SUPERANNUATION:
ITS ROLE IN ESTATE PLANNING

THE 55TH ANNUAL ARMIDALE
CLE WEEKEND

Kevin Munro
Munro Lawyers
9 February 2014

---

1. Estate Planning Concept

The concept of estate planning is not confined solely to the drafting of a will and an enduring power of attorney.

A properly constructed estate plan is one which includes the transfer of ownership and control of the family group asset holdings without adverse tax consequences. At the very least, an estate plan that fails to consider tax and superannuation issues will have lost the opportunity to gain the tax benefits that are potentially available. At the most, unnecessary tax costs may be incurred.

The estate planning considerations that need to be considered include:

(i) Asset protection planning.

(ii) Family law issues (and of particular concern the potential exposure of claims that may be made by spouses of the children of the family).

(iii) Ownership and control of assets.

(iv) Revenue issues such as stamp duty, capital gains and income tax.

(v) Claims made by family members in contradiction to the plan.

(vi) Providing for members of the family that may be unable to look after their own affairs.

(vii) Superannuation.

The estate planning advice should consider the transfer of ownership and/or control of assets held by the family group and what structuring can be undertaken to provide the most efficient result for the family group on the death of a family member. As such, the issues above need to be considered at different levels of generations in the family group. The movement of assets from one generation to the next is obviously a time when substantial restructuring in the family asset holding occurs.

2. Overall Strategies for Estate Planning

The general approach that can be taken in estate planning can be summarised as follows (the following is not intended to be an exhaustive check list):

1. Preparation of a group structure diagram setting out the current structure and future structures as a consequence of the death of various family members. A "picture is worth a thousand words" is very true for clients to understand as to what exists and how the ownership and control of the family assets will look with the death of different family members.

2. Consideration should be given as to whether

    (i) entities need to be established either in the will (for example, testamentary trusts) or otherwise;

    (ii) to create the transfer of assets to selected entities at the time of death of one of the spouses or on death of the surviving spouse. The precedent of leaving "all my assets to my spouse" can result in a doubling of assets (and the resulting taxable income) of that surviving spouse let alone increase asset protection issues;

    (iii) to create one structure for all family members or individual structures for each member of the family. Here, family law issues for the beneficiaries of an estate are of considerable importance.

3. Review the ownership of assets including whether

   (i) assets are held in individuals' names or in entities;

   (ii) individual family members hold assets as joint tenants or tenancy in common;

   (iii) assets will in fact move in ownership as a result of the proposed plan. In particular, what will be dealt with through the deceased estate and what will not be dealt through the deceased estate;

   (iv) loan balances within the group will be appropriate or cause issues in the estate plan.

4. Consider whether to

   (i) convert joint tenancy ownership to tenant-in-common (or *vice versa*);

   (ii) alter recipients of life insurance policies on more the ownership of life policies;

   (iii) examine the control of existing companies and trusts. In particular, the rights attaching to shares, the entitlement for appointment of directors and the position of appointors of trusts.

5. Make decisions on how the current superannuation arrangements may best move to the next generation (including arrangements in regard to binding death benefit nominations). Superannuation issues in the estate plan, of course, will be the main focus of this paper.

6. Implement a mechanism through a deed of family agreement or a so-called family constitution to govern the decision making process and parameters for the family group in the future. I am of the view that this matter is highly important and unfortunately is either ignored by estate planners or regarded by the client as either too difficult or simply not necessary. In my limited experience, where families have adopted a family agreement as part of the estate plan considerable benefits have been achieved.

3. Significance of Superannuation in the Estate Plan

The importance of superannuation for wealth accumulation has increased dramatically in the past 20 years (it is in fact 20 years since the introduction of the wide sweeping reforms in the form of the Superannuation Industry (Supervision) Act was passed). Superannuation savings is now an important component to be considered by solicitors, accountants and financial planners advising on estate planning issues.

There are essentially two choices when it comes to superannuation (assuming you have decided or are required to use superannuation). Namely, you either run your own fund (a self-managed superannuation fund or SMSF) or you join a managed (including industry) fund.

(a) Current Statistics

The following is a summary of statistics relating to superannuation and is taken from material published annually by the Australian Tax Office (ATO).

- *The SMSF sector is the largest sector of the Australian superannuation industry, with 31% of the $1.6 trillion total assets held in superannuation funds as at 30 June 2013. In the five years to 30 June 2013, the SMSF sector was the strongest growing sector of the superannuation industry and grew by $175 billion or 53%.*

- *At 30 June 2013, there were 509,000 SMSFs holding $506 billion in assets. There were also approximately 964,000 members in the SMSF sector, almost 8% of roughly 11.6 million members in Australian superannuation funds.*

- *SMSF members tend to be older than members of APRA funds (namely, superannuation funds other than SMSFs) and had both higher average balances and higher average taxable incomes.*

- *The majority of SMSFs are solely in the accumulation phase (65%) with the* *remaining 35% reporting they were making pension payments to some or all members.*

- *At 30 June 2012, the two most significant SMSF asset holdings were in Australian listed shares (28.6%) and cash and term deposits (32.5%). Real property investments amounted to 24.2% (inclusive of investments in unlisted trusts).*

- *Over the five years to 2011–12, there was an increase to 14% in the proportion of SMSFs holding all of their investments in one asset class.*

- *At 30 June 2012, SMSFs held $6.3 billion in borrowings. The level of borrowings was equivalent to 1.4% of total SMSF assets. The proportion of SMSFs with borrowings increased progressively to 3.7% in 2012.*

Namely, there is approximately one-third of all superannuation savings held by SMSFs with the average savings per member of about $525,000.

It is obvious from the above statistics the overall importance of the asset class represented by superannuation savings. For this reason, clients are mindful as to how these savings are transferred to their beneficiaries as part of their estate planning. The real question is whether we as advisers (not just adviser but also the "legal architect" and "legal engineer" in respect of the estate plan) have adapted to this change in the community. It is not uncommon to see a retired couple with two asset classes. Namely assets in a self-managed superannuation fund and a principal residence.

(b) Advantages of a Self-Managed Superannuation Fund

During the accumulation phase, a self- managed superannuation fund as an investment vehicle provides the following advantages:

(i) an entity for investment with a low rate of tax – 15% tax rate for income derived and 10% tax rate for capital gains (provided you retain the asset for more than 12 months);

(ii) the opportunity to obtain a tax deduction – by way of contributions made to the fund (albeit limited in scope);

(iii) an asset protection vehicle (protection from creditors in the case of bankruptcy of the member);

(iv) the opportunity to transfer funds into the entity on a tax free basis (subject to certain limits);

(v) control of investment strategies and asset dispersal on the death of a member.

In addition to the above matters, it is now possible for a self-managed superannuation fund to borrow when acquiring an asset (section 67A of the *Superannuation Industry (Supervision) Act*, 1993, referred to in this paper as the **SIS Act**). Note that from the statistics discussed above the level of borrowing in 2012 by self-managed superannuation funds was relatively low (1.4% of assets held). However since that time the interest in self-managed superannuation funds gearing investment into real estate assets has increased even to the extent that the news media have blamed gearing real estate investments by self-managed superannuation funds for the property price rises in inner Sydney. There are also now certain opportunities to obtain stamp duty relief on the transfer of real estate by an individual (or individuals) to a superannuation fund. For example, in NSW there is nominal duty provisions for individuals to transfer property into a self-managed superannuation in which they are members (section 62A of the *Duties Act*, 1997 (NSW)).

Once a self-managed superannuation fund is in a pension phase then the rate of tax applicable (whether income or capital gains) reduces to a nil rate. Further, a pension paid to a member of the superannuation fund who is 60 years or over is tax free to that member. The ultimate tax free structure. As they say, if it is "too good to be true" then it is. The reason I say that is taxes can and do arise on the benefits held in a superannuation fund on the death of a member. This is discussed further in this paper.

4. What Superannuation Rules does the Estate Planner Need to Know

(a) Payment of Death Benefits from Superannuation

In order to properly take into account superannuation benefits in an estate plan it is necessary to understand the form that, and to whom, superannuation may be payable. In addition an understanding as to the tax treatment is necessary. Note that there are restrictions that apply both under the SIS Act and the tax provisions.

(b) Form of Payment of Death Benefits

Under both the tax provisions and the SIS Act provisions, on the death of a member of a superannuation fund that member's benefits as at the date of the death (so called '**death benefits**') may be paid out in the form of:

(a) a lump sum
(b) a pension, or
(c) a combination of a lump sum and pension.

(c) Restrictions on where Death Benefit Payments can be made

(i) *SIS Act Requirements*

The SIS Act restricts a trustee for a superannuation fund as to whom death benefits may be paid. This is obviously important to the estate planner as the application of superannuation benefits specified in a plan may be prohibited by the statutory provisions.

Regulation 6.22(2) provides that in the case of death benefits cashed as a lump sum then such benefits must be in favour of either or both of the following:

(a) the member's legal personal representative;
(b) one or more of the member's dependants.

Regulation 6.21(2A) provides that in the case of death benefits cashed in the form of a pension then such benefits must be in favour of a recipient that at the time of death of the member:

(a) is a dependant of the member; and
(b) in the case of a child of the member:
  (i) is less than 18 years of age; or
  (ii) being 18 or more years of age:
    (A) is financially dependent on the member and less than 25 years of age; or
    (B) has a disability of the kind described in subsection 8(1) of the *Disability Services Act 1986* .

Note that a ***"dependant"*** is defined for the purposes of the SIS Act (see section 10) to include the spouse of the person, any child of the person and any person with whom the person has an interdependency relationship. Interdependency relationship is defined (see section 10A) as two persons (whether or not related by family) if:

(a) they have a close personal relationship; and
(b) they live together; and
(c) one or each of them provides the other with financial support; and
(d) one or each of them provides the other with domestic support and personal care.

Provided that if paragraph (a) of the requirements for an interdependency relationship is satisfied and the other requirements are not satisfied because either or both of the persons suffer from a physical, intellectual or psychiatric disability then an interdependency relationship is deemed to apply.

(ii) *Tax Act Requirements*

Under the Income Tax Assessment Act, 1997 (referred to in this paper as the **ITAA 1997**)), the ability of a trustee for a superannuation fund to pay a pension out of death benefits is more restrictive than what is allowed under the SIS Act. Namely, a pension payable out of a deceased member's death benefits must only be paid to a '**death benefit dependant'**. A death benefit dependant is defined for the purposes of the ITAA 1997 (see section 302-195) to mean

(a) a spouse (including *de facto* spouse),
(b) a child under the age of 18 years,
(c) any person with whom the deceased was in an 'interpendency relationship' (as defined above, see section 302-200); and
(c) any other person who was a dependant of the deceased member.

A "**spouse**" is defined to include another person (including of the same sex) with whom the first is in a relationship that is registered under a law of a State or Territory or who, although not legally married to the first person, lives with that person on a genuine domestic basis in a relationship as a couple (see section 995-1). This definition essentially mirrors the definition of a spouse in section 10 of the SIS Act.

The definition of a "**child**" includes someone who is a child of the person within the meaning of the *Family Law Act 1975*. A stepchild ceases to be a dependant of a step-parent upon the death of or divorce from the natural parent (unless the step-child remains financially dependent): see ATO Interpretative Decision ID 2011/77.

The ordinary meaning of the term dependant includes someone who is financially dependent on the person. In *Re Malek* (1999) 42 ATR 1203, the Administrative Appeals Tribunal held that the payment to the estate of a deceased taxpayer was in effect a payment to a dependant for tax purposes on the basis that it could reasonably be expected that a dependant of the deceased taxpayer (his mother) would benefit from the estate. In AAT *Case [2000] AATA 8* 43 ATR 1273, the parents of a deceased son were held not to be his dependants for tax purposes as they were not financially dependent upon him.

As a consequence of the different definition of dependant under the tax provisions (as compared to the definition in the SIS Act) it is not possible to commence a pension (from the deceased's death benefits in a superannuation fund) payable to a non-death benefit dependant of a deceased person. For example, if the deceased member only had adult children surviving (and not a surviving spouse) who were financially independent then the death benefits of the deceased member in the superannuation fund must be paid as a lump sum. In other words, the death benefits of a deceased member cannot be retained in a superannuation fund and for the superannuation fund structure to be inherited by adult children. In such a case, the assets of the superannuation fund will need to be realized either by selling the assets and paying the proceeds to the adult children or by transferring the assets to the adult children.

The removal of the option to allow pensions to be paid to non-death benefit dependants of a deceased member (which applied from the date of the major tax changes to superannuation in 2007) is a major restriction in respect of estate planning. As a result of this restriction, it is often stated that it is now not possible to cause say a self managed superannuation fund to become an 'inheritance vehicle' for the family group (namely, allowing the next generation to inherit investment assets by retaining the self managed superannuation fund that owns those assets). This comment however may not be entirely correct and is addressed shortly in this paper below.

The great advantage of having an SMSF (as distinct from a managed fund) is that with a self-managed superannuation fund the beneficiaries of the estate have the choice to decide whether to pay out the death benefits as so-called lump sum death benefits or to retain the SMSF structure and pay pensions to certain beneficiaries. This is important where for example there is a surviving spouse.

(d) Trustee's Discretion to Determine to Whom Death Benefits are Paid

A trustee of a superannuation fund is required to cash a member's benefits as soon as practicable after the member dies: (see Regulation 6.21). Subject to the terms of the trust deed, trust law and the superannuation legislation, the trustee has a discretionary power in relation to distributing a deceased member's benefits to dependants unless there is an effective **binding death benefit nomination**.

Namely, where an effective binding death benefit nomination does not apply then the trustee for a superannuation fund can over-ride any statement of wishes made by the deceased member under the plan. This is an extremely important issue for the estate planner particularly if the client is a member of an APRA superannuation fund where the trustees will be unrelated persons of the deceased member's family. It is also important for self-managed superannuation funds as the trustee for the fund on the death of a member could be limited to particular family members having different perception than what the deceased may have had as to who should benefit from the superannuation fund.

(i) *Binding Death Benefit Nomination and APRA Funds*

For APRA funds (funds other than self-managed superannuation funds) in order for a death benefit nomination to be effective, it must be permitted under the trust deed and meet several strict conditions: see section 59(1A) of the SIS Act and Regulation 6.17A. See also *Wooster v Morris* [2013] VSC 594; *Ioppolo & Hesford v Conti* [2013] WASC 389.

The estate planner should review therefore the Rules of any APRA Fund in which the client is a member and where a binding death benefit nomination provision applies, ensure that the requirements of that nomination are correctly implemented. Given the fact that the SIS Act requires such nominations to be renewed each 3 years then the estate planner has an added burden to ensure this renewal is appropriately undertaken.

(ii) *Binding Death Benefit Nomination and Self-Managed Funds*

For self-managed superannuation funds the Commissioner of Tax accepts that there are no restrictions on the trustee of the fund from accepting a binding death benefit nomination from a member in any form as specified in the Rules of the fund. Note, of course that such nominations must not be to a person who cannot receive a benefit in accordance with the operating standards in the Regulations as discussed above: (see Determination SMSFD 2008/3).

Accordingly, it is possible to provide in the Rules of a self- managed superannuation fund that the trustee must comply with any form of notice given by the member. That notice does not need to be renewed every three (3) years nor otherwise comply with the conditions that are applicable in such cases to an APRA fund.

So it is important when undertaking an estate planning for a client to review the provisions of any deed in which the client is a member. In the case of a self-managed superannuation fund then the member should be able to make a binding death benefit nomination and remove any discretion left with the surviving trustees for the fund in how the deceased member's benefits are to be applied. The form that a binding death benefit nomination ('BDBN') can take in a self-managed superannuation fund is as follows

> *A Member may:*
>
> *(a) state in writing the Member's wishes as to the payment of the Member's Benefits in the event of the death of the Member; or*
>
> *(b) make a Binding Death Benefit Nomination.*
>
> *A Member may revoke a nomination by completing a new form pursuant to* ***Rule XYZ.*** *Where a Member has made a Binding Death Benefit Nomination the Trustee must pay the Benefit to the nominated person or persons. Where a Member does not make a Binding Death Benefit Nomination, any Benefit shall be paid as the Trustee in its absolute discretion decides (after taking into consideration the Member's wishes as provided in accordance with* ***Rule ABC****) to such one or more of the nominated beneficiaries (if any) or other Dependants or a legal personal representative of the Member.*
>
> *"****Binding Death Benefit Nomination****" means a notice given to the Trustee by a Member to require the Trustee to provide any Benefits of the Member on the death of the Member to a person or persons nominated in the notice.*

(e) Tax Treatment of a Member's Death Benefits

(i) *Lump Sums Paid to Death Benefit Dependant*

The tax treatment of superannuation death benefits paid from complying superannuation plans is set out in Division 302 of the ITAA 1997. Since 1 July 2007 all death benefits paid as a lump sum to a death benefit dependant (see above for the definition under the tax provisions, but essentially a spouse, child under 18 years, a person in an interpendency relationship or a person who was financially dependant) are tax free.

(ii) *Lump Sums Paid to Non-Death Benefit Dependant*

A lump sum payment of a death benefit to a non-death benefit dependant (for example, a financially independent adult child) may be exposed to tax. The tax treatment in this case may vary depending on the components of the superannuation benefit (namely, there are two possible components being a tax-free component and a taxable component) and whether the taxable component contains an element untaxed in the fund.

The tax-free component of a superannuation benefit is the balance of the member's benefits represented by so-called non-concessional contributions made to the fund by the member during the life of the member. These are contributions that did not receive the benefit of a tax deduction when made. The balance (the taxable component) will be made up of what remains of concessional contributions made to the fund on behalf of the member, income and capital profits derived in respect of the member's benefits and proceeds of insurance policies held by the fund for the member.

The receipt of a lump sum amount to the extent it represents a tax free component by a non-death benefit dependant (adult child for example) will be tax free. In the case of the taxable component paid to a non-death benefit dependant, a flat rate of tax of 15% (plus Medicare - which from 1 July 2014 will be 2.0%) applies. However, that rate of tax increases to 30% (plus Medicare) in respect of any element of the taxable component that was untaxed in the fund. That element will essentially be limited to life insurance proceeds received by the fund. See ATO ID 2010/76.

Accordingly, the inclusive of a life insurance policy in a superannuation fund may at first appearance been seen as advantageous. Namely, the fund can claim as a tax deduction the insurance premiums which would otherwise not be deductible to the member personally. Where a member of a superannuation fund dies leaving a death benefit dependant (for example, a spouse) then the proceeds of the life insurance on the deceased member will be received by the fund tax free and the proceeds could then be paid as a lump sum to the surviving spouse on a tax free basis. A good result.

However, if the deceased member does not have a surviving spouse or other death benefit dependant (for example, only, adult children survive) then the lump sum payment from the fund to the adult children represented by the life insurance proceeds will be exposed to tax at a rate of 30% plus Medicare. Not a good result.

For this reason, where a spouse dies it may be preferable for the surviving spouse to shift the life insurance policy out of the fund and instead be held personally.

(iii) *Pension Paid to Death Benefit Dependant*

If the deceased member was aged 60 years or over at the time of death then a pension paid to a death benefit dependant (whatever age the death benefit dependant) will be tax free. So you can see the advantage of marrying someone much older than yourself – provided the person has a significant superannuation benefit! Namely, the young widow or widower can inherit the superannuation fund which will be tax free on its earnings and any pension paid to that younger surviving spouse will also be tax free. My daughters have not taken my tax advice!

If the deceased was under the age of 60 at the time of death then the tax treatment of the pension will depend on the age of the death benefit dependant receiving the pension. In the case of a surviving spouse, if under 60 years then the pension will be taxable in the surviving spouse's hands until that person attains 60 years. Note that the tax rate receives some favourable concessions.

A pension paid to a dependent child must be commuted to a lump sum when the child turns 25, unless the child is permanently disabled: (see Regulation 6.21). A superannuation lump sum arising from the commutation of a superannuation pension is also tax free when received by a person who is under 25 or permanently disabled when the lump sum is received: (see section 303-5).

(iv) *Pension Paid to Non-Death Benefit Dependant*

As discussed above, the tax provisions prohibit the payment of a pension to a non-death benefit dependant.

(f) Death Benefits Paid to Trustee of Deceased Estate

(i) *Tax Treatment*

If a superannuation death benefit is paid to the trustee of a deceased estate, whether it is treated as being paid to a "death benefit dependant" depends upon the extent to which death benefits dependants of the deceased have benefited, or may be expected to benefit from, the superannuation death benefit. That is, to the extent that one or more beneficiaries of the estate who were death benefit dependants of the deceased have benefited, or may be expected to benefit from the superannuation death benefit, the payment is treated as if it had been made to the trustee as a person who was a dependant of the deceased: (see section 302-10(2)).

In the same way, to the extent that a non-death benefit dependant of the deceased may be expected to benefit from the payment, the payment is treated as if it had been made to the trustee as a person who was not a death benefit dependant of the deceased: (see section 302-10(3)).

Accordingly, in drafting the will, consideration should be given to specific items of superannuation benefits in the event that such benefits are paid into the estate. I normally include a provision in the Will in case the superannuation benefits are applied to the estate in the following form

> ***I REQUEST*** *my trustees of any superannuation fund or pension fund of which I was a member immediately prior to my death to apply any death benefit entitlement to my wife provided that if my wife does not survive me by the period then to my Executor to form part of my residue and applied in accordance with* ***clause 3*** *of* ***Part 1*** *of this my Will.*

(ii) *Can the Trustee of a Deceased Estate Divide the Death Benefits into Different Components?*

In the event that superannuation death benefits are paid into the estate of the deceased member then it would seem logical if both death benefit dependants (a surviving spouse) and non-death benefit dependants (adult children) were to receive different shares of such death benefits to apply the taxable component to the surviving spouse and the tax free component to the adult children. Unfortunately, this is not possible.

Under the proportioning rule in section 307-125, a superannuation death benefit is split into the tax-free component and taxable component reflecting the proportion of those components in the total value of the superannuation interest. That is, the proportioning rule stops a trustee of a deceased estate from applying the tax-free component for the benefit of a non-dependant and the taxable component for the benefit of a death benefits dependant.

In such cases it is preferable if the terms of the Will are drafted in a reasonably flexible basis so that the trustee of the deceased estate can substitute the source of benefit entitlements. Namely, if the client wishes say to leave 50% of his death benefits to his surviving spouse and 50% to his surviving adult child then the following course should be considered

- a binding death benefit nomination is made so that the superannuation benefits are applied to the legal personal representative (the deceased estate);
- the Will then to provide that any superannuation death benefits are to be applied equally to the spouse and the adult child with the proviso that the trustee for the estate has the discretion to apply all of the death benefits to the spouse if the child receives an equivalent benefit from the remainder estate (obviously in addition to the child's otherwise entitlement to the remainder).

In addition, thought could be given under binding death benefit nomination to allow the spouse the option of retaining the death benefits in the fund and not have the benefits applied to the estate. For example, a binding death benefit nomination could state (and there would need to be a similar clause as indicated in paragraph (b) below in the Will)

I nominate

(a) my wife shall be entitled to receive 50% of any death benefit which may become payable in respect of me from the Fund ('wife death benefit entitlement') and such benefit may at her option and in whatever proportion be paid as a lump sum or a pension. Provided that if my wife does not survive me, then to apply the benefit that she would otherwise have been entitled to my legal personal representative to be applied in accordance with my Will;.

(b) my legal personal representative the remaining 50% of my death benefit ('remaining death benefit entitlement') provided that the remaining death benefit entitlement be not applied to the legal personal representative but instead added to the wife death benefit entitlement and applied in accordance with paragraph (a) provided that the discretion under this paragraph may only be exercised as stated if the legal personal representative applies an amount equivalent to the remaining death benefit entitlement to my son being an amount in addition to any benefit that my son is entitled to otherwise under my estate.

(g) Tax Treatment within the Fund upon Death of Member

The earnings derived by a superannuation fund on the investments supporting a pension are tax free in the fund. In other words, if the superannuation fund (or a part of the fund) is in pension phase then the income and capital gains of the assets supporting the pension will not be exposed to tax in the fund. The issue is whether that tax exemption continues post the death of a member previously receiving a pension.

In 2011 the Commissioner of Tax released a draft ruling (Draft Ruling TR 2011/D3) stating that the pension phase ceases on the death of the member receiving that pension. In other words, if an asset of the fund that supported the pension was sold to pay the death benefit then the fund would be subject to capital gains tax on any realized capital gain. That raised numerous concerns in the professional bodies as to adverse tax treatment post the death of a member.

The draft ruling was finalized in Taxation Ruling TR 2013/5 and confirms that a superannuation income stream (a pension) ceases as soon as the member in receipt of a pension dies. However, as a consequence the tax provisions were amended to provide a period for a period post the death of a member previously receiving a pension for that situation to be deemed to continue. The definition of "superannuation income stream benefit" was expanded to allow the tax exemption for fund earnings on investments supporting superannuation pensions to continue following the death of a pension member. The expanded definition is designed to ensure that, where a fund member was receiving a pension immediately before their death, the superannuation fund will continue to be entitled to the earnings tax exemption in the period from the member's death until their benefits are cashed by paying them out as a lump sum (or by commencing a new pension – for example, for a surviving spouse).

This provides certainty for deceased estates by allowing superannuation funds to dispose of fund assets on a tax-free basis in order to meet death benefits payment requirements.

5. Dealing with Superannuation Death Benefits in the Will

(a) Should the Will Refer to Superannuation Benefits?

I believe the answer is yes. I have already discussed the importance of binding death benefit nominations. Accordingly, any care spent in respect of the drafting of a binding death benefit nomination should not be lost by ignoring the appropriateness of similar drafting in the Will. The two documents should work together and be seen as an extension of the other.

(b) Should Death Benefits be Paid as a Lump Sum or Pension?

The question is whether to recommend to the client as part of the estate planning advice to have their death benefits paid out as a lump sum or as a pension and, in the case of a lump sum, whether to have such benefits paid to a beneficiary or to the deceased's estate. For example, in an estate plan for a couple, should the recommendation be

(i) to withdraw moneys from superannuation and pay the death benefits to a surviving spouse as a lump sum, or

(ii) to leave the money within the superannuation fund and pay the death benefit to the spouse as a pension.

The advantage of paying a death benefit to a surviving spouse as a lump sum is that the amount of the death benefit will be received on a tax free basis in the hands of the spouse. This will be the case for a deceased of any age at the time of death or the age of the surviving spouse. In other words, a lump sum payment of any amount will be tax free to a surviving spouse of a deceased member, whatever age the deceased or the surviving spouse was at the time of the death.

The disadvantages of paying a death benefit to a surviving spouse as a lump sum are that investment assets are moved out of a low tax or possibly tax free environment. With the restrictions on re-contributing amounts back into such a beneficial tax environment (these are both restrictions in respect of the age of the surviving spouse and the quantum of amounts that in any event may be contributed into superannuation) there is a loss of opportunity in respect of tax planning.

If the surviving spouse receives the death benefits as a lump sum and invests the amount personally then the income (and capital gains) so derived will be exposed to that spouse's personal rates of tax. Alternatively, if the death benefit was retained in the superannuation fund and paid as a pension to the surviving spouse then the fund would not be subject to tax and the pension paid to the surviving spouse may also be tax free or subject to a reduced rate of tax.

The answer to this question when advising on the estate plan may come down to the age of the spouse. If the spouse is relatively young with say children under the age of 18 years then the estate plan may be to require the death benefits to be paid as a lump sum. This would be of course the case where there are immediate cash requirements.

The reality though is to leave the decision open as far as possible. Namely, the Will/binding death benefit nomination provisions should be drafted in most cases so that the beneficiaries can make the appropriate decision at the time of death.

6. Unwinding Self-Managed Superannuation Funds on Death

There appears to be at least two potential myths developing in regard to estate planning under the current law:

(i) As payments are tax free from a superannuation fund after age 60 years there is no need to be concerned with taxation issues in respect of superannuation in estate planning.

(ii) Non-concessional contributions are no longer relevant in improving the tax position of payments from a superannuation fund.

I am certainly of the view that these two conclusions have no credibility.

Given the many advantages of a self managed superannuation fund structure many clients hold real estate investments including farms, offices, residential and commercial investment properties in superannuation funds. On the death of the principals in a family group in such cases the issue arises as to how these assets are to be moved from the superannuation fund to the surviving family members without the incurrence of tax and stamp duty consequences.

This possibility can arise on the death of a member of a superannuation fund where that member does not have a surviving spouse. Namely, the assets in the self managed superannuation fund may need to be realised (either sold or transferred in specie) in order for the death benefits of that deceased member to be paid to the beneficiaries.

(a) Case Study

Take the example of Bill Smith as follows

(i) Bill is widowed with two adult children (Anne and Peter);

(ii) Bill has a self-managed superannuation fund with $2,000,000 in benefits;

(iii) None of the accrued benefits are sourced from non-concessional contributions (that is the entire $2 million is a so-called taxable component);

(iv) The superannuation fund has a commercial real estate property in NSW which was acquired for $500,000 and is now valued at $1,500,000;

(v) The balance of the benefit ($500,000) is held as cash deposits;

(vi) Anne and Peter are keen to retain the ownership of the commercial property rather than selling the property.

(b) Tax and Stamp Duty Implications

What are the consequences if Bill dies, assuming he is over 60 years at the date of death?

(i) There are no "death benefit dependants" that can take a pension from the superannuation fund after the death of Bill. That is, Bill's death benefits ($2 million) must be paid either directly to Anne and Peter or to Bill's estate as a lump sum amount.

(ii) Since Bill's death benefits are required to be paid as a lump sum it would be necessary for the superannuation fund to dispose of its assets, being the commercial property and the cash deposits. These assets could be transferred *in specie* to Anne and Peter (or Bill's estate) but this does not alter the fact that a disposal will occur for tax and stamp duty purposes.

(iii) On the death of Bill the earnings on the investments held for the benefit of Bill will continue to gain tax exempt status - see the amended definition of "superannuation income stream benefit" (Regulation 995-1.01 of the Income Tax Act Regulations).

(iv) The disposal of the assets of the superannuation fund will therefore not trigger a taxable capital gain (which would be otherwise $1 million in respect of the commercial property).

(v) That is, there would be $2.0 million to be distributed as a lump sum to Anne and Peter. As this amount is a taxable component, the entire amount will be taxed at 15% (plus Medicare) in the hands of the adult children. This will incur tax of $330,000.

(vi) The transfer of the commercial property to Anne and Peter will also incur stamp duty (in NSW) of $67,500.

(vii) The net result is that the adult children will receive $1,602,500 net of tax and stamp duty (80.1% of the original super fund balance).

(viii) Worse still from a tax planning perspective (and asset protection prospective) is that the previous fund assets are now outside a tax free environment and held in personal names. It may be possible to transfer the commercial property back into a superannuation environment without further exposure to capital gains tax and stamp duty. Namely, Peter and Anne will own the commercial property as individuals and could utilize the concessional provisions of section 62A of the Duties Act to transfer the property to a self-managed superannuation in which they are members. Note that there is no capital gain realized as they will inherit a market value cost base for the property (being $1.5 million). The only problem is whether they have a superannuation fund with adequate finances to support the acquisition – certain non-concessional contributions could be made and advantage taken of the limited recourse borrowing provisions.

(c) Alternative Strategies to Minimise Exposure to Tax and Stamp Duty

The challenge in the future for the estate planner is to minimise the impact of the tax and stamp duty costs as indicated above on the death of a client with substantial investments held through a self-managed superannuation fund.

(i) Option 1 – Retaining the Superannuation Fund Structure

Under this strategy the aim is to retain the superannuation fund entity with the commercial property remaining as an asset of that entity. The objective in this strategy would be to avoid having the superannuation fund dispose of the commercial property on Bill's death and incur stamp duty.

This strategy would require Anne and Peter joining Bill's superannuation fund on (or before) the death of Bill. If Anne and Peter joined the superannuation fund after Bill's death then the issue will be whether they can fund the full value of the property ($1.5 million). That is, the superannuation fund will still be required to make a notional distribution of death benefits amounting to $2.0 million.

This could be met by paying out cash of $500,000 (the cash deposits of the fund) plus a notional amount of $1.5 million (representing the value of the property which in effect would need to be funded from benefits held in the superannuation fund for Anne and Peter). That is, Anne and Peter will need to contribute (or otherwise finance) sufficient amounts to cover the value of the commercial property retained in the superannuation fund.

The maximum amount that Anne and Peter will be allowed to contribute into the superannuation fund will be $450,000 each (on the basis they have not made non concessional contributions into superannuation in the past 3 years and they are under 65 years). As there are only two adult children then that would only allow a maximum re-contribution of $900,000. The balance ($600,000) could be funded by one or more of the following options

(1) Anne and Peter could transfer into the superannuation fund benefits held in their own superannuation funds.
(2) The spouses of Anne and Peter could also join the fund and apply non-

concessional contributions.

(3) The fund could transfer a part interest in the property to a non superannuation fund entity – that is only partially triggering stamp duty – for example, the fund could retain a 60% share of the commercial property (valued at $900,000) and transfer out a 40% share to Peter and Anne.

The change of membership of the Bill's superannuation fund should not trigger a stamp duty exposure in NSW. The change in members will not create a new entity (*FCT v Commercial Nominees of Australia Ltd* (2001) 47 ATR 220). Further, the landholder provisions under Chapter 4 of the NSW Duties Act, 1997, should not apply as this would require a superannuation fund to fall within the definitionof a unit trust scheme. A unit trust scheme is defined for the purposes of the *Duties Act* 1997 to mean

> '*any arrangements made for the purpose, or having the effect, of providing, for persons having funds available for investment, facilities for the participation by them, as beneficiaries under a trust, in any profits, income or distribution of assets arising from the acquisition, holding, management or disposal of any property whatever pursuant to the trust'*.

Although it is arguable that a superannuation fund may fall within this broad definition there are specific provisions in the *Duties Act* dealing with superannuation funds (see for example section 61) and if the Act was meant to include superannuation funds in the landholder provisions then one would assume that specific reference would have also been made to such funds in the provisions concerned. In any event, the example in this paper of Bill's fund does not meet the threshold land value test of $2 million (based on the unimproved value).

(ii) Option 2 – Transfer of Benefits during Bill's Lifetime

Under this strategy the ownership of the superannuation fund is in effect transferred to Anne and Peter prior to Bill's death. For example, Bill could consider withdrawing benefits from the superannuation fund (on a tax free basis) and then lending such money to Anne and Peter who in turn join Bill's fund and make non-concessional contributions to that superannuation fund. In essence, over time, Anne and Peter will become the major members of the fund with Bill's benefits reducing over that time. In this way the ownership of the fund is transferred to Anne and Peter on a tax free basis.

The advantage of this strategy is that on Bill's death there is no need to transfer assets out of the superannuation fund nor is there any exposure to the 15% (plus Medicare) tax on the taxable component of Bill's death benefits – since Bill will on death have little amounts remaining in the fund to his benefit. The other advantage is that Anne and Peter inherit the commercial property through the superannuation fund structure providing them with the tax and asset protection available using the superannuation fund as an entity to make investments.

The assets of Bill's estate would then include the loans Bill had made to Anne and Peter in order that they are able to finance their contributions to the superannuation fund. Therefore the loan assets could be gifted under Bill's Will to Anne and Peter (the debts forgiven) or, preferably, gifted to a trust established under the Will.

(iii) Option 3 – Conversion of the Fund to a Fixed Trust

Under this strategy the objective is to change the nature of the superannuation fund either prior to or on the death of Bill. This could be achieved by simply amending the Rules of Bill's superannuation fund so that the fund ceases to be a complying superannuation fund and instead becomes a fixed trust.

The conversion of the superannuation fund to a fixed trust would not trigger a stamp duty exposure (for the same reasons as discussed in Option 1 above). Similarly, there would be no capital gains tax as the Commissioner of Tax will treat the change as a disposal but the nil rate of tax will still apply. Namely, the new entity will have a market value cost base (obtaining a step up in cost base).

That is, if the conversion is left to after the death of Bill then for tax purposes there will be deemed to be a disposal of the commercial property by the superannuation fund to the 'new' fixed trust and therefore an exposure to capital gains tax will arise but at a nil rate of tax. The major saving in this case being the stamp duty.

If the conversion is undertaken prior to the death of Bill then, as in the case of the post death as described above, despite the fact for tax purposes there will be deemed to be a disposal of the commercial property by the superannuation fund to the 'new' fixed trust, there will not be an exposure to capital gains tax as the superannuation fund would be in pension phase. In this case, Anne and Peter (or a trust established under Bill's Will) would inherit Bill's units in the fixed trust.

(iv) Option 4 – Transfer the Property to a New Fund

This strategy needs to be implemented prior to the death of Bill. Under this strategy Bill's superannuation fund transfers the commercial property to a new superannuation fund.

This transfer could be undertaken utilising the stamp duty relief provision of section 61 of the *Duties Act* which states in part

> *(1) This section applies to a relevant transfer that occurs in connection with a person:*
>
> > *(a) ceasing to be a member of, or otherwise ceasing to be entitled to benefits in respect of, a superannuation fund that is a complying superannuation fund or was a complying superannuation fund within the period of 12 months before the transfer was made, and*
> >
> > *(b)…*
>
> *(1A) For the purposes of this section, each of the following is a relevant transfer:*
>
> > *(a) a transfer of dutiable property from a trustee of a superannuation fund, or a custodian of the trustee, to the trustee of another superannuation fund, or to a custodian of the trustee*

of another superannuation fund,

(b)…

(2) The duty chargeable on a transfer to which this section applies is ad valorem duty in accordance with this Chapter or $500, whichever is the lesser.

Provided that the transfer is undertaken when the original fund (in which Bill is the member) is in pension mode then despite the fact that the disposal of the commercial property by the fund will trigger CGT Event A1 the result is that nil tax is payable as the fund concerned is in pension phase.

The new fund will acquire the commercial property with a cost base for CGT purposes equal to the market value of the property at the time of the transaction (namely, the new fund will obtain a CGT up-lift in the cost base of the commercial property). This would have the result that if the commercial property needs to be transferred from the new fund on the death of Bill (or at a time when the fund is not in pension mode) then the CGT triggered will be less as the new fund will have a higher cost base than the existing fund.

The new fund could acquire the commercial property for the full value by having Bill transfer from the original superannuation fund to the new fund benefits sufficient to acquire the property. Alternatively, the new superannuation fund could be established for the benefit of Anne and Peter. In this case, the new fund could acquire the property utilising the limited recourse borrowing provisions of the *SIS Act* (section 67A). That is, under the limited recourse borrowing option the new fund would borrow the purchase price from the Bill's superannuation fund.

Note that section 67A does not allow a superannuation fund to, amongst others, acquire an asset from a related party unless that asset falls within one of the exempt assets in section 66(2) of the SIS Act. That provision provides

(2) Subsection (1) does not prohibit a trustee or investment manager acquiring an asset from a related party of the fund if:

(a) the asset is a listed security acquired at market value; or
(b) if the fund is a superannuation fund with fewer than 5 members-- the asset is business real property of the related party acquired at market value; or
(c) the trustee of a regulated superannuation fund acquired the asset under a merger between regulated superannuation funds; or
(d) the asset is an asset of a kind which the Regulator, by legislative instrument, determines may be acquired by:
(i) any fund; or
(ii) a class of funds in which the fund is included.

Accordingly, in this example, provided the commercial property owned by Bill's fund is a business real proerty (which it probably would be as it is described as a commercial property) then the provisions of section 66(1) would not operate to prohibit the new fund from acquiring the property from Bill's current fund.

(v) **Option 5 – Transfer by Grant of Life Estate**

This strategy would be similar to Option 4. Namely, Bill establishes a second superannuation fund during his lifetime (Bill being the sole member). The second (or new) superannuation fund acquires from the existing fund a life interest in the commercial property measured by Bill's life.

The grant of a life estate in NSW is not subject to stamp duty (as it is not a transfer as defined for the purposes of the Duties Act). For tax purposes however, the Commissioner of Taxation regards the grant of a life estate as a part disposal of an asset (see Taxation Ruling TR 2006/14). However, this would not trigger a CGT liability provided the grant is made during Bill's lifetime and the fund is in pension phase.

Bill then transfers his benefits to the second fund leaving only the remainder interest in the commercial property in the existing fund. Over time Bill withdraws benefits from the existing fund and allows his children to contribute to that fund utilising loans made by Bill to the children see Option 2 above). In effect, the children become the sole members of the existing fund.

On the death of Bill, the life estate held by the second fund is extinguished. Namely, there is no disposal for both CGT and stamp duty purposes. In addition, there are no (or substantially less) death benefits to be paid in respect of Bill's interest in the second fund. The entire ownership of the commercial property reverts to the existing superannuation fund on the death of Bill. That is, the existing superannuation fund would at that time have as its sole members the adult children and the ownership of the commercial property. Accordingly, the adult children "inherit" the existing fund with the commercial property still owned in that entity.

Kevin Munro
MUNRO LAWYERS

Suite 18, Pier 2, 13 Hickson Road,
Walsh Bay, NSW 2000
Ph (02) 9256 3888
Fax (02) 9256 3833
Email kevinmunro@taxlegal.com.au