Scrutinising the major concerns of CGT and estate planning

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Overview

- General principles of CGT
- CGT principles as they apply to a deceased estate
  - CGT obligations of the deceased
  - CGT obligations of beneficiaries and legal personal representatives
- Estate planning opportunities and considerations
- CGT checklist for will drafting

General CGT principles

- A capital gain is the increase between the amount paid when an asset was acquired, and the amount that was received when the asset was sold.
- Capital Gains Tax (CGT) is not a separate tax. Rather, a person's assessable income includes their net capital gain for an income year. That is, total capital gains reduced by certain capital losses.
- Legislative framework:
  - Part IIIA of the *Income Tax Assessment Act 1936* (Cth) introduced a tax on capital gains arising as a result of the disposal of assets acquired on or after 20 September 1985.
  - Replaced by the *Income Tax Assessment Act 1997* (Cth). The replaced CGT provisions of the 1936 Act do not operate after the 1997/98 tax year.

General CGT principles (2)

- A taxpayer makes a capital gain or loss when a 'CGT event' occurs.
- How to determine whether a CGT event has occurred?
  - CGT events are summarised in the table in section 104-5 of the 1997 Act
  - Example:

Event	Time	Capital gain	Capital loss
A1 – Disposal of a CGT asset	Time of disposal contract, or when entity stops being owner	Capital proceeds *less* asset's cost base	Asset's reduced cost base *less* capital proceeds

General CGT principles (3)

- In many cases it is necessary to first determine whether the asset is a CGT asset
  - Threshold question is the time of acquisition (ie. on or after 20 September 1985)
  - Categories defined in Division 108 of the 1997 Act.
  - Broadly, a CGT asset is:
    - Any kind of property; or
    - A legal or equitable right that is not property
  - A CGT asset is also expressed to include:
    - part of, or an interest in, such property;
    - goodwill or an interest in goodwill;
    - an interest in an asset of a partnership; and
    - an interest in a partnership that is not an interest in an asset of a partnership.

General CGT principles (4)

- Exemptions:
  - exempt assets (for example, cars);
  - exempt of loss-denying transactions (for example, compensation for personal injury);
  - anti-overlap provisions (reduction of capital gain by the amount that is otherwise assessable);
  - small business relief (Division 152)
- Examples of exempt assets (Division 118)
  - a car, motorcycle or similar vehicle;
  - a decoration awarded for valour or brave conduct;
  - a collectable that was acquired for \$500 or less, however, if the collectable is an artwork, jewellery, antique, coin or medallion, rare folio or book, postage stamp or first day cover, then the gain or loss is disregarded only if the market value of the asset at the date of acquisition was \$500 or less;
  - a personal use asset acquired for \$10,000 or less.
- Special rules surrounding a main residence

General CGT principles (5)

- For most CGT events, the amount of a capital gain or capital loss is calculated by comparing the capital proceeds from the event with:
  - For calculating the amount of a capital gain, the cost base of the CGT asset involved; or
  - For calculating the amount of a capital loss, the reduced cost base of the CGT asset.
- The cost base of a CGT asset may consist up to five elements:
  - **first element** — the amount of any money or the market value of any property the taxpayer paid or gave, or was required to pay or give, in respect of the acquisition of the asset
  - **second element** — the incidental costs the taxpayer incurred in relation to the asset.
  - **third element** — the amount of costs of owning the asset provided the asset was acquired on or after 21 August 1991
  - **fourth element** — the capital expenditure incurred, the purpose or expected effect of which is to increase or preserve the asset's value, or that relates to installing or removing the asset. The expenditure does not apply to capital expenditure incurred in relation to goodwill.
  - **fifth element** — the capital expenditure incurred by the taxpayer to establish, preserve or defend the taxpayer's title to, or a right over, the asset.
- The reduced cost base of a CGT asset is, with one exception, the various elements that comprise the cost base of the asset that are not tax deductible.

General CGT principles (6)

- If an asset that was acquired before 21 September 1999 has been owned for 12 months or more, most elements that comprise the cost base of the asset are indexed for inflation. Indexation of cost bases is not available for CGT assets acquired after that time. There is no indexation of the elements that comprised the reduced cost base.
- Alternatively, the taxpayer may wish to have a 50% CGT discount apply to the capital gains as calculated without indexation.

General CGT principles (7)

- Did a CGT event occur?
  - CGT Asset?
  - After 20 September 1985?
- Does an exemption apply?
- Calculate the cost base
- Does indexation apply?
- Do the capital proceeds exceed the cost base? If so, does the discount apply?
- Does the reduced cost base exceed the capital profits?

CGT and deceased estates

Assets of the deceased taxpayer

- Death is not a CGT event.
- If legal personal representative transfers an asset to a beneficiary pursuant to a will (or on intestacy), any capital gain or loss that the legal personal representative makes if the asset subsequently passes to a beneficiary is disregarded.
- Exceptions (Division 104):
  - If a taxpayer dies, and a CGT asset that the taxpayer owned just before dying passes to a beneficiary who is either:
    - an exempt entity (Division 50);
    - the trustee of a complying superannuation entity; or
    - a foreign resident.
  - In those circumstances, the CGT event is deemed to occur just prior to the taxpayer's death. A capital gain is made if the market value of the asset on the day of death is more than the asset's cost base. Conversely, a capital loss is made if that market value is less than the asset's reduced cost base.

CGT and deceased estates (2)

Section 50-5 exempts (subject to conditions) the following:

- charitable institutions;
- religious institutions;
- scientific institutions;
- public educational institutions;
- funds established for public charitable purposes by will or instrument of trust;
- funds established to enable scientific research to be conducted by or in conjunction with a public university or public hospital;
- societies, associations or clubs established for the encouragement of science which are not carried on for the profit or gain of their individual members;

Section 50-10 exempts (subject to conditions):

- a society, association or club established for community service purposes (except political or lobbying purposes) provided it is not carried on for the profit or gain of its individual members;.

Section 50-15 exempts (subject to conditions):

- an employee or employer association registered under an Australian law relating to the settlement of industrial disputes as well as trade unions.

Section 50-20 exempts (subject to conditions):

- a friendly society (except a friendly society dispensary) provided it is not carried on for the profit or gain of its individual members

Section 50-25 exempts:

- a municipal corporation, a local governing body or a public authority constituted under a Commonwealth law

Section 50-30 exempts (subject to conditions):

- public hospitals;
- a hospital carried on by a society or association which is not carried on for the profit or gain of its individual members;
- a medical benefits, health benefits or a hospital benefits organisation registered for the purposes of the National Health Act 1953 and which is not carried on for the profit or gain of its individual members;

Section 50-40 exempts (subject to conditions):

- a society or association established for the purpose of promoting the development of aviation or tourism which is not carried on for the profit or gain of its individual members;
- a society or association established for the purpose of promoting Australian agricultural, horticultural, industrial, manufacturing, pastoral or viticultural resources, provided the particular society or association is not carried on for the profit or gain of its individual members;

Section 50-45 exempts (subject to conditions):

- a society, association or club established for the encouragement of animal racing, art, a game or sport, literature or music, providing it is not carried on for the profit or gain of its individual members;
- a society, association or club established for musical purposes and not carried on for the profit or gain of its individual members;
- the Australian Film Finance Corporation Pty Ltd.

Liability of beneficiaries and LPRs

- Subject to modifications the following are subject to CGT:
  - LPR that disposes of an asset
  - LPR that acquires an asset and disposes of it
  - Beneficiary that sells an asset that it has inherited
- Property that devolves to a legal personal representative, or passes to a beneficiary, is taken to have been acquired on the day that the deceased passed away (Section 128-15)
- An asset that was acquired by the deceased before, on, or after 20 September 1985 will be subject to CGT where:
  - the deceased died on or after 20 September 1985; and
  - the asset is disposed of by:
    - the LPR (other than by transfer to the beneficiary); or
    - the beneficiary

Calculating the cost base

- Where a beneficiary or legal personal representative 'acquires' an asset of the deceased for the purposes of Division 128, special rules for calculating the cost base of the asset apply (Section 128-15(4)).
  - CGT assets acquired before 20 September 1985
  - CGT assets acquired after 20 September 1985
  - Main residence
  - Trading stock
  - Asset that was not taxable Australian property where the deceased was a foreign resident

CGT asset acquired before 20 September 1985:

- A pre-CGT asset of the deceased is taken to have been acquired by the LPR or beneficiary for its market value at the date of the deceased's death.
- The 12 month holding period for the purposes of the CGT discount commences from the date of acquisition on the date of the deceased's death

<u>Example 1:</u>

- Tim purchased 1,000 shares in an Australian public company before 20 September 1985 for $1,000.
- Tim died on 1 July 2011 and left the 1,000 shares to Bill.
- At the time of death, the market value of the shares was $16,000.
- The shares are deemed to have been acquired by Bill at $16,000 at the date of Tim's death.

<u>Example 2:</u>

- Tim purchased a boat in 1984. He installed a new mast in 1999.
- Tim died in 2001 and left the boat to his son Bill.
- Section 128-15 deems the boat to have been acquired at the date of Tim's death
- Bill is deemed to have acquired the boat (including the improvement) at the sate of Tim's death for the market value of the boat at that date.

CGT and deceased estates (6)

CGT asset acquired after 20 September 1985:

- A post-CGT asset of the deceased is taken to have been acquired by the LPR or beneficiary for the cost base or reduced cost base of the asset in the hands of the deceased at their date of death (There are exceptions in the case of a main residence and trading stock).
- For the purposes of any indexation or discount, the 12 month ownership requirement is satisfied if the deceased acquired the asset 12 months or more before the disposal by the legal personal representative or the beneficiary. (ss. 114-10(6); 115-30)

<u>Example</u>:

- Tim purchased 1,000 shares in an Australian public company on 5 October 1999 for $1,000.
- Tim died on 1 July 2011 and left the 1,000 shares to Bill.
- The shares are deemed to have been acquired by Bill as at the date of Tim's death.
- The cost base (or reduced cost base) is the cost base (or reduced cost base) of the asset on the date of Tim's death.

CGT and deceased estates (7)

- **A dwelling that was the deceased's main residence and was not as at the date of death being used for the purpose of producing assessable income**:
  - Taken to have been acquired by the LPR or beneficiary for its market value.
  - This rule applies even if the dwelling was used for income producing purposes during the deceased's ownership of the dwelling
  - Note that section 118-145 provides that even though a person is absent from a residence (eg. In a nursing home) they may still treat the residence as their main residence.
  - This rule does not apply if the residence transferred to the LPR or beneficiary before 20 August 1996 – in this case, it is taken to have been acquired for the deceased's cost base.
- **Trading stock in the deceased's hands just before death**:
  - Assets that were trading stock in the deceased's hands immediately before his or her death will be taken to have been acquired by the LPR and beneficiary for the amount worked out under s. 70-105(2). That is, for their market value as at the date of death (unless the trading stock is used in a business carried on after death).
- **Not taxable Australian property and the deceased was a foreign resident**
  - Taken to have acquired the asset for its market value at the deceased's date of death
  - Rule applies to CGT events occurring from 12 December 2006

CGT and deceased estates (8)

- Beneficiary's cost base to include expenditure of the LPR (s. 128-15(5))
- Example:
  - Tim died on 1 May 1995. Tim owned land.
  - On 15 May 1995, Sally (LPR) paid rates of $500 on the land.
  - On 31 July, Sally transferred the land to a beneficiary, who was deemed to have acquired the land on 1 May 1995.
  - The beneficiary is permitted to include the $500 in the third element of the cost base of the land.
- Types of expenditure:
  - Costs of probate/administration
  - Challenges to validity of will
  - Valuation costs

Cost base where property owned jointly

- If a CGT asset is owned by joint tenants and one of them dies, the interest of the deceased joint tenant in the asset is deemed to be acquired by the surviving joint tenant. The date of the deemed acquisition is the date the deceased joint tenant died.
- Cost base:
  - If the deceased joint tenant acquired his or her interest on or after 20 September 1985: cost base of deceased's interest at date of death / number of surviving joint tenants
  - If the deceased joint tenant acquired his or her interest before 20 September 1985: market value of deceased's interest at date of death / number of surviving joint tenants
- <u>Example</u>:
  - Jenny and Barry acquire a block of land as joint tenants on 1 December 1984 for $20,000
  - Barry dies on 1 July 2009. Market value of the land is $800,000
  - Jenny is taken to have acquired Barry's 50% share on 1 July 2009 for its market vale ($400,000)
  - She still retains her original 50% pre-CGT interest

Main residence exemption

- Where a dwelling passes to a beneficiary or LPR, section 118-195 creates CGT exemptions on disposals of the dwelling:
  - Within 2 years of the death of the deceased; or
  - Where the dwelling was the main residence of one or more of the deceased's spouse or a person having a right of occupancy under the will from the date of the deceased until the disposal
- In addition:
  - If the deceased acquired the dwelling after 19 September 1985, the dwelling must have been the deceased's main residence immediately before death and was not then being used to produce income; or
  - If the dwelling passed to the beneficiary or LPR before 20 August 1996, it was the deceased's main residence throughout the deceased's period of ownership.

Estate planning considerations

- Emphasise the importance of keeping accurate records:
  - To testator
  - To legal personal representatives and beneficiaries
- Payment of debts – to avoid CGT liability, use cash, assets that have not appreciated, exempt assets
- Recognise the different value of Pre and Post CGT assets
  - Consider two assets, each with a market value of $100,000
    - Pre-CGT asset is taken to have been acquired at market value at date of death
    - Post-CGT asset is taken to have been acquired at deceased's cost base at date of death

Estate planning considerations (2)

- CGT consequences of an inter vivos gift compared to a testamentary disposition
  - Post-CGT asset:
    - The benefit of unabsorbed capital losses ceases with the death of the taxpayer who incurred them.
    - May be advantageous for the taxpayer to dispose of an asset or assets and realise a capital gain prior to death so as to absorb the net capital loss.
    - Example:
      - Mr Smith has a net capital loss of $100,000. He owns a block of land acquired after 19 September 1985. That land, if sold, will give rise to a capital gain of $90,000.
      - If Mr Smith disposes of the property, the capital gain will be offset by the capital loss.
      - On his death, Mr Smith will have cash rather than an asset. As a result, the capital gain that would have otherwise accrued to his legal personal representative or beneficiary would not accrue.
  - Pre-CGT asset:
    - Can be advantageous to make an inter-vivos gift of an asset acquired before 20 September 1985 if the value of the asset is declining and is likely to continue to decline.

Estate planning considerations (3)

- Gifts to exempt entities
  - A bequest of a post-19 September 1985 asset to an exempt entity will result in a CGT event happening so that there is effectively a deemed disposal of the asset of the testator immediately before death with the possibility of an immediate CGT liability on the estate.
  - Consider the possibility of:
    - an inter vivos gift if the gift would qualify for a deduction (Division 30); or
    - making the gift conditional on the entity reimbursing the estate for any tax attributable to the disposal of the asset

Estate planning considerations (4)

- Recognising Pre-CGT disposals
  - A disposal by a deceased's legal personal representative or a beneficiary of a deceased estate of an asset owned by the deceased at death is not subject to CGT if the deceased died before 20 September 1985.
  - This is a possibility because the deceased's legal personal representative or beneficiary is deemed to have acquired the asset at the date of death no matter when probate or administration is granted, or the asset is transmitted or transferred to the legal personal representative or beneficiary (This may arise, for example, if the asset is to be held by the executor on trust until the beneficiary reaches the age of 21).
  - Examples:
    - Tim died on 18 September 1985. A block of units owned by him at his death is inherited by Jack, his son. The title to the units is transmitted to Jack on 10 December 1986. Jack sells the units in January 2010. Jack is deemed, for CGT purposes, to have acquired the units on 18 September 1985 and, therefore, the subsequent disposal of the units in 2010 is not subject to CGT.
    - Jenny died on 10 July 1984. Under her will, her daughter Sally has a life estate in a property, with the remainder to Alfred. Sally dies on 1 December 1998, and the property is transmitted to Alfred in January 1999. Alfred is treated as having acquired the property on 10 July 1984.

Estate planning considerations (5)

CGT checklist for will drafting:

- The major assets of the testator, the current market values, whether they have a sufficient connection with Australia, and whether they were acquired before, on, or after 20 September 1985
- Whether a proposed beneficiary is a resident
- Whether there is a substantial accrued and unrealised capital gain in any of those assets
- In the case of assets acquired on or after 20 September 1985, the current market values, and the various elements that comprise the cost base and the reduced cost base
- Details of personal use assets and collectables
- Whether the testator wishes to benefit an exempt entity
- Whether the testator has any unapplied net capital losses or any unrecouped forward ordinary income tax losses
- The ordinary income position of the testator or testatrix and the potential beneficiaries
- The persons whom the testator wishes to be liable to pay any increased tax as a result of the operation of CGT provisions