TAX IMPLICATIONS DURING ADMINISTRATION OF DECEASED ESTATES

FirstTech Strategic Update – Chris Chow, Technical Analyst

Administering a deceased estate can be a difficult process, especially as it is during a time of grief. However, the tax treatment of assessable income, such as investment income and capital gains, of a deceased estate during administration can be utilised by an executor to minimise tax payable and maximise inheritances for beneficiaries.

As the saying goes, nothing can be said to be certain in life except death and taxes. Unfortunately, these two certainties are not mutually exclusive.

While Australia does not have an ‘inheritance’ or ‘death’ tax, there are still tax implications that need to be considered not just for the deceased, but also for the executor of their estate and the beneficiaries.[1]

This article will focus on the tax treatment of assessable income derived by the executor when administering a deceased estate and how this tax treatment can be utilised to minimise tax payable and maximise inheritances for beneficiaries. Other executor responsibilities, such as lodging the deceased’s final date of death tax return, are not considered in this article.

However, given the complicated nature of the taxation and legal matters for an executor during the administration of a deceased estate, it is prudent for clients to seek professional tax and legal advice.

Administration of a deceased estate

The executor of a deceased estate is responsible for its administration, which includes, amongst other things:

- applying for probate where necessary
- determining the deceased’s assets and liabilities
- collecting the income and paying expenses associated with estate assets
- lodging tax returns.

After all estate debts are extinguished, the residual estate is distributed to beneficiaries in accordance with the terms of the will.

In order to look at the tax treatment of assessable income in a deceased estate, it is important to consider the process of administering a deceased estate, the different types of income and when income derived is considered to be assessable income to the deceased estate.

Stages of administration

The stages of administration of the estate of a deceased person may be illustrated as follows in Table 1.

TABLE 1: PERIOD OF ADMINISTRATION[2]

	Stages of administration
1	Burial of deceased
2	Executor appointed by will or administrator appointed by Court
3	Probate applied for and granted by Court
4	Assets vest in executor who pays debts and testamentary expenses: • Initial stage - net income of estate is applied to reduce debts, etc. • Intermediate stage - part of the net income of estate that is not required to pay debts, etc., may be paid to beneficiaries. • Final stage - debts are paid or provided for in full and net income of estate is available for distribution.
5	Administration of estate is complete

Assessment of income derived during administration of estate

If, during the administration of the estate, the executor receives any amount after the date of death that would normally have been assessable income of the deceased person, that amount is treated as assessable income of the deceased estate to which no beneficiary is presently entitled.[3]

1 For the purposes of this article, ‘executor’ includes a person appointed in the deceased’s will and also a court appointed administrator where the deceased died intestate.

2 ATO, Taxation Ruling IT 2622, Income tax: present entitlement during the stages of administration of deceased estates, Paragraph 6.

3 Subsection 101A(1), Income Tax Assessment Act 1936 (ITAA 1936).

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Income received may include the following:

- unpaid salary and wages
- bank interest
- superannuation death benefits
- employment termination payments
- share dividends
- managed fund distributions
- rent
- capital gains.

Present entitlement

Beneficiaries are not presently entitled to income derived by a deceased estate during the administration of the estate. While the estate is in the stages prior to completion of administration as detailed in Table 1, any assessable income derived is assessable income of the executor of the estate.[4]

Upon completion of estate administration, the beneficiaries become presently entitled to the income derived by the estate.

Beneficiaries under legal disability

If a beneficiary is presently entitled but under a legal disability, such as a minor, the executor would need to pay tax on the beneficiary's share of the net income of the estate on the beneficiary's behalf, as if it were the income of the beneficiary.

The income derived will be taxed at adult individual income tax rates. This also applies to minors as income from a deceased estate is 'excepted income'.[5]

Completion of administration of estate

Generally, an estate is considered to be fully administered only upon the payment or provision for the payment of funeral and testamentary expenses, death duties, debts, annuities, and legacies and where the residual amount of the estate has been ascertained.[6]

Present entitlement prior to completion

In some circumstances, the executor may exercise discretion and pay an amount that is considered surplus to the needs of the estate to the beneficiaries. This could arise as it may become apparent that some of the estate assets or income will not be required for the payment of expenses, debts and any other liabilities.

In this situation, the beneficiaries will be presently entitled to amounts paid to them, and therefore assessed on the net income paid to them or on their behalf, even though the estate has not been fully administered.[7]

Estate fully administered during income year

Generally, beneficiaries not under any legal disability bear the tax on their shares of the net income of the estate for the income year that they become presently entitled.[8]

The net income of the estate and whether any beneficiaries are presently entitled should be determined on 30 June of that income year.[9]

However, it is important to note that it is also acceptable to apportion the income derived during the income year that the administration of the estate is completed.

Provided there is supporting evidence that an amount of income was derived before administration is complete, it will be assessable income to the executor, while income derived afterwards is assessable to presently entitled beneficiaries.[10] However, it is important to note that income of the estate distributed to a beneficiary before the estate is fully administered will be assessable to the beneficiary.[11]

Tax rates applicable to deceased estates

The tax rates applicable to taxable income of a deceased estate differs depending on how long after the date of death that income was incurred.

First three income years

During the first three income years, the assessable income of a deceased estate is taxed at the individual adult income tax rates, including access to the full tax-free threshold.

Taxable income of a deceased estate does not benefit from most income tax offsets, such as the Low Income tax offset (LITO). The Medicare levy does not apply.[12]

First income year

It is important to note that the first income year commences from the day following the date of death and ends on 30 June of that same income year.

Therefore, the amount of time that an executor has in the first income year to conduct any affairs will vary depending on the date of death.

Example: Deceased estate income years

Axel passed away on 17 March 2016.

The income years for Axel's estate will cover the following periods:

- **First year** – 18 March 2016 to 30 June 2016
- **Second year** – 1 July 2016 to 30 June 2017
- **Third year** – 1 July 2017 to 30 June 2018.

Fourth income year and later

Deceased estates that continue to be administered beyond the third year are subject to special progressive tax rates where the tax-free threshold effectively reduces from $18,200 to $416.

TABLE 2: TAX RATES FROM FOURTH INCOME YEAR10

Deceased estate taxable income (no present entitlement)	Tax rates
$0 – $416	Nil
$417 – $670	50% of the excess over $416
$671 – $37,000	$127.30 plus 19% of the excess over $670 If the deceased estate taxable income exceeds $670, the entire amount from $0 will be taxed at the rate of 19%
$37,001 – $80,000	$7,030 plus 32.5% of the excess over $37,000
$80,001 – $180,000	$21,005 plus 37% of the excess over $80,000
$180,001 and over	$58,005 plus 45% of the excess over $180,000

4 ATO, Taxation Ruling IT 2622, Paragraph 9.
5 Section 102AE, ITAA 1936.
6 Federal Commissioner of Taxation v Whiting s [1943] HCA 45; (1943) 68 CLR 199 (19 March 1943).
7 ATO, Taxation Ruling IT 2622, Paragraph 14.
8 Section 97, ITAA 1936.
9 ATO, Taxation Ruling IT 2622, Paragraph 19.
10 ATO, Taxation Ruling IT 2622, Paragraph 21.
11 ATO, Taxation Ruling IT 2622, Paragraph 23.
12 ATO, Doing trust tax returns for a deceased estate – Tax rates, as at 1 October 2016. www.ato.gov.au/Individuals/Deceased-estates/Doing-trust-tax-returns-for-a-deceased-estate/Tax-rates/

Special treatment of certain types of income

Superannuation death benefits

In circumstances where a deceased's superannuation benefits are paid to deceased estate, no tax is withheld upon payment by the trustee of the super fund.

The tax treatment when received by the estate is as follows:

- to the extent that death benefits dependants will (or could be expected to) benefit from the death benefit, it is non-assessable non-exempt income of the estate and not taxed
- to the extent that non-death benefit dependent beneficiaries will (or could be expected to) benefit from the death benefit, it is subject to the same taxation in the estate as a non-death benefit dependant would pay had they received the benefit directly. However, Medicare levy does not apply.[13]

Superannuation death benefits paid to a deceased client's estate which are then distributed to beneficiaries are not assessable in the hands of the beneficiaries.

Death benefit termination payments

If the deceased's employer pays their employment termination payment (ETP) to their deceased estate, special tax rates apply to the payment. This amount of tax payable by the executor depends on the amount of taxable component of the ETP, and also whether the ultimate beneficiaries of the ETP are dependants or non-dependants for tax purposes.[14]

Unused annual and long service leave

Amounts of unused annual and long service leave paid to the deceased person's beneficiaries or the executor are not included as assessable income of the beneficiaries or executor, but are rather included as assessable income of the deceased.[15]

13 For more information on rates of tax on superannuation death benefits, please see chapter 10.3 of the FirstTech Super Guide.

14 For more information on the rates of tax of death benefit termination payments, refer to the FirstTech reference guide, Termination Payment Essentials (chapter 1.12).

15 Subsection 101A(2), ITAA 1936.