Life's near certainties — nursing homes and blind-sided advisers

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Fashionable questions in 2015

In 2015 practitioners are increasingly being asked questions relating to the tax consequences of the disposal of a dwelling that is, or was, a family home.

Sometimes the question is from an elderly person contemplating moving to or funding an acquisition in a retirement village, perhaps after the death of a spouse. On other occasions it is the trustee of a deceased estate. Often it is an adult child of two elderly parents or even the survivor of deceased parents.

At some time we may need to consider the disposal of our own former family home.

While the facts relating to the former family home (including its occupancy) remain unchanged, the tax consequences of disposing of the former family home can vary significantly.

An example

An illustrative real life example involves the following facts:

- Husband and wife jointly owned a pre-capital gains tax (CGT) dwelling.
- Husband died in 1997 with his wife taking the husband's former ownership interest through survivorship.
- Wife moved into a nursing home in 1997 and died while being a resident in the nursing home.
- The dwelling was rented when the wife moved into the nursing home in 1997 and continued to be rented up until the date of the wife's death in 2010.
- The whole property passed through the wife's estate to the daughter in 2010.
- The daughter has let the property since 2010.

The adviser was asked by the daughter whether the main residence exemption meant she wouldn't have to pay tax when she disposed of the property because she was the executor and beneficiary of the estate.

The adviser posed the question: "If the daughter sells the dwelling, is she able to claim the market value at 1997 when the property was initially rented for the post-half of the property?"

At its simplest the daughter wants to know:

- what her tax bill will be if she disposes of the old family home; and
- whether her tax bill will reflect the difference between the capital proceeds that she receives for disposing of the old family home less her cost base.[2]

Simplifying the question

For the sake of simplicity, we assume that:

- neither the husband and wife together, nor the wife as the survivor, ever carried out any renovations, extensions or additions to the dwelling during their respective ownership periods;
- prior to the husband's passing in 1997 the dwelling was never used to produce assessable income;
- the adjacent land is less than 2 ha; and
- the wife left the former family home to the daughter in her will.

What question should be asked? And in respect of which taxpayer?

The way the daughter framed the question, by including a reference to the time at which the property was initially let,[3] suggests that the daughter has contemplated the availability of the main residence exemption.

That the question requires consideration of more than the main residence exemption is more readily understood after the taxpayers and CGT assets are identified.

In the example, the taxpayer entities, at different times, have been or are:

- the partnership of husband and wife that held the dwelling jointly (although it was neither a general law partnership nor a tax law partnership) until the time of the husband's death;
- the husband — as an individual;
- the wife — as an individual;
- the deceased wife's estate; and
- the daughter.

What is the main residence exemption?

Broadly, the main residence exemption is a device, at s 118-110 of the Income Tax Assessment Act 1997 (Cth), that allows an individual to disregard a capital gain (or capital loss) arising on the disposal of their main residence.

The expression "main residence" is not defined and so takes its ordinary meaning.

To what can the main residence exemption apply?

The main residence exemption at s 118-110 can apply only to:

- the dwelling, being a unit of accommodation, and the land immediately under the dwelling; and
- up to 2 ha of adjacent land.

When can the main residence exemption apply?

The main residence exemption allows an individual to disregard a capital gain if the relevant CGT event happens in relation to a dwelling that was the individual's main residence throughout the individual's ownership period.

Subdivision 118-B contains various modifications to provide for:

- periods when the dwelling was used to produce assessable income;
- periods of construction;
- overlaps when the individual holds two dwellings; and
- dwellings that are demolished.

Subdivision 118-B also contains rules for dwellings acquired from a deceased estate.[4]

Joint ownership at law

At law when one of two joint owners of an asset dies:

- the surviving joint tenant acquires the deceased's ownership interest in the asset through survivorship;
- the deceased's interest in the asset does not form part of the deceased's estate; and
- the asset does not pass to the surviving joint tenant as a beneficiary in the deceased joint tenant's estate.

Joint ownership for CGT purposes

For CGT purposes:

- individuals who own a CGT asset as joint tenants are treated, for CGT purposes, as if each owned a separate CGT asset as tenants in common (s 108-7); and
- when a joint tenant dies the survivor is taken to have acquired the interest of the deceased joint owner in the CGT asset and to have done so on the day the deceased joint owner died (s 128-50(2)).

The situation in relation to the wife

For CGT purposes, just before her death, the wife, although holding a single asset (the family home), is taken under the ITAA 1997 to have held two CGT assets:

- the original CGT asset being the interest in the dwelling that the wife acquired pre-CGT; and
- the second CGT asset being the CGT asset that the wife is taken by s 128-50(2) to have acquired on the date of her husband's death.

When the wife died:

- each of the CGT assets passed to her estate;
- a CGT event occurred in relation to each of those CGT assets (s 102-23);
- any capital gain arising from the CGT events is disregarded (s 128-10);
- each of the CGT assets eventually passed from the wife's estate to the daughter as a beneficiary in the wife's estate.

Section 128-20 defines, for the purposes of the ITAA 1997, when an asset "passes to a beneficiary in [a deceased's] estate".

The situation in relation to the daughter

Although the daughter acquired the former family home from the wife's deceased estate, she cannot apply Subdiv 118-B in relation to her proposed disposal because the former family home has never been the daughter's main residence during the daughter's ownership period, which commenced in 2010.

Although the daughter acquired a single CGT asset when the family home was passed on to her as a beneficiary of the wife's estate, she was taken to have acquired both the wife's original CGT asset and the second CGT asset on the day the wife died.

Determining the cost base for the daughter of the former family home involves considering the two CGT assets that the wife held just before her death.

The original CGT asset

Because the daughter did not provide any capital proceeds for the original CGT asset (the family home) there is no first element of the cost base for the original CGT asset in the daughter's hands.

However, s 128-15 modifies the cost base of the original CGT asset in the daughter's hands by deeming a first element of the cost base for the original CGT asset in her hands.

By item 4 of s 128-15, the first element of the cost base, for the wife's original CGT asset in the daughter's hands, is equal to the market value of that asset on the day the wife died.

There is no other item in the table at s 128-15 that is relevant.

The second CGT asset

The wife is taken to have acquired the second CGT asset on the day in 1997 on which her husband died.

Because the daughter did not provide any capital proceeds for the second CGT asset there is no first element of the cost base for the second CGT asset in the daughter's hands.

However, s 128-15 modifies the cost base of the original CGT asset in the daughter's hands by deeming a first element of the cost base for the original CGT asset in her hands.

Although the former family home was the deceased wife's main residence, it was being used to produce assessable income just before she died in 2010.

The only item in the table of s 128-15 that is relevant is item 1.

By item 1 of s 128-15, the daughter is taken to have a first element of the cost base for the wife's original CGT asset equal to the wife's cost of that second CGT asset on the day she died.

What is the wife's cost base for the second CGT asset on the day she died?

It is determining the wife's cost base for the second CGT asset on the day she died that proposes the greatest difficulty.

The wife, as the surviving joint tenant of the family home, was taken to have acquired the second CGT asset on the day the husband died.[5]

The rule in s 128-50(2) ensures that, for CGT purposes, the wife, as the surviving joint tenant, satisfies the requirements in s 128-15(2).

The second CGT asset is therefore one that the wife acquired on or after 20 September 1985.

First element of wife's cost base for second CGT asset

The wife, who did not provide any capital proceeds, will not have a first element of a cost base for her second CGT asset.

However, s 128-15 modifies the cost base of the second CGT asset in the wife's hands by deeming a first element of the cost base for the second CGT asset.

The former family home was the husband's main residence and was not being used to produce assessable income just before the husband died in 1997.

Section 118-197 operates to ensure that Subdiv 118 applies to the wife, as the surviving joint tenant, as if the ownership interest of the husband had passed to the wife as a beneficiary of the husband's estate.

The relevant item in the table of s 128-15 is item 3. By item 3 of s 128-15, the first element of the cost base for the second CGT asset in the wife's hands is equal to the market value of the second CGT asset on the day the husband died in 1997.

Establishing other elements of wife's cost base for second CGT asset

The cost base of the second CGT asset will include not only the deemed first element but also the actual second, third, fourth and fifth elements of the cost base.

To establish the second, third, fourth and fifth elements of the cost base for the second CGT asset in the wife's hands, the daughter will need to locate the records of the wife's expenditure back to the date of the husband's death.

In this example that task will not be too difficult as most of those expenditures will have been deductible and therefore will be excluded as elements of the cost base.

It is easily seen that in some circumstances the task of establishing the second, third, fourth and fifth elements will be monumental.

The short answer

The short answer to the daughter's reframed question is "NO".

When a client is allowed to frame a question rather than simply required to lay out the facts and identify a general request, such as what are the tax consequences, there is an increased likelihood of the adviser being blind-sided.

Advisers must focus on getting the facts on the desk.

When the main residence exemption might have been relevant

The main residence exemption would be relevant in determining the many tax outcomes, including where there was a disposal:

- by the daughter within 2 years of the mother's death;
- by the daughter if the daughter had occupied the former family home as a main residence even for a relatively short period immediately after the wife's death;
- where the daughter had occupied the dwelling pursuant to a right of occupancy granted in the wife's will; and
- by the executor pursuant to the executors power of sale.

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Footnotes

1. Liability limited by a scheme approved under Professional Standards Legislation.
2. Income Tax Assessment Act 1997 (Cth), ss 100-45 and 102-22 [ITAA 97].
3. ITAA 97, s 118-192 — Special rule for first use to produce income.
4. ITAA 97, ss 118-195 to 118-210 inclusive.
5. ITAA 97, s 128-50(2).