Tax implications of certain asset transfers

- "In-kind" distributions and gifts
- Transfers of assets on a taxpayer's death

An officials' issues paper

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Prepared by the Policy Advice Division of the Inland Revenue Department and the New Zealand Treasury

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Chapter 1

INTRODUCTION

1.1 Asset transfers are a normal business occurrence, and the tax legislation often utilises such events as the point at which to calculate a tax adjustment. Often these transfers are as a result of market transactions, but there are also many instances when assets are transferred without any element of market exchange. "In-kind" asset transfers from companies and trusts and gifts are key examples of this, as are transfers of assets on a taxpayer's death.[1]

1.2 To be facilitative, the law should be clear on the consequences of these transfers. Although the general law is clear on how they are treated, the tax legislation is not. The tax legislation in some instances provides specific rules, but in most cases it is silent, leading to considerable confusion, multiple interpretations and repeated calls for greater clarity. How to address this lack of clarity is the subject of this paper.

1.3 We shall never know when Benjamin Franklin made his now famous comment that "in this world nothing can be said to be certain except death and taxes" whether he had in mind these two events occurring simultaneously. But we do know, given that the Income Tax Act 1994 is not clear in this area, that policy makers have not in the past turned their mind to the issue in any comprehensive way.

1.4 Also, given the court cases in recent years on distributions of forests and financial arrangements from companies, it seems reasonable to proceed with generic rules for distributions.

1.5 This paper has been prepared by the Policy Advice Division of Inland Revenue and the New Zealand Treasury as part of the consultation involved in the policy development process. Subject to the results of the consultation, we aim to present the suggested solutions to the government for consideration, with the intended ultimate outcome being the introduction of amending legislation.

1.6 Specifically, the key suggestions outlined in the paper are that, for income tax purposes:

- "In-kind", or *in specie*, distributions by companies and trusts (including estates) should be treated as dispositions and acquisitions at market value.
- Gifts should be treated in a similar fashion.

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[1] This is not to say that there is no exchange in these circumstances; for example, shareholders who receive an in-kind distribution may be indirectly giving up part of the value of their shares in exchange. In the case of gifts and inheritances, however, assets are transferred without the recipients having to provide any exchange.

- A disposal and acquisition of a taxpayer's assets should be deemed to occur on the day of death, at market value. The subsequent transfer of the assets from the executor/trustee to the beneficiaries should be treated as a separate disposition and acquisition at market value.
- There should be a special rule to ensure that a taxpayer's death does not in itself lead to an asset being brought into the tax base merely because the ten-year period for land held on capital account has not elapsed. This exception to the suggested generic rules should apply if such land passes to an associated person and is held by that person for the balance of the ten years.
- A variation from the requirement to use market value should apply to unexpired accrual expenditure, which would instead be valued at cost. These assets are typically not held for resale, and valuing at cost may reduce compliance costs.
- Relief from provisional tax use-of-money interest rules should be available for the deceased's estate in respect of any liability arising from the taxpayer's death.

1.7 The deeming of transactions at market value does not by itself cause taxation consequences – those consequences will arise only if the asset is already inside the tax base. Thus if the asset is held on capital account there will generally be no taxation consequences. Depreciation adjustments are the major exception to this.

1.8 There are also a number of related GST issues that it would be opportune to address. These are being handled separately, later this year.

Submissions invited

1.9 Submissions on any aspect of this paper are welcome. They can be mailed to:

Taxation Implications of Asset Transfers
C/- The General Manager
Policy Advice Division
Inland Revenue Department
P O Box 2198
WELLINGTON

1.10 Alternatively, submissions may be made in electronic form to:

policy.webmaster@ird.govt.nz

Please put "Taxation Implications of Asset Transfers" in the subject line for electronic submissions.

1.11 Submissions should be made by 13 June 2003 and should contain a brief summary of the main points and recommendations. Submissions received by the due date will be acknowledged.

1.12 Please note that submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you consider that there is any part of your submission that could be properly withheld under the Act, please indicate this clearly in your submission.

Chapter 2

BACKGROUND AND CONTEXT

Why and when deemed transactions are necessary

2.1 The measurement of taxable income in relation to assets and liabilities that fall within the ambit of the income tax system focuses on a comparison between the net position of a taxpayer at the beginning and the end of an income period. Put simply, an increase in net assets may represent income that can be subject to tax under the Income Tax Act.

2.2 The period used to measure the change in net assets is not necessarily an income year. For assets whose market values are readily determinable, such as financial arrangements, changes in value can be recognised as they accrue and can be, therefore, measured on an income year basis. For other assets, changes in values are usually taxed only when a transaction takes place and a change of ownership occurs. One reason that the Income Tax Act takes this approach is that it is only at the time a transaction takes place that there is a clear identification of the market value of the asset.

2.3 Hence, to crystallise a taxable event, the Act requires in many cases the identification of when a transaction has taken place and values to be attributed to the taxable event. In the normal course of arm's length trading, these requirements can generally be applied without great difficulty, and the Act is sufficiently clear on the tax implications. However, in some key areas, there is a lack of clarity and consistency as to whether a taxable event has taken place and what values should be attributed to that event.

2.4 The general principle should be that a taxable event occurs whenever a transaction takes place with another party. When appropriate, this should include transactions with related parties because the taxpayer can equally make gains or losses on such transactions.[2] The significant exception to the recognition of related party transactions under the Act is matrimonial property settlements. This reflects both the fact that matrimonial assets are held in common and the desire not to discourage such transactions by way of tax impediments.

2.5 Transactions should sometimes be deemed to take place when there has been no actual transaction. Three instances are:

- when property enters or leaves the New Zealand tax base (for example, when the owner of offshore property becomes a resident of New Zealand, or revenue assets become private or domestic assets);

[2] This is reinforced by the Act's focus on individual taxpayers. Tax is generally determined on the basis of the position of each taxpayer, whether it be an individual, a company or a trust.

- when an asset changes its character in the hands of the taxpayer with no other party being involved (for example, if trading stock is used as fixed assets); and
- when there is a non-market disposition of an asset or liability by way of a gift, legacy or distribution from a company or trust (which, for example, may result in a capital account asset transferring to a person who holds the asset on revenue account and vice versa).

2.6 These events should be treated as disposals and acquisitions for tax purposes to buttress the capital/revenue boundary and to ensure that, when appropriate, taxpayers pay their share of any tax that is due.[3]

2.7 Deeming a transaction to take place is not, however, in itself sufficient. The relevant assets and liabilities must also be given a value. Logically, because the events are deemed to be market transactions, they should be generally recorded at market value.

2.8 If the assets were deemed to be transferred at other than their market value, such as at cost price, the distribution would still result in a transfer of part of the tax implications across the two parties to the transaction. Accrued capital gains, for example, might otherwise be taxable should the asset be gifted to a person who holds the asset on revenue account. Similarly, accrued taxation on an asset that is held on revenue account could be avoided by gifting it to someone who holds the asset on capital account.

2.9 Deeming a transaction to take place, such as when a taxpayer dies, alters the time at which tax is paid if the taxpayer's assets would have otherwise been held to maturity. This means accumulated gains on revenue assets that have not already been taxed are brought to account for tax purposes earlier than might have been anticipated. However, it has to be borne in mind that this situation results from the fact that the accumulated gains were being held untaxed and from recognising transactions as a taxable event. Had the property been taxed on an accrual basis, as some assets currently are, or on an imputed return basis as floated by the Tax Review 2001, the gains would have been taxed at an even earlier stage and the deemed transaction would have had a lesser tax impact, if any.

Generic policy rules required

2.10 The following discussion outlines some areas within the current legislation that are unclear or inconsistent in terms of deeming transactions to have taken place. In particular, in-kind, or *in specie*, distributions from companies and trusts are addressed, as are gifts and the vexed question of the tax consequences of death.

[3] These events are discussed in more detail in the February 1991 discussion document *Tax Accounting Issues* by the Consultative Committee on the Taxation of Income from Capital (the "Valabh Committee") (pages 43-47).

2.11 To overcome these shortcomings in the legislation, we are suggesting the application of generic policy rules based on recognising deemed dispositions and acquisitions at market value.

Chapter 3

"IN-KIND" DISTRIBUTIONS AND GIFTS

3.1 In-kind, or *in specie*, distributions are a common form of transaction and can be made at any time as a substitute for a cash dividend or payout. A prime example of such distributions is the transfer of physical assets to a beneficiary as part of the distribution of a deceased's estate. Another area where in-kind distributions often arise is when a company is liquidated.

3.2 Treating all such distributions as dispositions and acquisitions is justified because they are non-market transactions and may result in assets entering or leaving the tax base. As discussed previously, when non-market transactions occur and assets enter or leave the tax base without recognition of any taxable event, an incorrect tax outcome may arise.

3.3 A similar situation arises when an individual makes a non-monetary gift. Clearly, these types of distributions are essentially transactions and should be recognised as events for all parties to the transaction.

3.4 Conceptually, the result of the in-kind distribution should be the same as if the provider had disposed of the asset(s) to an arm's length party at market value and then made a cash distribution or gift. This will help to prevent inequities and to discourage avoidance that might arise from any differential tax treatment.

Suggested approach

3.5 The legislation currently lacks sufficient clarity and consistency in terms of treating in-kind distributions and gifts as dispositions. We suggest this situation be rectified by including a general rule in the legislation that would:

- treat an in-kind distribution made by a company or a trust, or a gift of revenue account or depreciable property as a disposition at market value at the date of distribution;
- deem the recipient of the distribution to have acquired the distributed assets at the same market value; and
- to the extent appropriate, still construe the proceeds to be a dividend when made by a company to a shareholder.

This would make the proceeds of the disposition gross income of the distributor to the extent the assets are already in the tax base. It would also trigger depreciation gain/loss on sale calculations.

Comment

3.6 It may be argued that the current law already contains rules that indicate how these types of transfers should be treated. The suggested treatment already applies to all distributions of depreciable assets[4], and to distributions of trading stock[5] from companies. Also, there are rules in respect of sale of trading stock for inadequate consideration. It may be that as part of the clarification, these rules could be brought together under a generic provision. But court cases in recent years have shown that uncertainty surrounds how asset transfers should be valued for tax purposes, particularly for non-companies, and whether a transfer is a disposal.[6]

3.7 For example, there is some question as to whether a distribution of standing timber by a trust is a "disposal". If it is a disposal, it is correct to record it as a sale at market value.

3.8 Further, there is some doubt as to whether the acquirer of revenue account property distributed *in specie* obtains an appropriate cost base for the property, and what that cost base is or should be.

3.9 Also, the *CIR v Auckland Harbour Board* case[7] demonstrated the uncertainty about what happens if financial arrangements are transferred for no consideration.

3.10 Thus there is a clear need for consistency of treatment between various types of distribution/disposal across all assets within the tax base. The suggestions described here are a step towards that consistency.

3.11 The suggested treatment is also consistent with the proposals in relation to distributions of financial arrangements by a company in liquidation, as set out in the 1997 government discussion document *The Taxation of Financial Arrangements* and subsequently enacted.

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[4] See section EG 19. The exception is section EG 17, which requires a recipient who is an associated party to value the depreciable assets at the lower of market value and the transferor's cost. This treatment would continue under the suggested treatment.
[5] See section GD 2 (now including standing timber).
[6] *Tasman Forestry Limited* v *CIR* (1999) (Court of Appeal, CA168/98), which dealt with the factual situation before section GD 2 was extended to cover standing timber. The suggested approach follows the tenor of that decision from the recipient's perspective.
[7] *CIR v Auckland Harbour Board* (2001) (Privy Council, Appeal No 30 of 2000)

Chapter 4

TRANSFER OF ASSETS ON A TAXPAYER'S DEATH

4.1 The tax treatment of transactions arising from a taxpayer's death is another example of where the current law would benefit from greater clarity and consistency.

4.2 A taxpayer's tax affairs need to be settled as at the date of death, which includes bringing to account all income to that date not already accounted for and valuing the taxpayer's assets. A key issue from a policy perspective is whether this process should include a deemed disposition of the deceased taxpayer's taxable property.

4.3 A taxpayer's death and the subsequent distribution of the deceased's property are occasions when deemed dispositions are justified because non-market transactions are involved and assets and liabilities may leave the tax base. For example, the deceased's estate might be charitable.

Legal process of transmission of property from deceased to beneficiaries

4.4 On the death of a taxpayer, the estate can be dealt with in several ways, depending on whether a will exists and, when a will does exist, the taxpayer's intentions as set out in the will (for example, whether there are to be a trust, legacies, and so on). Normally, it takes one to two years to wind up an estate and distribute the assets to the beneficiaries. There are several discrete points in this process at which a property disposition could be deemed to have occurred – on death, on transfer from executor to trustee, or on distribution to legatees and beneficiaries.

4.5 A will usually provides for the appointment of one or more executors. In the absence of a will, a court will appoint someone to administer the deceased's estate. Legal and beneficial ownership of the deceased's property vests in the executors or administrators from the time of death through to the end of the period of executorship or administration. The beneficiaries have a right to have the deceased's estate administered properly during this period but do not, with the exception of specific legacies, have more than an inchoate right in the assets.

4.6 The duties of the executor or administrator are to collect the assets of the deceased, pay all debts, testamentary expenses and taxes and to distribute the legacies. At the end of the period of executorship or administration, the executor or administrator becomes a trustee of the residual assets on behalf of the beneficiaries.

4.7 Property that has been bequeathed or devised under a will may be gifted as a specific legacy, general legacy or residuary gift. Under the "doctrine of relation back", specific legacies take effect from the date of death, whereas

general and residuary legacies vest in the beneficiary(ies) at the time of distribution.

Current legislative position

4.8 Although there is little doubt under the general law as to the outcomes of transfers, transmissions and vestings on and subsequent to death, the tax consequences of these events are far less clear.

4.9 Tax law is not consistent in outlining the tax treatment of assets disposed of on the death of a taxpayer. For some types of assets there are express provisions covering death of the taxpayer, but for other types of revenue account assets the provisions refer only to "sale or other disposition".

4.10 Nor is legal opinion particularly helpful in these circumstances because opinions differ as to whether a disposition occurs at death and, if a disposition does occur then, what the consequences are.

Earlier reviews

4.11 In 1992 the Valabh Committee recommended that the Income Tax Act be changed to clarify the tax treatment of assets when a taxpayer dies. Although the committee specifically looked at financial arrangements, it also proposed standardising the rules for all property by deeming deceased persons to have disposed of all their assets at the date of death for market value.

4.12 The committee's recommended changes in respect of financial arrangements were incorporated in the discussion document *The Taxation of Financial Arrangements*. Submissions on that discussion document reinforced the need for a comprehensive review of the tax rules governing death, and that the tax treatment of financial arrangements should be consistent with the results of the review.

Suggested approach

4.13 Although there may be several transfers as a result of winding up a deceased taxpayer's estate, from a practical perspective the two key points at which deemed transactions should be recognised are (1) on death and (2) on transfer to the beneficiaries. Moreover, as highlighted earlier, these are clear points where, from a policy perspective, disposals should be recognised because assets may leave the tax base and non-market transactions take place.

4.14 The transfer at death may result in the property moving from revenue to capital account or from a taxable holder to an exempt holder. Similarly, as discussed in the preceding chapter, the transfer of the deceased's property from the trustee to the beneficiaries is an example of a non-market, in-kind transaction that can have similar results. Consistent with the principles

previously outlined, both of these transactions should be recorded at market value.

4.15 These two points[8] were chosen for the 1999 update of the accrual rules, and we suggest that they also be used for all other forms of "revenue" property so that:

- A disposition and acquisition would be deemed to occur on the day of death at market value.
- The subsequent transfer of the assets from the executor/trustee to the beneficiaries would be treated as a separate disposition and acquisition at market value.

Coverage

4.16 We suggest that the clarification be comprehensive, covering all natural taxpayers, including their interests in partnerships, with respect to:

- trading stock, including livestock;
- depreciable property (plant and machinery, buildings, and so forth)[9];
- financial arrangements;
- foreign investment fund interests; and
- revenue account property, including land, forests and other personal property.

Exception

4.17 An exception to the suggested approach is justified when, by altering the timing of the tax recognition, it would also change the tax outcome from being non-taxable to taxable.

4.18 The particular example of when an exception is required is found in the ten-year rules in section CD 1(b), (c), (d) and (e).[10] These rules provide that the proceeds from the disposition of land by a person who is in the business of either dealing in land, developing or subdividing land, or building are income if the land is disposed of within ten years of acquisition. The proceeds are also considered income if at least 20 percent of the disposition profits result from a re-categorisation or change in the conditions applying to the land in relation to the Resource Management Act 1991. Property covered

[8] Other options are discussed later in this chapter.
[9] Section EG 17 would still apply, where applicable, however, so that a recipient who is an associated party would value the assets at the lower of market value and the transferor's cost.
[10] This exemption would not extend to section CD 1(f), which covers schemes involving the development of land because the ten-year rule in that paragraph relates only to commencement of the scheme, not the disposition of the land. So deeming the land to be disposed of on the taxpayer's death does not have any implications in terms of section CD 1(f).

by these provisions is referred to as "tainted". To ensure that death does not lead to substantially different tax consequences than had the taxpayer survived the ten-year period, limited rollover relief is proposed.

4.19 Specifically, the exception would apply to tainted property *if* the property passes to an associated person or is retained by the estate, so long as the beneficiaries are associated persons. In such cases the taxpayer's death would be ignored, with the balance of the ten years (after adjusting for the time the asset is held by the executor) applying to the beneficiary (ies) or the estate. For example, if a taxpayer dies seven years after acquiring the property and the estate takes one year to wind up, a beneficiary would need to hold the property for a further two years to prevent the proceeds being taxable. As part of the rollover, the assets would transfer to the estate and, if necessary, the beneficiary at the cost recorded in the accounts of the deceased (for this purpose only).

4.20 The reason for limiting the exception to transfers to associated persons is to cover genuine cases where property is passed on to relatives as part of a normal inheritance.

Variant

4.21 "Unexpired" or "unapplied" expenditure under section EF 1(1) should also be covered by the suggested clarification of the tax consequences of death. Examples of such expenditure are fertiliser on hand and prepaid rentals and rates. As discussed earlier, this expenditure should only be deducted as the goods and services are "used". If a person dies before the expenditure is fully "used" and the estate continues to run down the unexpired portion of the expenditure, that unexpired portion should, for tax purposes, be able to be passed on to the deceased's estate.

4.22 Under the suggested approach, the unexpired portion of the accrual expenditure would be deemed to be disposed of and acquired both at the point of death and at the point of transfer to the beneficiary. The only difference from the rules suggested earlier for other assets is that these dispositions and acquisitions would be deemed to take place at the relevant values that section EF 1 would have used if applied at year end, except that the determination relief of section EF 1(3)[11] would not apply.

4.23 This variant is justified on the basis that the accrual expenditure is not held for resale. It should also reduce the costs of complying with the suggested new rules as market values will not need to be ascertained for the unexpired portion of the accrual expenditure.

[11] Section EF 1(3) enables the Commissioner of Inland Revenue to exempt a taxpayer from the requirements of section EF 1 after having regard to certain factors, such as the costs to the taxpayer in complying with section EF 1.

Partnerships and joint property

4.24 Death of a business partner may trigger a disposal for tax purposes. Again, the legislation is generally unclear on this point. It is proposed to confirm that for tax purposes, death triggers a disposition of the deceased's interests in the partnership. Wider partnership policy issues are being dealt with by a separate project. In the meantime, Inland Revenue has confirmed that from an operational perspective, surviving partners will not be affected in respect of their continuing interests in partnership assets.

Compliance cost implications

4.25 For assets other than "accrual expenditure", a requirement to carry out a base price adjustment or market valuation at the date of death should not lead to added compliance costs: the estate is in an ascertainable form, and a tax return must already be filed at this date. Market values should be able to be readily estimated for many types of property, particularly where there are established secondary markets. Even in other cases valuers should be able to provide valuations. In any case, estate law often requires market values to be ascertained at the date of death.

Other options considered

4.26 A disposition could be deemed to take place every time there is a change of beneficial ownership during the winding up and distribution of the estate. This could include the point at which the assets are transferred from executor or administrator to a trustee at the end of an executorship or administration period and, in some cases, on each distribution to a beneficiary. As previously noted, the vesting of different legacies can occur at different times for different beneficiaries. However, it is not proposed that these legal distinctions be reflected in the tax rules.[12] A uniform approach to all forms of distribution is therefore suggested, particularly for compliance reasons.

4.27 Whether to have only one deemed disposition point was also considered. The conclusion was that two deemed disposition points are necessary because:

- At both points there is potential for assets to leave the tax base.
- It may take several years to wind up an estate, and hence asset value can vary substantially between death and distribution.[13]

[12] The Valabh Committee was also of the view that such a requirement would be excessive and would create unnecessary complexity in income tax law.

[13] The Valabh Committee also considered having only one point of disposition – at the time of distribution. But it also proposed a two-year rule whereby a disposition would be deemed to take place two years after death if no distribution had been made by then. In such cases a disposition would also be deemed to take place when the subsequent distribution also took place. The Valabh Committee subsequently replaced this set of proposals with the two points of recognition – at death and at distribution.

- Having a deemed disposition only at the date of death would add complexity and compliance costs in relation to financial arrangements that fall under the accrual rules because it would require additional rules for the calculation of the adjusted acquisition cost for the beneficiary. The accrual rules have incorporated two deemed disposition points since 1999 without any apparent problems.
- Assets may vest in a beneficiary before actual transfer from the trustee. Some thought was therefore given to whether the point at which the property vests absolutely in interest in the beneficiary would be a better point of recognition than the point of transfer. This concept is already used in the Act in the definition of "beneficiary income". It would overcome situations where the timing of the transfer is deferred to reduce the tax liability by waiting until asset values have declined. The problem with this approach, however, is the difficulty in verifying when property vests absolutely in interest in the beneficiary.

Alternative treatment for consultation

Should there be only one valuation point (the day of death) when the net assets of the estate are immediately distributable, and the following circumstances apply?

- the deceased's estate is left to close relations only; and
- there is no life tenant;
- the income of the estate while it is under administration is distributed as beneficiary income; and
- the net assets are transferred to the beneficiaries as soon as is reasonably practicable.

No rollover relief for property held to maturity

4.28 Several submissions on the proposed changes in relation to financial arrangements noted the different implications of holding the arrangements to maturity rather than realising the gains that become taxable on death. If a financial arrangement is held to maturity, there may be no net gain or loss. However, requiring it to be marked-to-market when the taxpayer dies before the arrangement matures may impose additional tax on a temporary gain.

4.29 Similarly, the rule would also mean that tax on the profits from forestry interests is brought forward when a forest owner dies before the forest is harvested.

4.30 Also, some taxpayers may be concerned about the cash implications of a requirement to pay tax when there has been no actual sale of the assets to generate cash to pay the tax liability.

4.31 It has been suggested that these are reasons for rollover relief, similar to that applied in Australia when a taxpayer dies with accrued capital gains. Rollover relief would enable the assets to be transferred to the estate and beneficiary at the values recorded in the books of the deceased before death so that any tax liability would not be recognised until the beneficiary subsequently sold the assets.

4.32 These are not sufficient reasons for providing rollover relief, however. In our view, rollover relief would undermine the purpose of this policy clarification primarily because of the potential for differences in the tax circumstances of the deceased and the estate/beneficiaries, which might be wholly or partially charitable. In these circumstances it seems that the forest proceeds might never constitute taxable income, even though the deceased may have deducted the costs associated with the forest in previous years. The same situation could also apply to depreciable property were rollover relief provided rather than requiring over-claimed depreciation to be squared up on the death of the taxpayer.

4.33 In overseas jurisdictions rollover relief is often associated with comprehensive capital gains taxes, which do not exist in the New Zealand tax system. The relevant assets affected by the suggested policy change are, with the exception of depreciable assets, held on revenue account, not capital account.

4.34 This distinction is important in the case of forestry. Most forestry investment occurs through the purchase of shares in a company (often a loss attributing qualifying company) and in almost all cases those shares would be held on capital account and would, therefore, be outside the tax base. In these circumstances, the suggested change would not be applicable and the taxpayer’s death would produce no tax consequences in relation to their forestry investment. The suggested change is therefore only of relevance in the forestry context to those individuals who own forests directly or who for some other reason hold the asset on revenue account.

4.35 Also, in terms of concerns about having insufficient cash to pay any tax liability, taxpayers are likely to have a number of options as to how to meet this liability, given that they still have the underlying asset.

4.36 This issue is different from the ten-year rule in relation to land. That rule envisages the gains from the sale of the land as being non-taxable after ten years and, therefore, the assets are only potentially within the tax base. In contrast, financial arrangements, forestry assets and depreciable assets are already clearly within the tax base, and it is important to ensure that the appropriate tax is paid.

4.37 Further, although the suggested approach may result in taxation at an earlier stage than had the assets been held to maturity, the taxpayer has still received a tax advantage relative to taxing on an accrual basis or on an imputed return basis.

Specific issue for consultation

Should there be rollover relief when the only beneficiary is a spouse or de facto (same sex or opposite sex) partner in terms of the Relationship Property Act 1976, on the basis that the tax circumstances of the deceased and the beneficiary are likely to be similar?

Use-of-money interest

4.38 Use-of-money interest applies to underpaid and overpaid provisional tax. The extent to which interest applies depends on whether a taxpayer is in the tax's "safe harbour". To be in the safe harbour taxpayers must have a residual income tax of less than $35,000 and not have estimated their provisional tax liability.

4.39 Underpayments or overpayments of provisional tax could arise as a result of a deemed disposition of assets on the death of a taxpayer. This is because the provisional tax rules assume income to be earned evenly through the year, whereas under the suggestions described here, a taxpayer's death would bring to account, on a one-off basis, any accrued gains or losses at the date of death.

4.40 The further into the income year that death occurs, the greater the potential exposure to use-of-money interest. This is particularly an issue when the disposition gives rise to significant income.

4.41 Because death is an event for which the timing is not usually controlled, the circumstance differs from a normal asset disposition, when a taxpayer has at least some discretion over the timing of the disposal. Some modification of the use-of-money interest and provisional tax rules seems desirable to recognise this difference.[14] The suggested approach is as follows:

- The income arising from the deemed disposition of assets on death would be taken out of the definition of "residual income tax".
- The income tax liability arising from the deemed disposition would still be due for payment on the terminal tax date for the income year in which the taxpayer died.
- Use-of-money interest would be charged from six months after the date of the taxpayer's death to the taxpayer's terminal tax due date on deemed disposition amounts.

[14] We are not suggesting that this approach be applied more widely. There may also be other events that generate unexpected income or losses such as changes in exchange rates, but taxpayers can hedge to reduce exposures to such events, and have chosen to enter into these arrangements in the knowledge of potential outcomes.

- Late payment penalties and use-of-money interest would apply to any outstanding income tax liability from the terminal tax due date for the income year in which the taxpayer died.

4.42 The suggested approach provides six months relief from use-of-money interest so as to enable the executor or administrator reasonable time to get the estate in order, including gathering the assets and establishing their value.

4.43 This approach would not affect the provisional tax and use-of-money interest on income other than that generated by the deemed disposition of assets on the death of the taxpayer. Therefore underpayments and overpayments of provisional tax in relation to "ordinary" income would still be subject to use-of-money interest as appropriate. This means that the executor or administrator would need to identify separately the magnitude and timing of the tax consequences of the deemed disposition from normal income and, therefore, provisional tax flows.