STEP Australia
ADVISING FAMILIES ACROSS GENERATIONS

12 August 2022

The Hon Stephen Jones MP
Assistant Treasurer and Minister for Financial Services
PO Box 6022
House of Representatives
Parliament House
Canberra ACT 2600
By email: Jones.MP@APH.gov.au.

Dear Hon. Jones,

RE: Report into the ATO's Systems and Processes Relating to the Taxation of Deceased Estates

On behalf of the Society of Trust & Estate Practitioners Australia Pty Limited (STEP Australia) I would like to congratulate you on your recent appointment as Assistant Treasurer and Minister for Financial Services. STEP Australia looks forward to working with you throughout this term of government to bring about much needed law clarification in regard to a range of tax issues that our members and their clients have to contend with on a regular basis.

Our members include members of the judiciary, lawyers, accountants, financial wealth advisors and trustee company professionals from across Australia working in the administration of deceased estates. Uncertainties in the current tax legislation, leave executors and administrators exposed to unnecessary tax risks. To mitigate those risks, resources that would otherwise flow to estate beneficiaries are expended on tax advice.

Many defects were identified in the past as requiring legislative clarification. However, they were abandoned in 2013 as part of the then government's approach to 'Restoring Integrity to the Tax System'.[1] The issues however did not go away and more have since been identified.

Some defects come at a cost to revenue and from a tax policy perspective are clearly unintended.[2] The cost to revenue will continue to grow as the intergenerational wealth-transfer which is just beginning, moves into full swing. At a time when government debt is high, we suggest that these issues should not be ignored.

We have attached for your reference, some papers that discuss various issues that would benefit from legislative clarification. We would be more than happy to discuss these and other issues with you or your representatives.

In due course, we hope that the government will reintroduce to its legislative agenda bills focussing on meaningful 'care and maintenance' amendments in relation to all tax issues. While we appreciate that drafting resources are limited, issues of this kind should not be ignored. Law clarification creates certainty for all taxpayers and reduces compliance and administrative costs.

[1] https://ministers.treasury.gov.au/ministers/arthur-sinodinos-2013/media-releases/restoring-integrity-australian-tax-system
[2] For example, our members are aware of numerous estates where the recognised defect in CGT event K3 has resulted in gains in excess of $1m not being taxed. More recently, issues associated with the residence (for tax purposes) of an estate mean that there are broader opportunities for capital gains that had accrued to a deceased person to escape tax.

If you would like to discuss any of the above, please contact Bryan Mitchell TEP, STEP Australia Board Chair, on email bmitchell@mitchellsol.com.au

Yours sincerely

Bryan Mitchell TEP
Chair of STEP Australia

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STEP Australia
ADVISING FAMILIES ACROSS GENERATIONS

20 August 2021

Michael Sukkar
Assistant Treasurer
Federal Member for Deakin
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Mitcham, VIC 3132
By email: Michael.Sukkar.MP@aph.gov.au

Dear Mr Sukkar,

RE: Report into the ATO's Systems and Processes Relating to the Taxation of Deceased Estates

We the Society of Trust & Estate Practitioners Australia Pty Limited (STEP Australia) represent professionals from across Australia who are specialists in trusts, estate planning and in supporting the needs of families (young and old, wealthy and modest). The objective of a STEP Professional is to advance the interests of families across generations. This often involves us in identifying issues of relative importance to families and bringing these to the attention of those who can make a positive difference. This is the purpose of this submission.

STEP Australia's membership includes lawyers, accountants, financial wealth advisors and trustee company professionals from across Australia; our members bring a multi-disciplinary approach to the benefit of their clients. It is this unique multi-disciplinary approach that supports this submission.

We are writing to you to seek your government's support for a review of the taxation provisions that apply to deceased estates.

In July 2020, the Inspector General of Taxation and Tax Ombudsman (**IGTO**), released a report into the ATO's systems and processes relating to the taxation of deceased estates. The Report observed that the undifferentiated application of general taxation of trusts principles to deceased estates may give rise to unintended tax consequences.

While noting that broad policy change was outside her remit, the IGTO recommended that:

- the ATO: explore with external stakeholders, such as members of the National Tax Liaison Group or other consultation forum, the consequences and challenges associated with applying general taxation of trusts principles to deceased estates; and

- where appropriate, make submission for further inquiry to bodies such as the Board of Taxation or lodging minutes with the Treasury noting the potential for law change.

Our members are keen to explore options for change in this area and suggest that this may be an issue that you could usefully request the Board of Taxation to review.

Whilst ideally there would be a separate code for the taxation of deceased estates, at the very least some further differentiation from general trust principles would be appropriate (for example as in the UK where the residence of the estate is taken to be the same as the deceased

unlike the case in Australia where the mere choice of an LPR can determine the residence of the estate and its tax outcomes).

If progress is not made in this area, we expect that compliance costs of securing the level of tax advice needed to manage the vagaries and imponderables in the current law will continue to escalate. We observe that as the current law is not producing the intended policy outcomes in many instances there is also a risk to revenue. The attached paper outlines some specific issues relevant to this matter.

If you would like to discuss any of the above, please contact Peter Bobbin TEP, STEP Australia Board Chair, on email pbobbin@colemangreig.com.au or Daniele Bechelet, STEP Australia Policy Committee Chair, on email danielle@avonlegal.com.au.

We thank you for your assistance and look forward to hearing from you.

Yours sincerely

Peter Bobbin TEP

Chair of STEP Australia

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Reflecting on Recommendation 6 of the IGTO: Review into Death and Taxes

October 2020

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Reflecting on Recommendation 6

Introduction

1. The Inspector-General of Taxation and Taxation Ombudsman (IGTO) recently released a report entitled *Death and Taxes: An Investigation into Australian Taxation Office Systems and Processes for dealing with Deceased Estates*. The report makes a number of recommendations that are intended to reduce the tax compliance and other cost burdens associated with the administration of an estate of a deceased individual.

2. The Report noted that there were broader taxation policy issues at play which fell outside the IGTO's tax administration functions. However, the IGTO observed that these policy issues should be carefully considered and, where possible, a solution designed to minimise or reduce the complexity and compliance costs for people seeking to finalise the estate of their loved ones[1].

3. To this end, Recommendation 6[2] provided that the ATO:
   - explore with external stakeholders, such as members of the National Tax Liaison Group, or other consultation forums, the consequences and challenges associated with applying general taxation of trusts principles to deceased estates; and
   - where appropriate, make submission for further inquiry to bodies such as the Board of Taxation or lodging minutes with the Treasury noting the potential for law change.

4. While acknowledging that, in the current circumstances, law change in this area may not be high on the government's list of priorities, this paper seeks to examine issues that arise in the context of the current legislative provisions and considers what an alternative regime for taxation of deceased estates might look like.

5. The paper considers how the current administrative an policy issues might be alleviated by treating the deceased and their estate as one tax entity (separate from any trust that might arise from the estate).

Background

6. For tax purposes, a deceased person and their estate are treated as separate tax entities. This immediately adds administrative complexity because each entity will require separate TFNs and income tax returns.

7. An 'upside' for taxpayers is that they get two tax free thresholds in the year of death, but the 'downside' is that losses (and certain other tax attributes) do not pass across from the individual to their estate. [3]

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[1] Page 72

[2] Page 38

[3] This itself can be confusing as there are other provisions which have the effect of allowing those attributes to pass across (such as section 70-105 of the ITAA 1997 for trading stock).

8. Failure to obtain an estate TFN in a timely fashion can draw the estate into the TFN withholding rules[4] and in some cases mean that an estate tax return must be lodged merely to recover tax withheld.

9. While one might think that obtaining a TFN should be a relatively straightforward/low cost activity, that is not necessarily the case particularly if the the legal personal representative (LPR) is a foreign resident.[5]

10. A foreign LPR must pass the same identification process as if he/she were applying for a personal TFN. The LPR must:
    - provide at least two proof of identity documents of which one must be primary.
    - the documents must be certified by a notary public or staff at the nearest Australian embassy.

11. Australian consulates and embassies aren't widely available and are not necessarily easy to get to in a pandemic. Imagine the dismay of an elderly LPR who resided outside of a town centre and made a special trip for certification only to find that they had brought the wrong document and had to undertake the journey a second time. Further as the ATO will accept only original paper copies of the certified documents there can be significant delays in the documentation being received in Australia and then being processed by the ATO.

12. However, the biggest driver in terms of complexity is the fact that a deceased estate is taxed as a trust (even though it isn't at general law).

13. The trust assessing provisions are notoriously difficult and the preparation of trust tax returns would generally require the services of a tax agent (even where the return is only being lodged to obtain a franking credit refund or a refund of tax withheld). In many instances, the cost of the return will be more than the amount of the refund.

14. Even determining the rate of tax that an LPR might pay is not a straightforward question. For example, although there is a concessional rate for deceased estates; that rate applies at the Commissioner's discretion.[6] And there is a difference in the rate depending on the number of years since the death of the individual.[7]

15. Not only do the trust assessing provisions apply, but estates can be drawn into other complex trust rules like the closely-held trust TFN rules and all that those rules entail.[8] [For example, an LPR who fails to withhold where a TFN has not been quoted by a beneficiary could be subject to a penalty equal to the amount of tax that should have been withheld.]

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[4] These rules require an mount to be withheld from payment of certain income by where a TFN has not been quoted – see Subdivision 12-E of the *Tax Administration Act* 1953.

[5] ATO website QC20108

[6] While the Tax law Improvement Project sought to replace discretions with tests of reasonableness, the trust provisions have never been rewritten into the ITAA 1997.

[7] As explained in TD 1992/192

[8] sub-paragraph 12-175 (1) (c) (i) in Schedule 1 to the TAA and section 272-100 in Schedule 1 to the ITAA 1936. These rules apply if the estate is unadministered for more than five years

16. The broad approach to tax for a deceased estate is that LPR will be assessed (at concessional rates compared to other trustees, especially for the 3 years after death) until the administration in respect of the various assets of the estate has been completed. Thus, for example, if the LPR assents to the distribution of an asset to a particular beneficiary, that asset is technically held on a bare trust for distribution and subsequent income from that asset will be assessed to the beneficiary entitled to the asset; while the income from the residue may continue to be assessed to the LPR of the estate.

17. Testamentary trusts may also arise at the end of administration. Notwithstanding the separateness for legal purposes of the estate, bare trusts and testamentary trusts arising after administration, in practice this is not well understood by the tax community and different approaches are likely to be taken in practice.[9]

18. Further complexity arises from the fact that the tax position of the estate of an Australian deceased individual may well depend on the residency of their LPR even though all of the deceased's assets are held in Australia and all beneficiaries are Australian resident for taxation purposes.[10]

19. As the IGTO observed in this regard:

    it is unlikely that deceased persons will turn their minds to the residency of their deceased estate when nominating their executor. It may also be the case that at the time of establishing their will, they could not foresee a situation where their nominated executor would become a non-resident for Australian tax purposes. The lack of control in such a situation places both the executor and the estate's beneficiaries in a difficult situation and having to navigate not only laws on taxation of trusts, but additional rules specific to non-residents. [11]

20. And in the converse, the estate of a 'foreign' deceased person will be an Australian resident trust if the only connection it has with Australia is an Australian resident LPR (including if others are resident overseas). This means that to the extent that the beneficiaries are not assessable, the LPR will be assessable on the worldwide income of the estate (subject to the operation of any double tax agreement).

The current system: more detail

21. The complexity is brought into sharp focus in the context of determining how capital gains from the sale of assets that the deceased owned are to be taxed.

22. The general policy of the CGT deceased estate rules is that the recognition of a gain or loss from an asset owned by a resident deceased person is deferred until the asset is sold by their LPR or a beneficiary in their estate. This is achieved by transferring the deceased's cost base and reduced cost base for the asset to their LPR/and later to a

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[9] Even ATO practices are at times inconsistent – although paragraph 5 IT 2622 suggests an estate and testamentary trust would be treated as one entity, we are aware of the ATO ringing practitioners advising that the trust should apply for a separate TFN (so that the trustee does not incorrectly obtain a medicare levy exemption).

[10] If the trustee (or all trustees) of a trust is (are) foreign resident(s), the trust estate will not be a resident trust estate. This can affect the amount that is taxed in Australia.

[11] page 72 of Report

beneficiary.[12]

23. However, gains and losses that would otherwise avoid taxation in Australia are intended to be brought to tax. Thus, CGT event K3 happens when an asset passes to certain tax advantaged entities; including when non-taxable Australian property[13] passes to a foreign resident[14]. [The event is taken to happen just before death and so captures gains only up to the time of death in the deceased's final income tax return.[15]]

24. If a resident LPR sells an asset that the deceased owned before death, then any gain or loss is taken into account in working out the net income of the estate. The rules for determining who is assessed on a net capital gain are quite complex. An LPR can choose to be specifically entitled to a capital gain (if trust property representing the gain has not been paid or applied to a beneficiary within two months of the end of the relevant year of income) with the result that the LPR will be assessed at the rates applicable under section 99 of the ITAA 1936[16] (this includes the benefit of the CGT discount).

25. If a beneficiary is made specifically entitled to a trust capital gain then they will be assessed on it; or if the beneficiary is a non-resident at the end of the income year the trustee will be assessed on their behalf under section 115-220 of the ITAA 1997/section 98 of the ITAA 1936.

26. If there are capital gains to which neither the trustee or beneficiaries are specifically entitled, the trustee will be assessed if there is no trust income or income to which no beneficiary is presently entitled. Otherwise the beneficiaries (or the trustee on their behalf) will be assessed.

27. This result is largely consistent with the intended policy, although there are some irregularities. For example, if a non-resident beneficiary is made specifically entitled to a capital gain a from a non-TAP asset, section 855-40 of the ITAA 1997 may apply to disregard it (depending on whether the stage of administration has been reached

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[12] Division 128 of the ITAA 1997

[13] 'Taxable Australian Property' is defined in section 855-15 of the ITAA 1997. Primarily it consists of land in Australia and interests in land rich entities.

[14] There is a separate question whether an asset 'passes' to a beneficiary prior to it being transferred to them. The ATO suggests that an asset can pass to a beneficiary if the beneficiary becomes absolutely entitled to the asset – which could perhaps happen if an executor makes an assent in favour of the beneficiary. However, given that the ATO takes the view that only a single beneficiary can be absolutely entitled to a trust asset, an estate asset would not pass if the executor had made an assent in respect of joint beneficiaries.

[15] An issue arises when the estate administration process exceeds past the period available to amend the deceased person's assessment for their final return. As it currently stands, if CGT event K3 happens after the amendment period of 2 or 4 years has expired, then it is essentially a tax-free gain because an amendment of a prior year assessment is statute barred. However, the general anti avoidance provisions Part IVA of the ITAA 1936 may need to be considered if this eventuality is planned.

This problem is known to regulators and was proposed to be addressed by amendment.[15] The proposed amendment was designed to capture any gain or loss from this CGT event in either the estate or testamentary trust tax return at the date of transfer, albeit at market value at the date of death of the testator. The subsequent Federal Government announced on 15 December 2013, as part of its 'Announced but unenacted measures' review, that it was not proceeding with the measure. The same issue will arise when assets are held within a testamentary trust for the benefit of a life tenant, and on their death, transferred to a tax advantaged entity such as a non-resident beneficiary.

[16] section 115-222 of the ITAA 1997

where the estate might be regarded as a fixed trust). This is inconsistent with the notion that gains that accrued to the deceased should be brought to account here (ie under CGT event K3).

28. However, the existing regime appears to assume that the LPR of a deceased person who was a resident of Australia will also be resident here. When the provisions were drafted having a foreign resident LPR was probably uncommon. But with high levels of migration to and from Australia (at least pre-pandemic), it is likely to be more commonly encountered.

29. As illustrated in the examples below, inappropriate policy outcomes arise where the LPR is a tax resident of a country that is different from the deceased.

Resident deceased – foreign LPR

30. Where the LPR of a deceased estate is a foreign resident, the estate will not be an Australian resident trust for taxation purposes. This means that capital gains and losses from non-TAP assets are not taken into account in working out the 'net income' of the estate.

31. This is because section 855-10 of the ITAA 1997 which requires the trustee of a foreign trust to disregard gains and losses from non-TAP assets overrides the requirement in subsection 95(1) of the ITAA 1936 that the trust net income be calculated on the basis that the trustee was a resident taxpayer.[17]

32. However, when untaxed amounts are paid to a resident beneficiary those amounts are potentially assessable under section 99B of the ITAA 1936. [Section 99B does not apply if the beneficiary is a non-resident for the entire income year in which the distribution is paid].

33. The ATO takes the view in Taxation Determination TD 2017/24, that an amount attributable to the non-TAP gain of a non-resident trust will be assessable under section 99B of the ITAA 1936 when distributed to a resident beneficiary. Further, the TD takes the view that the amount made assessable by subsection 99B(1) does not have the character of a capital gain for Australian tax purposes, nor is there any linkage between subsection 99B(1) and Subdivision 115-C of the ITAA 1997. This means that an amount which is included in assessable income under section 99B cannot be reduced by a capital loss or the CGT discount.

34. There are exceptions to the application of section 99B[18]. Perhaps the most important exception is for distributions of trust corpus. However, that exception does not apply to so much of a corpus distribution that would have been assessable had it been derived by a resident taxpayer. Accordingly, TD 2017/24 takes the view that a distribution from corpus that is attributable to a capital gain does not fall within the corpus exception.

Example – resident deceased; foreign LPR

Bob Builder resided in Sydney throughout his life. When he died in 2019, he had an extensive portfolio of ASX listed and foreign company shares.

[17] The consequences are discussed later.

[18] see subsection 99B(2) of the ITAA 1936

Bob was survived by his three children, Boris, Doris and Wendy. Doris and Wendy live in Sydney. However, Boris lives in the UK, having migrated there in 2014.

Bob's Will, which he executed in 2010, appointed Boris as his LPR.

Boris, as LPR, sold Bob's shares and made capital gains totalling $6m.

As Boris is a non-resident, the $6m is excluded from the net income of the estate and is therefore not taxed in the year it is made.

Two years later, Boris distributes $2m attributable to the gains to each of Doris, Wendy and himself. Boris is not assessable in Australia. Doris and Wendy however are each assessed on $2m. They are not entitled to any CGT discount even though Bob/Boris owned the shares for at least 12 months.

- If Doris had been the LPR, the gains would have been included in the estate net income. Depending on the particular circumstances, Doris as LPR may have been assessed under section 99 of the ITAA 1936 on $3m ($6m capital gains reduced by the 50% CGT discount). [This may be because Doris chose to be specifically entitled to the capital gains under section 115-230 of the ITAA 1997 or because there were no beneficiaries presently entitled to income of the estate.]

- Alternatively, if the beneficiaries were assessed in respect of their share of the capital gains (because they were made specifically entitled to them), Doris and Wendy would be entitled to the CGT discount. [Boris may be exempt under section 855-40 if the estate administration had reached the stage where the trust could be regarded as a fixed trust.]

Foreign resident deceased – resident LPR

35. Other issues arise where a foreign deceased individual has a resident LPR. That is, as their estate is a resident trust estate all foreign income might[19] be assessed here even though the deceased individual's only connection with Australia is their choice of LPR.

36. The CGT rules mainly produce an appropriate policy outcome. The LPR is taken to acquire the deceased's non-TAP assets for their market value at the date of the death. This ensures that any gain inherent in the asset at the time of death is not subject to tax here. Further if the LPR sells the asset and makes a capital gain, a foreign resident beneficiary's share may be able to be disregarded under section 855-40 (if the estate administration has reached the point where it is regarded as a fixed trust).

37. However somewhat inconsistently with the general policy of the CGT discount provisions, it appears that a resident LPR is not prevented from claiming the CGT discount in respect of TAP assets that the deceased owned even though the deceased, as a non-resident, would not have qualified for it.[20]

Example – foreign deceased; resident LPR

[19] Subject to operation of relevant DTA

[20] See private ruling 1051756645843. The Commissioner may refuse to exercise the discretion to apply section 99. If the LPR were assessed under section 99A, section 115-222 of the ITAA 1997 denies the benefit of the CGT discount.

Kerry Kiwi resided in New Zealand. She owned a rental property in Sydney that she acquired in 2015.

Kerry died in June 2018. She appointed, as her LPR, her sister Kylie who resides in Australia.

Kylie, as LPR, sells the property in June 2019 and makes a capital gain.

Kerry would not have been entitled to the CGT discount if she sold the property because of section 115-105 of the ITAA 1997. However, as Kylie is a resident trustee, she is entitled to the CGT discount.

Kylie may wish to confirm that the Commissioner will exercise his discretion to assess the rental income and capital gain under section 99 of the ITAA 1936.

A new approach

38. As suggested by the IGTO, the key to simplification would be to remove deceased estates from the regime that applies to trusts. One approach might be to treat the deceased individual and their estate as one tax entity; that is, as if the deceased had continued to live, though with rules about the collection of tax from living taxpayers such as their LPR.[21]

39. The table below looks at some of the advantages and disadvantages of such an approach:

Advantages	Disadvantages
Single tax file number – cost saving; avoid processing delays; avoid TFN withholding issues – that is, no need to lodge returns where tax withheld. Treatment of the estate as in individual taxpayer rather than a trust – much simpler to prepare returns and there is an existing system in place to obtain franking credit refund. Facilitates ongoing PAYG collection	
Removing demarcation between the deceased and their estate would render unnecessary the numerous rules that deal with this interface – for example, technical disposal and the need for rollovers of gains and losses (including with trading stock and depreciating assets), revenue and expense allocation would not be needed Much simpler and cheaper to administer. In the year of death, the at times significant compliance cost of splitting income and deductions between pre and	Only one tax free threshold in year of death

[21] If the deceased has separate LPRs in different jurisdictions, then the rules would need to specify which LPR was responsible for the payment of tax. See issue in private ruling 1051658665187.

post death periods can be avoided. In many cases, we suspect that taxpayers simply do not comply with this requirement and so the burden of compliance falls on the better advised. Revenue implications: • Losses of the deceased can be used after death • Pre-CGT assets would stay pre-CGT longer until transfers to beneficiary. • Tax free threshold would be available for indefinite period after death – ie no 3 year rule. [BUT, specific rules could be adopted to stop these revenue effects if desired by Government.]	
Avoids complexity where the LPR is resident in a different country- and avoids the section 99B issue for non-resident estates and the complexity of section 102AAM interest calculations if the estate administration extends beyond three years	Non-resident deceased and TAP – lose access to discount – but access to discount appears to be unintended and so the result would be consistent with policy. Ability to split estates – lose ability to split estates between resident and non-resident to obtain an Australian tax advantage. [Would still need rules about who tax is to be recovered from in this scenario]
Avoids complexity of present entitlement rules and disputes between the LPR and beneficiaries about who pays tax. Greater certainty – avoids issues about application of section 99/99A in the context of the estate – Commissioner discretion becomes irrelevant Avoids Div 11A application where LPR/beneficiary are foreign residents and complex interactions with Division 6	Lose the ability to manipulate the present entitlement rules Not clear how the DTAs would apply
Other issues	
CGT event K3 – could happen when asset passes – this deals with the defect in amendment period which prevents gains from being taxed as intended	Gains that are not taxed because of amendment period defect will be taxed – although the result would be consistent with the intended policy.

	Similarly, section 855-40 could not be relied on to exempt non-resident beneficiary's share of gain. Again, this would appear to be consistent with the intended policy.

40. While there are clearly other issues that need to be considered, such as whether a similar arrangement should apply for GST purposes, it seems at first blush that an approach like this would be simpler, more robust and operate more equitably. It might alleviate some of the administrative gridlock that exists under the current system.

Death duties again? Really?

by Ian Raspin, CTA, Managing Director, Lyn Freshwater, Senior Tax Consultant, and Mark Morris, FTI, Senior Tax Counsel, BNR Partners

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

Introduction

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

Murmurings abound at the moment about different ways that the federal government may want to bring in more tax revenue to pay off post-COVID-19 debt, or to better fund aged care in the future, or to do both.

Inevitably, when base broadening and wealth taxes come up, death duties enter (or re-enter) the discussion. Having been part of Australia's tax mix since before Federation at a colonial level, and since 1914 at a federal level, death duties were ditched at both levels by the early 1980s, but that does not stop people advocating for their reintroduction.

On one view, any form of wealth tax, or any new form of tax on capital for that matter, may inappropriately stifle economic recovery following the COVID-19 recession. The creativity, innovation and drive of the small and medium-sized enterprise market will be critical in that phase. But if there has to be a whole new tax on wealth or capital (and, as stated below, the authors do not think that there does have to be), at least a death duty or inheritance tax, properly targeted to inter-generational wealth transfer with decent concessions for active business assets, may be the least of the "evils".

That said, however, any serious proposal to reintroduce death duties (imposed on the estate) or inheritance/succession taxes (imposed on beneficiaries), or any combination of the two, would face significant challenges.

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

Second, death duties would face considerable "political" opposition and lobbying, doubtless coming, at least in part, from those who supported their removal throughout the 1960s and 1970s, such as farmers and those advocating for newly impoverished widows.

And, if finding a new source of significant revenue is the main requirement, there is the question of whether they would bring in enough tax revenue (or otherwise sufficiently enhance our society and economy) to justify the pain.

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

- the income tax law already has a number of features that look and feel like a "death" tax and these could readily be tweaked or expanded if desired without the need for a "whole new tax"; and
- there are many smaller, easily implemented changes to estate taxation that could expand the existing tax base to pick up some of the revenue likely to be generated by a conventional set of death duties.

If significant tax changes in the wealth tax space are in contemplation, the authors believe that all possibilities should be considered, including what have to date been seen as "sacred cows". Loopholes in the existing base could be fixed, the breadth of the base could be adjusted (including exemptions, such as the main residence exemption), and one could also tinker with tax rates that apply to different parts of the base (eg the CGT discount).

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

Existing aspects of the tax base that look like death duties

Some say that the fact that the legal personal representative (LPR) is liable for tax on the deceased's date of death income tax return (to the extent of assets in the estate) is akin to a "death" duty because it is tax imposed after the taxpayer has died. But there are perhaps better examples.

Superannuation provides one example. The superannuation death benefit is only tax-free if it goes to dependants and financially dependent offspring. If it goes to non-dependent

adult beneficiaries, the benefits are generally taxed to the estate. This is similar to a death tax. However, some may argue that tax on superannuation should apply more broadly unless the benefit goes to the surviving spouse.

Now to CGT. Unrealised capital gains to the deceased are not generally taxed at death (although there are exceptions to this) and the LPR or beneficiaries usually inherit the deceased's cost base, exposing them to tax on disposal (again, there are exceptions). So, in a sense, tax on capital gains is "inherited".

If an asset is left to a charity (other than a deductible gift recipient), or if something other than Australian land is left to a non-resident, there is *theoretically* a taxed capital gain under CGT event K3 at death (a "death duty") on the basis that, if unrealised gains are not captured at that time, they will disappear from the tax net after death. The tax is *theoretical* because it will not be collected if the asset passes to the charity or to a non-resident outside the two-year (or sometimes four-year) amendment period for date of death return assessments. This is a big loophole.

Existing aspects that look like a "free kick"

On the other hand, there are CGT concessions that perhaps go too far. A dwelling that was the main residence of the deceased *just before* death, and not used to produce income at that time, can be sold by the LPR or beneficiary completely tax-free within two years of death. This is irrespective of how the dwelling was used before *just before* death or even whether it had been the deceased's main residence for much (if any) of that period. Indeed, there seems to be nothing to prevent the claiming of another dwelling as an *actual* main residence of the deceased for that period. A real double dip! This is a case of an intended compliance cost concession for estates that is poorly targeted and arguably goes "too far".

There are other examples where the CGT base is curiously narrower than good policy would suggest. Pre-CGT dwellings that were never the main residence of the deceased also enjoy a two-year tax-free selling window. Further, the LPR can rent out any dwelling during that two-year period (whether pre-CGT or post-CGT to the deceased) with zero effect on the exemption. This period can be extended with the "okay" of the Commissioner. When CGT began, the window was only 12 months.

The current main residence exemption and death rules also have some drafting deficiencies which may permit (and, in the ATO's view, do indeed permit) taxpayers to "double up" on exemptions, for example, by obtaining a market value cost base on a main residence at death (which eliminates any pre-death capital gain or capital loss) *and* taking account of main residence days *before* death to reduce any capital gain over that market value if the dwelling is not sold within the two-year window.

When one examines examples like this, the existing tax arrangements after death, but as a result of death, reflect different policy considerations and sometimes reveal inconsistencies. Small changes can be made to tidy up the rules for estates and beneficiaries to bring in the tax they should.

Small change approach

A "small change" approach could involve simply fixing loopholes (such as those involving CGT event K3 and the main residence exemption as outlined above) and making minor policy changes or clarifications where necessary.

For example, it has never been clear whether the death roll-over in ss 128-10 and 128-15 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) is meant to come to an end once an estate asset passes to a testamentary (often discretionary) trust, or whether it is meant to continue until the asset finally reaches the hands of an individual beneficiary from a testamentary trust (and perhaps other intervening trusts). Literally, the law exempts only an LPR, and *not* a trustee of a testamentary trust. The ATO's administrative approach (see PS LA 2003/12) exempts transfers from testamentary trusts (including discretionary testamentary trusts). However, if the beneficiary is the trustee of another trust, the practice does not extend to a transfer to any beneficiary of *that* trust.

Curiously, a foreign resident deceased would not be eligible for the CGT discount if they sold Australian land, but the CGT discount is available if their estate has an Australian resident LPR who sells the asset.

On the flipside, a resident deceased person whose estate has a non-resident LPR can avoid CGT on non-Australian land assets even though CGT event K3 should apply.

A more recently observed phenomenon is the concept of "multiple" estates for the one deceased person whereby foreign-sited assets are kept out of the hands of the Australian resident trust rules.

An approach that treated the deceased and their estate as a continuing entity, thereby removing the estate from the trust assessing rules, might overcome some of the anomalous outcomes where the LPR is a resident of a different country from that of the deceased.

Bigger change approach

The full range of tax concessions which are currently enjoyed by deceased estates could be reviewed, including the concessional tax rates that are available to estates under s 99 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), assuming that "sacred cows" are no longer "sacred".

It appears that people are already trying to subvert the recent amendments to restrict the "excepted income" concession for minors in Div 6AA ITAA36 (broadly, to income from the deceased's own assets and superannuation proceeds etc) by trying to divert income from discretionary trusts through the deceased estate itself. While the Commissioner may seek to apply s 99A ITAA36 to such arrangements, it is a blunt instrument. There is a broader question about the need for a policy rethink because the nature of deceased estate planning has changed from relatively simple trust arrangements for surviving spouses and minor children to highly intricate succession plans involving (in the main) discretionary trusts, including multi-generational arrangements.

When CGT was introduced with effect from 20 September 1985, the federal government was keen to avoid the impression that it was, in any sense, a reintroduction of death

duties by stealth. Hence, as mentioned above, the death roll-over in ss 128-10 and 128-15 usually defers recognition of any capital gain or loss until an LPR or beneficiary sells the deceased's assets.

Of course, it would be relatively simple in terms of drafting to remove the roll-over either fully or partly. The impact of such a change, would, however, be considerable in terms of the sheer number and cost of valuations required at death (noting that this was probably one of the reasons why Australia introduced a pre-CGT/post-CGT regime rather than the United Kingdom's original 1965 valuation date approach). This change could also generate real cash flow issues where illiquid assets are concerned.

Notwithstanding the problems, this sort of change would be a de facto death duties regime — without the need for a new and separate piece of legislation while avoiding interactions between CGT and death duties that may otherwise have to be addressed. Unlike a real death duty that would tax the value of assets rather than accrued gains on assets, this approach would just bring CGT collection forward, but that may be more palatable than a duty on estate value and capital gains tax to those who realise estate assets with accrued gains.

Serious consideration could then be given to what assets should be taxed at death and what are not taxed at death. A case would no doubt also be made to continue to defer CGT on agricultural land and small business assets. There would also be a good argument for leaving a concession for spousal transfers of all (or some) assets (such as a main residence).

Some may query at this point whether the fact that the deceased who resided in the property should remain relevant if the property passes to beneficiaries who do not also live there.

In fact, a bigger change approach, beyond death duties, would be to consider whether the main residence exemption should continue at all. It is a very costly exclusion (to government revenue) from the CGT base. For example, it was estimated to cost the budget $74b in the 2017-18 forecast, and $327.5b over the forward estimates.[2] The removal of the exemption for non-residents is estimated to result in a revenue saving of $155m in 2020-21.[3]

No doubt, removal of the main residence exemption would be politically difficult and raise concerns over "lock-in" and further decreases in housing availability (and affordability). But the main residence has become an important (if not *the* most important) store of wealth for many individuals under all but the highest wealth brackets, and so may well feature in any wealth tax that is introduced.

Partial removal of the main residence exemption might also be considered, but the difficulty there has always been fairly balancing the treatment of individuals in different housing markets (that is, Sydney and Melbourne as opposed to the rest of Australia).

If all of this looks just too hard, the 50% CGT discount, which was originally to be a replacement for cost base indexation, has become much more than that in low inflationary times. It is extraordinarily generous and encourages saving and investment to generate capital rather than income returns which are subject to progressive income tax.

Some advocate the return of indexation (but, please, not the rounded to 3 decimal place indexation factors), and this would take trusts and companies back to a neutral playing field. However, a better option may be to reduce the discount rate to a smaller percentage, say, 5% or 10%. Or, as applied in other jurisdictions, the discount rate could increase on a "stepped" basis the longer the asset is held. A lesser change might involve removing or reducing the CGT discount for assets which taxpayers have negatively geared.

The "big bang" – reintroduce death duties or a similar wealth tax

If none of the above appeals, and the government really does want to "bite the bullet", what can be said about a reintroduction of death duties/inheritance taxes?

The first thing of interest is, as previously mentioned, that Australia had got rid of death duties by the early 1980s, notwithstanding the fact that countries with similar taxing regimes retained them (and some, like the United States and the UK continue to have them (at about 40%). The OECD average rate is 15%.

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

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

Prior to the 1980s, Australia's duties were at both a state and federal level, full of complexity, with a combination of relatively low exemptions, moderate to high rates, and, except towards the end, not much in the way of concession for spousal transfers. Death duties were extremely unpopular.

Strong inflationary pressures in the late 1960s and early 1970s had brought ever smaller estates into the net, increasing the overall costs of administration and compliance. Death duties were relatively easy to avoid with the use of trusts, especially discretionary trusts, so high wealth individuals in the main did avoid the duties, but duties fell harshly on business people who died unexpectedly and on people who operated through partnerships and owned assets in their own names. Impoverished widows ended up relying on state pensions, and farmers, who had high value but low income-producing and hard to sell assets, were often worst hit of all. The duties did not produce much government revenue for all of the pain.

These factors would surely have to be addressed in any possible reintroduction.

What are some of the other issues?

Federal or state (or, God forbid, both)?

It seems highly unlikely that the previous arrangement of both state and federal duties would come to pass, although that does remain the approach in the US. In Australia, it would presumably be at a federal level only (if at all).

Estate tax or inheritance tax (or a bit of both)?

Should duties be levied on the estate or on those who inherit (or a bit of both)? Don't laugh — Western Australia previously assessed some duties on the estate and some on successors!

The Henry review[4] pointed to the possibility of introducing an estate tax, an inheritance tax or an accessions tax.

Broadly, an estate tax would apply to the whole of an individual's estate, regardless of how many recipients there were. It could be modified to favour bequests to spouses or to other categories of dependent recipient, as such bequests could be concessionally valued or be subject to a flat percentage discount.

By contrast, an inheritance tax would apply separately to each inheritance received by an individual, which would typically be levied at progressive tax rates.

An accessions tax would essentially tax gifts and inheritances received by a particular person on a cumulative basis. It would take into account the fact that some recipients receive a number of substantial inheritances over the course of their lives and that they should be taxed cumulatively on the value of those amounts. Ireland has such a system (capital acquisitions tax, or CAT), with a hefty 33% tax applying once the threshold is reached, and the record-keeping required for a lifetime system may present some challenges.

Prima facie, an inheritance tax is more aligned with the progressive income tax system as it taxes the bequest in the hands of the recipient rather than the estate of the donor. However, it would provide tax planning opportunities as the deceased may be able to reduce the overall tax burden by allocating the inheritance differentially among such beneficiaries, compared to the total tax that would be payable on the entire estate under an estate's tax. This is in the same way, broadly, that discretionary trusts are now used to split tax liability for income tax, or for CGT purposes, where, to avoid CGT event K3, cash or pre-CGT assets are given to non-residents, with residents taking the bulk of other assets.

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

The Henry review concluded that, while there were arguments in favour of both an estate tax and an inheritance tax, an estate tax would be the best model for Australia if a bequest tax was to be introduced.

In reaching that conclusion, the Henry review noted[5] that an estate tax would avoid the lifetime complexity of the accessions tax and be simpler to administer than an inheritance tax. It also accords with the tax system structure under which income savings are subject to relatively uniform low rates of tax, and it removes incentives for donors to split up their estates to minimise the tax payable.

Such an outcome is consistent with the reforms proposed under ch 24 of the Asprey report in 1975 which similarly concluded that there were merits to taxing under both proposals but that an estate tax would be administratively simpler and would more easily control tax avoidance.

Interestingly, discretionary trusts were much less prevalent in the mid-1970s than they are today (today, there are approximately one million such trusts, split roughly 50/50 investment and business), so an estate tax may possibly be used as a lever against discretionary trusts.

Recommendation 25 of the Henry review stated that, while no recommendation was made on the possible introduction of a tax on bequest, the Commonwealth Government should nonetheless promote further study and community discussion on the options available.

Nonetheless, the Henry review's findings that the preferred form of any reform should be in the nature of an estate tax is clearly influenced by the detailed findings of the Asprey report.

What assets?

The Asprey report suggested that the tax base of an estate duty should at least include the real and personal property owned by the deceased at the time of their death, which then becomes part of the estate administered by the LPR. However, the report also proposed that the base on which estate duty is levied should also include property that the deceased had power to acquire at the time of their death. Thus, it would include property the subject of a power of appointment which the deceased had at the time of their death, which could have been exercised in their own favour. While not directly referred to, this would appear to place a constraint on the use of discretionary trusts as a possible means of avoiding duty as was the experience under the former estate duty regime.

The Asprey report also suggested that, in relation to certain illiquid assets (such as farming land), LPRs should have an option to spread the payment of duty over a number of years to minimise the cash-flow effect of the duty.

Threshold, rate and revenue potential?

Now we get to the nitty gritty!

The Henry review pointed out that raising revenue should be done to cause the least harm to economic efficiency, provide equity (horizontal, vertical and intergenerational), and minimise complexity.

The Henry review also pointed out[6] that no OECD country regards wealth transfer taxes as a major source of revenue and that, on average, OECD countries only raised 0.41% of their total tax revenue from such taxes.

If the tax has a large threshold, and therefore fewer cases, a high rate is needed to ensure a reasonable revenue take. This is broadly the current approach federally in the US. But a high rate means that there are big incentives to get around the impost.

Too small a threshold, even with a smaller rate, could bring too many small estates into the net and lead to an increase in administration, compliance complexity and costs, as was the case with the old death duties in Australia.

That seems to leave a large threshold so only large estates are caught, and a low rate to minimise efficiency distortions and discourage avoidance. But will this produce much revenue?

The Henry review recommended that the merits of introducing a bequest tax should be considered and that, if it

was introduced, it should only be levied at a low flat rate and be designed to affect only large bequests.

It seems that the only way in which an estate or inheritance tax could generate a significant amount of revenue in Australia is where it is imposed on a broad base at a low rate of tax. Currently, there is no modelling which indicates what level of revenue would be generated by the introduction of such a tax (which would also be contrary to international trends). However, an interesting article published by the Australian Institute for Business and Economics of the University of Queensland does discuss the economic merits of such a broad-based proposal.[7]

One of the arguments is that, even if significant revenue is not generated, a death duty or inheritance tax may address wealth inequality to some extent. As people are now living longer, assets are increasingly left to financially secure spouses and children, causing wealth inequality (and the economic and social disadvantages that that creates) to increase. A tax may help to reduce these effects.

Any revenue raised from the tax could also be used to increase opportunities, for example, with spending on education and scholarships, and the tax may be reasonably efficient. It may not "distort" the behaviour of the deceased to the extent that bequests are from assets that the testator kept for a "rainy day" but, in the end, were not needed, or where the deceased died unexpectedly. Even if testators decide to spend rather than save in order to leave to others, there may be a positive effect on demand, as well as helping to break down stores of wealth. To the extent that the tax did discourage some saving and investment by living people, at least the actual impost is deferred until after death.

Spousal transfer exemption?

Politically, duties with a spousal transfer exemption would be easier to sell, as there would then be a clear focus on the *inter-generational* transfer of wealth. This would be essentially a deferral of tax in relation to many spousal transfers, as is the case in the UK (which also allows any unused threshold to be passed to surviving spouses). The Asprey report suggested, however, that there should be a monetary limit on a spousal transfer exemption.

Complexity, structuring and costs

One of the major concerns about the reintroduction of inheritance taxes is that they become very complex and encourage advisers to design structures to get around the tax, for example, by using chains of trusts to separate the assets from the true owners. One of the key issues is that these structures will have an impact on the effectiveness of other taxes, which is unlikely to be desirable from either a compliance cost or administration perspective.

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

International dimension

Would any new tax be like income tax and assess residents on worldwide wealth, and non-residents on Australian assets? If so, similar complexities would arise, for example:

- How would the ATO track overseas gifts that were relevant for a resident's tax-free concession?
- What structuring would be entered into by non-residents to ensure that they were not sufficiently "connected" to Australian assets?

There would also be the question of foreign tax credits and the need to amend the scope of treaties. Treaty interactions would inevitably be complex because of the different ways that countries levy death duties and inheritance taxes. More cases would also arise because, pre-COVID-19 at least, there have been significant increases in the international mobility of income and capital.

Interaction with other taxes

It goes without saying that interactions with other taxes and duties would be needed, especially CGT and stamp duties.

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

Other considerations

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

- the cash-flow implications for estates that are held predominantly in the form of liquid assets;
- the treatment of bequests to charities, which are concessionally taxed in many countries;
- how any such tax would interact with CGT;
- how the tax would interact with the taxation of superannuation benefits on death;
- the treatment of non-resident donors and property located outside Australia; and
- the design of the gift tax to accompany the request tax.

Other wealth taxes

Of course, death duties are not the only "wealth tax" around. There are many others.

Land holdings have sometimes been targeted because they can easily be identified and (usually) valued, but clearly that is highly distortional and inequitable.

In the OECD's report, *The role and design of net wealth taxes in the OECD*,[9] it was observed that there had been a renewed interest in wealth taxation for collection and wealth redistribution purposes, although fewer OECD countries then levied them than in the past.

The report observed that repeal had often been because of administrative and efficiency concerns, redistributive goals had not been met, and the revenue collected had been very low. However, the report argued that there was a strong case for addressing wealth inequality through the tax system — that it is far greater than income inequality and tends to be self-reinforcing. The question was whether a wealth tax was the most effective way of addressing wealth inequality.

Australia already has progressive income tax and a CGT regime where net capital gains are taxed essentially as income (thus progressively), but as noted above, CGT contains some very significant exemptions and rate concessions that weaken its potential effect on addressing wealth inequality. For example, non-assessable distributions from discretionary trusts are not taxed as income or as capital gains.

It may well be that, if there is a desire to reduce wealth inequality, instead of imposing a new wealth tax via a death duty or something similar, fixing base and rate erosion in CGT may provide much of the answer.

It must be remembered too that wealth taxes tend to be very complicated in nature, and this leaves them open to abuse and avoidance. Even former prime minister Paul Keating's recent proposal in the aged care royal commission for an alternative basis to fund aged care (a repayable loan system, like HECS, after death) was met with a question from Commissioner Tony Pagone QC (a noted former tax lawyer and judge) as to whether the proposal could be seen as a death tax. Mr Pagone observed that, putting on his former tax lawyer hat, he could see many people trying to make sure that there would be no assets left to repay the loan.

Conclusion

Many significant impediments would be faced by any serious proposal to reintroduce death duties. A better approach may lie in making smaller policy and technical changes to the existing tax base, especially the CGT rules that apply to deceased estates. If this is done well, a greater degree of progressivity could be achieved on "capital" income, with a consequent effect on wealth inequality.

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