Double Death Tax

Delays in administrating an estate can now have huge tax consequences according to the ATO's latest draft, draft ruling. This draft, draft isn't even available to the public or most Accountants yet, but its likely retrospective application means we need to be prepared. This could tax everything from the family home to wedding rings, if a second parent dies before the estate of the first parent is administered.

When CGT was introduced the voting public still had memories of the financial hardship caused by death taxes in the past. It was certainly a dirty word. Paul Keating wanted to be clear that CGT was not a death tax by another name. Section 128 ITAA 1997 allows a deceased's assets to be transferred to a beneficiary without any CGT consequences. The beneficiary is treated as if they have owned the asset in the same way as the deceased, they inherit the deceased's cost base. It also allows the deceased's home to transfer with a cost base of market value at date of death.

The problem is that section 128 refers to "a CGT asset you owned just before dying". If the beneficiary dies before they actually own the asset, then their estate does not get the advantages of the section 128 rollover and there will be no reset to market value even if the beneficiary is living in the home when they die. It also means that none of the main residence concessions will apply in the beneficiary's estate's, such as two years to sell or longer period if the spouse is living there.

By far the absolute worst outcome is when the beneficiary's estate is dealt with by passing the property to their heirs there will be a CGT event. The beneficiary's estate will

have to pay CGT on the difference between the current market value and the original deceased's cost base, if it was not the original deceased's home. If it was the original deceased's home, then the CGT will be payable on the difference between the market value when the beneficiary died and the market value when the original deceased died plus holding costs etc. This tax will be payable by the beneficiary's estate, leaving less for the residual beneficiaries or forcing the family home to be sold to pay the tax. None of the concessions intended to protect the family home passing through to children will apply, simply because there was not enough time between deaths to administer the estate.

It is not unusual, when there is just one beneficiary, that they take years to wind up the estate, not a priority. Consider older couples who are not likely to outlive each other by much or in the case of a couple being killed in the same accident. This could even cause a problem when the beneficiary's will has heirs that have not reached an age that the estate can be distributed to them.

The wealthy who can afford elaborate arrangements and advice are less likely to be caught out by this interpretation than a family of young children. They are the ones that will end up having to sell the family home to pay CGT simply because Dad's estate was not finalised before Mum died.

This is not just about the family home. If Mum dies Dad might receive her wedding ring but if he dies before Mum's estate is administered the ring may pass down to the children but CGT will be payable as if the Dad's estate had sold it at market value.

There may be some relief if a specific asset is left to the beneficiary that dies before they receive it. There is no certainty on that yet but a recent PBR on this stated:

"A CGT asset owned by a deceased person at the time of their death passes to a beneficiary of the deceased's estate if the beneficiary becomes the owner of the asset if the legal ownership in the asset is transferred to them, or if the beneficiary becomes absolutely entitled to the asset as against the trustee/executor."

The ATO draft, draft TD suggests that it is enough for probate to be granted before the beneficiary dies. Though of course that can take years if the estate is challenged.

A couple might have only one child, who is of course the beneficiary of both their estates if their spouse predeceases them. If there is not enough time between the parents' deaths, then the child is caught by the double death tax. Same of course if there are multiple children. The one beneficiary example is just showing how even the simplest situation is caught, it is going to be a great revenue raiser for the ATO!

Looking at how this will work in practice for a typical family. Broken heart disease they call it, when one parent does not last that long after the death of the other. It generally takes a year or two to administer an estate providing it is not challenged. If you are lucky

your parents have had a long life, so it is not so surprising that their deaths are not that far apart.

Let's say Dad's will leaves everything to Mum, Mum's will leave the family home to the daughter who lived there and cared for them, missing the opportunity for home ownership herself and the rest of the estate they leave to their son. They have the following assets:

Family home owned in Dad's name – Under the old interpretation this would have passed to Mum with a cost base of market value at the date of Dad's death and if she was living there when she died the daughter would have inherited the house with a cost base of market value at Mum's date of death. Under the new interpretation Mum has not lived in the house while owning it so it is not her home at date of death and no rollover because she did not "own" it at DOD. Mum's estate will have to treat the transfer to the daughter as the sale of an asset. Starting with the market value at the date of Dad's death adding in any holding costs paid by the estate but not if paid my Mum or the daughter. The difference between this and the market value when transferred to the daughter is a taxable capital gain to Mum's estate and the tax comes out of the Son's share as he is the residual beneficiary.

If the family home was held by Mum and Dad as joint tenants, then the title does not transfer through the will. It happens automatically due to Mum surviving Dad. This transfers under section 128-50 where there is no reset to market value of the Deceased's home on death but at least a CGT event is unlikely to be trigger because Mum should have an indefeasible right of ownership. So, as a joint tenant on Mum's death, assuming she is covering it with her main residence exemption, the daughter will inherit it with a cost base of market value at the date of Mum's death, no CGT payable by the estate.

Shares held in Dad's name only – Assuming post 1985 the cost base is the price he paid for them. When they are transferred from Mum's estate into the son's name Mum's estate must pay capital gains tax on the difference between what Dad paid and the current market value. This tax will come out of the residual estate so out of the Son's share but at least he gets a reset of his cost base to market value.

Shares held in joint names – Now this is interesting and certainly more information is needed from the ATO. These shares would be considered to be owned as joint tenants, so Mum automatically became the owner on Dad's death. Probably meaning that Mum did own them at her DOD, so the section 128 rollover applies. This means no tax payable by Mum's estate when transferring them to the son. The son's cost base on these shares is the price originally paid.

Family car held in Dad's name – Cars are not subject to CGT so this slips through to the son without any tax consequences.

Dad's wedding ring – If it cost $500 decades ago (say purchased in 1986) and now maybe work $1,500 the son receives this but Mum's estate must pay CGT on $500 after allowing for the 50% CGT discount.

Mind you in the time between deaths Centrelink won't hesitate to consider Mum to have received Dad's assets and cut her pension. Further, if Mum was a bankrupt the bankruptcy trustee would have the right to take Mum's share of Dad's estate even if she did not live long enough for the assets to be transferred to her.

There is a very different tax outcome depending on nothing more than the timing of events, let's hope common sense prevails. In the meantime, all that you can do is make sure estates are round up as quickly as possible. Not having a will means more delays and more chance of falling into this tax trap. Holding the family home as joint tenants may avoid this problem, but you need to seek advice, if the home already has some CGT exposure tenants in common maybe a better option.

There has been no new legislation or test case, to use the ATO words, they are now "confirming their interpretation of section 128". On this basis the ruling is likely to apply retrospectively despite a completely different interpretation appearing in private rulings for the last 40 years.