

Inheriting property

Are you subject to capital gains tax on a property you've inherited? As **Julia Hartman** explains, the answer depends on a number of factors.

THERE'S NO CAPITAL GAINS TAX (CGT) payable on death in relation to a property inheritance unless the beneficiary is: a non-resident for tax purposes, a super fund, or an entity exempt from tax. *Section 128-15 ITAA 1997* covers the basic rules. It states that any CGT event is disregarded on the transfer from the deceased to a beneficiary or to the executor and then to the beneficiary. The trouble is transfers to a testamentary trust aren't included in the legislation so the transfer to the testamentary trust is exempt as it's considered the beneficiary, but when the testamentary trust ultimately transfers to the beneficiary that transfer isn't disregarded.

In *PSLA 2003/12* the Australian Tax Office (ATO) recognises that this is the case at law but has agreed to disregard a transfer from a testamentary trust to a beneficiary. A testamentary trust is one created by a will. This may be fine if you're currently a beneficiary of a testamentary trust but it does create an element of doubt if you're preparing your will, as PSLAs are only ATO statements of practice and can be withdrawn at any time.

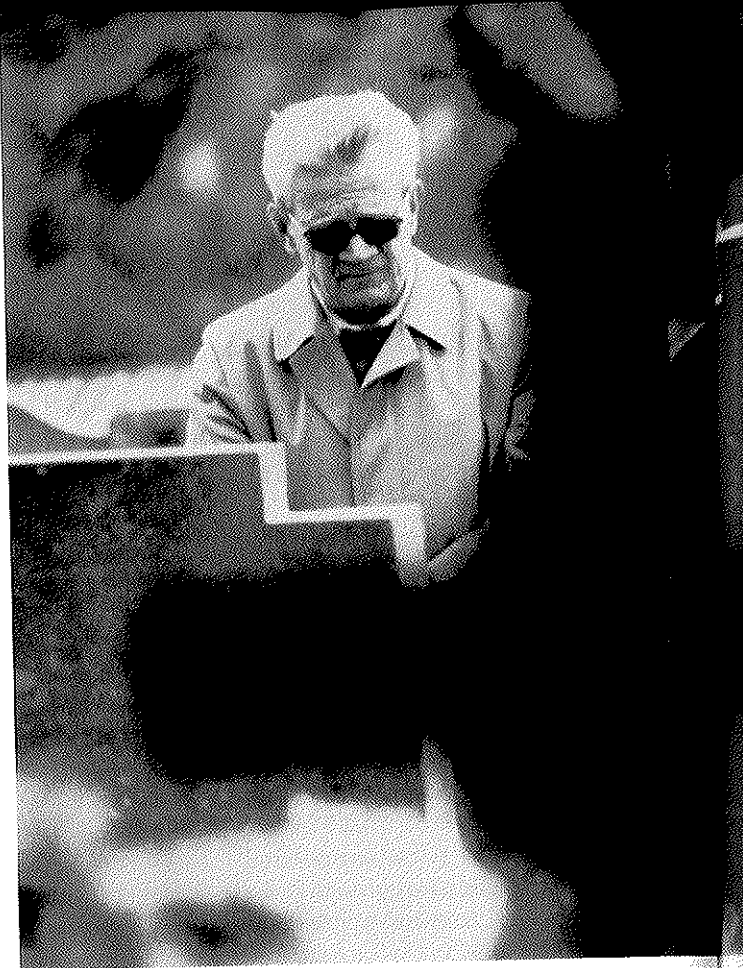
It's important to note that disregarding the capital gain event doesn't mean the asset is exempt from CGT while in the testamentary trust. The clock is ticking but at this point in time a transfer from the trust to a beneficiary doesn't trigger a tax liability – the beneficiary takes over the asset at the cost base to the trust.

Qualifying for the concessions

Certain houses qualify to have their cost base reset at market value on death and no tax liability accrues after death in the circumstances discussed below. Firstly, let's look at the detail on just which houses will qualify.

A house purchased by the deceased before September 19, 1985 qualifies, regardless of whether the deceased lived in it or not. But a house purchased by the deceased after September 19, 1985 will only qualify if it was the deceased's residence at the date of death and not used for income producing purposes at that time.

Being used for income producing purposes includes the deceased living there but renting out part of the house to boarders,



or running a business from home. On the other hand, if the house is completely rented out but the deceased had lived there within the last six years before death, *section 118-145* can be used to deem the house to be the home of the deceased. If the post-September 19, 1985 house had been used as the deceased's home and was then not used to produce income (i.e. it was used by family or vacant at the date of death) it can be considered the deceased's home at the date of death, regardless of the period of time since the deceased last lived there. Of course the concessions associated with the deceased's home can only apply to one property, so if possible it should be applied to a post-September 20, 1985 property if the deceased had once lived there.

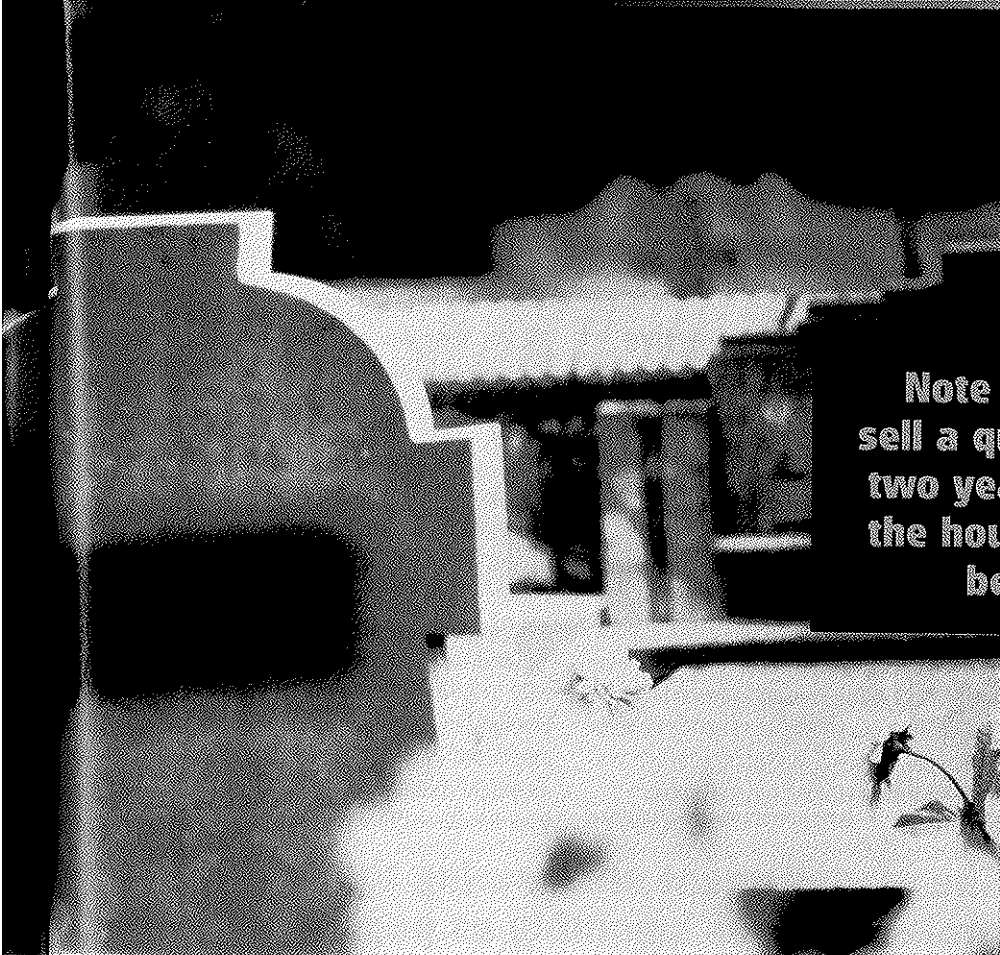
Got that? Okay, I will now refer to a house that was acquired before September 19, 1985 or a house that was the deceased's home or deemed home at the date of death as a qualifying house.

A beneficiary who inherits a qualifying house receives it with a cost base of the market value at the date of death (*section 128-15*). If the house was acquired by the deceased after September 20, 1985 and doesn't qualify as the deceased's home, the beneficiary's cost base is the deceased's cost base.

If the deceased's home was purchased after September 20, 1985 and he or she was partially using it to produce income at the date of death (i.e. running a business from home or had boarders) then the market value concession isn't available. Accordingly, it's inherited at the deceased's cost base.

Houses with a chequered history

If the deceased made considerable post-September 19, 1985 improvements to a pre-September 20, 1985 property, *section 108-70* would have classed these improvements as a separate asset and thus subject to CGT. Fortunately, this problem dies with the deceased so such a property is simply inherited at the market value of the whole property even if the deceased never lived there. The same concessions apply if the deceased had used a post-September 20, 1985 property as a rental or for income producing



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subject to CGT on the proceeds unless they qualify for one of the other exemptions under *section 118-195* as discussed earlier.

Note that as long as you sell a qualifying house within two years you can even rent the house out in that two-year period and still not be subject to CGT.

Tips

► The 50 per cent CGT discount is available on the sale of a house you've

inherited, even if you haven't held it for 12 months, providing it's 12 months since the deceased purchased it. *Section 114-10(6)* and *TD 94/79*.

► Any capital losses accumulated by the deceased are lost on death (i.e. the estate can't utilise them). When planning your estate it may be worth churning some post-September 20, 1985 assets to offset the loss and reset their cost base at a higher rate for the benefit of your beneficiaries. 'Churning' means to sell the asset with low transaction costs then buy them back. The capital gain to date is realised but no tax is payable as the gain is offset by the losses. The asset that was bought back has a new higher cost base which will then become the beneficiary's cost base. If this wasn't done then the beneficiary's cost base would be the deceased's original cost base (as they're post '85) but the beneficiary won't have the loss to offset against the gain. This may not be economical considering the transaction costs associated with houses, but it might be worthwhile for shares.

► Leaving a beneficiary the right to occupy the house can cause major restrictions and CGT nightmares if things don't go specifically according to plan. Many of the problems surrounding this issue haven't yet been addressed by the courts or ATO rulings so I can't draw conclusions, but the CGT laws as they currently stand could be interpreted to mean that should the person entitled to life tenancy ask the eventual beneficiaries of the house (remaindermen) to sell the home so they can move elsewhere, such as a retirement village, both the remaindermen and the life tenant could be subject to CGT on the transactions with a zero cost base.

There are more sections of CGT law relevant to this topic but they cover less common circumstances and many little traps, so it's important to seek professional advice on your particular circumstances before you act on this information. ■

Julia Hartman is a CPA, registered tax agent and founder of BAN TACS Accountants Pty Ltd.

purposes while living there. If the deceased had sold the property while alive, he or she would have had to pay CGT on a portion of the gain. Apportionment isn't necessary if the property is sold by a beneficiary or executor of the estate, providing that at the date of death the property wasn't partially used for income producing purposes (i.e. it was totally the deceased's home or vacant, or totally rented out but covered by the six-year absence rule); then it's simply inherited at the market value at the date of death (*section 118-195*).

Extending the exemption beyond death

Section 128-15 allows an inherited house to continue to be exempt from CGT if it's a qualifying house as discussed earlier. If you sell a qualifying house, there's no CGT payable if it's sold within two years of the date of death. But be careful – one day over the two years and you'll have to pay CGT on the difference between the market value at the date of death plus any non-deductible costs associated with it and the selling price. This is where diligent record keeping can save you heaps.

You can increase the cost base by any cost of acquiring title in the property, selling it, improvements and any holding costs you haven't claimed against rental income. Holding costs include rates, interest, insurance, land tax, repairs and maintenance (*section 110-25*). It's the repairs and maintenance that have huge potential. You need to get a big box and keep receipts for lawnmowing, plants, even changing a light globe etc.

The two-year limit is extended indefinitely while the house remains the main residence of the spouse of the deceased or a person given the right to occupy the house under the will (i.e. life tenancy). There's a further concession if the occupier of the house from the date of death until the eventual transfer of the house is a beneficiary entitled to receive all or part of the house (but not a life tenant). They wouldn't be subject to CGT on what's technically their share of the sale proceeds. But if they had to buy out their fellow beneficiaries, those beneficiaries would be