Estate affairs

Welcome to Estate Affairs – May 2013 edition

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Death, super and the estate: misconceptions can be costly

By Damian Hearn, National Manager – Technical Services

Over the past few years advisers have been using estate and super planning strategies to minimise the taxation on lump sum death benefits paid to non-death benefit dependants. However, several well-known strategies can result in tax for lump sum death benefits, especially when involving a client's estate or life insurance.

Misconception 1: No tax is payable if lump sum death benefits are paid into a client's estate
The payment of a lump sum death benefit to a non-death benefit dependant for taxation purposes (such as a financially independent adult child) from the trustee of the superannuation fund will result in lump sum death benefit taxes applying (as shown in table 1).

There is a misconception that the payment of the deceased client's superannuation account into the estate will avoid the lump sum death benefits tax – however the taxation outcome is the same.

Table 1 - Taxation of death benefits – lump sum death benefits

	Death benefit dependant	**Non-death benefit dependant**
Tax-free component	Non-assessable non-exempt income (100% tax-free)	Non-assessable non-exempt income (100% tax-free)
Taxable component - taxed element	Non-assessable non-exempt income (100% tax-free)	15% ^
Taxable component - untaxed element	Non-assessable non-exempt income (100% tax-free)	30% ^

^ Plus Medicare levy

When a lump sum death benefit is paid into an estate, the taxation treatment of the lump sum death benefit will depend upon who will receive the payment as dictated by the Will. Since a non-death benefit dependant (for taxation purposes) receives the payment, the taxable component remains taxed at 15 per cent.

Misconception 2: Tax on lump sum benefits that include life insurance will not exceed 15 per cent
Another misconception is the inclusion of life insurance within the lump sum death benefit will not increase the tax rate above 15 per cent. However, this is not the case. The inclusion of life insurance means a taxable component – untaxed element (the 'untaxed element') is created and the amount of tax paid significantly increases.

One of the major benefits of clients purchasing insurance within superannuation is the fund's ability to claim a deduction for the premiums. The tax deduction can be used to reduce the taxable income of the fund and the tax rate applied to earnings (including capital gains) and contributions.

However claiming the life insurance premium as a deduction within the current and/or previous financial years will create an untaxed element when the trustee pays out a lump sum death benefit to a non-death benefit dependant. This is demonstrated within the following case study when Joshua receives a lump sum death benefit from his father's estate.

Case study

George (age 52*) died on 7 October 2012 with a superannuation account balance of $482,000 (100 per cent taxable component) including $200,000 of life insurance. His account had a binding death benefit nomination to his estate and the trustee of the fund made the payment to the estate in January 2013.

As per George's Will, his son Joshua who is a non-death benefit dependant (for taxation purposes) will receive his superannuation. The tax payable will be $92,527 (or 19.2 per cent of the gross lump sum death benefit) as shown in table 2.

* Date of birth 26/3/1960, last retirement date 26 March 2025 and eligible service date was 1 September 1980.

Table 2 - Taxation of the lump sum death benefit

	Gross payment	**Tax rate**	**Tax withheld**	**Net payment**
Taxable component - taxed element	$347,154	15% ^	$52,073	$295,081
Taxable component - untaxed element	$134,846	30% ^	$40,454	$94,392
Total	**$482,000**		**$92,527**	**$389,473**

^ Excludes Medicare levy

The calculation of the untaxed element is shown in table 3.

Table 3 - Calculation of the untaxed element

A. Amount of the lump sum death benefit (including any anti-detriment payment) will be	$482,000
B. The reduced death benefit using the formula below will be: $= \text{death benefit} \times \dfrac{\text{days in service period}}{\text{days in service period + days from death to retirement age}}$	$347,154
C. Reduce the amount in step B by the tax exempt component. This will form the taxed element in the fund.	$347,154
D. Subtract the element taxed of the reduced death benefit from step C and the tax-exempt component from the taxable component in step A to determine the untaxed element.	**$134,846**

Important: The above example and calculation does not apply to a death benefit dependant (such as a spouse or a minor child of the deceased member). When a death benefit is paid as a lump sum to a death benefit dependant, the funds will remain tax-free irrespective of the presence of life insurance and the untaxed element.

What happens if the executor does not withhold the correct amount of tax?

The executor of the estate must withhold the appropriate amount of tax when paying a lump sum death benefit to a non-death benefit dependant. Otherwise, the executor could be personally liable for the tax.

How can the untaxed element be avoided?

Having life insurance outside of super is an obvious choice for clients who have non-death benefit dependants (such as financially independent adult children). However, the downside to this is that the annual premium will not be funded from the client's super fund and the client will need to meet premium costs out of their own pocket. The cost of the annual premium appears to be an insignificant amount in order to avoid death benefits tax payable as highlighted in the case study.

Is it tax efficient to pay a lump sum death benefit into a testamentary trust?
When the superannuation lump sum death benefit passes into a testamentary trust, in accordance with s302.10 of the Income Tax Assessment Act 1997, the Australian Tax Office will seek to determine whether the beneficiaries of the trust are death benefit dependants or non-death benefit dependants for tax purposes.

Referring back to the case study, the lump sum death benefits tax will still apply if the lump sum death benefit is paid into a testamentary trust via George's estate. This is due to the terms of the testamentary trust deed within George's Will which allows beneficiaries to include non-death benefit dependants for taxation purposes. Also, George doesn't have any death benefit dependants, including Josh, his wife and daughter who are beneficiaries of the trust.

This issue can also impact the popular strategy whereby the beneficiaries of the trust are death benefit dependants for tax purposes (such as the remaining spouse or minor children) and the funding source of the lump sum death benefit is insurance.

How can this be avoided?
In practical terms, this issue is more far reaching because the terms of most testamentary trust deeds are constructed to be flexible in nature and allow a wide class of potential beneficiaries, including non-death benefit dependants for taxation purposes. This means even if the intended beneficiaries (such as the spouse and minor children) are death benefit dependants, the lump sum death benefit tax will still apply because of the range of potential beneficiaries within the testamentary trust (such as brothers or sisters of the deceased client) as per the Will.

The opportunity exists for an estate planning specialist to draft the terms of the testamentary trust deed within the Will and avoid the lump sum death benefit tax. The deed could exclude beneficiaries that are non-death benefit dependants for taxation purposes. This type of arrangement is commonly called a superannuation proceeds trust since the beneficiaries are specifically limited to both superannuation dependants and death benefit dependants for taxation purposes.

Summary
Advisers need to be aware of the misconceptions involving the tax payable on payments of lump sum benefits to non-death benefit dependants and the impact on a client's estate planning strategy. Consequently, engaging an estate planning specialist when using testamentary trusts is essential to ensure the strategy does not result in an adverse taxation outcome for the estate (and the intended beneficiaries). Advisers may need to review the estate planning strategies that are in place for any existing clients who may be impacted and modify strategies they recommend to their clients in the future.

Estate planning and insurance ownership – the price of getting it wrong?

By Neil Page, Legal Counsel – Estate Planning Manager SA & WA for AET Ltd.

Insurance and estate planning are complementary and, therefore, should be considered together, not only for the purposes of taxation but also for how the money will flow, as this will generally be an estate planning consideration.

The tax implications set out in Damian's article means the estate planning considerations of insurance ownership must be considered as part of the client's overall financial strategy. And, it's essential that the issue of insurance ownership be carefully considered before implemented.

What are the consequences of not considering these issues?
1. Is the ownership structure of insurance complementary to the client's overall estate planning objective? If not, an estate planning lawyer may request the insurance ownership be changed, and, for various medical or other reasons, this may not be possible.

2. Will your client's ownership of insurance result in tax-being paid that might otherwise be avoided? If so, your advice could become the subject of a complaint to the Financial Ombudsman or result in Court action from a beneficiary whose inheritance has been reduced as a result of the tax paid. As beneficiaries and their legal advisers become more aware of these tax issues the greater the risk of your advice being questioned.

Whilst it is difficult to predict how a Court will consider such issues from a negligence perspective, as a financial adviser, when providing insurance advice, you have a duty to provide information about the various taxation aspects or, at the very least, make sure that the client receives specific advice about the taxation consequences. A referral to an estate planning specialist will not only help to resolve those liability issues but, more importantly, will also provide the clear basis for an overall ownership strategy for your client.

What are the benefits?
The benefits of considering insurance ownership together with estate planning are driven by taxation outcomes (as outlined in Damian's article) and certainty; the peace of mind that clients will have knowing that their insurance will be distributed according to their wishes when they pass away.

Estate planning gives clients the opportunity to ensure that the intended recipients of any insurance proceeds actually receive the funds and without unexpected tax deductions. By having an estate plan in place, therefore, clients have certainty around who will receive the funds, instead of the possibility of it ending up in the hands of an unintended beneficiary.

As you can see from the scenarios below, ownership of the insurance plays a significant role in the provision of certainty to clients.

Ownership of insurance within superannuation
Upon the death of a client, the person who ends up with the insurance proceeds from a superannuation fund may depend on whether there is a binding nomination in place or, more to the point, if the nomination is valid. If there is no binding nomination in place, then the recipient will be at the discretion of the Trustee. For example, if you have clients who are currently in a relationship, but have children from a first marriage, a valid binding death benefit nomination is the only way to ensure the intended recipients receive anything, otherwise payment will be at the discretion of the Trustee, which may not be in line with the client's wishes.

There are of course adverse taxation consequences if insurance within super is paid to non-tax dependants.

Self-ownership of insurance
Absolute certainty that funds will flow into the estate and be dealt with in accordance with the terms of the Will can be achieved in this method of ownership. This will fund a testamentary trust which may well provide potential tax benefits. Funds being paid into an estate will however be subject to any family provision claims and self-ownership would not necessarily be suitable if there is a potential for a claim to be initiated.

Cross-ownership of insurance or holding an insurance policy with a nominated beneficiary
This form of insurance ownership will not be relevant within a superannuation fund but may well be the appropriate choice of ownership or nomination depending on the estate planning requirements. These policies will provide absolute certainty as to where funds are going without any issues in relation to family provisions claims but will not provide any taxation benefits that may come from funds being held within a testamentary trust. Certainty of funds can often over-ride possible taxation benefits.

Conclusion
As you can see, the ownership of insurance is an important issue. It's not, however, the sole province of a financial adviser. Instead, it must be part of the client's overall estate planning strategy; our estate planning specialists can help determine an insurance ownership strategy that best suits the needs of your clients.

Changes to our trustee licences

At AET, we have been providing executor and trustee services to Australians for over 130 years.

Over these years, a number of mergers and amalgamations have expanded the number of trustee entities available to provide the range of services we offer. As a result of these mergers and acquisitions, we had six licensed trustee companies including AET.

Effective 31 January 2013, ASIC approved the consolidation of the trustee entities so that Australian Executor Trustees Ltd is the only company now providing executor and trustee services. Click here for more information.

If you have any questions, or need more information, please call us on 1800 882 218 or visit www.aetlimited.com.au