DEATH, CGT AND YOUR HOME

Fact Sheet

This fact sheet was prepared to accompany Episode 502 by Bryce Holdaway, Ben Kingsley and Julia Hartman on July 2024.

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Hi there!

Thank you for downloading the 'Death, Capital Gains Tax and Your Home' fact sheet, a companion to our insightful Episode 502 with Bryce Holdaway, Ben Kingsley and Julia Hartman.

Understanding how the title of your home is held is crucial for effective estate planning. The implications can be significant, influencing everything from ownership continuity to tax benefits. But it's not easy to understand it!

Which is why Julia has meticulously prepared this fact sheet, offering valuable insights to enrich your understanding.

Should you wish to revisit the episode, please feel free to click here. Remember, this fact sheet serves as a directional guide only, and we strongly recommend seeking professional advice before making any financial decisions.

Now, let's get started!

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Death, CGT and Your Home

How you hold the title of your home has a major effect on how it is treated when you die.

If it is through a company or trust, then your death will not affect ownership of the property. Though if the trust is a fixed trust and you hold the units personally then your will must deal with ownership of the units. Likewise with the shares of a company. Holding your home in a company or a trust will prevent you or your estate from taking advantage of the CGT concessions for main residences.

If you have a right to occupy or are a life tenant the property does not transfer to your estate, it transfers to the remaindermen.

Note: If the deceased had been a foreign resident for tax purposes for over 6 years immediately before death, then none of these main residence concessions are going to apply. The CGT calculation will go right back to the original purchase price. Australia is always going to retain the right to tax Australian Real Estate no matter where in the world the owner resides.

Joint Tenants Do Not Technically Inherit

If you own your home as a joint tenant, then upon your death ownership of the home is automatically transferred to the surviving owners. As they do not technically inherit the property there is no resetting of the cost base to market value at date of death under section 128-15 ITAA 1997, instead it is transferred under section 128-50 which only allows a reset to market value if it was a pre-20 September 1985 asset.

Your surviving joint tenant receives the property at your cost base which maybe back to the original purchase price but all other increases to the cost base are available and the minimum of two years to sell without triggering CGT, under section 118-195. For the accountants reading this, according to section 118-197, all of division 118 treats the survivor as a beneficiary. It is only when you get to division 128, where the cost base is discussed, that joint tenants have their own section so cannot qualify for the reset.

In the case of joint tenancy, the days the property is not covered by the deceased's main residence exemption will be applicable to the surviving joint tenant's CGT calculation, under section 118-185 ITAA 1997, should they eventually sell the property. It is important that there is a record kept of this.

Changing the ownership from joint tenancy to tenants in common will mean that section 128-15 ITAA can be used to reset the cost base of the deceased's share of the house to market value at date of death. Provided that the property is covered by the deceased's main residence exemption at date of death. Changing from joint tenancy to tenants in common will not trigger CGT because there is no change in the actual ownership interest just the title, nor should it trigger stamp duty. The downside is that the deceased's portion of the home will become part of the deceased estate and exposed to all those complications. So, if the property has always been covered by the deceased's main residence exemption and therefore carries no CGT liability there may not be a benefit in changing.

Switching to tenancy in common when the property is not 100% covered by a main residence exemption, not only reduces the tax liability but also the CGT paperwork! On the other hand, it moves half the house into the estate, increasing the risk of the will being challenged. There should be no stamp duty payable when switching from joint tenancy to tenancy in common as the ratio of ownership has not changed. For the same reason there is no CGT event either.

Example of when changing from joint tenancy to tenants in common will save CGT:

Harley and Rose having successfully transitioned to working from home, in Victoria, during the first wave of COVID decide to relocate to Queensland. Buying a house just before the second COVID wave hits Victoria. Unable to enter quarantine with their dogs they choose to remain in Victoria and rent out their new Queensland house. This, using the property to produce income before they have an opportunity to establish it as their main residence, means the property will always be exposed to CGT on a pro rata basis.

After two years as a rental Harley and Rose finally move to Queensland to live in the home. Rose dies a year later. The house was owned as joint tenants, so Harley becomes the sole owner through survivorship. Three years after Rose's death Harley sells the house and returns to Victoria.

Harley has owned his original half of the house for 6 years but only 4 years were covered with his main residence exemption so 1/3rd of the capital gain on his original half will be subject to CGT, though the 50% CGT discount should apply. Whether the property was owned as joint tenants or tenants in common, the outcome would have been the same for Harley's original half.

Now to the half Harley received by surviving Rose. Harley is treated as owning this half from the time that Rose acquired it i.e., 6 years ago. It is covered by Rose's main residence exemption for one year and by Harley's main residence exemption for three years. So, the same outcome - 1/3 of the gain is subject to CGT. But if the property had been owned as tenants in common then Harley would have acquired this half as beneficiary of Rose's estate, not through survivorship. Section 128-15 ITAA 1997 would have reset the cost base of Rose's half to market value at the date of her death. It would also have deemed Harley to have acquired it on the date of her death. Then when Harley sells the property 3 years after Rose's death, he has only owned that half for 3 years, using it as his main residence the whole time. Accordingly, there is no CGT payable on this half of the property.

CGT Cost Base of the Deceased's Home

If the home is not held in joint tenancy the deceased's interest is dealt with as per their will. Providing the beneficiary is not a concessionally taxed entity such as a superannuation fund or a charity and that the deceased's home is Australian real estate, Section 128-15 states that a pre-1985 property or a dwelling that was the deceased's home at date of death has the first element of its cost base reset to market value at date of death. Note as discussed above there is no reset in the case of joint tenancy. Section 109-55 deems that the beneficiary became the owner of the asset at date of death.

This reset to market value is how any capital gain liability looming for the deceased is completely forgiven and forgotten as long as the dwelling was covered by their main residence exemption at the time they died. Note if they were living there and using it to produce income at the same time then this reset does not happen.

Some examples of when the deceased's home may have been exposed to CGT prior to death would be, that in their lifetime they chose to cover another home with their main residence exemption or had used the property to produce income such as a place of business as well as a home or having rented it out before they first lived there.

It is not necessary for the deceased to be actually living there when they die just as long as the dwelling is fully entitled to be covered by their main residence exemption. Section 118-145 ITAA 1997, the absence rule, can be used to continue to cover the property with their main residence exemption up to 6 years after they move out if it is being used to produce income or infinitely if it is not producing income.

When the dwelling has been lived in at the same time as it is being used to produce income, section 118-145 (6-year rule) cannot be used because the owner is not absent. If the property is used partially to produce income at the time the deceased moved out of the home, then during the deceased's absence it can only be partially covered by their main residence exemption in their absence. The same portion that applied before they moved out. If the deceased then dies during this absence there is no reset to market value at death because section 128-15 specifically requires the property to be fully covered by their main residence exemption at date of death.

Example of how using your home to produce income can cost CGT:

Mr Burns, finding it difficult to manage as he ages, agrees to allow Waylon Smithers to move into his mansion with him. Mr Burns being Mr Burns, deducts rent from Smithers' wages at the Springfield Nuclear Power Plant. If Mr Burns was to die under these circumstances the mansion would be subject to capital gains tax. Part of the main residence exemption would be lost for the portion of the property used by Smithers (let's say 50%) and because it is not fully covered with the main residence exemption at date of death there can be no reset to market value at date of death.

Maybe Mr Burns doesn't die at home, instead, Smithers can no longer manage, so Mr Burns is moved out of the mansion into palliative care. At the time of moving out the mansion was 50% used to produce rent from Smithers. Accordingly, it can only ever be covered 50% with his main residence exemption going forward, in Mr Burns' absence. So again, there will be no reset to market value at date of death.

Alternatively, if Mr Burns had allowed Smithers to live in the mansion rent free it would have been fully covered by Mr Burns' main residence exemption when Mr Burns died, and his heirs would have inherited it at the market value at the date of Mr Burns' death. That is assuming the grounds are less than 2 hectares as that is the maximum amount of curtilage that can be covered by a main residence exemption. If the grounds exceed 2 hectares then the property needs to be treated as two separate assets, the excess land not qualifying for any main residence concessions.

This problem could not have been so easily solved if Mr Burns ran his nuclear power plant in his basement. One would hope in those circumstances Mr Burns had incorporated his business, to protect himself from the ramifications of any nuclear accidents. This company is a separate legal entity from himself, it is the company that is using the basement to produce income, not Mr Burns. As long as the company did not pay Mr Burns any rent and did not try and claim a share of occupancy costs such as rates and building insurance, the mansion would not be considered to be producing income.

Continuing the Main Residence Exemption After Death

Most people are aware of the “two-year rule” in Section 118-195 ITAA 1997. It is not a complex piece of law so worth a read of the legislation: https://www.ato.gov.au/law/view/document?docid=PAC/19970038/118-195

This section also requires the property to be covered by the deceased’s main residence exemption at the time of death and not also be used to produce income unless the deceased was absent and section 118-145 ITAA 1997 applied (6-year rule), refer section 118-190(3) ITAA 1997.

You have at least two years in which to sell the deceased home at date of death without attracting a CGT liability. Note this is ownership period so you need to have settlement, not just a contract signed. Though if there are problems leading to settlement you may be able to extend the two years. During the “two years” the property can be rented out without interfering with the full concession.

This two-year period can be extended at the ATO’s discretion when there are delays beyond the control of the executor. Examples of this is when the will is challenged, COVID delays the sale or probate is delayed. It certainly does not cover extra time to do the property up to get the best price. The delay must not be a choice.

It is not always necessary to apply to the ATO for discretion. If you fit into one of the exemptions described in PCG 2019/5 you can self-assess and grant yourself, up to an extra 18 months, if within that first 2 years, more than 1 year was lost due to any one of the following:

- The ownership of the dwelling or the will is challenged.
- A life or other equitable interest given in the will, delays the disposal of the dwelling.
- Complexities of the deceased estate delays the completion of administration of the estate.
- Settlement of the contract for sale of the dwelling is delayed or falls through for reason outside of the executor’s control i.e., COVID.
- Further, if you want to self-assess you are also required to put the home on the market as soon as the issue is resolved and sell it within 12 months.

The above are just the conditions required to be permitted to self-assess that the ATO will exercise its discretion without needing to apply for it. You are still entitled to apply to the ATO to exercise its discretion for longer periods and different reasons as long as they are outside of the executor’s control.

If you do go beyond the 2 years without qualifying for the discretion, the two years is lost completely. The date of exposure to CGT goes back to the date of death. Though this still might not be a problem as it would take considerable time before there is likely to be a capital gain. The gain will only be the difference between the selling price and the market value at date of death. From this gain you also deduct selling costs, improvements and holding costs since death. Expenses paid by the estate in relation to the property can also be deducted, even consider the portion of the probate costs relating to the property.

There is a second limb to section 118-195 ITAA 1997 that allows the deceased's main residence exemption to continue to cover the property while it is occupied as the main residence of the deceased's spouse, a person given the right to occupy under the will or a beneficiary. Though in the case of just a beneficiary it will only protect that beneficiary's share of the property. So co beneficiaries living elsewhere will be subject to CGT on their share. If there is more than one beneficiary you could try arguing that the residing beneficiary had an implied right to occupy under the will, this will allow the whole property to be covered. I have seen the ATO accept that a family had agreed informally that there would be a right to occupy when Mum died, she just never got around to writing it in the will.

Tax Tip:

If the 2 years since DOD is nearly up and you haven't sold the deceased's home, first consider whether there have been circumstances beyond your control so maybe you will qualify for an extension. If not and the property has increased in value since DOD beyond its holding and selling costs then you might want to put a tenant in there.

This is a bit of a quirk of the rule that resets your cost base on your home when it is first used to produce income. You see even if the deceased didn't always use the property as their home as long as it was their home at DOD and not being used to produce income the cost base is reset to market value at DOD and so is the deemed acquisition date. The 2 year rule, in which you can sell the deceased's home effectively covers it with the deceased's main residence exemption during those two years. So, when applying the reset on first used to produce income test the test period for being fully covered by the main residence exemption is from DOD to when first rented out if this is within the 2 years. Thus, allowing the cost base and date of acquisition to be reset once again to the market value just before it was rented out. Hopefully protecting most of the capital gain and excluding that almost 2 year period from the days not covered pro rata calculation. For the fine print go to section 118-192 ITAA 1997.

Your Home Exposed to CGT After Death

Providing the property qualified as the deceased's home at date of death there is no need to look back beyond that date. Section 128-15 resets the cost base to market value at that date and deems to have been acquired at date of death.

Despite the problems mentioned earlier about joint tenancy, if this is the death of the final surviving joint tenant and the property was covered by their main residence exemption at date of death then all those problems go away because of the resetting of the deceased's home (surviving tenant) to market value at date of death.

In the simple case of the two years having expired the market value at date of death is the first element of the cost base. This is increased by any improvements, selling costs and legal costs including a portion of probate, after date of death. The cost base can also be increased, under section 110-25(4) ITAA 1997, by holding costs right down to cleaning materials, lawn mower fuel, repairs, rates, insurance etc. The only condition with holding cost is that they cannot be used to create a capital loss.

If at times the property qualified for some exempt days due to it becoming the main residence of the deceased's spouse or someone given a right to occupy under the will, there is an apportionment. Count the total number of days from date of death to date of settlement of the sale. Count the number of days that it was not the main residence of the deceased's spouse or person with a right to occupy under the will. The percentage of days not so occupied of the total days, is the percentage of the capital gain that will be taxable on sale.

Whether it is the estate or the beneficiary that pays the tax depends on present entitlement. If the executor has allocated the funds to the beneficiaries before 30 June then the capital gain could be taxed in the hands of the beneficiaries rather than the estate. If it is the final year of the estate the gain is also likely to be taxed in the hands of the beneficiaries, not the estate.

Your Home Does Not Qualify for the Reset to Market Value at Date of Death

This could be because the home was also being used as a place of business at date of death or like the Mr Burns' example you may have been charging people who live with you, rent.

Note that contributions family members make to the household will not be considered rent by the ATO, but the situation would be different if you have someone living with you that is claiming rent assistance from the government or an arm's length lease arrangement.

Another reason the place where the deceased is living at date of death might not be covered by their main residence exemption is if they, or their executors on their behalf, elect to cover another property because it has a higher CGT liability or the house they were living in is a pre-1985 asset so does not need the main residence exemption or the house they were living in when they died has a capital loss. A choice can be made to cover another property with the deceased's main residence exemption if they have more than one property that qualifies. This choice can be made if section 118-145 applies. That is the deceased had lived in the other property previously and it has not earned income for more than 6 years since they last lived there.

Note the start of the period that is considered to be earning income is when it is made available for rental i.e., advertised, even if the owner is still living there at the time. If there are gaps where the property is not available to earn income, then it can be covered by the absent owner's main residence exemption during that time and there is no cap on the number of days/years that a non-income producing property can be covered. Further the owner can move back into the property and reset the 6 years.

In the circumstances where the reset to market value under section 128-15 does not apply, the first element of the beneficiary or estate's cost base is the deceased's cost base at date of death. Let's be very clear here as it is sometimes confused. It is not market value but the deceased's cost base which probably starts with the price they originally paid for the property.

There is no two years to sell after the life tenant dies or any reset to market value at their date of death. In these circumstances it is worth considering leaving the property in specie to the person you were considering giving some sort of right to occupy or life tenancy. If it is covered by their main residence exemption when they die, their heirs (who

are hopefully also your heirs) will inherit at market value at the date of their death and all that CGT exposure is forgiven and forgotten. Consider mutual wills.

Now to how the capital gains tax is calculated, there is nothing too complicated about it compared with any other CGT calculation. The capital gain is the difference between the selling price and the cost base.

The cost base is made up as follows:

- Original purchase price
- Stamp Duty to acquire
- Legal Fees and other advice regarding the purchase and other incidental costs
- Cost of maintaining the title – this is where a portion of probate comes in
- Improvements to the property
- Selling Costs
- Holding Costs but only to offset a capital gain - they cannot be used to create a capital loss

It is the holding costs that present the biggest opportunity. These include anything associated with the property that has not otherwise been claimed as a tax deduction - for example claimed against rental income. Think about rates, insurance, interest, repairs, cleaning materials, lawn mower, fuel, etc.

It does not matter whether any of these costs have been incurred by the deceased, the estate or the beneficiary, they still qualify.

If the property was acquired by the deceased after 13 May 1997 and had been used to produce income then consideration has to be given to any building depreciation claimed by the deceased, it may need to be added back.

Regarding the plant and equipment such as stoves, carpet, curtains, air conditioners, hot water systems etc., if these have been depreciated, say against rent they are treated as a separate asset from the property and need to be removed from any CGT calculation both from the original purchase price and the selling price.

The 50% discount is available as long as more than 12 months have expired since the deceased purchased the property.

Trap Transferring Ownership Before Death

By the time you get to the end of this fact sheet you may feel that a simpler solution would be to simply transfer the property to your chosen beneficiary before you die. This has its own set of CGT consequences. Unless the transferee lives in the home as their main residence then the protection from CGT due to the status of it being your main residence is lost. That means a tax on inflation.

An old-fashioned family strategy was to hold the title of the family home in the widow and unmarried adult children's names in joint tenancy to ensure that the adult children would not be homeless in the event of the parent's death. Unfortunately, now that we have CGT, if that child was to eventually move into their own home and chose to cover it with their main residence exemption then, unless someone thinks of it and pays the stamp duty, only half of the parent's home is covered by their main residence exemption resulting in a tax bill should they need to downsize or when the estate sells.

When Your Home is on More than Two Hectares

This is not a problem if the property was purchased by the deceased before 20 September 1985 as all the concessions for main residence also apply to pre-CGT properties regardless of size. Be careful here, only half of it may be pre-1985, as the deceased may have inherited the other half post-1985 from their spouse. This would be an issue regardless of whether it was originally held as joint tenants or tenants in common.

In the case of post-1985 properties the main residence exemption can only cover the dwelling that is your home and up to two hectares. The two hectares include the land under the dwelling and adjacent land used for private purposes. Adjacent does not mean adjoining. It can even include a block on a separate title down the street but the catch here is that it has to be sold to the same purchaser on the same day as the block on which the dwelling stands.

Back to the concept of the deceased's post-1985 home being, say on a 4-hectare block, all just used for private purposes. Only two hectares qualifies for the main residence exemption so only 2 hectares can have its cost base reset to market value. This means that the property will need to be treated as two separate assets for CGT purposes.

The part covered by the main residence exemption gets all the concessions. The rest, unless it qualifies for the small business concessions or is a pre-1985 asset, is inherited at the deceased's cost base at date of death. The CGT can be minimised if the deceased kept good records during their lifetime.

Note if the excess land was used in a business such as farming, veterinary surgery or storing construction materials and vehicles, then it may qualify for the small business CGT concessions. The executor is entitled to make this election. This is covered in section 152-80 ITAA 1997 which also provides a concession in the case of deceased estates, allowing 2 years to sell, no need to be over 55 years of age or meet the retirement condition or put the money into superannuation.

This will mean at least another 50% active asset discount providing it has been used in the business at least half the time it was owned or 7.5 years - whichever is the shortest period. The remainder can be reduced by up to $500,000 for the retirement concessions. If the property has been owned for 15 years and used in the business for more than 7.5 years, then the 15-year small business concession exempts all of the capital gains on the portion used in the business.

Life Tenancy

Life tenancy can create problems when things don't go according to plan. There is no doubt that in a situation where you can trust that the life tenant will be willing and able to carry out your wishes, through their will, it is better to just leave them the property outright. Or consider joint/mutual wills.

A life tenancy does not make life easier for your spouse compared to leaving them the responsibility of owning the home outright. To the contrary, it is far more complex to have to deal with the complexities of a life tenancy, relying on the trustee and having every issue associated with the house dealt with in an uncommon way to normal ownership.

A life tenancy can have a variety of fine points but basically it allows a person to continue to live in a property for the rest of their life, without actually owning the property. When they die the ownership of the property transfers to the remaindermen named in the original deceased's will. Who pays for the costs of maintaining the property in the meantime also needs to be provided for in the will.

The problem with life tenancies is that they can be very short sighted. The life tenant may be happier living in a different area or a different style of house. They may one day need to move into a retirement village. If they sell the home to be able to afford this, if the remaindermen are obliging, there could be tax consequences in varying the arrangement for both the life tenant and the remaindermen.

In short by setting up a life tenancy arrangement you are attempting to rule from the grave without a crystal ball. It can be quite cruel and should only be a last resort or for a very short period of time rather than for life. Example of this would be a comfortable amount of time to allow your carer to relocate. This may also be a good strategy to extend your main residence exemption coverage of your home, after death, beyond the 2 years, but they need to be living there.

If you are likely to be the beneficiary of a life tenancy, you should consider entering into negotiations with the other beneficiaries to vary you rights under the will to full ownership of the property or take advice on challenging the will.

Record Keeping

Consider the situation for your executor finding all the records to undertake the CGT calculation if your home is exposed to CGT. Of course, if you have any other assets there is definitely CGT issues to consider there too. This spreadsheet helps you keep all the information you need in the one place electronically so you can give a copy to your solicitor, spouse, executor etc.

https://www.bantacs.com.au/shop-2/getting-your-affairs-in-order-made-simple/

It also includes a copy of the spreadsheet for keeping records when your home is on more than 2 hectares, as discussed above. As well as recording lots of other information that is needed such as passwords and copies of birth and marriage certificates.

Additional Resources

We hope you found this Fact Sheet helpful. If you're looking for more educational material on property, finance and money management, make sure to check out our podcast, The Property Couch!

Hopefully you can see all the opportunities here that make professional advice and planning well worth your while.

If you are looking for someone to bounce some ideas or help you with your accounting & tax matters, our sister company, Empower Wealth would love to help! Book a **free and no-obligation initial consultation** with one our Tax Experts here >> www.empowerwealth.com.au/tax

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