Keeping the inheritance in the family

Putting off estate planning can mean your dependants will be left with an unwanted tax bill, writes **Sally Patten**.

Estate planning can be a grisly affair but for individuals who prefer that they, their spouse and their children pay less tax rather than more, it is worth the effort.

Although Australia may have no official inheritance tax, the death benefit from a superannuation account can be subject to tax, depending on to whom it is paid.

Estate management is becoming an increasingly important task as the amount of money saved inside super rises.

For many savers, super already forms the largest part of their estate, a trend that is likely to accelerate as the system matures.

Under the current rules, if the beneficiary of a super benefit is a spouse, child under the age of 18 or anyone with whom the deceased has had an interdependent relationship, the super benefit will be tax free.

But if the beneficiary is an adult child who is not dependent financially or otherwise, they will be subject to 16.5 per cent tax on any "taxable" component of the fund. A taxable component is a part of a fund on which no tax concession has been awarded, such as non-concessionary contributions.

Furthermore, as Fitzpatricks Financial Advisers points out, any untaxed component of the super fund, such as life insurance, will be taxed at 31.5 per cent.

"Most people think that when they reach 60 they don't have to think about tax issues any more," says Phillip Bailey, a lawyer with Dixon Advisory Law, referring to the fact that super payouts for savers over the age of 60 are tax free. "People turn a blind eye to the fact that many of the benefits are taxable."

Besides the tax, there are also differences in how super benefits can be paid, which need to be factored into estate planning. A spouse or child under the age of 18 can receive the benefit as a pension. An adult child must take the benefit as a lump sum. Unsurprisingly, the tax rules have given rise to a number of strategies that individuals can employ to limit the tax liabilities, particularly for non-dependent children.

One key strategy, "withdrawal and re-contribution", is designed to shift investments in the fund from a taxable to a non-taxable component. This will reduce the super benefits tax that an adult child will incur.

Bailey notes that the strategy is best suited for individuals over the age of 60 who are not exploiting their non-concessionary contributions caps.

So it works well for savers who are not injecting their full $150,000 of after-tax contributions into super each year, or who are under 65 and not utilising the $450,000 limit every three years.

If a large portion of the super fund is still part of the taxable component, it might make sense to transfer the money outside super before death.

Bailey notes that the sick or the elderly have only to take their money out of super for 10 minutes before they pass away in order to help their offspring avoid a super benefits tax. And yes, this strategy has given rise to a many a sick joke.

It is also worth thinking about how an individual might best hand down some of their inheritance after they die, but while their spouse is still alive.

Rather than stipulate in a non-binding death nomination – a document that requests a fellow trustee to pay super in the manner that has been nominated – that, say, an adult child be paid $50,000 from the fund, it would be more tax effective if the surviving spouse be gifted the money.

It would require trust between husband and wife that the widowed spouse would do this. The upside is that a gift from the surviving spouse will be tax free whereas a payout from the fund will not.

If a re-contribution strategy has not succeeded in removing the entire taxable component of the fund, so-called anti-detriment strategies can help, although Bailey cautions the advantages of the scheme are a shadow of what they once were. Anti-detriment is effectively a refund for the contributions tax paid during the fund's accumulation phase.

In a self-managed scheme, the refund comes in the form of a tax loss that can be carried forward, rather than a cash payment.

The downside is that the tax loss can only be used if the benefit is paid as a lump sum, and not a pension. This means that the strategy works best when all the beneficiaries are non-dependants and will, in any case, be forced to take the benefit as a lump sum.

The other downside with this strategy is that the tax loss has to be held in a reserve account, which will attract 15 per cent earnings tax because it is not considered to be part of a pension, says Bailey.

And finally, a word on binding death benefit nominations – which must be renewed every three years in large pooled funds but can be non-lapsing in a self-managed scheme. By signing one, an individual can eliminate the ability of people to contest an estate, at least outside NSW, notes Bailey.

In NSW, any transaction entered into three years before the death of an individual can be set aside by the court if it is satisfied that the main purpose was to avoid a family provision claim. This means that other strategies may be needed if the individual wants assurance over how their inheritance pie will be carved.

Tax treatment

- The death benefit from a superannuation account can be subject to tax.
- If the beneficiary is a spouse, or child under 18, the super benefit will be tax free.
- If the beneficiary is an adult child who is not dependent financially, they will pay 16.5pc tax on any "taxable" component.