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Estate planning is complex because it involves so many areas: trust law, super law, tax law, family law. There are so many questions to answer. So many documents to prepare. Then they all need to sync without contradicting each other. Stand the test of time. And that is even before looking at the tax side.

Ben Symons, a barrister in Sydney, discusses the role of super and testamentary trusts in estate planning. Ben also briefly covers the super reform changes since these will obviously affect estate planning.

Estate Planning

Estate planning usually happens with three objectives in mind: asset protection (also important in the event of bankruptcy, relationship breakdown or professional negligence), tax minimisation and cost effective transfer of wealth upon death.

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Why Relevant

Most people will typically have at least their family home and super that require protection and planning, but often also assets held in a family trust.

Plan Early

Plan ahead – before a situation arises where your client needs asset protection

Review Regularly

Review estate plans regularly. Assets change, beneficiaries may change, their circumstances may change. All this will impact on the most tax effective way to distribute assets.

Options

Estate planning usually revolves around:

a) CGT Death Exemption

Assets passing to executor / beneficiaries are generally exempt from CGT, but there is one big BUT. A ssets passing to non-residents, tax exempt bodies or superannuation funds do not have access to this concession. So avoid gifts to these entities.

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b) Main Residence Exemption

Smart use of Primary Residence Exemption by beneficiaries.

c) Life insurance

Payments to policy holder, spouse or family member (child, parent, grandparent, aunt, uncle, neice, nephew, brother or sister) are exempt. Exemption will not apply for joint policies between unrelated parties.

d) Testamentary Trusts

Split income between minor beneficiaries at preferential tax rates.

e) Superannuation

Even though super isn't part of an estate but stands separate from this, it is still an important part of estate planning. While the SIS Act and SIS Regulations determine who a super death benefit can go to, ITAA 97 determines how this payment is taxed.

Let's look at Testamentary Trust and Superannuation in more detail.

Testamentary Trusts

Now typically a standard clause in most wills – a trust created by will upon death.

Advantages

- Tax planning – Minor beneficiaries taxed at preferential tax rates
- Some flexibility – trustee can determine how to distribute
- Asset protection
- Streaming of capital gains and franking credits

Disadvantages

- Lack of flexibility – beneficiaries determined by will. Need to create a new trust to add a beneficiary.
- No access to main residence exemptions for CGT or land tax.
- On-going administrative costs.

Tax Planning

Can distribute income to resident minors (aged less than 18) at preferential marginal tax rates (excepted trust income within sec 102AG ITAA 1936)

- 0% tax on distributions up to $18, 200
- Highest marginal tax rate of 47% (plus medicare levy) only reached when distribution exceeds $180,000 +

In comparison, distributions to minor beneficiaries from inter-vivos trusts taxed at penalty rates of 47% (plus medicare levy)

Superannuation

Superannuation does not automatically form part of an estate on death. The assets of a super fund are administerd by the trustee:

- According to the trust deed

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- As modified by the SIS Act/regulations

The trustee is not bound to follow a direction in a will; Ioppolo-v-Conti [2015] WASCA 45)

A death benefit must cashed (pension or lump sum) immediately upon members death (SIS reg 6.21)

A death benefit must be paid to:

- A dependent;
- The deceased legal personal representative/executor;
- If neither of the above can be found, such person as the trustee nominates (SIS reg 6.22)

Death Benefit Nominations

Must make a death benefit nomination to direct the trustee how to distribute. There are 3 types of nomination:

1. Non-binding nomination
2. Binding death benefit nomination – must renew every 3 years
3. Non-lapsing binding death benefit nomination (independent or built in to trust deed)

Some authority that non-lapsing binding death benefit nominations are valid for SMSF's (Munro v Munro [2015] QSC 61)

May have multiple nominations (e.g. Pay multiple pensions or lump sums)

May have cascading nominations (e.g If a beneficiary predeceases taxpayer, then the taxpayer has a secondary nominee)

Valid Nominations

The case law is clear that the binding death benefit nominations must be clear and precise or else they will be invalid;

Any nomination must be in accordance with trust deed

Care should be taken to comply with trust deed and completing nomination form – the use of word "trustee of the deceased estate" rather than the "executor" inavlidated a binding death benefit nomination in Munro V Munro [2015} QSC 61

An invalid nomination is likely to have serious implications for the drafter, they are likely to be liable for a prefessional negligence (drafter likely to owe a duty of care to deceased as well as beneficiary – contrast High Court case Badenach V Calvert [2016] HCA 18

Advantages / Disadvantages

Non-binding nominations give trustee the flexibility to take account of tax and non-tax considerations, but on the other hand the deceased has no say who the super is distributed to.

Binding nominations allow the distribution of super according to deceased wishes are difficult to challenge if done properly, but must be renewed every 3 y

Reversionary pension

If deceased was in retirement phase – a nomination could be made to pay a reversionary pension to a death benefit dependent – spouse, minor child or other dependent (lump sum only payable to non-dependents SIS reg 6.17 A)

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Any nomination for a reversionary pension must be in accordance with trust deed and terms of pension.

Advantages

- Preserve tax free status of fund if in pension mode
- Less likely to be challenged that where no nomination – ATO considers a reversionary pension prevails over BDBN where trust deed silent

Disadvantages

- Can't make nomination during accumulation phase
- Lacks flexibility for tax planning

Duties of an SMSF trustee

The trustee must exercise their discretion in accordance with the trust deed, the SIS regs and the principles of equity when cashing a death benefit.

From general principles in equity the trustee is to:

a. act in the best interests of the beneficiaries;
b. act in good faith;
c. avoid conflict of interest;
d. act impartially between different classes of benefeciaries

In NSW, the trustee should also give thought to whether a family provision claim might be made on the estate (superannuation will almost always form a part of the notional estate – if the trustee pays out super being aware of a FPA claim and the super is dissipated, the trustee may be liable to a successful claimant)

Forum to litigate a superannuation dispute:

a. SMSF's – disputes go to Supreme Court
b. retail super funds – disputes go to the Superannuation Tribunal

Wooster v Morris [2013] VSC 594

The deceased had around $1 million in his SMSF and made a binding death benefit nominations in favour of his 2 adult daughters from his first marriage;

His second wife was the surviving member and a director of the trustee company of the SMSF and resolved that the BDBN's were invalid, and paid the superannuation to herself as a dependent

His daughters sought a declaration that the BDBN was binding a valid on the trustee and that they were entitled to be paid the deceased super interest;

The court found that the BDBN was valid (although it did not examine in detail why) and the second wife was ordered to pay over the super money in dispute

The second wife as a director of the trustee, rather than the trustee company, was made personally liable for the costs of the plaintiffs

The trustee director (second wife) has a conflict of interest with the other beneficiaries. She should have sought judicial advice

Ioppolo & Hesford v Conti [2015] WASCA 45

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Surviving trustee and member (second husband) paid the SMSF benefits to himself, despite contrary direction in the deceased wife's will that the super be paid to her four daughters from her first marriage;

two previous BDBN had been made in favour of her husband, both had lasped after 2 years (not in force at time of her death)

Held: the second husband / trustee did not exercise his powers with a lack of good faith – there was no evidence to show that he didn't take account of the daughters interest or their financial position vis-a-vie his own financial position;

However, the plaintiffs at first instance were refused an opportunity to cross examine because they had not given sufficient notice that they wanted to do so (the outcome may have been different is they had an opportunity to cross examine him)

A trustee should seek judicial advice if theuy are facing a conflict of interest, are concerned that their bona fides may be questioned or are even unsue whether to honour a BDBN or pay a reversionary pension

Tax on Super Death Benefits

A death benefit dependent receives a lump sum tax-free, while non-dependents pay tax upon receipt of a lump sum. So it is often better tax-wise to leave a lump sum to a dependent like a spouse rather than to a non-dependent like an independent child over 18.

A lump sum to a death benefit dependent is simple. It is tax-free. End of story. A pension to a death benefit dependent is more complicated. The tax treatment depends on the age of the beneficiary and deceased at the time of death (over or under 60) and the amount of any taxed and untaxed element in a taxable component.

Death Benefit Dependent

Death benefit dependent (sec 302-195 ITAA 1997);

- Spouse or former spouse
- Child under 18
- Person who deceased had an "interdependency relationship" with
- Person dependent at "common law"

An "interdependent relationship exists where two persons (sec 302-200 ITAA 1997):

- Have a close personal relationships; and
- Live together (unless either or both suffering form disability); and
- One or each provides the other with financial support or personal care

Changes to Superannuation 2016-2017 Federal Budget

Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016 contains changes to superannuation laws – enacted December 2016 and applying since 1 July 2017:

a. The EM stated that the purpose of superannuation is to provide for an individual's retirement;
b. The work test that less than 10% of an individual's income must come from employment to allow a tax deduction for personal contributions no longer applies;
c. The threshold at which the rebate cuts out for spousal contributions is now $40,000. A rebate of up to $540 maybe granted. The rebate starts to decrease once a spouse earns more than more than $37,00;
d. Low income tax offset for individuals earning $37,000 or less. A rebate of up to $500 for concessional contributions applies. To continue indefinitely from 1 July 2017;
e. The annual non-concession contributions cap is now $100,000 for individuals under 65;
f. This results in a 3 year bring-forward non-concessional contribution cap of $3000,000;

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g. Individual's with superannuation balances greater than $1.6 million are no longer able to make non-concessional contributions;
h. The threshold at which Division 293 tax applies is now $250,000;
i. The concessional contributions cap is now $25,000 for all individuals;
j. Individuals are able to transfer a maximum of $1.6 million into a tax-free retirement phase account; and
k. individuals with super balances of less than $500,000 can make catch up concessional contributions for their unused concessional caps for up to 5 years (commencing 1 July 2018).

Exceeding the Transfer Balance Cap

Where the $1.6 million will transfer balance cap is exceeded, the Commissioner can direct the super income stream to be commuted to bring the assets supporting the super income below the $1.6 million threshold. Excess transfer balance earnings tax will apply to the notional earnings on the excess balance

Commutation

A super income stream can commute to a super lump sum prior to 1 July 2017 and move to an accumulation account:

a. Segregated funds – transfer out is CGT free. To the extent the transfer is to bring the TBA under $1.6 million, the asset cost base resets to market value at 1 July 2017 or before;
b. Unsegregated funds – CGT arises and calculation of this capital gain uses the proportional method:
    - However, a fund may choose to defer a gain on these assets until sale of the asset;
    - The assets cost base can reset at 1 July 2017;

    There is a specific form to exercise this choice.

Reversionary Income Stream

Where a tax payer is receiving a super income stream and receives a reversionary super income stream, they have 12 months to rectify any excess over their transfer balance cap without penalty.

Defined benefit income stream – taxed element:

a. Half of income over $100,000 included in individual's taxable income and taxed at margin rates (previously 0%)

Defined benefit income stream – untaxed element;

a. The 10% tax offset is limited to the first $100,000 of income on the untaxed element. Marginal tax rates apply to the excess.

Super death benefit dependents generally retain their existing treatment:

a. But if they receive a defined benefit income stream, their defined benefit income cap is reduced accordingly

Transitional CGT relief

From 1 July 2017, SMSF's may transfer a maximum of $1.6 million assets to an account that supports a pension (the earnings on those assets being free from tax);

Assets in excess of the transfer balance cap of $1.6 million in retirement phase can move back to accumulation phase (commutation).

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The government is offering CGT relief a transfer tax free) and an opportunity to step the cost base of these assets up at the time that the reforms take effect;

Qualifying Conditions

Applies to funds existing at or before 9 November 2016;

Must be a complying Australian superannuation fund;

Ownership of asset since 9 November 2016 or earlier;

Election for tyransitional relief on an asset by asset basis

Owned asset continuously from 9 November until concession time (30 June 2017 at the latest)

Segregated funds

Can transfer assets out of a segregated account / de-segregate any time up until 30 June 2017;

Can elect CGT relief on an asset basis:

- Disregard gain (asset sale from segregated fund in pension mode not taxable); and
- Reset cost base of asset at de-segregation time – reset to market value;

Two main reasons not to choose CGT relief:

- Asset would incur a notional capital loss
- Sale of an asset is likely to occur before 30 June 2018 and qualifies for 1/3rd capital gains tax discount (asset held on capital account for greater than 12 months)

Main reason to de-segregate prior to 30 June 2017 is that taxpayer may want access to the 1/3rd capital gains tax discount earlier than 30 June 2018

Non-segregated funds

Funds using the proportional method can elect that assets in excess of the $1,6 million transfer balance are eligible for CGT relief;

Can elect CGT relief of an asset by asset basis:

a. defer gain [(market value – cost base) x ECPI% (exempt current pension income%)]; and
b. Reset cost base of asset at de-segregation time – reset to market value;

3 main reasons not to choose CGT relief;

a. Where an asset would realise a notional capital loss;
b. Trade off: where future ECPI % likely to be higher than present ECPI % (trade off against resetting cost base)
c. Whether carry forward capital losses available to offset any capital gains realised now (and whether capital losses are likely to be available in the future);
d. When anticipated sale of asset is likely to be before 30 June 2018 and would qualify for 1/3rd capital gains tax discount for trust (asset held on capital account for greater than 12 months)

Effects of these Changes on Estate Planning

Likely that beneficiaries will contribute their lump sum super death benefits to family trusts and no longer to super;

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The non-concessional contributions rules that apply from 1 July 2017 will make it difficult to re-contribute a large super lump sum death benefit to another super fund;

The transfer balance cap will limit a super death benefit staying in the super environment.

The surplus money is likely to find its way to family trusts.

Part IV A

See particular paragraphs 42 – 50C of LCG 2016/8;

Mere single asset transfer out of a segregated fund to comply with the new transfer balance cap of $1.6 million will not result in a tax benefit;

Contrived schemes involving transfers of assets in to and out of a segregated fund likely to attract Part IV A (LCG 2016/8 paragraph 50B);

Summary

So this was a brief overview of estate planning focusing on the legal side of testamentary trusts and super death benefits.

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