24 January 2024

The Honourable Stephen Jones MP
Assistant Treasurer and Minister for Financial Services
PO Box 6022
House of Representatives
Parliament House
Canberra ACT 2600

By email: PreBudgetSubmissions@treasury.gov.au

Dear Minister,

Pre-budget Submission

Thank you for the opportunity to make a submission.

STEP is a global professional body comprising lawyers, accountants, trustees and other specialist practitioners. STEP Australia represents professionals from across Australia whose objective is to advance the interests of families by bringing a multidisciplinary approach to their estate planning and intergenerational wealth transfer Our mission is set and uphold high professional standards, inform public policy, promote professional education and connect practitioners globally to share knowledge and best practice.

Our members involved in estate administration are concerned that, despite issues having been previously raised as outlined below, nothing has been done to amend various aspects of the law relating to deceased estates that bring about unintended outcomes for those involved in the administration of those estates.

By way of context, we note that:

- in 2022 there were 190,394 record deaths in Australia (521 per day)
- according to the 2021 Productivity Commission Report, *Wealth transfers and their economic effects*, the value of inheritance in 2018 was $107b and projected to be $224b per year by 2024.
- 52% of Australians are either first or second-generation migrants, meaning that many deceased estates involve international aspects.

Some of the issues confronting practitioners were highlighted by the Inspector General of Taxation and Tax Ombudsman in her report into the ATO's systems and processes relating to the taxation of deceased estates (See in particular Recommendation 6)[1]. Others were identified as far back as 2011 in Treasury *Minor amendments – proposals paper May 2011* and *Minor amendments to the capital gains tax law Proposals Paper June 2012 (*extracted at **Attachment A)**.

In a Press Release by the then Assistant Treasurer on 14 December 2014 curiously entitled '*Integrity Restored to Australia's Tax System'* it was decided not to proceed with them thereby providing no level of integrity from a user perspective (see Item 63(a) and (b) of that Release). Significantly, by identifying these issues (and then not progressing them) the effect has been both to increase uncertainty and to confirm (in a sense) that the law, as it stands, does not result in effective outcomes, making it difficult for the ATO to come up with a solution. There is also an increased compliance cost for executors trying to do the right thing but unsure of the ATO's approach.

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[1] Included as part of Attachment C

They must incur the costs a private ruling (not to mention the cost to the ATO).

While from a macroeconomic perspective, these anomalies are not significant they nonetheless expose LPRs and trustees, as well as tax practitioners, to unnecessary risk and compliance cost. An LPR is often in a unique position in that they are responsible for payment of tax for the estate but may have no interest in the estate assets. If they get the answer wrong, they may have to fund the estate tax from their own funds.

The robodebt saga has highlighted that defective laws should be reviewed to protect those that are affected by them.

In the past the ATO and Treasury would have put these issues forward as part of their 'care and maintenance of the tax system' role. But, no doubt for a number of reasons, over the last decade, issues of this type have not received any attention from them.

We have also attempted raising some other issues through the Board of Tax 'Sounding Board' **(Attachment B)** but again that was to no avail. The only way that we can see to bring about change is to lobby the government directly.

Our Main Concerns

In line with the submission that we made on 12 August 2022[2], we would like to see all of the legislative issues affecting deceased estates to be addressed. Doing so is unlikely to come at a cost to revenue and may be revenue positive. For example, there is a defect in the partial main residence exemption which means that beneficiaries get a double tax benefit – clearly this was not intended and is not consistent with the approach where there is a cost base uplift for a pre-CGT asset. In times of rapidly increasing property values, the defect can have a six or seven figure cost to revenue.

However, given the growing number of migrants to Australia, our main concern is to have a special rule introduced to determine the tax residency of a deceased estate. Our proposal is that a deceased estate should have the same residence as the deceased individual when they died. Adopting this approach would produce more predictable results for estates and revenue authorities and be consistent with the way practitioners have previously applied the law.[3]

You may wonder why this issue in particular has become important given that the residency rules for trusts have not changed. The answer lies in the release by the ATO of Taxation Determinations in 2017. Although these TDs are directed at discretionary trusts, they necessarily apply to deceased estates (because they are taxed like trusts). Practitioners who do not consider having a foreign LPR for certain estates are at real risk of a negligence claim from their clients. You can see from the example attached to this submission (**Attachment C**), that tax which is intended to be picked up by CGT event K3 (for example on Australian shares) is lost to the Australian tax system if the deceased appoints a foreign LPR. The potential lost revenue can involve quite significant amounts.

Our other priority issue is to ensure that the CGT death roll-over treatment applies if the beneficiary of an estate dies before assets of that estate pass to them. Currently the law operates to recognise a capital gain when the assets of the first estate pass from the LPR of the second estate to beneficiaries in that estate. This is because, the roll-over treatment only applies to assets that a person owned when they died. This was intended to be addressed in the 2011 amendments but did not proceed. The issue was raised but rejected as a candidate for the Commissioner's remedial power. Frustratingly, the ATO told us that in their view the scenario does not arise that often. You don't have to look far to see this is absolutely not the case.[4]

[2] Letter dated 12 August 2022 to The Hon Stephen Jones MP attached for ease of reference
[3] This is another way of addressing the issues raised by the Inspector General in Recommendation 6
[4] https://www.abc.net.au/everyday/widowhood-effect-increased-risk-dying-after-spouse-death/103132084
https://www.abc.net.au/news/2024-01-16/dallas-hayden-dies/103325142

I would like the opportunity to discuss with you how these matters might be progressed, particularly if this cannot be done as part of the Budget process.

Yours sincerely

Ian Raspin TEP
Chair of STEP Australia

CC: Jennifer Sheean TEP, STEP Australia Policy Committee Chair
E: sheean@qldbar.asn.au

Attachment A

Treasury 2011 Paper [Minor Amendments to the Capital Gains Tax Law Treasury.gov.au]

Deceased estates

These changes apply to CGT events happening on or after the day the legislation receives Royal Assent.

Background on Division 128

Division 128 provides a CGT roll-over when a taxpayer dies and a CGT asset owned just before their death passes to their legal personal representative (LPR) and also where it subsequently passes to a beneficiary in the estate. There is a similar CGT roll-over where an asset which the deceased owned as a joint tenant passes by survivorship to the remaining joint tenants.

- CGT event K3 (section 104-215) provides an exception to this if the asset passes to a beneficiary in the taxpayer's estate that is an exempt entity, trustee of a complying superannuation entity or a foreign resident. The event is taken to have happened just before the death of the individual — so that any capital gain or capital loss is included in the deceased's final income tax return.

CGT roll-over for a trustee of a testamentary trust

Current treatment

Division 128 does not currently provide a CGT roll-over if the asset is transferred from a trustee of a testamentary trust to a beneficiary of the trust. This means that a CGT taxing point will happen when an asset is transferred from a trustee of a testamentary trust to a beneficiary.

- A testamentary trust is established under a will and has effect after the individual's estate has finished administration. A testamentary trust provides flexibility in the distribution of income and assets of the trust to beneficiaries. These trusts are often used for planning for the future needs of family members, including being used to protect assets for the benefit of a minor or an individual with a disability.

However, in Law Administration Practice Statement PS LA 2003/12, the Commissioner of Taxation indicated that he will treat the trustee of a testamentary trust in the same way that an LPR is treated for the purposes of Division 128. In essence, this provides a CGT roll-over when an asset is transferred from a trustee of a testamentary trust to a beneficiary.

The Tax Office has concerns about the sustainability of the practice. Changes to the CGT small business concessions in section 152-80 which specifically identify trustees of testamentary trusts, might suggest that section 128-15 is intended only to apply to an LPR.

Proposed treatment

A CGT roll-over will be provided where the deceased's asset (or interest in that asset) passes from a trustee of a testamentary trust (including a discretionary testamentary trust) to a beneficiary of the trust.

- This effectively defers any CGT liability until a later dealing with the asset by a beneficiary.

Technical Amendments

The Government is aware of a number of minor technical issues relating to the application of CGT to deceased estates. These changes will either resolve deficiencies in the current law or reduce legislative uncertainty to ensure the provisions operate appropriately.

Current law	*Current proposal*
Issue 1. Acquiring an interest in the deceased's asset	
To access a CGT roll-over under Division 128, the provisions require the LPR or beneficiary of a deceased estate to acquire the deceased's CGT asset. On a strict view of the law, this cannot be satisfied where two or more beneficiaries acquire the deceased's asset. This is because each beneficiary acquires only an interest in the deceased's CGT asset, rather than the entire CGT asset.	A CGT roll-over will apply where two or more beneficiaries each acquire an interest in the deceased's CGT asset.
Issue 2. Cost base modification deficiency — land	
Item 3 in the table in subsection 128-15(4) provides a market value cost base for the deceased's dwelling where it was their main residence just before their death, and at that time it was not being used for the purpose of producing assessable income. The market value cost base rule does not extend to land that is adjacent to the dwelling, even where that land would be eligible for the CGT main residence exemption. This is because under section 118-120, land adjacent to a dwelling is generally treated as if it were a dwelling only for the purposes of Subdivision 118-B. This is deficient in that it is not extended to Division 128, which is where the cost base modification rules on death are located.	The cost base modification for a main residence dwelling will take into account adjacent land, to the extent that the land would be eligible for the CGT main residence exemption.

Current law	*Current proposal*
Issue 3. Cost base modification deficiency — income-producing use	
Following on from Issue 2, the market value cost base rule also does not apply where the deceased's dwelling was used for producing assessable income just before their death where that income-producing use would not have affected the deceased's entitlement to a full CGT main residence exemption. This situation could occur when the deceased was accessing the absence extension in section 118-145. Under the main residence exemption, this income-producing use can be disregarded under subsection 118-190(3). However, this only applies for the purpose of calculating a main residence exemption, not for the purposes of Division 128.	The cost base modification for a main residence dwelling will take into account where the dwelling was used for producing assessable income but where that use would not have affected the deceased's entitlement to a full CGT main residence exemption.
Issue 4. Death before administration	
Division 128 does not provide a roll-over when the intended beneficiary of a deceased estate dies before administration is completed and an asset owned by the first deceased person passes from the intended beneficiary's LPR to a trustee of a testamentary trust or a beneficiary in the intended beneficiary's estate. This is because the asset was not one which the intended beneficiary owned when they died.	In cases where an individual (the first deceased) dies and the intended beneficiary also dies before an asset which the first deceased owned passes out to them, the asset will be treated as though it had passed to the intended beneficiary before they died. This ensures that a roll-over will apply when an asset passes from the intended beneficiary's LPR to a trustee of a testamentary trust or a beneficiary in their estate.
Issue 5. Joint tenant cost base modification	
A surviving joint tenant whose interest is enlarged due to the death of a joint tenant is unable to access equivalent cost base rules to those of a beneficiary of a deceased estate (see section 128-50).	Cost base modifications will be available for surviving joint tenants that are equivalent to those available to a beneficiary of a deceased estate. This maintains consistency between joint tenants and deceased estate cases.

Current law	*Current proposal*
This is because the cost base rules for joint tenants do not replicate rules that apply to assets that pass through a deceased estate such as those in items 2, 3 and 3A in the table in subsection 128-15(4).	
Issue 6. Joint tenant issues regarding CGT discount	
The table in subsection 115-30(1) contains special rules for determining when CGT assets are taken to have been acquired for the purpose of determining eligibility for the CGT discount. Beneficiaries of deceased estates are deemed to have acquired pre-CGT assets of the deceased at the time of the deceased's death. However, there is no equivalent rule for pre-CGT assets for surviving joint tenants. Item 7 in the table in subsection 115-30(1) provides that these assets are acquired by the surviving joint tenant(s) when the deceased acquired his or her interest in the asset.	When an interest in a pre-CGT asset passes by survivorship, for the purposes of the CGT discount, the interest in the asset will be taken to be acquired by the surviving joint tenant(s) when the deceased died, rather than when the deceased acquired the asset. This ensures consistency between joint tenants and deceased estate cases.
Issue 7. CGT event K3 — Delay seeking endorsement	
CGT event K3 can be circumvented where an entity would be entitled to tax-exempt status but has not been endorsed as such by the Commissioner until after the asset has passed to it. This could happen due to an entity delaying seeking endorsement or if the trust is only created when the asset passes to it.	CGT event K3 will happen if at the time an asset passes to an entity, the entity satisfies all of the conditions required for exempt entities, despite not yet having been endorsed by the Commissioner.
Issue 8. CGT event K3 — Amendment period	
CGT event K3 can also be circumvented where an asset does not pass to an entity listed in that CGT event until after the deceased's standard amendment period has expired. Where the deceased's assessment cannot be amended (usually two or four years after the assessment), effectively no capital gain or capital loss can be recognised.	An embedded capital gain or loss will still be subject to tax when an asset is transferred to an entity listed in CGT event K3 outside the deceased's standard amendment period. This can be achieved by excluding CGT event K3 from the standard amendment period.

Current law	*Current proposal*
Issue 9. CGT E Events — Issues with deceased estates	
Section 102-20 requires a CGT event to 'happen' for a taxpayer to make a capital gain or capital loss. If more than one CGT event happens in particular circumstances, section 102-25 generally requires the taxpayer to use the CGT event that is most specific to their circumstances. CGT events E5 to E8 (relating to trusts, sections 104-75 to 104-100) contain an exception so that they do not 'happen' to a 'trust to which Division 128 applies.' The exception was intended to ensure that neither the trustee nor the beneficiary made a capital gain or capital loss in the circumstances giving rise to those CGT events. However, if the exception is satisfied, it means that those events do not 'happen' at all and another (less relevant) CGT event which has happened may apply. Although it is immaterial to an LPR which event happens when an asset passes to a beneficiary (because of the exception in subsection 128-15(3)), the same is not true for a beneficiary. The beneficiary's interest in the trust may come to an end (in whole or in part) when an asset owned by the deceased passes from their LPR to the beneficiary or when the beneficiary disposes of their capital interest in the trust to a third party before administration is complete. Because another CGT event would happen to the beneficiary instead of CGT events E5-E8 at this time, the beneficiary generally cannot disregard any capital gain or capital loss on their trust interest. There is nothing in the CGT provisions to disregard that capital gain or loss.	The relevant CGT E event will 'happen' for 'trusts to which Division 128 applies' but both the trustee and beneficiary of these trusts will not realise a capital gain or capital loss when these events happen, to the extent the gain or loss relates to assets owned by the deceased.

Treasury 2012 paper [Minor Amendments to the Capital Gains Tax Law | Treasury.gov.au]

Refinements to the income tax law in relation to deceased estates

This proposal amends the income tax law to make refinements to the 2011-12 Budget measure in relation to income tax changes for deceased estates.

Under the CGT provisions, any CGT consequences that arise on the death of an individual are typically deferred until a later dealing with that asset by the beneficiary of the estate. The 2011-12 Budget measure ensures that a CGT deferral also operates where the deceased's asset passes through a testamentary trust or a trust established through the operation of law as a result of the ending of the administration of a deceased estate. As part of these changes, the 2011-12 Budget measure involves making technical amendments relating to the deceased estate provisions. The 2011-12 Budget changes were to take effect for CGT events happening on or after the day the legislation receives Royal Assent.

Amendments to CGT event K3

CGT event K3 provides an exception to the policy principle of the CGT regime relating to deceased estates, ensuring that if an asset passes to a concessionally taxed entity from a deceased estate, a capital gain or capital loss is still recognised in the deceased's final tax return. The rationale for having this exception is to prevent assets with an embedded capital gain escaping taxation (or being taxed at a reduced rate) when they are later disposed of by the concessionally taxed entity.

Amending the deceased's final tax return

Background

CGT event K3 can be circumvented where an asset does not pass to a concessionally taxed entity until after the deceased's standard amendment period has expired. Where the deceased's assessment cannot be amended (usually four years after the assessment), effectively no capital gain or capital loss can be recognised. The technical amendments announced as part of the 2011-12 Budget measure ensure that where CGT event K3 happens outside of the deceased's standard amendment period, a CGT liability still arises in the deceased's tax return. It was proposed this could be achieved by excluding CGT event K3 from the standard amendment period.

Industry raised concerns that, in some cases, the 2011-12 Budget measure would require the deceased's tax return to be amended potentially decades after the deceased's death. This would add more compliance costs as the deceased's tax return (and the administration of the estate) would have been resolved a long time before CGT event K3 happens. This issue of increased compliance costs arises more generally for CGT event K3 and may arise even where the asset passes to a concessionally taxed entity within the standard amendment period, as the deceased's tax return might have already been finalised.

Proposed treatment

This proposal will modify CGT event K3 for deceased estate cases so that the CGT event will happen to the relevant entity that passes the asset to the concessionally taxed entity, ensuring that no CGT liability escapes taxation outside of the deceased's amendment period while minimising compliance costs by avoiding the need to amend the deceased's tax return in all cases involving CGT event K3.

- This is consistent with how Division 128 operates where a testamentary trustee (using an ATO practice statement) or a legal personal representative (LPR) sells an asset to a third party, rather than passing the asset to the intended beneficiary of the estate. Essentially, no CGT roll-over is provided and the entity selling the asset is required to pay the CGT liability.

Under this proposal, the tax liability will lie with the relevant entity (such as the LPR or testamentary trustee) that passes the asset to the concessionally taxed entity, rather than resting with the beneficiary. This entity will now be able to utilise their realised capital losses against CGT event K3, instead of the current practice of the deceased utilising their capital losses against their capital gain from CGT event K3.

This proposal will ensure that the tax liability is still calculated on the same basis as the current operation of CGT event K3 (that is, based on the difference between the cost base and the market value of the asset at the time of the deceased's death). However, the time at which the event happens is now aligned to when the asset passes to the concessionally taxed entity.

To prevent any retrospective impacts, this change will apply to CGT events that are triggered following the death of an individual, provided the death occurs on or after the day the amending Bill receives Royal Assent.

CGT event K3 happening in joint tenant situations

Background

In developing the more detailed design of the 2011-12 Budget measure, it was identified that CGT event K3 does not happen in situations where an asset passes via survivorship on the deceased's death to a surviving joint tenant (or joint tenants) that is a concessionally taxed entity (for example, a foreign resident). Rather, CGT event K3 is currently limited to cases where an asset passes through a deceased estate.

Proposed treatment

This proposal will remedy this technical deficiency, providing consistent CGT treatment for assets that pass to concessionally taxed entities regardless of whether an asset passes through a deceased estate or via survivorship. In joint tenant cases, this will ensure the deceased will recognise any CGT consequences in their final tax return.

To ensure consistency with the main changes to CGT event K3, this change will apply to CGT events that are triggered following the death of an individual, provided the death occurs on or after the day the amending Bill receives Royal Assent.

Attachment B

Sounding Board suggestions

Partial main residence: sections 118-200

Submitted by
Ian Raspin
Topic
What were they thinking: clarifying the policy
Date
21/11/2019
Issue
There is a defect in the way that the main residence exemption applies if a deceased person's legal personal representative (LPR) or beneficiary is taken to have acquired the deceased's main residence for market value at the date of death: item 3 in the table in subsection 128-15(4) of the ITAA 1997. The defect is that the rewritten partial main residence rules in section 118-200 of the ITAA 1997 fails to incorporate the effect of subsection 160ZZQ(20AA) of the ITAA 1936.

It was an important policy principle underlying the introduction of the market value cost base rule for a dwelling that was just before death the deceased's main residence and not used for income production, that there should be no further account taken of the use of the property prior to death.

This is because the market value 'wipes the slate clean' and effectively builds in an exemption up to this point for compliance cost saving purposes.

Example

Assume that the deceased owned and lived in a post-CGT acquired dwelling for three years just before death and it was not used to produce income at that time. The settlement of the sale of the dwelling occurred 3 years after the date of death. For the period after death, the dwelling was not the main residence of any person.

Assume the dwelling was purchased for $400,000, had a market value of $600,000 at the time of death, and was sold on arm's length terms 3 for $900,000.

If the Commissioner does not exercise the discretion in section 118-195 of the ITAA 1997 to extend the relevant two year period, the way the legislation is intended to operate is that the gain arising between death and sale ($900,000 less $600,000 = $300,000) should be fully subject to CGT (disregarding CGT discount etc.)

Under the ITAA 1936, the calculation would have been as follows. Under subsection 160ZZQ(19), before modification by subsection 160ZZQ(20AA), the formula AB/C would have been as follows:

A = $300,000 (capital gain)

B = number of days dwelling not main residence of deceased and of relevant person (after death)

C = number of days from deceased's acquisition until day of disposal.

In other words $300,000 x (in days) 3 years/8 years = $150,000.

This would of course be wrong as a matter of policy because the fact that the deceased used the dwelling as a main residence would be counted more than once (once in the market value step up and then again in the pro-rata calculation in relation to a post death gain). The calculation would only partly bring to tax the gain post death, whereas it should all be brought to account.

However, in the ITAA 1936 subsection 160ZZQ(20AA) modified the formula outcomes in subsection 160ZZQ (19) by ignoring the days before death (treating these as zero) and taking as the denominator the period from death not from acquisition. Hence $300,000 x (in days) 3 years/3 years = $300,000.

Under the ITAA 1997, however, the effect of subsection 160ZZQ(20AA) is not replicated in section 118-200.

Of course, the outcome under a literal reading of the ITAA 1997 may not necessarily favour taxpayers. For example, if on the above facts the dwelling was the deceased's main residence for only ½ year during the period before death (including immediately before death), and it was the main residence of a relevant person for the entire period after death until sale, the assessable gain should be nil, but the formula would produce $300,000 x (in days) 2.5 years 6 years = $125,000.

It is understood that many taxpayers are likely to be calculating partial exemptions mechanically and without regard necessarily to the appropriateness of the outcome.

Given the fact that the provisions are rewritten law, there is some uncertainty as to the outcome that a court, before whom the issues were fully explored, would come to. On one view this sort or rewrite problem goes beyond section 1-3 (as discussed in Sherlinc Enterprises Pty Ltd v Federal Commissioner of Taxation [2004] AATA 113), but the outcome produced is clearly one the legislature cannot have intended. But it is unclear whether a court would be able to find a way to read the provisions in a way that they would make any sort of purposive sense. It may be the defect is one the courts just cannot fix (for example, see Paule v Commisioner Taxation [2019] FCA 394) and section 15AA of the Acts Interpretation Act 1901 (Cth)).

The result of this is uncertainty and high compliance costs for estates in debating the issue and requesting private rulings or simply taking the view (where favourable) that no other approach may be taken to the law.

An exercise of the CRP must be considered unlikely as it could not close off opportunities to exploit inappropriately the literal effect of the provisions.

Solution
In subsection 118-200(2) of the ITAA 1997:

• non-main residence days (a) after '20 September 1985' add ' and it is not one to which item 3 in the table in subsection 128-15(4) applies'

• total days (a) after '20 September 1985' add ' and it is not one to which item 3 in the table in subsection 128-15(4) applies'

• total days (b) delete 'if the deceased acquired the ownership interest after that date' and replace with 'otherwise'

Partial main residence exemption: section 118-205

Submitted by
Ian Raspin
Topic
What were they thinking: clarifying the policy
Date
21/11/2019
Issue
There is a defect in the way that the main residence exemption applies where ownership of a dwelling has passed through a number of deceased estates.

Some of the most complicated deceased estate cases occur where a dwelling passes through several persons each of whom dies before a sale is made. The complexity arises because if a partial exemption is being determined, then it may not be appropriate to consider the use of the dwelling during just the last period of ownership of the deceased.

The capital gain or capital loss may often reflect changes over the entire period. This can work for or against a taxpayer, depending on circumstances. If, for example, the last deceased person used the dwelling as a main residence for a small amount of the ownership period (and not at death), but previous deceased persons used it almost entirely as a main residence, the taxpayer is aided by going back. In the opposite scenario, the taxpayer is worse off by going back.

The current provision dealing with this in the ITAA 1997 is section 118-205. It is based on section 160ZZQ(20B) of the ITAA 1936, inserted in 1990.

The ITAA 1936 provision was much more flexible than the current provision giving the Commissioner a discretion to make an appropriate adjustment if needed because it is clear that there are so many possible scenarios to consider that they cannot all be individually legislated for.

Importantly, section 160ZZQ(20B) did not apply where the taxpayer got a market value acquisition cost because if the dwelling was the (last) deceased's main residence just before death (see 160ZZQ(20B)(ba)).

That limitation is not, however, evident in the rewritten provision section 118-205.

Although there is clearly a defect which, in itself, seems beyond section 1-3 of the ITAA 1997 (see Sherlinc Enterprises Pty Ltd v Federal Commissioner of Taxation [2004] AATA 113), there are some other features of the provision that may assist a court to get to the correct policy answer. The Note in section 118-205, though not binding, suggests that there should be no adjustment where gains and losses earlier in the inheritance chain are not included. This is also fully consistent with the Explanatory Memorandum to the ITAA 1936 provision.

This is another issue where uncertainty can lead to higher tax compliance costs

Solution

A possible solution is to amend section 118-205 of the ITAA 1997 so it states a broad principle rather than mechanics which don't cover all the cases.

That is, the provision could say you may be required to widen the examination and make appropriate adjustments to the outcome in subsection 118-200(2) where a dwelling has been acquired from a deceased individual or through a chain of individuals and the ultimate capital gain or capital loss has regard to cost bases or reduced cost bases the amounts of which would have been relevant for calculating a main residence exemption for one or more of those deceased individuals had they disposed of the dwelling immediately before death. In these cases it is appropriate to have regard to whether the dwelling was or was not the main residence of a deceased person during their period of ownership (or of a relevant person during a period trustee ownership).

Surviving joint tenant cost base

Submitted by
Ian Raspin
Topic
What were they thinking: clarifying the policy
Date
21/11/2019
Issue
There is a defect in the way that cost base rules in section 128-50 of the ITAA 1997 apply where a dwelling that was the main residence of a joint tenant passes by survivorship to the other joint tenant(s).

For CGT purposes generally, joint tenants are treated as tenants in common: section 108-7 of the ITAA 1997. However that deeming does not override the operation of the 'rule of survivorship' that apply on death. That rule has the effect that when a joint tenant dies their interest in an asset passes to the surviving joint tenants, the interest does not form part of their estate.

As a joint tenant's interest does not form part of their estate, the rules in section 128-15 of the ITAA 1997 do not apply to determine the cost base etc of the deceased's interest in the hands of the surviving joint tenant(s).

But section 128-50 of the ITAA 1997 has rules that are intended to produce a similar outcome. The cost base rules in section 128-50 operate by apportioning the deceased's cost base (in the case of a post-CGT asset of the deceased) or market value (in the case of a pre-CGT asset of the deceased) among the surviving joint tenants.

However, one significant difference is the absence of a market value acquisition cost rule for an interest in a dwelling that was the deceased's main residence when they died and which was not being used to produce income (that is, there is no equivalent in section 128-50 to item 3 in the table in subsection 128-15(4) of the ITAA 1997). [There is also no equivalent to items 2, 3A or 3B.]

This is an issue that Treasury was proposing be dealt with by way of legislative amendment: see item 5 in the table in Section 5.3 of Treasury Proposals Paper, Minor amendments to the capital gains tax law, May 2011. However, the proposed amendment was one of the unenacted measures that the government did not proceed with.

As a result of the defect, joint tenants are disadvantaged compared to those holding their interests as tenants in common. They face additional compliance costs in establishing the cost base of the interest of a deceased person. It can also mean that those who are better advised may end up in a worse tax position than those whose advisors are not aware of the issue.

Example

After the death of her husband in 1999, Gertie decided to move closer to her only child Sue. However she could not afford to buy a home near Sue with her own funds.

In April 2000, Sue and Gertie purchased a home as joint tenants for $500,000 (of which they each contributed $250,000). They agreed that Gertie would live in the house and meet all outgoings etc and on her death the property would pass to Sue.

Over the years, Gertie paid all the rates and insurance and maintenance expenses. She also paid to have the property landscaped including the construction of a garage. However she did not keep any records of these amounts.

When Gertie died in 2015, Sue rented the property for a while and then decided to sell it in 2019. In working out her capital gain Sue had assumed that she would inherit Gertie's interest for market value at death ($450,000) and she was alarmed to learn that she would have to establish all of the costs that Gertie had incurred in order to work out the cost base of the interest that she had inherited .

Solution
Amend subsection 128-50(3) to exclude interests covered by subsection 128-50(4)

Amend subsection 128-50(4) to include an interest in a dwelling that was the deceased's main residence at the date of death (and also an interest in a property that was not taxable property of a non-resident deceased).

Cost base of deceased main residence

Submitted by
Ian Raspin
Topic
What were they thinking: clarifying the policy
Date
21/11/2019
Issue
There is a deficiency in the CGT main residence exemption relating to deceased estates which has a considerable impact on tax compliance costs.

The deficiency is that the market value cost base rule in item 3 in the table in subsection 128-15(4) of the ITAA 1997 does not literally apply where a deceased's dwelling was used to produce assessable income just prior to death, but this would not have affected an exemption for the deceased because, for example, of an absence choice (section 118-145 of the ITAA 1997).

Literally, the income producing use can be disregarded under subsection 118-190(3) but only for the purposes of the main residence exemption, not the cost base rule in subsection 128-15(4).

This is at odds with the way the ITAA 1936 operated – see paragraph 160X(5)(a) and note.

Example

Frank owns his own home in Sydney. He moved into a nursing home in 2017 and made a choice to continue to treat the dwelling as his main residence. He rented the home to help cover costs. Frank died in April 2019.

Because the house was rented for less than 6 years, Frank's LPR is able to qualify for a full main residence exemption if the dwelling is sold within two years of Frank's death. The income-producing use is able to be disregarded for the purposes of section 118-195.

However the income-producing use is not disregarded for the purposes of item 3 in the table in subsection 128-15(4). So if the LPR is not able to sell the property within 2 years they will have to go through the arduous process of establishing what Frank's cost base would have been, rather than rely on the market value rule which was introduced to overcome this very problem.

The defect was included as a minor technical amendment measure in the 2011-12 Budget, and was consulted on between May and July 2011.

However, the measure did not proceed following the government's decision on the backlog of announced but unenacted measures in December 2013.

In the case of the deficiency, the CGT rewrite in 1998 did not clearly reflect the effect of the ITAA 1936, but it is difficult for the ATO to take the same view in light of the view taken in Sherlinc Enterprises Pty Ltd v Federal Commissioner of Taxation [2004] AATA 113 regarding the scope of section 1-3 of the ITAA1997 and the long passage of time since the rewrite.

Further there are limits to what a court would choose to do to overlook deficiencies in drafting (see Cooper Brookes (Woollongong) P/L v FCT and the more recent case of Paule v Commisioner Taxation [2019] FCA 394).

At the same time the ATO has not issued any binding public advice (such as a Tax Determination or Practical Compliance Guideline) to confirm its approach to the interpretive question underlying the measure.

As a result, people administering deceased estates face a high degree of uncertainty as to the way the current law operates. This translates into further compliance costs for example, if a private ruling is requested, it would involve at the least several thousands of dollars. It can also mean that those who are better advised may end up in a worse tax position than those whose advisors are not aware of the issue. [For example, the NTAA, takes the view that a cost base uplift is not available – see Deceased Estate Seminar 2019 Notes – page 74.]

Solution
Clarify that in item 3 in subsection 128-15(4) income producing use does not include use that can be disregarded under section 118-190.

Attachment C

Extract from IGTO Report

RECOMMENDATION 6: The IGTO recommends 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.

REASONS

The undifferentiated application of general taxation of trusts principles to deceased estates may give rise to unintended tax consequences, such as a deceased estate being treated as a non-resident trust simply by virtue of the named executor being (or becoming) a non-resident for tax purposes. Furthermore, it leads to requirements such as the need to obtain a new TFN for the deceased estate and to lodge trust tax returns to obtain small refunds and credits.

The majority of deceased estates are simple and finalised within three financial years following the death of the taxpayer. There is generally no intention to create testamentary trusts and nor would there likely have been specific consideration of the residency status of the deceased estate during the taxpayer's lifetime.

It is unlikely that the Commissioner could rely on his Remedial Powers to adopt a different residency treatment for a deceased estate as the principles set out in Division 6 of the Income Tax Assessment Act 1936 are clear on the residency rules.

Any changes to the broader policy approach to taxation of deceased estates falls outside of the tax administration remit of the IGTO and will therefore require broader inquiry by a body such as the Board of Taxation or the Treasury

Example of difficulties caused by current residency rules for deceased estates

> Jon, an Australian tax resident, dies. He has three adult children. His son lives in the US and is a tax resident there, his daughters live in Australia and are tax residents here.
>
> Jon appoints his son Jacob as the executor of his Will. Jon's estate consists of a large portfolio of Australian shares.
>
> Jacob sells the shares and makes a $4m capital gain. Because the estate is regarded as a non-resident trust for tax purposes, no capital gain is required to be included in the net (or taxable) income of the estate in the year that these gains are made.
>
> To the extent that the proceeds attributable to the capital gains are later distributed to the Australian beneficiaries, they are likely to be assessed <u>without</u> the benefit of the CGT discount. This would equate to a circa $626,600 tax liability for each his daughters. Jacob however being a non-resident is not taxable on his share of the proceeds distributed to him as a beneficiary.
>
> Had Jon appointed one of his daughters as executor or co- executor, the capital gains would have been included in the net income of the estate in the year they were made and taxed to the executor or beneficiaries. After applying the 50% CGT discount, this would have equated to circa $900,000 tax liability.

Had Jacob been the sole beneficiary of the estate, on tax would have been collected on the disposal. However, had the executor have transferred the shares to him in specie, CGT K3 would have been deemed to have occurred at date of death of the deceased, and subject to market values of the shares at that date, tax of $940,000 would have been payable.

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

CC: Ian Raspin TEP, Vice Chair of STEP Australia
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Danielle Bechelet, STEP Australia Policy Committee Chair
E: danielle@bechelet.co

20 August 2021

Michael Sukkar
Assistant Treasurer
Federal Member for Deakin
5/602 Whitehorse Road,
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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ESTATE & TRUST TAXATION SPECIALISTS

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.]

---

[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

[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

[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.

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[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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