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Death and Taxes

Tax implications of wills

They say there are two things certain in life – death and taxes! It should be no surprise then that upon death tax can be triggered.

If you operate your business as a sole trader or through a partnership then the terms of your will determine how your business interest is taxed upon your death. Therefore, you should regularly review your will to ensure it does not trigger any unintended tax outcomes. However, the tax outcomes should not determine how you draft your will. Instead these tax outcomes need to be weighed against other factors, such as who the property is best to pass to upon your death for asset protection reasons.

General proposition

The general proposition is that upon your death there is a deemed disposal of foreign investment funds, revenue account property, financial arrangements and depreciable property, at market value. This can result in tax payable on unrealised gains even though no cash has been generated to pay the tax owing.

The deemed disposal at market value occurs both on the transfer of the deceased person's estate to the executor, administrator, or trustee of the estate and on the transfer of property from the executor, administrator, or trustee of the estate to a beneficiary under the will.

In some cases there is an exception to the rule that there is a deemed disposal at market value. We now outline these exceptions.

Exception when property transferred to spouse, civil union partner, or de facto partner

The deemed disposal is not at market value if "tax-base property" is transferred to the surviving spouse, civil union partner, or de facto partner of the deceased, and no other person apart from a "close relative" of the deceased is entitled to "tax-base property" under the will. In these circumstances the property is deemed to be disposed of at its tax value, meaning no tax issues arise upon the person's death or when the property is distributed under the will. Instead any underlying tax liability is passed to the spouse, civil union partner, or de facto partner of the deceased.

Note this exception only applies to the tax-base property transferred to the surviving spouse, civil union partner, or de facto partner. It does not apply to tax-base property transferred to a close relative.

Tax-base property means-

- Revenue account property
- Foreign investment funds
- Financial arrangements
- Depreciable property

A close relative is a surviving spouse, civil union partner, de facto partner, or a person within the second degree of relationship to the deceased person.

Exception when property transferred to charities or to close relatives

The transfer of "tax-base property" from an executor, administrator, or trustee of an estate to a beneficiary of the estate is deemed not to be at market value when the only beneficiaries under the will are either close relatives of the deceased or charities and all of the following requirements are met:

- No life interest is created in the tax-base property
- No trust over the property is created
- Whilst the administration of the estate is continuing, the net income of the estate is distributed to the extent allowed by the trustee's legal obligations and under the will.

In these circumstances there will be a deemed disposal at market value when the property transfers from the deceased to the executor, administrator, or trustee of the estate. The income arising will need to be reflected in the final return for the deceased taxpayer.

However, when the property transfers from the executor, administrator, or trustee of the estate to the close relative or charity the deemed disposal will not be at market value. Instead the disposal will occur at the same value the deceased was deemed to dispose of the property to the executor, administrator, or trustee of the estate. This means there is no further tax liability for the executor, administrator, or trustee of the estate.

Exception for land transferred to close relatives

If the deceased owned land and was associated with a land dealer, developer, subdivider or builder at the time of acquiring that land they would, generally, be taxed on disposal of the land if the disposal was within 10 years of acquisition.

In these circumstances, if the land is disposed of to a close relative of the deceased, then no tax liability arises either on the disposal from the deceased to the executor, administrator, or trustee of the estate or on the disposal from the executor, administrator, or trustee of the estate to a beneficiary under the will. Instead the close relative is deemed to have acquired the land on the date the deceased acquired it, for the same cost the deceased acquired the land for and to have incurred the same costs on the land as the deceased.

However, if the close relative disposes of the land within 10 years of the date the deceased acquired it, they will be taxed on the disposal.

Forestry assets transferred to close relatives

A forestry asset means timber, standing timber or a right to take timber. There is no deemed disposal of a forestry asset at market value where it is transferred to a close relative. In this circumstance the forestry asset is deemed to be disposed of at its tax value. This means no tax arises upon the person's death, or when the forestry asset is distributed under the will. Instead any underlying tax liability on the forestry asset is passed to the close relative.

Financial arrangements

Upon death the disposal of a financial arrangement is at cost, and not at market value, if the deceased and the deceased person's estate are cash basis persons. This means no tax arises upon the person's death or when the financial arrangement is distributed under the will. Instead any underlying tax liability on the financial arrangement is passed to the beneficiary. Under this exemption there is no requirement for the beneficiary to be a spouse, civil union partner or de facto partner or a close relative.

Leaving property to a family trust

If a person leaves property under their will to a family trust, there will be a deemed disposal of this property at market value both on the transfer of the deceased person's estate to the executor, administrator, or trustee of the estate and on the transfer of property from the executor, administrator, or trustee of the estate to a beneficiary under the will. There are no exclusions from the rule that there is a deemed disposal at market value when property is left to a family trust. Therefore, you should think very carefully about what property should be left to a family trust under your will.

Leaving property to a family trust can be sensible from an asset protection point of view. However, this could result in unintended tax outcomes.

Husband and wife partnerships resulting in dissolution of partnership

The partnership tax rules provide that where a partnership is finally dissolved there is a deemed disposal of each partner's interest, to a single third party, for market value. This will result in tax liabilities arising on each partner's interest.

The death of a partner in a two partner partnership will, generally, result in dissolution of the partnership where the deceased partner leaves their partnership share to the other partner. In this instance both partners would be deemed to have disposed of their interest for market value.

However, a deemed disposal at market value does not apply where there are two partners in partnership who are married to each other, in a civil union together, or in a de facto relationship together, then one of the partners dies and all of the deceased partner's interest is transferred to the other partner under the terms of the will. In this situation the disposal is deemed to be made at the property's tax value if all other tax-base property of the deceased, other than the partnership interest, goes to either the deceased's spouse, civil union partner, or de facto partner or a close relative of the deceased. In this instance no tax issues arise on the disposal of the deceased partner's interest upon their death or when the deceased partner's interest is distributed under the will. Instead any underlying tax liability on the interest is passed to the spouse, civil union partner, or de facto partner of the deceased partner.

If somebody other than the deceased's spouse, civil union partner, or de facto partner or close relative of the deceased was entitled to tax base property under the will, the disposal of the interest would be at market value.

Partnerships where death does not result in dissolution

Where a partnership carries on after the death of a partner there will be a deemed disposal, under tax law, of the partner's interest. The value of the deemed disposal depends on who is entitled to the partner's interest and whether anyone other than the deceased's spouse, civil union partner, or de facto partner or close relative is entitled to tax-base property under the will. The disposal will be at the market value of the partner's interest if anyone other than these people inherit the property.

However, in some cases the partnership rules provide that even if the disposal is at market value this income is not taxable. In this situation the person who is entitled to the deceased's interest steps into their shoes and assumes their tax liabilities.

Specific legacy versus residuary

If a deceased person holds property from which income is derived then how this income is taxed, between the time the property is transferred to the executor, administrator or trustee of the estate and the time it is distributed to the beneficiary, depends upon whether the property is a specific legacy or forms part of the residue of the estate.

If the property is a specific legacy then any income derived from the property during the administration of the estate can be allocated to the beneficiary entitled to the property. The income will then be taxed in the name of the beneficiary at the beneficiaries' marginal tax rate.

However, if the property forms part of the residue of the estate, then any income derived during the administration of the estate is retained as trustees' income and tax paid at the trustees' tax rate, currently 33%. This can be disadvantageous if the beneficiaries of the estate are on lower tax rates. In this situation it would be appropriate, if possible, to have this property distributed as soon as possible to the beneficiaries, in order for them to have the tax advantage of the lower tax rates.

Consideration should be given, when drafting wills, as to whether property, from which income is derived, is left as a specific legacy or as part of the residue of the estate.

Debt forgiveness and wills

In some cases when a deceased person is owed money by another party there will be a clause in the will that forgives the debt upon their death.

If the person who owes the deceased is a natural person and the deceased has natural love and affection for this person then generally no income tax issues arise upon the forgiveness of the debt.

If the person that owes the deceased is a trust and the trust was established to mainly benefit a charity and/or a natural person, for whom the deceased has natural love and affection, then generally no income tax issues arise upon the forgiveness of the debt.

However, in all other cases the person that owes the debt will be taxed on the value of the debt that is forgiven. For example, if a deceased forgives a debt owed by a company the company will be taxed on the value of the loan forgiven.

If your will contains a clause that forgives a debt, this may result in taxable income to the other party. Please contact us to discuss how your will and the arrangement could be restructured to avoid this issue.

If you are concerned that your will may result in unexpected tax liabilities we suggest you contact us in order to review it and provide possible solutions.

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