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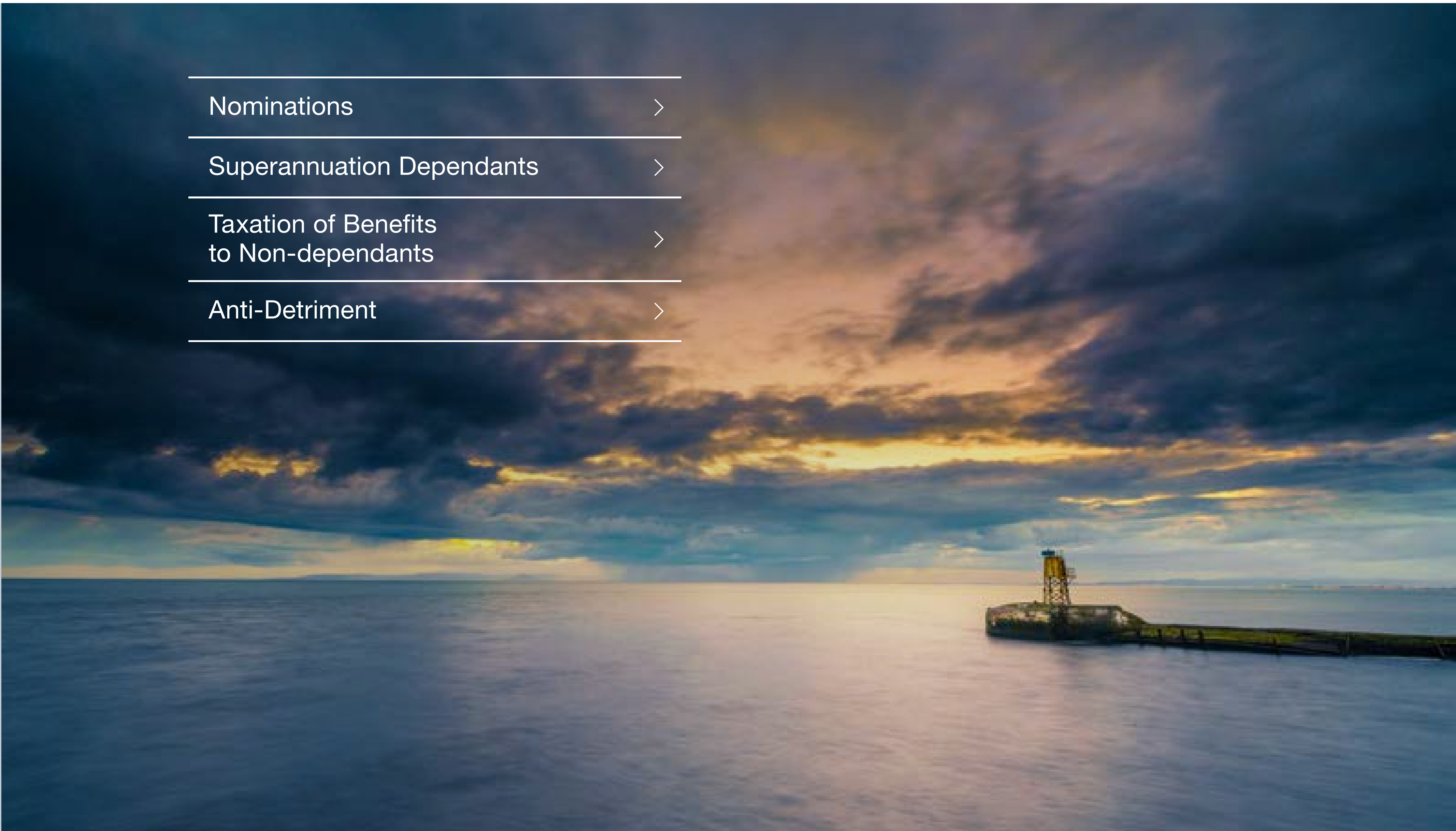
TechKnowledge

Estate Planning and SMSFs



Estate planning can offer greater flexibility to beneficiaries

One of the main reasons an individual would use an SMSF is for estate planning which can offer greater flexibility to beneficiaries than is available in a public offer fund. Where a member dies without a binding nomination, the distribution of the death benefits is at the discretion of the remaining trustees. This can allow the situation after the death of the member to be taken into account when determining the best outcome. For example, one child may be still a minor and be entitled to receive the death benefits tax-free. In this case, the trustee could allocate a greater amount to that child and rely on an estate equalisation clause in the will to ensure that the other children receive a greater share of the estate assets.

However, there are a number of traps when using an SMSF for estate planning, particularly where there are blended families. It may eventuate that the individual controlling the trust does not agree with the wishes of the deceased and as they have control of the fund, they can frustrate the attempts of other beneficiaries, such as children from a previous marriage to receive their inheritance, even where the trustee has agreed there is a valid binding nomination in the favour, Morris V Wooster.

SMSF members have more options when making a nomination

Nominations

SMSF members have more options when making a nomination than they have in a public offer fund. As well as having access to non-binding, binding, non-lapsing binding and reversionary, they also have the option of making an SMSF will.

An SMSF will is a collection of rules written into the governing rules of the fund's trust deed which broadly have a similar format to a will. These rules place an obligation on the trustee and they can be as complex as the member wishes specifying who is to benefit, any contingent beneficiaries and in what form.

It may also be possible to provide for a 'life interest' death benefit pension whereby one beneficiary, such as a spouse has an entitlement to the pension payments during their lifetime, but on their death, the capital would be distributed to the beneficiaries of the first deceased, such as the children from a previous marriage.

Superannuation Dependants

There are 3 types of dependant we are concerned about in relation to death benefits being paid from a superannuation fund. They are:

- SIS dependants who can be paid directly from a superannuation fund
- dependants who are entitled to take their benefit as an income stream
- death benefit dependants who can receive a lump sum death benefits tax-free.

Relationship	SIS Dependant	Death Benefit (Tax) Dependant
Spouse	X	X
Former Spouse		X
Child under 18	X	X
Child 18 or over	X	Only if financially dependant
Financial Dependant	X	X
Interdependent	X	X

If the member wants some or all of their superannuation benefits to be paid to someone other than those in the above list, they would need to have that portion paid to their legal personal representative and make a provision for that person in their will.

All beneficiaries who are entitled to receive death benefits directly from a superannuation trustee are allowed, under superannuation legislation, to take that benefit as a lump sum. However, there are restrictions on who can receive death benefits as an income stream. While most of the aforementioned dependants can receive the benefits as an income stream, children of the deceased who are aged over 18 can only receive an income stream if they are financially dependent and under 25 or they are disabled. Where a child of the deceased receives death benefits as an income stream, the income stream must be commuted and the benefits withdrawn as a tax-free lump sum no later than their 25th birthday unless they are disabled.

As with a lot of aspects of superannuation, the legislation specifies what is allowable, however individual funds may have further restrictions in place through their trust deed.

Taxation of Benefits to Non-dependants

Where the beneficiary is not a death benefits dependant, the benefits must be taken as a lump sum and the taxable component of the benefit will be subject to tax of up to 15% plus Medicare levy on the taxed element and up to 30% plus Medicare levy on the untaxed element. While the definitions of dependant in the SIS Act and death benefits dependant in the Tax Act are substantially the same, there is a notable difference. Adult children are SIS Act dependants and therefore, can be paid directly by the trustees of the superannuation fund, however as they are not death benefits dependants as defined in the Tax Act, the benefits will be subject to tax.

For tax purposes, the beneficiary to be considered is the ultimate beneficiary. Therefore, a benefit that passes through the estate but is paid to a death benefits dependant will be tax-free. There can be an issue where the benefits are paid to the beneficiaries via a testamentary trust. While it may be envisaged that the only persons to benefit from the fund are death benefits dependants, the trust may have potential beneficiaries that aren't death benefits dependants in which case all benefits appropriated to the trust will be subject to tax.

A possible solution is to provide in the will for a superannuation benefits testamentary trust that limits beneficiaries and potential beneficiaries to death benefits dependants.

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Where are the funds for the anti-detriment going to come from?

Anti-Detriment

Self-Managed Super Funds (SMSFs) like all other superannuation funds are entitled to increase a death benefit payment using the anti-detriment provisions which are discussed here. However, due to the mechanism by which a superannuation fund claims the funds back from the Government, most SMSFs are unable to make anti-detriment payments and in reality, very few actually do.

The problem arises due to the fact that the fund does not get the funds directly back from the Government but is instead allowed to claim deductions which will reduce their tax liability by the applicable amount. However, in an SMSF it is often the case that when one member dies, the other is in pension phase and the fund has no current tax liability and no future tax liability can be foreseen.

In addition, even if the fund was paying tax, where are the funds for the anti-detriment going to come from? Consider the example where Tony and Sarah are married and in an SMSF where they each have $85,000 of fully taxable component and their eligible service dates are after 1 July 1988. On Sarah's death, Tony would be entitled to receive an anti-detriment payment and indeed, if they were in a public offer fund, he would receive a death benefit of $100,000. However, if the SMSF makes a payment of $100,000, there will only be $70,000 of cash left in the fund even though Tony's member balance is $85,000. The remaining $15,000 of asset value is made up of a deduction of $100,000 which will reduce future tax liabilities by that amount.

However, the SMSF may never get to use the deduction if there is insufficient future tax liabilities meaning that Tony or his estate will not get the full value of his balance which would have been payable if the SMSF did not make the anti-detriment payment. As such, using the benefits of another member to make an anti-detriment payment is seen as detrimental to the other member in the fund and is not allowed.

This leaves 2 options of funding the anti-detriment, through reserves or insurance. The reserving method is problematic as the anti-detriment payment will be deemed to be allocated to the member's account before the death benefit is paid and as the allocation is unlikely to qualify for any exemption, it will count towards the deceased member's concessional cap and may attract further tax.

The insurance option is equally problematic as the age of the member's may make insuring them prohibitively expensive.

An important point to remember is that the anti-detriment is most often calculated on the formula method which means the length of time the benefits have been in the fund is irrelevant. Therefore, even if SMSF benefits were rolled over to a public offer fund shortly before the member's death, the beneficiaries would still be able to claim the full anti-detriment payment.

As such, where the trustees of an SMSF are getting older, it is often worth considering rolling them to a public offer fund so that their beneficiaries can claim this benefit. In addition, the administration of their superannuation benefits will be simpler and less problematic if they lose capacity.

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