Minor amendments to the capital gains tax law

Proposals Paper
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Consultation Process

Request for feedback and comments

We invite interested parties to lodge written submissions on the design of these measures.

We also encourage the identification of any other issues, including interaction issues with other parts of the tax law that may be relevant to the design of these measures. While submissions may be lodged electronically, by post or by facsimile, electronic lodgement is preferred.

Submissions will be made available on the Treasury website unless you clearly indicate that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. A request made under the *Freedom of Information Act 1982* for access to a submission marked confidential will be determined in accordance with that Act.

Closing date for submissions: Friday, 22 July 2011

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SUMMARY

The 2011-12 Budget included measures to make amendments to the capital gains tax (CGT) provisions in order to provide greater certainty for taxpayers by fixing technical deficiencies, removing anomalies and addressing unintended outcomes in the law.

The Government will:

- provide a CGT exemption for taxpayers that obtain a right to a financial incentive granted under an Australian government initiated scheme to encourage the use of assets with environmental benefits or where they agree to preserve a part of Australia's environmental amenity;
- make minor amendments to the CGT roll-overs for the exchange of shares in one company for shares in another company, the disposal of assets by a trust to a company and the transfer of assets between certain trusts to ensure that these roll-overs operate as intended;
- provide a CGT exemption for certain compensation or damages and for payments received from life insurance policies (including continuous disability policies); and
- rewrite the CGT provisions relating to deceased estates, including allowing a testamentary trust to distribute the deceased's assets without a CGT taxing point happening and fixing technical deficiencies in the law.

1. PURPOSE

This proposals paper forms the basis for consultation on these measures and sets out, in broad terms, the way they may be implemented. The purpose of this proposals paper is to provide interested parties with an opportunity to comment on the policy design of these measures.

All legislative references in this paper refer to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise stated.

2. Income tax treatment for right to a financial incentive granted under government schemes to benefit the environment

This proposal will ensure the effective operation of Australian government schemes that provide a right to a financial incentive for purchasing assets that benefit the environment or for agreeing to preserve Australia's environment by providing a CGT exemption and ensuring appropriate recoupment and depreciation consequences for taxpayers that realise such rights.

The proposal will not affect environmental scheme credits which are held by taxpayers on revenue account or as trading stock.

This proposal will apply to income tax assessments for the 2007-08 income year and later income years in order to cover transactions that have already occurred under current schemes.

2.1 Background and current treatment

Different government schemes (Commonwealth, State or Territory) provide taxpayers with a right to a financial incentive to acquire an underlying asset to encourage the use of a renewable resource or to agree to preserve a part of Australia's environmental amenity. The financial incentive is most often provided in the form of a right to a certain financial incentive such as a fungible asset (for example, a Renewable Energy Certificate (REC) or Small-scale Technology Certificate (STC)) or an environmental scheme credit.

Under some schemes, taxpayers may realise the right to the financial incentive by exchanging it for a discount on the cost of an underlying asset or they may sell the right for other consideration.

A taxpayer will realise a capital gain or capital loss at this time, which is calculated with respect to the amount of the discount or the consideration received for the sale of the right.

2.2 Proposed treatment

This proposal will remove the income tax impediments to environmental schemes by providing a CGT exemption for taxpayers that realise a right to a financial incentive granted under these schemes. This will exempt any capital gain or capital loss made by realising the right to the financial incentive, whether it is in the form of receiving a discount on the underlying asset, selling the right or using the right to create a fungible asset.

This will ensure an appropriate outcome for situations where the right to create or receive an environmental scheme credit or a similar asset is assigned in exchange for a discount on the cost of the underlying asset. Also, the exemption will cover capital gains that arise where the taxpayer privately sells the right to an environmental scheme credit (or a similar asset) to a third party or uses the right to create and then hold an environmental scheme credit.

If a taxpayer receives an environmental scheme credit or a similar asset from realising the right to the financial incentive, they will be taxable on any capital gain or loss they make on any future realisation of that asset.

This proposal also switches off the recoupment rules in Division 20 and in section 110-45, which otherwise may operate to include recouped expenditure in the taxpayer's assessable income or to reduce the taxpayer's cost base for the asset by the recouped expenditure. In situations where the right to create or receive an environmental scheme credit or similar asset is assigned in exchange for a discount on the cost of the underlying asset, this will ensure that the taxpayer has the original price without the discount as their cost for depreciation and CGT cost base purposes.

Example 1(a): Small-scale Technology Certificate — right exchanged for discount

Alice purchases a solar water heating (SWH) system for her business premises. The system she purchases comes with a statutory right to receive 22 STCs. The supplier offers to give Alice a discount on her SWH system in return for her right to the STCs, at a rate equivalent to $30 per STC ($660 in total). This is less than the market STC clearing house price of $40 per STC.

Without these amendments, Alice would make a capital gain of $660 (assuming a nil cost base for the right) on realising her right to a financial incentive (the STCs) when she obtains the discount from the supplier. However, these amendments allow Alice to disregard this capital gain.

Alice's tax cost for the SWH system is its original price without the discount. She does not need to account for the discount as a recoupment.

Example 1(b): Small-scale Technology Certificate — right sold

The same scenario as Example 1(a) applies, except Alice decides rather than exchanging her right to the 22 STCs for a discount, she will sell the right privately.

Three months after having the SWH system installed, Alice sells her right to create 22 STCs to a third party for $682. This will result in Alice making a $682 capital gain (assuming a nil cost base for the right) which will be exempt under the proposed amendments.

The tax cost of Alice's SWH system remains unchanged from the original price without the discount for the system.

Example 1(c): Small-scale Technology Certificate — certificates obtained

The same scenario as Example 1(a) applies, except Alice decides rather than exchanging her right to the 22 STCs for a discount, she will use this right to create the STCs.

Accordingly, Alice uses her right to create 22 STCs on the REC register. The STCs are the capital proceeds for realising the right to the financial incentive and under the amendments, any capital gain or capital loss realised by Alice by receiving the STCs is disregarded.

The tax cost of Alice's SWH system remains unchanged from the original price without the discount for the system.

The exemption will apply to a right to a financial incentive that taxpayers are entitled to receive because they have entered a government scheme which preserves Australia's environmental amenity. These schemes often involve a taxpayer restricting the use of land that they own or by improving the land to protect its environmental status and receiving tradeable credits. The credits attain their value by representing the protection of environmentally valuable land and can be used to offset developments that impinge on environmental amenity. The amendments will ensure that no capital gain or capital loss will arise for the taxpayer when they receive these credits as a realisation of a right to the credits or if they sell or assign the right to the credits to a third party.

Example 2: Ecological credits

Greg owns a large tract of rural land and he wishes to preserve part of the land to protect its ecological value.

To achieve this, Greg enters into a State government scheme which provides land owners with 'eco credits' for preserving the ecology and biodiversity of parcels of land. These credits are able to be traded on an open market allowing land owners to generate income from the conservation of their land. Also, developers can purchase these credits and 'retire' them to offset conservation or biodiversity requirements of their projects.

Under the scheme, when Greg enters into the agreement to preserve the land, he acquires a statutory right to receive the eco credits. This is a right to a financial incentive. When Greg receives the eco credits, which are valued at $25,000, he effectively realises his right to the financial incentive.

Under the current law, Greg would make a capital gain of $25,000 for realising the right (assuming a nil cost base for the right). The amendments will exempt the capital gain Greg makes from receiving the eco credits in return for realising the right to the financial incentive.

This result undermines the effectiveness of the preservation scheme, as it reduces the value of the incentive of receiving eco credits in exchange for preserving land.

3. AMENDMENTS TO CGT ROLL-OVERS

This proposal will make amendments to correct technical defects in the CGT provisions relating to the CGT roll-overs for:

- the disposal of assets by a trust to a company — Subdivision 124-N;
- the transfer of assets between certain trusts — Subdivision 126-G; and
- the exchange of shares in one company for shares in another company — Subdivision 124-G.

Defects in the current law undermine the objective of these CGT roll-overs which aim to ensure that CGT considerations do not impede the beneficial restructuring of businesses and trusts, and to simultaneously ensure appropriate tax consequences for shareholders and beneficiaries.

The proposed amendments will ensure the availability of roll-overs under Subdivisions 124-N and 126-G in instances where trusts and companies that receive CGT assets in a trust restructure hold rights, which are CGT assets, associated with deeds or contracts entered into purely to facilitate the transfer of assets. Also, the proposed amendments will make the Subdivision 124-G roll-over for the exchange of shares in one company for shares in another company function appropriately where the shares being exchanged are revenue assets.

3.1 CGT ROLL-OVER FOR THE DISPOSAL OF ASSETS BY A TRUST TO A COMPANY AND THE ROLL-OVER FOR THE TRANSFER OF ASSETS BETWEEN CERTAIN TRUSTS

Background and current treatment

A CGT roll-over is available where a trust transfers CGT assets to a company (Subdivision 124-N) or to another trust (Subdivision 126-G) as part of a trust restructure. However, paragraphs 124-860(4)(b) and 126-225(1)(b) restrict these roll-overs to circumstances where the asset-receiving company or trust has ‘no CGT assets other than small amounts of cash or debt’.

Companies and trusts that receive CGT assets may be required to hold contracts or deeds to facilitate the transfer of assets from one entity to another. These contracts or deeds may have associated rights held by the receiving company or trust which are CGT assets. The current provisions prevent access to the roll-overs for these transactions as the company or trust is holding a CGT asset: the deed or contract.

As these rights associated with the contract or deed are assets which are only held to facilitate the relevant transaction, they should be ignored for the purpose of the roll-overs. Therefore, the following amendments are proposed.

Technical Amendments

Current law	*Current proposal*
Paragraphs 124-860(4)(b) and 126-25(1)(b) restrict the CGT roll-overs for disposal of assets by a trust to a company and the transfer of assets between certain trusts to restructures where the companies and trusts that receive the assets have 'no CGT assets other than small amounts of cash or debt'.	The roll-overs will be amended to allow for roll-over in circumstances where the companies and trusts that are receiving assets hold, just before the transfer time, rights (CGT assets) associated with a deed or similar document designed to facilitate the transfer of assets.

The amendment to Subdivision 124-N is proposed to take effect for CGT events happening after 7.30pm AEST on 10 May 2011.

The amendment to Subdivision 126-G is proposed to take effect for CGT events happening on or after 1 November 2008, the application date of Subdivision 126-G.

3.2 CGT ROLL-OVER FOR THE EXCHANGE OF SHARES IN ONE COMPANY FOR SHARES IN ANOTHER COMPANY — REVENUE ASSET TREATMENT

Background and current treatment

Subdivision 124-G defers CGT consequences arising from company restructures by providing a roll-over when all of the shares in one company are exchanged for shares in another company.
The roll-over includes provisions to provide deferral of a profit or loss on an exchange of shares in one company for shares in another company where the original shares are revenue assets at the time of the exchange. However, the current provisions do not effectively provide this relief.

Section 124-390 sets out additional consequences of the roll-over for circumstances where the original shares being exchanged are held as trading stock or revenue assets. The section defers immediate tax consequences and sets the cost of replacement assets received in exchange for the original shares that were held as trading stock or revenue-assets.

Currently, section 124-390 works effectively to grant a deferral of tax consequences for shares held as trading stock but does not do this for shares held as revenue assets. The trading stock deferral works by including an amount as part of a taxpayer's assessable income for the trading stock value of the item disposed of, redeemed or cancelled under the restructure. The corresponding deduction for trading stock (section 70-35), and the cost of the replacement trading stock (given by subsection 124-390(3)) results in a deferral of tax consequences. Subsection 124-390(4) uses the same approach to provide deferral for revenue assets, but as no corresponding deduction exists for revenue assets, there is no deferral of tax consequences.

The proposed amendments will correct this defect to ensure the deferral of a profit or loss on an exchange of shares in one company for shares in another company where the original shares are revenue assets at the time of the exchange.

Technical Amendments

Current law	*Current proposal*
The existing roll-over provisions do not effectively defer a profit or loss on an exchange of shares in one company for shares in another company where the original shares are revenue assets at the time of the exchange.	Subdivision 124-G will be amended to provide that for each of the exchanging members' shares in the original company that is a revenue asset immediately before it is exchanged for a share in the interposed company, a member will be taken to have received an amount so that, they would not make a profit or loss on disposing of, or ceasing to own, that share at that time. The amendment will also provide that the cost for the shares received in the interposed company will be equal to the total of the amounts taken to have been received described above divided by the number of shares received in the interposed company in exchange for the shares that were revenue assets.

These amendments to Subdivision 124-G are proposed to have effect from 7.30pm AEST on 10 May 2011.

4. CGT EXEMPTION FOR CERTAIN COMPENSATION AND INSURANCE PAYMENTS

This proposal removes uncertainty in the application of the income tax provisions by providing a CGT exemption for payments received from life insurance policies (including continuous disability policies) by a trustee of a complying superannuation entity, and for certain compensation or damages received by a trustee.

This proposal also extends the CGT exemption arising from a policy of insurance on the life of an individual or an annuity instrument made by its beneficial owner. The extended exemption will now also cover capital gains or losses from such a policy or instrument held by a non-superannuation trustee on behalf of a beneficiary.

These changes apply to CGT events happening in the 2005-06 income year and later income years.

4.1 CGT EXEMPTION FOR COMPENSATION PAYMENTS AND DAMAGES PAID TO A TRUSTEE

Current treatment

Subsection 118-37(1) disregards a capital gain or capital loss in a number of circumstances, including where the taxpayer receives compensation or damages ('compensation payment') for:

- a wrong or injury the taxpayer suffers in their occupation; or
- a wrong, injury or illness the taxpayer or their relative suffers personally.

Taxation Determination TD 14, which was based on the equivalent provision in the *Income Tax Assessment Act 1936*, allows compensation payments to be exempt from CGT when paid to trustees on behalf of the beneficiary who suffered the wrong, injury or illness. However, subsequent changes to the tax law have meant that TD 14 is no longer effective.

Proposed treatment

The exemption in subsection 118-37(1) will be extended to cover compensation payments paid to trustees that are not trustees of complying superannuation entities on behalf of an individual beneficiary.

- Compensation payments made to trustees of a complying superannuation entity on behalf of a beneficiary will be dealt with separately under section 118-300, in order to consolidate the CGT exemptions for superannuation trustees for capital gains and losses on their rights under insurance policies. This is discussed further below.

4.2 CGT EXEMPTION FOR CERTAIN INSURANCE PAYMENTS MADE TO SUPERANNUATION TRUSTEES

Current treatment

Item 5 in the table in subsection 118-300(1) disregards a capital gain or capital loss made by a trustee of a complying superannuation entity from a CGT event happening to the trustee's rights under a policy of insurance on the life of an individual, or under an annuity instrument.

This exemption applies to insurance policies that have regard to the duration of a human life. This is a narrower category than 'life insurance policies' as defined in the ITAA 1997, which includes continuous disability policies.

Proposed treatment

The CGT exemption in item 5 of the table in subsection 118-300(1) will be extended to cover life insurance policies more generally, including similar policies issued by a non-resident entity. As foreshadowed above, this will allow compensation payments paid under a life insurance policy to a trustee of a complying superannuation entity to be exempt from CGT.

The exception to the 'CGT primary code' rule in section 295-85 for capital gains or losses exempted under item 5 in the table in subsection 118-300(1) will also be removed. This ensures that the CGT exemption for life insurance policies for trustees of complying superannuation entities does not result in these policies being taxed on revenue account.

4.3 CGT EXEMPTION FOR INSURANCE POLICIES ON THE LIFE OF AN INDIVIDUAL AND ANNUITY INSTRUMENTS

Current treatment

Item 3 in the table in subsection 118-300(1) exempts a capital gain or loss in relation to a CGT event that happens to the rights of the original beneficial owner under an insurance policy on the life of an individual or an annuity instrument.

However, where the capital gain or capital loss is made by a trustee that holds the policy or instrument on behalf of a beneficiary and is the original owner of the policy or instrument, there is uncertainty over whether the exemption would flow through to the beneficiary.

Proposed treatment

The exemption in item 3 in the table in subsection 118-300(1) will be extended to cover capital gains or losses from a policy of insurance on the life of an individual or an annuity instrument held by a trustee (that is not a trustee of a complying superannuation entity) who is the original owner of the policy or instrument.

- Payments of this type made to trustees of complying superannuation entities are already covered by item 5 in subsection 118-300(1).

5. DECEASED ESTATES

These changes apply to CGT events happening on or after the day the legislation receives Royal Assent.

5.1 Background on Division 128

Division 128 provides a CGT roll-over when a taxpayer dies and a CGT asset owned just before their death passes to their legal personal representative (LPR) and also where it subsequently passes to a beneficiary in the estate. There is a similar CGT roll-over where an asset which the deceased owned as a joint tenant passes by survivorship to the remaining joint tenants.

- CGT event K3 (section 104-215) provides an exception to this if the asset passes to a beneficiary in the taxpayer's estate that is an exempt entity, trustee of a complying superannuation entity or a foreign resident. The event is taken to have happened just before the death of the individual — so that any capital gain or capital loss is included in the deceased's final income tax return.

5.2 CGT roll-over for a trustee of a testamentary trust

Current treatment

Division 128 does not currently provide a CGT roll-over if the asset is transferred from a trustee of a testamentary trust to a beneficiary of the trust. This means that a CGT taxing point will happen when an asset is transferred from a trustee of a testamentary trust to a beneficiary.

- A testamentary trust is established under a will and has effect after the individual's estate has finished administration. A testamentary trust provides flexibility in the distribution of income and assets of the trust to beneficiaries. These trusts are often used for planning for the future needs of family members, including being used to protect assets for the benefit of a minor or an individual with a disability.

However, in Law Administration Practice Statement PS LA 2003/12, the Commissioner of Taxation indicated that he will treat the trustee of a testamentary trust in the same way that an LPR is treated for the purposes of Division 128. In essence, this provides a CGT roll-over when an asset is transferred from a trustee of a testamentary trust to a beneficiary.

The Tax Office has concerns about the sustainability of the practice. Changes to the CGT small business concessions in section 152-80 which specifically identify trustees of testamentary trusts, might suggest that section 128-15 is intended only to apply to an LPR.

Proposed treatment

A CGT roll-over will be provided where the deceased's asset (or interest in that asset) passes from a trustee of a testamentary trust (including a discretionary testamentary trust) to a beneficiary of the trust.

- This effectively defers any CGT liability until a later dealing with the asset by a beneficiary.

5.3 Technical Amendments

The Government is aware of a number of minor technical issues relating to the application of CGT to deceased estates. These changes will either resolve deficiencies in the current law or reduce legislative uncertainty to ensure the provisions operate appropriately.

Current law	*Current proposal*
Issue 1. Acquiring an interest in the deceased's asset	
To access a CGT roll-over under Division 128, the provisions require the LPR or beneficiary of a deceased estate to acquire the deceased's CGT asset. On a strict view of the law, this cannot be satisfied where two or more beneficiaries acquire the deceased's asset. This is because each beneficiary acquires only an interest in the deceased's CGT asset, rather than the entire CGT asset.	A CGT roll-over will apply where two or more beneficiaries each acquire an interest in the deceased's CGT asset.
Issue 2. Cost base modification deficiency — land	
Item 3 in the table in subsection 128-15(4) provides a market value cost base for the deceased's dwelling where it was their main residence just before their death, and at that time it was not being used for the purpose of producing assessable income. The market value cost base rule does not extend to land that is adjacent to the dwelling, even where that land would be eligible for the CGT main residence exemption. This is because under section 118-120, land adjacent to a dwelling is generally treated as if it were a dwelling only for the purposes of Subdivision 118-B. This is deficient in that it is not extended to Division 128, which is where the cost base modification rules on death are located.	The cost base modification for a main residence dwelling will take into account adjacent land, to the extent that the land would be eligible for the CGT main residence exemption.

Current law	*Current proposal*
Issue 3. Cost base modification deficiency — income-producing use	
Following on from Issue 2, the market value cost base rule also does not apply where the deceased's dwelling was used for producing assessable income just before their death where that income-producing use would not have affected the deceased's entitlement to a full CGT main residence exemption. This situation could occur when the deceased was accessing the absence extension in section 118-145. Under the main residence exemption, this income-producing use can be disregarded under subsection 118-190(3). However, this only applies for the purpose of calculating a main residence exemption, not for the purposes of Division 128.	The cost base modification for a main residence dwelling will take into account where the dwelling was used for producing assessable income but where that use would not have affected the deceased's entitlement to a full CGT main residence exemption.
Issue 4. Death before administration	
Division 128 does not provide a roll-over when the intended beneficiary of a deceased estate dies before administration is completed and an asset owned by the first deceased person passes from the intended beneficiary's LPR to a trustee of a testamentary trust or a beneficiary in the intended beneficiary's estate. This is because the asset was not one which the intended beneficiary owned when they died.	In cases where an individual (the first deceased) dies and the intended beneficiary also dies before an asset which the first deceased owned passes out to them, the asset will be treated as though it had passed to the intended beneficiary before they died. This ensures that a roll-over will apply when an asset passes from the intended beneficiary's LPR to a trustee of a testamentary trust or a beneficiary in their estate.
Issue 5. Joint tenant cost base modification	
A surviving joint tenant whose interest is enlarged due to the death of a joint tenant is unable to access equivalent cost base rules to those of a beneficiary of a deceased estate (see section 128-50).	Cost base modifications will be available for surviving joint tenants that are equivalent to those available to a beneficiary of a deceased estate. This maintains consistency between joint tenants and deceased estate cases.

Current law	*Current proposal*
This is because the cost base rules for joint tenants do not replicate rules that apply to assets that pass through a deceased estate such as those in items 2, 3 and 3A in the table in subsection 128-15(4).	
Issue 6. Joint tenant issues regarding CGT discount	
The table in subsection 115-30(1) contains special rules for determining when CGT assets are taken to have been acquired for the purpose of determining eligibility for the CGT discount. Beneficiaries of deceased estates are deemed to have acquired pre-CGT assets of the deceased at the time of the deceased's death. However, there is no equivalent rule for pre-CGT assets for surviving joint tenants. Item 7 in the table in subsection 115-30(1) provides that these assets are acquired by the surviving joint tenant(s) when the deceased acquired his or her interest in the asset.	When an interest in a pre-CGT asset passes by survivorship, for the purposes of the CGT discount, the interest in the asset will be taken to be acquired by the surviving joint tenant(s) when the deceased died, rather than when the deceased acquired the asset. This ensures consistency between joint tenants and deceased estate cases.
Issue 7. CGT event K3 — Delay seeking endorsement	
CGT event K3 can be circumvented where an entity would be entitled to tax-exempt status but has not been endorsed as such by the Commissioner until after the asset has passed to it. This could happen due to an entity delaying seeking endorsement or if the trust is only created when the asset passes to it.	CGT event K3 will happen if at the time an asset passes to an entity, the entity satisfies all of the conditions required for exempt entities, despite not yet having been endorsed by the Commissioner.
Issue 8. CGT event K3 — Amendment period	
CGT event K3 can also be circumvented where an asset does not pass to an entity listed in that CGT event until after the deceased's standard amendment period has expired. Where the deceased's assessment cannot be amended (usually two or four years after the assessment), effectively no capital gain or capital loss can be recognised.	An embedded capital gain or loss will still be subject to tax when an asset is transferred to an entity listed in CGT event K3 outside the deceased's standard amendment period. This can be achieved by excluding CGT event K3 from the standard amendment period.

Current law	*Current proposal*
Issue 9. CGT E Events — Issues with deceased estates	
Section 102-20 requires a CGT event to 'happen' for a taxpayer to make a capital gain or capital loss. If more than one CGT event happens in particular circumstances, section 102-25 generally requires the taxpayer to use the CGT event that is most specific to their circumstances. CGT events E5 to E8 (relating to trusts, sections 104-75 to 104-100) contain an exception so that they do not 'happen' to a 'trust to which Division 128 applies.' The exception was intended to ensure that neither the trustee nor the beneficiary made a capital gain or capital loss in the circumstances giving rise to those CGT events. However, if the exception is satisfied, it means that those events do not 'happen' at all and another (less relevant) CGT event which has happened may apply. Although it is immaterial to an LPR which event happens when an asset passes to a beneficiary (because of the exception in subsection 128-15(3)), the same is not true for a beneficiary. The beneficiary's interest in the trust may come to an end (in whole or in part) when an asset owned by the deceased passes from their LPR to the beneficiary or when the beneficiary disposes of their capital interest in the trust to a third party before administration is complete. Because another CGT event would happen to the beneficiary instead of CGT events E5-E8 at this time, the beneficiary generally cannot disregard any capital gain or capital loss on their trust interest. There is nothing in the CGT provisions to disregard that capital gain or loss.	The relevant CGT E event will 'happen' for 'trusts to which Division 128 applies' but both the trustee and beneficiary of these trusts will not realise a capital gain or capital loss when these events happen, to the extent the gain or loss relates to assets owned by the deceased.

5.4 REWRITE THE INCOME TAX LAW IN RELATION TO DECEASED ESTATES USING A PRINCIPLE-BASED FORMAT

The proposal will rewrite the existing roll-overs in Division 128 using CGT roll-over principles, encompassing the testamentary trust (issue 5.2) and the technical amendment issues (issue 5.3).

Current treatment of CGT roll-overs in Division 128

The technical operation of Division 128 differs from the technical operation of other CGT roll-overs. Under other CGT roll-overs, the first element of the entity's cost base (and reduced cost base) will equal the cost base of the previous entity. However, Division 128 provides a different method of calculating cost base for a beneficiary of a deceased estate.

When an asset of the deceased's estate passes to the LPR, the normal roll-over principles apply and the LPR picks up the deceased's cost base (as modified by subsection 128-15(4)) as their first element of cost base. However, this also becomes the beneficiary's first element of cost base, instead of the beneficiary receiving the LPR's entire cost base as their first element of cost base. Special rules are available to ensure costs incurred by the LPR are included in the applicable element of the beneficiary's cost base (see, for example, subsection 128-15(5)). These costs are not rolled into the beneficiary's first element; rather, they are included in the same element as incurred by the LPR. There is no policy reason why this roll-over should operate differently to other CGT roll-overs.

- This change would be beneficial to taxpayers as third element costs incurred by the LPR that are currently not recognised by a beneficiary in a capital loss situation (see subsection 110-55(3)) would now be recognised, as these costs would be included in the first element of reduced cost base. This treatment would be consistent with CGT roll-over principles.

Proposed treatment

This rewrite will ensure traditional CGT roll-over principles apply. That is, the trustee of a testamentary trust and beneficiary of a deceased estate will receive as their first element of cost base and reduced cost base the previous entity's cost base.

- Appropriate cost base modifications (for example, to give a market-value cost base for pre-CGT assets) would still apply to the LPR. This would ensure that when subsequent entities acquire the deceased's asset, this modified cost base is reflected in their cost base and reduced cost base.