99 or s99A may apply to the assessment of a deceased estate is discussed below, but we will assume for the moment that s99 applies. It is important to recognise that s99 progressive rate assessments can apply to deceased estates as well as to trusts arising from Wills (commonly known as testamentary trusts). Where a deceased estate is treated differently is in the availability of the full threshold for a certain period – this is not available for testamentary trusts.

The tax rates (for the first three years of a deceased estate) are the same as the individual rates with the benefit of the full threshold of $18,200. This threshold provides a tax break for smaller deceased estates.

3.3.1 The three-year rule

After 3 years, the threshold is reduced to $416 and if taxable income exceeds $611 the entire amount from 0 to $45,000 will be taxed at 16%.

Some people assume that s99A rates apply automatically to a deceased estate after three years, which is not the case. However, discussed later, the ATO may have concerns if income is being accumulated in the estate over a period of time just to take advantage of progressive rates when it could actually be paid out.

The three income years includes the one in which the deceased dies, so it is not usually a full three years. The only way that would potentially arise is if a person died on 30 June. As discussed above, the conventional practice of the industry and the ATO is to regard all of the date of death as relating to the deceased, and the day after when the deceased estate arises. This is arguably not technically correct because the deceased estate comes into existence immediately after death, and not the next day. While this would not normally raise any technical point, one wonders if the ATO would necessarily agree that a full three income years is available for the deceased estate of a person who died on 30 June.

3.4 Stages of administration: the importance of present entitlement

3.4.1 Stages of Administration

The Commissioner's old Ruling IT 2622 identifies various stages of administration and in what circumstances during those stages present entitlement may exist (or be regarded by the ATO as existing!).

The Ruling identifies three key stages

The initial stage

The intermediate stage

The final stage

During the initial stage, the executor or administrator is getting the assets in and paying and providing for debts of the deceased or the estate.

During the intermediate stage, part of the income of the estate that is not required to pay debts may be paid to beneficiaries.

During the final stage, debts etc are provided for or paid in full and income of the estate may be paid to beneficiaries.

The Ruling says that whether a beneficiary is presently entitled to a share of the trust estate's income depends on the stage of administration reached, the terms of the Will etc and succession and trust law, and whether any discretionary payments have been made by the executor or trustee.

Paragraph 9 of the Ruling is seemingly contradictory because it cites the *Whiting* case to the effect that no beneficiary can be presently entitled to estate income while the estate is being administered, and then limits that to the **initial** period of administration referred to above where income is being used or kept for the payment of debts. Why not the entire administration period?

The answer to this seems to lie in the fact that administration is (at least in one sense) 'complete' when the residue has been 'ascertained' (that is, debts etc. paid or provided for) and not when the estate is brought to a close.

Hence, it is theoretically possible for a beneficiary to be presently entitled at a point after the residue has been ascertained. But when is the residue 'ascertained'? This is not entirely clear as the estate may be administered in a way that enables certain amounts to be freed up for distribution without necessarily having determined what the residue *as a whole* is (except that the certain amounts will not be required and might be distributed). It is for this reason that the Ruling probably focuses on amounts **actually paid to, or applied for the benefit of, a beneficiary,** rather than 'arguing the toss' over what 'might' be available for distribution in the intermediate phase**.**

The Ruling makes an assumption that if the beneficiary is paid an amount etc. that is sufficient to demonstrate that the beneficiary is 'presently entitled' to the amount so dealt with by the executor or trustee. It amounts to an assumption that net residue must have been determined at least to that extent, and that the beneficiary could have demanded the amount.

This is more than questionable. The leading case on present entitlement in Australia (FCT v Harmer[13]), which was decided by the High Court after IT 2622 was released, says the test is that the beneficiary must have a **right to demand and receive payment**. It really confirmed that was the test, as most people thought that was how it worked in any case following *Whiting*[14]*.* Does a beneficiary in a partly-administered estate have such a right? Possibly not, even with the extended meaning of present entitlement in s95A(2) to include a vested and indefeasible interest in the income. At that point (prior to ascertainment of the residue in full) a beneficiary may be a bit like a beneficiary of a discretionary trust with a right to due administration and to be considered for a distribution at the discretion of the executor.

The possible application of s101 ITAA 1936 must also be considered. It was intended to apply to 'discretionary trusts' (as its heading indicates), and that would not ordinarily describe a deceased estate. However, the heading was not part of the ITAA 1936 and provided it could be said that the trustee was 'exercising a discretion' to pay or apply amounts to a beneficiary, the beneficiary could be deemed to be presently entitled to the amounts so paid or applied. Maybe this is taking s101 too far outside its intended ambit of operation.

It would be a brave executor who would seek to clarify this in a courtroom, although that may fall to a beneficiary who gets a payment and insists that they were not actually presently entitled.

If beneficiaries were presently entitled to amounts paid during a year of income, they are taken to still be presently entitled to them *at the end of the year of income* (s95A(1) ITAA 1936 which amended the law to address the issue raised by Barwick CJ's dictum in the *Union Fidelity* decision[15]).

During the final stage, debts etc are provided for or paid in full and income of the estate may be paid to beneficiaries, and the Commissioner considers that beneficiaries are presently entitled to the income. Here the residue in full has been determined, and the author considers this is a sounder proposition.

During the year the estate is finalised, the Commissioner takes the view that ordinarily if beneficiaries are presently entitled to all of the income at the end of the income year they would be assessed on their share of the trust's s95 net income irrespective of when that net income was derived. However, the Commissioner has usually accepted an apportionment where accounts were struck and there was clear evidence that amounts were derived before and after the date of 'final administration'. The Commissioner does not accept an apportionment based solely on 'time' before and after the completion of administration.

A couple of points may be made here.

If present entitlement is to be determined at the end of the income year, what happens if the estate is finalised before 30 June? Does that mean present entitlement has to be determined at the date the estate ends or still at 30 June (using provisions such as s95A(1)). But arguably, s95A(1) implicitly assumes that the trust is still in existence at 30 June.

Are distributions of net residue or surplus the final acts of administration of the estate or once residue has been ascertained does a separate trust arise for distribution of the residue (either immediately or into a testamentary trust)?

[13] 89 ATC 5180
[14] See footnote 4.
[15] *Union Fidelity v FCT* (1969) 119 CLR 177.

The Commissioner glosses over this point with comments of the kind that suggest that although the estate and any subsequent trust are separate at general law (a correct statement), the Commissioner often administers them seamlessly, noting that often the same person will be the 'trustee'. Of course, this may be the case for 'shorter term' trusts for immediate distribution, but separate file numbers are required for estates and testamentary trusts

Other points and criticisms of IT 2622

In general, IT 2622 still provides some useful assistance (especially for those looking a deceased estates for the first time), but it has some significant limitations (other than the issues referred to above). Despite efforts from Tax Institute and STEP to have the Ruling revised and updated, the ATO has not to date done so.

The limitations of the current version include:

- It predates the public ruling system which commenced in 1992, and does not offer legal protection for those relying on it. (It does provide a degree of administrative protection in the sense that the ATO would be unlikely to depart from it. The ATO treats this ruling as administratively binding covering primary tax, penalties and interest).
- It predates the *Harmer* decision[16], although that may not change the outcomes of the Ruling.
- It considers the stages of administration as if they are largely 'linear' whereas it is understood that in practice various assets or funds may still be subject to 'administration', and others not.
- It is limited in coverage to present entitlement to income. While CGT was in existence in 1990, it is not referred to. The Ruling does not therefore deal with absolute entitlement or specific entitlement (which applies to capital gains and franked dividends), how these interact with succession law concepts of appropriation and assent, and the widespread practice (discussed later) of selling assets to which beneficiaries are not absolutely entitled (usually because there is more than one of them) and streaming resulting capital gains to exempt entities without triggering CGT event K3.

IT 2622 was drafted in an era where marginal individual tax rates were higher and so there was a greater incentive to accumulate in the estate. There remains the issue of progressive v top marginal rate, but in many cases now trustees are looking to distribute because of tax concessions available at the beneficiary level (exemptions, capital loss offset, CGT discount, ability to utilise franking credits).

3.5 Section 99A and the discretion

Now we are moving into uncertain and contentious territory. We will examine the interplay between s99 and s99A. Why is this very important for deceased estates and testamentary trusts? The answer is that s99A is 'A for awful' (flat penal tax rate, no decent threshold, and CGT discount reversed) and s99 is the 'goodie' in terms of tax outcomes (decent threshold, progressive tax rate, CGT discount). Assuming that there is not present entitlement to all of the income of the trust, the aim of estate planners is to have the trustee assessed under s99.

One might think that the law would operate on the basis that s99 would apply in the case of an ordinary deceased estate or testamentary trust where there is no 'naughtiness' going on, and that the

[16] See footnote 13.

Commissioner may have a discretion to invoke s99A in limited circumstances (where the ‘naughtiness’ is apparent).

But the law actually operates the other way even for deceased estates and testamentary trusts (and other entities such as bankruptcy estates) where s99A is the default provision and s99 is only available if the Commissioner exercises his discretion! (Of course, the provision dates from before self-assessment so an assessor processing a trust tax return would effectively exercise the discretion by applying s99 rates rather than s99A rates. But we live today in a self-assessment environment).

Under the law it would appear that self-assessments for **all** deceased estates should be submitted on the basis of **s99A** unless and until the Commissioner has turned his mind to the question and positively exercised his discretion in favour of s99. This would require the matter be brought to the Commissioner’s attention, which would require an ‘assessment’ approach for deceased estates and testamentary trusts. The ATO probably could not cope with the flood of requests for exercise of the discretion. In the past it is understood that for a time requests were made in returns for the Commissioner to do just that, but this meant returns went off-line and the system slowed down.

What people are now understood by the author to be doing, except in isolated cases, is **anticipating** the positive exercise of the discretion, and **self-assessing** on that basis. This of course puts all the tax risk in the hands of the taxpayer, because there is no guarantee that on audit the Commissioner would do that.

So how can tax risk for clients be managed? We will discuss this further below, but firstly let’s consider the history of s99A and how it came to be that pretty much all accumulations in trusts were viewed with suspicion.

In 1964, the government introduced s99A (with a rate of 50%) to address the fact that (mainly *inter vivos*) trusts were accumulating income (e.g. under powers given to trustees) to take advantage of s99 progressive rates. The alternative would have been to make beneficiaries (perhaps at the top marginal rate) presently entitled.

In relation to certain trusts, the Commissioner had a discretion not to apply s99A. Initially, deceased estates (and testamentary trusts) were automatically excluded from s99A and did not have to rely on any exercise of a discretion.

In 1977, however, the law was amended to bring deceased estates and testamentary trusts within the scope of the Commissioner’s discretion (ITAA No 2 1977), while at the same time exempting them from the health insurance levy. The s99A rate was also increased from 50% to 60%, the then top marginal individual rate.

Phillip Lynch’s Second Heading speech in the House said that the exclusion had given rise to ‘tax avoidance by most unpleasant means’.

> ‘Some family groups, few in number I’m pleased to say, have arranged for unrelated aged people who are expected not to live for any length of time, and who have little in the way of assets of their own, to set up multiple ‘shell trusts’ under a will for the benefit of members of the sponsor’s family. On the death of the aged person, the family channels income into these trusts which, because they qualify as deceased estates, are outside the scope of the special rate of tax under s99A.’

The relevant Explanatory Memorandum (Introductory Note) said:

> 'Section 99A is to be capable of application to deceased estates set up for tax avoidance purposes in the same way as it is at present applicable to *inter vivos* trusts set up for such purposes".

The EM also indicated (clause 6):

> 'The exclusion has been exploited for tax avoidance purposes by some family groups. Through multiple trusts set up by will, each trust having an income of $416 or less, very substantial amounts of income have been made tax free'. The EM noted that a trustee assessed under s99A would have objection rights to be assessed under s99.

In 1980, further amendments were made to s99A. Whereas formerly the discretion could apply to any type of trust initially within s99A, this was changed so that the discretion would only apply to certain trusts, including deceased estates and testamentary trusts. This was intended to further limit the scenarios in which the progressive rates of s99 would apply to accumulated trust income.

The EM referred to 'tax avoidance connotations' that would prevent the usual outcome where income was accumulated in deceased estates, testamentary trusts (and other entities such as bankruptcy estates).

It is quite clear from the above that the concern was about setting up, or using, deceased estates or testamentary trusts for quite overt tax avoidance purposes. This suggests that where that was not the case the Commissioner would readily exercise his discretion to apply s99 rates.

While there is no doubt truth to this, the experience with s100A tells us that provisions must be interpreted as enacted, and cannot be read down based solely on statements in parliamentary speeches or EM's.

3.5.1 Current operation of s99A to deceased estates etc

As of today, s99 (rather than s99A) will apply to the trustee assessment of a deceased estate etc **only** if the Commissioner is of the opinion that it would be unreasonable that the section should apply in relation to the year of income of the trust estate.

Before proceeding further, it is stressed that one must be sure that s99 actually could have application – that is, there is **some income of the trust estate to which no beneficiary is presently entitled**. This could be wrongly assumed and is a trap. For example, if the estate residuary has been ascertained, there may well be beneficiaries who are presently entitled to income.

The discretion is, as discussed above, an anachronism and completely at odds with a self-assessment regime of taxation. Had the trust provisions been rewritten as part of the Tax Law Improvement Project of the 1990's (TLIP), an objective test is likely to have been inserted. However, this did not happen because it was thought that trusts would, under A New Tax System and the Review of Business Taxation, be treated as companies (which also did not happen). So we are left with the discretion.

What was done more recently with s102AG ITAA (albeit a provision dealing with excepted income and minor beneficiaries, and with many of its own problems and issues) suggests some possibilities for converting it into an objective test.

The nature of the discretion is particularly challenging – it applies to the standard case of a simple deceased estate not just an egregious exception. It should be recalled that the last version of the provision was from an era (late 1970's) where trust abuse was endemic!

It should be noted that if the discretion is not exercised, all (and not just some) of the net income otherwise falling within section 99A will stay under section 99A. It is an 'all or nothing' discretion. So if there is income which comes from the deceased's assets, and some from injections of assets or income, the whole lot would fall under s99A.

The Commissioner must act reasonably in exercising the discretion, but there is little guidance as to what this means.

The Commissioner is required take into account a list of factors in s99A(3) and (3A) but they are not exhaustive. Broadly, they focus on various ways and means of increasing the income etc. that would come from the trust potentially eligible for the s99 rate. For example transferring assets, conferring rights to income etc. Subsection 99(3A) refers to 'padding' the deceased before death rather than the estate.

As the factors are not exhaustive, it is difficult to determine what other cases might be ones where the Commissioner might reasonably decline to exercise the discretion.

In any situation it will obviously be a question of having regard to all the relevant facts and context.

In the author's opinion, it would be dangerous to assume that the discretion would only not be exercised in the presence of **egregious** tax avoidance.

In the author's opinion, the accumulation of income will be **almost certain** to receive a favourable exercise of the discretion where it occurs for the **payment of, or reasonable provisioning for, the payment of legitimate debts** of the deceased, the deceased estate and/or testamentary trust. Or where it is accumulated to pay legacies.

Because in a deceased estate or testamentary trust the trustee may be personally liable to pay such debts, it seems to the author likely that the Commissioner would not exercise the discretion only where the provisioning for debts is manifestly unreasonable or excessive.

It would seem also to be the case that **if the Will is contested** that may also provide a good non-tax reason for accumulating, but that would depend on the nature of the contest. Some may argue that accumulations are justified while the period remains open for a person to make a valid TFM application, but it is thought that this will again depend on the facts and the likelihood of such an application being made.

In the author's view, the presence of either of the following is likely to increase the risk that the Commissioner (if called upon to do so) would not exercise the discretion so that s99 rather than s99A applies.

- Something artificial and/or contrived in relation to the way the trustee is said to be properly assessable under s99 and not s99A – for example, clearly excessive provisioning for debts or for excessive payments to be made to 'related parties' (including beneficiaries) for services to the administration of the estate
- 'Padding' the estate or testamentary trust (or the deceased before death) with income-producing or gain-producing assets, or directing or diverting income or gains from other places into the trust

The following circumstances are ones where it is less clear that the Commissioner would be concerned, but cannot be ruled out.

- The exercise of a power to accumulate income, or where accumulation happens by default, in circumstances where a significant purpose of avoiding tax because of the progressive rates in s99 can objectively be discerned
- The accumulation of income in one year, and payment of that income (or providing a benefit) to higher rate taxpayers (who may be minors) in subsequent years.

Let's now consider some brief examples.

- The LPR 'delays' administration (e.g. leaving a small debt outstanding or waiting for tax bills without provisioning) to take full advantage of the threshold for the 3 years. This case might be problematic from a tax perspective, but perhaps more problematic from a succession law perspective as an LPR must carry out their duties in a timely and efficient manner: see *Re Howden; Howden v Rackstraw* [2020] VSC 315 (VIC).
- A testamentary trustee is accumulating income under a power in the deed where beneficiaries are at the top tax rate and do not need the money. This may be a scenario where the Commissioner does not apply the discretion for s99 rates, but this is uncertain.
- A testamentary trustee accumulates income in order to meet future living and education expenses of minor beneficiaries (as provided for under the Will). This scenario is unlikely to be one where the Commissioner would not exercise the discretion as long as the accumulated amounts were reasonable.
- The deceased was evading tax as a result of which the estate was larger than it would have otherwise been. The proper approach here would be for the ATO to seek the tax due from the LPR. But the Commissioner might also regard this as 'padding' prior to death and decline to exercise the discretion favourably. This could be challenged, however, as taking into account an irrelevant consideration.
- The trustee chooses to be specifically entitled to a capital gain under s115-230 and assessed rather than making a beneficiary specifically entitled. This is prima facie just the exercise of a choice available under the Act. Without more, it is submitted that this is unlikely to be a case where the Commissioner would not exercise the discretion for s99. A variant of this where the outcome may be less predictable is where the s115-230 choice is made to ensure a full CGT discount when only a partial discount would apply under s98/s98A assessments in relation to a non-resident beneficiary. This is especially so if the amount is actually distributed to the non-resident just after 2 months following the end of the income year.
- The trustee of an estate sold TAP that a non-resident deceased person had owned and claimed the CGT discount and asserted that a s99 assessment was appropriate. Here there is arguably a deficiency in the law, which applies automatically. Arguably this is an irrelevant consideration for deciding whether to exercise the discretion to apply s99, and could be challenged successfully if the Commissioner refused because s99A would deny the discount.
- The trustee of a testamentary trust accumulates income that would have been subject to s102AG and Div 6AA rates if used in that year for the benefit of minor beneficiary. It is used to benefit the minor beneficiary in next year. This is a tax avoidance arrangement to try and 'get around' s102AG, but it is questionable whether it is a consideration that may be taken into account in the s99A/s99 discretion

For completeness, it should be noted that even if the discretion were exercised to apply s99, that does not mean that s100A or Part IVA may not have applied to the arrangement set out.

How should tax risk associated with the discretion be managed?

It is obviously unrealistic to request the Commissioner to exercise his discretion in every case. (That strategy if implemented industry-wide would no doubt lead to advice from the ATO, or a law change).

The author's suggestion is that if, absent egregious or overt tax avoidance activity, accumulation can be justified for reasons other than getting a better tax outcome than any reasonable alternative, there is no sound basis for the Commissioner not to exercise the discretion.

One of the contentious cases at the moment is where there is some loophole in the law (not especially related to reasons why the discretion is there) which either applies automatically or the taxpayer takes advantage of the loophole. In the case where it applies automatically, the author thinks the Commissioner would have difficulty in using that as rationale for a proper exercise of the discretion. The second case (where the loophole is not accessed automatically but requires some activity other than the making of a simple choice provided by the Act), is less clear, especially where the loophole has the effect of increasing the income etc. of the estate or testamentary trust. Also, Part IVA may be relevant in such a case.

In short, without the assistance of an ATO PCG which would indicate where it thinks the safe territory exists (between the flags), we are left with trying to work that out piecemeal through perusal of edited versions of private rulings.

In the author's view, there is a need for a PCG to provide guidance (obviously without fettering the discretion) on the sorts of issues listed below:

Assuming the income/assets of a deceased estate or testamentary trust have not been manipulated:

- Does the ATO consider that the discretion would almost always be exercised to apply s99 to a deceased estate? A testamentary trust?
    - For example, would a deceased estate that was being properly administered in a timely and efficient way be safe from s99A where it accumulated irrespective of the time period? Only for 3 years?
    - For example, if a testamentary trust accumulated income under a power or by default of appointment, does that raise any concerns?
- If no to these two examples, where would the ATO concerns lie?
- If income accumulations may in some cases be an issue, are capital accumulations (especially where s115-230 is chosen) to be regarded differently?
- Are there any factors that would always be irrelevant in applying the discretion? Such as law problems that apply automatically (such as a foreign deceased individual but the CGT discount available to the estate under s99 if the discretion is exercised)?

Discretion letter or private ruling – or public advice?

The author is aware of recent cases where the ATO has declined to issue a private ruling on whether the discretion would be exercised, but instead has favoured the issuing of a 'discretion letter'. It is not clear why, for example, there are different practices in relation to discretions under s99/s99A and under extensions to the main residence two year exempt period for deceased estates.

As noted, there is also no reason why the ATO could not issue public advice (e.g. a PCG) on the exercise of the discretion, provided it did not fetter the discretion. This has been done in other areas, for example the discretion to extend the two year period for a CGT free sale of a deceased's main residence at death. Such a document may discourage people from sending in requests for the exercise of the discretion, or private rulings. In theory, the way the discretion applies, one who was risk averse would think that every case – even the simplest – requires the exercise of this discretion.

It is understood that in some parts of the ATO discretion letters have been issued. Some use unfortunate language e.g. assessing trustees under s99 on the net income to which no beneficiary us presently entitled. While the intent is clear, this is not the way the law works and the discretion should perhaps simply confirm that the trustee is to be assessed on amounts not assessed elsewhere under s99 rather than s99A. It is not clear whether the exercise of a discretion that is not consistent with the way the law works is effective or not.

A trustee would not be able to object against the decision in the discretion letter itself, but ADJR action may be appropriate if it is considered that the discretion was not properly exercised. Of course, an objection may lie against the assessment itself. (That is, the trustee may self-assess under s99A if the ATO does not do it and object)

4. Death and the effect on assets for CGT and other purposes, and some tricky trust distribution issues

We now come to some further concepts and issues which are regularly in play for advisers working on who will be taxable (if anyone) on estate income and gains, or if certain distributions are made. We will start with some basic CGT.

4.1 CGT general rule upon death

It is common knowledge that, for CGT purposes, death usually produces no direct CGT consequences for the taxation of the deceased or the estate. Any capital gain or capital loss is disregarded for the deceased.

Similarly, when assets 'pass' from the LPR to beneficiaries, again the general case is that no capital gain or capital loss is recognised (s128-15 ITAA 1997).

In each case, for most post-CGT assets the LPR/ beneficiaries take the deceased's cost base/reduced cost base, and for pre-CGT assets they take market value just before death.

There are two important exceptions to this.

CGT event K3 where certain assets pass to beneficiaries such as would put any gains outside the full Australian tax net (e.g. because the beneficiary is exempt or taxed at a reduced rate, or because it is a non-resident and the asset is non-TAP.

A post-CGT dwelling that was the deceased's main residence just before the time of death and not then used for income producing purposes. It is taken to be acquired at market value at the date of death.

4.1.1 "Double-death"

A difficulty can arise however, where the asset cannot pass to a beneficiary of a deceased estate because that person has died beforehand and his or her LPR takes instead. Arguably the beneficiary does not acquire ownership of the asset, but rather his or her LPR does.

This is known as a 'double death' situation. The author's view is that the law when enacted did not contemplate such a situation and whereas it might be possible to get the law to 'work' in some cases, it won't be possible in all cases. This was in fact one of the issues that was announced for amendment by the government and then not proceeded with. The Commissioner was unable to resolve it using the remedial power.

The Tax Office has 'double death' as part of its CGT advice under development [No 4188 with expected completion late 2025]. It is developing a Tax Determination to deal with the issue. As noted earlier, targeted consultation is being undertaken on a draft. The author's firm is involved, but not the author.

In the author's view[17]. Div 128 relief applies when the LPR of the second deceased acquires the asset from the estate of the first, as they can be regarded as a 'beneficiary' of that estate. More problematic is the question of relief for a transfer of an asset from the estate of the second deceased person on the assumption that the asset was never 'owned' by that person. 'Ownership' would include legal or beneficial, and we know from the *Sandini* case law [2018] FCAFC 44 that beneficial or equitable ownership requires more than an equitable interest.

Worthy of consideration may be a principle from succession law that specific assets passing to beneficiaries are taken to be acquired just after death of the first deceased (on a relation back basis), and hence could be regarded as 'owned' by the second beneficiary at their death. Unfortunately, this principle would not appear to have application to assets forming part of residue.

In the author's view, satisfactory resolution of this issue overall requires a legislative amendment, as was originally recognised when several years ago an amendment was announced but later not progressed.

4.2 Movement of deceased's asset from LPR to beneficiary or via a testamentary trust to a beneficiary

As noted earlier, as well as death not usually triggering any CGT liability, the same holds when the deceased's asset passes from the LPR to the beneficiary or, under a long-standing CGT ATO concession, via a testamentary trust to a beneficiary of that trust. Note carefully that this applies only to assets **of the deceased** and not subsequently acquired assets, referred to generally as after-acquired property. Where that passes out of the estate or testamentary trust the usual CGT rules must be considered.

The apparent need for the ATO's concession is the fact that the LPR does **not** strictly include the trustee of a testamentary trust arising from the Will, even if it's the same person (as it often is).

In a situation where administration in respect of an asset is complete, and it is goes directly to a beneficiary, it is generally thought that the law applies. It is perhaps a little unclear whether the person distributing is still acting in the role of the LPR (as opposed to a trustee of a trust for distribution), but in practice this issue is generally ignored either because the distribution is seen as still part and parcel of the LPR's role following ascertainment of the residue, or if not because it happens just a moment in time after. If the view were taken that in **no** case did an asset pass from LPR to beneficiary (because in each case the asset was held on a separate trust), the CGT rule would have no application at all, and that is an outcome a court is likely to reject.

The position is much more complex for a testamentary trust. Often these are in place for a considerable period of time (e.g. life estates, and trusts holding for minor beneficiaries).

The ATO has long had an administrative practice (see now PSLA 2003/12) since the introduction of CGT of reading the reference to LPR in the law to include a reference to a trustee of a testamentary trust arising from the will. Whether such an outcome is possible technically would depend, the author submits, on the sorts of considerations on statutory interpretation discussed in the *BBlood* and *Ausnet* decisions[18].

[17] See CGT Handbook 2025-26 16th edition, Chapter 20, Thomson Reuters, by Evans and Davies

[18] See footnotes 1 and 2

Part of the difficulty technically is that if the words ‘or trustee of a testamentary trust’ are read in, a view then needs to be taken about the meaning of ‘beneficiary’ in the second case.

If there is a policy problem with the ATO’s approach it is in how far should the approach be extended i.e. what ‘beneficiaries’ as recipients of the asset are covered. There is a clear policy logic where an asset is left by the deceased in a fixed will trust for their spouse for life and thereafter the children. The children were likely named in the will and clearly contemplated by the testator as intended beneficiaries.

It is somewhat more difficult in a policy sense where the testamentary trust is discretionary. On one view, the testator’s gift is complete when the trustee of the testamentary trust acquires the asset (that is, it is the true beneficiary and not any beneficiary who later obtains it from the discretionary trust). But while the trustee has a discretion in distributing the asset, the class of eligible beneficiaries would have been known to the testator.

The ATO now draws the line in its approach (it did not do so previously) where the beneficiary of the testamentary discretionary trust is itself the trustee of a discretionary trust. Subsequent distributions of assets from that discretionary trust are not covered by the ATO’s approach.

The ATO makes as a condition of its approach that the beneficiary accepts the deceased’s cost base etc. for a post CGT asset and not market value on the assumption that any gain should have been taxed in the testamentary trust (which it isn’t under the ATO’s practice).

The law may eventually be tested if a beneficiary on audit challenges the cost base issue in the court, arguing that whatever the position of the trust and trustee, and whether tax is paid or not, the beneficiary has a market value cost base at the date of absolute entitlement or transfer to them.

4.3 Non-CGT implications of death - revenue assets (including trading stock)

It is far from clear what happens where the asset is a revenue asset and provisions other than CGT have also to be considered (revenue assets are potentially subject to CGT but gains and losses on trading stock are explicitly disregarded, and s118-20 and 20(1A) and the reduced cost base rules normally address the overlap on revenue assets).

The trading stock rules work because there is a deemed market value disposal and acquisition, with the possibility of ‘roll-over’ relief in certain cases where the deceased’s business is carried on (see s70-105).

Revenue assets seem to be a problem. There is no actual consideration passing from the LPR (and no rules to deem consideration) which might suggest that the deceased gets a loss (probably unable to be utilised) and the LPR no acquisition cost, which could be a significant problem if the deceased’s activities were completed by the LPR.

4.4 Section 99B

The possible operation of s99B was discussed briefly earlier in this paper in association with a change of residence of a deceased estate. In general, the ATO will consider that s99B may apply where the trust is a non-resident (or has been a non-resident) at some stage. Beyond that, however, there are few if any concessions.

It is evident from Taxation Determination TD 2024/9 that the Commissioner considers that s99B may apply where cash distributions are made from non-resident estates, where the trustee has sold the deceased's assets, to resident beneficiaries. So, for example, if the deceased held non-TAP, which is then disposed of by the trustee, and a cash distribution is made from the proceeds to a resident beneficiary. See also PCG 2024/3.

In this circumstance, the ATO applies the residency assumption in s99B to find that the distribution is sourced in an amount that may have been assessable had the disposal been by a resident. But the disposer is not assumed to be a 'trustee' (so various exemptions, such as some relating to main residence, are not available), nor is CGT discount notionally available. However, in working out the amount that would have been assessable to a resident, the ATO uses a Division 128 cost base which is often the deceased's cost base. The ATO considers that s99B can apply to gains that 'accrued' to the deceased and arguably became corpus of the estate upon the death of the deceased. The ATO's approach is a debatable reading-down of the corpus exception and general law, and a reading-up of the CGT cost base rules.

In some cases, it also needs to be considered whether s99B can apply (and operate in tandem with CGT or other rules) where assets are passed from a trust that has been a non-resident at some point in time to a resident beneficiary.

The ATO unfortunately declined the invitation to address specifically *in specie* distributions and s99B in TD 2004/9 (see TD 2004/9EC issue 20).

Section 99B essentially deals with distributions sourced from (attributable to) amounts 'derived' in trusts that would have been assessable if they had been derived by a resident. So if the trust receives a non-TAP asset as a fee for rendering a foreign service that would have been assessable to a resident, and that asset is then distributed, that fairly clearly could, in the author's view, be a distribution caught by s99B. But if a deceased estate has obtained an asset (its only property) following a death, the deceased's cost base of the asset was $100, the market value at death $200, and the market value on distribution $300, is any amount potentially caught by s99B? The only amount ever 'derived' by the estate was arguably corpus when the estate arose, and no amount is derived' by the estate on the *in-specie* transfer for which nothing in return is received. Can CGT market value substitution rules apply, and even if they can is there still a problem because any amount that could have been assessable to a resident would not arise before the distribution? (This is not entirely dissimilar to the well-known issue in s47 for capital gains arising on *in specie* asset distributions).

4.5 Tax advantaged entities: distributions and passing of assets

4.5.1 Distributions to exempt entities

As far as exempt entities, including charities, are concerned, there are two important provisions to be considered.

Section 100AA ITAA 1936

The first is s100AA which has limited application in practice because charities etc are often very well aware of what they are or may be entitled to. The section provides that if an exempt entity has not been paid or notified (in writing) of their present entitlement to income, the exempt entity shall be treated as not having been presently entitled. The Commissioner has a discretion to disregard the failure in particular circumstances.

The provision does not deal with specific entitlement.

Section 100AB ITAA 1936

The second is s100AB which is a complex provision aimed, essentially, at stopping abuses of the proportional approach by making an exempt entity presently entitled to a small amount of trust income so the balance of the s95 net income (e.g. a net capital gain) is not taxable (and can be enjoyed by someone else).

Note that s100A ITAA 1936 is not excluded in relation to either deceased estates or testamentary trusts, and sometimes must be considered.

Essentially, s100AB assesses the trustee having regard to the amount by which the beneficiary's present entitlement to trust income (as a percentage) exceeds their entitlement to adjusted net income (adjustments to net income are made, for example, for things like capital gains to which others have been made specifically entitled and certain notional amounts).

So for example if there was $10 distributable income of the estate to which a charity as the only beneficiary was presently entitled but a $90 capital gain (ignoring discount), the charity's percentage of trust income 100% would exceed its benchmark percentage of adjusted net income 10% and so the beneficiary would be treated as not being presently entitled to $9 of the $10. The effect of this would be that the trustee would be assessed on $90 and the beneficiary $10 ($1/$10 x $100).

As with s100AA, the Commissioner has a discretion not to apply the section if considered unreasonable.

4.5.2 Non-residents (estates and or beneficiaries)

Many interesting issues can arise where non-residents are concerned whether they be estates, beneficiaries or both.

Resident trust estate with non-resident beneficiaries

The most common scenario is probably a resident deceased estate with one or more non-resident beneficiaries. Although income and gains from all sources enter s95, foreign source income may usually be distributed to non-beneficiaries without an Australian tax impact. The same used to be true for foreign source gains, but that is no longer the case since the streaming amendments and as confirmed in the recent case of *Greensill*[19]. So, for example, if a foreign sourced gain on non-TAP is distributed to a non-resident beneficiary, s98 will assess the trustee and the beneficiary will then be

[19] *Peter Greensill Family Co Pty Ltd (Trustee) v CofT* [2021] FCAFC 99.

assessed under s98A (with credit for any tax paid by the trustee). In some cases, the possible effect of tax treaties would need to be considered, but in general they do not tend to offer much by way of relief, and any relief potentially available tends to be uncertain.

The removal of source with the streaming amendments did not however extend to s99D ITAA 1936 which offers a tax planning opportunity for foreign sourced gains compared to the other provisions. It requires that the trustee accumulate initially, be assessed under s99 or s99A, then distribute to the non-resident who can then seek a refund of tax paid by the trustee.

Unfortunately, this approach is probably not available to a deceased estate (as opposed to a testamentary trust) because s99D requires a distribution of trust 'income' (which a capital gain in a deceased estate is not). The approach may however work with a testamentary trust that has an appropriate income equalisation clause.

Note that s100A could apply to arrangements with non-resident beneficiaries where someone else (usually on-shore) is benefiting from the distribution.

Non-resident trust estate with resident beneficiaries

Where non-resident trusts have only non-resident beneficiaries, there will usually only be implications for Australian source income and TAP gains and losses.

More interesting is where resident beneficiaries are involved. As far as non-CGT assessable income is concerned, all amounts (regardless of source) will be included in the s95 net income of the trust. CGT is different – the residency assumption is considered by the ATO not to apply - which means that non-TAP gains are not included in s95. While the ordinary trust assessing provisions will not then apply to them if they are accumulated or distributed to a non-resident beneficiary, section 99B could well apply to amounts from such gains distributed to resident beneficiaries. The tax plan is generally to try and avoid such outcomes, as they can be extremely disadvantageous to taxpayers. See TD 2017/24, TD 2024/9 and PCG 2024/3.

4.5.3 Passing of assets to tax advantaged beneficiaries - CGT event K3

CGT event K3 may happen where a CGT asset of the deceased would otherwise escape the tax net completely such as where the asset passes to a tax exempt entity (but not a DGR) or tax advantaged entity (such as a complying superannuation fund) or a non-TAP asset passes to a non-resident beneficiary. The effect of the provision is that a CGT event is triggered just prior to death and the market value of the asset at that time is used to work out whether there is a gain or loss (or neither).

Sometimes it will be tax-advantageous to trigger the event where there is a capital gain, for example, if the deceased had a revenue or capital loss that could be offset and would otherwise be lost. Or where a capital loss results that can be utilised in the date of death return.

In most cases, CGT event K3 prevents a challenge and not a tax opportunity of this kind. The provision has two widely-known weaknesses that are set out below.

The first weakness is that the asset has to 'pass' to the beneficiary before the event is triggered. In many cases, this will not be until the amendment period for the date of death return assessment has ended. So the capital gain cannot be included, and the tax payable cannot be collected. Some tax officers have suggested (and not in a joking way) that the way around this difficulty is for trustees to object, and agree to a longer amendment period. The challenge for trustees is that they have an obligation to preserve the value of the estate.

The second weakness is that if the asset is sold or otherwise disposed of by the LPR before it has passed to the tax advantaged entity etc. (such that it doesn't pass) then CGT event K3 is not triggered and, for example, the gain can be distributed to a tax advantaged entity with low or no tax payable.

A critical factor affecting both of these 'weaknesses' is what is meant by the 'passing' of the asset to the beneficiary. The word 'passing' is not defined. Some say that it requires transfer to the beneficiary. Others say that an assent by the LPR is enough. The ATO takes the view that if the beneficiary becomes absolutely entitled as against the trustee to the asset at any point, the asset has passed (see TD 2004/3).

It should also be noted that if there is more than one beneficiary, it is probable that absolute entitlement does not even arise. This would include the case, in the author's view, where the assets are fungible. While the ATO states in Draft TR 2004/25 that beneficiaries can be absolutely entitled in such a case (for example, if there are 3 beneficiaries and 30 fungible assets, each beneficiary is absolutely entitled to 10 of them), the author considers that for CGT purposes (as opposed to equity) it is necessary to specify which 10 because absolute entitlement as against the trustee applies to an 'asset' owned by the trustee, and this specification is impossible. For that reason, the ATO's approach on this point in the Draft Ruling should be regarded as a concession rather than a rule, and can be ignored if it is unfavourable to the taxpayer (as would usually be the case for CGT event K3). Finally, the observations of Jagot J in the *Sandini* case[20] that shares acquired on different dates with different cost bases may not be fungible bears on the practicality ATO's approach, even if it is correct.

4.5.4 Main residence exemption

Some concluding remarks can be addressed to the importance of maximising the main residence exemption as the deceased's dwelling. In smaller estates this is often the most significant non-monetary asset, and even in larger estates it is usually significant because wealthy people usually have very nice expensive homes.

It is well known that if the dwelling was the deceased's main residence just before death and not used then to produce income, it is taken to be acquired by the LPR (or beneficiary) for market value at the date of death, and provided it is sold (sale settled) within two years of the date of death (or such further period as the Commissioner may allow), any capital gain made is CGT free.

Importantly, the test for a qualifying dwelling is a 'point in time' test, and the rule was introduced because LPR's and beneficiaries may have no knowledge of, or records relating to, the use of the dwelling before that time. However, the rules do not require that the absence of any knowledge of prior use be proved. This provides some significant tax planning opportunities depending on circumstance, but a number of qualifications can be noted.

Firstly, it may not actually have been the deceased's main residence at that time e.g. because the deceased had moved into a nursing home. In that situation, there is the possibility of what is referred to as an absence choice in relation to the dwelling to 'treat' it as the deceased's main residence at the time. Unfortunately, the TLIP CGT rewrite did not replicate the ITAA 1936 Act provision allowing the choice to be made by the LPR, but the ATO generally accepts this. (It is less clear whether a choice

[20] *Ellison v Sandini* [2018] FCAFC 44

made by a beneficiary in relation to the deceased would be accepted by the ATO). If the LPR makes the absence choice, there is a further question whether the point in time test is satisfied if the dwelling is being rented out. For most of the exemption, such use is disregarded where an absence choice is in play, but it is unclear whether this applies for the ' point-in-time' test. Arguably, the dwelling is being used to 'produce income', but it is understood that the ATO does not take this view resulting in a sensible degree of consistency with income use being disregarded under the absence concession.

Secondly, even if a dwelling was used to produce income by the deceased (e.g. as a rental property) for much of the period of ownership, provided it becomes a main residence again before death (and income use ceases) it will qualify. Examples of this are when the deceased relocates from a country property to occupy a former rental property in the city to be closer to family and/or medical facilities. Very close to two full main residence exemptions can often be obtained in such cases (on the former and new home), and sometimes provisions such as the 6 month rule in s118-140 can be utilised to get more exemption on the former home. Note, however, that if the deceased has already moved from the country dwelling to a nursing home, an absence choice would not be possible for the former city rental property because it has to actually be the deceased's main residence before an absence choice can be made.

Thirdly, there may be a CGT issue in respect of a retirement home where the deceased has an ownership interest. But often this can be a loss, and so the MRE is not wanted and an absence choice can be made on another dwelling likely to produce a capital gain at a later point.

Some other features of the MRE for deceased estates can be briefly noted:

- The 2 year limitation does not apply if the deceased's dwelling is occupied during the administration period by the deceased's spouse, the ultimate beneficiary of the dwelling, or a person with a right to occupy under the will. (The ATO has signalled it will be issuing guidance soon on what such a right requires e.g. whether the person has to be named in the will etc). It would clearly apply to the holder of a full life interest (even though they would have potential rights to income as well as occupancy). Note that the spouse and beneficiary do not need to have any right to occupy under the will to satisfy the requirements. There are some odd statements in the TLIP EM to the effect that it does not matter when in the period of ownership by the LPR/beneficiary spouse, beneficiary or person with a right to occupy use the dwelling as a main residence. Some have suggested this means that if the property is transferred to a child of the deceased, the exemption continues for them if their mother or father (spouse of deceased) continued to reside there. It is suggested that this is not correct, as the context of the provision clearly indicates that spousal or right to occupy use is limited to the period the property was in the hands of the LPR. However, and this is probably what the EM is getting at, a beneficiary could reside during the administration period and then later when they owned the dwelling – both periods would qualify.
- If the dwelling is subject to a life interest, it will generally be the case that the dwelling cannot be sold while that is in place. This period will often extend past the 2 years from the date of death. So the question arises what happens if the life interest ends and the dwelling is sold as soon as practicable. Would the ATO agree to extend the period? Our experience is that in general the answer is yes, although each case must obviously be tested on its facts. See PCG 2019/5. In some cases the ATO has been known to allow 2 years from the date the life interest ended.
- It would appear than the ATO allows an occupant of the dwelling during the administration period to make an absence choice that can apply to a dwelling in the ownership of the LPR. A purist might say that this is a different dwelling – the LPR has one (the freehold), and the occupier another (some lesser interest) – but the ATO seems to allow this, probably as both

relate to the same underlying property. Hence, the exemption period can be extended if for example the life tenant lives somewhere else for an extended period. But it should be noted that the effect of an absence choice is that the life tenant could not obtain an exemption on another dwelling during the same period.

- The 2 year rule is available for pre-CGT dwellings as well as post-CGT dwellings, and because use as a main residence by the deceased is not required, it would appear than more than one dwelling can access the concession. For example, a block of six flats! It is not entirely clear whether adjacent land to a pre-CGT dwelling (as opposed to the building) will be eligible for the 2 year concession. While pre-CGT assets will receive a market value at date of death in any case, there can be a significant tax advantage in the 2 year rule in a rising market. The 2 year period may also be extended by the Commissioner.

As a final point, an issue that has come up quite a bit in relation to the main residence exemption and deceased estates is the operation of the partial exemption provisions in s118-195 and s118-200. Literally, these provisions appear to have been defectively rewritten counting a wrong set of days for post-CGT dwellings of the deceased. The ITAA 1936 Act provisions were correctly drafted. For example, assume a dwelling was owned and used as a main residence by the deceased for 2 years until death, a market value cost base at the date of death was obtained, then the LPR sold the dwelling after holding the property for 3 years with no main residence use. Assuming a capital gain of $5m over the market value at the date of death was made, one would think the whole gain should be assessable and that was the way the ITAA 1936 worked. (3 years non-main residence use/3 years total use, so no main residence exemption). However, the ITAA 1997 rewritten provisions seem to allow the pre-death main-residence period to count (so 3/5 x $5m = $3m only as non-exempt), which is ostensibly a double-dip given the market value cost base at date of death. Whether a court may find a way around these problems is difficult to ascertain, but the considerations and statutory interpretation approaches for 'defective' legislation taken in the *BBlood* and *AusNet* cases[21] discussed earlier in this paper would be relevant.

[21] See footnotes 1 and 2.

5. Conclusion

This paper has explored some key concepts and issues dealt with on an almost daily basis in determining how estate income and gains are taxed. Many of the issues are not straightforward.

The author considers that in a self-assessment environment, some greater assistance by the ATO in terms of public rulings or PCG's would significantly help to reduce compliance costs in the estate industry, and to prevent ATO administrative costs from increasing as estate practitioners and LPR's increasingly look for individual rulings and advice.

Two areas identified in this paper as warranting the ATO's attention in the short term, are the s99/s99A discretion and IT 2622.

The ATO is to be commended on trying to provide guidance on and administer defective law that governments have chosen not to fix, but in the author's view that is not a satisfactory situation either for the ATO and taxpayers. It cannot be right, for example, that the current law arguably does not achieve appropriate policy outcomes in the 'double death' scenario. In the author's view, taxpayers deserve a better approach, part of which may include consideration of other ways (such as the use of regulations) to create and amend the detail of complex tax law without having to involve the usual full parliamentary processes.