Deceased estates, real property and real issues

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Notwithstanding that death is generally not a taxing event, there are a number of complex legal and tax issues which need to be considered, particularly in relation to real property. An executor who sells real property will need to understand how the capital gains tax cost base and main residence rules apply. It is also relevant to beneficiaries who inherit property. Further, the manner in which an interest in property is passed to a beneficiary (for example, directly or via a testamentary trust or life interest) will affect the tax treatment of that interest. Finally, estate administration is rarely straightforward, and if a dispute or other complication arises over the distribution of assets, the parties may wish to resolve the issue by entering into a deed of family arrangement. This has its own set of tax risks and considerations.

Introduction

According to the McCrindle 2016 wealth transfer report, it is estimated that, over the next 20 years, Australian "baby boomers" over the age of 60 will transfer $3.5tr in wealth, growing at 7% per year, to generations X and Y (gen X & Y).

An estimated 7.5 million people in gen X & Y are set to be the recipients of that wealth. On their retirement, the baby boomers are expected to spend only a small portion of their wealth in maintaining their lifestyle in retirement. The Grattan Institute 2014 *The Wealth of Generations* report suggests that, on current trends, the majority of wealth of older households will be saved and passed on. Assuming that 30% or so will be spent, if 70% of the "baby boomers" wealth were to be transferred to gen X & Y, an average of $320,000 would be passed on to each beneficiary.

Wealth in this context refers to a combination of assets, including superannuation, shares, business ownership and other assets. However, for many people, a large part of their wealth is Australian real property, such as the family home, rental properties and commercial properties.

We can expect that there will be a growing demand among gen X and Y for high-quality estate administration and tax advice due to the exponential growth in this area. It is therefore essential as tax practitioners, advisers or potential estate administrators to understand and plan for it.

The effective transition of wealth comes with a range of challenges and opportunities, particularly when dealing with property. The deceased estate administration process has a range of legal issues and tax issues that need to be considered carefully. This article focuses on those issues relevant to real property.

This article:

- reviews the key legal considerations, including mode of property holding, and the relevant probate and land transfer processes;
- addresses the key income tax, capital gains tax and stamp duty issues for deceased estates;
- explains the main residence exemption;
- considers life and remainder interests; and
- explores the use of deeds of arrangement to vary a will after death.

Other issues that are of interest in this area, but are not covered in this article, are:

- pre-death planning and restructuring;
- property held through superannuation funds;
- property held through companies; and
- dealing with property where the owner loses legal capacity and exercising powers of attorney.

Legal considerations

Mode of holding

Determining the correct position

One of the first steps when dealing with real property on the death of an owner is identifying the deceased's mode of holding of that property.

The legal consequences and processes that apply are very different depending on the mode of holding, and so it is important for this to be dealt with up-front.

The property may be:

- wholly owned by the deceased;
- owned by the deceased and their spouse or another person as joint tenants;
- owned by the deceased as tenants in common with a spouse or another person; or
- owned alone or together with another person as trustee for a trust.

Each of these is addressed in more detail later in this section of the article.

To determine which of the above is applicable, the deceased's legal personal representative (LPR), that is, the executor or administrator of the estate, will need to gather some information.

Initially, the LPR will typically use their own knowledge of the property or ask for information from family members of the deceased. However, it is important not to make assumptions or move forward on that basis alone.

The LPR should undertake a certificate of title search through the relevant Land Titles Office (LTO), or similar entity, depending on the state or territory the deceased held assets in. This will give an indication of how the mode of holding has been legally recorded.

In some instances, there is doubt about whether the mode of holding is correctly recorded on the title or the title is not determinative. For example, the deceased's family may hold a belief about how a property is owned which does not reflect what is on the title (for example, the family may believe that farm land is co-owned with a child who worked on the farm with their deceased parent, but the title was never updated to reflect this understanding or arrangement).

Further, LTOs in some states do not record the existence of trusts on its titles (this is certainly the case in South Australia). That said, a title may indicate that the deceased and another person are the legal owner, but with "no right of survivorship". A fiduciary relationship also may be recorded by a caveat lodged on the title on behalf of the relevant beneficiaries. Either of those scenarios are a strong indication that the deceased held the property on trust rather than for their own benefit.

In circumstances where the position is not clear, it is necessary to undertake further investigations. This may involve locating and reviewing the original contract for purchase of the property, the original memorandum of transfer, original bank documentation, past documentation regarding restructures, divorces or inheritances, and relevant historic correspondence from lawyers, conveyancers and accountants.

While this may give rise to additional work and cost, it is necessary because the LPR needs to be certain whether the property forms part of the estate or whether it is owned by someone else or perhaps held on trust for the benefit of another person. It is better that these issues be identified early, rather than part way through the estate administration process, or worse, when the estate has been distributed or a dispute has arisen.

Once the LPR has determined the correct mode of holding, it is necessary to look at the legal consequences and processes that follow.

Wholly owned by deceased

If the property is wholly owned by the deceased, the LPR will need a grant of probate to deal with that property. Once the grant has been obtained, there will also be a process to work through with the LTO.

The probate and LTO process is discussed further below.

Joint tenants

Property is held as joint tenants when the co-owners of that property do not have discreet shares in that property that they are able to deal with separately from the other owner. In other words, they do not have a percentage ownership interest in the property but rather a full ownership of the whole property together with another person or persons.

If the property is held as joint tenants, the deceased's interest in the property will automatically revert to the surviving joint owner on the death of the deceased. In this case, the LPR will not need to apply for a grant of probate in order to deal with the property. Instead, an application to register death by survivor will need to be lodged with the LTO.

This means that the property can be dealt with relatively quickly and simply and does not need to get caught up in the probate and estate administration process.

Tenants in common

Property is held as tenants in common when the co-owners have discreet shares or percentages in that property that they are able to deal with separately from the other owner. This will often be expressed on the title as an owner having a particular percentage, a particular fraction, "one undivided second part" (50%), "one undivided third" part (33.33%), and so on.

When a co-owner of a property held as tenants in common dies, the deceased's interest in the property will form part of their estate and the surviving co-owner will not receive control of that interest unless it is gifted to them under the deceased's will or purchased by them from the deceased's estate.

Where there is an interest in real property held as tenants in common in an estate, the LPR will need to apply for a grant of probate in order to deal with the deceased's interest, and will need to move through the LTO process similar to if the deceased owned the property wholly by themselves.

Trust

If a property was owned by the deceased as trustee for a trust, the property will not form part of the deceased's estate. Instead, it will be necessary to review the relevant trust deed, the will and the relevant trustee legislation to determine what will happen with the deceased's role as trustee.

> *"It is better that these issues be identified early, rather than part way through the estate administration process."*

Probate application process

For the above scenarios where probate is required (that is, where the property is wholly owned by the deceased or the deceased had an interest as tenants in common), it is necessary to work through the relevant formal process.

If there is a will, the LPR applies for probate. If there is no will (that is, the deceased has died intestate), the LPR applies for letters of administration.

Obtaining a grant of probate requires the LPR to gather detailed information about the deceased and all of the assets and liabilities of the deceased (not just the property assets) and prepare and submit that information to the Probate Registry of the relevant Supreme Court in the form required by that court. The deceased's last original will must be submitted to the Probate Registry for examination as well.

The Probate Registry will assess the application and, if they require further information or evidence to support the application, they may ask for affidavits to be prepared or other documents to be provided.

Probate is usually applied for in the state in which the deceased lived at the date of their death. Probate will also need to be applied for in other states (or a re-seal obtained) if property is held interstate.

Once granted, probate gives the LPR the formal authority to deal with the assets of the deceased in accordance with the will. Except as mentioned above with respect to registering an application to register death by survivor of a joint property, the LTO requires the LPR to obtain a grant of probate in order to deal with real property in the estate.

LTO process and estate administration considerations

Once probate has been obtained, the LPR ordinarily takes steps to call in all of the assets of the estate. This involves closing bank accounts, having shares transmitted into the LPR's name and, in the case of real property, having the property transmitted into the LPR's name with the LTO.

The LTO process for transmitting real property into the name of the LPR is relatively straightforward. It is necessary to submit with the LTO a transmission application or similar, usually along with the grant of probate and a certificate confirming that the property was disclosed to the Probate Registry as part of the probate application process. There are also identification verification processes to be attended to.

Once the property is in the name of the LPR, the LPR needs to determine what will happen with the property. It will be necessary to check the will to determine whether the property has been left to a particular beneficiary, whether a trust or life interest is applicable to the property or whether it simply forms part of the residuary estate. If the property forms part of the residuary estate, the LPR needs to decide whether the property will be sold (on the open market or to a family member), or whether the property will be transferred to the beneficiaries.

If the property is sold, the LTO process is the same as a normal sale or conveyance.

If the property is to be transferred to the beneficiaries, a transfer is prepared between the LPR and the beneficiaries. The consideration is recorded as "pursuant to the will" or similar.

Alongside dealing with the property, the LPR will need to work through the myriad of issues and steps required in administering the estate. It will be necessary to pay off all of the liabilities, lodge date of death and estate tax returns, deal with any disputes in relation to the estate (including claims brought against the estate under relevant family inheritance legislation), take steps to protect the executors (including possibly placing a notice in the public notices), distributing gifts under the will, and then dividing and distributing the residuary estate.

Other considerations

In conjunction with all of the above, the LPR also needs to make sure that they work closely with banks, insurance companies, tenants, service providers and other people that are involved with properties affected by the deceased's death and the probate and LTO process.

The process of gathering information, lodging an application for probate, calling in the assets of the estate, administering the estate and distributing the estate can take months and even years, depending on the complexity of the estate. Beneficiaries are often anxious to receive their inheritances. Their expectations in this regard should be managed. Also, decisions need to be made about ensuring properties are used, secured and protected properly in the intervening period.

Key tax issues for deceased estates

General comments

Whenever assets move from one person to another, it is necessary to consider the possible income tax, CGT and stamp duty implications.

Death is generally not a taxing event.

Various exemptions apply for transmission of property from the deceased to the LPR, and for transfers from the LPR to the beneficiaries. However, it is necessary to understand the extent of those exemptions, and the effect of their application. Also, as is often the case in tax law, there are exceptions to the exemptions.

Income tax

In the context of property and deceased estates, income tax is less relevant. However, it is still worth raising.

Income tax is a relevant consideration if the deceased was a property developer that was holding property as trading stock.

If the LPR continues carrying on the property development business and makes an appropriate election, the trading stock is treated as if there was no death and the closing value of the trading stock in the date of death return will be the opening value of the stock in the estate's first tax return (s 70-105(6) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)). In these circumstances, the death essentially does not trigger a taxing event.

However, if the LPR will not be carrying on the property development business, the stock will be attributed with its market value as at date of death (s 70-105). In other words, if the property development business comes to an end on death, there is a taxing event.

Income tax is also relevant to the transfer of depreciating assets. Depreciating assets are often transferred in conjunction with a property (for example, hot water systems, tanks, curtains and other fixtures and fittings).

On the death of the deceased, a "balancing adjustment event" occurs in respect of any depreciating assets that they held. However, to avoid the transfer to an LPR triggering a taxing event, the termination value or sale price will be its adjustable value/written down value as at date of death. However, when depreciating assets are distributed to a beneficiary, they are deemed to be disposed of at market value, and therefore potentially trigger a taxing event. These rules are set out in the table in s 40-180 ITAA97.

CGT

Where property was held by the deceased on capital account, which is ordinarily the case, Div 128 ITAA97 applies.

Division 128 sets out how capital gains and losses are dealt with, and how this affects a person's LPR and beneficiaries of their estate.

A deceased person's assets are taken to have been acquired by their LPR on the day they passed away (s 128-15(2) ITAA97).

Any capital gain or loss on death is disregarded (s 128-10 ITAA97).

Similarly, when an asset of the deceased is transferred from the LPR to a beneficiary, any capital gain or loss made by the LPR is disregarded (s 128-15(3)). A CGT event technically occurs but it is does not give rise to tax.

It is worth mentioning the key limitations on this exemption.

First, the asset being transferred must be an asset of the deceased. It cannot be an asset that the LPR has acquired after death. Therefore, the LPR cannot acquire an asset during the estate administration process and then subsequently transfer the asset to a beneficiary without triggering CGT. This can unintentionally become an issue if the LPR takes up shares through a dividend reinvestment plan, takes up rights issues, or similar. In the context of property, it can unintentionally become an issue if property is strata titled, subdivided, or improved during the estate administration process. The position needs to be looked at carefully if those circumstances arise.

Second, the asset must pass to the beneficiary in their capacity as a beneficiary. If the beneficiary buys an asset from the estate (which is a common occurrence), CGT applies.

Calculating the new cost base

While the capital gains or losses of a property passed through an estate are generally disregarded, there is still a very important CGT task to be attended to on death. That is the calculation of the new cost base in the hands of the LPR or the beneficiaries.

The cost base is critical because it will determine the CGT payable by the LPR if they sell the property. If the LPR does not sell the property, but instead distributes it to a beneficiary, the beneficiary will have the same cost base. When the beneficiary sells the property (which may be shortly after inheriting the property, or many years later), a capital gain or loss may arise on that sale, and they will need to know the cost base.

The LPR is in the best position to obtain this information as the LPR is the legal owner of the deceased's tax and financial records. The LPR should therefore either calculate the cost base on death or at least pass on records to the relevant beneficiary on distribution.

The new cost base will depend on whether the deceased purchased the property before CGT legislation came into effect on 20 September 1985 (pre-CGT) or on or after that date (post-CGT).

The cost base of the property in the hands of the LPR or the beneficiary will be in accordance with the table of "modifications to cost base and reduced cost base" found in s 128-15(4), as follows:

"**Modifications to cost base and reduced cost base**

Item	For this kind of CGT asset:	The first element of the asset's cost base is:	The first element of the asset's reduced cost base is:
1	One you acquired on or after 20 September 1985, except one covered by item 2, 3, 3A or 3B	the cost base of the asset on the day you died	the reduced cost base of the asset on the day you died
2	One that was trading stock in your hands just before you died	the amount worked out under section 70-105	the amount worked out under section 70-105
3	A dwelling that was your main residence just before you died, and was not then being used for the purpose of producing assessable income	the market value of the dwelling on the day you died	the market value of the dwelling on the day you died
3A	If you were a foreign resident just before you died — an asset that was not taxable Australian property just before you died, except one covered by item 2	the market value of the asset on the day you died	the market value of the asset on the day you died
3B	One that passes to a trustee of a special disability trust	the market value of the asset on the day you died	the market value of the asset on the day you died
4	One you acquired before 20 September 1985	the market value of the asset on the day you died	the market value of the asset on the day you died

Note 1: Section 70-105 has a general rule that the person on whom the trading stock devolves is taken to have bought it for its market value. There are some exceptions though.

Note 2: Subdivision 118-B contains other rules about dwellings acquired through deceased estates.

Note 3: The rule in item 3 in the table does not apply to a dwelling that devolved to your legal personal representative, or passed to a beneficiary in your estate, on or before 7.30 pm on 20 August 1996: see section 128-15 of the *Income Tax (Transitional Provisions) Act 1997*."

The most likely scenarios for real property in a typical deceased estate will fall under items 1, 3 or 4 of the table in s 128-15(4) (being a post-CGT, main residence or pre-CGT asset).

In short, the rules are:

– if the property was pre-CGT in the hands of the deceased, the cost base will be the market value of the property as at the date of the deceased's death;
– if the property was post-CGT in the hands of the deceased, the cost base will be the deceased's historic cost base; and
– if the property was a main residence (whether pre-CGT or post-CGT), the cost base will be the market value as at date of death.

Where it is necessary to determine the market value of a property as at date of death, it is important to arrange a valuation as soon as possible after death through a licensed valuer.

Example 1

The deceased, Frank, died on 1 September 2018 leaving a rental property with a market value at his date of death of $500,000, which Frank had purchased in 1990 for $200,000. The rental property was not Frank's residence.

Raymond has inherited Frank's rental property. As we know, the rental property is a post-CGT asset with a cost base of $200,000. Raymond takes that same cost base. Raymond decides to sell the house soon after inheriting at a time when the market value is still $500,000.

If Raymond sells the house, he will make an assessable capital gain of $300,000.

Example 2

If Frank's rental property was purchased by Frank before 20 September 1985, the rental property would be a pre-CGT asset.

When Raymond on-sells the rental property, Raymond's cost base for the rental property will be the market value on Frank's date of death ($500,000). Assuming Raymond achieves market value for the rental property (as at Frank's date of death) and obtains $500,000 in the sale, Raymond's capital gain or loss will be zero.

Special considerations in relation to pre-CGT assets

There are obviously benefits in treating an asset as pre-CGT. It gives the asset a higher cost base and therefore a lower capital gain.

It should also be noted that, when determining whether a property is pre-CGT or post-CGT, it is relevant to consider carefully the ownership history of the property and other events that may have affected the property. It cannot be assumed, simply because a property was initially purchased by a family pre-CGT, that the whole of the property continues to be a pre-CGT asset.

Below are some examples of where a property that has been in the family since before 20 September 1985 will not be pre-CGT or will not fully be pre-CGT:

– an improvement has been made to the property that becomes a separate post-CGT asset pursuant to s 108-70 ITAA97;
– the property has previously been inherited after 20 September 1985 — all assets lose their pre-CGT status on death;
– the property has been the subject of a family group restructure and was transferred out of a company or trust or from another family member after 20 September 1985; and
– the property was initially held by husband and wife as joint tenants and the first of them passed away after 20 September 1985.

Special rules for joint tenants

In addition to dealing with CGT issues in relation to deceased estates, Div 128 also sets out rules about what happens when a joint owner of a property dies.

Notwithstanding that joint tenants do not have a distinct percentage interest in a property, the legislation deems that to be the case. In other words, if there are two joint tenants, each is deemed to have a 50% interest.

Section 128-50(2) ITAA97 states that the survivor is taken to have acquired the deceased's share on the day the deceased died. This means that the survivor ends up with two assets with different acquisition dates and different cost bases.

If the property was purchased pre-CGT, the deceased's share in the property will pass to the surviving joint tenant, with a cost base equal to market value of that share (s 128-50(4)). Therefore, the original 50% of the property owned by the survivor will not attract CGT when a capital gains event occurs with respect to the property. However, the 50% share the survivor inherited will have a cost base equal to the market value of 50% of the property on the deceased's date of death.

If the property was purchased post-CGT, the deceased's share of the property will pass to the survivor, with the deceased's cost base for that share (s 128-50(3)).

Where a property was purchased by a couple as joint tenants pre-CGT, but the first member of the couple passed away on or after 20 September 1985, the surviving member of the couple will inherit a share of the property which has become post-CGT. The following example sets out how this would operate in practice.

Example 3

We will continue with the fact scenario from examples 1 and 2 above. However, in this example, Frank is married to Marie and the property is owned by them jointly. In addition, the property was purchased pre-CGT.

On Frank's death, Frank's share automatically reverts to Marie. Frank's 50% share passes to Marie, with a cost base equal to market value on the day he died.

Example 3 (cont)

You will recall that the property has a market value of $500,000 on Frank's date of death. Therefore, the cost base of Frank's share is 50% * $500,000 = $250,000.

After a few years, Marie decides to sell that property. When calculating Marie's tax for the year in which she sold the property, her accountant will disregard any CGT attributable to the share Marie originally held (which will continue to be treated as a pre-CGT asset). However, Frank's share is no longer pre-CGT but post-CGT. CGT will have to be paid on Frank's share and the cost base will be market value of that share from a few years earlier.

If Marie sells the property for $600,000, the CGT calculations will be as follows:

– as to Marie's original 50% share of the property sale ($300,000), there is no capital gain as that share is still a pre-CGT asset; and
– as to the share Marie received on Frank's death, CGT applies as that share is now a post-CGT asset. Therefore, Marie makes a capital gain of $50,000 with respect to Frank's share ($300,000 – $250,000).

Accordingly, Marie's tax return will need to reflect a capital gain of $50,000 in respect of the sale of the property.

Subdivision 115-A: discount capital gains

Individuals (and trusts) can access a 50% discount on any capital gain they generate on an asset they have held for at least 12 months (s 115-25(1) ITAA97).

In the context of deceased estates, the 12-month period is not reset on death (except for pre-CGT assets). The LPR, and ultimately the beneficiary, gets the benefit of the asset holding period of the deceased (items 3 and 4 of s 115-30(1) ITAA97). The same applies for the survivor of a joint tenant property (item 7 of s 115-30(1)). That means that an asset can be disposed of within 12 months of date of death (if it has been at least 12 months since the deceased purchased the asset), and can still obtain the benefit of the 50% discount.

Example 4

Going back to example 1, assume that Frank bought the rental property on 1 September 1990, Frank died on 4 July 2019, the property was distributed to Raymond on 6 September 2019, and Raymond sold the property the next day. Accordingly, Raymond has held Frank's share for less than 12 months.

Notwithstanding this, Raymond is deemed to have held the property since 1 September 1990 and is entitled to the 50% discount. This means that Raymond will need to pay tax at the applicable marginal income tax rate on $150,000 of the capital gain (50% discount × $300,000).

Small business concessions

There are a range of small business CGT concessions available, which are well known to most tax practitioners. If the deceased owned a property that was used in a small business, there might be some opportunity to access those concessions.

The LPR or beneficiary can access the small business concessions if they dispose of the property within two years of the deceased's date of death and the property would have qualified for the CGT small business concessions if the deceased had disposed of it immediately before their death (s 152-80(1) ITAA97).

Treatment of testamentary trusts

All of the rules above apply to trustees of testamentary trusts, as well as to LPRs. This is because it is commonly accepted that the transfer of a property to the trustee of a testamentary trust established pursuant to the will of the deceased is not a distribution of that property to the beneficiary in accordance with the will. For the purposes of Div 128, the ATO treats the trustee of a testamentary trust in the same way as the LPR (PS LA 2003/12).

This means that property in an estate can pass from the deceased to the LPR, from the LPR to the trustee of a testamentary trust, and then finally from a trustee to a beneficiary of the testamentary trust, and any capital gain or capital loss will be disregarded.

The ATO has issued a number of publications relating to this particular practice of treating trustees of testamentary trusts in the same way as they treat the LPR. These publications have changed in form over the years, but have remained the same in substance and practice.

Stamp duty

Stamp duty is generally not payable in relation to transmission of property from the deceased to the LPR. Similarly, stamp duty is typically not payable where property is transferred to a beneficiary pursuant to the terms of a will.

You will need to consider carefully the applicable stamp duty legislation in the state or territory where the real property is located to ensure that the property is in fact exempt when transferred pursuant to a will.

If a property is sold by the LPR to a beneficiary, rather than distributed to the beneficiary pursuant to a will, stamp duty will likely apply. Depending on where the property is located, there may be other exemptions available. In South Australia, if the property is a commercial property, the transfer of that property since 1 July 2018 has been fully exempt from stamp duty.

Main residence exemption

Legislation

A property which is used as a person's main residence is generally exempt from CGT. There are special rules that apply in relation to deceased estates.

The relevant legislation is s 118-195 ITAA97, which states as follows:

> "**118–195 Dwelling acquired from a deceased estate**
>
> (1) A capital gain or capital loss you make from a CGT event that happens in relation to a dwelling or your ownership interest in it is disregarded if:

(a) you are an individual and the interest passed to you as a beneficiary in a deceased estate, or you owned it as the trustee of a deceased estate; and

(b) at least one of the items in column 2 and at least one of the items in column 3 of the table are satisfied.

Beneficiary or trustee of deceased estate acquiring interest

Item	One of these items is satisfied	And also one of these items
1	the deceased acquired the ownership interest *on or after* 20 September 1985 and the dwelling was the deceased's main residence just before the deceased's death and was not then being used for the purpose of producing assessable income	your ownership interest ends within 2 years of the deceased's death, or within a longer period allowed by the Commissioner
2	the deceased acquired the ownership interest before 20 September 1985	the dwelling was, from the deceased's death until your ownership interest ends, the main residence of one or more of: (a) the spouse of the deceased immediately before the death (except a spouse who was living permanently separately and apart from the deceased); or (b) an individual who had a right to occupy the dwelling under the deceased's will; or (c) if the CGT event was brought about by the individual to whom the ownership interest passed as a beneficiary — that individual

Note 1: You may make a capital gain or capital loss if the dwelling was used for the purpose of producing assessable income: see section 118-190.

Note 2: In some cases the use of a dwelling to produce assessable income can be disregarded: see sections 118-145 and 118-190.

Note 3: There are special rules for dwellings acquired before 7.30 pm on 20 August 1996. These rules also affect the operation of section 118-192 and subsections 118-190(4) and 118-200(4): see section 118-195 of the *Income Tax (Transitional Provisions) Act 1997*."

Different treatment for pre-CGT and post-CGT properties

To apply s 118-195, you must first determine whether the property in question is a pre-CGT asset or a post-CGT asset.

If the property is pre-CGT, the property does not even need to have been the main residence of the deceased to obtain the exemption. It can be any dwelling of the deceased (for example, a rental property). In other words, pre-CGT properties are rewarded with the main residence exemption even though the property might not even be a main residence.

If the property is post-CGT, it is necessary for the property to be the deceased's main residence immediately before death, and it cannot at the date of death be being used for income-producing purposes (for example, renting out part of the property, conducting a business from the property, and so on).

Two-year period and extensions

To access the exemption, the property must generally be sold within two years. That said, the period can be extended. An automatic extension occurs if one of the following persons occupies the property from the date of death until the property is ultimately sold:

- the spouse of the deceased;
- a person granted a right to occupy the property under the deceased's will; or
- the beneficiary which the property was passed to under the will.

Where a married or de facto couple are not both owners of their main residence and the owner of the property is the first to pass away, the property will pass to the LPR and then a beneficiary. If the deceased's spouse continues to occupy the property until it is sold, the main residence exemption will not be lost or will not "expire" during that period. This is the case even if the spouse is not the beneficiary of the property (for example, if the house is left to a child but the spouse lives there). Also, the spouse simply needs to live in the property. There does not need to be any formal right to occupy.

Where it is someone other than the spouse that occupies the property, that person either needs to be the beneficiary that will inherit the property or a person who is expressly granted a right to occupy the property under the will.

This gives rise to planning opportunities. By drafting a will carefully, and granting rights of occupancy, the main residence exemption can be extended for lengthy periods of time. In fact, as testamentary trusts are treated by the ATO as a continuation of the estate, it is possible to set up discretionary testamentary trust wills with rights of occupancy such that the main residence exemption is preserved even though the property is held in a trust.

Example 5

Frank has passed away and his will leaves his residuary estate equally between Marie and Raymond. One of the assets owned by Frank was the family home.

The family home has been transmitted to the LPR.

Marie continues to live at the family home during the administration of the estate.

Three years following Frank's death, the LPR sells the property and distributes the proceeds to the beneficiaries.

Notwithstanding that it has been more than two years since Frank died, the main residence exemption is still available to the LPR.

Example 5 (cont)

An extension to the two-year period can also be obtained by the Commissioner exercising his discretion to allow the period to be longer. There are safe harbour scenarios in which the LPR or beneficiary can self-assess that the discretion should be exercised (PCG 2019/5).

Absences and using property to produce income

Rules about absences

There are certain scenarios in which a person may cease living in their property and still qualify for the main residence exemption. This is provided another residence is not claimed as a main residence during that time (s 118-145 ITAA97).

An example used in the ITAA97 is where a person is posted overseas for a number of years for work. A similar scenario would be if an elderly person moves out of their home to obtain some long-term specialist care or to move into a nursing home.

If the property is not used to produce income after they cease living in the property (such as being rented out), that person can continue to claim that property as their main residence indefinitely and there is no limitation on the length of the absence.

If the property is used to produce income after the person ceased living in the property, they can only claim the main residence for a maximum period of six years while they are absent from the property. If they return to the property and then leave again, the property can again be rented out for a further six years.

These rules can assist in an LPR or a beneficiary accessing the main residence exemption when the deceased was not living at their home at the time of death.

Using main residence for income-producing purposes

If a main residence is used for income-producing purposes, an LPR or a beneficiary can still often claim the main residence exemption. This is the case whether that income-producing purpose occurred before or after death.

If the income-producing purpose occurred prior to death, it can be ignored by the LPR or beneficiary provided the purpose did not occur while the deceased also lived in the property (s 118-190(3) ITAA97). If the deceased lived in the property while the income-producing purpose occurred, a partial exemption from CGT may be available. This is discussed further below.

If the income-producing purpose occurred after the deceased's death, provided the property is on-sold within two years of the deceased's date of death, the income-producing purpose can be ignored. This is because the main residence exemption does not require the property to be the main residence for that two-year period (see the example in s 118-190(1)).

Partial exemption

Where the deceased used part of the property for income-producing purposes while they lived in the property (for example, used their garage to run their mechanics business), the LPR or beneficiary may be able to access a partial exemption.

Section 118-190(3) provides a formula for calculating a partial exemption from CGT under certain circumstances.

Life and remainder interests

What is a "life interest" and what are they for?

A life interest is a right granted in a property which will continue for the life of the person who holds that right and gives the person the right to have possession of the property and to receive the income of the property. That person is known as a life tenant or life interest beneficiary. When the life interest beneficiary passes away, the property passes to another person (known as the remainderman or remainder beneficiary). The property does not form part of the life interest beneficiary's estate when they die, but automatically reverts to the remainder beneficiary.

Life interests can be granted inter vivos (during the grantor's lifetime) or on death via the grantor's will. This article focuses on life interests granted via the will of the deceased.

Life interests can be "legal" or "equitable".

A legal life interest is one which is no longer in the hands of the LPR or trustee of the estate. The property has been distributed to the remainder beneficiary but subject to the life interest beneficiaries' right to the possession and use of the property. The life interest arrangement is recorded on the certificate of title.

An equitable life interest is one where the LPR or other trustee holds the property for the benefit of the life tenant and remainder beneficiaries under the terms of the will. This is the more common arrangement. This article deals only with equitable life interests.

In an environment where families are more complicated than ever and blended families are becoming the norm, life interests can be an important tool to address the competing interests of beneficiaries. For example, a testator on their second marriage can leave a life interest in the family home to their spouse while preserving the capital for their children from their first marriage.

There are many planning opportunities in the use and structure of life interests. However, care should be taken to ensure that a life interest clause in a will properly sets out in detail the various rights and obligations of the life interest beneficiary to occupy and maintain the property. If this is not set out clearly, it can give rise to disputes.

Other similar interests

In addition to life interests, there are other similar arrangements which commonly arise in the context of deceased estates:

- rights to occupy for life which grant a beneficiary a right of possession only (but no right to income); and
- a mere licence to occupy the property.

While these are often referred to as life interests, they are not, strictly speaking, life interests. They have a different tax treatment.

Rights to occupy are formal rights which are enforceable by the occupant. Conditions can be imposed on the period of the occupation such that the right may be for the beneficiary's lifetime, for so long as the beneficiary chooses to reside at the property or for a specific period (for example, until the beneficiary remarries).

A licence to occupy can sometimes simply be at the discretion of the LPR or as a result of informal family arrangements. In those circumstances, it is not a "right", but a mere licence and may not have the same tax consequences as life interests or rights to occupy.[1]

Creation of life interests

When an equitable life interest is created under a will, CGT event E1 technically occurs. However, any capital gain or loss is ignored pursuant to s 128-10.

The life interest beneficiary and the remainder beneficiary do not pay for their interest and so they are deemed to have a market value cost base for their interest (s 112-20 ITAA97).

The transfer of property is typically exempt from stamp duty if the transfer is to or by the LPR or trustee of an estate and pursuant to the will. Therefore, the transfer of the property to the LPR or trustee to hold on trust for the life interest and remainder beneficiary will likely be exempt from stamp duty.

Expiry/ending of a life interest

When a life interest expires because the holder of that interest has died, there will be a transfer of that life interest to the remainder beneficiary. That expiration would ordinarily be CGT event C2 (which is the expiry of a CGT asset, but any capital gain or loss made by the life tenant is disregarded under s 128-10).

The remainder beneficiary becoming entitled would ordinarily trigger CGT event E5. However, provided the life interest was granted pursuant to a will and not brought to an end earlier than the death of the beneficiary (or such other period of time granted under the will), CGT event E5 does not apply. This is because the ITAA97 provides that CGT event E5 does not apply to a trust (being a deceased estate) to which Div 128 applies.

Stamp duty will also not typically apply to the expiry of a life interest which occurs in accordance with the will. The ending of a life interest is not a conveyance of property. The remainder beneficiary becoming entitled and the transfer of the remainder interest to that beneficiary is a conveyance pursuant to the will and therefore ought to be exempt from stamp duty.

Early surrender or disposal of life or remainder interests

A beneficiary may wish to surrender or dispose of an interest for a number of reasons.

Sometimes beneficiaries may wish to surrender their life interest or remainder interest, dispose of it, or otherwise bring it to an end prior to the life interest beneficiary's death (for example, in order to avoid further legal, accounting and other compliance costs in relation to the life interest, or to pass the property to the next generation).

Where this occurs, it is treated as the disposal of an asset just like any other. Where the life or remainder interest is surrendered or disposed of for no consideration (which is ordinarily the case), it will be deemed to have been disposed of for market value. The capital gain or loss in relation to that will be the market value of the interest at the time of surrender less the cost base.

Because the surrender or disposal of the interest is not pursuant to the will, any capital gain or loss will *not* be disregarded pursuant to Div 128. Similarly, the surrender or disposal may also be dutiable under the relevant stamp duty legislation.

Disclaimer of interest versus surrender

Reason for disclaimer. Because a surrender or disposal of a life or remainder interest triggers CGT and stamp duty, beneficiaries will sometimes consider a disclaimer of the interest upfront rather than receiving the interest and then subsequently dealing with it.

Timing of disclaimer. If a beneficiary disclaims an interest prior to receiving it, there is no CGT event because the beneficiary never acquired the property interest.[2]

An asset "passes" to a beneficiary of an estate when that asset is transferred to that beneficiary or the beneficiary becomes absolutely entitled to it. A beneficiary is absolutely entitled to an asset of an estate when that beneficiary has a vested, indefeasible and absolute interest in that asset. It is the view of the Commissioner in TD 2004/3 that, provided a beneficiary is absolutely entitled, the actual transfer of the asset does not have to have legally occurred for it to have "passed" for the purposes of s 128-20(1) ITAA97.

Therefore, if a beneficiary wishes to disclaim an interest in an asset of the estate, that beneficiary ought to do so before becoming absolutely entitled. Otherwise, in the eyes of the Commissioner, if the beneficiary is absolutely entitled to the asset, then notwithstanding that there has been no actual transfer, the asset has passed to the beneficiary and any subsequent attempt to disclaim that asset could give rise to a CGT event.

A beneficiary is also taken to have accepted an interest where the beneficiary is made aware of it and does not take steps to disclaim it within a reasonable time frame.[3]

Stamp duty on disclaimer. Notwithstanding that an effective disclaimer is not subject to CGT, it may still trigger stamp duty. The relevant stamp duty legislation will need to be examined closely.

Valuation of life interests and remainder interests

As you can see from above, the market value of life interests and remainder interests becomes relevant for the purposes of calculating the cost base on creation and also the deemed proceeds on surrender. It is also relevant for stamp duty purposes.

Due to the nature of life interests and remainder interests, they are difficult to value. They largely depend on the age of the life tenant, but also on the terms and conditions of the arrangements.

Some state revenue offices have published a table of life tenant factors calculated by the Australian Government Actuary. This can also be a helpful guide for CGT purposes.

Example 6

In this example, under his will, Frank grants Marie an equitable right to possession and the income of the property for her lifetime. On Marie's death, the remainder in fee simple is to be divided equally between Raymond and his brother, Robert.

Marie initially lives in the property. However, after some years, Marie is unable to manage the property and moves into a retirement village. Marie rents the property out and uses the rental income to supplement her pension.

When Marie dies, the remainder reverts to Raymond and Robert.

There is no taxing event on Marie's interest expiring. As set out above, this would be a CGT event C2, but any capital gain/loss is disregarded under s 128-10.

There is also no taxing event on Raymond and Robert becoming entitled to the property because CGT event E5 does not apply to Div 128 trusts.

Deeds of arrangement

Using deeds in deceased estates

What is a "deed of arrangement" and when might they be used?

A deed of arrangement is a deed entered into to settle a dispute between the beneficiaries or potential beneficiaries of an estate.

Depending on the jurisdiction in which probate is applied for, there are time frames in which a person may challenge a will or an estate. A challenge can typically only be made by certain persons (being close family members or other dependants).

The parties to that dispute can settle by entering into a "deed of arrangement". The document may be called something else like a "settlement deed" or '"deed of family arrangement". As a result of the settlement, the assets of the estate may ultimately be distributed differently to the manner set out in the will.

CGT position of deeds

As discussed throughout this article, CGT arising from assets of the deceased passing to a beneficiary of the estate is disregarded under ss 128-10 and 128-15(3).

An asset can pass to a beneficiary not only pursuant to a will, but also in other ways, including the will as varied by a court order or pursuant to a deed of arrangement (s 128-20(1)(a) to (d)).

In the case where the estate parties enter into a deed of arrangement, the assets of the estate are not being distributed in accordance with the will or pursuant to a court order. Notwithstanding this, any CGT will be disregarded under the following circumstances.

The deed must have been entered into by the beneficiary to settle a claim to "participate in the distribution" of the estate. The deed must settle a claim made by a person eligible to bring proceedings, but the Commissioner does not require that person to actually commence proceedings. This allows for claims to be resolved between "friendly parties".

The Commissioner is of the view that the parties to the deed must have entered into it within the time frames available under the relevant family inheritance legislation to make an application to vary the will.[4] An extension to this time frame may be considered by the Commissioner if the beneficiary can demonstrate that the court would have entertained their application for family provision or would have granted an extension in order to file such an application.[5]

Under the deed of arrangement, the only consideration given for the asset must be the satisfaction or waiver of a claim to the estate assets. In other words, the beneficiaries cannot exchange non-estate cash or assets as part of the settlement. This is so a full or part sale of assets cannot be disguised through a deed of arrangement.

For the purposes of disregarding CGT under Div 128, when drawing such a deed, it will be important to ensure that the background to the deed clearly sets out the dispute which is being settled and the relevant beneficiary's right to bring a claim under the relevant family inheritance legislation. The operative clauses of the deed will need to clearly set out those parts of the will being altered by the deed and how the assets of the estate will ultimately be distributed and when.

Stamp duty and deeds

Stamp duty legislation may be stricter in application than the ITAA97 and may not recognise a deed of arrangement as altering the will. Accordingly, while a deed can resolve the issue of triggering a capital gain when trying to settle a dispute, it may not allow you to avoid stamp duty triggered by a beneficiary receiving an interest or disposing of an interest in dutiable property.

However, if the relevant stamp duty legislation does not recognise a deed of arrangement as varying the will, an order of the court under family inheritance legislation will usually operate and take effect as though it was a codicil executed by the deceased immediately before they died. If the court makes such an order, the distribution of property will be a transfer in pursuance with the will and will likely be exempt from stamp duty. Court orders can be obtained by consent if all parties agree.

Again, this issue will need to be carefully considered and the relevant stamp duty legislation closely examined before proceeding with the preparation and execution of a deed of arrangement.

Example 7

Both Frank and Marie have died leaving the house and some cash in equal shares to Raymond and Robert.

The house was purchased pre-CGT.

A dispute arises between the brothers. Robert has indicated that he intends to bring a claim against the estate under the relevant family inheritance legislation for further provision from the estate. Specifically, Robert believes he should receive a transfer of the house in specie and that Raymond should receive the balance of

Example 7 (cont)

the estate, which is a lesser value than the market value of the house.

Robert states that this is fair given that:

– he has been living in the house with Frank and Marie for some years now and providing them with physical and emotional support which Raymond did not need to provide;
– he has invested significant funds into the upkeep of the house and even made some major capital improvements; and
– Raymond already owns a house and is in a better financial position overall compared with Robert.

To minimise costs to the estate and to Raymond of litigating Robert's contentions, the LPR and Raymond consider Raymond's ongoing relationship with Robert and decide to settle the dispute by way of deed of arrangement.

The LPR's lawyer drafts the deed which captures the nature of Robert's claim against the estate and the manner in which the estate will now be distributed.

The agreed arrangements do not trigger CGT. They may trigger stamp duty unless the parties obtain a court order.

Appropriation powers

It is not uncommon for beneficiaries to work out between them that they would prefer to distribute the assets of the estate differently to the manner set out in the will.

A deed of arrangement can be used in this situation as well. However, without a genuine dispute, s 128-20(1)(d) may not operate to disregard any CGT triggered by the distributions.

Some wills contain an appropriation power, which enables the LPR discretion to appropriate particular assets to be distributed to particular beneficiaries.

In that case, the parties can enter into a "deed of appropriation" in which they agree to the distribution of the assets in a particular way. Provided the distribution is still in pursuance of the will (for example, to the beneficiaries named in the will and in the percentages contemplated in the will), the distribution is in accordance with the will and any CGT and stamp duty will be disregarded.

Final remarks

As practitioners, we often deal with LPRs who find the cost of professional advice to be prohibitive. However, as you can see from this article, there are a number of complex tax and other legal issues which arise in the course of an estate administration. Sometimes mistakes made in relation to tax and the duties of administering an estate, even when innocently made, are costly to the estate and others.

Unless the LPR is a relevantly qualified professional, it is unlikely that they will be in a position to recognise and attend to those issues as they arise. It is therefore important that LPRs seek and obtain advice on estate administration and practitioners give high-quality and relevant advice.

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1 Para 105 of TR 2006/14.
2 Paras 29 and 30 of TR 2006/14.
3 *Ramsden v FCT* [2004] FCA 632 at [80]; *Hodge v Griffiths* [1940] Ch 260.
4 Paras 210 and 212 of TR 2006/14.
5 Para 36 of TR 2006/14.